

THE CONSUMERIZATION OF FINANCIAL REGULATION

HELEN A. GARTEN*

As deregulation proceeds, consumer protection may become the sole remaining rationale for any ongoing government involvement in financial markets. Decades ago, in the name of safety and soundness, government regulators enforced legal barriers between banks, securities firms, and insurance companies. Now, as these barriers are being dismantled, the regulatory function is shifting as well, as regulators increasingly concentrate on fashioning consumer protection standards to govern the deregulated and diversified financial institution. A new rule of regulation is emerging: Regulatory intervention is necessary to the extent that financial institutions have the potential to deal unfairly with the public. Otherwise, market controls usually are adequate.¹

Consumer protection is a serious concern in financial markets, where information asymmetries are common and, as financial products become more complex, levels of sophistication between suppliers and consumers may diverge. This is especially true in U.S. financial markets, where direct participation by individuals is significant. Equality of access to financial services is an important norm and, in some cases, an explicit goal of U.S. financial regulatory policy.² Nevertheless, while the need for consumer protection in financial markets is apparent, the assumption that consumer protection provides the primary justification for regulating financial markets is not. Moreover, that assumption is fueling a regulatory strategy that is likely to be inefficient and even counterproductive.

This Essay explores these issues. Part I shows how consumer protection is

* Professor of Law, Rutgers-Newark. I presented an earlier version of this Essay at a conference sponsored by the Merrill Lynch Center for the Study of International Financial Services and Markets, Frank G. Zarb School of Business, Hofstra University.

1. This view has been endorsed by, among others, Nobel Prize-winning economist Merton Miller. *See Hooked on Financial Red Tape: Banking Industry Regulation*, *ECONOMIST*, July 22, 1995, at 65 (quoting Merton Miller, "There is no justification at all for regulating wholesale markets."). Regulators may protest that preventing systemic risk must always be their primary responsibility, especially in deregulated wholesale markets. As this Essay argues, however, deregulation has narrowed regulatory discretion both to define systemic risk and to use systemic risk to justify government intervention in wholesale markets. *See infra* Part I.C (describing changes in bank failure policy that make bank bailouts less likely). It remains to be seen whether financial regulators still have the tools and political authority to deal with a true systemic crisis.

2. *See, e.g.*, Community Reinvestment Act of 1977, 12 U.S.C. § 2901 (1994) (stating intent of Congress to require regulated financial institutions to meet needs of their communities for banking services).

becoming the leading rationale for financial regulation. This shift in regulatory emphasis represents a departure from the past, when the desire for financial stability frequently trumped consumer protection. For example, bank regulators traditionally resisted full disclosure of negative financial information in order to avoid adverse investor reaction that could result in bank failure.³ In contrast, recent financial regulatory initiatives have sought to correct information asymmetries and other customer abuses, such as conflicts of interest and tying arrangements, that injure bank customers rather than the bank itself.

Part II argues that the consumerization of financial regulation may distort analysis of the costs and benefits of regulation, leading to the inefficient production of regulation. In a few cases, consumerization provides too simplistic a rationale for deregulation, especially when consumer benefits are indirect and difficult to quantify. In other cases, consumerization means overregulation, increasing the cost of operating in retail markets and potentially denying retail customers the advantages of competition and innovation in financial services enjoyed by wholesale customers.

Part III assesses the effect of the consumerization of regulation on the regulators themselves. Increasingly, financial regulators are called upon to create and enforce rules of conduct governing the offering and sale of financial products, ranging from uninsured money market funds to complex derivatives. Although such rules may be desirable, the question then arises whether financial regulators are the most efficient providers of those rules. Further, the ability of the regulators to enforce consumer rules is problematic, particularly in today's deregulated financial environment.

I. THE RISE OF CONSUMERISM

Historically, safety and soundness rather than consumer protection were the principal articulated goals of most financial regulation, particularly of the law governing banks. Although, in theory, safety and soundness and consumer protection are not inconsistent,⁴ bank regulation was characterized by many examples of safety and soundness rules that, deliberately or accidentally, were anticonsumer in effect. For example, until relatively recently, federal Regulation Q imposed ceilings on the interest rates that banks could pay depositors.⁵ These ceilings originally were designed to

3. See *infra* Part I.B.

4. See, e.g., Robert Charles Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 11 (1976) (soundness regulation protects financial firm's public suppliers of capital).

5. The Federal Reserve's authority to cap interest rates was provided by the Banking Act of

protect the banking industry from dangerous (to the banks) overcompetition for deposits.⁶ They also were intended to discourage small banks from maintaining their liquid reserves in the form of interest-bearing deposits at their correspondent banks, a practice that was thought to increase interbank exposure and systemic risk.⁷

These motives for interest rate regulation are more accurately characterized as safety and soundness related than as consumer related, although consumers as a group may have indirectly benefited from efforts to strengthen the banking industry.⁸ Consumers, however, were directly harmed by a rule that prevented them from earning market rates of interest on their savings. Eventually, as unregulated alternatives such as money market mutual funds became available,⁹ retail depositors defected,¹⁰ forcing Congress and the regulators to dismantle most of Regulation Q's ceilings.¹¹

Even when regulation benefited consumers, consumer protection was usually tangential to its main goal of preventing systemic risk. Further, the administration of regulation tended to emphasize safety and soundness concerns over consumer goals. For example, federal insurance of bank deposits appears to be primarily consumer legislation, but protecting the small depositor has always been at best a secondary goal. The primary goal

1933, Pub. L. No. 73-66, § 11(b), 48 Stat. 162, 181-82 (codified as amended at 12 U.S.C. § 371b (1994)). The Act also banned the payment of any interest on demand deposits. Regulation Q, the Federal Reserve's implementing regulation, was found at 12 C.F.R. § 217. Regulation Q is no longer in effect.

6. See MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867-1960, at 443-45 (1963) (citing historical view that payment of interest on deposits led to "excessive" competition among banks, forcing them to reduce reserves and engage in risky investment policies).

7. In the 1920s these interbank deposits were often invested in callable brokers' loans that were used to fund securities speculation. When the depositing banks withdrew their funds, brokers' loans had to be liquidated and the underlying securities sold, thus increasing stock market volatility. According to the Federal Reserve, the 1933 Banking Act's ban on the payment of interest on demand deposits was expected to slow the flow of interbank deposits into the call-loan market. See BOARD OF GOVERNORS OF THE FED. RESERVE SYS., A REVIEW AND EVALUATION OF FEDERAL MARGIN REGULATION 133-34 (1984). Once the prohibition took effect, interbank balances declined significantly. See FRIEDMAN & SCHWARTZ, *supra* note 6, at 444.

8. This is not to say that interest rate regulation was particularly effective in strengthening the banking industry or that its implementation was not due in whole or in part to successful lobbying by bankers for regulatory favors. Consumer protection, however, was not the primary motive.

9. The first money market mutual fund began offering shares to the public in 1972. See Timothy Q. Cook & Jeremy G. Duffield, *Money Market Mutual Funds and Other Short-Term Investment Pools*, in FEDERAL RESERVE BANK OF RICHMOND, INSTRUMENTS OF THE MONEY MARKET 158 (6th ed. 1986).

10. By the late 1970s and early 1980s, as market interest rates rose above the Regulation Q ceilings, money market mutual fund assets rose from \$4 billion to \$235 billion. See *id.* at 158-59.

11. In the Depository Institutions Deregulation and Monetary Control Act of 1980, Congress mandated a six-year phaseout of interest rate ceilings on time (savings) deposits. Pub. L. No. 96-221, § 204, 94 Stat. 132, 143 (codified at 12 U.S.C. § 3503 (1982)). As of 1998 the statutory prohibition on the payment of interest on demand deposits remained in place, although repeal was considered.

of federal deposit insurance was to maintain the stability of the banking system, and this goal has shaped how the insurance scheme has been implemented.

The history of deposit insurance suggests that the intended beneficiaries were the banks themselves, especially small local institutions that were struggling to win back reluctant retail depositors during the Depression.¹² That the architects of deposit insurance had institutional rather than consumer goals in mind is demonstrated by their willingness to insure both small and large depositors. Without insurance, large depositors presumably would have protected themselves by identifying the safest banks (or nonbanks) to hold their funds. This market discipline would have penalized those banks, typically smaller and less diversified, that were considered the most risky, leading to more bank closings, which was exactly what policymakers were determined to prevent.¹³ Thus, under the original \$5000 insurance ceiling put in place in 1934, 98.5% of all deposit accounts were insured in full.¹⁴

Moreover, the deposit insurance scheme historically has been administered to promote bank stability rather than consumer protection. Under the FDIC's controversial "too big to fail" policy, the agency employed deposit insurance resources to prevent the closing of large banks such as Continental Illinois whose failure threatened the safety of fellow institutions.¹⁵ Under this policy, deposit insurance coverage depended on the economic significance of the bank rather than the consumer's need for protection. When a bank thought to be too big to fail was rescued by

12. See Helen A. Garten, *A Political Analysis of Bank Failure Resolution*, 74 B.U. L. REV. 429 (1994); Carter H. Golembe, *The Deposit Insurance Legislation of 1933: An Examination of Its Antecedents and Its Purposes*, 76 POL. SCI. Q. 181 (1960). Ironically, in the 1930s few banks considered themselves beneficiaries of deposit insurance legislation. Small and large banks had different objections to the legislation, and these differences may have fractured organized industry opposition, which otherwise might have defeated the legislation. See Garten, *supra*, at 449-58.

13. There is another reason to conclude that the goal of deposit insurance was to protect banking institutions rather than consumers. In the early 1930s some policymakers suggested that legalizing nationwide bank branching would provide an alternative to federal deposit insurance since national (and nationally-regulated) bank chains were more financially stable than less diversified independent local banks. Congressional supporters of a local banking system preferred deposit insurance. See Golembe, *supra* note 12, at 198-99.

14. See Garten, *supra* note 12, at 453 (citing 1934 FDIC ANN. REP. 61). As originally designed, insurance coverage was to be even more generous, covering all deposits up to \$10,000 and a portion of deposits over \$10,000. See *id.* at 453 & n.127. The deposit insurance ceiling now stands at \$100,000, higher than necessary to protect small depositors.

15. For a chronology of the Continental Illinois bailout, see IRVINE H. SPRAGUE, *BAILOUT: AN INSIDER'S ACCOUNT OF BANK FAILURES AND RESCUES* 149-99 (1986). Under federal banking law, the FDIC had broad statutory authority to provide "open bank assistance" to failing institutions when the stability of large numbers of insured banks or of insured banks with significant resources were threatened. 12 U.S.C. § 1823(c)(1) (1994).

government intervention, all of its depositors and other creditors were protected, regardless of their financial sophistication or legal entitlement to insurance.¹⁶

Even apart from the too big to fail policy, considerations that have nothing to do with consumer protection traditionally have driven bank failure resolution. The FDIC's mandate was (and is) to resolve bank failure at the lowest possible cost to the insurance fund.¹⁷ In the past, if the FDIC could find a buyer for the failed bank's franchise, the agency usually determined that selling the bank cost less than liquidating its assets. In most cases the buyer was eager to assume both the insured and uninsured deposits.¹⁸ Because few banks were liquidated, uninsured depositors rarely suffered the uncertainty and risk of loss associated with bank liquidation.¹⁹ Moreover, large sophisticated depositors found ways to guarantee themselves insurance protection regardless of regulatory disposition. For example, large depositors would use brokers to break up their investments into fully insured \$100,000 pieces.²⁰ As a result, virtually every depositor enjoyed protection from loss in the event of bank failure.²¹

Deposit insurance is not the only example of regulation that was designed with banks rather than their customers in mind. The Glass-Steagall Act,²² which barred banks from the securities business, was adopted in 1933 at a time when concerns were voiced about protecting the investing public, particularly retail depositors who had been persuaded by their banks to speculate in the stock market.²³ Nevertheless, Glass-Steagall's prohibition on

16. See Helen A. Garten, *What Price Bank Failure?*, 50 OHIO ST. L.J. 1159, 1164 (1989).

17. See 12 U.S.C. § 1823(c)(4).

18. See John F. Bovenzi & Arthur J. Murton, *Resolution Costs of Bank Failures*, 1 FDIC BANKING REV. 1, 2 (1988). Until the 1980s virtually all bank failures were handled through this purchase and assumption procedure. See Garten, *supra* note 16, at 1164.

19. Until the 1980s, even in liquidation, uninsured creditors recovered most or all of their investments. According to FDIC statistics, as of the end of 1983, 99.1% of depositors in failed banks were repaid in full. See Garten, *supra* note 16, at 1164 n.29.

20. In 1991 Congress tried to discourage this practice by limiting the interest payable on deposits placed by brokers. See Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 302, 105 Stat. 2236, 2345 (codified as amended at 12 U.S.C. § 1831f(e) (1994)).

21. The exceptions were depositors large enough to have accounts over \$100,000, unsophisticated enough to be unable to exploit state-of-the-art risk management techniques, and unlucky enough to have deposits in a bank that no one wanted to save. For example, payroll depositors and other "involuntary" depositors who could not easily change banks might suffer a loss because they did not have complete protection. See Helen A. Garten, *Banking on the Market: Relying on Depositors To Control Bank Risks*, 4 YALE J. ON REG. 129, 134-39 (1986).

22. 12 U.S.C. §§ 24 (seventh), 78, 377-378 (1994 & Supp. III 1997).

23. The Pecora hearings on stock market abuses, conducted by a Senate subcommittee in 1933-34, highlighted abusive sales tactics by the large retail brokerage arms of commercial banks. See FERDINAND PECORA, WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS 84-104 (1939). These hearings may have influenced congressional deliberations on the Glass-Steagall Act in the months leading to its passage in June 1933, but other more significant forces were also at

virtually any bank involvement in the securities business was far more sweeping than what would have been required to protect consumers from unfair sales practices. Moreover, during congressional debate, critics of Glass-Steagall warned that the Act would actually hurt small businesses, local governments, and individual investors who had been the clients of bank securities divisions.²⁴ Thus, the original goals of Glass-Steagall appear to have been institutional, protecting the banking industry from the volatility of the stock market and from the competition from nonbank financial firms.²⁵

It would be an exaggeration to conclude that bank regulation and bank regulators were actively hostile to consumer interests. In fact, a compelling argument can be made that strengthening the banking industry benefits the consumer who relies on her bank for essential services. Yet what is good for the banking industry is not always good for the banking customer, who occasionally needs protection from her own bank. The Federal Government responded to this need by adopting fair lending and consumer credit laws,²⁶ but these rules dealt with discrete lending problems and, with one notable exception, were administered separately from traditional soundness regulation.²⁷ Moreover, bank regulators interpreted national banking laws to

work. *See infra* note 24 and accompanying text.

24. Populist proponents of easy money feared that Glass-Steagall would exacerbate the credit crunch by taking banks out of the underwriting business. *See* Walter Lippmann, *To-day and Tomorrow—The Glass Bill*, N.Y. HERALD TRIB., Jan. 29, 1932, reprinted in 75 CONG. REC. 2987 (1932). Senator Huey Long charged that Glass-Steagall would prevent the “people’s banks” from selling bonds, leaving local governments and small businesses at the mercy of Wall Street investment bankers. 76 CONG. REC. 1460 (1933) (statement of Sen. Long). The U.S. Chamber of Congress argued that banks had opened the securities markets to the small investor and disputed the suggestion that banks had foisted worthless securities on retail customers, maintaining that “the best interests of the investing public are served by commercial banks.” 77 CONG. REC. 3956 (1933).

25. For evidence that Glass-Steagall’s creators were motivated by institutional rather than consumer concerns, see H. PARKER WILLIS & JOHN M. CHAPMAN, *THE BANKING SITUATION* 62-83 (1934) (reviewing history of Act’s origins from perspective of one of its key drafters). Section 21 of the Act, which forced unlicensed private investment banks to stop taking deposits, was apparently drafted by Winthrop Aldrich, chairman of Chase National Bank, and took direct aim at commercial banks’ principal financial competitors at the time. *See* ARTHUR M. JOHNSON, WINTHROP W. ALDRICH: LAWYER, BANKER, DIPLOMAT 150-51 (1968).

26. *See* Truth-in-Lending Act of 1968, 15 U.S.C. §§ 1601-1667f (1994 & Supp. III 1997); Fair Credit Reporting Act of 1970, 15 U.S.C. §§ 1681-1686 (1994 & Supp. III 1997); Equal Credit Opportunity Act of 1975, 15 U.S.C. §§ 1691-1691f (1994 & Supp. III 1997); Home Mortgage Disclosure Act of 1975, 12 U.S.C. §§ 2801-2810 (1994 & Supp. III 1997); Right to Financial Privacy Act of 1978, 12 U.S.C. §§ 3401-3422 (1994 & Supp. III 1997).

27. The exception was the Community Reinvestment Act, which made banks’ local lending records a factor in the regulatory approval process for bank expansion. 12 U.S.C. § 2903 (1994). Because the regulatory approval process is driven principally by soundness concerns, however, the potential conflict between soundness and consumer goals made CRA enforcement problematic. *See infra* Part I.D.

preempt state consumer laws in areas such as usury ceilings²⁸ and prohibitions on credit card late charges.²⁹

Recently, however, a sea change has occurred in bank regulation. Significant portions of traditional regulation have been repealed³⁰ or are under attack.³¹ Interestingly, however, as deregulation proceeds, regulatory attention has shifted to consumer protection. This trend manifests itself in two ways. First, and most obvious, is the promulgation of explicitly proconsumer regulation, in the form of new rules or operating conditions attached to decisions on regulatory applications. Second, and more subtle, is the selective dismantling of certain restrictions that leave wholesale banking markets deregulated while the regulation of retail markets remains intact. The result is the creation, for bank regulatory purposes, of two markets: a largely unregulated, sophisticated wholesale market and a highly regulated, retail consumer market.³²

A. Case 1: Bank Sales of Nondeposit Investment Products

The gradual dismantling of Glass-Steagall's restrictions on bank securities activities during the 1980s and 1990s provides a good example of the changing goals of bank regulation. Even before legislative repeal of Glass-Steagall was seriously considered,³³ creative regulatory interpretation of statutory language, endorsed by the federal courts, permitted banks to

28. See generally *Marquette Nat'l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978) (authorizing "exportation" of credit card interest rates permitted under usury ceilings of one state to another state by national bank headquartered in first state and doing business in second).

29. See generally *Smiley v. Citibank*, 517 U.S. 735 (1996) (upholding Office of Comptroller of the Currency ("OCC")'s regulation, 12 C.F.R. § 7.4001(a)).

30. See, e.g., *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994*, Pub. L. No. 103-328, 108 Stat. 2338 (repealing interstate banking restrictions).

31. See *Financial Services Act of 1999*, H.R. 10, 106th Cong. (proposing repeal of key sections of Glass-Steagall).

32. Although this Essay focuses on bank regulation, one may tentatively draw similar conclusions about regulatory initiatives in other areas of financial law. For example, although securities disclosure regulation was designed in part to protect consumers of securities products, scholars traditionally identified other occasionally conflicting motives for the statutory scheme. See, e.g., Alison Grey Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311 (1974) (suggesting dichotomy between consumer protection and informational functions of securities regulation); Homer Kripke, *Fifty Years of Securities Regulation in Search of a Purpose*, 21 SAN DIEGO L. REV. 257, 260-77 (1984) (suggesting multiple purposes for disclosure scheme). Recently, however, securities regulation appears to be driven primarily by consumer aims, as manifested by initiatives such as the "plain English" requirement for disclosure documents, which attempts to make prospectuses more user-friendly to less sophisticated investors, see *Plain English Disclosure*, 63 Fed. Reg. 6370 (1998) (to be codified throughout 17 C.F.R. §§ 228-230, 239, 274), and the deregulation of wholesale securities markets, such as the 144A market, which reflects the new paradigm that mandatory disclosure regulation is unnecessary unless unsophisticated consumers are implicated.

33. See *supra* note 31.

reenter most aspects of the securities business, from stock brokerage³⁴ to securities underwriting and dealing.³⁵ Along the way, however, banks have been held to special standards governing the sales of securities products to retail consumers. The language of Glass-Steagall made no distinction between retail and wholesale securities activities.³⁶ Rather, these new standards reflected a modern consumer-oriented reading of statutory purpose.

A review of a few of the decisions that permitted banks to enter the securities business illustrates this consumerization of Glass-Steagall law. In 1986 the Federal Reserve Board decided that Glass-Steagall did not prohibit a bank affiliate from offering full brokerage services, including investment advice and trade execution, to its customers.³⁷ Although the Board concluded that full service brokerage did not constitute the “issue, flotation, underwriting, public sale, or distribution” of securities prohibited by the Act,³⁸ it did require that the brokerage services be offered only to institutional customers.³⁹ The Board favored this limitation because, when dealing with wholesale clients, the bank affiliate would be less likely to engage in “churning,”⁴⁰ or to offer unsuitable recommendations to unsophisticated customers.⁴¹

Nothing in the language of Glass-Steagall supported this distinction between retail and wholesale brokerage customers. In reading Glass-Steagall

34. See *Securities Indus. Ass'n v. Board of Governors of Fed. Reserve Sys.*, 468 U.S. 207, 214-21 (1984).

35. See *Securities Indus. Ass'n v. Board of Governors of Fed. Reserve Sys.*, 839 F.2d 47 (2d Cir. 1988).

36. Glass-Steagall barred banks from affiliating with firms “engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities.” 12 U.S.C. § 377 (1994). It also prohibited banks from directly underwriting securities issues or dealing in securities except for purchases and sales without recourse, solely upon the order, and for the account of, customers. See 12 U.S.C. § 24 (seventh) (1994 & Supp. III 1997) (national banks); 12 U.S.C. § 335 (1994) (Federal Reserve member banks). Finally, Glass-Steagall prevented management interlocks between banks and securities firms and deposit-taking by securities firms. See 12 U.S.C. § 78, 378 (1994).

37. See *National Westminster Bank PLC*, 72 Fed. Res. Bull. 584 (1986), *aff'd sub nom. Securities Indus. Ass'n v. Board of Governors of Fed. Reserve Sys.*, 821 F.2d 810 (D.C. Cir. 1987).

38. *Id.* at 592-93. In *Securities Industry Association v. Board of Governors of Federal Reserve System*, the Supreme Court upheld the Board's determination that a discount brokerage was not a prohibited securities activity. 468 U.S. 207 (1984). In *National Westminster Bank PLC*, the Board decided that the addition of investment advice did not alter the legality of brokerage activities under Glass-Steagall. 72 Fed. Res. Bull. at 591.

39. Institutional customers included financial institutions and natural persons with a net worth over \$5 million. A later ruling lowered this threshold to \$1 million. See *Manufacturers Hanover Corp.*, 73 Fed. Res. Bull. 930 (1987).

40. Churning refers to excessive trading in brokerage accounts for the purpose of generating commissions for the broker and is actionable under the antifraud provisions of the Securities Exchange Act of 1934. See, e.g., *Nesbit v. McNeil*, 896 F.2d 380 (9th Cir. 1990).

41. See *National Westminster Bank PLC*, 72 Fed. Res. Bull. at 591.

as a consumer-protection statute, the Board was following the lead of the Supreme Court. In an early look at congressional intent, the Court had concluded that at least one of the goals of Glass-Steagall was to eliminate certain “subtle hazards,” or conflicts of interest, that arose in the 1920s when banks acted as securities sellers in retail markets.⁴² The Federal Reserve Board went even further, relying on consumer protection goals to justify the imposition of new rules governing how and to whom banks might offer brokerage services.⁴³

Although the Board eventually relaxed its interpretation of Glass-Steagall to permit the offering of full service brokerage services to retail customers,⁴⁴ each subsequent expansion of bank securities powers was coupled with new rules designed to protect consumers. For example, when the Federal Reserve Board permitted banks to establish securities affiliates to engage in limited amounts of securities underwriting and dealing,⁴⁵ its decisions contained a series of operating conditions that were designed to maintain “firewalls” between banking and securities operations. Several of these firewalls were intended to prevent retail customers from confusing deposits with securities products by requiring specific disclosures to customers that the securities

42. See *Investment Co. Inst. v. Camp*, 401 U.S. 617, 630-33 (1971). For an analysis of how, after *Camp*, preventing conflicts of interest became the chief articulated goal of Glass-Steagall, see Helen A. Garten, *Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314, 323-30 (1990). Ironically, this reading of Glass-Steagall planted the seeds for the statute’s destruction. Because the Glass-Steagall remedy of barring banks from virtually all securities markets went so far beyond what was required to address consumer abuses, the statutory language was construed narrowly in situations after *Camp* where retail concerns were minimal. See, e.g., *Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst.*, 450 U.S. 46, 66-67 (1981) (finding that “subtle hazards” were not present when bank acted as investment adviser to closed-end mutual fund subject to regulatory oversight).

43. In deciding the *NatWest* application, the Board also had to determine the legality of brokerage activities under the Bank Holding Company Act, which required consideration of whether the public benefits of the proposed activity outweighed its possible adverse effects, including conflicts of interest. See 12 U.S.C. § 1843(c)(8) (1994 & Supp. III 1997); see also *National Courier Ass’n v. Board of Governors of Fed. Reserve Sys.*, 516 F.2d 1229 (D.C. Cir. 1975). In applying this balancing test, it is not unusual for the Board to consider the applicant’s acceptance of operating conditions that minimize opportunities for consumer abuse. Nevertheless, in *NatWest*, the applicant’s commitment to abide by consumer protection rules figured prominently in the Board’s Glass-Steagall analysis as well. See 72 Fed. Res. Bull. at 595; see also *Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys.*, 821 F.2d 810 (D.C. Cir. 1987) (holding that Board properly considered operating limitations when deciding whether bank securities activities would create “subtle hazards” that Glass-Steagall was enacted to prevent).

44. See *Bank of New Eng. Corp.*, 74 Fed. Res. Bull. 700, 704 (1988).

45. These decisions were known as the “Section 20 decisions” because they relied on an interpretation of section 20 of the Glass-Steagall Act, which prohibited banks from affiliating with companies “engaged principally” in securities underwriting and dealing. See 12 U.S.C. § 377 (1994). The Board construed this language to permit bank holding companies to establish nonbank subsidiaries that limited their securities underwriting business to a specified percentage of total revenues. See *Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys.*, 839 F.2d 47, 62-67 (2d Cir. 1988) (upholding this interpretation of section 20).

affiliate and the bank were completely independent entities⁴⁶ and that, unlike deposits, securities products offered by the bank securities affiliate were not insured.⁴⁷

The Board eventually dismantled many of its original firewalls that had proved burdensome to banks,⁴⁸ but it retained these disclosure requirements for banks dealing with retail customers.⁴⁹ Further, in 1994 the federal banking agencies issued an Interagency Statement on Retail Sales of Nondeposit Investment Products that extended the disclosure requirements to all retail sales of securities products by employees of banks, bank securities affiliates, and even unaffiliated broker-dealers operating on bank premises.⁵⁰ In many cases, repeat disclosure is required every time that a sales presentation is made or investment advice is provided to a retail customer.⁵¹ The Interagency Statement also specifies where sales of securities products may occur and who may make them.⁵² Securities sales must be made as far as possible from the deposit-taking area of the bank and by bank employees who are not tellers. In 1998 bank regulators considered granting formal rule status to the Interagency Statement guidelines and applying them specifically

46. See Citicorp, 73 Fed. Res. Bull. 473, 503 (1987). Firewall #11 states:

An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting Subsidiary and its banking affiliates The statement shall also indicate that the obligations of the underwriting subsidiary are not those of any affiliated bank and that the bank is not responsible for securities sold by the underwriting subsidiary.

Id.

47. See J.P. Morgan & Co., 75 Fed. Res. Bull. 192, 215 (1989). Firewall #14 states:

In addition [to disclosure of corporate separateness] the statement shall state that securities sold, offered, or recommended by the underwriting subsidiary are not deposits, are not insured by the Federal Deposit Insurance Corporation . . . are not guaranteed by an affiliated bank . . . and are not otherwise an obligation or responsibility of such a bank.

Id.

48. For example, restrictions on credit extensions to underwriting customers, a significant part of the original firewall structure, were removed in 1997. See Bank Holding Companies and Change in Bank Control (Regulation Y); Amendments to Restrictions in the Board's Section 20 Orders, 62 Fed. Reg. 45,295 (1997) (to be codified at 12 C.F.R. pt. 225).

49. See Bank Holding Companies and Change in Bank Control; Clarification to the Board's Section 20 Orders, 63 Fed. Reg. 14,803 (1998) (to be codified at 12 C.F.R. § 225.200(b)(4)). "Retail customers" include anyone other than "accredited investors," as defined in 17 C.F.R. § 230.501(a) (1998). Accredited investors are institutions, insiders, and wealthy individuals with over \$1 million in net worth or \$200,000 of income during each of the past two years.

50. See Interagency Statement on Retail Sales of Nondeposit Investment Products, 1 Fed. Reserve Reg. Serv. 3-1579.51 (Transmittal 177, Nov. 1995) [hereinafter Interagency Statement].

51. *But see* Bank Holding Companies and Change in Bank Control; Clarification to the Board's Section 20 Orders, 63 Fed. Reg. at 14,803 (allowing securities affiliates operating off premises of deposit-taking bank to satisfy disclosure requirements by providing one-time disclosure in writing).

52. See Interagency Statement, *supra* note 50, at 3-1579.51.

to bank sales of retail insurance products.⁵³

Legislative proposals to deregulate bank product markets also have included new consumer regulation. Glass-Steagall repeal bills have contained new antitying rules for the joint sale of bank and investment products that would supplement existing prohibitions under banking and antitrust law.⁵⁴ Some proposals also would call upon the bank regulators to create and administer a new federal consumer complaint procedure to address problems arising out of bank marketing of retail investment products.⁵⁵

The significance of these requirements from a regulatory standpoint is threefold. First, new consumer regulation has originated as a condition to deregulation: Banks are being permitted to diversify into new financial markets only if they comply with new regulatory requirements designed to protect the consumer. Second, these rules only apply to dealings with retail customers; wholesale customers presumably are sophisticated enough to purchase nondeposit investment products from their banks without special disclosures, tougher anticoercion rules, and new administrative remedies.

Finally, the new regulation reflects a view that the existing legal framework prohibiting unfair marketing tactics in the sale of financial products, whether under federal securities law, antitrust law, or state consumer law, is inadequate for sales to retail bank customers. The recent involvement of the bank regulators may reflect gaps in existing regulation; for example, federal securities law currently exempts some banks from regulation as broker-dealers.⁵⁶ New regulation may also reflect a degree of regulatory competition between bank regulators and other financial regulatory agencies, particularly the Securities and Exchange Commission ("SEC"), for authority over newly diversified banks.⁵⁷

53. See OCC News Release 98-12 (Jan. 30, 1998), available in 1998 WL 36006.

54. See, e.g., Financial Services Act of 1999, H.R. 10, 106th Cong. § 176. In the past, bank regulation has focused on both express tying arrangements that force customers to buy investment products from their bank and so-called "voluntary" ties, or conduct that leads customers to believe that buying an investment product improves their chances of obtaining bank credit. For discussion of antitying rules as a possible example of overregulation, see *infra* Part II.B.2.

55. See Financial Services Act of 1999, H.R. 10, 106th Cong. § 176.

56. See, e.g., 15 U.S.C. § 78c(a)(4)-(5) (1994). Bank securities affiliates, which are separate entities from the bank, are not exempt from registration as broker-dealers and are already subject to securities regulation of marketing practices. Legislation pending in early 1999 would narrow the bank exemption, requiring many banks directly engaged in securities activities to register with the SEC. See H.R. 10 § 201.

57. See, e.g., *Securities: Roberts Voices Concerns About Bank Securities Activities*, Banking Rep. (BNA), at 459 (Sept. 29, 1994) (SEC officials call for legislation giving SEC oversight authority over all bank securities activities). At present, both the bank regulators and the securities regulators have asserted authority to supervise sales of securities products to bank customers. In 1998 the NASD adopted a rule governing retail sales of securities products by broker-dealers on bank premises that overlaps with the Interagency Statement. See NATIONAL ASS'N SEC. DEALERS, NASD NOTICE TO MEMBERS 97-89: SEC APPROVES BANK BROKER/DEALER RULE; EFFECTIVE FEBRUARY 15, 1998, at

B. Case 2: Mandatory Disclosure

Traditionally, bank regulatory policy reflected considerable ambivalence about the desirability of public disclosure of information about bank condition, particularly for problem banks. Although most large banking organizations with public shareholders were subject to the mandatory disclosure requirements of the federal securities laws,⁵⁸ at times bank regulators resisted the SEC's attempts to force public revelation of banking problems.⁵⁹ Moreover, banking law barred disclosure of certain regulatory data, such as the results of supervisory examinations⁶⁰ and the agencies' problem bank lists, that were material to bank investors and depositors. In 1986 I identified the lack of regulatory information about banks as a possible obstacle to realistic market discipline of banks by either wholesale or retail depositors.⁶¹

Traditionally, the justification for secrecy was that adverse market reaction to negative information about banks might lead to deposit runs and bank failure, compounding the regulatory cost of dealing with banking problems. Since regulatory examinations and supervision of banks were designed to safeguard the deposit insurance fund, not to protect bank investors, regulators had no duty to inform the public of impending problems.⁶² In some cases, in the name of preserving confidence in the banking system, regulators may have even misled investors. For example, just one week before the government bailout of Continental Illinois, the Comptroller of the Currency issued a press release stating that it was unaware of any basis for the rumors of the bank's imminent failure.⁶³

735, 739-40 (1997). For further discussion of the consequences of this regulatory duplication, see *infra* Part III.B.

58. The federal securities laws treat banks differently from bank holding companies. Banks, but not holding companies, were originally exempted from the periodic disclosure requirements of the Securities Exchange Act of 1934. See Amendment to Rule AN8, 1 Fed. Reg. 2117 (1936). In 1974 Congress required the bank regulators to adopt disclosure rules for banks that were substantially similar to the SEC's disclosure requirements applicable to nonbanks, including bank holding companies. See Act of Oct. 28, 1974, Pub. L. No. 93-495, tit. I, § 105(b), 88 Stat. 1500, 1503 (codified as amended at 15 U.S.C. 78l(1) (1994)).

59. See, e.g., John R. Evans, *Disclosure Through a Glass Darkly*, 27 ADMIN. L. REV. 357, 358-63 (1975) (describing bank regulators' opposition to SEC's attempt to require disclosure of problems at U.S. National Bank and Franklin National Bank).

60. See 12 C.F.R. § 7.6025(c) (1994) (forbidding disclosure of examination reports); *Consumers Union v. Heimann*, 589 F.2d 531, 535 (D.C. Cir. 1978) (affirming exemption of bank examination reports from FOIA disclosure).

61. See Garten, *supra* note 21, at 143.

62. See *First State Bank of Hudson County v. United States*, 599 F.2d 558, 563 (3d Cir. 1979).

63. See *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings Before the Subcomm. of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong. 273

Recently, however, disclosure by and about banks has improved substantially, including information about regulatory assessment of bank condition.⁶⁴ Although the regulators' motive has been to substitute private market discipline for government supervision,⁶⁵ the effect, whether intended or unintended, has been to correct some information asymmetries that previously disadvantaged bank investors and consumers. Of course, improving disclosure does not enhance consumer protection if consumers cannot use information for their own benefit. Wholesale investors may be more likely than retail investors to employ information efficiently.⁶⁶ Nevertheless, information provides every investor with opportunities for self-protection that were unavailable under a regulatory regime that attempted to hide banking problems from public view. Perhaps more important for the retail investor, a disclosure regime also provides investors with a powerful legal remedy if they suffer investment losses as a result of misleading or incomplete information.⁶⁷

C. Case 3: Bank Failure Resolution

Traditional bank failure policy was driven primarily by the desire to eliminate systemic risk. The most serious risk was the domino effect, when one bank's failure disrupts the operations of large numbers of correspondent banks, causing them to fail as well. Alternatively, the failure of a single major bank may destroy public confidence in the banking system as a whole, resulting in widespread deposit runs and multiple failures.

(1984).

64. See, e.g., 12 U.S.C. § 1818(u) (1994) (mandating publication of content of cease and desist orders imposed on banks by regulators).

65. For critical analysis of this motive, see Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 *FORDHAM L. REV.* 501, 558-64 (1989). For evidence that this motive is still driving regulatory strategy, see Jaret Seiberg, *Fed Officials Say the Markets Could Do Regulators' Work*, *AM. BANKER*, Sept. 21, 1998, at 1 (Federal Reserve governor suggests that subordinated debt markets could act as early warning system to alert regulators of impending financial problems at regulated banks).

66. The ability of depositors to use disclosure to protect themselves from bank risk is subject to debate. See Garten, *supra* note 21, at 129. Even more sophisticated investors may not use information efficiently. Some scholars question the ability of bank equityholders to interpret correctly the signals conveyed by the current regime of risk-based capital requirements, suggesting that investors may draw unduly negative inferences from new capital issues and demand excessive risk premiums from some issuing banks. If banks could meet mandatory capital requirements by substituting subordinated debt, which is less sensitive to market signals, bank capital costs would decline. See Larry D. Wall & Pamela P. Peterson, *The Choice of Capital Instruments*, *FED. RESERVE BANK OF ATLANTA ECON. REV.*, 2d Quarter 1998, at 4.

67. Under federal securities laws, false or incomplete disclosure may give rise to a private civil action for damages. See, e.g., 17 C.F.R. § 240.10b-5 (1998). Moreover, if the misstatement is part of public disclosure, then the plaintiff need not prove actual reliance. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

Scholars continue to debate whether either of these scenarios is likely to occur, and that assessment is beyond the scope of this Essay. Certainly, however, most critics would agree that the bank regulators took these risks seriously. Moreover, even when systemic risk was not a factor, bank failure policy was constrained by the concern, common to all insurance schemes, to minimize expenditures from the insurance fund.⁶⁸ Correctly or incorrectly, bank regulators usually concluded that maintaining a bank as a going concern, usually by selling its franchise to a healthy bank, was a less costly solution than liquidating the bank's assets.⁶⁹

As a result, bank failure resolution became identified with bank failure prevention, an approach that seemed inconsistent with a deposit insurance scheme that appeared to be concerned primarily with protecting small depositors. Critics cited the willingness of the regulators to dispose of failing banks in ways that protected wholesale institutional depositors, non-U.S. investors, and even nondeposit creditors as evidence of a departure from the consumer protection goals of the insurance scheme.⁷⁰ Although historical analysis suggests that, from the beginning, deposit insurance was designed with institutional goals in mind,⁷¹ critics were certainly correct that consumer protection had been relegated at best to secondary status.

In recent years, however, bank failure policy has been reshaped to reflect the consumer protection rather than the institutional goals of deposit insurance. Legislative limitations on regulatory discretion to fashion solutions for banking problems were designed to strip bank failure policy of its failure-prevention bias, relegating the FDIC to the more narrow role of administrator of an insurance scheme for small depositors.⁷² The most dramatic change has been the legislative curtailment of the too big to fail policy. Currently, any decision that systemic risk justifies the use of deposit insurance monies to save a failing bank must be a political rather than a

68. See 12 U.S.C. § 1823(c)(4) (1994 & Supp. III 1997) (requiring least cost resolution of bank failure).

69. See *supra* note 18 and accompanying text.

70. See, e.g., EDWARD J. KANE, *THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE* 163 (1985) ("Conceived in 1933 as a device for protecting small depositors[, deposit insurance] functions today as a system for implicitly guaranteeing the capacity of the deposit institution system to make good on all but a small percentage of outstanding debt.").

71. See, e.g., Garten, *supra* note 12; Golembe, *supra* note 12.

72. For example, in the name of keeping deposit insurance funds available for their "intended purpose only," the FDIC is forbidden from taking any action that would increase losses to the insurance fund by protecting uninsured depositors or creditors. See 12 U.S.C. § 1823(c)(4)(E) (1994 & Supp. III 1997). Moreover, although "least cost" remains the primary determinant of resolution technique, Congress has specified how the agency may make its calculation, for example, requiring lost federal tax revenues to be treated as a resolution cost. See *id.* § 1823(c)(4)(B)(ii).

regulatory judgment.⁷³

Interestingly, the complaint against traditional bank failure policy was not just its cost but also its unfairness. Deposit insurance funds, intended for the benefit of the retail depositor, were unjustly enriching sophisticated wholesale investors. Although exposing wholesale investors to the risk of loss in the event of bank failure does not by itself enhance the protections afforded the retail consumer,⁷⁴ it does reflect a philosophy of regulation that is consistent with the consumerization of regulatory function. Traditionally, intrusive government regulation of private business relationships between banks and their customers has been justified by the existence of the deposit insurance subsidy. Since insurance removes incentives for banks to limit their own risktaking, the government as insurer must protect itself by imposing its own controls. Conversely, if public subsidies of private contracts between banks and their large sophisticated customers are removed, the government has no reason to intrude upon those relationships.

Thus, the shift in bank failure policy provides a justification for deregulation of banking markets except to the extent that it implicates insured depositors and the deposit insurance fund. Banking markets are bifurcated into a highly regulated retail sector that enjoys the insurance subsidy and an unregulated and unsubsidized wholesale sector. This bifurcation is reflected in recent legislative proposals for uninsured wholesale financial institutions that would give up the right to accept insured retail deposits in exchange for broader powers to diversify than those afforded insured retail banks.⁷⁵

D. Case 4: Community Reinvestment

Since its adoption in 1977, the Community Reinvestment Act (“CRA”)⁷⁶ provided an exception to the traditional safety and soundness orientation of bank regulatory policy. CRA requires federal bank regulators to encourage financial institutions to help to meet the credit needs of their local

73. Rather than making its own finding that systemic risk justifies failure prevention, the FDIC, together with the Federal Reserve Board, must now (1) take a formal vote of board members and (2) make a recommendation to the Secretary of the Treasury. *See* 12 U.S.C. § 1823(c)(4)(G)(i). The Secretary of the Treasury must (3) consult with the President, (4) notify relevant congressional committees, and (5) prepare and maintain documentation of the determination. *See* 12 U.S.C. § 1823(c)(4)(E)(i),(iii),(v). The documentation is to be (6) reviewed by the GAO. *See* 12 U.S.C. § 1823(c)(4)(G)(iv).

74. Since deposit insurance is funded by assessments paid by insured banks, the cost of subsidizing large depositors is not imposed directly on the public. But if the government grants tax benefits to entice buyers to acquire failing institutions, the public may bear some indirect costs. *See supra* note 72.

75. *See, e.g.*, Financial Services Act of 1999, H.R. 10, 106th Cong. § 136.

76. 12 U.S.C. §§ 2901-2907 (1994).

communities.⁷⁷ Enforcement takes place through the regulatory application process, which requires regulators to take CRA compliance into account in ruling on bank requests to establish new branches, merge, or engage in certain other corporate restructurings that require prior regulatory approval.⁷⁸

To the extent that the goals of the Community Reinvestment Act are in conflict with soundness goals, the statute has been criticized by both scholars⁷⁹ and bank regulators.⁸⁰ Moreover, the conflict was at least partially responsible for an enforcement record that was unsatisfactory both to the statute's defenders and to its opponents. On the one hand, community activists could legitimately complain that CRA implementation was random and lax, depending on the fortuity of a regulatory application process that was preoccupied with other issues.⁸¹ Critics could make the same charge, arguing that CRA considerations were irrelevant to the real concerns raised by regulatory applications, such as competitive effect and managerial competence.⁸²

Although these critiques could have resulted in the demise of CRA, in recent years enforcement has been strengthened.⁸³ Bank regulators rate banks for CRA compliance just as they rate banks for safety and soundness. Since 1990 CRA ratings have been disclosed to the public.⁸⁴ Repeal of legal restrictions on interstate bank branching has been accompanied by new rules requiring special regulatory oversight of CRA compliance by the new multistate megabank.⁸⁵ The Comptroller of the Currency has begun

77. See *id.* § 2901. The statute qualifies this obligation by requiring that community lending be consistent with the safe and sound operation of the bank, but this caveat suggests the inherent conflict between CRA goals and the soundness goals of other bank regulation.

78. See *id.* § 2902.

79. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 295 (1993) (arguing that CRA impairs safety and soundness of banking industry).

80. See, e.g., Claudia Cummins, *Boston Fed Chief Faults Broad-Brush Use of CRA*, AM. BANKER, July 22, 1983, at 1.

81. Since the regulators lacked statutory authority under CRA to punish noncompliance by direct administrative action, enforcement had to await the offending bank's filing of a regulatory application. Even then, CRA compliance was simply one factor to be considered, and an unsatisfactory record did not require a denial of the application. See, e.g., *Corning Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 571 F. Supp. 396 (E.D. Ark. 1983), *aff'd*, 736 F.2d 479 (8th Cir. 1984).

82. See, e.g., 12 U.S.C. § 1842(c)(2) (1994) (requiring Federal Reserve to consider competitive effects and financial and managerial resources, as well as convenience and needs of community, when deciding an application for expansion under Bank Holding Company Act).

83. See Community Reinvestment Act Regulations, 60 Fed. Reg. 22,156 (1995) (creating new CRA regulations intended to improve administration of Act).

84. See 12 U.S.C. § 2906(b)(2) (1994).

85. See Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, tit. I, § 110, 108 Stat. 2338, 2364 (codified as amended at 12 U.S.C. § 2906 (1994)) (requiring state-by-state evaluation of CRA compliance by banks with interstate branches); *id.* § 109, 108 Stat. at

continuous CRA examinations of large multibranch national banks.⁸⁶

Moreover, deregulation is making CRA enforcement a relatively more significant factor in the regulatory application process. Removal of legal barriers to interstate acquisitions has resulted in the filing of more regulatory applications, subjecting more banks more frequently to the enforcement mechanism of CRA. As traditional antitrust and competitive concerns become less significant barriers to bank expansion, CRA compliance is emerging as a more important determinant of the success or failure of a regulatory application. Although in the past competitors might have been expected to protest applications for bank expansion, deregulation has turned challengers into applicants. Community groups, however, remain ready and willing to challenge proposed mergers and acquisitions, particularly large deals that tend to generate significant publicity. Such large deals carry the possibility of substantial financial commitments by the resulting megabank to increase community lending.⁸⁷

Finally, as a political matter, legislators must justify their support for financial deregulation to constituents who are worried about its effect on the consumer. Coupling deregulation of wholesale financial markets with heightened CRA enforcement can satisfy community groups that might otherwise lobby against banking law reform. This may explain why, as deregulation is freeing financial institutions to compete across industry lines, political pressure is mounting to extend the CRA obligation beyond banks to all financial firms.⁸⁸

II. THE COSTS OF CONSUMERIZATION

If the sea change suggested in this Essay is real, does it create any dangers for the bank regulatory system? Two possibilities exist: consumerization may result in either the underproduction or the overproduction of regulation. Ironically, in the long run, the latter may present the more serious problem. The creation of two markets may disadvantage the retail consumer who is denied the quality and variety of services available in less regulated markets.

2362 (allowing bank regulators to close interstate branches for noncompliance with CRA).

86. See Jaret Seiberg, *Comptroller To Keep Year-Round CRA Watch on New Megabanks*, AM. BANKER, May 20, 1998, at 1.

87. Some new megabanks have agreed to make long-term national commitments to fund community projects in order to avoid CRA challenges although at least one expansion-minded bank has resisted this trend. See Brett Chase, *New Banc One Shuns Nationwide CRA Pledge*, AM. BANKER, July 9, 1998, at 8.

88. See, e.g., Jaret Seiberg, *Regulators' Plea to Banks: Lend More to Inner Cities*, AM. BANKER, Jan. 13, 1998, at 1 (citing political call to extend CRA to insurance and securities firms).

A. *Underproduction of Regulation*

The consumerization of regulation means that financial markets, traditionally bifurcated along producer lines, are now bifurcating along customer lines. In theory, if this trend continues, wholesale financial markets will operate largely without regulation while retail financial markets will remain largely regulated. Although this result initially may appear to be a proper allocation of regulatory resources, it raises several questions of regulatory efficiency that deserve more careful consideration. First, is the premise that there is no justification for government regulation of wholesale markets correct?⁸⁹ Second, in practice, can that premise ever become a sufficient basis for a regulatory policy?

The case for deregulation of wholesale markets has both economic and philosophical roots. Sophisticated investors presumably can bargain with financial services providers for the degree of protection that they require more efficiently than the government can legislate on their behalf. Private bargains may avoid externalities, such as moral hazard, that result from sweeping government protection schemes such as deposit insurance.⁹⁰ As a result, proponents of deregulation of wholesale markets argue, everybody wins. But the argument for deregulation of wholesale markets is also an argument against subsidization of sophisticated investors and, in this respect, has distinctly moral overtones. Government subsidies, the argument goes, are intended to protect small consumers who cannot protect themselves, not to excuse sophisticated investors from the responsibility of negotiating for their own protection. Inequality of bargaining power becomes a proxy for entitlement to regulatory protection.

Nevertheless, occasionally even the most sophisticated of investors appear incapable of protecting themselves. In the 1990s the unlucky experiences of several corporate and institutional investors with derivatives led to regulatory intervention, despite the sophistication of the derivatives market. Banks that sold derivatives were forced to comply with mandatory disclosure rules and other consumer protection regulations that were strikingly similar to the regulations imposed on banks that sell investment products to retail consumers.⁹¹

89. See *Hooked on Financial Red Tape*, *supra* note 1, at 65 (quoting Merton Miller).

90. Moral hazard arises from the different risk tolerances of insured parties (in this case, private investors) and insurers (in this case, the government). Government subsidization makes private investors more willing to take risk than they would be absent the subsidy. Although usually applied to deposit insurance, the moral hazard concept may be relevant to other forms of regulatory subsidy as well. See KANE, *supra* note 70, at 14-15.

91. See *New Derivatives Safeguards Imposed As Bankers Trust, Fed Reach Agreement*, 63

In other cases, although wholesale customers have been able to protect themselves, the consequences of self-protection have been intolerable and have required regulatory intervention. The fact that wholesale deposit runs are likely to be far more devastating to the depository bank and the banking system than retail deposit runs informed bank failure policy in the 1930s. Evidence showed that, between 1930 and 1933, large deposits were withdrawn at a faster rate than small deposits.⁹² The same problem emerged in the 1980s, when Continental Illinois' heavy reliance on wholesale deposits made the bank vulnerable to sudden electronic runs and forced government intervention.⁹³ As a result, at least in the past, regulators used bank failure policy to reassure wholesale investors in order to discourage them from protecting themselves from bank risk by joining deposit runs.

Although changes in the law governing bank failure resolution have deemphasized bank runs and systemic risk as justifications for government protection of uninsured depositors,⁹⁴ recent concern over the danger of global financial market disruption has provided a new reason to intervene in wholesale financial markets. Ironically, government intervention to prevent market disruption may prove to be even more intrusive than traditional bank failure policy because the intervention is no longer limited to bank deposit markets. The September 1998 rescue of the troubled hedge fund, Long-Term Capital Management, provides an indication of what may be coming. Although the rescue package did not include public funds, the Federal Reserve reportedly played a pivotal role in brokering a private bailout, justifying its intervention in wholesale markets by reference to the possible financial market disruption that might have occurred had the fund failed and been forced to liquidate its portfolio of complex financial instruments.⁹⁵

This concern over market disruption is in some ways reminiscent of 1970,

Banking Rep. (BNA), at 895 (Dec. 16, 1994). Among other requirements, the derivatives sales business must be conducted so that each customer has the "capability to understand the nature and material terms, conditions, and risks" of the transaction, and sales personnel must provide specific information to assist customers to understand risk factors associated with derivatives products. The Interagency Statement covering bank sales of retail investment products calls on sellers to disclose that nondeposit investment products are subject to investment risks, including the possible loss of principal. See Interagency Statement, *supra* note 50, at 3-1579.51.

92. See *Behavior of Deposits Prior to Suspension in a Selected Group of Banks—Analysis by Size of Account*, 25 Fed. Res. Bull. 178, 178 (1939) (showing 70% decline in demand deposits of \$100,000 or more but negligible decline in deposits of \$200 or less).

93. See *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank*, *supra* note 63, at 28.

94. See *supra* Part I.C.

95. See *Remarks Prepared for Delivery by Federal Reserve Board Chairman Alan Greenspan Before the House Committee on Banking and Financial Services Re: Private-Sector Refinancing of the Large Hedge Fund, Long-Term Capital Management*, Federal News Service, Oct. 1, 1998, available in LEXIS, News Library, FEDNEW file [hereinafter *Greenspan Remarks*].

when Penn Central's default threatened the commercial paper market. As nervous wholesale investors abandoned the market, other commercial paper issuers faced liquidity crises and potential insolvency. The Federal Reserve intervened to reassure the market, making liquidity available through the banking system to allow issuers to pay off maturing paper that could no longer be rolled over.⁹⁶

Although not perfectly analogous, both examples demonstrate that wholesale financial markets are vulnerable to panic despite the sophistication of their players. Moreover, to the extent that modern wholesale financial markets are increasingly integrated, deal in esoteric financial products, and rely on reputational interest and informal agreement to structure relationships,⁹⁷ loss of confidence may be even a more serious problem in wholesale markets than in retail markets. If the danger of global financial disruption is sufficient to justify government intervention in wholesale markets, then the bifurcation of markets as a practical matter can never be completed.

Finally, globalization may actually retard the bifurcation of financial markets. The distinction between wholesale and retail markets may have little currency outside of the United States, where universal banks have traditionally operated in both markets. If, in much of the world, the universal banking model shapes public perception of banks, regulatory distinctions between the two markets may prove counterproductive. U.S. regulators may be forced to rescue wholesale financial institutions for fear that a wholesale bank failure will cause non-U.S. investors to lose confidence in retail banks as well.

If some regulatory involvement in wholesale markets is likely to continue, then the question arises whether deregulation will complicate regulatory responsibility. One might argue that wholesale markets, unlike retail markets, require supervision rather than regulation. In other words, the government should monitor wholesale financial markets to detect problems but should not prevent risktaking by their participants. Nevertheless, supervision is likely to prove increasingly difficult as deregulated firms grow larger, more integrated, and more complex. If monitoring fails, yet regulators are still

96. For a description of the Federal Reserve's role following the bankruptcy of Penn Central and the threat to the commercial paper markets, see WILLIAM C. MELTON, *INSIDE THE FED: MAKING MONETARY POLICY* 157-58 (1985).

97. For example, Federal Reserve Board Chairman Greenspan cited the "scale and scope of [Long-Term Capital Management's] operations, which encompassed many markets, maturities, and currencies and often relied on instruments that were thinly traded and had prices that were not continuously quoted" as reasons why the hedge fund's failure might have had unpredictable and potentially devastating effects on world financial markets. See *Greenspan Remarks*, *supra* note 95.

required to intervene to minimize market disruption, regulatory costs may mount.

In response, regulators are likely to rely increasingly on participants in wholesale financial markets to monitor the health of financial firms and to provide an early warning of impending trouble. Nevertheless, reliance on wholesale customers may prove misplaced if those customers are incapable of recognizing and protecting themselves from risk. For example, wholesale investors apparently failed to appreciate the volume and nature of risks taken by Long-Term Capital Management.⁹⁸ Even equityholders, who as residual claimants have reason to appreciate investment risk, may not always be good monitors. Critics of bank capital regulation, which requires banks to subject themselves to the discipline of the equity market, now argue that equityholders are prone to overestimate bank risk and that subordinated debtholders may be better at reading market signals.⁹⁹

This quest to find the perfect monitor suggests the difficulty of supervision and implies a need for some continued government involvement in wholesale markets. A regulatory policy that focuses primarily on retail markets runs the danger of underregulation, which may prove costly to all financial markets in the long run.

B. Overproduction of Regulation

The consumerization of regulation means that, as wholesale financial markets are deregulated, regulation of retail markets remains intact or is strengthened. This is occurring partly by legislative design and partly by accident as financial institutions evade regulatory restrictions by innovating products and services. For example, financial firms circumvented laws requiring banking, securities, and insurance activities to be conducted as separate lines of business by developing financial equivalents. Banks were prohibited by law from underwriting insurance, but they could write put options protecting clients against declines in the value of their assets. These options were functionally equivalent to insurance contracts but were legally still bank products.¹⁰⁰

With the important exception of the money market mutual fund,¹⁰¹ however, innovative financial products tend to be restricted to wholesale markets. Retail consumers may be wary of unfamiliar and esoteric

98. See *supra* note 95 and accompanying text.

99. See Wall & Peterson, *supra* note 66, at 4.

100. See Greenspan *Tells Why Financial Modernization Is Urgent*, 16 BANKING POL'Y REP. 6 (May 19, 1997) (citing this example of financial equivalents).

101. See *supra* text accompanying notes 9-10.

instruments such as put options and may prefer the more familiar insurance policy. Moreover, the development and mass marketing of complex hybrid financial products may cost too much to warrant their use in retail markets.

Through financial innovation, therefore, wholesale financial markets (but not retail markets) have experienced significant deregulation without congressional action. Ironically, the impact of formal statutory deregulation is likely to be felt primarily by retail markets, whose participants have not yet shared the benefits of financial innovation. Nevertheless, statutory deregulation is likely to be accompanied by the imposition of new consumer protection rules that make operating in retail markets more costly. If these costs are shifted to retail customers, or if financial firms respond by avoiding retail markets, then the new consumer regulation may prove counterproductive, denying retail customers the benefits of deregulation that wholesale markets already enjoy.

1. Marketing Restrictions

The potential for overregulation of retail markets is suggested by the new rules governing the marketing of retail investment products to bank customers. As previously described, sellers of nondeposit investment products such as mutual funds, securities, and insurance must comply with detailed disclosure rules when dealing with retail bank customers.¹⁰² Despite the straightforward content of the mandatory disclosure,¹⁰³ in many cases, the disclosure must be repeated each time that a sales presentation is made or investment advice is given to a retail customer.¹⁰⁴ Moreover, the disclosure requirements apply not just to bank employees, but also to the employees of bank securities affiliates operating off-bank premises and to representatives of unaffiliated broker-dealers making recommendations or sales on bank premises.¹⁰⁵

The requirement for repeat disclosure imposes significant monitoring costs on banks with substantial securities operations, particularly those with large numbers of registered representatives operating from multiple offices. In fact, the Federal Reserve has agreed with the banking industry that, when retail securities operations are conducted by separately incorporated securities affiliates that do not operate on bank premises, the burden of

102. *See supra* Part I.A.

103. Sellers must disclose that nondeposit investment products are not insured and are subject to investment risks, including possible loss of principal. *See* Interagency Statement, *supra* note 50, at 3-1379.51.

104. *See id.*

105. *See id.*

complying with the repeat disclosure requirement outweighs the benefits to consumers. Therefore, employees of securities affiliates are required to make the disclosures only once, in writing, upon opening a retail investment account.¹⁰⁶

If compliance costs outweigh the benefits of repeat disclosure in the case of bank securities affiliates, may the same calculation be made with respect to any seller of retail investment products, even those operating on bank premises? The obligation to make repeat disclosure only arises in the context of an ongoing relationship between broker and customer. Established customers, however, may telephone their brokers several times a day to discuss their investments.¹⁰⁷ If these customers have opened an investment account, they have already acknowledged in writing that they have received and understand the mandatory disclosures.¹⁰⁸

Moreover, many of these clients, although retail customers, are experienced investors who understand that securities products are not insured deposits. For the purposes of the bank disclosure rules, retail customers may include anyone other than "accredited investors" as defined by the securities laws.¹⁰⁹ As a result, nonfinancial corporate clients and individuals who do not meet the securities law's net worth or income tests may be treated as retail investors, regardless of their prior experience in the securities markets.

For established customers, repeat disclosure may be unnecessary at best. At worst, banks have argued, it may interfere with client relationships.¹¹⁰ Moreover, repeat disclosure may prove counterproductive if bank securities employees and their customers view it as "boilerplate," ignoring its content as they repeat it by rote.

The disclosure rules are not the only examples of consumer regulation that may not always benefit consumers. Regulation of retail sales of investment products also aims to separate as far as possible the bank's deposit-taking operations from its nondeposit investment sales operations. Regulation governs both the physical location of investment sales operations and the methods used by the bank to market securities products. For example, customers must go to a different area of the bank from the deposit-

106. See Bank Holding Companies and Change in Bank Control; Clarification to the Board's Section 20 Orders, 63 Fed. Reg. 14,803 (1998) (to be codified at 12 C.F.R. § 225.200(b)(h)).

107. See *id.* at 14,803.

108. See Interagency Statement, *supra* note 50, at 3-1579.51 (requiring written acknowledgment when investment account is opened that customer has received and understands disclosures).

109. Accredited investors are institutions, insiders, and high net worth individuals. See 17 C.F.R. § 230.501(a) (1998). Although the Interagency Statement on Retail Sales of Nondeposit Investment Products does not define a "retail customer," the Federal Reserve's Regulation Y, which requires bank securities affiliates to follow the Interagency Statement, defines a retail customer as anyone other than an accredited investor. See 12 C.F.R. § 225.200(b)(4)(i) n.4 (1998).

110. See 63 Fed. Reg. 14,803 (1998) (to be codified at 12 C.F.R. pt. 225) (noting this complaint).

taking area in order to buy securities products.¹¹¹ Overall, the regulatory goal is to minimize customer confusion of insured deposit products with uninsured securities products. The effect may be to call into question many cross-marketing techniques that deregulated banks intend to use to introduce their retail customers to new and unfamiliar investment products.

A 1998 enforcement action brought by securities regulators against a national bank and its securities subsidiary illustrates the vulnerability of many cross-marketing techniques to the charge that they create the potential for customer confusion. The facts of this case suggested violations of both suitability and antifraud rules. For example, securities regulators found that the bank's securities sales personnel had specifically targeted unsophisticated bank depositors to buy high-risk closed-end bond funds that invested in derivatives.¹¹² Although these legal violations were sufficient to warrant a regulatory enforcement action, the regulators also criticized specific cross-marketing practices that, while not illegal by themselves, taken together were found to blur distinctions between bank and securities products. These practices included mass mailings of securities sales literature in envelopes similar to those used for bank statements,¹¹³ posters in bank branches with the slogans "Invest in Tomorrow Where You Bank Today" and "Introducing the Investment Firm You Can Bank On," and instructions to securities sales personnel to avoid securities "lingo" because bank customers would find bank terminology "less alarming."¹¹⁴

In this case, investors complained that they had assumed that the bond funds were bank products; these complaints, together with the extreme disparity between the investors' experience and the riskiness of the investment, explain the regulators' interest in this bank's marketing practices. Nevertheless, the regulators' repeated criticism of the bank's "blurring conduct" suggests that other banks contemplating cross-marketing may have to presume *ex ante* that their retail customers lack sufficient sophistication and experience easily to distinguish between insured and uninsured investments. Moreover, when cross-marketing is involved, it is unclear

111. See Interagency Statement, *supra* note 50, at 3-1579.51.

112. See *In re NationsSecurities and NationsBank, N.A.*, SEC Admin. Proceeding File No. 3-9596, 1998 SEC LEXIS 833, at *12-*13 (May 4, 1998). Typical investors were elderly, low-income and inexperienced, having never invested in anything other than bank certificates of deposit. They were told that the bond funds were "as safe as CDs but better because they paid more." See *id.* at *11-*14.

113. Cf. Interagency Statement, *supra* note 50, at 3-1579.51 (allowing joint advertising of deposit and nondeposit products but requiring that advertising materials "clearly segregate" information about each product).

114. See *In re NationsSecurities and NationsBank, N.A.*, 1998 SEC LEXIS 833, at *22-*26.

whether compliance with the mandatory disclosure requirements can counteract the blurring effect that other sales practices may create.¹¹⁵

If banks must presume that joint selling of bank and securities products may create customer confusion, then they may have to rethink many cross-marketing techniques. Yet the opportunity to cross-market products to retail customers is one of the reasons for banks to invest in new nonbanking businesses—and one of the public benefits cited by the bank regulators when they have permitted banks to enter new businesses.¹¹⁶ Among the potential benefits for retail bank customers are access to new financial products and the convenience of “one-stop shopping” for financial services. The customers most likely to value these benefits are novice investors who do not already employ independent securities brokers or financial advisers. These customers have the most to gain from cross-marketing but are also the most likely to be confused.

Ironically, in the past, the failure of most newly diversified banks to implement aggressive cross-marketing strategies that integrate retail sales of bank and nonbank products may have cost them clients and deprived their customers of the benefits of one-stop shopping. A 1998 survey found that many bank employees were not yet aware that their banks offered insurance products and actually turned away prospective retail customers.¹¹⁷ According to one bank brokerage executive, similar problems arose when banks first began offering retail securities products but were resolved when management encouraged securities sales personnel to work alongside bankers so that they “became part of the banking family.”¹¹⁸ Now that the securities regulators have indicated that making a securities sales employee “a face at the bank” may impermissibly blur distinctions between insured and uninsured financial products,¹¹⁹ however, it is unclear how far banks can go in attempting to integrate their different product marketing teams.

Banks may face another problem as they compete in new retail financial markets. The securities regulators have also suggested that the “hub and spoke” organizational structure¹²⁰ typical of independent brokerage firms is

115. In the *NationsSecurities* case, sales manuals instructed securities sales personnel to disclose to customers that securities products were not FDIC-insured, but the regulators concluded that this policy was inadequate to prevent the blurring caused by other sales practices, including the failure to differentiate between securities employees and bank employees. *See id.* at *27-28.

116. *See, e.g.*, Travelers Group Inc., 84 Fed. Res. Bull. 985, 1009-12 (1998) (Order Approving Formation of a Bank Holding Company and Notice to Engage in Nonbanking Activities).

117. *See* Michael O'D. Moore, *Bankers Drawing a Blank on Insurance Offerings*, AM. BANKER, Oct. 13, 1998, at 1 (survey of 26 banks found that 69% of branch employees did not know that their banks sold insurance).

118. *Id.* at 9 (quoting chairman of bank brokerage unit).

119. *See In re NationsSecurities and NationsBank, N.A.*, 1998 SEC LEXIS 833, at *22.

120. *Id.* at *26. Under this structure, supervisors worked in hubs while registered representatives

inappropriate for a banking organization engaged in retail securities sales because it does not permit adequate monitoring and control of the marketing practices of sales personnel.¹²¹ Since similar monitoring problems presumably plague nonbank brokerage firms with decentralized organizational structures, why have banks been singled out for special criticism? It may reflect the regulators' belief that conduct by bank securities sales personnel that blurs distinctions between bank and securities products is either more pervasive or more pernicious than other consumer abuses in the brokerage industry. Nevertheless, if banks must adopt special new organizational structures to guard against the dangers of blurring conduct, they are likely to face significant costs and possible competitive disadvantages when they enter retail securities markets.

2. *Tying Restrictions*

Interestingly, the charge of overregulation that may be leveled at the new consumer rules governing retail sales of nondeposit investment products is reminiscent of the complaints traditionally made about enforcement of bank antitying regulation. Antitying rules attempt to protect bank customers from pressure to purchase multiple financial products from their banks as a condition to obtaining credit. If interpreted too broadly, however, antitying rules may actually deprive retail investors of opportunities for cost savings in the purchase of financial products. In the past, bank regulators have recognized this anomaly and created exceptions to the tying rules when benefits to consumers were apparent. Ironically, the consumerization of regulation may reverse this trend, breathing new life into antitying regulation.¹²²

As a legal matter, tying by banks traditionally has been viewed more seriously than tying by nonbank firms.¹²³ For example, in tying cases involving banks, most courts have not required a showing that the offending bank had any special market power over the tying product (usually credit).¹²⁴ Moreover, banks have been accused of exploiting customers through so-

worked in spokes, which in this case consisted of over 2000 separate banking centers. *See id.* at *26-*27.

121. *See id.*

122. *See generally supra* note 55 and accompanying text.

123. In addition to the antitrust laws, banks are subject to special antitying rules contained in the Bank Holding Company Act and administered by the Federal Reserve. *See* 12 U.S.C. § 1972 (1994 & Supp. III 1997).

124. *See, e.g.,* Parsons Steel, Inc. v. First Alabama Bank of Montgomery, 679 F.2d 242 (11th Cir. 1982); *cf.* Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 13-16 (1984) (requiring proof of market power to prosecute tying arrangements under Sherman Act).

called “voluntary” ties, when prospective borrowers simply believe that buying a second product from the bank will help them obtain credit.¹²⁵ The danger of voluntary tying has often been cited as a reason to bar bank entry into new retail financial product markets such as insurance.¹²⁶

Some economists have argued that even explicit tying arrangements may benefit consumers through cost savings from joint production and sale of related products, reductions in transactions costs, and the efficient reallocation of risk between seller and buyer.¹²⁷ For example, by requiring customers to purchase a package of financial products, a supplier can economize on its monitoring costs, allowing it to charge less for each service. Likewise, the supplier can fashion a package of financial products specifically designed for its customer’s individual needs and financial position. For retail customers with modest investment goals, shopping separately for bank, securities, and insurance products involves high transactions costs. Moreover, the customer’s demand for each individual financial product may be too small to interest many independent financial services providers. In these cases, one-stop shopping for financial services, even when mandated by the bank, is efficient for both supplier and consumer.

Thus, convenience rather than coercion may explain many tying arrangements, particularly “voluntary” ties. Policing voluntary ties has proved particularly problematic: Bank regulators typically have viewed the bank’s market power over the tying product and its success in selling the tied product to its customer base as indicia of improper influence.¹²⁸ Yet success in cross-marketing does not necessarily mean that customers have been coerced. Customers may simply value convenience and familiarity over diversity when choosing a financial services provider.

The bank regulators have recognized that not all tying arrangements are coercive. For example, the Federal Reserve Board has permitted banking organizations to offer a discount on fees for loans, deposits, and securities brokerage services to customers who purchase a second product from the bank.¹²⁹ The Board noted that discounts would benefit consumers, who would gain access to a greater variety of financial products. Moreover, rival nonbank financial services providers were already offering similar discounts

125. See, e.g., *Alabama Ass’n of Ins. Agents v. Board of Governors of Fed. Reserve Sys.*, 533 F.2d 224, 250 (5th Cir. 1976).

126. See *id.* at 249-50 (citing this argument made by National Association of Insurance Agents in opposition to bank entry into insurance business).

127. See Richard Craswell, *Tying Requirements in Competitive Markets: The Consumer Protection Issues*, 62 B.U. L. REV. 661 (1982).

128. See *Alabama Ass’n of Ins. Agents*, 533 F.2d at 250.

129. See 12 C.F.R. § 225.7(b)(1)(2) (1998).

to their own customers.¹³⁰

This ruling suggests that the bank regulators did not believe that the risk of coercive tying by banks selling multiple financial products was so great as to warrant holding banks to a higher legal standard than nonbank financial firms. In fact, past evidence suggests that product tying in the marketing of retail financial services has not been a pervasive problem. A study of private litigation involving allegations of bank tying concluded that most claims arose out of troubled lending relationships when the bank took steps to improve its position as a creditor.¹³¹ Recent complaints about tying of banking and securities products have come not from retail customers but from corporations that complained that they were pressured to use their lending bank to underwrite their securities offerings.¹³²

Experience with antitying regulation offers some lessons for regulators seeking to prevent blurring and other abuses in the cross-marketing of bank and nonbank financial products. The new marketing restrictions, like antitying regulation, may deter some unfair sales practices, but they may also hurt retail customers if consumers are denied the convenience and cost savings resulting from joint sales of financial products. Moreover, if banks incur substantially higher compliance costs as they attempt to monitor the sales practices of their employees, they may simply pass these costs onto their retail consumers, destroying the economic benefit of one-stop shopping. Monitoring costs are likely to be particularly high if banks must comply with vague and subjective requirements, such as rules against blurring and voluntary tying, violation of which depends on the perception and experience of each individual customer. Moreover, policing compliance with these kinds of rules may be just as difficult for financial regulators as it is for financial company managers, a dilemma considered in Part III of this Essay.

III. THE COST OF REGULATORY IMPLEMENTATION

The consumerization of financial regulation suggests a reshaped role for the financial regulator as creator and enforcer of operating rules governing transactions in retail markets. Although some financial regulators have always performed this function, for some, including many bank regulators, the role is new, and, for most, the detail and complexity of the new rules

130. See Revisions Regarding Tying Restrictions, 59 Fed. Reg. 65,473, 65,474 (1994).

131. See BERNARD SHULL, TYING AND OTHER CONDITIONAL AGREEMENTS UNDER SECTION 106 OF THE BANK HOLDING COMPANY ACT: A RECONSIDERATION (National Econ. Research Assoc., Inc. Working Paper No. 19, 1993).

132. See, e.g., Vicky Stamas & John Pryde, *NationsBank May Have Violated 'Anti-Tying' Law, Letter Shows*, AM. BANKER, July 29, 1994, at 5.

present new supervisory challenges. This raises two questions. First, which regulatory body is the most efficient provider of the new consumer marketing rules? Second, can any regulatory agency be expected to enforce these rules effectively?

Consider again the rules governing the retail sale of nondeposit investment products. The banking agencies' guidelines cover bank securities affiliates and third parties, such as independent broker-dealer firms, that contract to sell securities products to bank customers on bank premises.¹³³ Yet bank securities affiliates and independent broker-dealers are also subject to regulation under the securities laws, and the National Association of Securities Dealers has adopted its own rule governing retail sales of nondeposit investment products on bank premises.¹³⁴ State securities regulators have also claimed authority to regulate some portion of these sales.¹³⁵

Is regulatory overlap inefficient? It may be inefficient if firms are subjected to inconsistent standards. Bank and securities regulators have attempted to harmonize their rules, requiring similar disclosures from all sellers of investment products dealing with retail bank customers. Nevertheless, discrepancies are inevitable whenever multiple regulators assert authority.¹³⁶

This problem may resolve itself if competition among regulators results in the survival of the most efficient set of rules—and the most efficient regulator. In theory, regulatory competition may eventually solve two problems potentially affecting retail financial regulation: It may eliminate inefficient overregulation and it may identify which regulatory agency is the best provider of consumer rules. Nevertheless, competition to regulate retail financial services markets may not be as efficient as other forms of regulatory competition, such as competition for corporate charters. Effective regulatory competition assumes that regulated entities can signal their dissatisfaction with a regulatory regime by exiting and choosing a better regulator. Yet exit is costly for financial firms; for example, firms that take deposits are regulated as banks and cannot escape bank regulation without

133. See Interagency Statement, *supra* note 50, at 3-1579.51.

134. See NASD Rule 2350 Broker/Dealer Conduct on the Premises of Financial Institutions, 1997 NASD Notice to Members 89, 1997 NASD LEXIS 108.

135. See Stan Wilson, *Bank Criticism Prompts NASAA To Revamp Model Bank Securities Sales Rules*, INSTITUTIONAL INVESTOR, Apr. 28, 1997, at 1. Retail sales of insurance products, traditionally governed by state insurance law, are also likely to face dual regulation as banks and bank regulators enter the field. See *supra* text accompanying note 54.

136. For example, the bank regulatory guidelines require that the mandatory disclosures be repeated during every sales contact while NASD rule does not. Likewise, the NASD and the bank regulators might adopt differing positions on issues such as the permissibility of referral fees paid to tellers for locating potential securities customers.

altering their charters and powers. And exit may be meaningless for diversified firms that already are subject to multiple regulators.

Further, regulatory competition is complicated by differences in enforcement styles and priorities among different financial regulatory agencies. For example, securities regulators have argued that they should supervise all financial firms, bank or nonbank, engaged in retail sales of nondeposit investment products in order to ensure uniform enforcement. Securities regulators have suggested that the bank supervisory scheme has been too lax, lacking enforceable standards of conduct¹³⁷ and discouraging private lawsuits by aggrieved consumers.¹³⁸ Yet securities regulators have evinced an intention to hold banks selling securities to higher standards than nonbanks.¹³⁹ This suggests that, if given a choice, banks will opt for bank regulation and securities firms will opt for securities regulation. If uniformity of regulatory application is the goal, then regulatory competition may not be the best way to achieve it.

Finally, competition among regulatory agencies does not appear likely to answer the empirical questions that arise with respect to retail financial regulation. Are bank customers as a group more vulnerable to unfair sales practices than other investors, and will they remain so even when one-stop shopping for financial services becomes more common? Is disclosure the best remedy, or should cross-marketing be regulated? Banks and their customers can answer these questions more effectively than can federal regulators, suggesting a role for some self-regulation to help fashion and monitor the effectiveness of rules governing transactions with retail bank customers. Although the banking industry has only limited experience with self-regulation, this approach may be more efficient than the current “top-down” imposition of federal consumer rules.¹⁴⁰

137. See *Prepared Statement of Arthur Levitt, Chairman, Securities and Exchange Commission, Before the Senate Comm. on Banking, Housing and Urban Affairs*, Federal News Service, June 25, 1998, available in LEXIS, NEWS library, FEDNEW file [hereinafter *Prepared Statement of Arthur Levitt*]. As previously noted, bank regulation of retail sales of nondeposit investment products originally took the form of guidelines rather than rules. See *supra* text accompanying notes 52-53. Although giving the guidelines formal rule status will facilitate their enforcement, the bank regulators always had the power to treat violations as “unsafe and unsound” banking practices punishable through regulatory enforcement action. See 12 U.S.C. § 1818 (1994).

138. SEC Chairman Levitt has complained that most banking statutes do not give rise to private rights of action for violation. See *Prepared Statement of Arthur Levitt, supra* note 137. Of course, not all securities regulation gives rise to such rights. See *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980) (finding no private right of action for violation of NASD rule).

139. See *supra* notes 120-21 and accompanying text (discussing securities regulators’ criticism of bank’s use of organizational structure that is standard in brokerage industry).

140. One self-regulatory organization, the NASD, has already adopted a rule governing retail sales of securities products to bank customers, and at least in the past, most banks have chosen to sell

Self-regulation may also be necessary to guarantee effective enforcement. If, as the bank regulators have recognized, large banking organizations have difficulty monitoring compliance by their employees with detailed operating rules such as mandatory disclosure during each sales presentation,¹⁴¹ monitoring costs are likely to be even higher for regulatory agencies that are more remote from day-to-day sales operations than the bank's own management. As deregulation allows banks to diversify into new businesses, growing institutional size and complexity will further complicate regulatory oversight. Reliance on aggrieved customers to identify and report violations of consumer rules is also inadequate. If bank customers are as unsophisticated about the nature of bank and nonbank investment products as the regulators apparently believe, they are likely to be unaware of their bank's obligations under federal bank and securities regulation. Therefore, they are most likely to complain if and when they lose money on an investment product marketed by a bank—which may be the first time that the regulators (and perhaps senior bank management) become aware of past violations.

Therefore, enforcement of detailed operating rules may require a significant degree of voluntary compliance by the financial services industry and its retail sales personnel. In the past, however, industry professionals seemed ignorant of the rules. Surveys in 1995 and 1996 of retail sales of nondeposit investment products to bank customers found that neither bank employees nor representatives of registered broker-dealers routinely made the disclosures required by bank regulation.¹⁴² Although a more recent survey suggests improved compliance,¹⁴³ ambiguities in current regulation, such as identifying which customers are “retail”¹⁴⁴ and how often disclosures

securities products through registered broker-dealers, affiliated or unaffiliated, many of whom are already NASD members. See *Prepared Testimony of Andrew C. Hove, Jr., Acting Chairman, Federal Deposit Insurance Corporation, Before the House Commerce Comm. Finance and Hazardous Materials Subcomm. on Financial Modernization*, Federal News Service, July 17, 1997, available in LEXIS, NEWS library, FEDNEW file [hereinafter *Prepared Testimony of Andrew C. Hove*]. So is the NASD likely to emerge as the best regulator of retail financial markets? There may be some reluctance on the part of banks and bank regulators to accept the authority of an organization identified with their rival securities industry. This attitude may change, however, with time. For example, between 1931 and 1933, representatives of bank securities affiliates led the Investment Bankers Association of America despite their relatively recent entrance into the securities business. See Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 *BANKING L.J.* 483, 496 (1971).

141. See *supra* text accompanying note 107.

142. See *Prepared Testimony of Andrew C. Hove, Jr., supra* note 140 (citing survey).

143. See Steven Goldstein, *Disclosure at Bank-Affiliated B/Ds*, INSTITUTIONAL INVESTOR COMPLIANCE REP., Sept. 14, 1998, at 8 (finding that 76% of bank-affiliated brokers surveyed in 1997 disclosed that securities products were not FDIC-insured, 81% mentioned that securities were not backed by bank deposits, and 92% discussed securities market risk with customers).

144. See *supra* text accompanying note 109.

must be repeated,¹⁴⁵ are likely to cause confusion, leading to violations.

Moreover, substantial voluntary compliance requires industry consensus as to the legitimacy of regulation. In the case of the new consumer rules, the absence of conclusive empirical evidence as to the efficacy of regulation may discourage industry cooperation. Ironically, industry doubts may be fueled by the willingness of the regulators to accept the argument that, in some cases, compliance costs outweigh consumer benefits;¹⁴⁶ if true in some cases, why not in others? In addition, if the rules are interpreted so broadly that they outlaw standard marketing practices in the industry or practices necessary for successful diversification, then the regulators cannot count on widespread industry cooperation.

CONCLUSION

Growing sentiment for financial deregulation reflects a consensus that traditional legal rules designed to preserve safety and soundness are no longer needed in modern financial markets, especially in markets in which the players are sophisticated and can bargain for their own levels of protection. Nevertheless, government involvement in financial markets persists, shifting in focus as regulators are called upon to fashion new rules to protect less sophisticated customers in retail financial markets.

This Essay has argued that the bifurcation of financial markets implied by this shift in regulatory focus may prove to be unsustainable in the long run. Retail financial markets may require less regulation than is currently assumed in order to guarantee equal access to new investment opportunities to all consumers. And wholesale financial markets may require more regulation in order to guard against the growing danger of global market disruption.

145. *See supra* text accompanying notes 106-108.

146. *See supra* text accompanying note 110.