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THE NEW FINANCIAL ORDER:
AN ESSAY FOR ALAN BROMBERG

Joel Seligman*

In the aftermath of the 2008–2009 financial crisis, I characterized its causes broadly:

First, there was an ongoing economic emergency, initially rooted in the housing and credit markets, which has been succeeded by the collapse of several leading investment and commercial banks and insurance companies, dramatic deterioration of stock market indices, and a rapidly deepening recession.

Second, there were serious breakdowns in the enforcement and fraud deterrence missions of federal financial regulation, notably as illustrated by matters involving Bear Stearns and the other four then independent investment banks subject to the SEC’s former Consolidated Supervised Entities program, the government creation of conservatorships for Fannie Mae and Freddie Mac, and the Bernard Madoff case.

Third, there was a misalignment between federal financial regulation and financial firms and intermediaries. The structure of financial regulation that was developed during the 1930s did not keep pace with fundamental changes in finance.

In the New Deal period, most finance was atomized into separate investment banking, commercial banking, or insurance firms. By 2008, finance was dominated by financial holding companies, which operated in each of these and cognate areas such as commodities.

In the New Deal period, the challenge of regulating finance was domestic. By 2008 when credit markets were increasingly reliant on trades originating from abroad, major financial institutions traded simultaneously throughout the world, and information technology had made international money transfers virtually instantaneous—the fundamental challenge was increasingly international.

In 1930, approximately 1.5 percent of the American public directly owned stock on the New York Stock Exchange. A report estimated that in the first quarter of 2008, approximately 47 percent of U.S. households owned equities or bonds. A dramatic deterioration in stock prices affected the retirement plans and the livelihood of millions of Americans.

In the New Deal period, the choice of financial investments was largely limited to stocks, debt, and bank accounts. By 2008, we lived in an age of complex derivative instruments, some of which experience had shown were not well understood by investors and on some occasions by issuers or counterparties.

Most significantly, our system of finance was more fragile than earlier believed. The web of interdependency that was the hallmark of sophisticated trading meant that when a major firm such as Lehman Brothers went bankrupt, cascading impacts had powerful effects on an entire economy.1

While this is a useful catalog of many of the causes of the crash, I now believe it is more illuminating to distinguish proximate causes such as an ongoing economic emergency initially rooted in the housing and credit markets from ultimate causes, of which one, the misalignment between financial regulation and the new financial order, is by far the most important.

The financial history of much of the 20th and 21st centuries is a history of convergence. After a high point of atomization during the New Deal when finance effectively was separated into investment banking, commercial banking, and insurance firms with corresponding banking, securities, and insurance regulation, the past several decades have largely been characterized by the emergence of financial holding companies which operate in all or virtually all financial arenas.2


For a long time, one generalization was safe: public distributions in this country were generally underwritten by investment bankers. National banks, national bank holding companies, and their affiliated securities companies were prohibited from underwriting securities by sections 16 and 21 of the Glass-Steagall Act. Sec. Indus. Ass’n v. Bd. of Governors of the Fed. Reserve Sys., 468 U.S. 137, 140 (1984) (popularly known as the A. G. Becker case to distinguish it from a companion case with the identical case name). In the companion case, Sec. Indus. Ass’n v. Bd. of Governors of the Fed. Reserve Sys., 468 U.S. 207, 220 (1984) (popularly known as the Schwab case), the Court held that it was permissible for a bank holding company to acquire a non-banking affiliate engaged in securities brokerage activities.

Before the Glass-Steagall Act, commercial banks, trust companies, and their affiliated securities companies used to underwrite in large volume. See Franklin Escher, Investments, 78 BANKERS’ MAG. 1025 (1909); V. Carosso, Investment Banking in America: A History 368–75 (1970); Edwards & Scott, Regulating the Solvency of Depository Institutions: A Perspective for Deregulation, in Issues in Financial Regulation 65 (F. Edwards ed., 1979). But all companies engaged in the business of receiving deposits had to stop (except for government and municipal securities and a few other special types) with the divorcement of commercial and investment banking in the Glass-Steagall Banking Act of 1933.

Then, in 1999, sections 20 and 32 of the Glass-Steagall Act were repealed by the Gramm-Leach-Bliley Act, effectively ending the remaining barriers between commercial and investment banking. See generally Laurence H. Meyer, F. Hodge O’Neal Corporate and Se-
One measure of this convergence of the preeminence of bank ownership of securities firms was the 2008 collapse of the SEC Consolidated Supervised Entity (CSE) program which earlier oversaw the five largest investment banking holding companies (Bear Stearns, Goldman Sachs, JP Morgan, Merrill Lynch and Lehman Brothers). After the publicly acknowledged failure of the SEC’s CSE oversight³, the oversight of the enduring investment bank holding companies was transferred to the Federal Reserve Board.⁴ Similarly, today Merrill Lynch, one of the nation’s largest broker-dealers, for example, is owned by Bank of America.⁵

Financial regulation, however, remains largely atomized with separate federal and state banking agencies, federal and state securities regulation and state insurance commissions. The atomized regulatory structure has increasingly proven inadequate because of the rivalrous behavior of the regulators, inadequate information, misconceived objectives, and political obstacles. We have developed a financial regulatory system that often works well enough in routine circumstances, but is inadequate to deal with fast moving crises or to address wise policy formation to reduce the likelihood of systemic crisis. To put it simply, the problem with the United States’ approach to financial regulation is not that it tolerates firms too big to fail. The problem is that the regulatory structure is too divided to effectively regulate large firms.


The last six months have made it abundantly clear that voluntary regulation does not work. When Congress passed the Gramm-Leach-Bliley Act, it created a significant regulatory gap by failing to give to the SEC or any agency the authority to regulate large investment bank holding companies, like Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns.

As I have reported to the Congress multiple times in recent months, the CSE program was fundamentally flawed from the beginning, because investment banks could opt in or out of supervision voluntarily. The fact that investment bank holding companies could withdraw from this voluntary supervision at their discretion diminished the perceived mandate of the CSE program, and weakened its effectiveness.


⁴. See, e.g., Dafna Avraham, Patricia Selvaggi & James Vickery, A Structural View of U.S. Bank Holding Companies, 18 FED. RES. BNY ECON. POL’Y REV. 65 (July 2012).

⁵. See Bank of America 10-K (year ending 12-31-2013) at 71, available at http://www.sec.gov/Archives:
The Corporation’s principal U.S. broker/dealer subsidiaries are Merrill Lynch, Pierce, Fenner & Smith (MLPF&S) and Merrill Lynch Professional Clearing Corp. (MLPCC). MLPCC is a fully-guaranteed subsidiary of MLPF&S and provides clearing and settlement services.

The Act did attempt to address systemic economic risk by establishing the Financial Stability Oversight Council, which includes members from the Department of Treasury, the Federal Reserve Board, the Comptroller of the Currency, the newly created Bureau of Consumer Financial Protection, the SEC, the FDIC, the CFTC, the Federal Housing Funding Agency, and the National Credit Union Administration Board. The Act also grants the Council authority to require new capital, liquidity, and risk management standards for banks and nonbank financial companies.6


The emphasis in the Council’s duties is on monitoring and deterrence rather than crisis management, which statutorily is delegated to the Federal Reserve Board and Federal Deposit Insurance Corporation. Through the enactment and Conference Report process, many provisions in the Act were compromised in order to ensure passage. Section 112(a)(2)(L), for example, limits the Council’s role with respect to existing or proposed accounting principles, standards or procedures, to review and comment, rather than an approval or veto role.

Section 113(a)(1) authorizes the Council on a vote of no fewer than two-thirds of the voting members then serving, including an affirmative vote of the Chairperson, to require that a United States nonbank financial company be supervised by the Federal Reserve Board of Governors and subject to prudential standards as defined in section 115 if “the Council determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.”

Section 113(c) authorizes the Federal Reserve to supervise the financial activities of any company incorporated or organized in the United States or abroad when the Council on a two-thirds vote determines that the Company’s material financial distress of the company “would pose a threat to the financial stability of the United States.” Section 113(c)(1)(B) requires a determination that “the company is organized or operates in such a manner as to evade the application of this title.”

Section 119 addresses a different type of challenge in the pre-Dodd-Frank Act regulatory structure, by empowering the Council to make recommendations to resolve a dispute among two or more of its members, when:

(1) a member agency has a dispute with another member agency about the respective jurisdiction over a particular bank holding company, nonbank financial company, or financial activity or product (excluding matters for which another dispute mechanism specifically has been provided under title X);
(2) the Council determines that the disputing agencies cannot, after a demonstrated good faith effort, resolve the dispute without the intervention of the Council; and
(3) any of the member agencies involved in the dispute –
   (A) provides all other disputants prior notice of the intent to request dispute resolution by the Council; and
   (B) requests in writing, not earlier than 14 days after providing the notice described in subparagraph (A), that the Council seek to resolve the dispute.

Recommendations under section 119(c)(3) require an affirmative vote of two-thirds of the voting members of the Council then serving, but are not binding “on the Federal agencies that are parties to the dispute.”
The Dodd-Frank Act addressed what were perceived to be critical gaps or omissions in financial regulation by extending SEC jurisdiction to investment advisers, to hedge funds, and to other private equity fund advisers, authorizing the CFTC and SEC to regulate OTC derivatives, and enhancing SEC authority to regulate credit rating agencies. The enactment of the Dodd-Frank Act ushered in a new period in U.S. financial regulation in which the regulatory departments and agencies are less independent of each other, the White House, and Congress. By emphasizing financial stability and risk reduction as paramount goals, the Dodd-Frank Act stressed the need for regulatory coordination, elimination of some gaps and omissions, and regulatory tools to optimize early warning and prompt responses to a burgeoning crisis.

But the new approach to financial regulation built on the structure of the old financial regulatory agencies. The Dodd-Frank Act strengthens the SEC, the CFTC, the Department of the Treasury, the Office of the Comptroller of the Currency, the FDIC, and especially the Federal Reserve System.

Indeed, much of the lengthy text of the Act appears to have been written by these agencies’ or department’s staffs. Only one agency—the late unlaunted Office of Thrift Supervision—was abolished. Only one new agency—the Bureau of Consumer Financial Protection—was established.

The Dodd-Frank Act did not go far enough either to provide an effective structure to reduce as much as is reasonably possible the probability of the next catastrophic financial failure nor did the Act fully develop policies that will effectively address systemic risk.

What should be done? Underlying the limits of Dodd-Frank is the tension between an idea of a single coordinating agency such as Japan’s Ministry of Finance, which in the United States’ case would directly report to the President, and the more customized set of agencies currently extant in the United States, some of whom, such as the Securities and Exchange Commission, are designed at least to be in theory politically independent.

The Financial Stability Oversight Council is an awkward and to date largely toothless coordinator. The fact that its response to the August

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2012 failure of the Commission to adopt new money market rules was a set of “proposed recommendations” in November 2012 is a measure of its weakness.11

There is a wiser way to address the tension between the command-and-control and atomized models suggested by Constitutional law. We have one written Constitution of the United States, but operate under U.S. Supreme Court precedent as if we have two. During war time, the Constitution has consistently been interpreted differently than during peace time.12 As Justice Holmes memorably wrote in Schenck v. United States: “When a nation is at war many things that might be said in time of peace are such a hindrance to its effort that their utterance will not be endured so long as men fight and no Court would regard them as protected by any constitutional right.”13

As a practical matter, we have followed a similar approach with respect to financial emergencies. Under the formal rules, if an emergency is dire enough, the White House, the Department of Treasury, and the Federal Reserve largely take over. If appropriations are necessary, Congress also is involved, typically through an accelerated process.14

Our economy would be most wisely regulated through a hybrid system. During financial emergencies and with respect to designated rules designed to reduce systemic risk, a small decisional body chaired by the Secretary of the Treasury should have the power of rule and policy adoption. This unequivocally would reduce agency independence but essentially only during or to prevent financial emergency.

In other circumstances, the atomized current structure largely would be retained. However, even during nonemergency circumstances, it would be wise to simplify regulatory oversight in three ways.

First, the dysfunction of a rivalrous SEC, Commodities Futures Trading Commission (CTFC), and multiple federal banking agencies should be simplified. The SEC and CFTC should be combined. The Federal Reserve banking regulator, Comptroller of the Currency, and Federal Deposit Insurance Corporation also should be consolidated.

Second, insurance regulation should be modernized by adopting a concurrent federal-state regulatory model today similar to that employed in


In a crisis the Federal Reserve Board and the FDIC become the operational executors of the Dodd-Frank Act’s provisions to reduce systemic risk.

Upon an affirmative vote of two-thirds of the voting members of the Council then serving, section 121 of the Dodd-Frank Act authorizes the Federal Reserve Board to take actions to mitigate risks posed by a covered bank holding company or nonbank financial company when such a company “poses a grave threat to the financial stability of the United States.”
the banking and securities industries. A Federal Insurance Commission should address interstate life, property, and other forms of insurance; intrastate regulation should remain with state commissions.

Third, as much as possible, new enabling legislation should establish common regulatory standards applicable to all competitive, covered financial firms. The most effective provision of Dodd-Frank created enhanced prudential standards, applicable to nonbank financial companies and large interconnected bank holding companies. A combination of the passage of time, which strengthened the ability of regulated firms to resist stating new standards, and the increased exactitude of judicial review have diminished the likelihood that regulatory agencies can effectively adopt new standards concerning other consequential topics, such as the Volcker Rule.

Will this type of approach ever occur? The conventional wisdom today is that political considerations make any approach like this improbable. This is, of course, correct under current circumstances. But someday there may be yet another financial meltdown and the misalignment of the current system of the financial regulator to the new financial order will be writ large. I hope that day never comes. But if it does, I hope we more effectively address the structure of our financial system than we have to date.

15. Section 115 authorizes the Council “in order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, failure, or ongoing activities of large, interconnected financial institutions,” to make recommendations to the Federal Reserve “concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to nonbank financial companies . . . and large, interconnected bank holding companies.” These recommendations may be more stringent than those that do not present similar risks. Enhanced prudential standards are a pivotal risk reduction technique in the Dodd-Frank Act. Section 115(b) provides:

   The recommendations of the Council . . . may include --

   (A) risk-based capital requirements;
   (B) leverage limits;
   (C) liquidity requirements;
   (D) resolution plan and credit exposure report requirements;
   (E) concentration limits;
   (F) a contingent capital requirement;
   (G) enhanced public disclosures;
   (H) short-term debt limits; and
   (I) overall risk management requirements.” Dodd-Frank Act, supra note 6, § 115.

Significantly, section 165(j) directs the Federal Reserve to require each covered bank holding company or each supervised nonbank financial company to maintain a debt to equity ratio of no more than 15 to 1, but the Federal Reserve Board only is required to do so, “upon a determination by the Council that such company poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States. . . .” Id. § 165(j).


17. The Volcker Act prohibits specified financial institutions from proprietary trading and sponsoring or investing in hedge funds and private equity funds. Avraham et al., supra note 4.