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## **Is the Public Utility Holding Company Act a Model for Breaking up the Banks That are Too-Big-To-Fail**

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## Articles

# Is the Public Utility Holding Company Act a Model for Breaking Up the Banks That Are Too-Big-to-Fail?

ROBERTA S. KARMEL\*

*During the financial crisis of 2007–08 and the debates on regulatory reform that followed, there was general agreement that the “too-big-to-fail” principle creates unacceptable moral hazard. Policy makers divided, however, on the solutions to this problem. Some argued that the banking behemoths in the United States should be broken up. Others argued that dismantling the big banks would be bad policy because these banks would not be able to compete with universal banks in the global capital markets, and in any event, breaking up the banks would be impossible as a practical matter. Therefore, better regulation was the right solution. This approach was generally followed in the financial reform legislation that was passed.*

*In the past, the United States has taken a variety of approaches to reining in banks. These include capital constraints, geographical restrictions, activities restrictions and conflict of interest restrictions. The primary techniques for reining in big banks recently enacted by Congress were increasing capital requirements, walling off proprietary trading and/or derivatives trading from commercial banking, and creating a resolution regime for failed financial institutions.*

*One approach that has not been tried or even seriously discussed with regard to the big banks is the approach that was used to break up the utility pyramids created during the 1920s, that is the antitrust approach utilized in the Public Utility Holding Company Act of 1935. This targeted and highly effective regulatory framework empowered the Securities and Exchange Commission to dismantle and simplify the corporate structures of the utilities without destroying them. This Article argues that this approach should be considered as a solution to the too-big-to-fail problem since it combines deconcentration, capital limits, activities restrictions and conflict of interest restrictions as an alternative to antitrust regulation, outside of adversarial prosecutorial case development.*

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## INTRODUCTION

During the financial crisis of 2007–08 and the debates on regulatory reform that followed, there was general agreement that the “too-big-to-fail” principle creates unacceptable moral hazard. This principle is based on the belief that “certain institutions are so large or so complex that the government will intervene and prevent their failure by protecting uninsured creditors from their losses due to the perceived systemic risk presented by the organization’s failure.”<sup>1</sup> Policymakers divided, however, on the solution to this problem. Some argued that the banking behemoths in the United States should be broken up. Others argued that dismantling the big banks would be bad policy, because these banks would not be able to compete with universal banks in the global capital markets, and in any event, breaking up the banks would be impossible as a practical matter. Instead, better regulation was the right solution.<sup>2</sup> The key policymakers in the Obama administration believed in better regulation rather than in breaking up the banks. Therefore, an improved

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1. Yomarie Silva, *The “Too Big to Fail” Doctrine and the Credit Crisis*, 28 REV. BANKING & FIN. L. 1, 115–16 (2009).

2. David Wessel, *The “Too Big” Divide on Banks*, WALL ST. J., June 10, 2010, at A2.

regulatory approach was generally followed in the Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") passed by Congress.<sup>3</sup> Yet, voices in favor of a return to the wall between commercial and investment banking of the Glass-Steagall Act of 1933 ("Glass-Steagall"),<sup>4</sup> or using some other technique for curtailing risky bank activities, continue to be heard and studied. Thus, further inquiry concerning the question of whether the big financial institutions should be curtailed remains relevant.

Financial intermediation transforms savings into investments, prices and adds liquidity to those investments, and spreads financial risk. At one time, financial institutions engaged in these tasks were segmented. Commercial banks accepted deposits, both demand and time, and made commercial and personal loans and acted as underwriters of U.S. government and municipal debt. They also engaged in a variety of permitted ancillary services, such as estate and trust services and the advising of trust accounts, acceptances and letters of credit, and management of the payments system.<sup>5</sup> Savings and loan associations ("S&Ls") or thrifts accepted savings deposits and were engaged in extending mortgage loans.<sup>6</sup> Broker-dealers and investment banks acted as underwriters for corporate and municipal issuers, advised customers on securities purchases, mergers and acquisitions and other transactions, and acted as agents and dealers in securities.<sup>7</sup> There were no financial futures or dealing in derivatives until 1975;<sup>8</sup> commodities trading was

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3. Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank].

4. Ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C. (2006)), *repealed in part* by Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

5. Commercial banks have continuously engaged in these kinds of activities, as well as some securities activities, depending on the legislative and economic climate at the time. *See* Thomas G. Fischer et al., *The Securities Activities of Commercial Banks: A Legal and Economic Analysis*, 51 TENN. L. REV. 467, 468-69 (1984). As Congress eased restrictions on commercial banks, it sought to allow commercial banks to operate on an even footing with investment banks, particularly with regard to underwriting activities. Christian A. Johnson, *Holding Credit Hostage for Underwriting Ransom: Rethinking Bank Antitying Rules*, 64 U. PITT. L. REV. 157, 159-60, 167-69 (2002); *see also* United States v. Phila. Nat'l Bank, 374 U.S. 321, 326-27 n.5 (1963) (noting the principal banking products for commercial banks).

6. *See* JAMES RING ADAMS, *THE BIG FIX: INSIDE THE S&L SCANDAL* 21-22 (Karl Weber ed., 1990); *see also* Sharon E. Foster, *Too Big to Fail—Too Small to Compete: Systematic Risk Should Be Addressed Through Antitrust Law but Such a Solution Will Only Work If It Is Applied on an International Basis*, 22 FLA. J. INT'L L. 31, 36-38 (2010). The restrictions on S&Ls were lifted by Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-73, § 208, 103 Stat. 193, 211 (1989) (codified as amended at 12 U.S.C. § 1821 (2006)).

7. *See* SAMUEL L. HAYES III & PHILIP M. HUBBARD, *INVESTMENT BANKING: THE TALE OF THREE CITIES* 68-69, 98-112 (1990).

8. DEP'T OF THE TREASURY, *THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE* 46 (2008) [hereinafter BLUEPRINT] ("In 1975, the [Commodity Futures Trading Commission], with its new authority over futures markets, approved the first futures contracts on financial assets, including the Chicago Board of Trade's futures contract on Government National Mortgage Association certificates, and the Chicago Mercantile Exchange's futures contract

confined to agricultural futures traded on exchanges.<sup>9</sup> Investment management was a shared activity among insurance companies, mutual funds, and individually advised clients.

Because financial intermediation was reasonably separated, and because the United States regulated banking, securities issuances, and insurance on a state level before federal regulation of financial firms came into existence, the United States developed functional regulation of financial institutions and products. Functional regulation led to the creation of numerous financial regulators, each with a stake in maintaining such regulation.<sup>10</sup> Regulated industries also had a stake in functional regulation.<sup>11</sup>

This regulatory system was challenged by a number of economic and technological developments, starting in the 1960s, accelerating in the 1980s, and coming to a crashing conclusion in the first decade of the twenty-first century. Because President Nixon did not want to devalue the dollar during the first oil shock, fixed exchange rates were abandoned for a floating exchange rate system.<sup>12</sup> Nevertheless, inflation inevitably eroded the value of the dollar and also the fixed interest rate ceilings that had supported the profitability of commercial banking.<sup>13</sup> The invention

on 90-day U.S. Treasury bills.”).

9. See BLUEPRINT, *supra* note 8, at 11.

10. The United States has had a system of functional regulation with numerous federal and state regulators for financial organizations, whereas other countries have a single regulator of twin- or three-peaks regulation. *See id.* at 139–44. The head of the trade group for the securities industry urged a three-peaks solution to the U.S. regulatory order when financial reform was under consideration in 2008. *See Regulatory Restructuring and Reform of the Financial System: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 51–54 (2008) (statement of T. Timothy Ryan, Jr., President & Chief Exec. Officer of the Sec. Indus. & Fin. Mkts. Ass’n).

11. The theory that regulatory competition resulted in regulatory efficiency justified the deregulation that prevailed from 1980 to 2008. *See, e.g.*, Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2385, 2394 (1998); Shelley Thompson, *The Globalization of Securities Markets: Effects on Investor Protection*, 41 INT’L LAW. 1121, 1123 (2007). Some scholars demurred. *See, e.g.*, Robert A. Prentice, *Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred*, 66 OHIO ST. L.J. 1155, 1156–57 (2005). This theory was one of the factors that enabled regulatory industries to capture the congressional committees that had oversight over the federal financial agencies, not only through the mechanism of campaign contributions, but ideologically. *See* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 92–97 (2010).

12. Deficits due to the Vietnam War as well as the rising power of OPEC contributed to a dollar devaluation and currency instabilities. *See* HENRY KAUFMAN, INTEREST RATES, THE MARKETS, AND THE NEW FINANCIAL WORLD 87–88, 93–94, 189 (1986). During the 1970s and early 1980s, a number of large corporate and bank failures threatened the financial system and should have served as an early warning of problems within the U.S. and international financial regulatory systems. *See id.* at 5, 94. Bailouts of Chrysler and Continental Illinois Bank (“Continental Illinois”) led to the too-big-to-fail doctrine. *See infra* notes 100–02 and accompanying text.

13. Until 1980, the rate of interest that depository institutions could pay on deposits was fixed. Beginning in 1980, interest rate limitations were eliminated, and by 1986, they were completely removed. *See* 12 U.S.C. § 3501–09 (Supp. V 1980), *repealed by* Depository Institutions Deregulation Act of 1980, Pub. L. 96-221, 94 Stat. 142. The connection between interest rate deregulation and

and growth of financial derivatives was one reaction to the unfixing of exchange rates. The instability injected into the financial system transformed financial intermediation from a business that turned savings into investments and then packaged those investments into loans and liquid securities, to a business that priced and traded risks. A tremendous growth in the amount of savings under private management led to the divorce of savers from investment decisionmaking<sup>14</sup> and gave institutional investors great power over investment banks and securities exchanges. This power, coupled with technological advances, led to the unfixing of stock exchange commission rates that had supported the profitability of securities firms. Financial intermediaries profit from inefficiencies and anomalies in the process of intermediation. Computerization of financial services greatly reduced the costs of intermediation, with respect to banking and investment banking services and securities trading, and banks and securities firms were no longer protected by government-sanctioned price fixing for their services.

Changes in the American and global economies also threatened the U.S. financial regulatory model. Although the dollar remained the reserve currency, it began to be challenged by the Euro and other currencies. Also, commodity prices, especially oil and real estate, became significant measures of valuation. The U.S. budget and trade deficits and a floating rate currency regime injected risks into the financial system that contributed to the growth and further development of financial futures. By the late 1980s, derivatives had become the pricing mechanism for securities trading. This became apparent at the time of the stock market crash of 1987.<sup>15</sup> The dominance of derivatives injected further leverage and speculation into the capital markets, completely undermining the margin rules passed in the 1930s to limit leverage and speculation in the securities markets.<sup>16</sup> It also became apparent that in view of the changes in financial intermediation, old fashioned banking, investment banking, and securities trading were no longer viable. Further, the United States was overbanked. Thousands of banks and securities firms failed due to the combination of global competition, the financial firms' inability to compete in the changed world of competitive

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further bank deregulation is drawn in *Taking Account: Banking Deregulation Benefits Many People but Stirs Some Worry*, WALL ST. J., Sept. 30, 1985, at 1.

14. See Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561, 564-65 (1981) (reviewing TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS* (1980) and HARVEY E. BINES, *THE LAW OF INVESTMENT MANAGEMENT* (1978)).

15. See PRESIDENTIAL TASK FORCE ON MKT. MECHANISMS, REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS, at vi (1988); see also DIV. OF MKT. REGULATION, SEC. EXCH. COMM'N, *THE OCTOBER 1987 MARKET BREAK*, at 3-6 to 3-9 (1988) [hereinafter 1987 MARKET BREAK].

16. See Roberta S. Karimel, *The Future of the Securities and Exchange Commission as a Market Regulator*, 78 U. CIN. L. REV. 501, 516-17 (2009).

interest and commission rates, and the efficiencies wrought by computerization of financial intermediation and global competition. Because of the existence of deposit insurance and the need to protect the deposit insurance fund of the Federal Deposit Insurance Corporation ("FDIC"),<sup>17</sup> regulators were incentivized to prevent financial institutions' failures. As a result, the too-big-to-fail doctrine developed in the 1980s: Mega-banks and financial supermarkets came into existence, because apparently sound institutions were willing to acquire failing institutions, especially if they could thus avoid regulatory restrictions.<sup>18</sup> Banks pushed to get into securities trading and investment banking, and securities firms pushed to get into banking. Their regulators, Congress and the courts, all participated in dismantling the regulatory system that had held these businesses in separate compartments, but did not put any new regulatory system in place. Dodd-Frank also does not put any new regulatory system in place, but rather attempts to modify and reform the existing system. Moreover, this legislation gives expanded authority to the same regulators who failed to prevent the crisis of 2008. Furthermore, these regulators are now confronted by financial institutions that are behemoths and are extremely difficult to regulate or even to understand. Yet, they exert great economic and political power.

In the past, the United States has taken a variety of approaches to reining in banks. These include capital constraints, geographical restrictions, activities restrictions, and conflict of interest restrictions.<sup>19</sup> None of these restrictions were able to withstand the end of the Bretton Woods Agreement, the unfixing of interest rate restrictions for banks and stock exchange fixed commissions, the invention of financial futures, the globalization of the capital markets, and perhaps most importantly, computerization of financial information. Furthermore, as Congress engaged in the deregulation of banking, from approximately 1980 to

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17. Federal deposit insurance was created in 1933 as a result of the numerous bank failures after the 1929 stock market crash. See Federal Deposit Insurance Corporation Act, ch. 89, sec. 8, § 12B, 48 Stat. 168 (1933) (codified as amended at 12 U.S.C. § 263 (2006)).

18. When there was a run on Continental Illinois after the failure of Penn Square Bank ("Penn Square") because Continental Illinois had purchased \$1 billion in oil and gas exploration loans from Penn Square, the FDIC committed \$4.5 billion from its insurance fund, and the Fed agreed to lend the bank an additional \$3.6 billion. Laurie S. Goodman & Sherrill Shaffer, *The Economics of Deposit Insurance: A Critical Evaluation of Proposed Reforms*, 2 YALE J. ON REG. 145, 151 n.31 (1984). The FDIC was unable to find a merger partner, and so it announced it would purchase problem loans from the bank. *Id.* The FDIC then made a finding of "essentiality" and provided a \$2 billion subordinated loan to the bank, becoming an 80% owner. Tim Carrington, *U.S. Won't Let 11 Biggest Banks in Nation Fail—Testimony by Comptroller at House Hearing Is First Policy Acknowledgment*, WALL ST. J., Sept. 20, 1984, at 2. New managers and directors were then appointed. *Id.* In connection with these events, the Comptroller of the Currency told Congress that the federal government would not "allow any of the nation's 11 largest banks to fail." *Id.* Committee members retorted that he had created a new category of bank—the too-big-to-fail bank. *Id.*

19. See *infra* Part I.

1999, culminating in the Gramm-Leach-Bliley Act (“Gramm-Leach-Bliley”),<sup>20</sup> it did not create a new regulatory regime for banking, investment banking, and securities and commodities trading.<sup>21</sup> Additionally, due to Dodd-Frank, functional regulation remains, enabling different agencies with different approaches to continue regulating financial institutions and markets. The largest financial institutions have grown even larger than before, increasing the risks and costs of their failure. While some in Congress believe they have outlawed too-big-to-fail, the size and connectivity of the largest financial institutions probably make this a vain hope.

The primary techniques for reining in big banks considered by Congress or financial regulators in current regulatory reform efforts include increasing capital requirements,<sup>22</sup> taxing financial transactions,<sup>23</sup> and walling off proprietary trading and/or derivatives trading from commercial banking.<sup>24</sup> In addition, the Dodd-Frank legislation puts into place a resolution regime for failed financial institutions.<sup>25</sup> Increased capital requirements will undoubtedly be imposed, not only in the United States, but globally.<sup>26</sup> Some activities restrictions may also survive as regulatory options, but derivatives trading is being dealt with primarily through increased regulation by the Commodity Futures Trading Commission (“CFTC”), and the extent to which this new regulation will dampen derivatives trading is uncertain.

One approach that has not been tried or even seriously discussed with regard to the big banks is the approach that was used to break up the utility pyramids created during the 1920s: that is, the antitrust approach utilized in the Public Utility Holding Company Act of 1935 (“PUHCA”).<sup>27</sup> This targeted and highly effective regulatory framework empowered the Securities and Exchange Commission (SEC) to dismantle and simplify the corporate structures of the utilities without destroying them. This program was so successful that even after it was essentially completed, the statute and SEC regulation of utilities remained on the books until quite recently. This Article will argue that this approach

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20. Also known as the Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 & 15 U.S.C.).

21. See *infra* Part II.

22. See Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

23. This idea collapsed before it was even fully developed. See Francesco Guerrera et al., *A Line Is Drawn*, FIN. TIMES, July 1, 2010, at 9.

24. See *infra* notes 88–89 and accompanying text.

25. Tit. VII, 124 Stat. at 1641–1802.

26. See Damian Paletta & David Enrich, *Banks Get New Restraints Historic: Refashioning of Rules Aims to Trim Risk-Taking, Limit Future Crises*, WALL ST. J., Sept. 13, 2010, at A1; see also Declaration, G-20, Toronto Summit 16 (June 26–27, 2010), available at [www.g20.org/Documents/g-20\\_declaration\\_en.pdf](http://www.g20.org/Documents/g-20_declaration_en.pdf).

27. Ch. 687, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. § 79 to 79(z)-6 (2000)), repealed by Energy Policy Act of 2005, 42 U.S.C. §§ 16451–16463 (2005).



should be considered as a solution to the too-big-to-fail policy, because it combines deconcentration, capital limits, activities restrictions, and conflict of interest restrictions as an alternative to antitrust regulation, outside of adversarial prosecutorial case development. Although some antitrust actions aimed at breaking up monopoly power have succeeded in restructuring an industry,<sup>28</sup> other actions have failed,<sup>29</sup> and the Department of Justice has not been especially successful in prosecuting cases against the banking and securities industries.<sup>30</sup>

Part I of this Article will summarize the demise of geographical and activities restrictions on U.S. banks that culminated in the enactment of Gramm-Leach-Bliley in 1999. This Part will also explain why a return to Glass-Steagall is a nice idea but impractical if not impossible. Among other reasons, securitization has turned all commercial banks into securities firms, and the largest investment banks have become bank holding companies. Part II will set forth how deregulation of banking, against the backdrop of the continuing failure of banks and thrifts, contributed to the growth of large financial supermarkets. Part III will explore the extent to which the PUHCA is a possible model for dealing with the excesses of the mega-financial institutions. The Article will then conclude.

In a global capital market economy, the United States is not as free as it once was to go its own way in financial regulation. Not only are U.S. banks in competition with European, Asian, and other banks, but the United States is a key member of the G-20 and other organizations that are creating new paradigms for financial regulation in response to the financial crisis. Therefore, the views, laws, and policies of other key jurisdictions will affect the path of U.S. financial regulation and regulatory reform. Nevertheless, the United States has a different history and tradition with regard to bank regulation than many other countries. The First Bank of the United States, the first federal central bank, was controversial and was destroyed by Andrew Jackson,<sup>31</sup> not to be resurrected until 1913.<sup>32</sup> Banks have long been demonized by populists, and politicians have opted for weak banks and cheap money during

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28. See e.g., *United States v. W. Elec. Co.*, 1982-2 Trade Cas. ¶ 64,900 (D.D.C. Aug. 24, 1982) (consent decree ending ongoing AT&T antitrust litigation). For an additional discussion, see Thomas E. Kauper, *Notable Antitrust Cases: The AT&T Case: A Personal View*, 5 COMPETITION POL'Y INT'L 253 (2009).

29. Nathan Koppel, *Justice Department Launches Antitrust Investigation of IBM*, WSJ LAW BLOG (Oct. 8, 2009, 11:30 AM), <http://blogs.wsj.com/law/2009/10/08/justice-department-launches-antitrust-investigation-of-ibm/>.

30. See *supra* note 29 and accompanying text; *infra* note 143 and accompanying text.

31. See JOHNSON & KWAK, *supra* note 11, at 19-22.

32. Federal Reserve Act, ch. 6, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. §§ 221-522 (2006)).

many periods of American history.<sup>33</sup> The Federal Reserve Board (“Fed”) has been tarnished by its failure to prevent the financial meltdown of 2008, and while it has maintained and even increased its powers in the 2010 financial reform, it is probably less independent than before. Therefore, although the United States is not the economic hegemon it was after World War II, and although the global regulators may choose to do so, Americans may not decide to embrace an all-powerful central bank regulator and a corresponding oligopoly of money center banks.

## I. THE REGULATION AND DEREGULATION OF BANKING: 1933–1999

Between 1933 and 1999, banks were subject to geographical and activities restrictions that were gradually eroded by regulatory fiat and Congressional action and inaction. By the end of the twentieth century, U.S. banks were allowed to operate as universal banks. Dodd-Frank did not reverse this development.

### A. GEOGRAPHICAL RESTRICTIONS

Some of the important restrictions on banks designed to prevent excessive concentration of financial power were the prohibitions against branching interstate and intrastate. These restrictions were based on a desire to control banks on a community level, to have and encourage close relationships between bankers and borrowers within those communities, and to avoid centralized financial power.<sup>34</sup> These restrictions were also utilized to limit competition.<sup>35</sup> When the federal banking system was established in 1864, the National Bank Act allowed banks to be either chartered as a state or as a national bank, but national banks were not permitted to branch.<sup>36</sup> Then, in the 1900s, states began granting branching powers to state-chartered banks, giving state banks a competitive edge over national banks. In 1927, Congress authorized national banks to open a limited number of branches in local communities if the law of that state permitted state-chartered banks to do so, and by way of a 1933 amendment, provided national banks with full equality to branch throughout their home states to the same extent the states permitted their own banks to branch.<sup>37</sup> The effect of this

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33. See generally MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994).

34. Patrick Mulloy & Cynthia Lasker, *The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Responding to Global Competition*, 21 J. LEGIS. 255, 255–56 (1995).

35. See George Melloan, *The Efficiency Argument for Banking Reform*, WALL ST. J., Dec. 29, 1987, at 15.

36. See National Bank Act, ch. 106, 13 Stat. 99 (1864); see also *First Nat’l Bank in St. Louis v. Missouri*, 263 U.S. 640, 648–49 (1924).

37. McFadden Act, ch. 191, § 7, 44 Stat. 1224, 1228 (1927) (codified as amended at 12 U.S.C. § 36 (2006)); Mulloy & Lasker, *supra* note 34, at 257.

deference to state regulators was to prevent out-of-state banks from opening branches, with the result that weak banks were propped up and the country became over-banked.<sup>38</sup> Some states also prevented branching intrastate. For example, a provision to this effect was in the Illinois Constitution from 1870 to 1993, preventing the Chicago money center banks from branching into city, suburban, and downstate neighborhoods.<sup>39</sup>

In the 1940s and 1950s, banks formed bank holding companies as a device to circumvent the restrictions on interstate and intrastate branching. The holding company structure allowed a bank to effectively create a branch in different states or communities even though branching was not allowed.<sup>40</sup> The Douglas Amendment to the Bank Holding Company Act of 1956<sup>41</sup> partially closed this end-run around geographic restrictions by prohibiting a bank holding company from acquiring an interstate bank unless there was explicit statutory authorization by the state where the bank to be acquired was located.<sup>42</sup>

In the 1970s, American banks complained that foreign banks operating in the United States had a competitive advantage, because they were not restricted by the McFadden Act<sup>43</sup> and therefore could establish interstate branches easily.<sup>44</sup> In response, Congress passed the International Banking Act of 1978, restricting foreign bank branching in the United States, and also establishing federal rules to govern those foreign bank operations.<sup>45</sup> After Ronald Reagan became President, the Department of the Treasury issued a report to Congress criticizing the McFadden Act as “ineffective, inequitable, inefficient and anachronistic.”<sup>46</sup>

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38. See Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 234 (2000).

39. *Illinois Bank Branching History*, ILL. DEP'T OF FIN. AND PROF'L REGULATION, <http://www.obre.state.il.us/cbt/STATS/br-hist.htm> (last visited Mar. 31, 2011). For a brief discussion of how the constraints on branching in Illinois may have led to the collapse of Continental Illinois, see Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501, 507–08 n.24 (1989); Goodman & Shaffer, *supra* note 18, at 151 n.33; Joseph Silvia, *Efficiency and Effectiveness in Securities Regulation: Comparative Analysis of the United States's Competitive Regulatory Structure and the United Kingdom's Single-Regulator Model*, 6 DEPAUL BUS. & COM. L.J. 247, 260–61 (2008).

40. Mulloy & Lasker, *supra* note 34, at 257.

41. Ch. 240, sec. 3(d), 70 Stat. 133, 135 (1956) (codified as amended at 12 U.S.C. § 1842(d) (1994)), *repealed in part by* Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified as amended at 12 U.S.C. § 1942(d) (2006)).

42. Mulloy & Lasker, *supra* note 34, at 258. As some states recognized the benefits holding companies offered in terms of attracting new investment capital to their states, this restriction slowly eroded, but in some cases was limited by reciprocity requirements. *Id.*

43. Ch. 191, 44 Stat. 1224 (1927) (codified as amended in scattered sections of 12 U.S.C. (2006)).

44. Mulloy & Lasker, *supra* note 34, at 259.

45. Pub. L. 95-369, 92 Stat. 607 (codified as amended at 12 U.S.C. §§ 3101–3111 (2006)).

46. DEP'T OF THE TREASURY, *GEOGRAPHIC RESTRICTIONS ON COMMERCIAL BANKING IN THE UNITED STATES: THE REPORT OF THE PRESIDENT* 17 (1981).

Although Congress did not respond to this criticism for another decade, the banking industry was able to persuade some states to move to regional compacts permitting interstate branching. Such compacts were upheld by the Supreme Court on the ground that the legislative history of the Douglas Amendment contemplated that some states might partially lift the ban on interstate banking but not open up to banking from all states.<sup>47</sup> In addition, banks began to introduce automated teller machines (“ATMs”) as a way to expand their operations. At first, some courts held that ATMs were branches, but when the Comptroller of the Currency ruled that shared ATMs were not subject to the McFadden Act’s branching limitations, ATMs spread across the country.<sup>48</sup>

In the early 1990s, Congress finally ended branching restrictions by passing the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (“Riegle-Neal”).<sup>49</sup> A number of reasons were given for the statute, including a concern that the geographic banking restrictions hindered the competitiveness of the U.S. banking industry, the view that interstate branching would promote diversification of bank assets and loan portfolios, and greater customer convenience and choice.<sup>50</sup> The Act allowed bank holding companies to acquire separate banks in multiple states as long as the Fed found the holding company adequately capitalized and managed.<sup>51</sup> Riegle-Neal also authorized the Comptroller of the Currency to approve the establishment and operation of interstate national bank branches,<sup>52</sup> and the FDIC to approve interstate branches of insured state nonmember banks.<sup>53</sup>

The geographic restrictions on banking did prevent concentration of banking in the United States, and, in fact, resulted in the opposite problem—too many uncompetitive banks that failed when they were forced by economic and technological developments and deregulation to compete with bigger and better capitalized banking and other financial institutions. Furthermore, with the advent of the Internet and national

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47. *Ne. Bancorp., Inc. v. Bd. of Governors of the Fed. Reserve Sys.*, 472 U.S. 159, 168–69, 172 (1985).

48. Markham, *supra* note 38, at 249 nn.181–82. Nevertheless, the Comptroller’s ruling was challenged in a case in the D.C. Circuit that held that ATMs were branches within the meaning of the National Bank Act. *Indep. Bankers Ass’n of Am. v. Smith*, 534 F.2d 921, 930 (D.C. Cir. 1976), *cert. denied*, 429 U.S. 862 (1976). The Comptroller was then forced to reverse his position that ATMs were not branches. *See* Customer Bank Communication Terminals, 41 Fed. Reg. 48,333 (Nov. 3, 1976). This did not stop the spread of ATMs. About 50,000 ATMs were operating in the United States in 1983, and by 1996, there were 120,000. Markham, *supra* note 38, at 249 & n.182.

49. Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified as amended in scattered sections and titles of U.S.C. (2006)).

50. Mulloy & Lasker, *supra* note 34, at 266–67, 269.

51. Stacey Stritzel, *The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Progress Toward a New Era in Financial Services Regulation*, 46 SYRACUSE L. REV. 161, 174–79 (1995).

52. 12 U.S.C. § 36(c) (2006).

53. *Id.* § 1828(d)(4).

connectivity via new technologies, it would be wholly unrealistic to attempt to contain the size of banks and other financial institutions through geographical limitations.

#### B. ACTIVITIES AND CONFLICT OF INTEREST RESTRICTIONS

Banks traditionally performed three functions of value to the economy. They accepted deposits for savings and trust funds, and also for liquid assets; they acted as payments intermediaries for both consumers and businesses; and, they channeled deposits into the credit markets to meet the needs of businesses and consumers.<sup>54</sup> Because of the importance of maintaining depositor confidence in banks, banks have enjoyed special governmental privileges, including federal deposit insurance since 1933, and they have also been subject to regulation. Among other things, Congress has endeavored to minimize the exposure of banks to risk, to prevent major commercial banks from concentrating financial power, and to prevent banks from becoming entangled in conflicts of interest.<sup>55</sup> The thrust of federal bank regulation has been aimed at maintaining the safety and soundness of banks through capital controls, activities restrictions, and conflict of interest prohibitions. Activities restrictions and conflict of interest prohibitions are closely related. When banks engage in activities that involve conflicts of interest, they undermine their safety and soundness. Likewise, if banks engage in lines of business that are unnecessary to effective banking, they undertake needless risks.<sup>56</sup>

Therefore, only regulators determined banks' ability to engage in activities incidental to banking. S&Ls were more circumscribed than banks, but when Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980, which phased out interest rate caps on commercial banks and S&Ls,<sup>57</sup> it also deregulated the activities restrictions on S&Ls so that they could generally compete with commercial banks and also invest up to 20% of their assets in commercial real estate loans.<sup>58</sup> Further, they were allowed to sell their mortgage loans and use the proceeds to seek better returns.<sup>59</sup> This

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54. Vincent Di Lorenzo, *Public Confidence and the Banking System: The Policy Basis for Continued Separation of Commercial and Investment Banking*, 35 AM. U. L. REV. 647, 653-54 (1986).

55. Note, *National Banks and the Brokerage Business: The Comptroller's New Reading of the Glass-Steagall Act*, 69 VA. L. REV. 1303, 1335 (1983).

56. *Id.* at 1336-37.

57. Pub. L. No. 96-221, § 401(c)(2)(A), 94 Stat. 142 (codified as amended in scattered sections of 12 U.S.C. (2006)).

58. *Id.*

59. *Id.* § 401(c)(1)(B) (codified as amended at 12 U.S.C. § 1464(c)(2)(A) (2006)). Removing the cap on interest that S&Ls could pay depositors, but taking no action to change the fixed long-term mortgage rates—generally capped by state usury laws that were much less than the rate of inflation—was a recipe for widespread bankruptcies by S&Ls. Trying to fix this problem by allowing S&Ls to

deregulation led to the failure of numerous S&Ls. Commercial bank and S&L failures between 1980 and 1994 were somewhere between 1300 and 1600.<sup>60</sup> The taxpayer bailout of these failed institutions may have cost as much as \$300 billion.<sup>61</sup>

The most important activities and conflict of interest restrictions for purposes of this Article were those in Glass-Steagall, which was passed in 1933 as an important part of the New Deal effort to restore public confidence in the country's financial system.<sup>62</sup> It was linked with the passage of the Federal Deposit Insurance Act, which provided federal insurance for retail bank accounts.<sup>63</sup> Glass-Steagall was passed to prevent banks from exploiting conflicts of interest in certain activities, specifically: making loans to corporations for which the bank or its affiliates had underwritten securities, selling securities to trust accounts, and giving investment advice to bank managed accounts.<sup>64</sup>

This legislation had two types of provisions separating investment and commercial banking. Direct combinations were regulated under section 16 of Glass-Steagall, which prohibited national banks and state banks that were members of the Federal Reserve System from purchasing, underwriting, or dealing in securities, except as provided in the Act.<sup>65</sup> Section 21 prohibited institutions involved in underwriting, selling, or distributing securities from also taking deposits.<sup>66</sup> The second type of provision prevented indirect combinations. Section 20 prohibited Federal Reserve System member banks from being affiliated with any organization engaged in the issuance, underwriting, public sale, or distribution of non-exempt securities.<sup>67</sup> Section 32 prohibited Federal Reserve and state member banks from sharing personnel with entities primarily engaged in the issuance, underwriting, public sale, or distribution of securities.<sup>68</sup> The policy of restricting bank activities was

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engage in risky real estate ventures clearly made matters even worse.

60. Heidi Mandanis Schooner & Michael Taylor, *Convergence and Competition: The Case of Bank Regulation in Britain and the United States*, 20 MICH. J. INT'L L. 595, 636 (1999). Several of the factors accounting for the large number of failures included an increase in competition from within the banking industry and non-bank competitors that led banks to participate in more speculative activities, deregulation in the early 1980s, regional recessions—especially given the fact that geographic banking restrictions were still in place—and management inattention and misconduct. *Id.*

61. See ADAMS, *supra* note 6, at 17, 279; see also Richard W. Stevenson, *G.A.O. Puts Cost of S.&L. Bailout at Half a Trillion Dollars*, N.Y. TIMES, July 13, 1996, at 34.

62. Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 BROOK. L. REV. 1295, 1298 (1995).

63. See *supra* note 17.

64. Di Lorenzo, *supra* note 54, at 677.

65. Ch. 89, § 16, 48 Stat. 162, 185 (1933) (codified at 12 U.S.C. § 24 (2006)).

66. *Id.* § 21 (codified at 12 U.S.C. § 378 (2006)).

67. *Id.* § 20 (codified at 12 U.S.C. § 377 (1994) (repealed 1999)).

68. *Id.* § 32 (codified at 12 U.S.C. § 78 (1994) (repealed 1999)).

further developed in the Bank Holding Company Act of 1956,<sup>69</sup> which gave the Fed the power to pass upon new business activities by large banks. Under section 4(c)(6) of that statute, nonbank subsidiaries of bank holding companies were permitted to engage in activities the Fed found to be closely related to banking and, therefore, “a proper incident thereto.”<sup>70</sup> Similar regulatory approvals by the Office of the Comptroller of the Currency (“OCC”) enforced Glass-Steagall as to national banks.<sup>71</sup> This was not a complete separation of banking and securities activities, since banks were allowed to underwrite and deal in U.S. government and municipal bonds.<sup>72</sup>

During the 1980s and 1990s, the bank regulators and Congress engaged in a general deregulation of banking that over time, permitted banks, and especially large money center banks, to engage in most aspects of the securities business. This story has been told by others and will not be repeated here.<sup>73</sup> In addition, securities firms pushed into banking by establishing money market funds and cash management accounts and buying “nonbank banks.”<sup>74</sup> Many of these activities could only be conducted in separate subsidiaries, and so this reintegration of the banking and securities businesses occurred in financial holding companies.<sup>75</sup> This suited the SEC and the bank regulators, since they were able to maintain jurisdiction over the entities they had traditionally regulated through the mechanism of functional regulation. Unfortunately, functional regulation meant that no financial regulator had a complete picture of financial institution holding companies or the power to curtail their activities in subsidiaries not regulated by their primary regulator, or in many cases, by any regulator.<sup>76</sup>

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69. Ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841–1850 (2006)).

70. *Id.* § 4(c)(6) (codified as amended at 12 U.S.C. § 1843(c)(8)); see *Am. Ins. Ass’n v. Clarke*, 865 F.2d 278, 284 (D.C. Cir. 1988); *Ass’n of Data Processing Serv. Orgs., Inc. v. Bd. of Governors of the Fed. Reserve Sys.*, 745 F.2d 677, 681 (D.C. Cir. 1984).

71. See, e.g., *First Tennessee Bank*, 1999-WO-08-0015, Conditional Approval No. 351 (Comp. Currency Jan. 28, 2000), available at <http://www.occ.gov/static/interpretations-and-precedents/feb00/ca351.pdf>; *Zions First National Bank*, 97-WO-08-0003, Conditional Approval No. 262 (Comp. Currency Dec. 11, 1997) [hereinafter *Zions First National*], available at <http://www.occ.gov/static/interpretations-and-precedents/dec97/ca262.pdf>.

72. *Zions First National Bank*, *supra* note 71.

73. See, e.g., Foster, *supra* note 6, at 39–48; Joseph Karl Grant, *What the Financial Services Industry Puts Together Let No Person Put Asunder: How the Gramm-Leach-Bliley Act Contributed to the 2008–2009 American Capital Markets Crisis*, 73 ALB. L. REV. 371, 399 (2010); Markham, *supra* note 38, at 250–52; Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation and Increased Risks*, 2002 U. ILL. L. REV. 215, 312–13, 316; see also Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441, 468 n.172 (1998).

74. See David M. Eaton, *The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks*, 44 EMORY L.J. 1187, 1200–13 (1995).

75. See *id.* at 1200–02.

76. See Markham, *supra* note 38, at 264.

Two additional developments changed the nature of the banking and securities industry and injected enormous risks into the capital markets: the development and growth of derivatives and securitization. Financial futures began to be traded on the Chicago Mercantile Exchange in 1975.<sup>77</sup> The Fed approved J.P. Morgan & Co.'s application to create a "futures commission merchant" in 1982. The business of this subsidiary was to deal in bullion and foreign exchange, U.S. government securities, money market instruments and Eurodollar CDs.<sup>78</sup> One side effect of this development, which seemed innocuous enough at the time, was that yet another functional regulator—the CFTC—was added to the mix of federal regulators of banks.<sup>79</sup> The second important development was the widespread use of securitization to transform loans by banks and other financial institutions into liquid, asset backed securities.<sup>80</sup>

Congress finally blessed the financial supermarket concept that the financial services industry had already created with the permission of their financial regulators, and the cooperation of the courts, when it passed Gramm-Leach-Bliley in 1999, repealing Glass-Steagall.<sup>81</sup> From at least two perspectives, the financial meltdown of 2008 can be blamed on the repeal of Glass-Steagall. First, the immediate cause of the meltdown was the collapse of the subprime mortgage market, which had been propelled by the widespread securitization of real estate loans and the change of the banking business from an "originate to hold" model to an "originate to distribute" model of financing mortgages and other consumer loans.<sup>82</sup> Second, in Gramm-Leach-Bliley and subsequently, in the Commodity Futures Modernization Act of 2000,<sup>83</sup> Congress not only failed to construct a regulatory system to match the permitted commingling of banking and securities, but it specifically prohibited any regulatory agency from controlling the growth of certain derivatives transactions.<sup>84</sup> Therefore, excessive leverage and risk were injected into the financial system.

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77. *CFTC History in the 1970s*, U.S. COMMODITY FUTURES TRADING COMM'N, [http://www.cftc.gov/About/HistoryoftheCFTC/history\\_1970s.html](http://www.cftc.gov/About/HistoryoftheCFTC/history_1970s.html) (last visited Mar. 31, 2011).

78. See Markham, *supra* note 38, at 252.

79. See *id.*

80. Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1557–58 (2008); see also Wilmarth, *supra* note 73, at 389.

81. Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 & 15 U.S.C.).

82. See JOHNSON & KWAK, *supra* note 11, at 76–77; see also Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1329–30 (2009).

83. Pub. L. 106-554, 114 Stat. 2763 (2000).

84. JOHNSON & KWAK, *supra* note 11, at 136–37 (discussing the passage of the Commodity Futures Modernization Act and the driving forces behind it); see Onnig H. Dombalagian, *Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation*, 85 IND. L.J. 777, 793–96 (2010) (addressing the passage of Gramm-Leach-Bliley and the failed attempt at a comprehensive regulatory system for the



Nevertheless, it is unlikely that Glass-Steagall can be resurrected in the form in which it previously existed. The banking and securities businesses are very different from what they were in 1933. Securitization has transformed all bank loans into securities.<sup>85</sup> Investment firms own banks, and market and manage money market funds that function like bank accounts.<sup>86</sup> Yet, the same conflict-of-interest problems remain and such conflicts still lead to dangerous risk-taking. The current reincarnation of a Glass-Steagall wall between deposit-taking institutions and the conflicts and risks inherent in the securities business have come in the form of the Volcker Rule, as proposed by the Department of the Treasury and included in the original Senate version of Dodd-Frank. The Volcker Rule was seriously compromised in the final form of the Act: This Rule, essentially, would have prohibited any banking entity from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund.<sup>87</sup> Lobbyists injected numerous big exceptions to the Rule, including transactions on behalf of customers, and wide discretion is given to financial regulators to permit activities in derogation of the Rule.<sup>88</sup> Yet, limits on permitted activities demonstrate the Rule's fundamental purpose. These limits are that no transaction may be permitted if it would involve or result in a material conflict of interest, result in a material exposure to high risk assets or high risk trading strategies, pose a threat to the safety and soundness of the

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commingling of banking and securities); see also Carol A. Needham, *Listening to Cassandra: The Difficulty of Recognizing Risks and Taking Action*, 78 FORDHAM L. REV. 2329, 2331 (2010).

85. See Wilmarth, *supra* note 73, at 230–31.

86. See GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 29 (2009) (recommending money market funds be regulated as banks). During the financial meltdown, when the Reserve Fund “[broke] the buck,” the Treasury provided insurance akin to deposit insurance on money market fund accounts. See Joseph R. Fleming et al., *The Future of Money Market Funds: Implications of the Recent Turmoil*, 42 REV. SEC. & COMMODITIES REG. 107, 108 (2009).

87. Dodd-Frank Act, Pub. L. No. 111-203, secs. 619, 621, §§ 13, 27B, 124 Stat. 1376, 1620–32 (2010) (amending the Bank Holding Company Act by adding new section 13, and the Securities Act of 1933 by adding new section 27B).

88. *Id.* The exceptions to the Volcker Rule, identified in section 619 of the Act, *id.* sec. 619, § 13(d)(1), 124 Stat. at 1623–26, and which apply to all covered banking entities, are as follows: First, a range of U.S. government securities and state government obligations are excluded from the definition of covered instruments. *Id.* § 13(d)(1)(A). Second, transactions that are made in connection with underwriting or market-making related activities, to the extent those activities are not designed to exceed the reasonably expected demands of clients, customers or counterparties, are exempt. *Id.* § 13(d)(1)(B). The third exception is for risk-mitigating hedging activities in connection with individual or aggregated holdings of the covered banking entity. *Id.* § 13(d)(1)(C). The fourth exception is for transactions on behalf of customers. *Id.* § 13(d)(1)(D). There is also an exception for regulated insurance companies and their affiliates that make investments for the general account of the insurance company in accordance with state law, *id.* § 13(d)(1)(F), and one permitting a covered banking entity to trade solely outside the United States as long as it is not directly or indirectly owned or controlled by a covered banking entity organized under the laws of United States or any of the states. *Id.* § 13(d)(1)(H).

banking entity, or pose a threat to U.S. financial stability.<sup>89</sup> The past conduct of financial regulators in bowing to the interests of banks and allowing them to undermine and then completely destroy Glass-Steagall suggests that the Volcker Rule, already watered down, will not be rigorously applied over time. The largest banks are simply too big and too powerful to be constrained. The questions posed by this Article are whether they need to be dismantled, and if so, how can such deconcentration be accomplished.

## II. BANK FAILURES, DEREGULATION, AND THE GROWTH OF FINANCIAL SUPERMARKETS

The deregulation of stock exchange commission rates and bank interest rates led to the failure of many broker-dealers, S&Ls, and banks. Before 1980, the FDIC reported approximately six bank closures annually.<sup>90</sup> In 1981, the number increased to ten.<sup>91</sup> During the 1980s, bank failures and consolidations occurred at a record level, and the too-big-to-fail doctrine was born.<sup>92</sup> By the end of the 1980s, 200 banks annually were forced to close.<sup>93</sup> By 1991, the FDIC had paid approximately \$11.8 billion to protect depositors in the fourteen failures of banks with assets over \$1 billion.<sup>94</sup>

In order to protect the federal deposit insurance fund<sup>95</sup> and similar guarantee funds for securities firms<sup>96</sup> and S&Ls,<sup>97</sup> financial regulators

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89. *Id.* sec. 619, § 13(d)(2).

90. Kenneth E. Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAW. 907, 908 (1989).

91. *Id.*

92. *See id.*; see also *infra* notes 99–101 and accompanying text.

93. Lindley H. Clark, Jr., *Financial Services: Regulation's Revival*, WALL ST. J., Oct. 29, 1990, at A1.

94. *Economic Implications of the "Too Big to Fail" Policy: Hearing Before the Subcomm. on Econ. Stabilization of the H. Comm. on Banking, Fin. and Urban Affairs*, 102d Cong. 36, 37 (1991) (statement of Johnny C. Finch, Dir. of Planning & Reporting, Gen. Accounting Office). At the time, some in Congress viewed FDIC insurance as reducing market discipline. *Id.* at 66–67 (statement of Rep. Thomas R. Carper, Chairman, Subcomm. on Econ. Stabilization & Comm. on Banking, Fin. & Urban Affairs).

95. *See supra* note 17 and accompanying text.

96. In the late 1960s, Congress enacted the Securities Investor Protection Act of 1970 ("SIPA"). Pub. L. No. 91-598, 84 Stat. 1636 (codified as amended at 15 U.S.C. §§ 78aaa-III (2006)). SIPA established the private, nonprofit Securities Investor Protection Corporation ("SIPC") that administers a fund to protect the accounts of securities investors. *See id.* SIPC protects investors from losses due to broker-dealer failure. *See* Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1074 (1999). Since its inception, SIPC membership grew rapidly, but so did broker-dealer failures due to "depressed securities markets, speculation in the new issue market, bookkeeping problems, inadequate capital, mismanagement, poor supervision of subordinates, and fraud." Harold S. Bloomenthal & Donald Salcito, *Customer Protection from Brokerage Failures: The Securities Investor Protection Corporation and the SEC*, 54 U. COLO. L. REV. 161, 162 (1983); see also Michael E. Don & Josephine Wang, *Stockbroker Liquidations Under the Securities Investor Protection Act and Their*

encouraged acquisitions of weak financial institutions by stronger organizations.<sup>98</sup> Indeed the “failing firm” doctrine enabled many financial institutions to acquire financial institutions that they otherwise would have been unable to acquire for either regulatory or antitrust reasons.<sup>99</sup> When merger partners could not be found for Continental Illinois, a troubled major bank in 1984, the financial regulators bought the bad debt, thus giving rise to the too-big-to-fail doctrine.<sup>100</sup> Being saved by the federal government did not prevent Continental Illinois from making further business errors. During the week of the 1987 stock market crash, it was forced to make a \$620 million capital infusion into First Options of Chicago, Inc., a Continental Illinois subsidiary that was a major clearing firm for options makers on the Chicago Board Options Exchange.<sup>101</sup> Finally, this too-big-to-fail bank was acquired by Bank of America in 1994, relieving the banking regulators of the burden of further overseeing this troublesome organization.<sup>102</sup> Ironically, one of the reasons the Fed saved Continental Illinois was because of the potential domino effect of its failure on other banks, including Bank of America.<sup>103</sup>

The banking crises of the 1980s, coupled with further deregulation of banking, led to the growth of ever bigger regional and national banks

*Impact on Securities Transfers*, 12 CARDOZO L. REV. 509, 510–12 (1990). As of the 2009 fiscal year, SIPC had 4956 members across the various national exchanges. 2009 SIPC ANN. REP. 8.

97. Federal Savings and Loan Insurance Corporation (“FSLIC”) was created as part of the National Housing Act of 1934 in order to insure deposits in S&Ls. *See* ch. 847, 48 Stat. 1246 (codified as amended at 12 U.S.C. §§ 1701–1750g (1988)). FSLIC administered deposit insurance for S&Ls. *See id.* §§ 402–403, 48 Stat. at 1256–58. By 1984, over 30% of all FSLIC insured institutions were operating at a loss. *See* Markham, *supra* note 38, at 245. Financially troubled S&Ls raised concerns that FSLIC would not have sufficient funds to pay insured deposits. *Id.* at 246. Still, the S&L industry lost some \$7 billion in 1987. *Id.* Over 1000 S&Ls closed down by 1988. *Id.* As a result, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 abolished FSLIC and replaced it with the Savings Association Insurance Fund, which is administered by the FDIC. *Id.* at 247; *see* Pub. L. 101-73, 103 Stat. 183 (codified in scattered sections of 12 U.S.C. (2006)).

98. *See* ZABIHOLLAH REZAEI, FINANCIAL INSTITUTIONS, VALUATIONS, MERGERS, AND ACQUISITIONS: THE FAIR VALUE APPROACH 15–16 (2001).

99. *See id.* (explaining that well-capitalized banks acquired weaker banks, partially because regulators look favorably upon the efficiency and high capital ratios of the stronger banks); Markham, *supra* note 38, at 245 n.151 (noting that the Federal Home Loan Bank Board encouraged mergers among S&Ls); *see also* MELANIE FEIN, SECURITIES ACTIVITIES OF BANKS, 1-44 to 1-44.2 (2011) (listing major acquisitions). It is noteworthy that acquisition by a stronger competitor is markedly different from acquisition by a regulator in the “too-big-to-fail” scenario. *See* Foster, *supra* note 6, at 52. Both arguably may lead to off-loading of toxic assets, improved balance sheets, and, hopefully, economic benefit for stakeholders and shareholder. Since there are fewer sizable competitors to absorb sizable organizations, mergers and acquisitions result in banks that are too-big-to-fail. *See* Foster, *supra* note 6, at 52.

100. Foster, *supra* note 6, at 51; *see also supra* notes 12 & 18 and accompanying text.

101. Dennis P. O’Connell, *Reviewing the Year: The Top 5 Stories*, AM. BANKER, Dec. 28, 1987, at 5.

102. BARRY RITHOLTZ & AARON TASK, BAILOUT NATION: HOW GREED AND EASY MONEY CORRUPTED WALL STREET AND SHOOK THE WORLD ECONOMY 218 (2009).

103. 1 FED. DEPOSIT INS. CORP., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 548 (1998).

and of the mega-financial institution holding company.<sup>104</sup> As the stronger banks went on a shopping spree, a new type of bank entered the scene in the 1990s: the super-regional bank.<sup>105</sup> The self-perpetuating dynamic led to stronger banks getting bigger and stronger, as the number of smaller local banks shrunk. The emerging regional banks outpaced the extant regulatory framework.<sup>106</sup> Mergers and acquisitions reduced the number of banks from around 14,000 in 1980 to fewer than 10,000 in 1995.<sup>107</sup> Similarly, as the barriers between investment banking and commercial banking continued to erode, further deregulation promoted “one stop financial shopping at banks and bank holding companies.”<sup>108</sup>

Further, as the country was lurching toward the complete dismantling of Glass-Steagall and other Depression-era constraints on banks and investment banks, a series of financial crises challenged financial regulators and led to the preservation of the new paradigm of mega-financial institutions dominating capital markets, ensuring their global competitiveness. These crises included the stock market crash of 1987, which became known as “Black Monday,”<sup>109</sup> the stock market crash of 1989,<sup>110</sup> the Latin American debt crisis of 1980s,<sup>111</sup> the Asian debt crisis of the 1990s,<sup>112</sup> the collapse of Long-Term Capital Management,<sup>113</sup> and

104. See JOHNSON & KWAK, *supra* note 11, at 82–87.

105. They included Banc One Corporation, First Chicago/NBD Corporation, Fleet Financial, Norwest Corporation, CoreStates, First Union, Wachovia Corporation, Wells Fargo, and NationsBank. Markham, *supra* note 38, at 256; see JOHN SPIEGEL ET AL., *HOW SUPERREGIONAL POWERHOUSES ARE RESHAPING FINANCIAL SERVICES*, at xiii (1996). These regional banks also were a response to the way in which the ban on interstate banking became eroded by regional interstate banking compacts. See *supra* notes 34–42 and accompanying text.

106. SPIEGEL ET AL., *supra* note 105; see Peter C. Carstensen, *Public Policy Toward Interstate Bank Mergers: The Case for Concern*, 49 OHIO ST. L.J. 1397, 1415–18 (1989).

107. SPIEGEL ET AL., *supra* note 105.

108. See Markham, *supra* note 38, at 260 (quoting David R. Satin, *Breaking Down the Wall: The Unofficial End of Glass-Steagall*, BANK SEC. J., July–Aug. 1997, at 11, 11) (internal quotation marks omitted).

109. Annelena Lobb, *Looking Back at Black Monday: A Discussion with Richard Sylla*, WALL ST. J. (Oct. 15, 2007), <http://online.wsj.com/article/SB119212671947456234.html>. It is noteworthy that the Black Monday crash was arguably the early warning signal of the recent May 6, 2010 flash crash. The price fluctuation aspects of both crashes ultimately were blamed on excessive and rapid automated computer trading. See *id.*

110. See Robert Shiller, *Exuberant Reporting: Media and Misinformation in the Markets*, 23 HARV. INT’L REV. 60, 63 (2001). The stock market crash that occurred on Friday, October 13, 1989 is widely believed to have been caused by a reaction to a news story of the breakdown of a \$6.75 billion leveraged buyout deal for UAL Corporation, the parent company of United Airlines. See *id.* (discussing but ultimately disagreeing with this position).

111. The Latin American debt crisis occurred in the early 1980s, when Latin American countries reached a point where their foreign debt exceeded their earning power, and they were not able to repay it. See Markham, *supra* note 38, at 242. Mexico’s announcement that it could not meet its debt obligations were followed by defaults in Brazil, Argentina, and more than twenty other countries. See *id.* at 242 & n.128. The largest American banks had Latin American loans on their books that amounted to nearly 50% of their capital. See *id.*

112. See generally THE ASIAN FINANCIAL CRISIS: ORIGINS, IMPLICATIONS, AND SOLUTIONS (William

the bursting of the technology stock market bubble in the 1990s.<sup>114</sup> These crises were caused in part by explicit and implicit government guarantees. Impeded by a credibility deficit and capital flight, developing countries were unable to manage the crisis. They turned to the International Monetary Fund and the Fed, which intervened to protect the creditor banks that kept credit flowing.<sup>115</sup> The loans to Mexico, for example, and subsequent packages to the Asian crisis countries, were perceived to be a bailout.<sup>116</sup> Indeed, crisis prevention in the form of a financial safety net, such as virtually universal deposit insurance, planted the seeds for another crisis.<sup>117</sup> The anticipation of a government bailout would create moral hazard and imprudent lending during subsequent years.<sup>118</sup> Thus, the doctrine of too-big-to-fail was to play a major role in the Fed's policy in the coming decade. In 1999, reacting to the mounting political pressure from banking giants, Congress repealed Glass-Steagall.<sup>119</sup> This final deregulation of Depression-era financial regulation resulted in a further consolidation of financial services, because banks could now freely form financial holding companies that could engage in a

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Curt Hunter et al. eds., 1999). On October 27, 1997, the Dow Jones industrial plunged 554 points or 7.2%, amid ongoing worries about the Asian economies. The New York Stock Exchange briefly suspended trading. DIV. OF MKT. REGULATION, SEC. EXCH. COMM'N, TRADING ANALYSIS OF OCTOBER 27 AND 28, 1997 (2008), <http://www.sec.gov/news/studies/tradrep.htm>. The crisis led to a drop in consumer and spending confidence. See *id.* The Basel Committee on Banking Supervision would eventually note that East Asian financial institutions, prior to the crisis, "took on excessive risk, in part due to implicit government guarantees." GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 28 (2004) (quoting Rudi Bonte et al., Bank for Int'l Settlements, *Supervisory Lessons to Be Drawn from the Asian Crisis* 57 (Basel Comm. on Banking Supervision Working Paper No. 2, 1999)).

113. Long-Term Capital Management ("LTCM") was a U.S. hedge fund which used trading strategies such as fixed income arbitrage, statistical arbitrage, and pairs trading, combined with high leverage. ALAN GREENSPAN, THE AGE OF TURBULENCE: ADVENTURES IN A NEW WORLD 193-95 (2007). It failed spectacularly in the late 1990s, leading to a massive bailout by other major banks and investment houses, which was supervised by the Fed. *Id.* One of the mega-banks that emerged from this crisis was Bank of America, which had taken a major hit when Russian bonds defaulted and was then acquired by NationsBank and renamed BankAmerica. The resulting entity had combined assets of \$570 billion and 4800 branches in twenty-two states. R. Christian Bruce & Eileen Canning, *NationsBank-BankAmerica Deal Clears; Merger Creates Largest U.S. Bank Firm*, Daily Rep. Exec. (BNA) No. 159, at A-9 (Aug. 18, 1998). Despite this large size, federal regulators insisted only upon the divestiture of thirteen branches in New Mexico. *Id.*; *Business Brief—NationsBankCorp.: Federal Reserve Approves Merger With BankAmerica*, WALL ST. J., Aug. 18, 1998, at 1.

114. Stephen E. Frank & E.S. Browning, *Bursting of the Tech Bubble Has a Familiar "Pop" to It*, WALL ST. J., Mar. 2, 2001, at C1.

115. See Wilmarth, *supra* note 73, at 224-25.

116. See generally Ian Vasquez, *A Retrospective on the Mexican Bailout*, 21 CATO J. 545 (2002).

117. See *id.*

118. *Id.* at 308-09.

119. Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act), Pub. L. No. 106-102, 113 Stat. 1338 (1999). The Act was signed by President William Jefferson Clinton on Nov. 12, 1999. See Markham, *supra* note 38, at 263-64; see also Michael Schroeder, *Congress Passes Financial-Services Bill*, WALL ST. J., Nov. 5, 1999, at A2.

broad array of financial services.<sup>120</sup> Gramm-Leach-Bliley broadly defined the modern functional regulatory framework that remains in place today, as embellished by Dodd-Frank.<sup>121</sup>

The merger of Travelers Group with Citicorp, the parent company of Citibank, in April 1998, challenged what remained of Glass-Steagall before Gramm-Leach-Bliley. Although Citigroup was given two years to divest any prohibited assets, aggressive lobbying by former Secretary of the Treasury Robert Rubin and the heads of Citicorp persuaded Congress to instead pass Gramm-Leach-Bliley.<sup>122</sup> At this time, Citicorp was the world's largest supplier of credit cards, and Citibank was the second largest bank in the United States.<sup>123</sup> When it acquired Travelers, it became a financial supermarket: a one-stop shop for insurance, investment banking, brokerage, and other financial services.<sup>124</sup> One commentator has called this "the moment when Citi went from being a very large bank to becoming an unmanageable Goliath."<sup>125</sup>

The decade following the passage of Gramm-Leach-Bliley witnessed both bank failures and continued contraction among financial services firms. According to the FDIC's Failed Bank List, 283 banks closed from 2000 to 2010.<sup>126</sup> These banks were local, less well-capitalized banks; their ranks included commercial banks, investment banks, and S&Ls.<sup>127</sup> Credit Unions around the country were also impacted, and many closed.<sup>128</sup> The first decade of the twenty-first century continued to witness contraction among financial institutions across the U.S. In order to deal with the collapse of large firms, regulators encouraged financial institutions to acquire firms that they otherwise would have been unable to acquire for either regulatory or antitrust reasons.<sup>129</sup>

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120. See Markham, *supra* note 38, at 263; see also Michael Schroeder, *Glass-Steagall Compromise Is Reached*, WALL ST. J., Oct. 25, 1999, at A2.

121. Commercial banking activities are regulated by the bank regulators, while securities activities are regulated by the SEC and state securities commissions. Commodity futures and options activities are regulated by the CFTC, and insurance activities are regulated by multiple state insurance regulators. Markham, *supra* note 38, at 264.

122. RITHOLTZ, *supra* note 102, at 213–14.

123. See *id.* at 212.

124. See Markham, *supra* note 38, at 262–63.

125. See RITHOLTZ, *supra* note 102, at 212.

126. *Failed Bank List*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/bank/individual/failed/banklist.html> (last visited Mar. 31, 2011).

127. *Id.*

128. The National Credit Union Administration ("NCUA") does not have a table of failed credit unions prior to 2009, but a list of credit unions that failed between 2009 and 2010 can be found on the NCUA's website. *Closed Credit Unions 2010*, NAT'L CREDIT UNION ADMIN., <http://www.ncua.gov/Resources/ClosedCU/2010.aspx#top> (last visited Mar. 31, 2011). For failed credit unions prior to 2009, see the NCUA press releases regarding failed credit unions. *Press Releases 2011*, NAT'L CREDIT UNION ADMIN., <http://www.ncua.gov/News/Publications/News/PressRelease.aspx> (last visited Mar. 31, 2011).

129. In 2007, Bank of America absorbed Countrywide and Merrill Lynch, increasing its assets from \$1.7 trillion to \$2.3 trillion. See JOHNSON & KWAK, *supra* note 11, at 180. JPMorgan Chase absorbed

The Fed dealt with continuous deregulation in the face of banking and stock market crises by keeping interest rates low, encouraging the use of derivatives, and allowing the growth of financial holding companies.<sup>130</sup> During the financial crisis of 2008, the Fed allowed and encouraged further mergers until only a baker's dozen of large U.S. financial institutions were left standing.<sup>131</sup> Other financial regulators cooperated in these matters by protecting their turf through the policy of functional regulation. The problem was that financial holding companies became huge, out-of-control hydras, that were "too-big-to-manage" and "too-big-to-discipline adequately."<sup>132</sup> Liabilities were pushed off the balance sheets<sup>133</sup> of regulated entities into unregulated entities, often abroad and beyond the reach of U.S. regulators.

Dodd-Frank has some features that, at least at the margins, ought to make for better regulation of financial firms by curbing excesses, promoting discipline, and increasing oversight.<sup>134</sup> Although the statute gives regulators the power to design new rules, other provisions merely authorize regulators to study certain issues.<sup>135</sup> An independent consumer protection agency has been created within the Fed, but many of its powers are a transfer of authority already existing at the Fed or other agencies.<sup>136</sup> Other measures include creation of a systemic risk regulator, greater transparency and stability in derivatives trading, improved regulation of credit-rating agencies, and a partial ban on proprietary trading by banks.<sup>137</sup> Nevertheless, Dodd-Frank accomplished a successful

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Bear Sterns and Washington Mutual, growing from \$1.6 to \$2 trillion. *Id.* Wells Fargo absorbed Wachovia and nearly doubled its assets. *Id.* In order for the deals to go through, Bank of America, JPMorgan, and Wells Fargo had to be exempted from a federal rule prohibiting any single bank from holding more than 10% of all deposits in the country, as well as from Department of Justice antitrust guidelines. *Id.*

130. Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 975–76 (2009); see also FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 56 (2011).

131. See JOHNSON & KWAK, *supra* note 11, at 180; Edward R. Herlihy et al., *Convergence, Consolidation, Consternation and Complexity in an Industry in Transition: An Annual Review of Leading Developments*, in FINANCIAL INSTITUTIONS M&A 2009, at 267 (PLI Corp. Law & Practice, Course Handbook Ser. No. 24859, 2010). See generally ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS—AND THEMSELVES (2009).

132. These terms have been used to describe mega-banks throughout the history of the too-big-to-fail doctrine. See Wilmarth, *supra* note 73, at 290 n.311.

133. See JOHNSON & KWAK, *supra* note 11, at 86; Kara Scannell & Carrick Mollenkamp, *SEC Homes in on Lehman, "Funds of Funds"*, WALL ST. J., Sept. 10, 2010, at C1.

134. See *infra* notes 252–74 and accompanying text.

135. Eleanor Laise, *Congress Overhauls Your Portfolio*, WALL ST. J., July 17–18, 2010, at B7.

136. *Id.*

137. Randall Smith et al., *Impact to Reach Beyond Wall Street*, WALL ST. J., July 16, 2010, at A4. With respect to hedge funds and derivatives, the bill authorizes the SEC and the CFTC to regulate derivatives jointly. *Id.* Derivative trades will run through clearing houses and exchanges, and hedge funds and private-equity firms must register with the SEC. See Laise, *supra* note 135. Also, companies

grab for more power by regulators who had set the stage for the financial meltdown by acceding to the creation of highly leveraged mega-banks. Furthermore, Congress has not addressed the basic economic problems that led to the meltdown, such as an overblown and speculative real estate market and enormous budget and trade deficits.<sup>138</sup> Observers, commentators, and even regulators share the concern that the true nature of the country's financial problems has not been addressed.<sup>139</sup>

### III. THE PUHCA AS A MODEL FOR DEALING WITH THE MEGA-BANKS

The PUHCA was a special regulatory program designed to break up the public utility holding companies according to antitrust principles, but with a view toward restructuring rather than destroying the holding companies. There are some surprising similarities between the public

that sell products like mortgage-backed securities must hold a stake in the instruments they sell. *Id.* With respect to bank regulation, the Fed has obtained more responsibility for big financial firms. *Id.* The Volcker Rule now prevents banks from trading with their own capital to some extent. Further, the new Bureau of Consumer Finance will have its own budget independent from the Fed. C. Boyden Gray, *Wall Street Reform That Flouts the Law*, WASH. POST, Dec. 31, 2010, at A17. To deal with the next bubble, the Financial Stability Oversight Council (the "Council") will search for and identify systemic risks. *Id.* The Treasury obtained a new Office of Financial Research to collect data and investigate potential systemic issues. *Id.* Credit rating agencies will now be regulated by a dedicated office at the SEC. *Id.*

138. See Editorial, *The Truth About the Deficit*, N.Y. TIMES, Feb. 7, 2010 (Week in Review) at 9; David Leonhardt, *Bubblenomics*, N.Y. TIMES, Sept. 21, 2008, (Week in Review), at 1; David E. Sanger & Mark Landler, *Obama Faces Calls for Rules on Finances*, N.Y. TIMES, Apr. 2, 2009, at A1.

139. The current framework allows for "regulatory arbitrage," in which participants in the market can exploit the gaps in the multi-regulator system. "A trend toward something as questionable as subprime mortgages can easily develop because there are too many cooks, too many supervisors and no one is really coordinating." John Poirier, *Mortgage Woes Spotlight Bank Regulation*, REUTERS, Dec. 7, 2007, available at <http://www.reuters.com/article/2007/12/07/us-usa-subprime-bankregulation-idUSN0738500720071207> (quoting Michael Malloy, a former senior attorney of the Office of the Comptroller of the Currency) (internal quotation marks omitted). In February 2008, FDIC Chairman Sheila Bair urged that in the future, "the home mortgage market needs strong rules." Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., Remarks at the Joint Venture Silicon Valley Network State of the Valley Conference (Feb. 22, 2008), transcript available at <https://www.fdic.gov/news/news/speeches/archives/2008/chairman/spfeb2208.html>; see also, e.g., Les Leopold, *Why the Wall Street-BP Double Standard?*, THE HUFFINGTON POST (June 25, 2010), [http://www.huffingtonpost.com/les-leopold/why-do-we-treat-wall-stre\\_b\\_625286.html](http://www.huffingtonpost.com/les-leopold/why-do-we-treat-wall-stre_b_625286.html) (noting that, unlike BP during the Gulf oil spill, Wall Street is getting off for the havoc it wreaked on the American economy); Richard Posner, *Abuse of Presidential Power?*, THE BECKER-POSNER BLOG (July 17, 2010, 4:21 PM), <http://www.becker-posner-blog.com/2010/07/abuse-of-presidential-power-posner.html> (focusing primarily on the Obama administration's purportedly expansive view of presidential authority, and noting that the recent financial legislation does not resolve anything). *The Economist* also noted:

Indeed, the new consumer bureau potentially creates another monster. Nor does it tackle the future status of Fannie Mae and Freddie Mac, to the chagrin of Republicans, who rightly view the two mammoth mortgage agencies as having played a leading role in causing the financial crisis. The final document may run close to 2,000 pages, but some very important issues are being left for another day.

*A Successful All-Nighter*, THE ECONOMIST ONLINE (Jun 25th 2010), [http://www.economist.com/blogs/newsbook/2010/06/americas\\_financial\\_reforms\\_agreed](http://www.economist.com/blogs/newsbook/2010/06/americas_financial_reforms_agreed).



utility holding companies of the 1920s and today's big bank holding companies, especially with regard to their complexity and political power. One solution to the systemic threat posed by the too-big-to-fail banks is to compel their restructuring by a regulatory agency according to a model based on the PUHCA.

#### A. THE ANTITRUST MODEL

Are banks and other financial institutions that are too-big-to-fail in fact too big to be? One solution that has been suggested for the too-big-to-fail problem is the consideration of systemic risk in the antitrust analysis with a view to breaking up the big banks pursuant to section 2 of the Sherman Act<sup>140</sup> or section 7 of the Clayton Act.<sup>141</sup> This is an appealing idea, because it involves the application of existing law to the problem of curtailing the size and power of the oligopoly of large financial institutions. Even if the political will could be found to embark on such a course, however, it would involve years of adversarial litigation with an uncertain prospect for success.<sup>142</sup> Historically, even when the Department of Justice has been determined to take on Wall Street, it has been mostly unsuccessful in the cases it has brought.<sup>143</sup> Yet, despite this lack of success in the courts, where a Department of Justice antitrust policy has been able to enlist the cooperation and support of the SEC or Congress, its views have prevailed.<sup>144</sup>

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140. Sherman Act of 1890, 26 Stat. 209, 209-10 (current version at 15 U.S.C. §§ 1-7 (2006 & Supp. III 2009)).

141. Foster, *supra* note 6, at 53-61; see Clayton Act, ch. 323, § 7, 28 Stat. 730, 731-32 (1914) (current version at 15 U.S.C. § 18 (2006)). See generally William E. Kovacic, *Failed Expectations: The Troubled Past and Uncertain Future of the Sherman Act as a Tool for Deconcentration*, 74 IOWA L. REV. 1105 (1989).

142. In 1948, the Fed issued a complaint against Transamerica, the holding company of Bank of America, for violating the Clayton Act, which prohibits a corporation from acquiring the stock of a corporation that substantially lessened competition or created a monopoly. MARQUIS JAMES & BESSIE ROWLAND JAMES, *BIOGRAPHY OF A BANK: THE STORY OF BANK OF AMERICA N.T. & S.A.* 501 (1954). In 1952, after almost two years of hearings, the Fed ordered Transamerica to divest all of its subsidiary banks and dispose of all of its stock in Bank of America. *Id.* But the Fed's action was overturned by the court of appeals, which held that the Fed had failed to prove its monopoly charges against Transamerica. *Id.* at 501-15.

143. See, e.g., *United States v. Morgan*, 118 F. Supp. 621 (S.D.N.Y. 1953) (exemplifying one of the biggest antitrust cases in history, against Wall Street underwriters, which did not lead to a conviction).

144. In the battle to unfix stock exchange commission rates, the Department of Justice Antitrust Division joined a suit against the New York Stock Exchange in *Gordon v. New York Stock Exchange*, but this assault failed, because the Supreme Court held that the SEC could exercise direct and active supervision of rate fixing. 422 U.S. 659, 691 (1975). Yet, the SEC and Congress mandated the unfixing of rates in 1975. See Securities Act Amendments of 1975, Pub. L. 94-29, § 6(e)(1), 89 Stat. 97, (1975). Similarly, the Department of Justice Antitrust Division joined with the SEC to eliminate the one-eighth trading convention in securities. National Association of Securities Dealers, Exchange Act Release No. 37,538, 49 SEC Docket 1346 (Aug. 8, 1996).

In the 1930s, a specialized antitrust program was brought against the public utility holding companies, fingered as culprits in the 1929 stock market crash, by the PUHCA. Although the PUHCA was passed in 1935,<sup>145</sup> it was not fully implemented until the 1950s, due to the intense opposition of the public utility companies, including court actions aimed at invalidating the statute.<sup>146</sup> Yet, once the mandate of the statute was accepted by the judiciary, and the industry understood that the SEC had the power to restructure the public utilities, the SEC succeeded in doing so with the cooperation of the industry.<sup>147</sup> The story of the PUHCA is an interesting one of an unusual and successful New Deal program that targeted a troublesome oligopoly, and one which could possibly serve as a model for future efforts to constrain mega-banks. Just as the antitrust laws would have to be applied globally to be utilized against the big banks,<sup>148</sup> a PUHCA-type effort to rationalize financial institution holding companies would have to be implemented in cooperation with international regulators. This might not be impossible, given that at least one key regulator abroad in the United Kingdom has looked at the problems of global financial weaknesses through the lens of the unwieldy size of banks.<sup>149</sup> Furthermore, the European Union is about to impose much stricter controls on risk-taking compensation structures in financial firms than the United States has even considered.<sup>150</sup>

## B. THE HOLDING COMPANY STRUCTURE

Traditional corporate law viewed every corporation as a separate juridical entity.<sup>151</sup> Until the end of the nineteenth century, one corporation could not own shares in another corporation.<sup>152</sup> This doctrine changed in 1890, when New Jersey—then a leading state for the development of corporate law—permitted the acquisition and formation

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145. Public Utility Holding Company Act, ch. 687, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. § 79–79(z)-6 (2000)), *repealed by* Energy Policy Act of 2005, 42 U.S.C. §§ 16451–16463 (2005).

146. MICHAEL E. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 218–19 (1970).

147. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 257 (3d ed. 2003).

148. Foster, *supra* note 6, at 61–64.

149. David Shay Corbett II, *Free Markets and Government Regulation*, 14 N.C. BANKING INST. 547, 552–53 (2010); *see also* JOHNSON & KWAK, *supra* note 11, at 209–10.

150. *Commission Report on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities Are Admitted to Trading on a Regulated Market*, COM (2010) 243 final (May 27, 2010); Stephen Fidler & Alessandro Torello, *Europe to Limit Banker Bonuses*, WALL ST. J., July 8, 2010, at A1; Elena Logutenkova, *EU Investment Banks May Be Hurt by New Pay Rules*, JP Morgan Says, BLOOMBERG (Jan. 18, 2011, 3:24 AM) <http://www.bloomberg.com/news/2011-01-18/eu-investment-banks-may-be-hurt-by-new-pay-rules-jpmorgan-says.html>.

151. Phillip I. Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities*, 28 CONN. L. REV. 295, 297 (1996).

152. *Id.*

of subsidiaries without any statutory authorization.<sup>153</sup> After that time, holding companies grew in a number of key industries. This change in corporate structures was recognized in a number of New Deal regulatory programs based on the recognition of enterprise principles, so that statutory imperatives applied not only to particular regulated entities, but also to persons controlling or controlled by them.<sup>154</sup> The PUHCA was the first major federal statute to concentrate its provisions on the holding company. In particular, this statute dealt with the abuses and insolvencies of the country's utilities.

Between 1900 and 1930, improved generating equipment and other engineering advances led to the growth of interstate, rather than merely local, electric transmission.<sup>155</sup> This technological advance led to the development of large holding companies with diversified and geographically-dispersed subsidiaries.<sup>156</sup> Through the use of leverage, a holding company with a small investment in the voting securities of various subsidiaries could gain control over a huge complex of companies.<sup>157</sup> Engineering, construction and financial companies were often housed in one system, in which the holding company earned income from dividends and management fees.<sup>158</sup> These holding companies became extraordinarily complex. For example, by 1932, the Associated Gas and Electric system had 264 corporate entities.<sup>159</sup> Further, these giant utilities gobbled up independent operating companies. In 1914, there were eighty-five systems controlling two-thirds of the country's private electric power output. By 1929, sixteen holding company groups controlled 92% of the country's output.<sup>160</sup>

The utility holding company was able to grow so large and complicated because it had certain advantages over other companies. A large holding company could secure capital on favorable terms, coordinate investment decisions based on engineering considerations rather than according to political boundaries, and attract and cultivate a larger pool of engineering talent.<sup>161</sup> However, the unsound financial

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153. *Id.* at 298.

154. *Id.* at 304.

155. PARRISH, *supra* note 146, at 145-50.

156. *Id.*

157. *Id.* at 147.

158. *Id.* at 146-47.

159. *Id.* at 148.

160. *Id.* at 149. The most famous of the public utility holding companies were those controlled by Samuel Insull, a self-made businessman, who started his career working as Thomas Edison's secretary, and who ended his career defending himself in a criminal prosecution after the bankruptcy of his holding company during the Depression. For an interesting description of Insull's rise and fall, and a comparison of Insull to Enron, see Hon. Richard D. Cudahy & William D. Henderson, *From Insull to Enron: Corporate (Re)Regulation After the Rise and Fall of Two Energy Icons*, 26 ENERGY L.J. 35 (2005).

161. JAMES C. BONBRIGHT, PUBLIC UTILITIES AND THE NATIONAL POWER POLICIES 23-24 (1940).

practices of these companies undermined these organizations and neutralized their advantages in comparison to isolated operating companies.<sup>162</sup> The public utility holding companies were complicated to a degree almost beyond comprehension. According to Ferdinand Pecora, “the Insull structure was so complex that no one could fully grasp it, not even, probably, Mr. Insull himself.”<sup>163</sup>

Like the public utility holding companies, financial holding companies have become large, complex, opaque and highly risky, in large part through the use of leverage. One could certainly conclude that the complexity and risks of their operations were not understood by their top officers and directors, or they would not have been allowed to spin out of control to the brink of extinction.<sup>164</sup> Also like the public utility holding companies, financial holding companies developed new products through financial engineering, made possible by technology, geographic expansion, and deregulation.<sup>165</sup> Banks and investment banks previously engaged in segmented aspects of the financial industry combined. These financial services holding companies had better access to capital than smaller specialized firms, were able to expand internationally, and had access to talented and entrepreneurial workers.<sup>166</sup> But they utilized off-balance sheet accounting to create leverage, and they invented financial instruments to spread risk that managed to create even greater risk.<sup>167</sup> These holding companies became so complicated and opaque that the risks they were assuming threatened them and other firms, and without federal assistance many of them would have failed, possibly bringing down the financial system.<sup>168</sup>

### C. THE HISTORY AND PURPOSE OF THE PUHCA

The restructuring of the public utility industry has been called “the SEC’s most useful accomplishment,” and also “by far the most difficult to attain.”<sup>169</sup> The PUHCA was directed at dismantling the public utility holding company oligopoly as described in a 101-volume study by the

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162. *Id.* at 24–26.

163. Cudahy & Henderson, *supra* note 160, at 94 (quoting FERDINAND PECORA, WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS 224–25 (1939)).

164. The mega-banks probably are too big and multifaceted to manage. *See* Grant, *supra* note 73, at 397–410 (describing the size and complexity of Citigroup and Bank of America); *see also* RITHOLTZ, *supra* note 102, at 212.

165. *See* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 980–97 (2009).

166. *See* JOHNSON & KWAK, *supra* note 11, at 82–85.

167. *See id.* at 74–87; Wilmarth, *supra* note 165, at 1027–35.

168. In October 2008, Congress passed the Emergency Economic Stabilization Act of 2008, providing \$700 million to the Troubled Asset Relief Plan (“TARP”) to buy up toxic assets from systemically important financial institutions. *See* Pub. L. No. 110-343, 122 Stat. 3765 (2008). Instead of doing so, the government made direct investments into these firms.

169. SELIGMAN, *supra* note 147, at 127.

Federal Trade Commission (FTC) and an investigation by the House Interstate and Foreign Commerce Committee.<sup>170</sup> Subject to state regulation, electric and gas utilities were inherently local or regional in their operations.<sup>171</sup> As a result, these businesses did not possess organizational economies of scale on a national basis.<sup>172</sup> During the 1920s, however, holding companies sought to build giant utility empires by purchasing various utility properties around the country. These empires grew quickly during the 1930s.<sup>173</sup> By 1932, holding companies controlled the majority of the electric and gas utilities in the U.S.<sup>174</sup> Thirteen large groups controlled 75% of the entire privately-owned electric utility industry.<sup>175</sup> Three holding companies (J.P. Morgan's United Corporation, Samuel Insull's holding company empire, and the Electric Bond and Share Company) generated 45% of the electricity in the United States, and four holding companies controlled more than 56% of the natural gas transportation system.<sup>176</sup> In addition to the power of these holding companies over rates, a number of evils in the operation of the holding companies provided an impetus for reform.<sup>177</sup>

170. See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 230 (3d ed. 1989).

171. 6 THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* § 18.1, at 440 (6th ed. 2009). See generally BONBRIGHT, *supra* note 161; MARTIN T. FARRIS & ROY J. SAMPSON, *PUBLIC UTILITIES: REGULATION, MANAGEMENT, AND OWNERSHIP* (1973); MARTIN G. GLAESER, *PUBLIC UTILITIES IN AMERICAN CAPITALISM* (1957).

172. 6 HAZEN, *supra* note 171. See generally BONBRIGHT, *supra* note 161; FARRIS & SAMPSON, *supra* note 171; GLAESER, *supra* note 171.

173. 6 HAZEN, *supra* note 171. See generally BONBRIGHT, *supra* note 161; FARRIS & SAMPSON, *supra* note 171; GLAESER, *supra* note 171.

174. 6 HAZEN, *supra* note 171. See generally BONBRIGHT, *supra* note 161; FARRIS & SAMPSON, *supra* note 171; GLAESER, *supra* note 171.

175. S. REP. NO. 74-621, at 55 (1935).

176. SELIGMAN, *supra* note 147, at 127. In 1939, there were fifty-one separate public utility systems, comprising 142 registered holding companies subject to SEC regulation, with aggregate assets in excess of \$14 billion. 5 SEC ANN. REP. 63 (1939). In 1986, there were twelve active public utility holding companies. 1986 SEC ANN. REP. 156. These twelve registered holding company systems had sixty-five electric or gas utility subsidiaries, seventy-four non-utility subsidiaries, and twenty-two inactive subsidiaries. *Id.* By 1999, the number of public holding companies registered under the Act had increased to nineteen. 1999 SEC ANN. REP. 62. These nineteen "registered systems were comprised of 107 public utility subsidiaries, 70 exempt wholesale generators, 216 foreign utility companies, 606 non-utility subsidiaries, and 110 inactive subsidiaries, for a total of 1128 companies and systems with utility operations in 31 states." *Id.* During the last quarter of the twentieth century, the number of registered publicly utility holding companies grew slowly. As of September 2002, there were twenty-eight registered public utility holding company systems and a total of sixty-four public utility holding companies. 2002 SEC ANN. REP. 65.

177. Nidhi Thakar, *The Urge to Merge: A Look at the Repeal of the Public Utility Holding Company Act of 1935*, 12 LEWIS & CLARK L. REV. 903, 910 (2008). Further, the Roosevelt administration was interested in local and government ownership of utilities, and President Roosevelt believed that holding companies needed to be eliminated from the public utility business. *Id.* The President viewed holding companies as "private socialism of concentrated private power." *Id.*; see also SELIGMAN, *supra* note 147, at 129 (quoting Markian M.W. Melnyk & William S. Lamb, *The PUHCA's Gone, What Is Next for Holding Companies?*, 27 ENERGY L.J. 1, 3 (2006)).

It was not only the size and geographic breadth of the utilities that disturbed policymakers, but also their unsound corporate structures and practices.<sup>178</sup> Federal regulators found the abuses adversely affected the interests of the American public as investors and consumers.<sup>179</sup> Among the evils uncovered were inflationary write-ups on the books of the operating companies, acquisitions of properties at inflated valuations, the financing of corporate expansions by issuing excessive amounts of senior securities and insufficient amounts of common stock (leading to excessive leverage and inequitable capital structures), giving favorable treatment to investment bankers, and the extraction of excessive dividends and fees.<sup>180</sup> A study by the FTC also noted that inappropriate partial bargaining between holding companies and their subsidiaries led to the imposition of excessive charges upon the operating subsidiaries; the allocation of charges from service, management, construction, and other contracts among subsidiary public utilities in different states, causing problems of regulation for any individual state; the complication of state regulation of subsidiaries through the exercise of control over subsidiary business policies; the use of inadequate equity investments to exert control over operating subsidiaries; and the extension of holding company systems without regard to operational, integration, and business logistics.<sup>181</sup>

Further, the holding company structure led to financial imbalances. Control of the utilities was accomplished by leverage, in that the holding companies held voting common stock, but the real equity was held by the public in the form of nonvoting preferred stock and debt securities.<sup>182</sup> Although this type of leverage made for high valuations during the boom of the 1920s, excessive debt-to-equity ratios were the principal cause of

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178. Section 1(b) of the Act sets out some of the abuses: inadequate disclosure to investors of the information necessary to appraise the “financial position or earning power” of the holding company; the issuance of securities “without the approval or consent of the States having jurisdiction over subsidiary public-utility companies”; the issuance of securities “upon the basis of fictitious or unsound asset values . . . and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies;” and the overcapitalization of operating subsidiaries, thus increasing fixed charges and “tend[ing] to prevent voluntary rate reductions.” Public Utility Holding Company Act, ch. 687, § 1(b), 49 Stat. 803, 803–04 (1935) (codified at 15 U.S.C. § 79a(b) (2000)), *repealed by* Energy Policy Act of 2005, 42 U.S.C. §§ 16451–16463 (2005); *see also* 6 HAZEN, *supra* note 171.

179. § 1(b), 49 Stat. at 803–04; *see also* 6 HAZEN, *supra* note 171.

180. *See* 1 LOSS & SELIGMAN, *supra* note 170, at 230–31.

181. § 1(b), 49 Stat. at 803–04; *see also* 6 HAZEN, *supra* note 171. The public utility systems became complex and overcapitalized systems. 6 HAZEN, *supra* note 171, § 18.1, at 441. Often beyond the power of any single state regulators, abuse of their complex structures led many holding companies into bankruptcies and caused tremendous losses for investors. *See* 10 SEC ANN. REP. 86 (1944).

182. *See* 1 LOSS & SELIGMAN, *supra* note 170, at 232.

the bankruptcies of many utility holding companies during the bust of the 1930s.<sup>183</sup>

The general purposes of the PUHCA were to strengthen the capital structure of holding companies by increasing the ratio of equity to debt,<sup>184</sup> to return control to local regulators and managers, and to improve their corporate governance.<sup>185</sup> A bitter and prolonged legislative battle preceded the enactment of the PUHCA, and after the statute was passed, the industry refused to comply.<sup>186</sup> The most important public utilities did not even register with the SEC but instead tested the constitutionality of the legislation.<sup>187</sup> However, careful legal maneuvering by the SEC avoided a declaration that the statute was unconstitutional, and in time, changes in the composition of the Supreme Court made such a declaration unlikely.<sup>188</sup> Yet, the SEC was not able to fully implement the statute until the Truman administration.<sup>189</sup>

#### D. OVERVIEW OF THE PUHCA

The PUHCA was primarily concerned with regulation rather than disclosure. It required all holding companies with subsidiaries engaged in the electric utility business or in the retail distribution of natural or manufactured gas to register with the SEC.<sup>190</sup> Thereafter, the holding company became subject to two principal provisions. Section 11

183. See SELIGMAN, *supra* note 147, at 128.

184. According to the SEC, "a balanced capital structure with a substantial amount of common stock equity . . . provides a considerable measure of insurance against bankruptcy[,] enables the utility to raise new money most economically, and avoids the possibility of deterioration in service to consumers if there is a decline in earnings." 10 SEC ANN. REP. 72 (1944).

185. 6 HAZEN, *supra* note 171, § 18.1, at 441. The Securities Act of 1933 and the Securities Exchange Act of 1934 address the securities markets generally and thus were ill-equipped to deal with problems peculiar to the public utilities industry. *Id.* Above and beyond the Acts, the PUHCA was intended "to compel the simplification of public-utility holding-company systems . . ." See § 1(b), 49 Stat. at 804. The fundamental purpose of the PUHCA was to "free utility operating companies from the absentee control of holding companies, thus allowing them to be more effectively regulated by the states." 6 HAZEN, *supra* note 171, § 18.1, at 441. According to Hazen, the following sources are illustrative:

North American Co. v. SEC, 327 U.S. 686, 704 (1946) (by compelling holding companies to "integrate and coordinate their systems and to divest themselves of security holdings of geographically and economically unrelated properties . . . Congress hoped to rejuvenate local utility management and to restore effective state regulation."); Alabama Elec. Co-op., Inc. v. SEC, 353 F.2d 905, 9 (D.C. Cir.1965), *cert. denied* 383 U.S. 968 (1966) ("The purpose of Public Utility Holding Company Act . . . was to supplement state regulation—not to supplant it.").

6 HAZEN, *supra* note 171, § 18.1, at 441 n.14.

186. See PARRISH, *supra* note 146, at 219.

187. See *id.* at 219–20.

188. See SELIGMAN, *supra* note 147, at 132–38.

189. *Id.* at 257.

190. § 5, 49 Stat. at 812–14.

mandated geographical integration and corporate simplification,<sup>191</sup> and other sections regulated the financing and operation of the holding company system, including transactions with affiliates.<sup>192</sup> The SEC's authority to review a holding company's financial structure included the regulation of intercompany loans, the payment of dividends, sale of assets, proxy solicitations, and service, sales, and construction contracts.<sup>193</sup> Very importantly, the SEC approved securities issuances and acquisitions according to a merit review regime, in addition to a disclosure based review.<sup>194</sup> Intracompany transfers were limited. The evil of a powerful oligopoly having an undue influence on political policy was recognized and controlled. The financial promotion of any candidate for public office or the support of any political party was prohibited.<sup>195</sup>

The SEC had the authority to determine what constituted a "holding company," "subsidiary," or "affiliate" subject to the PUHCA.<sup>196</sup> The standard utilized by the SEC was 10% voting stock ownership.<sup>197</sup> Because the main objective of the PUHCA was to achieve a balanced capital structure for utilities, the most important provision of the PUHCA gave the SEC the power to cause a holding company to eliminate more than two tiers of holding companies in any holding company complex.<sup>198</sup> Further, the SEC could restructure a holding company whenever necessary "to ensure that the corporate structure or continued existence of any company in the holding company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders . . . ."<sup>199</sup>

The PUHCA has been described as "the most ambitious legislation of the depression-inspired federal attack on concentrated economic

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191. *Id.* § 11. This section was sometimes called the "death sentence," because it put an end to the holding companies as they previously existed. See Thakar, *supra* note 177, at 912.

192. See §§ 5, 6, 49 Stat. at 812-14; Douglas W. Hawes, *Public Utility Holding Company Act of 1935—Fossil or Foil?*, 30 VAND. L. REV. 605, 608 (1977); see also *Elec. Bond & Share Co. v. SEC*, 303 U.S. 419, 442-43 (1938) (holding the registration provisions of the PUHCA constitutional); *N. Am. Co. v. SEC*, 133 F.2d 148 (2d Cir. 1943), *aff'd*, 327 U.S. 686 (1946).

193. See §§ 12(a)-(e), 13(a), 49 Stat. at 823-25.

194. See 1 LOSS & SELIGMAN, *supra* note 170, at 240-43.

195. *Id.* at 240-41.

196. *Pub. Serv. Comm'n v. SEC*, 166 F.2d 784 (2d Cir. 1948); *Phillips v. SEC*, 153 F.2d 27 (2d Cir. 1946).

197. Blumberg, *supra* note 151, at 305. This was a much lower number than the concept of control in other statutes. For example, the Bank Holding Company Act and the Savings and Loan Holding Company Act utilize 25% as the standard, although implementing administrative regulations go down to as low as 5% and 10%. *Id.*

198. Markian M.W. Melnyk & William S. Lamb, *PUHCA's Gone: What Is Next for Holding Companies?*, 27 ENERGY L.J. 1, 7 (2006).

199. Public Utility Holding Company Act, § 11(b)(2), 49 Stat. 803, 821 (1935) (codified as amended at 15 U.S.C. § 79-79(z)-6 (2000)), *repealed by* Energy Policy Act of 2005, 42 U.S.C. §§ 16451-16463 (2005).



power.”<sup>200</sup> Although the SEC had the authority to integrate and simplify the structure of the holding companies, the agency accomplished the restructuring of the utility industry by inducing the utilities to propose acceptable divestiture and simplification plans. It did so not only by interpreting some provisions of the statute in an uncompromising way and litigating its interpretations, but also by utilizing exceptions and giving rewards to companies that completed voluntary proceedings.<sup>201</sup> These rewards were to increase the value of both preferred and common stock in reorganization proceedings. The financial structure of both holding companies and operating companies was strengthened.<sup>202</sup> Although the SEC was forced to compromise with the utilities in order to achieve the PUHCA’s objectives, the agency’s geographic integration of the utilities and their corporate simplification was “the most comprehensive structural relief ever achieved by an agency of the federal government. The SEC’s enforcement . . . also was an illustration of the advantages of the process.”<sup>203</sup>

#### E. GEOGRAPHICAL INTEGRATION AND CORPORATE SIMPLIFICATION

In order to strengthen the capital structures of holding company systems and to bring the utilities industry back under the control of local management and local regulation, the SEC had to examine the corporate structures of holding companies and their subsidiaries.<sup>204</sup> The SEC had to determine “the extent to which their corporate structures could be simplified, or their voting power redistributed, and whether their properties and businesses were restricted to those necessary or appropriate to the operations of an integrated public utility system.”<sup>205</sup> The PUHCA’s geographical integration provision was its “very heart.”<sup>206</sup> It required that each holding company system be limited to a single integrated electric or gas utility system, and to such other businesses as were reasonably incidental, or economically necessary or appropriate, to the operations of the system.<sup>207</sup> The term “integrated public utility

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200. SELIGMAN, *supra* note 147, at 247 & 794–95 n.22 (quoting Ronald Finlayson, *The Public Utility Holding Company Under Federal Regulation*, J. BUS., July 1946, at 11, 11) (internal quotation marks omitted).

201. James W. Moeller, *Requiem for the Public Utility Holding Company Act of 1935: The “Old” Federalism and State Regulation of Inter-State Holding Companies*, 17 ENERGY L.J. 343, 350 (1996); see SELIGMAN, *supra* note 147, at 254.

202. Melnyk & Lamb, *supra* note 198.

203. SELIGMAN, *supra* note 147, at 263.

204. See § 11(a), 49 Stat. at 820.

205. See 6 HAZEN, *supra* note 171, § 18.4.

206. SEC v. New England Elec. Sys., 384 U.S. 176, 180 (1966) (quoting N. Am. Co. v. SEC, 327 U.S. 686, 704 n.14 (1946)).

207. § 11(b)(1), 49 Stat. at 820–21.

system” contemplated a group of naturally-related properties within a single area or region<sup>208</sup> with respect to both electric and gas companies.<sup>209</sup>

A single “integrated public utility system” could not include both gas and electric properties.<sup>210</sup> But a holding company had the right to continue to control one or more additional public utility systems, whether gas or electric, if the SEC, among other things, found that each such additional system could not be operated as an independent system without the loss of “substantial economies,”<sup>211</sup> and that all such additional systems were located in one state or in adjoining states, or in a contiguous foreign country.<sup>212</sup> As a precondition, the SEC also had to find that the continued combination of such systems under the control of a single holding company was not so large as to adversely affect the advantages of localized management, the efficiency of operations, or the effectiveness of regulation. For a holding company to continue control of one or more additional integrated public utility systems, all of the above conditions would have to be met.<sup>213</sup> The retention of an additional integrated system was very rare.<sup>214</sup> Only if the SEC found that it was “necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems,”<sup>215</sup> could a holding company retain an interest in a functionally related non-utility business.<sup>216</sup>

208. See *Nat'l Rural Elec. Co-op. Ass'n v. SEC*, 276 F.3d 609, 610–11 (D.C. Cir. 2002) (citing 15 U.S.C. §§ 79j(c)(1), 79k(b)(1), 79b(a)(29)(A) and vacating the SEC's decision to approve a merger involving two geographically distant companies); see also 6 HAZEN, *supra* note 171, § 18.4.

209. See § 2(a)(29), 49 Stat. at 810.

210. *Phila. Co. v. SEC*, 177 F.2d 720, 723 (D.C. Cir. 1949); *Columbia Gas & Elec. Corp.*, 8 S.E.C. 443, 462 (1941). This prohibition of utilities with both gas and electric divisions was later relaxed and eventually all but abandoned. See 6 HAZEN, *supra* note 171, § 18.5.

211. See § 11(b)(1)(A), 49 Stat. at 820; *New England Elec. Sys.*, 384 U.S. at 179; *Phila. Co.*, 28 S.E.C. 35, 46 (1948), *aff'd sub nom. Phila. Co. v. SEC*, 177 F.2d 720 (D.C. Cir. 1949); see also *City of New Orleans v. SEC*, 969 F.2d 1163, 1167–68 (D.C. Cir. 1992).

212. § 11(b)(1)(B), 49 Stat. at 820. See *Eng'rs Pub. Serv. Co. v. SEC*, 138 F.2d 936, 941–42 (D.C. Cir. 1943) (“[Within an integrated public utility system, all] additional systems [had to be] located in the same state with the principal system, or in adjoining states, or in a contiguous foreign country.”), *vacated as moot*, 332 U.S. 788 (1947).

213. *Eng'rs Pub. Serv. Co.*, 138 F.2d at 941; see also *Env'tl. Action, Inc. v. SEC*, 895 F.2d 1255, 1263 (9th Cir. 1990); *N. Am. Co. v. SEC*, 133 F.2d 148, 152 (2d Cir. 1943), *aff'd*, 327 U.S. 686 (1946).

214. *New England Elec. Sys.*, 384 U.S. at 180.

215. *N. Am. Co.*, 133 F.2d at 152 (quoting section 11) (internal quotation marks omitted); see also *Eng'rs Pub. Serv. Co.*, 138 F.2d at 947. But see *Phila. Co.*, 177 F.2d at 726 (quoting *N. Am. Co. v. SEC*, 327 U.S. 686 (1946)).

216. For a number of decisions relating such a finding, see *Panhandle E. Pipe Line Co. v. SEC*, 170 F.2d 453, 462–63 (8th Cir. 1948) (pipeline construction); *Columbia Gas Sys., Public Utility Holding Company Act Release No. 35-21895*, 21 SEC Docket 1480 (Jan. 23, 1981) (gas by-products); *Sys. Fuels Inc., Public Utility Holding Company Act Release No. 21367*, 19 SEC Docket 103 (Dec. 28, 1979) (uranium); *Ohio Power Co., Public Utility Holding Company Act Release No. 21173*, 18 SEC Docket 15 (Aug. 3, 1979) (railcar repair facilities); *Columbia Gas of Ohio, Inc., Public Utility Holding Company Act Release No. 20561*, 1978 WL 196975 (May 26, 1978) (lending for purpose of installing insulation); *New England Elec. Sys., Public Utility Holding Company Act Release No. 18635*, 5 SEC

Importantly, the PUHCA also required corporate simplification.<sup>217</sup> It mandated elimination of corporate layers that complicated the structure of the holding company system. The unduly complicated structure caused the distribution of voting power among the system's security holders to be unfair or inequitable.<sup>218</sup> The SEC was required to take whatever action was necessary to ensure that holding companies ceased to be holding companies with respect to any subsidiaries having their own subsidiaries that were also holding companies.<sup>219</sup> However, the SEC could not regulate the corporate structure of any company that was not a holding company, or whose principal business was that of a public utility operating company,<sup>220</sup> except to ensure fair and equitable distribution of voting power among the shareholders of such a company.<sup>221</sup>

An order of the SEC directing a registered holding company to simplify its corporate structure was required to be complied with within one year.<sup>222</sup> If the holding company refused to comply voluntarily, the SEC could enforce the order in a U.S. district court.<sup>223</sup> Because Congress intended for holding company systems to comply with the PUHCA voluntarily,<sup>224</sup> the SEC's orders "normally declared only that [a] particular holding company or subsidiary . . . reclassify its securities, . . . divest certain holdings, or liquidate, without specifying how this was to be accomplished."<sup>225</sup> Companies could file their own plan of compliance.<sup>226</sup> Even in reorganization proceedings, the PUHCA was not intended to cause forced liquidation of securities.<sup>227</sup>

Docket 372 (Oct. 30, 1974) (oil and gas exploration); Middle S. Utils., Public Utility Holding Company Act Release No. 185547, 5 SEC Docket 102 (Sept. 5, 1974) (refineries); N. Am. Co., 29 S.E.C. 521, 533 (1949) (coal properties); Cities Servs. Gas Co., 15 S.E.C. 962, 969 (1944) (production and transmission facilities); Eng'rs Pub. Serv. Co., 12 S.E.C. 41 (1942) (merchandising of appliances). For examples of businesses that have not been found to be functionally related, see Pennzoil Co., 43 S.E.C. 709, 719 (1968) (electrical instruments); N. New England Co., 20 S.E.C. 832, 842-44 (1945) (pulpwood); N. Am. Co., 11 S.E.C. 194, 226 (1942) (land development).

217. See § 11(b)(2), 49 Stat. at 821.

218. See, e.g., *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 108-09 (1946) (noting evidence was sufficient to support finding that two subsidiary companies unduly and unnecessarily complicate a holding company's system); *Wis.'s Envtl. Decade, Inc. v. SEC*, 882 F.2d 523, 527 (D.C. Cir. 1989) (finding a holding company's acquisition of a public utility did not unnecessarily complicate corporate structure of utility). See generally Leo W. Leary, "Fair and Equitable" *Distribution of Voting Power Under the Public Utility Holding Company Act of 1935*, 52 MICH. L. REV. 71 (1953).

219. § 11(b)(2), 49 Stat. at 821.; see, e.g., *Otis & Co. v. SEC*, 323 U.S. 624, 626 (1945).

220. See § 11(b)(2), 49 Stat. at 821.

221. 6 HAZEN, *supra* note 171, § 18.1.

222. See § 11(c), 49 Stat. at 821.

223. *Id.* § 11(d).

224. 10 SEC ANN. REP. 65 (1944).

225. 6 HAZEN, *supra* note 171, § 18.4.

226. § 11(e), 49 Stat. at 822. The SEC could approve the plan if it found the plan to be necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected. *Id.*

227. *N. Am. Co. v. SEC*, 327 U.S. 686, 709 (1946); *In re Elec. Bond & Share Co.*, 73 F. Supp. 426, 449 (S.D.N.Y. 1946). In fact, reorganization plans under section 11(e) frequently provided for

In addition to reducing the concentration of economic power in the utilities industry, the PUHCA had several beneficial effects upon investors, consumers, and utility companies. Operating companies became financially stronger and more responsive.<sup>228</sup> Investors began to buy securities in public utility companies. These investments were more accurately valued. Investors began receiving previously unseen dividends and other cash payments.<sup>229</sup>

#### F. CONTINUED OPERATION AND REGULATION

Geographical and corporate simplification requirements led many holding companies to self-liquidate. But the PUHCA did not intend elimination of all holding companies.<sup>230</sup> The PUHCA “prescribe[d] standards for the continued operation of compact, well-integrated systems,” regulated by the SEC.<sup>231</sup> The provisions of the PUHCA that continued to apply related to the issuance of securities<sup>232</sup> and to the acquisition of securities, utility assets, and other interests.<sup>233</sup> The PUHCA also addressed intercompany transactions,<sup>234</sup> reporting requirements,<sup>235</sup> and standards for accounting and record keeping.<sup>236</sup> In line with other federal securities laws, the PUHCA imposed liability for materially misleading statements<sup>237</sup> and prohibited certain activities by corporate insiders, including insider trading.<sup>238</sup>

Acquisitions also were regulated.<sup>239</sup> The SEC would not approve acquisitions of interests in another business if: (1) the acquisition led to interlocking relations or a concentration of control that was detrimental to investors or consumers,<sup>240</sup> (2) the consideration to be paid in connection with such acquisition was unreasonable or unfair,<sup>241</sup> or (3) the “acquisition

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alternative methods of compliance. *See* 10 SEC ANN. REP. 65 (1944). The SEC had to evaluate whether corporate reorganization plans were fair and equitable. *See id.* The SEC mainly sought to ensure that reorganization did not result in the destruction of values or in the taking of investment interest. *Id.*

228. *See* authorities cited *supra* note 171.

229. *See* 10 SEC ANN. REP. 65–66 (1944).

230. 15 SEC ANN. REP. 95 (1949).

231. *Id.*

232. Public Utility Holding Company Act, ch. 687, §§ 6, 7, 49 Stat. 803, 814–17 (1935) (codified at 15 U.S.C. § 79a(b) (2000)), *repealed by* Energy Policy Act of 2005, 42 U.S.C. §§ 16451–16463 (2005) (requiring a “declaration” containing the types of information required by 1933 Act registration).

233. §§ 8–10, 49 Stat. at 817–20.

234. *Id.* §§ 12, 13.

235. *Id.* § 14.

236. *Id.* § 15; *see also* 17 C.F.R. pt. 256 (2004).

237. § 16, 49 Stat. at 829–30.

238. *Id.* § 17.

239. *Id.* § 10.

240. *Id.* § 10(b)(1); *see e.g.*, *Tex. Utils. Co.*, 1 S.E.C. 944, 952 (1936).

241. § 10(b)(2), 49 Stat. at 819; *see, e.g.*, *Ohio Power Co.*, 44 S.E.C. 340, 346 (1970) (approving acquisition upon finding that the consideration had fair relation to the sums invested or the earnings

[would] unduly complicate the capital structure of the holding company system . . . or [would] be detrimental to the public interest or the interest of investors or consumers or the proper functioning of such holding-company system."<sup>242</sup> The SEC had to make specific findings that the transaction would "serve the public interest by tending towards the economical and the efficient development of an integrated public-utility system."<sup>243</sup>

By the end of the century, many holding companies<sup>244</sup> operated under exemptions from registration that continued "unless and except" the SEC found the exemption detrimental to the public interest or to the interest of investors or consumers.<sup>245</sup> Thus, exempt holding companies were indirectly regulated by the exemption, as they risked losing the exemption if they purchased a significant nonutility business not functionally related to the operation of the utility system.<sup>246</sup>

The PUHCA had subjected an entire industry sector to close scrutiny by a federal regulator. This was an unprecedented and successful experiment in America's economic history. While the PUHCA solution may be viewed as a product of its time, it worked effectively, and there is no reason a similar approach could not work again. This Article hypothesizes that certain aspects of the PUHCA model, for example a version of the corporate simplification framework, could be transplanted and utilized in an industry, such as financial mega-conglomerates, whose condition and symptoms resemble those that plagued the public utilities in 1930s.

#### G. HOW A PUHCA SOLUTION COULD BE APPLIED TO THE BANKS

The New Deal regulatory response to the problems of banking was similar in many respects to the New Deal regulatory response to public utility and common carrier regulation: "The essential features of [these regulatory systems] were entry control, price control, market allocation through the forced separation of commercial banking from investment banking and securities activities, and close supervision of investments

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capacity of the properties and that the amount was arrived at after arm's length bargaining); *see also* 6 HAZEN, *supra* note 171.

242. § 10(b)(3), 49 Stat. at 819; *see, e.g.*, Louisville Gas & Elec. Co., 10 S.E.C. 1091, 1091 (1942).

243. § 10(c)(2), 49 Stat. at 819; Am. Gas & Elec. Co., 22 S.E.C. 808, 810 (1946); *see, e.g.*, Envtl. Action, Inc. v. SEC, 895 F.2d 1255, 1258-59 (9th Cir. 1990) (upholding the SEC's approval of an asset acquisition in the face of a challenge by retail customers of one of the holding company's subsidiaries).

244. 1993 SEC ANN. REP. 44. In 1986, there were thirteen registered holding companies. 1986 SEC ANN. REP. 156.

245. Brian C. Elmer & Mark E. Mazo, *Utility Takeovers and the Holding Company Act*, PUB. UTIL. FORT., Sept. 30, 1982, at 17, 17. Ninety-one holding companies had exemptions from registration as of June 1982. *Id.*

246. *See* H.R. REP. NO. 1318, at 14-15 (1935); *see also* authorities cited *supra* note 171.

and related activities.”<sup>247</sup> One significant difference was the creation of the FDIC.<sup>248</sup> Although FDIC insurance undoubtedly prevented bank runs and assured the stability of banks for a long period of time, it also led to the too-big-to-fail principle that is now so questionable and controversial. The need to protect the deposit insurance fund also led to the creation of mega-banks.

It is not possible to go back to the economy of the 1930s, and the New Deal philosophy of protecting business through regulations that proved anti-competitive was discredited during the deregulatory decades of 1980 to 2010. Perhaps, however, in the aftermath of the financial meltdown of 2008, it is time to discredit the ideology of deregulation and return to some of the ideas of the 1930s. Uncontrolled competition in free markets led to the collapse of the financial system and enormous destruction in the real economy. The problems of the decade from 2000 to 2010, like the problems of the 1920s, were too much leverage in the financial system, too much complexity in the banking and investment banking systems, and the creation of holding company structures that proved unmanageable.<sup>249</sup> Furthermore, despite all of the financial regulation that continued to exist, functional regulation meant that no agency had regulatory oversight and control over subsidiaries of holding companies that sheltered off-balance sheet liabilities and threatened the viability of their parents and regulated entities. Legislation that would rationalize holding company structures, and make these organizations simpler and more transparent could therefore be of value.

A statute, analogous to the PUHCA, that rationalizes the corporate structure and operations of the financial services industry and eliminates conflicts of interest between banking and other activities would be a novel but effective antidote to the functional regulation that sowed the seeds for the financial crisis of 2008. Although the Fed will now have oversight of systemically significant institutions and a council composed of all of the financial regulators, headed by the Treasury, will be formed,<sup>250</sup> Dodd-Frank sets forth no comprehensive plan for controlling the size or complexity of the mega-banks. Some new ideas for curtailing risk through corporate structural reform were considered by Congress in the 2010 financial reform debates—specifically, concentration and growth limits for systemically important firms, moving derivatives trading to subsidiaries, and the Volcker Rule.<sup>251</sup> Unfortunately, these ideas have

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247. Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 303 (1987).

248. *Id.* at 302–03.

249. See John Kay, *We Should All Have a Say in How Banks Are Reformed*, FIN. TIMES, June 16, 2010, at 13.

250. Dodd-Frank Act, Pub. L. No. 111-203, § 1002, 124 Stat. 1376, 1955–64 (2010).

251. See Sewell Chan, *Financial Debate Renews Scrutiny on Size of Banks*, N.Y. TIMES, Apr. 21,

been watered down to the point where they may not be a meaningful curb on risky activities by the largest banks or prevent further concentration in the financial sphere.

Under Dodd-Frank, the Financial Stability Oversight Council (the "Council") is required to identify systemically important nonbank financial companies<sup>252</sup> and then to make recommendations to the Fed concerning the establishment of prudential standards and reporting and disclosure requirements.<sup>253</sup> Bank holding companies with \$50 billion or more in assets are automatically subject to enhanced prudential standards.<sup>254</sup> Large investment-banking holding companies will be subject to Fed supervision.<sup>255</sup> If the Fed finds a systemically important company poses a grave threat to financial stability, with the approval of two-thirds of the members of the Council, the Fed must take action to mitigate the risk.<sup>256</sup> Such action could include limiting the ability of the company to merge with or otherwise become affiliated with another company, restricting offers of a financial product, ordering termination of activities or imposing restrictions on such activities, or requiring the company to sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities.<sup>257</sup>

More drastic curtailment of concentration and growth limits has been left either to studies or to future Fed rulemaking. Six months after the passage of Dodd-Frank, the Council must complete a study on the prohibition on acquisitions by firms where the total assets of the resulting company would exceed 10% of aggregate U.S. liabilities.<sup>258</sup> Within nine months of the Council's study, the Fed must issue rules limiting merger and acquisition transactions that would result in a company holding greater than 10% of the aggregate consolidated liabilities of all financial companies.<sup>259</sup> The Fed is instructed to issue concentration limits for large interconnected bank holding companies with more than \$50 billion in

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2010, at A-1; John Gapper, *Volcker Has the Measure of the Banks*, FIN. TIMES, Jan. 28, 2010, at 15; Gretchen Morgenson, *Do You Have Any Reforms in Size XL?*, N.Y. TIMES, Apr. 25, 2010, (Sunday Business), at 1; Paul Volcker, *How to Reform Our Financial System*, N.Y. TIMES, Jan. 31, 2010, (Sunday Opinion), at 11.

252. Nonbank financial companies are any company other than a bank holding company predominantly engaged in financial activities, which means that 85% or more of the company's and its subsidiaries' consolidated annual gross revenues or consolidated total assets are attributable to activities that are financial in nature. § 102(a)(4)(B), (a)(6), 124 Stat. at 1391-92.

253. *Id.* § 112(a)(2)(I).

254. *Id.* § 165(a)(1)(A).

255. *Id.* § 113(a)(1), (b)(1). During the 2008 crisis, the largest broker-dealer holding companies were either acquired by banks or became bank holding companies. See *supra* note 129 and accompanying text.

256. § 121(a), 124 Stat. at 1410-11.

257. *Id.*

258. *Id.* sec. 622, § 14(b), (e).

259. *Id.* sec. 622, § 14(e).

assets and for systemically important nonbank financial companies.<sup>260</sup> Among other things, these rules must prohibit such companies from having credit exposure to any unaffiliated company that exceeds 25% of the capital stock and surplus of the company.<sup>261</sup>

The Volcker Rule prohibits any “banking entity”<sup>262</sup> from “engag[ing] in proprietary trading[,] . . . or acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or private equity fund.”<sup>263</sup> In the course of the negotiations for this legislation, the Volcker Rule became subject to many exceptions, including purchases or sales of any security in connection with underwriting or market-making activities, risk-mitigating hedging activities, and purchases or sales of any security or other instrument on behalf of customers.<sup>264</sup> Further, a bank may sponsor a private equity or hedge fund under certain conditions and maintain a 3% interest in the fund.<sup>265</sup> As initially proposed, the Volcker Rule was designed to control the conflicts of interest and risk generated by the trading activities of banks that led to the meltdown. It was viewed by its proponent as a mini-Glass-Steagall.<sup>266</sup> Dodd-Frank, as enacted, does not really accomplish this task. The Council is directed within six months after the enactment of Dodd-Frank to complete a study and make recommendations to implement the Volcker Rule,<sup>267</sup> but it can be anticipated that the same lobbying activities that led to the watering down of the Rule will occur in this process.<sup>268</sup>

A proposal to force all banks to conduct derivatives trading in a subsidiary was considered when the legislation was under consideration,<sup>269</sup>

260. *Id.* § 165(a).

261. *See id.* § 165(e)(2).

262. “Banking entity” is defined as any insured depository institution, any company that controls such an institution, or any company that is treated as a bank holding company under the International Banking Act. *Id.* sec. 619, § 13(h)(1).

263. *Id.* sec. 619, § 13(a)(1).

264. *Id.* sec. 619(d), § 13(d).

265. *See id.* It is uncertain how rigorously this provision will be enforced or whether banks will believe they need to come to the rescue of a hedge fund sold to their customers that gets into financial difficulty. The decision by Bear Stearns to financially support two hedge funds that it had sponsored was the beginning of that firm’s death spiral. *See* WILLIAM D. COHAN, *HOUSE OF CARDS* 362–71 (2009). This is the gist of the problem in the regulation of holding company subsidiaries. Instead of serving as a source of strength, they have served to seriously weaken their parents. *See supra* notes 12 & 18 and notes 100–03 and accompanying text (regarding Continental Illinois’ problems during the 1987 stock market crash).

266. Louis Uchitelle, *Volcker, Loud and Clear*, N.Y. TIMES, July 11, 2010, (Sunday Business), at 1.

267. Sec. 619, § 13(d)(2)(B), 124 Stat. at 1623.

268. *See* Daniel Indiviglio, *5 Ways Lobbyists Influenced the Dodd-Frank Bill*, ATLANTIC (July 5, 2010), <http://www.theatlantic.com/business/archive/2010/07/5-ways-lobbyists-influenced-the-dodd-frank-bill/59137/>; Aaron Lucchetti & Jenny Strasburg, *What’s a “Prop” Trader Now?*, WALL ST. J., July 6, 2010, at C1.

269. *See* Letter from Thomas Hoenig, President, Fed. Reserve Bank of Kan. City, to Senator Blanche Lincoln, Sen. of Ark. (June 10, 2010), available at <http://www.huffingtonpost.com/2010/06/10/>



but the final version of Dodd-Frank is not as draconian as initially envisioned. Nevertheless, two of the mega-banks have exited from derivatives proprietary trading in response to Dodd-Frank.<sup>270</sup> There is a push out of swap dealers and major swap participants from banks, but these provisions do not apply to an insured depository institution engaged in hedging or risk mitigation activities directly related to its business.<sup>271</sup> Moreover, the statute expressly permits an insured depository institution to enter into swaps involving rates, currencies, or any other assets that are permissible investments for national banks, including investment grade certificates of deposit.<sup>272</sup> Additionally, any bank or bank holding company is prohibited from becoming a swaps entity except in compliance with standards to be set by its prudential regulator,<sup>273</sup> unless such activities are conducted by a bank affiliate supervised by the Fed.<sup>274</sup>

Whether risky trading or other activities are conducted in a bank or in the subsidiary of a financial holding company is not the real issue. If the subsidiary is hiding the liabilities of the parent, or is out of control in terms of risk, the parent will be punished by the market if the subsidiary fails. Although Congress can prohibit the use of federal funds to save the subsidiary, the reality of the marketplace is that such a mandate does not matter.<sup>275</sup> Although appropriate capital charges can mitigate this type of risk, the only way to assure that a holding company subsidiary does not sink the parent is to spin off the subsidiary. Alternatively, subsidiaries engaged in risky businesses can be relegated to organizations which do not have deposit or other similar government insurance.

Although securities firms enjoy insurance from the Securities Investor Protection Corporation for customer funds and securities in the safekeeping of the firms, they are not allowed to use these customer assets as capital in the conduct of their business. Rather, such assets are segregated.<sup>276</sup> Therefore, when Drexel Burnham Lambert failed in 1990,

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thomas-hoenig-derivatives-banks\_n\_608297.html; see also Edward Wyatt, *In Tough Stance, Democrat Finds Few Allies*, N.Y. TIMES, May 16, 2010, at A16.

270. See Jerry A. DiColo, *With Big Banks Forced to Exit, Look for Speculators to Step In*, WALL ST. J., Sept. 7, 2010, at C10.

271. § 716(d), 124 Stat. at 1648–49.

272. *Id.* § 716(d)(2).

273. *Id.*

274. *Id.* at § 716(c).

275. See *supra* notes 100–02 and accompanying text.

276. In 1970, to compliment SIPC, the SEC enacted Rule 15c3-3, “to ease the particular tracing requirements of prior law so as to expand the definition of specifically identifiable property which remains outside the single and separate fund and is ‘reclaimable’ by customers in kind.” 17 C.F.R. § 240.15c3-3 (2010). Pursuant to the rule,

[A] broker-dealer must have possession or control of all fully-paid or excess margin securities held for the account of customers, and determine daily that it is in compliance with this requirement. The broker-dealer must also make periodic computations to

no customer funds or securities were lost, and the parent went into bankruptcy.<sup>277</sup> “The 152 year-old [firm] with 5,300 employees and \$3.6 billion in assets” was at the center of the debt-propelled takeover market of the 1980s.<sup>278</sup> Nevertheless, “[i]n Washington the Government’s top economic team stood by with folded arms and watched the company fail.”<sup>279</sup> Further, “[w]hile Congress [was] eager to investigate debacles like Drexel’s, it [showed] little interest in enacting new laws to curb financial markets, even after the 1987 crash.”<sup>280</sup>

Twenty years later, partly as a result of Gramm-Leach-Bliley, banks and investment banks had numerous subsidiaries in a wide variety of businesses, as did American International Group (“AIG”), an insurance holding company. It was not the business of banking that brought these firms to the brink of collapse. Rather, it was trading bets on and investments in securitized subprime mortgages and derivatives, including credit default swaps. Many of these businesses were conducted in non-banking subsidiaries.<sup>281</sup> The holding company parent was not properly supervised, and subsidiaries with very risky businesses were allowed to operate under the umbrella of firms with federal deposit insurance. Even worse, the federal financial regulators decided that the mega-firms were so interconnected that even an organization like AIG, which was essentially an insurance company, had to be bailed out.<sup>282</sup> Mega-banks strongly opposed pushing out derivatives to subsidiaries—as proposed in early versions of Dodd-Frank—because such a move requires devoting more capital to those businesses. However, even this regulatory change is insufficient to prevent the kind of problems that led to the 2008 meltdown. The problem in 2008, as in 1987, was excessive leverage. The concentration and complexity of the mega-banks simply made matters

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determine how much money it is holding that is either customer money or obtained from the use of customer securities. If this amount exceeds the amount that it is owed by customers or by other broker-dealers relating to customer transactions, the broker-dealer must deposit the excess into a special reserve bank account for the exclusive benefit of customers. This rule thus prevents a broker-dealer from using customer funds to finance its business.

*Guide to Broker-Dealer Registration*, U.S. SEC. & EXCH. COMM’N (Apr. 2008), <http://www.sec.gov/divisions/marketreg/bdguide.htm>.

277. Kurt Eichenwald, *Drexel, Symbol of Wall St. Era, Is Dismantling; Bankruptcy Filed*, N.Y. TIMES, Feb. 14, 1990, at A1.

278. John Greenwald, *Predator’s Fall: Drexel Burnham Lambert*, TIME, Feb. 26, 1990, at 46, 46.

279. *Id.* at 50.

280. *Id.*

281. The AIG unit that was at the center of the financial crisis was an unregulated subsidiary of an insurance holding company. See SORKIN, *supra* note 131, at 154–55, 160, 394–95.

282. AIG did own a trust company subsidiary, and so it was overseen by the Office of Thrift Supervision, the one regulator that will be eliminated in Dodd-Frank. Dodd-Frank Act, Pub. L. No. 111-203, § 312, 124 Stat. 1376, 1521–23 (2010).

worse, so that the government's top economic team no longer believed it could stand by and watch firms fail.

### CONCLUSION

Much of the implementation of Dodd-Frank has been left to the various functional regulators of financial institutions, and some of the more controversial proposed provisions have been relegated to studies. While the statute has many salutary provisions and is clearly an improvement over the existing regulatory system in many respects, it does not change the balkanized nature of the financial regulatory universe. Neither does it curtail the leverage inherent in derivatives trading.<sup>283</sup> Further, it does not reduce the size or complexity of the existing mega-banks. Thus far, there has been no political will to radically change the regulatory system or the composition of the banking industry. This is not surprising, since many of the same players who engaged in the deregulatory policies of the last three decades are still in power.<sup>284</sup> Another financial crisis, a prolonged recession, or changing political ideologies could cause a reexamination of the status quo and lead to decisions to break up the big banks. If that should happen, policymakers could well take another look at the PUHCA as model for doing so.

Since 1980, policymakers have believed that government regulation is problematic, free market competition is an unquestioned good, financial engineering should be encouraged, and we need not worry if financial enterprise eclipses industrial enterprise. These mantras are now being reconsidered. This reconsideration should lead to a more responsible balance between government, finance, and industry, but the poisonous partisanship that has prevailed in Washington in recent years does not give much hope of a sensible resolution of the country's economic problems. Dodd-Frank, despite its length and complexity, should serve as only the beginning to financial regulatory reform. Yet, in view of the intense opposition of the financial industry and the political theatrics of an election year, it is surprising that any reform legislation was enacted at all.

Financial regulators have now been tasked with conducting hundreds of studies and adopting myriad rules to implement Dodd-Frank. Will they cooperate or engage in further turf battles? In their efforts to avoid further bailouts of too-big-to-fail financial organizations,

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283. I have previously criticized the unwillingness of financial regulators to deal with the excessive leverage derivatives have injected into the financial markets. Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Is Appropriate?*, 80 NOTRE DAME L. REV. 909, 935-41 (2005); see also 1987 MARKET BREAK, *supra* note 15, at 3-19 to 3-22.

284. JOHNSON & KWAK, *supra* note 11, at 208.

will they work to make the mega-banks smaller, less opaque, and less complex? At one time, evasion of financial regulation was considered wrong, but during the deregulatory push of the last three decades, mechanisms to evade statutory and regulatory restraints on financial institutions were invented by clever bankers and their lawyers and sanctioned by financial regulators. One of the by-products of overly complex business and legal systems, this unhealthy syndrome of finding ways around laws and regulations should be discredited and changed.<sup>285</sup> Dodd-Frank is a continuation of such prolix complexity. Will financial regulators be sufficiently strong and statesman-like to avoid even more complicated regulations as they implement this legislation?

Financial crises have always followed similar patterns. Excessive leverage and speculation blow up a financial bubble that eventually bursts. The bigger the bubble, the greater the wreckage when the party ends. Ordinary Americans have lost their jobs, their homes, and their savings. It is not surprising that they increasingly distrust the elites in Washington and on Wall Street that cooperated in creating the biggest bubble and the greatest bust since the 1920s and 1930s. It is going to take much more dramatic and radical action to restore the public's confidence in the government and in the capital markets than Dodd-Frank has accomplished. While a twenty-first century New Deal may not be the answer to today's problems, it is at least worth considering which New Deal statutes did accomplish good goals and how these accomplishments were achieved. The PUHCA was one of those statutes.

Let me end on a cautionary note, however. The PUHCA remained on the books long after its goals were accomplished. I was a Commissioner of the SEC during the Three Mile Island disaster,<sup>286</sup> and one of my concerns was whether the PUHCA was in any way responsible for the problems of Three Mile Island. It is quite possible that the electrical utility industry had become too stodgy, and too entrenched, in part because of the PUHCA. Furthermore, it is possible that nuclear power plants like Three Mile Island were starved of necessary capital because utilities were unable to grow sufficiently to raise the amounts of capital needed in an economy more complicated than that of the 1930s. Furthermore, the idea that there should be a market in electrical utility production and the growth and implosion of Enron might have been one

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285. See Patrick Jenkins, *Banks Seek to Exploit New Rules*, FIN. TIMES, Apr. 12, 2010, at 17.

286. On March 28, 1979, the accident at the Three Mile Island Nuclear Generating Station in Middletown, Pennsylvania was the most serious nuclear power plant accident in American history. This generating station was constructed by General Public Utilities Corporation (later renamed GPU Incorporated), a public utility holding company registered with the SEC. See Fact Sheet, U.S. Nuclear Regulatory Comm'n, Backgrounder on the Three Mile Island Accident (Aug. 11, 2009), available at <http://www.nrc.gov/reading-rm/doc-collections/fact-sheets/3mile-isle.html>; see also Gerald Huesken, Jr., *The Legacy of Three Mile Island*, EXAMINER.COM (Dec. 2, 2010, 8:13 PM), <http://www.examiner.com/history-in-harrisburg/the-legacy-of-three-mile-island>.

unwelcome side effect of the continuation of the PUHCA beyond the time when it should have been sunset.

Accordingly, while I believe that the mega-banks need to be broken up and rationalized, and that deposit insurance and other government guarantees should not be allowed to support activities that are not part of the function of intermediation, any antitrust type of effort to reduce banks to a manageable size should not continue indefinitely. The capital markets are always in a state of flux, and we should aim to tame but not destroy the creative forces that drive the economy's engine. Nevertheless, the continued uncontrolled growth of a leveraged trading culture inside the banking system is a prescription for further financial volatility and turmoil that will not have a happy ending.