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United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets

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United Kingdom and United States Responses To the Regulatory Challenges of Modern Financial Markets

HEIDI MANDANIS SCHOONER† AND MICHAEL TAYLOR‡

SUMMARY

I. INTRODUCTION............................................................................................................. 317

II. FINANCIAL MODERNIZATION VERSUS REGULATORY MODERNIZATION.................... 319
   A. Overview of Financial Modernization ................................................................... 319
   B. Financial Modernization Forces Reconsideration of Regulatory Structure .......... 320
      1. Blurred Boundaries ....................................................................................... 320
      2. Conglomeration and Functional Despecialization ....................................... 321
   C. U.S. and U.K. Models of Regulatory Modernization .................................... 323

III. THE UNITED STATES' GRAMM-LEACH-BILLEY ACT: LONG-AWAITED, OVERSHADOWED, AND OBSOLETE ............................................................................ 324
   A. Just One Step Down the Road to Financial Modernization ............................... 324
   B. Repeal of Glass-Steagall Is Overshadowed by New Regulatory Demands .......... 326
   C. GLB's Approach to Regulatory Modernization Emphasizes Functional Regulation ................................................................. 327

IV. THE UNITED KINGDOM'S FINANCIAL SERVICES AND MARKETS ACT: A CONFLUENCE OF SEVERAL THEMES .......................................................................... 329
   A. Background—Regulatory Modernization, Not Financial Modernization .......... 329
   B. A Single Regulator ............................................................................................ 331
   C. The FSA's Objectives ....................................................................................... 332
      1. Consumer Protection and Awareness Regulation ........................................... 333
      2. Financial Crime .............................................................................................. 335
      3. The Stability of the Financial System ............................................................. 336

V. REGULATORY MODERNIZATION IN COMPARATIVE PERSPECTIVE......................... 340

I. INTRODUCTION

In recent years, both the United Kingdom and the United States passed landmark legislation transforming the regulation of financial markets and institutions in those

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Recent trends in financial services challenge the regulatory constructs devised in the last century. Traditionally, regulatory structures have been institution based with separate regulators for banking, securities, and insurance. This structure was premised on the existence of relatively clear distinctions between each business line. The products offered by each industrial sector were relatively easy to categorize, for example, in terms of the distinction between debt, equity, and insurance contracts.³ Similarly, institutions were easily distinguished and categorized into those that took deposits (commercial banks), sold securities (investment banks), and offered insurance (insurance companies). Accordingly, the businesses of banking, securities, and insurance were regulated as if they were separate industries, subject to separate statutes, and administered by separate regulatory agencies. The fading of such distinctions has forced policy makers to reevaluate the structure of regulation given this evolution. Moreover, these trends have resulted in significant changes to the nature and distribution of risk in the financial system: Banks have acquired market risks that were once exclusively borne by securities firms, while securities firms have been exposed to bank-type risk through their acquisition of securitized bank assets. These developments demand a policy response that we call "regulatory modernization."

Regulatory modernization must be understood in its relationship to and distinctiveness from the often discussed "financial modernization." Financial modernization is represented by legislation that removes previous structural restrictions on financial intermediaries. The quest for financial modernization has received extensive legislative attention, particularly in the United States. We believe, however, that regulatory modernization is a far more compelling policy issue. Regulatory modernization is the process of reforming the organization and practices of financial regulation to mirror the economic realities of today's financial services sector. Debate regarding regulatory modernization assumes the implementation of financial modernization policies—which are essentially deregulatory—and deconstructs the remaining regulatory framework to determine if it suits the new financial landscape. The FSMA, which creates a single regulator for all financial services firms, exemplifies an attempt to address regulatory modernization.⁴

This article will examine whether new legislation in the United Kingdom and the United States is successful in addressing the policies associated with regulatory modernization. Part II provides a brief context and background to the policy goals of financial modernization versus regulatory modernization and argues for concentration on regulatory modernization in the reform of finance laws. Part III and Part IV examine the extent to which the policies of regulatory modernization are met under the GLB and the FSMA respectively. We will show that the GLB and FSMA take quite different approaches to these issues. The divergence is not surprising given the long-standing differences in character of financial regulation in Britain versus the United States,⁵ but they

⁴. See discussion infra Part IV.
⁵. Historically, the United States has distinguished itself by having the most complex and restrictive set of rules governing financial institutions. Moreover, the style of regulation in the United States is a very formal one
also point to a much deeper philosophical difference between the two pieces of legislation. In Part V, we conclude with a broader comparative analysis in which the legislative approaches in the two countries are contrasted with trends in other leading industrialized countries. Finally, we offer our predictions and recommendations for future reform.

II. FINANCIAL MODERNIZATION VERSUS REGULATORY MODERNIZATION

Central to our thesis is the distinction between financial and regulatory modernization. Financial modernization seeks the removal of structural restraints, which segment markets and confine institutions to specific business lines. We begin with a brief background of financial modernization, discuss its link to regulatory modernization, and then set forth the importance of regulatory modernization to the effectiveness of regulation of modernized financial markets.

A. Overview of Financial Modernization

The goal of financial modernization is to allow competitive forces, rather than legal rules, to dictate the supply of services and structure of firms. Financial modernization rejects the segmentation of financial services and markets established by the New Deal. The most well known of these restrictions in the United States was the Banking Act of 1933, also known as the Glass-Steagall Act. Glass-Steagall, passed as part of the New Deal package, restricted banks from engaging in most securities business activities and separated the business of commercial banking from the business of investment banking. The current consensus of academic opinion now regards structural regulations as detrimental to safety and soundness. Past concerns about excessive concentrations of economic power and conflicts of interest inherent in multicapacity financial groups have been overridden by the recognition that structural deregulation can reduce risk through portfolio diversification. Consequently, much contemporary academic thinking, followed more slowly by policy-making practice, stresses the importance of leaving the determination of financial group forms to the operation of the market.

that relies heavily on the rule of law as opposed to agency discretion. In contrast, the United Kingdom has imposed relatively fewer restrictions on the activities of financial institutions and has relied on an informal, moral suasion style of regulatory control. For further comparison of bank regulation in the United States and the United Kingdom, see 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, 647-50 (1999).


7. Section 16 of the Glass-Steagall Act prohibits national banks from engaging in most underwriting. 12 U.S.C. § 24 (2000). Significantly, Section 16 was not repealed by GLB, although many other sections of the Glass-Steagall Act were. See discussion infra Part III.B.


9. Concentration of economic power appears to have been especially influential with the drafters of the 1933 Banking Act in the United States. See SUSAN EASTERBROOK KENNEDY, THE BANKING CRISIS OF 1933, at 207-08 (1974). The United States’ approach was very influential in post-war Japan, which modeled its restrictions on banks’ securities activities on those of the United States. However, the Occupation Authorities in Germany were much less successful in exporting their model of finance to that country.
Some countries have adopted financial modernization more rapidly than others. For example, the United Kingdom, which relied on informal measures and customary understandings rather than statute law to segment its financial markets, removed its structural regulations rapidly during the mid-1980s, mistakenly believing that the United States was already moving in the same direction. This process was symbolized by the 1986 “Big Bang” in the City of London, in which institutional membership in the Stock Exchange was permitted for the first time. By contrast, the process of removing structural barriers in the United States has been much slower, and the passage of GLB was preceded by a twenty-year struggle to enact financial modernization legislation. Although the debate on new financial legislation began in the early 1980s, Congress seemed unable to pass any modernization bills. Impatience with the legislative process led banking regulators, primarily the Federal Reserve, to permit incremental expansion by banks into the securities markets through progressively more liberal interpretations of the “engaged principally” clause of Section 20 of Glass-Steagall. Finally, GLB put the legislative stamp of approval on these early agency efforts at modernization.

B. Financial Modernization Forces Reconsideration of Regulatory Structure

While debate regarding financial modernization concerns the extent to which the structure and function of financial groups should be left to the functioning of the market and private ordering, regulatory modernization takes the market approach as a given. The removal of structural regulations in other jurisdictions provides ample evidence of what form of financial system will result from structural deregulation.

1. Blurred Boundaries

In announcing the decision to create a single financial regulator in the United Kingdom, Gordon Brown, MP, Britain’s Chancellor of the Exchequer (finance minister) argued that:

[It] is clear that the distinctions between different types of financial institutions—banks, securities firms and insurance companies—are becoming increasingly blurred. Many of today’s financial institutions are regulated by a plethora of different supervisors. This increases the cost and reduces the effectiveness of supervision.

10. Until the passage of GLB, the United States was practically alone among the industrialized economies in persisting with structural regulation of banking. In the European Union, the model of the universal bank, enshrined in the Second Banking Co-ordination Directive, prevails. Japan has recently repealed Section 65 of its Securities Act (similar in effect to the Glass-Steagall Act) as part of its “Big Bang” financial deregulation and has further moved to eliminate restrictions on holding company structures.


The once bright-line boundaries between the banking, securities, and insurance industries are now blurred.14 This evolution has forced a reconsideration of the basic structure of financial regulation and was part of the justification for the major regulatory reform embarked on in the United Kingdom with the passage of the FSMA. Although this may not be the only, or even the primary, reason for the radical reforms currently under way in the United Kingdom,15 it has nevertheless featured in the British debate to an extent that has no parallel in the United States. A similar process has been under way in Australia, which has also embarked on a radical overhaul of its financial regulatory structure. Significantly, and unlike the process in the United Kingdom, the Australian reforms were made after detailed consideration of the issues posed by the new financial landscape by a commission of inquiry (the Financial System Inquiry, also known as the Wallis Commission after the name of its chairman).16

2. Conglomeration and Functional Despecialization

The blurring of boundaries between the traditional financial sectors can be deconstructed into two overlapping, yet distinct, phenomena: the conglomeration of institutions and functional despecialization. Both conglomeration and functional despecialization support the need for regulatory modernization. First, as the boundaries—whether legal or customary—segregating different types of financial activity have been dismantled, new types of financial firms have emerged, combining at least two of the activities of banking, securities, and insurance.17 As a result, group structures have become more complex and are tending to resemble conglomerate forms, which involve a diversity of institutions operating in a range of different sectors and geographical locations and are subject to different supervisory regimes. Banks are becoming increasingly involved in asset management and broker-dealing activities, while securities houses have increasingly taken on bank-type financial risks. Banking/insurance linkages are also becoming commonplace, usually under a common holding company structure. Given these developments, the Tripartite Group of G10 banking, securities, and insurance supervisors argued in its 1995 report that a “group-wide” perspective is required to obtain an adequate supervisory overview of these financial conglomerates.18 This is difficult to achieve while regulation remains structured according to the outdated industrial categories.


15. As discussed infra Part IV.A, regulatory reform in the United Kingdom followed closely on the heels of a number of domestic financial “scandals” as well as changes to the monetary policy arrangements introduced by the incoming Labour government in May 1997.


17. The creation of Citigroup, the product of the merger of Citibank and Travelers Insurance, is an oftencited example.

The second dimension of industry developments that underpin the case for regulatory modernization might be described in general terms as "functional despecialization." Different financial institutions are increasingly serving the same or similar economic functions. Moreover, technological innovation has created products that cannot be easily accommodated within the traditional contractual forms of debt, equity, and insurance (e.g., credit derivatives). Financial innovation has increased dramatically the marketability and standardization of financial products. It has allowed the creation, concurrently, of more complex products and the unbundling of certain types of risk into their separate components. In addition, contract standardization and the unbundling of risks has permitted different financial institutions to take on exposure to risks that were previously outside their sectoral domain. Combined with considerable progress in the quality and effectiveness of internal risk management systems, and the emergence of new instruments for managing risks, the risk profiles of banks and other types of financial intermediaries have begun to converge. The recent growth of securitization is one manifestation of this trend. As a result, securities houses will increasingly be exposed to the type of risk that is typical of traditional banking business, as their assets include, for example, mortgage-backed securities or securitized bank loans. Similarly, bank balance sheets—previously characterized by their stability—are now subject to much greater volatility, as assets can be securitized and sold and trading activities account for a much larger share of profitability.

The banking industry in the United States provides an excellent example of the process of functional despecialization. A number of studies during the 1990s have stressed that banks are diminishing in importance, at least measured in terms of their share of financial sector assets. In the United States, the bank share of total financial sector assets was stable throughout the 1960s to the early 1980s at around forty percent; by the late 1990s this share had fallen to twenty-two percent. In the place of bank loans and deposits, securities and mutual funds have developed as the leading providers of credit and repositories of financial wealth. Not only has this trend diminished the relative importance of banks as the main type of financial intermediary within the system, but it has also resulted in a change in their risk profile. In particular, the squeeze on banks' net interest margins brought about by borrowers switching directly to the securities markets has resulted in a shift away from banks' traditional lending activities. As a result, banks have begun to rely on trading activities as a substantial source of their income, changing their risk characteristics to resemble much more closely those of securities brokers and dealers. This process has been most pronounced in the United States. To a lesser extent, the decline of banking can also be observed in Britain, Japan, and France. However, in several other leading industrialized economies this trend is not yet apparent.

19. See Julie L. Williams, Speech Before the American Banker’s Second Account Aggregation Conference (April 23, 2001), available at http://www.occ.treas.gov/ftp/release/2001-39.txt (last visited Mar. 20, 2003) (discussing the “deconstruction of the banking business [which] means the separation or segmentation of products, services, operations and information into component parts or processes so that they can be provided or obtained separately”).

20. For further discussion of these issues, see Michael Taylor, Towards a New Regulatory Paradigm, 49 MERCER L. REV. 793 (1998).


23. Id.; Edwards & Mishkin, supra note 21, at 28.

24. See the figures cited in H.J. Blommestein & K. Biltoft, Trends, Structural Changes and Prospects in OECD Capital Markets, in THE NEW FINANCIAL LANDSCAPE FORCES SHAPING THE REVOLUTION IN BANKING, RISK MANAGEMENT, AND CAPITAL MARKETS 287 (OECD ed., 1995), especially as they apply to Germany. The German financial system remains highly intermediated, although recent attempts by policy makers to encourage the growth of securities markets may result in the disintermediation trend also becoming apparent there over time. In
C. U.S. and U.K. Models of Regulatory Modernization

The emergence of financial conglomerates and the process of functional despecialization press the case for regulatory modernization. As Borio and Filosa note, "[C]onglomeration and the blurring of distinctions between activities . . . raise the question of the appropriate allocation of responsibilities between different supervisors." In the United States, an often-cited solution is functional regulation. Alan Greenspan described functional regulation "as a system in which each separate ‘function’—such as commercial banking, investment banking, or mortgage banking—is supervised by the same regulatory body, regardless of the function’s location within a particular financial institution." Functional regulation is an example of regulatory modernization to the extent that it rejects the institutional regulation model under which regulatory divisions are determined by entity type. The growth of financial conglomerates makes institutional regulation difficult to sustain. However, functional regulation has its limitations as well, not the least of which is its reliance on functional (i.e., product or activity) categories. Functional regulation is best understood as an outgrowth of U.S. federal securities law under which a panoply of disclosure, anti-fraud, and enforcement provisions hinge on the definition of a "security." The reliance on functional regulation under such a regime makes perfect sense since the substantive regulation is triggered by the type of product offered—a security. However, the application of a functional regulatory scheme in the context of bank regulation is problematic. Traditional bank regulation is not tied to the products offered but to the solvency of institutions offering those products. Functional regulation, with its focus on products, is not a natural fit when safety and soundness of institutions is the regulatory goal.

An alternative approach to regulatory modernization argues that since the boundaries between financial sectors are being eroded, regulation itself should follow suit. A single financial regulator, like Britain’s Financial Services Authority (FSA), which can dispense with the old boundary lines between banking, securities, and insurance, would seem to be better adapted to the realities of modern financial markets than the traditional tripartite structure of regulation. Such an agency also enjoys the advantage of being able to monitor the activities of a complex group in exactly the same way as the internal management of a conglomerate monitors its activities. As a result, the regulatory process can mirror the management process, conforming to the economic realities of the group rather than its legal form. This philosophy seems to lie behind the thinking of Britain’s FSA in its decision to create a division dealing exclusively with so-called “complex” groups.

As we will show in the next two sections, FSMA and GLB take radically different approaches toward regulatory modernization. In the United Kingdom, the process of...
financial modernization was completed prior to the passage of FSMA, and therefore the primary function of FSMA was regulatory modernization. In contrast, in the United States, the focus of GLB was on financial modernization, with regulatory modernization taking on only residual importance. The FSMA creates a single regulator for most of the financial services sector and creates the concept of a single authorization to conduct financial services business. By contrast, GLB is concerned with dismantling New Deal-era structural regulation, and the regulatory issues that this dismantling created received scant attention. Insofar as GLB takes these issues into account, it has opted for a continuation of institutionally based regulation with the Federal Reserve being assigned the role of an overarching "umbrella" regulator of financial services groups. To the extent that GLB recognizes that there is a problem in need of solution, this approach may at best be a temporary stop-gap measure, and it is, perhaps, significant that it runs counter to what would appear to be an emerging international trend toward regulatory modernization, at least in the industrialized world.

III. THE UNITED STATES’ GRAMM-LEACH-BLILEY ACT: LONG-AWAITED, OVERSHADOWED, AND OBSOLETE

GLB distinguishes itself among the major banking bills as one that accomplished relatively little with regard to prudential regulation and supervision. As discussed below, Congress' remarkable inability to pass financial modernization legislation over the last twenty years resulted in a bill that will have a relatively minor impact on the United States' bank regulatory regime. More importantly, however, is that GLB, when viewed in the context of international banking regulatory developments, was obsolete at the time of its passage. GLB failed to address, in any significant way, the realities of financial markets that have already modernized.

A. Just One Step Down the Road to Financial Modernization

Initiatives of the Fed and the Office of the Comptroller of the Currency (OCC) achieved significant deregulation of banks' activities restrictions prior to the passage of GLB. Beginning in 1987, the Fed approved securities activities housed in non-bank subsidiaries of bank holding companies. Such activities were subject to revenue limitations and firewalls. Over time, as the Fed became more and more comfortable with the new activities, the revenue limitations rose incrementally and the firewalls fell. By the time GLB was passed, the revenue limitations stood at twenty-five percent of the subsidiaries' gross revenue, and nearly all of the firewalls had been eliminated. Similarly, in 1996, the OCC adopted a controversial rule (commonly known as the "op-sub" rule) that allowed national banks to acquire or establish a subsidiary that could engage in activities that would not have been permissible for the bank itself. Thus, the regulatory framework prior to GLB allowed Citicorp, a commercial bank, and Travelers, an insurance and investment banking firm, to announce their intent to merge. The Fed approved their merger on September 23, 1998.

33. See Bank Holding Companies and Change in Bank Control (Regulation Y), 12 C.F.R. § 225 (1997).
GLB continues the incremental course originally charted by the Fed. Under GLB, financial holding companies (i.e., bank holding companies that are well capitalized, well managed, and whose banks have a satisfactory Community Reinvestment Act\textsuperscript{36} rating) may engage in any activity that is "financial in nature or incidental to such financial activity; or is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."\textsuperscript{37} The Act lists various activities as financial in nature, including insurance and securities underwriting, and, perhaps most significantly, merchant banking.\textsuperscript{38} Thus, under GLB a financial holding company and its non-bank subsidiaries may, for example, engage in unlimited securities activities. The consequences for failure to maintain status as a financial holding company are harsh. If, for example, a financial holding company fails at any point to maintain the necessary capitalization or management status, the Fed could force a sale of any subsidiary bank or order the financial holding company to cease any new activities (i.e., activities not previously permissible for a bank holding company).\textsuperscript{39}

While GLB offers great potential for new activities under the financial holding company rubric, the rules for banks and their subsidiaries are not so generous. Under GLB, a national bank (one that is well capitalized and well managed)\textsuperscript{40} may own a "financial subsidiary" that engages in activities that are not permissible to the bank itself. Financial subsidiaries may engage in the same activities as financial holding companies with two important exceptions. First, financial subsidiaries, as opposed to financial holding companies, are not permitted to underwrite insurance or annuity contracts, develop or invest in real estate, or engage in merchant banking or insurance portfolio investing.\textsuperscript{41} Second, financial subsidiaries are subject to a cap on assets equal to the lesser of forty-five percent of the consolidated total assets of the parent bank or fifty billion dollars.\textsuperscript{42}

The restrictions placed on financial subsidiaries represent a compromise in the hard-fought battle between Treasury and the Fed regarding the placement of new activities within the holding company structure. The dispute was argued on substantive grounds, with the Fed asserting that banks enjoy a government subsidy by way of federal deposit insurance and therefore should not be permitted to engage in new activities that would allow them to compete, unfairly, against firms that do not enjoy the subsidy.\textsuperscript{43} Treasury officials countered that no net subsidy exists and that the law should allow for maximum flexibility in the organizational structure of financial services firms.\textsuperscript{44} Many commentators, however, viewed the debate as one over turf. The Fed sought to house new activities within its sector of authority: in the holding company and the holding company's non-bank subsidiaries. While Treasury's position also sought OCC authority over new activities, its

\textsuperscript{37} 12 U.S.C. § 1843(k)(1) (2000). Contrast the "financial in nature" standard with the more restrictive standard set for bank holding company activities, i.e., "so closely related to banking to be a proper incident thereto." 12 U.S.C. § 1843(c)(8) (2000). The "so closely related" standard continues to apply to bank holding companies that do not choose to become financial holding companies.
\textsuperscript{40} 12 U.S.C. § 24a (2000).
\textsuperscript{41} Id.
\textsuperscript{42} Id. § 24a(a)(2)(D).
\textsuperscript{44} Id. at 400–01.
position on the substantive argument—the absence of a government subsidy—had the support of many leading experts.\textsuperscript{45} Despite this support, perhaps owing to the tremendous political power of Fed Chairman Alan Greenspan and/or the lack of political power of the Clinton Administration, Treasury was forced to compromise on its position as is evidenced by the restrictions placed on financial subsidiaries under GLB.

B. Repeal of Glass-Steagall Is Overshadowed by New Regulatory Demands

In the last century, the most significant U.S. banking bills were passed in the wake of catastrophic bank failures and, therefore, not surprisingly, those laws were prudential in nature, i.e., the purpose of the legislation was to secure the safety and soundness of banking institutions. The most obvious example is Glass-Steagall,\textsuperscript{46} which was passed in response to the bank failures of the Great Depression. The more recent examples are the Federal Financial Reform Recovery Act of 1989 (FIRREA)\textsuperscript{47} and the Federal Deposit Insurance Improvement Act of 1991 (FDICIA).\textsuperscript{48} Both FIRREA and FDICIA were passed in response to the S&L and banking crisis of the late 1980s and early 1990s. These crises provided the momentum and opportunity that would have been politically unavailable in a different climate, and Congress included bold measures in each of these statutes.\textsuperscript{49}

GLB is not legislation that was passed in response to a major banking crisis. Therefore, it is no surprise that as a prudential bill GLB contains no truly bold measures. The repeal of Glass-Steagall would have been a bold deregulatory measure if the repeal had been complete.\textsuperscript{50} As discussed earlier, however, the repeal of Sections 20 and 32 of Glass-Steagall serve primarily as a congressional stamp of approval on increasingly aggressive administrative interpretation. Time will tell whether new insurance powers, for example, will have any real impact. GLB has not sparked the slew of mergers that some anticipated and others feared.\textsuperscript{51}

The deregulatory aspects of GLB pale in comparison to the new regulatory measures it imposes. Regulatory measures contained in GLB include: privacy, ATM reform,
Community Reinvestment Act sunshine requirements, and consumer protection in insurance sales. GLB's privacy provisions will likely have greater practical as well as symbolic impact on the banking industry than the deregulatory portions of GLB.

Driven by fast developing internet technology and allegations of misuse of consumer information against U.S. Bancorp, Congress passed the first federal law that seeks to protect personal financial information. Title V of GLB provides: "It is the policy of the Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information." The practical implications of the privacy provisions are yet to be seen. A recent General Accounting Office report concluded: "It is too soon to assess the efficacy and adequacy of the remedies provided for under [the GLB privacy provisions]."

Apart from their specific impact and application, GLB's privacy provisions represent an important trend toward consumer protection in federal banking law. In sharp contrast to the SEC and FTC, federal bank regulators' traditional role was not consumer protection. Since the late 1960s, however, Congress has passed more and more legislation that imposes a consumer protection mandate on the bank regulators. Examples include: the Truth in Lending Act, Truth in Savings Act, Home Equity Loan Consumer Protection Act of 1988, Federal Fair Credit Reporting Act, Fair Debt Collection Practices Act, and Expedited Funds Availability Act of 1987. GLB continues that trend by creating new consumer protection provisions and placing their enforcement, at least in part, in the hands of the bank regulators.

C. GLB's Approach to Regulatory Modernization Emphasizes Functional Regulation

GLB addresses the question of regulatory modernization through its apparent endorsement of functional regulation. The conference report explains:

Both House and Senate bills generally adhere to the principle of functional regulation, which holds that similar activities should be regulated by the same regulator. Different regulators have expertise at supervising different activities.

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52. That is not to say that prior to GLB there were no federal statutes that addressed financial privacy. For example, The Right to Financial Privacy Act, 12 U.S.C. §§ 3401–22 (2000), restricts government access to financial information. There were, however, no broad-based federal standards of the magnitude provided in GLB. Still, the GLB privacy provisions are relatively narrow when compared, for example, to the European Union’s Directive on Data Protection. Council Directive 95/46/EC, 1995 O.J. (L 281) 31. "By its terms, the [Directive] applies to all processing of personal data by any person or organization whose activities are governed by EU law and, thus, provides comprehensive privacy standards for both private and governmental databases." L. Richard Fischer, Emerging Issues in the World of Financial Privacy, in FINANCIAL SERVICES MODERNIZATION 249 (ALI-ABA Course of Study, Feb. 3, 2000), available at WESTLAW, SEA1 ALI-ABA 241. In contrast, the GLB privacy provisions apply only to financial institutions.


61. See supra note 52 and accompanying text (discussing the regulatory aspects of GLB).
It is inefficient and impractical to expect a regulator to have or develop expertise in regulating all aspects of financial services. Accordingly, the legislation intends to ensure that banking activities are regulated by bank regulators, securities activities are regulated by securities regulators, and insurance activities are regulated by insurance regulators.62

Functional regulation as a means of dividing regulatory responsibility enjoyed virtually unanimous support among those advocating the bill. The support for this regulatory approach in the United States is not terribly surprising. The adoption of functional regulation in GLB meant essentially the maintenance of the status quo for the existing regulators. For example, under GLB, banks lost their general exemption from the definitions of “broker” and “dealer” under the federal securities laws,63 and therefore must register as brokers and dealers and submit to SEC regulation if they engage in securities brokerage. However, prior to GLB, most banks engaged in securities brokerage activities through an SEC-regulated subsidiary. Therefore, the practical effect of this seemingly important statutory change is less clear.64

Despite the statute’s affirmative statements otherwise, Congress did not create a functional regulatory scheme with the passage of GLB. The approach under GLB is more accurately described as a combination of functional and institutional regulation.65 GLB does not, for example, give the SEC the authority to regulate all sales of securities66 as would be the case under a truly functional scheme. The effect of the statute is to give the SEC the authority to regulate securities firms (including those that are affiliated with banks) and the bank regulators the authority to regulate banks (no matter what types of products they sell).67 This sounds a lot like institutional regulation. What brought GLB closer to functional regulation was the combination of two factors: (1) the repeal of the general exception of banks from the definitions of “broker” and “dealer” under the federal

64. The practical effect will be determined in large part by the parameters of the SEC’s future rulemaking with regard to the banks’ exemptions from the definitions of “broker” and “dealer.” See supra note 63 and authorities cited therein.
67. See supra note 63 (discussing the regulation of banks’ municipal securities activities).
securities laws and (2) the institutional restrictions that require new activities to be housed outside of the bank.

GLB diverges further from a pure functional regulation model by giving the Fed umbrella regulatory authority over financial holding companies. At the same time, the Fed’s umbrella authority is clearly diminished by Congress’s attempt to rest most power in the hands of the functional regulators. GLB grants the Fed the authority to require reports from holding company subsidiaries, but the Fed is admonished to rely on the reports made to the functional regulators first. GLB gives the Fed the authority to examine bank holding company subsidiaries, but the Fed may only make examinations of functionally regulated subsidiaries, such as securities and insurance subs, in certain circumstances. These circumstances include: if the Fed has reasonable cause to believe that the activities of the subsidiary pose a material risk to an affiliated depository institution or that examination is necessary to inform the Fed of the subsidiary’s systems for monitoring safety and soundness risk; or if the Fed has reason to believe that the subsidiary is not in compliance with GLB or any other law administered by the Fed. Finally, the Fed lacks authority to impose capital requirements on securities and insurance subsidiaries that meet the capital requirements of their own federal and state regulators.

The Fed’s regulatory objectives as umbrella supervisor of financial holding companies do not differ from those traditionally applied to the Fed’s supervision of bank holding companies: “The Federal Reserve, as umbrella supervisor, will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions.” While the safety and soundness goal is consistent with the Fed’s traditional role, the assumption is that financial holding companies will be more diversified in their financial activities, and thus represent a greater regulatory challenge than the traditional bank holding company. For that reason, the Fed’s role as umbrella supervisor under GLB can be seen as providing the Fed with an expanded role in financial institution supervision.

IV. THE UNITED KINGDOM’S FINANCIAL SERVICES AND MARKETS ACT: A CONFLUENCE OF SEVERAL THEMES

A. Background—Regulatory Modernization, Not Financial Modernization

FSMA reorders radically the United Kingdom’s regulatory regime. The Act’s main feature is its overhaul and unification of the oversight of banking, insurance, and other investment services by establishing the Financial Services Authority as a powerful and nearly universal regulator of the United Kingdom’s financial services industry. It
replaces most of the pre-existing financial services legislation, including the Financial Services Act 1986, the Banking Act 1987, and the Building Societies Act 1986. FSMA regulates a wide range of activities including deposit taking, the safekeeping and administration of assets, dealing in investments, arranging deals in investments, managing investments, and providing investment advice. It establishes a single authorization regime for all regulated activities, and envisages the eventual development of a single rulebook for all types of financial service business. Finally, the FSMA also introduces radical new sanctions to restrain the abuse of financial markets. Despite its considerable length (433 sections and 21 schedules), it is nonetheless best thought of as a framework act, leaving many of the details to be supplied by secondary (delegated) legislation.

FSMA was enacted in a context very different from GLB. For the best part of a decade and a half prior to the Act, Britain had witnessed the gradual dismantling of its largely informal system of segmenting financial services. First among the structural changes was the Stock Exchange’s “Big Bang,” under which the Exchange agreed to abolish minimum commissions, to put an end to single capacity (thus allowing the development of broker-dealers), and to permit outside firms to take over member firms. Previously, Stock Exchange members were restricted to adopting the partnership form, and outside firms had been limited to a thirty-percent shareholding. One result of these changes, which took effect in 1986, was thus to permit other types of financial intermediaries to acquire an interest in Stock Exchange member firms.

Legislative changes also took effect at approximately the same time. Most notably, the Building Societies Act 1986 introduced a significant measure of deregulation into this previously highly regulated sector. This move permitted the societies to compete with joint stock banks in retail financial products, including checking accounts. The privatization of the Trustee Savings Bank in 1988 also added an extra dimension to competition in high street banking.

Overarching these developments was the growing influence of EC law on the pattern of U.K. financial regulation. As part of the regulatory harmonization required to complete the European Internal Market in financial services, a series of directives relating to specific aspects of regulatory policy were enacted. A number of these were based on the concept of a “credit institution,” which embraced both banks and building societies, thus laying a common platform for their prudential regulation. Moreover, the banking directives were premised on the continental European model of a universal bank. Thus, the Capital Adequacy Directive, which set capital requirements for market risk for both banks and investment firms, raised the issue of how competitive equality between banks and securities

75. Financial Services Act, 1986, c. 60 (Eng.).
76. Banking Act, 1987, c. 22 (Eng.).
77. Building Societies Act, 1986, c. 53 (Eng.).
80. In contrast, GLB has 142 sections—quite terse by American standards.
81. Previously, Stock Exchange rules had required member firms to operate either as brokers or as “jobbers” (i.e., market makers).
82. Building Societies are mutual credit institutions, specializing in housing finance and consumer credit. In this respect they are similar to S&L institutions in the United States, but represent a much more significant part of the British financial system. Many have now converted into joint stock companies, after having attained a scale that put them among Britain’s leading deposit-taking institutions. Building Societies Act, 1986, c. 53 (Eng.).
firms could be preserved if the same directive was implemented by different sets of regulators.

As a result of the process of dismantling informal structural regulation, the late 1980s witnessed rapid industry evolution. The largest U.K. commercial banks acquired investment banking arms, and linkages between banks and insurance companies began to form. Financial conglomerates, straddling the banking, securities, and insurance sectors, began to emerge. One consequence of these developments was that the pace of structural change in the industry rapidly began to outpace the regulatory structure that had only just been put in place. For example, financial conglomerate groups found themselves subject to a plethora of different regulatory bodies, which both increased their regulatory burden and impeded the ability of any one regulator to obtain an overview of their risk profile.

The rapid evolution of the structure of firms and the industry gave rise to a short but intense policy debate in the eighteen months prior to the 1997 general election on the appropriate policy response.\(^8\) One of the main issues debated was how to ensure effective oversight of complex financial groups, and how to bring greater coherence to what was widely perceived as being an unnecessarily fragmented regulatory system with its associated problems of overlapping and underlapping jurisdictions. However, prior to the election, the Labour policy handbook, *New Labour, New Life for Britain*,\(^8\) had been vague about the new government’s plans for financial regulation. It promised only to “reform and strengthen the regulatory system” and “to simplify both the structure and the nature of the system so that it commands the confidence of both the public and the industry.”\(^8\) While consistent with both these statements, the FSMA went much further than many observers had expected in replacing nine existing regulators with a single agency, the FSA.

### B. A Single Regulator

The FSA is unique among regulatory agencies in the industrialized world in terms of the diversity of businesses regulated and its very broad scope, encompassing both prudential and business conduct regulation.\(^8\) While other integrated financial regulators have been in existence for some years, most notably in the Scandinavian countries, none has been established in a country with a financial sector as large as the United Kingdom’s, and all have have a predominantly prudential focus.\(^8\) In addition, the FSMA establishes a Financial Services Compensation Scheme, which unifies and replaces the separate schemes for banks, building societies, insurance companies, and securities and investment firms previously operated by the separate regulators.\(^9\) Thus the counterpart of a single regulator

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84. See TAYLOR, TWIN PEAKS, supra note 14; Reforming the City, THE ECONOMIST, Feb. 15, 1997, at 19; see also Speech by the Governor to the Edinburgh Finance and Investment Seminar and the Glasgow Discussion Group on Finance and Investment, Some Thoughts on Financial Regulation (Feb. 28, 1996), in BANK ENG. Q. BULL., 1996, at 213 (critiquing Michael Taylor’s Twin Peaks proposal and defending the status quo).


86. Id.

87. Prudential regulation is concerned with the financial soundness of regulated institutions, whereas business conduct regulation is concerned with the way in which financial products are marketed and sold.


is a single compensation scheme, which does not distinguish between depositors, policyholders, and investors in the terms of its coverage.

The FSA has a somewhat unusual constitutional status as a body corporate with the form of a company limited by guarantee. It is not a Crown corporation (as is the Bank of England) or an administrative agency attached to a government department. This vesting of powers in a body corporate represents a departure from either of the main administrative forms used for the regulation of other industries and in most other countries of the world, which have tended either to take the form of vesting responsibility in a single official (e.g., the Comptroller of the Currency) or in a multimember commission (e.g., the Securities and Exchange Commission). By contrast, the Act requires that the FSA’s constitution provide for a board of directors comprised of both executive and non-executive members and a chairman, who are all members of the governing body. This arrangement, it has been argued, provides a balance between the need for rapid decision making informed by special expertise (provided by the chairman and executive members of the board) and the need for maintaining an element of collegiality and a degree of independent oversight (provided by the non-executive members). A further advantage claimed for the board arrangement is that it enhances the transparency and accountability of regulatory bodies. The FSA has a clear line of accountability to the Treasury, which may both appoint and dismiss the chairman and the board, and which is specifically empowered by the Act to commission reports on the FSA’s performance of its duties.

C. The FSA’s Objectives

Four statutory objectives define the FSA’s overall purpose: maintaining market confidence; promoting public awareness; protecting consumers; and reducing financial crime. Each of the four statutory objectives illuminate an overarching theme of consumer
protection responsibility, the theme being most evident in relation to the explicit consumer protection and consumer awareness objectives. Still, the other objectives relating to financial crime and market confidence are also essentially oriented toward consumer protection. The former overlaps with the responsibilities of several other enforcement agencies, most notably the Serious Fraud Office. The latter overlaps with the Bank of England’s responsibility for ensuring the overall stability of the financial system. Each of the objectives is discussed in greater detail below.

1. Consumer Protection and Awareness Regulation

The FSA’s primary responsibility may be thought to be the protection of consumers and users of financial services, both from fraudulent or exploitative sales practices and the insolvency of the firm with which they have contracted. The need for enhanced protection of consumers of financial services in Britain was the primary rationale for the enactment of FSMA and the creation of the FSA. Although the radicalism of the government’s intentions had not been made clear prior to the 1997 general election, it was widely understood that a new Labour government would undertake far-reaching changes to the marketing and sales of retail financial products. Change was seen as necessary because of a serious regulatory lapse that became known as the “pensions mis-selling scandal.”

The “mis-selling” issue concerned the sales and marketing practices of personal pensions. Personal pensions, provided through life insurance companies, were investment vehicles introduced by the Conservative government in the mid-1980s and were intended to be an alternative to occupational pensions for employees who either did not have access to occupational pension schemes or who intended to change jobs with comparative frequency. However, once introduced, they were sold on a large scale to individuals who already enjoyed the benefit of occupational schemes and who had no intention of changing employers. One of the largest groups to suffer from alleged mis-selling were public employees, including teachers and health service workers. Although the actual numbers of people who were the victims of genuine mis-selling remains the subject of some dispute, by the early 1990s it had become clear that a significant minority of these public sector workers—who are also a core Labour constituency—had been persuaded to opt out of their occupational schemes and into private schemes. In only a very few cases would a private pension have offered better returns than the occupational scheme, especially since the latter also had the benefit of an employer’s contribution. Hence workers who were persuaded to switch to the private schemes were badly advised, and in at least some cases the mis-selling seems to have been due to the fact that insurance company salesforces were poorly controlled and were paid on a commission-only basis, thus leading to high pressure sales tactics.

The Financial Services Act 1986 had been intended to provide protection to individuals against the sale of unsuitable investment products.96 The responsibility for regulating the sale of personal pensions fell to a number of Self-Regulating Organizations (SROs) that failed to take early and sufficient enforcement action and that therefore failed to prevent widespread mis-selling. With their close ties to the industry and their practitioner-dominated boards, the SROs were believed to have been suffering from a particularly serious form of regulatory capture. Although the Securities and Investments

96. Under its regulatory regime investment advisers were under an obligation to offer “best advice” and to make full inquiry as to the “suitability” of a product for a clients’ investment needs. Both concepts had been introduced into the regulatory framework as a way of regarding the sale of complex, packaged financial products like pensions.
Board (SIB) was supposed to ensure that the SROs regulated in the public interest, in practice it lacked sufficient enforcement powers to ensure appropriate regulatory action. The SIB possessed only the power to “derecognise” an SRO, an option that was too draconian to be an effective basis for intervention.\textsuperscript{97}

In response to these apparent failures, the Labour party committed itself to establishing a powerful, independent regulatory authority for the sale of retail financial products. The FSA’s primary role—as evidenced by two of its four statutory objectives—is to prevent a repeat of episodes of the pensions mis-selling. The objectives of “securing the appropriate degree of protection for consumers”\textsuperscript{98} and “promoting public understanding of the financial system”\textsuperscript{99} may be regarded as the basis for a regulatory system which recognizes that the majority of users of financial services lack the knowledge, information, and skills to make informed judgments regarding financial investments. Regulation exists both to promote fairness in the sales process and to foster the skills necessary to make informed choices. This regulatory philosophy departs significantly from the past regulation in Britain and current regulation in the United States. Historically, regulation in Britain was largely informed by the principle of “freedom-with-disclosure,” which left the producer and the consumer free to enter into transactions subject to the important proviso that the consumer did so on the basis of full and accurate disclosure.\textsuperscript{100} Although this principle suffered dilution by certain features of the Financial Services Act 1986, it was explicitly rejected during the drafting stages of the bill for FSMA. In determining the appropriate degree of protection, the FSA is now obliged to take into account a consumer’s need for advice and accurate information.

The FSA’s \textit{A New Regulator for the New Millennium}\textsuperscript{101} spells out its approach to consumer protection. It distinguishes between a number of different risks, including what it terms “prudential risk,” “bad faith risk,” “complexity/unsuitability risk,” and “performance risk.”\textsuperscript{102} The FSA argues that it has a role to play in reducing the first three of these risks, but that regulation is not intended to guard against “performance risk,” namely the risk “that investments do not deliver the hoped-for returns.”\textsuperscript{103} Hence regulation can reasonably be expected to protect the consumer against the risk of firm collapse; the risk of fraud; misrepresentation or deliberate mis-selling; and the risk that consumers are sold a product that is unsuitable for their needs. But the FSA’s regulation is not intended to protect against the risk of under-performance.

\textsuperscript{97} In contrast, the SEC possesses significant authority over the SROs. The Commission must approve any new rules or rule changes proposed by the SROs. 15 U.S.C. § 78s(b) (2000). The Commission has the power to impose rules on the SROs. 15 U.S.C. § 78s(c) (2000). Moreover, disciplinary actions taken by the SROs against their members are subject to Commission review. 15 U.S.C. § 78s(d), (e) (2000). The Commission also has the authority to suspend or revoke an SRO’s registration or to censure or impose limitations upon the SRO’s activities. 15 U.S.C. § 78s(h) (2000). For an extensive analysis of the relationship between the SEC and the exchanges, see David A. Lipton, \textit{The SEC or the Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets}, 16 U.C. DAVIS L. REV. 527 (1983).


\textsuperscript{99} Id. § 4(1).

\textsuperscript{100} Perhaps the best statement of the principle was by Justice Louis D. Brandeis in \textit{OTHER PEOPLE'S MONEY and HOW THE BANKERS USE IT} 103 (1914): “[I]t is now recognized in the simplest merchandising, that there should be full disclosures . . . . The law has begun to require publicity in aid of fair dealing. The Federal Pure Food Law does not guarantee quality or prices; but it helps the buyer to judge of quality by requiring disclosure of ingredients. Among the most important facts to be learned for determining the real value of a security is the amount of water it contains.”


\textsuperscript{102} \textit{Id.} at 8.

\textsuperscript{103} \textit{Id.}
Closely connected to the consumer protection objective is the second statutory objective, which requires the FSA to promote "public understanding of the financial system."104 This is novel. None of the regulatory agencies that the FSA replaced was explicitly charged with a consumer education role. The prominence of this objective in the FSA’s statutory responsibilities suggests that the government assigns it a very high priority. The FSA has indicated that it will pursue two main aims under this objective.105 It will endeavor to promote a higher level of general financial literacy, and it will aim to improve the information and advice available to consumers. The second aim clearly involves significant overlap with the consumer protection objective. Thus, the FSA proposes to make greater use of league tables and relative performance indicators—methods that had been under development by the previous regulatory bodies. However, the promotion of financial literacy does involve a significant departure from previous practice, and the FSA has stated that it interprets this aim as involving the provision of programs to consumers to enable them to acquire the knowledge and skills that they need to become better informed consumers. This undertaking will also involve the FSA in fostering public understanding of retail financial products, with a particular focus on vulnerable or inexperienced consumers.

2. Financial Crime

The fourth statutory objective is the “reduction of financial crime.”106 This objective seeks to “reduc[e] the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime.”107 This objective covers a number of functions of the FSA’s predecessor agencies. These include the important function of protecting consumers of financial services from fraud or dishonesty.108 In particular, money laundering raises growing regulatory concern. The prevention of money laundering has important linkages with prudential issues, most notably the adequacy of a firm’s systems and controls. Moreover, the use of a financial firm for criminal purposes may also damage public confidence in that institution and in the financial system as a whole.109

Significantly, the concept of financial crime under the FSMA is expanded to include "misconduct in, or misuse of information relating to, a financial market."110 This provides the statutory underpinning for market integrity regulation. This represents a major extension of the FSA’s powers compared to the agencies it replaced. For several years prior to the FSMA, in speeches made by its then chairman, Sir Andrew Large, the SIB pointed to serious shortcomings in the investigation and disposal of cases of insider dealing and market abuse. In part, these shortcomings were due to fragmented jurisdictions. For example, the SIB had no power over market abuse resulting from the conduct of individuals who were not authorized persons under the Financial Services Act. In part they were due to the fact that such cases could only be prosecuted under the criminal law, with a criminal rather than a civil burden of proof.111 In complex cases in which the evidence could only

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104. FSMA, 2000, c. 8, pt. 1, § 4.
105. NEW MILLENIUM, supra note 101, at 7.
106. FSMA, 2000, c. 8, pt. 1, § 6.
107. Id. § 6(1).
108. Id.
109. In this sense, the fourth objective is connected to the financial system stability objective. See NEW MILLENIUM, supra note 101, at 9.
110. FSMA, 2000, c. 8, pt. 1, § 6 (3)(b).
111. Consider the analysis of Sir Andrew Large:
be interpreted by experts, the number of prosecutions brought for market abuse was very small and convictions even smaller. The regulators spent several years pressing for a revision to the law that would permit them to dispose of cases of market abuse through civil rather than criminal channels. Significantly, this was one aspect of U.K. regulatory reform in which its proponents seem to have drawn direct inspiration from U.S. law and practice.\(^{12}\)

One of the main features of the FSMA, and also one of its most controversial, is its introduction of just such a civil channel for disposal of cases of market abuse. Market abuse is not decriminalized by the new legislation, but it provides for a parallel civil disposal of such cases. The FSA will promulgate a Code of Market Conduct, breaches of which will be subject to civil rather than criminal sanctions. Where market abuse is established, the FSA is empowered to impose unlimited civil fines and restitution/disgorgement orders on application to the High Court. In addition, the FSA will also be authorized to bring criminal prosecutions under the existing criminal law for conduct that constitutes market abuse. Its jurisdiction will therefore overlap with the Serious Fraud Office, and much of the conduct covered by its code of practice on market abuse also falls within the scope of the rules of the exchanges. Hence, the historical gaps in the regulators' ability to dispose of abuse cases have been replaced by expanded powers and significant overlap of agency enforcement authority.

3. The Stability of the Financial System

The FSA's most important operational responsibilities in the future will be the consumer protection charge it has acquired from the merger of the SROs with its predecessor organization the SIB. In addition, the FSA will have a powerful role in dealing with financial crime that will take it a considerable distance from concerns for the stability of the financial system. Nonetheless, although systemic risk is not explicitly mentioned, the FSA retains a systemic protection mandate.\(^{13}\) This mandate arises under the first of its statutory objectives relating to "market confidence." This term is defined in FSMA as "maintaining confidence in the financial system,"\(^{14}\) including financial markets and exchanges, connected activities, and regulated activities. The term "confidence" is generally used in the context of the regulation of securities markets, where the purpose of regulation is to provide investors and potential investors with confidence in the integrity

\(^{112}\) Large observed: "People often remark that what we need in this country is a US-style Securities and Exchange Commission. . . . [W]here they have a point is when they say the SEC is an impressive enforcement body. And why? Because I think of the breadth and nature of its civil powers." Id.

\(^{113}\) A proposal to incorporate the systemic protection mandate explicitly in the objectives was made by a Joint Committee of the two houses of Parliament set up to scrutinize the draft Bill for FSMA. Although made by a committee comprising many knowledgeable experts, it was rejected by the government.

and orderly conduct of the market. However, the objective as formulated in the Act goes beyond this relatively limited conventional sense. The objective refers to confidence “in the financial system,” which indicates a comparatively extended meaning. An important element in this extended meaning relates to the stability of the financial system, which the Treasury and the FSA have made clear that they regard as being integral to the market confidence objective. The FSA explains that maintaining confidence “involves . . . preserving both actual stability in the financial system and the reasonable expectation that it will remain stable.”

Central banks have traditionally taken overall responsibility for maintaining the stability of the financial system. This is because the greatest systemic risk arises in the core of the payments system. However, other elements of the financial system infrastructure, including settlements and clearing systems, also contain the potential to act as a transmission mechanism for contagion between financial institutions. For this reason, although central banks have concerned themselves with the health of the banking system, they have at times of extreme financial distress also extended their concern to other elements of the financial system, including clearing houses and settlement systems.

While ensuring the overall stability of the banking system is widely accepted to be a core function of central banks, more controversy has attached to their appropriate role in the prudential regulation of individual banks. The argument for assigning the central bank a direct role in banking supervision stresses the synergies between the conduct of monetary policy and banking supervision. In particular, since banks are the conduit by which changes in short-term interest rates are transmitted to the wider economy, the central bank is vested in banks’ financial soundness as a precondition for an effective monetary policy. Moreover, this model suggests that a central bank needs access to information regarding the soundness of banks for monetary policy purposes and for the exercise of its lender of last resort function. For these reasons, the Bank of England argued strongly in favor of its retention of a role in banking supervision. The Bank could also point to the fact that there were relatively few examples of central banks ever having formally lost the responsibility for banking supervision, although in a number of cases central banks had avoided taking on this responsibility in the first place.

However, the financial modernization debate introduced a new factor to be considered in determining the appropriate role for the central bank in banking supervision. In essence, the traditional case for central bank involvement in banking supervision has rested on the proposition that banks’ asset and liability structures render them a “special” type of

115. NEW MILLENIUM, supra note 101, at 5.
116. See generally CHARLES ALBERT ERIC GOODHART, THE EVOLUTION OF CENTRAL BANKS 29-46 (1988) (discussing the role of an independent central bank in alleviating detrimental conflicts of interests that can occur in the clearinghouse system when overseen by a commercial central bank).
117. Id. at 4-5.
118. For an account of the formulation of the Banking Act 1979, see Schooner & Taylor, supra note 5, at 629-32. The Bank of England continued to insist on this view almost until the moment it lost the responsibility for banking supervision. See, e.g., E.A. George, Are Banks Still Special?, Remarks at the IMF 7th Central Banking Seminar (Jan. 29, 1997), available at http://www.bis.org/review/r970214c.pdf (last visited Mar. 20, 2003). The Bank of England had been statutorily responsible for the supervision of deposit-taking institutions only since the Banking Act 1979, but had practiced a non-statute-based form of supervision over what it regarded as the “core” banking system for a long time prior to this. Schooner & Taylor, supra note 5, at 629.
119. Chief among these examples was Germany’s Bundesbank, which has stressed the risks to a central bank’s involvement in bank supervision. First, a central bank that is also responsible for supervision may err on the side of laxity if it fears that tight monetary conditions may lead to bank failures. Second, bank failures inevitably will occur and when they do they will be blamed on the supervisor. If the supervisor is the central bank, its credibility will be undermined, and with it, its credibility in the conduct of monetary policy.
financial institution. By contrast, proponents of regulatory modernization argue that the specialness of banks can be overstated, especially as the boundaries between banks and other types of financial institutions become blurred. Hence the premise that it is possible to draw a clear line around a specific sub-group of financial institutions of exclusive concern to the central bank is becoming harder to sustain. Institutions with which the central bank has never previously enjoyed a close relationship are increasingly taking on bank-type risk characteristics. However, to place all of these institutions under the central bank’s direct supervision might be perceived as a dangerous extension of the government safety net. Moreover, the central bank often lacks the skills to appraise properly the risks associated with these types of institutions. For these reasons, a number of regulatory modernization proposals had recommended the creation of a single prudential regulator for all financial institutions outside the central bank.120

In reality, these largely theoretical considerations were probably much less decisive in the British case than the widespread perception that the Bank of England’s performance as a banking regulator had been undistinguished. Although Britain has avoided the type of serious banking crisis that has afflicted both developed and developing countries in recent years, the Bank of England’s handling of the Bank of Credit and Commerce International (BCCI) closure and its supervision of Barings merchant bank prior to Barings’s spectacular collapse in 1995 were widely criticized in both the press and Parliament.121 The Bank’s widely criticized performance may have reinforced the skepticism over its suitability as a bank regulator.122

Whatever the ultimate motivation for the decision to remove the Bank of England’s responsibilities for banking supervision, the system created by FSMA has resulted in a fundamentally different approach than that adopted by GLB. Whereas the latter has resulted in an expansion of the Federal Reserve’s regulatory role, the intention behind FSMA has been to remove the central bank from any direct regulatory responsibilities. Under FSMA, the FSA is clearly established as the institution responsible for the regulation of individual banks. The Bank of England’s regulatory responsibilities for deposit-taking institutions had already been transferred to the Securities and Investments Board by virtue of provisions of the Bank of England Act 1998.123

While the central bank may have retreated from the direct regulation of individual banks, its responsibility for the overall stability of the banking and financial system is acknowledged in a Memorandum of Understanding (MoU) between the Bank, the FSA, and the Treasury. The MoU divides responsibility for systemic stability between the Bank and the FSA on the following lines: The Bank is responsible for “the overall stability of the


121. Among the most influential criticisms of the Bank of England’s performance were those made by the cross-party House of Commons Treasury Select Committee, especially in its reports on the BCCI and Barings episodes. For more extensive discussion, see Schooner & Taylor, supra note 5, at 636–37.

122. Skepticism from Labour was not new. The 1974–79 Labour government had legislated to enact Britain’s first statute regulating banks since 1844. In 1977, when the legislation was being prepared, the then Prime Minister, James Callaghan, apparently questioned whether the Bank of England was the right body to regulate banks. Serious consideration was given to creating a new banking commission, although ultimately the views of the Bank’s Governor (Lord) Gordon Richardson prevailed over the skeptics and the task was handed to the Bank. See id. at 630.

123. The SIB changed its name by special resolution to the Financial Services Authority in October 1997.
financial system as a whole" which involves, inter alia, the financial system infrastructure (in particular the payments system) and the "broad overview" of the system. By contrast, the FSA's responsibilities are primarily institution specific, relating to individual firms, markets, and clearing and settlement systems. However, within this broad distinction, the Bank is also permitted to undertake official financing operations in "exceptional circumstances" and with the objective of "limit[ing] the risk of problems in or affecting particular institutions spreading to other parts of the financial system."

The practical application of the distinction between system-wide and institution-specific responsibilities remains to be seen. The test of such an arrangement is how it will handle the failure of an individual firm that is sufficiently large, potentially to pose a threat to the stability of the wider financial system. Paragraph 11 of the MoU requires the Bank and the FSA "immediately to inform and consult each other" in the event that either should become aware of a potentially systemic problem. While Paragraph 12 envisages the appointment of a "lead institution" to manage the situation and to coordinate the authorities' response in the event that a problem develops, there is no presumption that the "lead institution" should be the Bank. In fact, Paragraph 3(iii)(b) of the MoU appears to envisage that in at least some cases the FSA will take on a crisis resolution role, as it relates to an individual institution, and may assume the role of attempting to broker a private sector solution—something that has previously been the exclusive preserve of the central bank.

In theory, the relationship between the Bank and the FSA with regard to crisis management remains ambiguous. Difficulty in defining the roles of the FSA and the Bank are inevitable given the fact that it is rarely obvious that a problem arising at one institution is confined to that institution. In reality, it may be relatively easy to determine whether the problems in an individual institution are sufficiently serious to give rise to systemic problems and hence to decide on the allocation of crisis management roles. Nonetheless, the respective roles of the Bank and the FSA will not become entirely clear until the crisis management arrangements are tested in practice.

Beyond the crisis management role, the Bank of England continues to have an extensive role in supervisory and regulatory policy. A Financial Stability Wing of the Bank, comprising over 150 staff, continues to engage in a diverse range of activities relating to financial stability and the regulation of the financial system. As described in the Bank's annual report, this work includes involvement in policy initiatives regarding bank capital and liquidity (including initiatives conducted under the auspices of the Basel Committee on Banking Supervision in which the Bank retains its membership in addition to the FSA) and identifying potential threats to international financial stability. Thus, although the Bank lost its formal statutory role with respect to direct banking supervision, its continued involvement in bank regulatory issues was inevitable.
V. REGULATORY MODERNIZATION IN COMPARATIVE PERSPECTIVE

GLB and FSMA offer very different approaches to the regulatory modernization debate. While in places the accent of the two pieces of legislation is the same—in particular, both emphasize consumer protection—their solution to regulatory modernization is sharply at odds. GLB continues to assign an important direct regulatory role to the central bank, and indeed has enhanced that role. By contrast, FSMA removes the responsibility for banking supervision from the central bank and assigns the responsibility to a single unitary regulator of all types of financial intermediaries. The clear expectation is that a single regulatory authority will be able to deliver more effective and efficient regulation of diversified financial groups.

The regulatory modernization differences between GLB and FSMA may be explained in part by noting the different starting points of the two countries on the issue of financial modernization. Financial modernization is much further advanced in the United Kingdom than in the United States. The regulatory modernization differences can also be explained through observation of the different status and prestige of their respective central banks. Unlike the climate in Britain, the passage of GLB followed no crises or blame. The existing regulators enjoy generally a positive reputation and the banking, and S&L crises of the late 1980s and early 1990s had been addressed by earlier legislation. Nonetheless, GLB appears to be even more exceptional in its failure to address the need for regulatory modernization when it is placed in a broader comparative perspective. Recent reforms in Australia, Germany, Japan, and other OECD countries suggest that a clear trend exists toward the formation of unified regulatory authorities, often as a direct response to the emergence of a financial services sector in which the traditional industry/product categories are becoming increasingly irrelevant. By leaving the broad outlines of the U.S. regulatory system unchanged, and assigning responsibility to the Fed as the "umbrella" regulator of international groups, GLB bucks a prominent international trend.

Regulatory reform in Australia began before the United Kingdom’s decision to create the FSA. In 1996 the Australian government appointed a Financial System Inquiry under the chairmanship of Stan Wallis, a leading businessman, to consider the implications for the regulatory system of changes, both actual and prospective, in the financial system. The final report of this Inquiry represents the most detailed examination to date of the case for regulatory—as opposed to financial—modernization. The Inquiry stressed the impact of various deregulatory measures already taken in Australia as well as the effect of technological forces that were quite independent of policy decisions. Projecting forward on the basis of current trends, the Wallis Inquiry concluded that the future financial system would display a number of features, including:

The erosion of traditional financial institutions through advances in information technology, resulting in a financial system containing more niche and specialist institutions.

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130. The only conditions close to crisis surrounded GLB’s privacy provisions, not the prudential aspects of the bill. See supra note 52 and accompanying text.

131. See FINAL REPORT, supra note 14. The Inquiry was appointed by the Australian Treasurer (finance minister) in May 1996 with three terms of reference: (1) a stocktake of the results of financial deregulation since the early 1980s; (2) an analysis of forces driving further change in the financial system; and (3) recommendations for changes to regulatory arrangements, in particular to promote a more efficient and cost-effective financial system, consistent with stability, prudence, integrity, and fairness. The Final Report was published by the Australian government on March 9, 1997.
The continued evolution of large financial conglomerates that develop brand strengths to provide a range of financial services; indeed, the industry might become polarized between very small and large financial institutions.

The development of many new payment instruments and payment service providers may emerge, some divorced from traditional deposit products and many using new delivery channels.

The shift of a much larger share of financial wealth into market claims rather than deposits, which will continue to fall as a share of financial sector assets.\textsuperscript{132}

Based on this analysis, the Wallis Inquiry concluded that a regulatory system segmented along the traditional banking, securities, and insurance lines was no longer optimal, and would come under increasing strain as market innovation matured. The Inquiry, however, did not favor the creation of a single financial services regulator on the model that would later be adopted for Britain’s FSA.\textsuperscript{133} Instead, the Wallis Inquiry favored a regulatory structure that reflected the objectives of regulation, i.e., the type of market failure it was intended to correct.\textsuperscript{134} This gave rise to the creation of two regulatory agencies. One agency would provide federal regulation of corporations, financial market integrity, and consumer protection. The other regulatory agency would be responsible for the prudential regulation of all institutions licensed to conduct the general business of deposit taking or offering capital-backed life products, general insurance products, or pension investments.

The first agency, the Australian Securities and Investments Commission (ASIC),\textsuperscript{135} is the statutory body with the power to administer the various conduct and disclosure laws that apply in Australia. The intention was to permit the formulation of consistent and comparable disclosure requirements across a range of products, including deposit accounts, payment instruments, securities, collective investments, pensions, and insurance products. The separate regulation of securities and futures contracts has been replaced by a broad definition of “financial products,” with the ASIC able to declare financial products as being either covered by or exempt from the law.

The second agency, the Australian Prudential Regulatory Authority (APRA),\textsuperscript{136} is responsible exclusively for ensuring the financial soundness of both bank and non-bank financial intermediaries, with the exception of securities firms which are regulated by the ASIC. It shares with the Reserve Bank of Australia (RBA)\textsuperscript{137} responsibility for ensuring the integrity of the payments system, a function that is discharged by a subsidiary board of the RBA, the Payments System Board. Other areas requiring coordination between the

\textsuperscript{132} Id.

\textsuperscript{133} The Wallis Inquiry issued its report before the British government had made an announcement about the future of U.K. regulation. The extent to which the Wallis Inquiry may have influenced British official thinking is unclear, although there are many points of similarity between the Wallis analysis and Chancellor Brown’s statement to the House of Commons. On the other hand, the decision by the British government to remove banking supervision from the Bank of England was taken before the Australian government had made an official response to the Wallis Inquiry report. It is possible that the British government’s decision may have undermined the Reserve Bank of Australia’s position that it should not lose responsibility for banking supervision, as proposed by the Wallis Inquiry. Thus, the relationship between the British and Australian decisions appears to have been one of dialectical complexity.


RBA, APRA, and ASIC are dealt with under the auspices of the Council of Financial Regulators.

Although the structure proposed by the Wallis Inquiry, and subsequently implemented by the Australian government, is different in a number of important respects from the fully integrated regulatory agency created in the United Kingdom, the underlying analysis of these two reform efforts is remarkably similar in a number of important respects. Both responded to the issues created by the increasing overlap between the banking, securities, and insurance sectors. They represented an attempt to deal with the problems of regulatory jurisdiction presented not only by the formation of financial conglomerate groups, but also by the emergence of new types of financial instruments and the unbundling and rebundling of different types of products previously offered by different types of firms. In these respects the U.K. and Australian reforms represent genuine attempts to assess at least some of the regulatory implications of the new financial landscape.138

On January 25, 2001, the Finance Ministry of the Federal Republic of Germany followed the Australian and British lead by announcing far-reaching reforms to its regulatory system with the creation of a single financial regulatory authority for its banking, securities, and insurance sectors. The new German Financial Supervisory Authority, Bundesanstalt für Finanzdienstleistungsaufsicht (BAFin), will replace three existing agencies, the Federal Banking Supervisory Office (BAKred), which is responsible for the prudential regulation of banks and securities firms; the securities market regulator (BAWe), which is responsible for investor protection and for market transparency; and the insurance regulator (BAV), which is responsible for the prudential regulation of insurance companies. The justification given for the creation of the new agency was remarkably similar to the arguments advanced in Australia and Britain. The aspiration is that the new agency will be better equipped to deal with cross-sector issues like e-commerce, asset management, derivatives, insider trading, and consumer and investor protection.139 Consistency of supervision between the different parts of the financial sector, in a response to an increasingly integrated financial market, is also a goal. In Germany, banks, securities houses, and insurance companies compete for the same clients and offer similar or identical financial products and marketing channels. While banks have traditionally been the major players in the securities markets, recent deregulation of these markets has presented new issues of market transparency and investor protection. In addition, linkages between banks and insurance companies have become recently more prevalent, and with these linkages full-service financial conglomerate groups have begun to emerge.

One important difference between the German and the Australian and British reforms, however, was that Germany’s reforms did not involve a significant diminution of the

138. Not only does the United States have separate regulators for each of the traditional financial industry groups, but the United States has four federal regulators for banking institutions alone: Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, and the Federal Reserve Board. In the Fall of 1993, the Clinton Administration proposed the creation of a federal banking commission that would regulate all FDIC-insured depository institutions and their holding companies. See 1649 Fed. Banking L. Rep. (CCH) ¶ 89,593 (Dec. 3, 1993). The Clinton Administration’s proposal would have created a new Federal Banking Commission. Subsequently, however, the Clinton Administration officials recommended delaying action on agency consolidation pending Congress’s resolution of financial modernization legislation. Heidi Mandanis Schooner, Recent Challenges to the Persistent Dual Banking System, 41 ST. LOUIS UNIV. L.J. 263, 271 n.47 (1996).

Bundesbank’s regulatory role since it had never had direct responsibility for banking supervision.  

A number of other OECD countries have now adopted unified supervision. Japan has created a Financial Services Agency comprising the former bureau of the Ministry of Finance responsible for banking and insurance supervision and the regulation of securities markets. A quasi-autonomous agency, the Securities Exchange Surveillance Commission, was also transferred to the new organization. The Japanese FSA is unusual in that it reports to the Prime Minister’s office rather than to the Ministry of Finance; this arrangement was the result of the authorities’ desire to remove the potential conflicts of interest inherent in the Ministry’s role as both the regulator and the promoter of the financial services sector. However, the Ministry of Finance continues to exercise responsibility for financial policy planning and legislation. The FSA exercises its supervisory powers jointly with a number of other institutions including the Bank of Japan, which continues to conduct its own examinations of banks, the Ministry of International Trade and Industry (non-bank financial institutions), and the Ministry of Agriculture (for agriculture-related financial institutions). Credit cooperatives continue to be regulated by local governments.  

In December 1997, Korea also established a Financial Supervisory Commission that consolidated all financial sector supervision for commercial banks, merchant banks, securities firms, insurance companies, and other non-bank financial institutions. It was established in part to enhance the independence of supervision in the aftermath of the Asian crisis and in part to eliminate a number of gaps in regulation that had given rise to unsupervised financial intermediaries whose activities had contributed to the crisis. A number of countries with comparatively small financial sectors, including Estonia, Iceland, Ireland, and Lithuania have also recently embarked on the unification of their financial sector supervision. In these cases, however, the motivation for unification may have been primarily to obtain economies of scale in supervision.  

The GLB’s approach to regulatory modernization takes exception from not only the U.K. approach, but also from an emerging international trend towards unified financial sector supervision outside the central bank. GLB’s adherence to functional regulation is not surprising given its preservation of the status quo, but that approach is troubling to the extent that the bill incorporates safety and soundness regulation. Moreover, GLB’s expansion of the central bank’s powers runs against the trend in many other industrialized countries.  

The effectiveness of a unified supervisory agency in regulating financial conglomerates or as a response to the challenge of functional despecialization is by no means certain. It is noteworthy that most of the unified agencies established to date have preserved the traditional institutional division between banks, securities firms, and
insurance companies in their internal organizational structures. At a minimum, therefore, the chief advantages of unified supervision would appear to be the enhanced cooperation and communication that result from placing different institutionally focused regulators within a single management structure. No regulatory authority has yet been able to develop a risk assessment framework that is suitable for assessing the risks in diversified financial conglomerate groups, although this is the focus of a “complex groups” division created within Britain’s FSA.

Unified financial regulatory agencies may prove less effective than anticipated if their very broad scope overloads senior management. In addition, unified agencies may be susceptible to problems of reputational contagion, as regulatory failures—whether apparent or real—undermine their credibility over the broad range of their responsibilities. Since their formation, both Australia’s APRA and the United Kingdom’s FSA have been the subject of public criticism over their handling of two insurance companies, HIH and Equitable Life, respectively. In the Australian case, the HIH episode has already prompted some critics to question the effectiveness of the Wallis reforms, although it is likely that problems at HIH, like those in Equitable Life, predate the formation of the new agency. Nonetheless, if such episodes were to become commonplace, the reputation and effectiveness of the single regulatory agency might well be undermined.

The rapid evolution of the financial systems of leading industrialized countries over the past two decades has posed policymakers with a series of profound challenges. The adoption of unified regulatory agencies is the outcome of attempts to analyze and assess the implications of these developments for the structure of regulation. GLB’s functional regulatory scheme is not the result of any comprehensive analysis, but rather a slight variation of the status quo. The Fed’s role as umbrella regulator under GLB is at best a partial and constrained response to the issues that Australia, Germany, Japan, and the United Kingdom have each sought to address through more radical structural change. Thus, for example, the Fed’s role as umbrella regulator is relevant only to the goals of safety and soundness and does not address the potential need for a single regulator that is responsible for all financial regulatory goals, including, for example, consumer protection.

Unified financial sector supervision may not be a universal panacea for the problems presented by the formation of financial conglomerates and industry despecialization. For example, it remains to be seen whether a regulatory structure in which the central bank ceases to have direct supervisory responsibilities will be adequate to deal with episodes of severe financial stress. For this reason, it is too soon to assess the success or failure of the radical experiments in countries like Australia and Britain. Nonetheless, of the various alternatives to unified supervision, we predict that functional regulation will not prevail because it is a scheme not well suited to the regulation of banks and because it does not account for blurring of product lines and functional despecialization.

We are certain that the success of regulatory modernization will hinge on policymakers’ ability to remain focused on the ultimate goals of financial regulation. While we have highlighted the changes in financial markets over the last several decades and the significance of those changes for lawmakers, the ultimate goals of financial regulation remain constant. These basic goals are consumer protection, institutional safety and soundness, and systemic stability. Regulatory modernization can be achieved only

146. However, Britain’s FSA has established a “complex groups” division, and APRA is functionally organized around a distinction between “specialist firms” and “diversified groups.”

through systematic consideration of current market developments and trends and of how regulatory systems, consistent with regulatory goals, can contend with such evolution. Relative to other developed countries, the United States' consideration of issues of regulatory modernization has been perfunctory.