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Arthur E. Wilmarth Jr.

George Washington University Law School, awilmarth@law.gwu.edu

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THE ROAD TO REPEAL OF THE GLASS-STEAGALL ACT

Arthur E. Wilmarth, Jr.[†]

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I. INTRODUCTION

The financial crisis of 2007-2009 caused the most severe global economic downturn since the Great Depression.¹ The financial disruption that triggered the Great Recession began in the United States and spread to financial markets around the world, just as the financial contagion that began on Wall Street in October 1929 spread through foreign markets in the early 1930s.²

The recent crisis has generated renewed interest in the Glass-Steagall Banking Act of 1933,³ which Congress adopted in response to the collapse of the U.S. banking system and the freezing of U.S. capital markets during the Great Depression.⁴ Glass-Steagall included provisions that were designed to stabilize the U.S. financial system by separating commercial banks from the capital markets and by prohibiting nonbanks from accepting deposits.⁵ As described in this

¹ BARRY EICHENGREEN, *HALL OF MIRRORS: THE GREAT DEPRESSION, THE GREAT RECESSION, AND THE USES – AND MISUSES – OF HISTORY 1* (2015) (describing "the Great Recession of 2008–09 and the Great Depression of 1930–33" as "the two great financial crises of our age"); *see also* Benjamin S. Bernanke, Chairman, Fed. Reserve Bd., Swearing-In Ceremony Remarks (Feb. 3, 2010), <https://www.federalreserve.gov/newsevents/speech/bernanke20100203a.htm> (referring to the financial crisis of 2007–09 as "the deepest financial crisis since the Great Depression").

² ALAN S. BLINDER, *AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD* 168–70, 409–28 (2013) (explaining how the global financial crisis of 2008–09 began in America and spread to Europe); EICHENGREEN, *supra* note 1, at 173 (noting that financial crises began in America and spread to Europe during both the Great Depression and the Great Recession).

³ Banking Act of 1933, ch. 89, 48 Stat. 162 (including provisions repealed in 1999).

⁴ *See* EICHENGREEN, *supra* note 1, at 66; *see also* BARRIE A. WIGMORE, *THE CRASH AND ITS AFTERMATH: A HISTORY OF SECURITIES MARKETS IN THE UNITED STATES, 1929–1933* (1985) (explaining generally the breakdown of the U.S. banking system and capital markets between 1930 and 1933); Arthur E. Wilmarth, Jr., *Did Universal Banks Play a Significant Role in the U.S. Economy's Boom-and-Bust Cycle of 1921–33? A Preliminary Assessment*, 4 *CURRENT DEV. IN MONETARY & FIN. L.* 559, 559–60, 564–68 (2005) [hereinafter Wilmarth, *Universal Banks in the 1920s*]; Arthur E. Wilmarth, Jr., *Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the "Roaring Twenties"*, 90 *TUL. L. REV.* 1285, 1289, 1301–03, 1322–26 (2016) [hereinafter Wilmarth, *Prelude to Glass-Steagall*].

⁵ Sections 20 and 32 of Glass-Steagall prohibited commercial banks that were members of the Federal Reserve System (member banks) from affiliating with securities firms or sharing directors, officers, or employees with securities firms. Banking Act of 1933 §§ 20, 32. Sections 5(c) and 16 of Glass-Steagall barred member banks from underwriting or dealing in securities, except for specified categories of "bank-eligible" securities, such as U.S. government securities and state

article, a series of rulings by federal agencies and courts during the 1980s and 1990s undermined Glass-Steagall's structural barriers, and Congress repealed the most important provisions of Glass-Steagall in 1999 by passing the Gramm-Leach-Bliley Act (GLBA).⁶

Since the financial crisis, there has been a lively debate on the question of whether the removal of Glass-Steagall's structural barriers promoted the unsustainable and toxic credit bubble that led to the financial crisis of 2007-2009. Some authors have argued that Glass-Steagall's repeal was an important factor that helped to fuel the financial crisis, while others have contended that Glass-Steagall's disappearance did not contribute to the crisis in any significant way.⁷ This article sheds further light on that debate by describing Glass-Steagall's positive impact on the stability of the U.S. financial system from World War II through the 1970s and the adverse consequences of Glass-Steagall's disappearance.

and local bonds, which were lawful for underwriting or investment by national banks. Banking Act of 1933 §§ 5(c), 16. Section 21 forbade securities firms and other nonbanking firms from accepting deposits. Banking Act of 1933 § 21. For detailed discussions of these provisions, see DAVID H. CARPENTER & M. MAUREEN MURPHY, CONG. RESEARCH SERV., R41181, PERMISSIBLE SECURITIES ACTIVITIES OF COMMERCIAL BANKS UNDER THE GLASS-STEAGALL ACT (GSA) AND THE GRAMM-LEACH-BLILEY ACT (GLBA) 5-7 (2010); MELANIE FEIN, SECURITIES ACTIVITIES OF BANKS §§ 1.02, 4 (3d ed. 2002).

⁶ Pub. L. No. 106-102, 113 Stat. 1338 (1999).

⁷ For commentaries supporting the view that Glass-Steagall's demise helped to promote the toxic credit bubble that triggered the financial crisis, see EICHENGREEN, *supra* note 1, at 8-9, 69-70; Douglas M. Branson, *A Return to Old-Time Religion? The Glass-Steagall Act, the Volcker Rule, Limits on Proprietary Trading, and Sustainability*, 11 UNIV. ST. THOMAS L.J. 359, 360-61, 367-69 (2014); Carolyn Sissoko, *The Plight of Modern Markets: How Universal Banking Undermines Capital Markets*, 46 ECON. NOTES 53, 58, 88-90 (2017); Martin Mayer, *Glass-Steagall in Our Future: How Straight, How Narrow* 5-6 (Networks Fin. Inst., Working Paper No. 2009-PB-07, 2009), <http://ssrn.com/abstract=1505488>; Yeva Nersisyan, *The Repeal of the Glass-Steagall Act and the Federal Reserve's Extraordinary Intervention during the Global Financial Crisis* 2-4, 8, 21-22 (Levy Econ. Inst. Of Bard C., Working Paper No. 829, 2015), <http://ssrn.com/abstract=2554066>. *Contra* Jerry W. Markham, *The Subprime Crisis - A Test Match for the Bankers: Glass-Steagall vs. Gramm-Leach-Bliley*, 12 UNIV. PENN. J. BUS. L. 1081, 1082 (2010); Lawrence J. White, *The Gramm-Leach-Bliley Act: A Bridge Too Far? Or Not Far Enough?*, 18 SUFFOLK L. REV. 937, 937-38 (2010); Peter J. Wallison, *Did the 'Repeal' of Glass-Steagall Have Any Role in the Financial Crisis? Not Guilty; Not Even Close* 2-3 (Networks Inst. Pub. Policy Brief, Working Paper 2009-PB-09, 2009), <http://ssrn.com/abstract=1507803>; Paul G. Mahoney, *Deregulation and the Subprime Crisis* 1 (Univ. of Va. Sch. of Law & Econ. Research Paper Series, Working Paper 2957801, 2017), <http://ssrn.com/abstract=2957801>. See also Wilmarth, *Prelude to Glass-Steagall*, *supra* note 4, at 1287-88, 1329 (describing broader public debates about the repeal of Glass-Steagall and proposals for its reinstatement).

As Part II.A of this article explains, the Glass-Steagall Act and the Bank Holding Company Act of 1956 (BHCA)⁸ helped to maintain the stability of the banking industry and capital markets from World War II through the 1970s. Domestic and international developments began to challenge the post-New Deal system of financial regulation in the 1970s, but the structural barriers established by Glass-Steagall and BHCA maintained a significant degree of separation between commercial banks and other financial sectors until Congress removed those barriers in 1999.⁹ Glass-Steagall and BHCA limited the risks of contagion across the banking, securities, and insurance industries, thereby helping to ensure that problems arising in one sector would not spill over into other sectors.¹⁰

As discussed in Part II.B, large banks and nonbank financial institutions opened loopholes in Glass-Steagall and BHCA after 1980 by persuading federal regulators to approve limited exceptions to their structural prohibitions. During the 1980s and 1990s, federal banking agencies and courts adopted creative statutory interpretations that enabled banks to engage in capital market activities and allowed nonbank financial institutions to offer bank-like products, including substitutes for deposits.¹¹ The collective impact of those rulings eroded Glass-Steagall's and BHCA's barriers by permitting commercial banks to behave more like securities firms and insurance companies, and by allowing nonbank financial institutions to behave more like banks.

Part II.B highlights three of the most significant ways in which federal agencies and courts undercut Glass-Steagall and BHCA. First, nonbank financial institutions were allowed to fund their operations by offering short-term financial instruments that were redeemable at par and served as functional substitutes for deposits.¹² Those "shadow banking" instruments included money market mutual funds,

⁸ See Bank Holding Company Act, 12 U.S.C. §§ 1841–52 (2012).

⁹ Branson, *supra* note 7, at 368.

¹⁰ See *infra* Part II.A.

¹¹ See *infra* Part II.B.

¹² See EICHENGREEN, *supra* note 1, at 66–68; ROBERT E. LITAN, WHAT SHOULD BANKS DO? 34–35 (1987); JEFF MADRICK, THE AGE OF GREED: THE TRIUMPH OF FINANCE AND THE DECLINE OF AMERICA, 1970 TO THE PRESENT 97–98 (2011); Timothy Cook & Jeremy G. Duffield, *Money Market Mutual Funds and Other Short-Term Investment Pools*, in INSTRUMENTS OF THE MONEY MARKET 156–59, 164–67 (Timothy Q. Cook and Robert K. LaRoche eds., 7th ed. 1993) (discussing emergence and regulation of MMMFs); FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, AUTHORIZED EDITION: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 29–30, 33 (2011) [hereinafter FIN. CRISIS INQUIRY COMM'N (2011)].

commercial paper, and securities repurchase agreements (repos).¹³ The largest commercial banks also began to rely significantly on "shadow bank deposits" after they were allowed to establish securities affiliates beginning in 1987.¹⁴

Second, banks received permission to convert their consumer and commercial loans into asset-backed securities through the process of securitization.¹⁵ Third, banks gained authority to become dealers in over-the-counter (OTC) derivatives, which provided synthetic substitutes for securities, exchange-traded options and futures, and insurance.¹⁶ Shadow banking, securitization, and OTC derivatives helped to weaken Glass-Steagall's and BHCA's walls, which formerly separated banks from the securities and insurance industries. In addition, all three innovations were leading catalysts for the destructive credit bubble that led to the financial crisis of 2007-2009.¹⁷

As described in Part III, big banks were not satisfied with the limited victories they achieved by opening loopholes in Glass-Steagall and BHCA. The big-bank lobby and its allies launched a prolonged campaign in the 1980s and 1990s to repeal Glass-Steagall's and BHCA's provisions that restricted banks from expanding across state lines and prevented banks from establishing full-scale affiliations with securities firms and insurance companies.¹⁸ In 1991, the U.S. Treasury Department issued a landmark report, which called for the removal of state-law restrictions on interstate banking and branching as well as the repeal of Glass-Steagall's and BHCA's anti-affiliation rules.¹⁹ Congress adopted Treasury's plan for nationwide banking and branching by enacting the Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal) in 1994.²⁰ Ambitious bank executives quickly created giant megabanks, which were eager to

¹³ See *infra* Part II.B.1.

¹⁴ See *infra* notes 133, 136-37 and accompanying text.

¹⁵ See *infra* Part II.B.2.

¹⁶ Russell J. Funk & Daniel Hirschman, *Derivatives and Deregulation: Financial Innovation and the Demise of Glass-Steagall*, 59 ADMIN. SCIENCE Q. 669, 697 (2014); Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 19 (2011); see also *infra* Part II.B.3.

¹⁷ See *infra* notes 129-44, 242-56, 343-65 and accompanying text.

¹⁸ EICHENGREEN, *supra* note 1, at 69-70; Sissoko, *supra* note 7, at 76; White, *supra* note 7, at 941; Robert Scheer, *Privacy Issue Bubbles Beneath the Photo Op*, L.A. TIMES, Nov. 16, 1999, at B9; see *infra* Part III.A.

¹⁹ See generally U.S. DEPT. OF TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS, 49-61 (1991) (recommending legislation authorizing interstate banking and repealing the anti-affiliation rules of Glass-Steagall and BHCA).

²⁰ See generally Riegle-Neal Interstate Banking and Branching Efficiency Act, Pub. L. No. 103-328, 108 Stat. 2338 (1994).

expand their activities in the securities and insurance sectors.²¹ Securities firms and insurance companies abandoned their longstanding defense of Glass-Steagall's and BHCA's structural barriers after they realized that they could no longer counteract the growing political influence of the largest banks.²² However, community banks and independent insurance agents continued to block efforts by the largest financial institutions to remove those barriers between 1995 and 1997.²³

In 1998, the Federal Reserve Board (Fed) placed great pressure on Congress to repeal Glass-Steagall's and BHCA's anti-affiliation rules by approving a merger between Travelers, a large insurance and securities conglomerate, and Citicorp, the largest U.S. bank.²⁴ That merger created Citigroup, the first "universal bank" to operate in the United States since the 1930s.²⁵ President Bill Clinton, Treasury Secretary Robert Rubin, and Fed Chairman Alan Greenspan endorsed the creation of Citigroup, even though it was contrary to the clear intent of Glass-Steagall and BHCA.²⁶

Citigroup and other large financial institutions spearheaded a massive lobbying campaign that finally persuaded Congress to adopt GLBA in 1999.²⁷ GLBA authorized the creation of financial holding companies that could own banks, securities firms, and insurance companies, thereby confirming the validity of Citigroup's universal banking strategy.²⁸ As I argued in an article published in 2002, GLBA made the "too-big-to-fail" (TBTF) problem "much worse" by

²¹ See *infra* notes 510–18, 536–37 and accompanying text.

²² Arthur E. Wilmarth, Jr., *Citigroup: A Case Study in Managerial and Regulatory Failures*, 47 IND. L. REV. 69, 73–75 (2002) [hereinafter Wilmarth, *Citigroup*]; see also *infra* notes 541–43 and accompanying text.

²³ See *infra* notes 539–40 and accompanying text.

²⁴ See *infra* notes 544–57 and accompanying text.

²⁵ Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 220 (2002) [hereinafter Wilmarth, *Transformation*]. As used in this article, the term "universal bank" means a banking organization that can engage, either directly or through affiliates, in a broad array of banking, securities, and insurance activities. Unless otherwise indicated, the term "bank" includes both chartered banks and bank holding companies (including their subsidiaries and affiliates). *Id.* at 223 n.23.

²⁶ See *infra* notes 550–59 and accompanying text.

²⁷ Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered versions of 12 and 15 U.S.C.); see *infra* notes 562, 580–82 and accompanying text (discussing the lobbying campaign that led to the passage of GLBA).

²⁸ GLBA § 101, 113 Stat. 1341 (repealing §§ 20 and 32 of Glass-Steagall); Wilmarth, *Transformation*, *supra* note 25, at 219–21, 306–07 (describing the impact of GLBA).

expanding the scope of the federal "safety net" for banks to cover "the entire financial services industry."²⁹

The twenty-year campaign by big banks to destroy the barriers that separated them from the capital markets culminated in Congress' enactment of the Commodity Futures Modernization Act (CFMA) in 2000.³⁰ CFMA authorized large financial institutions to offer a complex array of OTC derivatives without any substantive regulation by federal or state authorities.³¹ GLBA and CFMA both ratified and significantly expanded the deregulatory measures that federal authorities had implemented on an incremental, piecemeal basis during the 1980s and 1990s.³² By providing legal certainty for those measures and expanding their scope, Congress validated a new regime of regulatory laxity that enabled giant financial conglomerates to operate with relatively few constraints. Those financial conglomerates led the way in financing the toxic credit boom that triggered the financial crisis of 2007-2009.³³

This article contends that Riegle-Neal, GLBA, and CFMA were highly consequential laws because they (i) allowed large banks to become much bigger and more complex, and to undertake a much wider array of high-risk activities, (ii) permitted securities firms and insurance companies to offer bank-like products (including deposit substitutes), and (iii) provided a blueprint for light-tough supervision of large financial institutions.³⁴ All of those factors helped to fuel the

²⁹ See Wilmarth, *Transformation*, *supra* note 25, at 444–51, 474–75; see also Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 1049–50 (2009) [hereinafter Wilmarth, *Dark Side of Universal Banking*]. At the time of the financial crisis, the federal "safety net" for banks consisted of federal deposit insurance, the Fed's role as "lender of last resort" in providing emergency loans to troubled banks through its discount window, and the Fed's guarantee of interbank payments made on Fedwire. Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 CONN. L. REV. 1539, 1588 n.284 (2007) [hereinafter Wilmarth, *Separation of Banking and Commerce*].

³⁰ Commodity Futures Modernization Act, Pub. L. No. 106–554, 114 Stat. 2763 (2000); see *infra* notes 746–56 and accompanying text (discussing the enactment of CFMA).

³¹ Letter from Lynn A. Stout, Professor, Univ. of Cal., L.A. Sch. of Law, to Comm. on Agric., Forestry, and Nutrition 1, 2 (June 4, 2009), available at https://www.agriculture.senate.gov/imo/media/doc/testimony_stout.pdf; see *infra* notes 750–52 and accompanying text (describing the impact of CFMA).

³² Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 UNIV. CIN. L. REV. 1283, 1360 (2013) [hereinafter Wilmarth, *Turning a Blind Eye*]; see *infra* Parts III.C and III.D.

³³ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 968–72, 1002–50.

³⁴ EICHENGREEN, *supra* note 1, at 69–73; see *infra* Part IV (discussing the

destructive credit boom of the early 2000s. Accordingly, I disagree with commentators who argue that those laws did not have any significant connection to the financial crisis.

As discussed in the Conclusion, this article does not include detailed recommendations for proposed reforms to address the problems created by Riegle-Neal, GLBA, and CFMA. I have discussed possible reforms in previous work, and I plan to develop a more detailed set of potential reforms in future work. At a minimum, as the Conclusion indicates, those reforms should (i) shrink the shadow banking system by prohibiting nonbanks from offering deposit substitutes, and (ii) establish a regime of strict separation between Federal Deposit Insurance Corporation (FDIC)-insured banks and the capital markets. The second reform should include a prohibition that bars FDIC-insured banks from entering into derivatives except for those that create bona fide hedges against risk exposures arising out of traditional banking activities.

II. GLASS-STEAGALL AND BHCA HELPED TO MAINTAIN POSTWAR FINANCIAL STABILITY BUT WERE UNDERMINED BY THE FINANCIAL INDUSTRY AND FEDERAL AUTHORITIES

Glass-Steagall and BHCA contributed to the stability of the financial system after World War II.³⁵ However, large U.S. banks resented the restrictions imposed on them by Glass-Steagall's and BHCA's structural barriers.³⁶ During the 1980s and 1990s, federal regulators opened loopholes in Glass-Steagall and BHCA by allowing banks and nonbank financial institutions to create short-term nondeposit liabilities, to engage in securitization, and to develop OTC derivatives.³⁷ In combination, those regulatory loopholes helped to undermine the post-New Deal system of financial regulation.³⁸

A. The Structural Barriers Established by Glass-Steagall and BHCA Helped to Preserve Financial Stability by Preventing Contagious Spillovers of Risks and Losses among the Banking, Securities, and Insurance Sectors

In adopting the Glass-Steagall Act and other Depression-era statutes, Congress sought to prevent a recurrence of the Great

collective impact of Riegle-Neal, GLBA, and CFMA).

³⁵ See *infra* Part II.A.

³⁶ See *infra* Part III.A.

³⁷ Markham, *supra* note 7, at 1095–1103; White, *supra* note 7, at 940–41.

³⁸ See *infra* Part II.B.

Depression by establishing a stable financial system comprised of separate and compartmentalized financial markets.³⁹ Congress barred banks from participating in speculative activities in the capital markets, and Congress required banks to focus on their traditional roles of accepting deposits, making loans to consumers and businesses, providing fiduciary services, and investing in low-risk government securities.⁴⁰ To deter banks from pursuing nontraditional banking activities, the Glass-Steagall Act barred the Fed from making loans to banks through its discount window if those loans would enable banks to finance speculative activities in the capital markets.⁴¹ At the same time, Congress prohibited nonbanks from accepting deposits, to prevent nonbanks from engaging in the banking business.⁴² Congress wanted to ensure that the Fed would not be forced "to rescue speculators to save depositors."⁴³

Congress took further steps to bolster the stability of the banking system. First, Congress established a system of federal deposit insurance to discourage destructive "runs" by depositors on banks.⁴⁴ Second, Congress tried to stop what it viewed as destructive competition between banks.⁴⁵ To accomplish that goal, the Glass-Steagall Act prohibited banks from paying interest on demand deposits (checking accounts) and required the Fed to adopt a rule (Regulation Q) that would limit the interest rates banks could pay on their certificates of deposit, savings accounts, and other time deposits.⁴⁶

³⁹ Wilmarth, *Separation of Banking and Commerce*, *supra* note 29, at 1564–65; Wilmarth, *Universal Banks in the 1920s*, *supra* note 4, at 564–68, 588–91, 611.

⁴⁰ LITAN, *supra* note 12, at 25–35; *See* Wilmarth, *Transformation*, *supra* note 25, at 225–30, 254–57; *see also* CARPENTER & MURPHY, *supra* note 5, at 1 (discussing Glass-Steagall's provisions that separated banks from capital markets activities).

⁴¹ Banking Act of 1933, §§ 3(a), 9, 11(a), 48 Stat. 163, 180–81 (1933); *Operation of the National and Federal Reserve Banking Systems*, S. REP. NO. 73-77, at 9, 15, 17 (1933). Section 11(a) of the statute barred member banks from encouraging speculation in securities by acting as "the medium or agent" for loans made by nonbank firms to securities brokers or dealers backed by stocks, bonds, or "other investment securities." 48 Stat. 181.

⁴² *See* Banking Act of 1933 § 21, 48 Stat. 189.

⁴³ RON CHERNOW, *THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE* 374–75 (1990).

⁴⁴ Banking Act of 1933 § 8, 48 Stat. 168; S. REP. NO. 73-77, at 11–12, 14 (1933); *see also* RICHARD SCOTT CARNELL ET AL., *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 21 (5th ed. 2017) (stating that federal deposit insurance "proved remarkably successful at preventing runs" on FDIC-insured banks).

⁴⁵ Glass-Steagall Act, Pub. L. No. 73–66, § 11(b), 48 Stat. 181; S. REP. NO. 73–77, at 15; FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 29.

⁴⁶ *Id.*; *see also* MADRICK, *supra* note 12, at 13 ("The fear was that competition for deposits would drive rates up and encourage banks to make risky investments to

Congress also maintained limits on geographic expansion by banks, as Congress allowed national banks to establish branches only within their home state and only to the extent that branching was permissible for state banks under state law.⁴⁷

In 1956, Congress enacted the BHCA to reinforce Glass-Steagall's policy of maintaining separate and decentralized financial markets.⁴⁸ The BHCA was enacted in response to the rapid growth and diversification of Transamerica and other large bank holding companies after World War II.⁴⁹ By 1956, Transamerica "controlled banks in ten states as well as several insurance companies and commercial businesses engaged in oil and gas development, fish canning and processing, frozen foods, and a variety of manufacturing ventures."⁵⁰

BHCA required holding companies to obtain the Fed's approval before they acquired banks.⁵¹ BHCA also authorized the Fed to regulate the activities of bank holding companies.⁵² The statute barred bank holding companies from engaging in industrial and commercial activities.⁵³ Under Section 3(d) of BHCA, bank holding companies could not acquire banks across state lines unless such transactions were specifically authorized by the laws of the states in which the acquired banks were located.⁵⁴ The states did not begin to pass such laws until 1975.⁵⁵

Section 4 of BHCA allowed bank holding companies, with the Fed's permission, to own nonbank subsidiaries whose activities were "closely related" to banking.⁵⁶ With limited exceptions, Section 4 prohibited bank holding companies from owning subsidiaries that engaged in most types of insurance activities or that conducted commercial or industrial operations.⁵⁷ Section 4 also prevented insurance, commercial, and industrial companies from owning

earn higher returns" unless Congress imposed restrictions on deposit interest rates).

⁴⁷ Banking Act of 1933 § 23; S. REP. NO. 73-77, at 11, 16-17 (1933); Arthur E. Wilmarth, Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957, 973-75 (1992) [hereinafter Wilmarth, *Too Big to Fail*].

⁴⁸ Wilmarth, *Separation of Banking and Commerce*, *supra* note 29, at 1566.

⁴⁹ *Id.* at 1566-67.

⁵⁰ *Id.*

⁵¹ See Bank Holding Company Act, 12 U.S.C. § 1842 (2012).

⁵² *Id.* §§ 1842-44.

⁵³ 12 U.S.C. § 1843.

⁵⁴ See Wilmarth, *Too Big to Fail*, *supra* note 47, at 975-76; Wilmarth, *Separation of Banking and Commerce*, *supra* note 29, at 1566-67 (discussing BHCA's enactment in 1956).

⁵⁵ Wilmarth, *Too Big to Fail*, *supra* note 47, at 977.

⁵⁶ Wilmarth, *Separation of Banking and Commerce*, *supra* note 29, at 1567.

⁵⁷ 12 U.S.C. § 1843.

banks.⁵⁸ Thus, BHCA represented "a powerful statement of Congress's intention to separate banking and commerce."⁵⁹

Under the financial system established by Glass-Steagall and BHCA, "banks accepted deposits and extended loans to businesses and consumers," while "securities firms accessed 'at risk' funds of long-term investors to meet the capital needs of commercial and industrial firms," and "the insurance industry collected premiums to underwrite business and individual risks, allocating the funds received to the capital markets."⁶⁰ The U.S. financial system of 1960 ensured that regulated depository institutions were the primary repositories for household savings and short-term funds held by business firms, while securities firms relied on longer-term commitments of invested funds and insurance companies financed their operations with longer-term streams of premium payments.⁶¹ This system of "segmented" markets "generally prospered well into the 1970s."⁶²

During the 1960s and 1970s, federal courts defended the post-New Deal financial system and struck down attempts by federal bank regulators to evade Glass-Steagall's and BHCA's structural barriers.⁶³ The courts overruled a series of rulings issued by Comptroller of the Currency James Saxon between 1961 and 1966, which attempted to expand the securities and insurance powers of national banks.⁶⁴

⁵⁸ *Id.*

⁵⁹ Wilmarth, *Separation of Banking and Commerce*, *supra* note 29, at 1566-67 (explaining that, while the original BHCA applied only to holding companies that controlled two or more banks, in 1970 Congress expanded BHCA's scope to reach one-bank holding companies).

⁶⁰ U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991), at XVIII-9.

⁶¹ *Id.* at XVIII-6 through XVIII-9.

⁶² *Id.*; *see also* EICHENGREEN, *supra* note 1, at 67 (noting that the United States enjoyed a "golden age of financial stability . . . [b]etween the end of World War II and the 1970s").

⁶³ *See, e.g., Inv. Co. Inst. v. Camp*, 401 U.S. 617, 639 (1971) (striking down a regulation authorizing national banks to establish and operate collective investment funds); *see also Saxon v. Ga. Ass'n of Indep. Ins. Agents*, 399 F.2d 1010, 1020 (5th Cir. 1968) (invalidating a ruling that allowed national banks to operate insurance agencies across the nation); *see also Port of N.Y. Auth. v. Baker, Watts & Co.*, 392 F.2d 497, 504 (D.C. Cir. 1968) (overruling a regulation that permitted national banks to underwrite municipal revenue bonds).

⁶⁴ *See, e.g., Inv. Co. Inst.*, 401 U.S. at 617; *see also Saxon*, 399 F.2d at 1010; *see also Port of N.Y. Auth.*, 392 F.2d at 497; Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133, 1157-58 (1990) [hereinafter Wilmarth,

Similarly, the courts and Congress prevented the Fed from enlarging the permissible insurance activities of bank holding companies during the 1970s and early 1980s.⁶⁵

As discussed below in Part II.B., the stable postwar financial system established by Glass-Steagall and BHCA experienced a series of economic shocks and legal challenges after 1970.⁶⁶ However, the anti-affiliation provisions of both statutes maintained a significant degree of separation between commercial banks and securities firms and insurance companies until GLBA repealed those provisions in 1999.⁶⁷ After Congress removed Glass-Steagall's and BHCA's structural barriers, large financial conglomerates grew rapidly in size and in scope, and their activities became more complex, opaque, and risky.⁶⁸ Large financial conglomerates were the dominant players in the U.S. financial industry by the early 2000s, and the systemic risk they generated steadily increased until it reached critical levels in 2007, on the eve of the financial crisis.⁶⁹

In an article published in 2002, I argued that Glass-Steagall and BHCA significantly reduced systemic risk in U.S. financial markets by separating the banking sector from the securities and insurance sectors.⁷⁰ As a result of that separation, risks and losses in one sector were less likely to spill over into other sectors, and financial institutions in one sector could support other sectors that were under stress.⁷¹ Major banks (with support from the Fed's discount window) provided emergency credit to the commercial paper market following Penn Central's default in 1970, to securities broker-dealers after the stock market crash of 1987, and to corporate borrowers after Russia's debt default in 1998.⁷² During each of those disruptions, major banks did not suffer crippling losses in the capital markets (although losses incurred by several large banks in 1998 revealed that those banks were increasing their exposure to securities activities).⁷³ Accordingly,

State Bank Powers].

⁶⁵ See Wilmarth, *Transformation*, *supra* note 25, at 226–27.

⁶⁶ See *infra* notes 88–98 and accompanying text.

⁶⁷ Wilmarth, *Separation of Banking and Commerce*, *supra* note 29, at 1566–73, 1580–81.

⁶⁸ See Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 972–97; Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 963–75 (2011) [hereinafter Wilmarth, *Dodd-Frank's Inadequate Response*].

⁶⁹ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 1002–50; Wilmarth, *Dodd-Frank's Inadequate Response*, *supra* note 68, at 963–82.

⁷⁰ See Wilmarth, *Transformation*, *supra* note 25, at 444, 451.

⁷¹ See *id.* at 235–37, 444, 451.

⁷² See *id.* at 235–37.

⁷³ *Id.* at 235–37, 375–77.

banks could serve as a "backup source of liquidity" for other sectors of the financial industry and nonfinancial corporations.⁷⁴ Similarly, securities firms were able to serve as an alternative source of credit for nonfinancial businesses when large banks suffered serious losses from nonperforming loans during the early 1990s.⁷⁵

In the same 2002 article, I contended that "the greatest danger" of GLBA was that it would increase "the concentration of credit risk and market risk within the U.S. financial system" by removing the "alternative financial channels . . . that acted as 'shock absorbers' for the U.S. economy" prior to the removal of Glass-Steagall's and BHCA's structural barriers.⁷⁶ I also warned that GLBA would "extend the scope of the TBTF subsidy to reach nonbank affiliates of large financial holding companies," because federal regulators would be "likely to conclude that they should protect nonbank affiliates of big financial conglomerates during economic disruptions in order to reduce systemic risk."⁷⁷ After GLBA, I argued, it was highly probable that "major segments of the securities and life insurance industry will be brought within the scope of the TBTF doctrine, thereby expanding the scope and cost of federal 'safety net' guarantees."⁷⁸ The financial crisis of 2007-09 exceeded my worst expectations.

In September 1999 – just two months before Congress repealed Glass-Steagall's and BHCA's anti-affiliation rules – Fed Chairman Alan Greenspan boasted that the U.S. financial industry had a "spare tire" that successfully maintained the stability of financial markets during the crises of 1990 and 1998.⁷⁹ As Greenspan noted, securities firms "were able to substitute for the loss of bank financial

⁷⁴ *Id.* at 235–37, 451. For additional discussions of how the Fed mobilized the banking system to provide emergency liquidity support to the capital markets during the commercial paper crisis of 1970 and the stock market crash of 1987, see CHERNOW, *supra* note 43, at 700–01; E. P. DAVIS, DEBT, FINANCIAL FRAGILITY, AND SYSTEMIC RISK, 161–63, 250–51 (1992); FREDERIC S. MISHKIN, ASYMMETRIC INFORMATION AND FINANCIAL CRISES: A HISTORICAL PERSPECTIVE, 98–104 (1991); Andrew F. Brimmer, *Distinguished Lecture on Economics in Government: Central Banking and Systemic Risks in Capital Markets*, 3 J. ECON. PERSP. 3, 5–7, 11–15 (1989); see also *infra* note 452 and accompanying text (explaining that the stock market crash in October 1987 did not have a contagious impact on the banking industry due to the structural insulation provided by the Glass-Steagall Act).

⁷⁵ Wilmarth, *Transformation*, *supra* note 25, at 451.

⁷⁶ *Id.*

⁷⁷ *Id.* at 446–47.

⁷⁸ *Id.* at 447.

⁷⁹ Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks by Fed Chairman Alan Greenspan Before the World Bank Group and International Monetary Fund, Program of Seminars (Sept. 27, 1999); see FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 56–58 (discussing Greenspan's "spare tire" speech).

intermediation" when "American banks seized up in 1990."⁸⁰ Conversely, when "public capital markets in United States virtually seized up" during the Russian default crisis of 1998, commercial banks "replaced the intermediation function of the public capital markets."⁸¹

It was highly ironic that Greenspan gave his "spare tire" speech at a time when he was strongly urging Congress to enact GLBA and thereby destroy the structural separations established by Glass-Steagall and BHCA. GLBA removed the "spare tire" lauded by Greenspan and facilitated the emergence of giant financial conglomerates.⁸² Those conglomerates exposed the U.S. economy to devastating spillovers of risks and losses between the banking industry and the securities and insurance sectors. It is hardly a coincidence that the financial crisis of 2007–2009 was triggered by failures or threatened collapses of leading firms *within all three sectors*.⁸³

In 2012, economist Luigi Zingales announced his support for a restoration of Glass-Steagall's structural barriers, in part because a separation of banks from the capital markets would "make the financial system more resilient."⁸⁴ He noted the evident benefits of Glass-Steagall during the 1987 stock market crash and the 1990-91 banking crisis.⁸⁵ In contrast, after Glass-Steagall was repealed, "in 2008 the banking crisis and the stock market crisis infected each other, pulling down the entire economy."⁸⁶

⁸⁰ Speech by Alan Greenspan, *supra* note 79.

⁸¹ *Id.*

⁸² Wilmarth, *Dodd-Frank's Inadequate Response*, *supra* note 68, at 957–59, 963–67, 970–77.

⁸³ *Id.*

⁸⁴ Luigi Zingales, *Why I Was Won Over by Glass-Steagall*, FIN. TIMES (June 10, 2012), <http://www.ft.com/intl/cms/s/0/cb3e52be-b08d-11e1-8b36-00144feabdc0.html>.

⁸⁵ *Id.*

⁸⁶ *See id.* In a March 2010 interview, former Citigroup co-chairman John Reed observed that "the compartmentalization that was created by Glass-Steagall would be a positive factor" because it would reduce the risks of "a catastrophic failure" affecting the entire financial system. *See* FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 55, 474 n.18 (quoting Mr. Reed); *see also* Wilmarth, *Prelude to Glass-Steagall*, *supra* note 4, at 1287 (discussing Mr. Reed's publicly-stated view that Congress made a serious mistake in enacting GLBA and repealing Glass-Steagall); Reed left Citigroup in April 2000, after Sandy Weill convinced Citigroup's board to put Weill in charge. MADRICK, *supra* note 12, at 314–15.

B. The Financial Industry and Federal Authorities Used Three Principal Strategies to Undermine the Separation of the Banking Industry from the Securities and Insurance Industries*1. The Demise of Regulation Q, the Creation of Deposit Substitutes by Nonbanks, and the Rise of Shadow Banking*

The interest rate ceilings on bank deposits established by Regulation Q were the first major component of Glass-Steagall to fall.⁸⁷ Regulation Q's interest rate limits became unviable during an extended period of high and volatile interest rates that lasted from the late 1960s until the early 1980s.⁸⁸ Inflationary pressures began to develop during the late 1960s and early 1970s, as the Johnson and Nixon Administrations ran large federal budget deficits to finance ambitious domestic spending programs as well as higher military expenditures for the Vietnam War.⁸⁹ Deficits and trade imbalances weakened the dollar and forced President Nixon to suspend the convertibility of dollars into gold in August 1971.⁹⁰ Nixon's action led to the collapse of the Bretton Woods regime of relatively stable international currency exchange rates.⁹¹ The demise of Bretton Woods resulted in much higher volatility for interest and currency exchange rates.⁹²

The oil embargo imposed by the Organization of the Petroleum

⁸⁷ Allan H. Meltzer, *Origins of the Great Inflation*, 87 FED. RES. BANK ST. LOUIS REV. 145, 158–72 (March/April 2005), <https://files.stlouisfed.org/files/htdocs/publications/review/05/03/part2/MarchApril2005Part2.pdf>.

⁸⁸ *Id.*

⁸⁹ *Id.*; ROBERT L. HETZEL, *THE MONETARY POLICY OF THE FEDERAL RESERVE: A HISTORY*, 67–93 (2008).

⁹⁰ See Michael D. Bordo, *The Operation and Demise of the Bretton Woods System, 1958 to 1971* 24 (Hoover Inst. Working Paper No. 23189, 2017), <http://www.nber.org/papers/w23189>.

⁹¹ See *id.* Under the Bretton Woods agreement of 1944, the United States promised to convert dollars into gold at a fixed price of thirty-five dollars per ounce, and many other nations agreed to peg their currencies to the dollar. *Id.* at 3. The Bretton Woods System permitted member nations to adjust their exchange rates under the oversight of the International Monetary Fund. *Id.* at 3. Nixon's suspension of the convertibility of dollars into gold in August 1971 led to the complete breakdown of the Bretton Woods System in early 1973, when many developed countries adopted floating exchange rates. See *id.* at 26. See also HETZEL, *supra* note 89, at 100–07 (discussing the breakdown of the Bretton Woods system); WILLIAM L. SILBER, VOLCKER: THE TRIUMPH OF PERSISTENCE 23–26, 86–92, 113–21 (2012) (same).

⁹² See PETER L. BERNSTEIN, *AGAINST THE GODS: THE REMARKABLE STORY OF RISK* 246, 251, 320–22 (1996); HETZEL, *supra* note 89, at 150–54.

Exporting Countries (OPEC) in 1973 caused a dramatic increase in oil prices,⁹³ and the Iranian revolution of 1979 triggered a second spike in oil prices.⁹⁴ Rising oil prices helped to push U.S. inflation rates to all-time highs by 1980.⁹⁵ Under the leadership of Chairman Paul Volcker, the Fed adopted an aggressive anti-inflation policy and hiked short-term interest rates to unprecedented levels.⁹⁶ The federal funds rate rose to twenty percent in early 1981 and remained as high as fourteen percent in 1982.⁹⁷

As short-term interest rates rose far above the interest rate ceilings established by Regulation Q, depositors withdrew their funds from bank accounts and sought higher-yielding investments.⁹⁸ Large banks looked for ways to offer higher-yielding deposits while avoiding Regulation Q.⁹⁹ Beginning in the 1960s, under Walter Wriston's leadership, Citibank issued negotiable-rate, large-denomination certificates of deposit (CDs) through its domestic branches and also accepted Eurodollar deposits through Citibank's overseas branches.¹⁰⁰ Both types of deposits paid interest rates higher than those permitted

⁹³ Greg Myre, *The 1973 Arab Oil Embargo: The Old Rules No Longer Apply*, NPR (Oct. 16, 2013, 12:15 PM), <http://www.npr.org/sections/parallels/2013/10/15/234771573/the-1973-arab-oil-embargo-the-old-rules-no-longer-apply>.

⁹⁴ See Laurel Graefe, *Oil Shock of 1978-79*, FED. RESERVE HIST. (Nov. 22, 2013), https://www.federalreservehistory.org/essays/oil_shock_of_1978-79.

⁹⁵ R.A., *Who Beat Inflation?*, ECONOMIST (Mar. 31, 2010), https://www.economist.com/blogs/freeexchange/2010/03/volcker_recession.

⁹⁶ See *id.*

⁹⁷ Business Desk, *What Led to the High Interest Rates of the 1980s?*, PBS (May 29, 2009, 12:02 PM), <http://www.pbs.org/newshour/making-sense/what-led-to-the-high-interest/>; MADRICK, *supra* note 12, at 165–66, 169–70. See also SILBER, *supra* note 91, at 165–215, 222–24 (discussing Paul Volcker's leadership of the Fed's anti-inflation policy during his tenure as Fed Chairman).

⁹⁸ MADRICK, *supra* note 12, at 18, 22, 97–98.

⁹⁹ See *id.*

¹⁰⁰ See *id.* at 17–19. HAROLD VAN B. CLEVELAND & THOMAS F. HUERTAS, CITIBANK, 1812–1970 253–57 (1985). Wriston's bank will be referred to as "Citibank" in this article, but the bank operated under the name of "First National City Bank of New York" from 1962 to 1976, when its name was changed to "Citibank." *Id.* In the early 1960s, Wriston arranged for Citibank to make a \$10 million loan to the Discount Corporation of New York, a government bond dealer (Discount), in order to persuade Discount to create a secondary market for investors who wanted to trade in Citibank's negotiable CDs. MADRICK, *supra* note 12, at 17. Citibank's loan to Discount created a situation where Citibank was effectively "making its own markets for the CDs they issued, taking a substantial risk and violating the spirit and perhaps even the letter of New Deal regulations that prevented conflicts of interest." *Id.* However, with "the Federal Reserve looking the other way," Citibank's negotiable CDs were very successful, and other major U.S. banks soon followed Citibank's example. *Id.* at 17–18.

by Regulation Q. Although Citibank acted without advance approval from the Fed, the Fed acquiesced in Citibank's circumvention of Regulation Q, and other large banks soon followed Citibank's example.¹⁰¹

In the early 1970s, the securities industry introduced its own innovative financial instrument, the money market mutual fund (MMMF).¹⁰² MMMFs were short-term investment vehicles that offered deposit-like features and were not subject to the interest-rate limits of Regulation Q.¹⁰³ MMMFs allowed investors to withdraw their funds based on a fixed net asset value (NAV) equal to the original purchase price of one dollar per share.¹⁰⁴ MMMFs were not federally insured like bank deposits, but they offered investors the ability to withdraw their funds on demand at par, were regulated by the Securities and Exchange Commission (SEC), and were required to invest in "safe" short-term securities, such as U.S. Treasury bonds and highly-rated commercial paper.¹⁰⁵ Investors generally believed that the institutional sponsors of MMMFs would provide financial backing to prevent their funds from breaking the buck.¹⁰⁶

In 1977, Merrill Lynch, a leading securities broker-dealer, created the "cash management account" (CMA), which allowed holders to write checks against their funds held in Merrill Lynch's MMMFs.¹⁰⁷ Other securities broker-dealers quickly added check-writing features to their own MMMFs.¹⁰⁸ MMMFs were exempt from Regulation Q because they were classified and regulated as mutual funds (equity investments) rather than "deposits."¹⁰⁹ As a result, MMMFs offered customers many of the functional attributes of deposits, including redemption at par on demand and check-writing, along with much higher yields on their invested funds.¹¹⁰ Institutions and individuals

¹⁰¹ See MADRICK, *supra* note 12, at 17–19. See also Morris, Marc D. & John R. Walter, *Large Negotiable Certificates of Deposit*, in INSTRUMENTS OF THE MONEY MARKET 34–47 (7th ed. 1993) (discussing negotiable certificates of deposit).

¹⁰² Cook & Duffield, *supra* note 12, at 156–67.

¹⁰³ See *id.*

¹⁰⁴ See FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 29–30.

¹⁰⁵ See *id.*; Cook & Duffield, *supra* note 12, at 156–60, 164–65.

¹⁰⁶ See FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 29–30. For discussions of the emergence and regulation of MMMFs, see Cook & Duffield, *supra* note 12, at 156–59, 164–67; LITAN, *supra* note 12, at 34–35.

¹⁰⁷ See FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 30.

¹⁰⁸ See *id.*

¹⁰⁹ See *Regulations Q and D: Interest on Demand Deposits/Reserve Requirements*, FED. RESERVE 1 (Jan. 2006), https://www.federalreserve.gov/boarddocs/supmanual/cch/200601/int_depos.pdf; FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 33.

¹¹⁰ See FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 30.

rapidly shifted their short-term funds from bank deposits to MMMFs, and the total volume of MMMFs mushroomed from \$3 billion in 1977 to \$235 billion in 1982.¹¹¹

As Morgan Ricks pointed out, the emergence of MMMFs "represented a deliberate end-run around the U.S. deposit banking system," an evasion that the SEC "abetted" through its decision to exempt MMMFs from many of the regulations governing mutual funds.¹¹² The most important exemption allowed MMMFs to redeem their shares based on a "stable" NAV of one dollar per share, instead of following the general rule that mutual funds must redeem their shares based on "current market value."¹¹³ The "stable" NAV, which permitted redemption at par, was crucial to the success of MMMFs because MMMFs "want[ed] investors to view shares in an MMF as close substitutes for savings and time deposits at commercial banks and other depository institutions."¹¹⁴

Morris Crawford, chairman of the Bowery Savings Bank in New York City, sent letters to the U.S. Attorney General and the SEC in October 1979, alleging that MMMFs with check-writing privileges were illegal deposits prohibited by Section 21 of the Glass-Steagall Act.¹¹⁵ The U.S. Department of Justice (DOJ) rejected Crawford's claims and concluded that an investor in an MMMF was not a "depositor."¹¹⁶ In the DOJ's view, an investor in an MMMF owned an equity interest with "the potential for capital gain or loss on his investment."¹¹⁷ The DOJ also determined that an investor's ability to "transfer his ownership" in an MMMF to other parties by writing checks was "a mere formality and serves in no way to alter the substance of his status as owner."¹¹⁸ The DOJ's rejection of Crawford's claims ignored the practical reality that MMMFs with CMA features offered services that were functional substitutes for

¹¹¹ See *id.* at 29–30; Cook & Duffield, *supra* note 12, at 157.

¹¹² MORGAN RICKS, *THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION 233* (2016).

¹¹³ See Cook & Duffield, *supra* note 12, at 164–65.

¹¹⁴ *Id.*

¹¹⁵ Letter from Philip E. Heymann, Assistant Attorney General in the DOJ's Criminal Division, and Lawrence Lippe, Chief of the Criminal Division's General Litigation and Legal Advice Section, to Martin Lybecker, Associate Director for the SEC's Division of Marketing Management (Undated letter evidently sent in December 1979) (rejecting claims made in letters sent to the SEC and the Attorney General in October 1979 by Morris D. Crawford, Jr., Chairman of the Board of the Bowery Savings Bank of New York) (photocopy on file with the author). I am indebted to Morgan Ricks for providing the photocopy of the letter to me.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.*

checking accounts. The significant advantages of MMMFs induced many customers to transfer their savings from bank accounts into higher-yielding MMMFs, and the total volume of MMMFs reached \$235 billion in November 1982.¹¹⁹

Fed chairman Paul Volcker's war on inflation between 1979 and 1983 made Regulation Q's interest-rate ceilings untenable for banks and savings and loan associations (thrifts).¹²⁰ The rapid growth of MMMFs (which federal regulators did not try to stop) provided a convenient rationale for abolishing Regulation Q. Congress passed statutes in 1980 and 1982 that phased out Regulation Q and permitted banks and thrifts to offer deposit accounts with market-based yields that could compete with MMMFs.¹²¹ However, MMMFs did not have to bear the costs of complying with banking regulations, and they generally offered higher returns than bank deposits. As a result, the outstanding volume of MMMFs continued to grow, rising from \$235 billion in 1982 to \$740 billion in 1995, \$1.8 trillion in 2000, and \$3.8 trillion in 2007.¹²²

The expansion of MMMFs encouraged the growth of the shadow banking system – a system in which securities broker-dealers, finance companies, and other nonbanks obtained funds on a short-term basis from investors and used those funds to provide longer-term loans to consumers and businesses.¹²³ Securities firms established MMMFs to attract large amounts of short-term funding from retail and institutional customers. MMMFs were leading investors in commercial paper and securities repurchase agreements (repos), which became two of the most important short-term funding vehicles for the

¹¹⁹ Cook & Duffield, *supra* note 12, at 157.

¹²⁰ Wilmarth, *State Bank Powers*, *supra* note 64, at 1143–44.

¹²¹ The 1980 and 1982 statutes authorized banks and thrifts to offer (i) negotiable order of withdrawal (NOW) accounts, which functioned in practice as consumer checking accounts, and (ii) money market deposit accounts, which were savings accounts that could pay market rates of interest. See EICHENGREEN, *supra* note 1, at 67–68; JENNIFER TAUB, OTHER PEOPLE'S HOUSES: HOW DECADES OF BAILOUTS, CAPTIVE REGULATORS, AND TOXIC BANKERS MADE HOME MORTGAGES A THRILLING BUSINESS 51–61 (2014); see Wilmarth, *Transformation*, *supra* note 25, at 239–40.

¹²² See Cook & Duffield, *supra* note 12, at 157–58; see also FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 30, 33; Joe Peek & Eric Rosengren, *Credit Supply Disruptions: From Credit Crunches to Financial Crisis* 20 (Fed. Reserve Bank of Boston, Working Paper No. 15-5, 2015), <http://ssrn.com/abstract=2687395>.

¹²³ See Zoltan Pozsar et al., *Shadow Banking*, FED. RESERVE BANK N.Y. (July 2010), at 11–20, 33–46, <http://ssrn.com/abstract=1645337>.

shadow banking system.¹²⁴ Commercial paper is a short-term debt security that typically has a maturity of less than ninety days.¹²⁵ A repo is a short-term, secured lending arrangement in which the lender provides a cash loan and the borrower provides collateral in the form of securities acceptable to the lender.¹²⁶ The amount of the repo loan equals the market value of the collateral minus a “haircut” reflecting the perceived riskiness of the collateral.¹²⁷ Upon the expiration of a repo’s term (typically one day or a few days), the parties either renew (“roll over”) the loan or the lender returns the collateral to the borrower and the borrower repays the cash loan with accrued interest.¹²⁸

As MMMFs grew, so did the commercial paper and repo markets. The volume of outstanding commercial paper increased from less than \$50 billion in 1975 to \$560 billion in 1990, \$1.3 trillion in 2000, and \$2 trillion in 2007.¹²⁹ The volume of repos entered into by large securities broker-dealers rose from \$110 billion in 1981 to \$800 billion in 1990, \$2.5 trillion in 2002, and \$3.5 trillion in 2007.¹³⁰ During that period, MMMFs were the largest purchasers of commercial paper and among the most important cash lenders for repos.¹³¹ Funding provided by MMMFs, commercial paper, and repos enabled securities firms and other nonbanks to compete with banks in providing credit to

¹²⁴ See Pozsar et al., *supra* note 123, at 46–52; Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007-2009*, 24 J. ECON. PERSP. 29, 30–31 (2010).

¹²⁵ See Kacperczyk & Schnabl, *supra* note 124, at 38; FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 30.

¹²⁶ Stephen A. Lumpkin, *Repurchase and Reverse Repurchase Agreements*, 73 FED. RESERVE BANK RICHMOND ECON. REV. 15, 15–17 (1987).

¹²⁷ *Id.* at 17.

¹²⁸ BETHANY MCLEAN & JOE NOCERA, ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS 241–42 (2010); see FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 31. The repo market consists of two major segments: triparty repos, in which a clearing bank manages the transaction as agent for both the lender and the borrower, and bilateral repos, in which the lender and the borrower deal with each other directly. Viktoria Baklanova et al., *Reference Guide to U.S. Repo and Securities Lending Markets* 8–13 (Office of Fin. Research, Working Paper No. 15-17, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2664207.

¹²⁹ See Kacperczyk & Schnabl, *supra* note 124, at 30–32, 38.

¹³⁰ Lumpkin, *supra* note 126, at 73–74; Peek & Rosengren, *supra* note 122, at 19; Michael Fleming & Kenneth Garbade, *The Repurchase Agreement Refined: GCF Repo*, 9 CURRENT ISSUES ECON. & FIN. 1, 1–7 (2003).

¹³¹ MMMFs owned about one-third of the outstanding commercial paper in both 1992 and 2007. Thomas Hahn, *Commercial Paper*, 79 FED. RESERVE BANK RICHMOND 45, 50–51 (1993); see Kacperczyk & Schnabl, *supra* note 124, at 35. MMMFs were also among the most significant cash lenders for repos. Pozsar et al., *supra* note 125, at 50–52.

consumers and businesses through the process of securitization.¹³² After regulators allowed banks to establish their own securities affiliates and to engage in securitization, large banking organizations became active participants in the shadow banking system.¹³³

The high inflation rates that led to the demise of Regulation Q did not compel policymakers to allow nonbanks to offer deposit substitutes and thereby create the shadow banking system. Congress and federal regulators could have removed or relaxed Regulation Q's interest-rate ceilings for bank deposits — thereby permitting fairer returns to savers — while enforcing Glass-Steagall's prohibition against the acceptance of deposits by nonbanks. As Morgan Ricks has recommended, federal regulators could have barred securities firms and other nonbanks from issuing deposit substitutes like MMMFs, short-term commercial paper, and repos.¹³⁴ However, regulators never chose the available option of prohibiting deposit substitutes and requiring nonbanks to fund their activities in a more stable and transparent manner by issuing stock and longer-term debt securities, or by entering into term loans with banks.¹³⁵

After the largest banks obtained regulatory permission to establish securities subsidiaries, beginning in 1987, those banks also increased their reliance on deposit substitutes in the shadow banking system.¹³⁶ Major banks and leading Wall Street securities firms brought in huge volumes of short-term funding by (i) selling commercial paper to MMMFs and to off-balance-sheet securitization conduits, and (ii)

¹³² Pozsar et al., *supra* note 123, at 33–46 (explaining how securities broker-dealers, finance companies and other nonbanks relied on short-term funding provided by MMMFs, commercial paper, and repos to originate or purchase longer-term consumer and business loans, including residential and commercial mortgages).

¹³³ *Id.* at 22–33.

¹³⁴ RICKS, *supra* note 112, at 5–6, 226, 230–37, 301.

¹³⁵ The check-writing privileges offered by Merrill Lynch's MMMFs with CMA features depended on Merrill Lynch's ability to employ a large regional bank (Banc One) to clear CMA checks through the banking industry's check-clearing system, which the Fed regulated. Mayer, *supra* note 7, at 10. Thus, the Fed could have blocked MMMFs with check-writing privileges by instructing banks not to clear their checks. In a 1981 interview, the noted financial journalist Martin Mayer asked Paul Volcker why the Fed allowed Merrill Lynch to offer MMMFs that functioned as substitutes for checkable deposits. *Id.* According to Mayer, Volcker replied, "It was one of those things where you look and think, 'That's interesting, I wonder where it will go,' and the next time you look at it it's so big you don't dare to do anything about it." *Id.* (quoting Volcker).

¹³⁶ Pozsar et al., *supra* note 123 at 22–36, 46–53.

entering into repos and other short-term securities lending arrangements with MMMFs and other cash lenders.¹³⁷ The total volume of short-term, shadow-banking liabilities grew from less than \$500 billion in 1980 to approximately \$1 trillion in 1990, \$6 trillion in 2000, and more than \$12 trillion in 2007.¹³⁸

When the shadow banking system reached its apex in 2007, the total amount of "shadow bank deposits" held by large banks and securities firms substantially exceeded the amount of traditional deposits held by FDIC-insured institutions.¹³⁹ As Morgan Ricks has explained, the rapidly increasing volume of shadow-bank funding after 1990 "can be understood as an increasing privatization of the broad money supply in the pre-crisis years."¹⁴⁰ The growing reliance of major banks and securities broker-dealers on shadow-bank funding exposed them to severe liquidity problems when investors engaged in panicked "runs" on MMMFs, commercial paper, and repos during 2007 and 2008.¹⁴¹ To prevent the failures of large banks and broker-dealers, the Fed, FDIC, and Treasury provided a "360 [degree] backstop" for shadow banking liabilities through an array of "liquidity facilities, large-scale asset purchases and guarantee schemes."¹⁴² Those ad hoc rescue programs served as the "modern-day equivalents of deposit insurance."¹⁴³ The collapse of shadow banking markets

¹³⁷ *See id.*

¹³⁸ Compare FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 32 (electing not to include uninsured bank deposits or Eurodollar deposits in its calculation of shadow banking funding), with RICKS, *supra* note 112, at 32–36 (including uninsured bank deposits and Eurodollar deposits in his classification of "private-money claims").

¹³⁹ *See* FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 32; *see also* Pozsar et al., *supra* note 123, at 50–52; Fed. Deposit Ins. Corp., *Quarterly Banking Profile: First Quarter 2008*, 2 FDIC QUARTERLY 2, 15 (2008), <https://www5.fdic.gov/qbp/2008mar/qbp.pdf> (reporting that at the end of 2007, FDIC-insured depository institutions held about \$8.4 trillion of deposits, including \$4.3 trillion of FDIC-insured deposits and about \$4.1 trillion of uninsured domestic and foreign deposits.); Tobias Adrian & Hyun Son Shin, *Money, Liquidity, and Monetary Policy*, FED. RESERVE BANK N.Y. 1, 1 (figure 1) (Jan. 2009), <http://ssrn.com/abstract=1331004> (showing that lenders funded by the securities markets held \$16.6 trillion of assets in mid-2007, compared with \$12.8 trillion of assets held by regulated depository institutions).

¹⁴⁰ RICKS *supra* note 112, at 36.

¹⁴¹ Gary Gorton, *Securitized Banking and the Run on Repo*, 104 J. Fin. Econ., 425, 423–36, 443–48 (2009); Kacperczyk & Schnabl, *supra* note 124, at 36–48; Pozsar et al., *supra* note 123, at 2–7, 58–66.

¹⁴² Pozsar et al., *supra* note 123, at 61, 64.

¹⁴³ *Id.*; *see also* RICKS *supra* note 112, at 96–101 (stating that the federal government's responses to the financial crisis "were aimed, with few exceptions, at propping up the private money-claim markets. . . . [E]very major category of private money-claim was specifically targeted with emergency stabilization programs in

during the financial crisis and the necessity for a massive bailout of shadow-banking liabilities cast a very dark cloud over the collective decision by federal authorities *not* to enforce Glass-Steagall's prohibition on deposit-taking by nonbanks.¹⁴⁴

2. *The Rapid Growth of Private-Label Securitization*

Securitization was the second major way in which the financial industry and federal authorities broke down Glass-Steagall's and BHCA's structural barriers. Securitization is a process that creates bankruptcy-remote pools of loans and other payment obligations (receivables), which are then used as collateral for the issuance of residential mortgage-backed securities (RMBS) and other types of asset-backed securities (ABS).¹⁴⁵ The process of securitization has been extensively analyzed elsewhere,¹⁴⁶ and only a summary will be presented here.

In a typical securitization, the sponsor – usually a large bank or a securities broker-dealer – either originates or purchases loans, pools the loans, and transfers the loan pool to a bankruptcy-remote special purpose entity (SPE).¹⁴⁷ The SPE sells the loan pool to a second SPE (which is usually organized as a trust) in exchange for the second SPE's promise to pay for the loans after it has securitized the pool.¹⁴⁸ The second SPE issues ABS, which confer upon investors the right to receive designated streams of income from payments made on the loans in the pool.¹⁴⁹ The second SPE hires a securities broker-dealer (frequently an affiliate of the sponsor) to underwrite the sale of ABS to investors.¹⁵⁰ After the underwriting has been completed, the second SPE transfers the proceeds from the sale of ABS to the first SPE, and the first SPE transfers the sale proceeds to the sponsor.¹⁵¹ The second SPE manages the loan pool and, in many cases, the second SPE hires the sponsor (or another of the sponsor's affiliates) to act as servicing agent for the pooled loans.¹⁵² The sponsor, the SPEs, the ABS underwriter, and the servicing agent all receive substantial fees for

2008.").

¹⁴⁴ RICKS, *supra* note 112, at 96–122, 184–99, 230–37.

¹⁴⁵ See FEIN, *supra* note 5, at § 13.

¹⁴⁶ See generally *id.*; see also SCHWARTZ ET AL., SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 1, 6-16 (LexisNexis 2004).

¹⁴⁷ See FEIN, *supra* note 5, at § 13.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*

their roles in the securitization process.¹⁵³

Government-sponsored enterprises (GSEs) began to securitize home mortgages in the late 1960s and early 1970s.¹⁵⁴ At first, GSEs structured their "agency" RMBS as pass-through certificates that gave investors pro rata interests in the pooled mortgages.¹⁵⁵ However, pass-through certificates were not attractive to many investors because they were long-term instruments subject to prepayment risk and interest rate risk.¹⁵⁶ To attract a broader group of investors for RMBS, Lawrence Fink of First Boston and Lewis Ranieri of Salomon Brothers developed collateralized mortgage obligations (CMOs) for GSEs in the early 1980s.¹⁵⁷ Unlike pass-through mortgage certificates, a CMO is a structured-finance vehicle whose securities are divided into multiple "tranches."¹⁵⁸ Those tranches offer investors differing rights and priorities for payments of income and principal from the pooled mortgages.¹⁵⁹ Junior tranches of CMOs receive higher payoffs but are exposed to greater risks of losses from prepayments or defaults on the pooled mortgages.¹⁶⁰ In contrast, senior tranches of CMOs receive lower yields but also benefit from greater protection against losses.¹⁶¹

Securities firms fought hard to prevent GSEs from capturing the entire market for issuing RMBS.¹⁶² Ranieri helped the Reagan Administration to draft proposed legislation allowing securities broker-dealers to underwrite "private label" RMBS on a more equal footing with the GSEs.¹⁶³ In 1984, Congress included many of

¹⁵³ See KATHLEEN ENGEL & PATRICIA MCCOY, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS* 43–51 (2011); see also SCHWARTZ ET AL., *supra* note 146, at 6–16.

¹⁵⁴ Jonathan J. McConnell & Stephen A. Buser, *The Origins and Evolution of the Market for Mortgage-Backed Securities*, 3 ANN. REV. FIN. ECON. 173, 176–78 (2011).

¹⁵⁵ *Id.*

¹⁵⁶ GSEs include the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (Ginnie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). McConnell & Buser, *supra* note 154, at 176–78.

¹⁵⁷ SUZANNE MCGEE, *CHASING GOLDMAN SACHS: HOW THE MASTERS OF THE UNIVERSE MELTED WALL STREET DOWN... AND WHY THEY'LL TAKE US TO THE BRINK AGAIN* 159 (2011); MCLEAN & NOCERA, *supra* note 128, at 5–8, 13.

¹⁵⁸ *Id.*; see also Investopedia Staff, *Tranches*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/tranches.asp> (last visited Aug. 19, 2017).

¹⁵⁹ ALAN N. RECHTSCHAFFEN, *CAPITAL MARKETS, DERIVATIVES AND THE LAW* 153 (2d ed. 2014).

¹⁶⁰ McConnell & Buser, *supra* note 154, at 178.

¹⁶¹ *Id.*; MCLEAN & NOCERA, *supra* note 128, at 5–8, 13.

¹⁶² MCLEAN & NOCERA, *supra* note 128, at 13–14; TAUB, *supra* note 121, at 73–75.

¹⁶³ *Id.*

Ranieri's proposals in the Secondary Mortgage Market Enhancement Act, which exempted private-label RMBS from state securities laws and also allowed insurance companies and pension funds to invest in private-label RMBS with high credit ratings.¹⁶⁴ Two years later, the Tax Reform Act of 1986 exempted tranches of private-label RMBS from the threat of double taxation.¹⁶⁵ In response to both statutes, securities broker-dealers launched ambitious programs to underwrite private-label RMBS and ABS backed by a wide array of obligations, including credit card receivables, automobile loans, boat loans, commercial real estate loans, home equity loans, student loans, and lease receivables.¹⁶⁶

Commercial banks were equally determined to enter the private-label RMBS and ABS markets. However, two Supreme Court decisions stood in their way.¹⁶⁷ In 1966, Walter Wriston's Citibank obtained a ruling from the Office of the Comptroller of the Currency (OCC), which allowed the bank to establish a collective investment fund called a "Commingled Investment Account."¹⁶⁸ The fund pooled and managed investments made by Citibank's customers, who received participating "units" in the fund. Citibank's collective investment fund was effectively "a mutual fund by another name."¹⁶⁹

In 1971, the Supreme Court struck down the OCC's ruling and held that Glass-Steagall prohibited Citibank's fund.¹⁷⁰ The Court determined that the "units of participation" sold to customers were "securities" within the meaning of the Glass-Steagall Act, and Citibank, therefore, engaged in an unlawful "underwriting" when it sold those units to its customers.¹⁷¹ After reviewing Glass-Steagall's legislative history, the Court described a number of "hazards" and "financial dangers" that Congress sought to prohibit by passing Glass-Steagall.¹⁷² Among other risks, Congress was concerned that a bank

¹⁶⁴ *Id.*

¹⁶⁵ MADRICK, *supra* note 12, at 360–61; MCLEAN & NOCERA, *supra* note 128, at 14–16; TAUB, *supra* note 121, at 75–76, 228–31.

¹⁶⁶ FEIN, *supra* note 5, at § 13.01; Thomas R. Boemio & Gerald A. Edwards, Jr., *Asset Securitization: A Supervisory Perspective*, 75 FED. RES. BULL. 659, 659–60 (1989).

¹⁶⁷ *See* Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys. (*Bankers Trust I*), 468 U.S. 137, 141 (1984); *see also* Inv. Co. Inst. v. Camp (*ICI v. Camp*), 401 U.S. 617, 622–23 (1971).

¹⁶⁸ CLEVELAND & HUERTAS, *supra* note 100, at 294.

¹⁶⁹ *Id.*; *see also* MADRICK, *supra* note 12, at 20 (referring to Wriston's "plans to sell mutual funds").

¹⁷⁰ *ICI v. Camp*, 401 U.S. at 622–23.

¹⁷¹ *Id.* at 634–36, 639; *see also* CLEVELAND & HUERTAS, *supra* note 100, at 294–95.

¹⁷² *ICI v. Camp*, 401 U.S. at 630.

would have a "salesman's stake" in promoting the distribution of securities underwritten by either the bank or its affiliate.¹⁷³ Accordingly, the bank would be tempted (i) to make unsound loans to support the sale of those securities, and (ii) to provide biased investment advice to persuade its depositors and other customers to buy those securities.¹⁷⁴ Congress also feared that banks could lose their "reputation" and their "customer good will" if they encouraged customers to buy bad investments that they or their affiliates had underwritten.¹⁷⁵

Thirteen years after *ICI v. Camp*, the Supreme Court issued a similar decision in *Bankers Trust I*.¹⁷⁶ *Bankers Trust I* struck down a Fed order that allowed Bankers Trust to act as agent for its corporate clients in selling their commercial paper to investors.¹⁷⁷ Based on a "functional analysis," the Fed argued that commercial paper was not a "security" within the meaning of the Glass-Steagall Act because a sale of commercial paper was closer to a commercial loan than an "investment transaction."¹⁷⁸ As in *Camp*, the Supreme Court applied a broad definition of "security" in *Bankers Trust I* and rejected the Fed's attempt to distinguish between commercial paper and other types of debt securities.¹⁷⁹ The Court also reaffirmed its analysis of Glass-Steagall's purposes in *Camp*.¹⁸⁰ Quoting *Camp*, the Court declared in *Bankers Trust I* that:

Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system.¹⁸¹

¹⁷³ *Id.* at 632.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Bankers Trust I*, 468 U.S. at 141.

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* at 139.

¹⁷⁹ *Id.* at 139–41, 149–57.

¹⁸⁰ *Id.* at 144.

¹⁸¹ *Id.* at 155 (quoting *Inv. Co. Inst. v. Camp*, 401 U.S. 617, 634 (1971)); see also *Bankers Trust I*, 468 U.S. at 154 (explaining that Congress' "concern about commercial-bank underwriting activities derived from the perception that the role of a bank as a promoter of securities was fundamentally incompatible with its role as a disinterested lender and adviser").

Despite the Supreme Court's strong defense of Glass-Steagall's policies in *ICI v. Camp* and *Bankers Trust I*, large banks and federal bank regulators continued to launch assaults on Glass-Steagall's and BHCA's structural barriers. After its defeat in *Bankers Trust I*, the Fed issued a revised order that permitted Bankers Trust to sell commercial paper under a different legal rationale.¹⁸² Instead of claiming that commercial paper was not a "security," the Fed's revised order declared that Bankers Trust would not be engaged in a prohibited "underwriting" of securities as long as the bank sold commercial paper issued by its corporate clients only in private placements involving sophisticated institutional buyers.¹⁸³ The securities industry challenged the Fed's revised order.¹⁸⁴ However, the U.S. Court of Appeals for the District of Columbia Circuit affirmed the Fed, and the Supreme Court denied further review.¹⁸⁵

The D.C. Circuit began its analysis in *Bankers Trust II* by stating that it owed "substantial deference" to the Fed's revised order in light of the Supreme Court's 1984 decision in *Chevron*.¹⁸⁶ Applying the first step of *Chevron*'s two-step formula, the D.C. Circuit held that the applicable provisions of Glass-Steagall were "ambiguous," and Congress, therefore "has not clearly addressed the question" decided by the Fed.¹⁸⁷ Proceeding to the second step of *Chevron*, the D.C. Circuit deferred to the Fed's "reasonable" determinations that Bankers Trust's sales of commercial paper in private placements (i) were permissible "brokerage" transactions falling within the "business of banking" defined in 12 U.S.C. § 24, as amended by Section 16 of

¹⁸² See FED. RESERVE SYS., STATEMENT CONCERNING APPLICABILITY OF THE GLASS-STEAGALL ACT TO THE COMMERCIAL PAPER ACTIVITIES OF BANKERS TRUST COMPANY (1985).

¹⁸³ *Id.*

¹⁸⁴ See *Sec. Ind. Ass'n v. Bd. of Governors of the Fed. Reserve Sys. (Bankers Trust II)*, 807 F.2d 1052, 1053 (D.C. Cir. 1986).

¹⁸⁵ *Id.* at 1055; *cert. denied*, 483 U.S. 1005 (1987).

¹⁸⁶ *Id.* at 1056 (citing *Chevron U.S.A., Inc. v. NRDC*, 467 U.S. 837 (1984) (*Chevron*)). The Supreme Court decided *Chevron* three days before it issued its decision in *Bankers Trust I*. See *Chevron*, 467 U.S. at 837 (stating that the decision was issued on June 25, 1984); *Bankers Trust I*, 468 U.S. at 137 (stating that the decision was rendered on June 28, 1984). The Court gave "little deference" to the Fed's original order in *Bankers Trust I* because that order did not include an analysis of whether the Fed's position was consistent with Glass-Steagall's purposes. *Bankers Trust I*, 468 U.S. at 143-44.

¹⁸⁷ *Bankers Trust II*, 807 F.2d at 1056, 1059. Under the first step of *Chevron*, the reviewing court asks "whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Chevron*, 467 U.S. at 842-43.

Glass-Steagall,¹⁸⁸ and (ii) did not represent a prohibited “underwriting” of securities under Sections 16 and 21 of Glass-Steagall.¹⁸⁹ The D.C. Circuit agreed with the Fed’s position that it was “reasonable” to interpret Glass-Steagall’s prohibition on “underwriting” as forbidding public offerings of securities but *not* private placements.¹⁹⁰

The D.C. Circuit acknowledged that private placements of commercial paper would involve at least one of the “subtle hazards” identified in *Camp* and *Bankers Trust I* – namely, the danger that a bank would lose its “reputation” and the “confidence” of its customers if it encouraged them to buy unsound securities.¹⁹¹ However, the court dismissed the significance of that risk.¹⁹² The court concluded that *Chevron* “requires our deference to an agency’s reasonable construction of its statute’s ambiguities,” and “an agency’s interpretation that impairs one of the statute’s purposes but not others may surely nonetheless be reasonable.”¹⁹³ The D.C. Circuit’s disregard of potential reputational risks from private placements proved to be a very serious miscalculation. Major banks subsequently paid large fines and civil settlements after selling toxic subprime RMBS and collateralized debt obligations (CDOs) to institutional investors in private placements under the SEC’s Rule 144A.¹⁹⁴

¹⁸⁸ *Bankers Trust II*, 807 F.2d at 1056–62. Under the second step of *Chevron*, “if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissible construction of the statute In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the . . . agency.” *Chevron*, 467 U.S. at 843, 844.

¹⁸⁹ *Bankers Trust II*, 807 F.2d at 1062–66.

¹⁹⁰ *Id.* at 1062–70.

¹⁹¹ *Id.* at 1069.

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ See FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 224–26; Katherine Engel & Patricia McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2066–73 (2007); Wilmarth, *Turning a Blind Eye*, *supra* note 32, at 1344–45; Arthur E. Wilmarth, Jr., *A Two-Tiered System of Regulation Is Needed to Preserve the Viability of Community Banks and Reduce the Risks of Megabanks*, 2015 MICH. ST. L. REV. 249, 280–81 (2015) [hereinafter Wilmarth, *Two-Tiered System*]. In fairness to the D.C. Circuit, it should be noted that the SEC issued Rule 144A in 1990, four years after the D.C. Circuit’s decision in *Bankers Trust II*. See Engel & McCoy, *supra* note 194, at 2071–71. Rule 144A substantially relaxed the rules for private placements made to institutional and other qualified investors in reliance on the private offering exemption in Section 4(2) of the Securities Act of 1933. See *id.* at 2072. Prior to 1990, private offerings had to comply with the much more restrictive provisions of the SEC’s Rule 144. See *id.* at 2066–73.

Bankers Trust II provided a blueprint for subsequent federal court decisions upholding agency regulations and orders that opened loopholes in Glass-Steagall's and BHCA's structural barriers.¹⁹⁵ Courts repeatedly invoked *Chevron* deference as a justification for affirming agency rulings that used creative interpretations of "ambiguous" statutory language to circumvent Glass-Steagall's and BHCA's prohibitions.¹⁹⁶

In April 1987, the Fed authorized bank holding companies to establish "Section 20 subsidiaries," which could underwrite and deal in "bank-ineligible securities" that were not lawful for banks to underwrite or trade under Section 16 of the Glass-Steagall Act.¹⁹⁷ The Fed's *Citicorp* order allowed Section 20 subsidiaries to underwrite and trade four types of "bank-ineligible securities" – municipal revenue bonds, private-label RMBS, ABS backed by consumer loan receivables, and commercial paper.¹⁹⁸ The Fed concluded that Section 20 subsidiaries would not violate Glass-Steagall as long as they were not "engaged principally" in underwriting or dealing in "ineligible securities."¹⁹⁹ The Fed's *Citicorp* order required Section 20 subsidiaries to focus most of their activities on underwriting and trading "bank-eligible" government securities.²⁰⁰ Accordingly, the Fed limited the "bank-ineligible" securities activities of Section 20 subsidiaries to five percent or less of their gross revenues.²⁰¹

¹⁹⁵ See *infra* notes 211, 218, 233 and accompanying text (discussing later court decisions in which federal courts granted deference to agency rulings that undermined Glass-Steagall and BHCA); see also FEIN, *supra* note 5, at §§ 1.05, 4-05[A] (same).

¹⁹⁶ CARNELL ET AL., *supra* note 44, at 153 (stating that the undermining of "Glass-Steagall restrictions on bank's securities activities . . . is a tale of legal ingenuity, and agency persistence, and the power of *Chevron* deference"); FEIN, *supra* note 5, at §§ 1.05, 4.05[A] (explaining that federal courts "played a major role in dismantling the Glass-Steagall Act" by issuing more than 15 decisions that affirmed rulings by federal agencies, and noting that "courts generally have upheld Glass-Steagall interpretations by the federal banking agencies based on the *Chevron* rule of agency deference").

¹⁹⁷ Federal Reserve Board, *Bank Holding Companies and Change in Bank Control (Regulation Y): Amendments to Restrictions in the Board's Section 20 Orders*, 62 Federal Register 45,296 (Aug. 27, 1997); Wilmarth, *Transformation*, *supra* note 25, at 318.

¹⁹⁸ Orders Issued Under Section 4 of the Bank Holding Company Act: *Citicorp*, J.P. Morgan & Co, and Bankers Trust N.Y. Corp. (*Citicorp*), 73 FED. RES. BULL. 473, 487 (1987).

¹⁹⁹ *Id.* at 474 (noting that Section 20 of Glass-Steagall prohibited banks from affiliating with companies that were "engaged principally" in "underwriting . . . stocks, bonds, debentures, notes, or other securities.").

²⁰⁰ *Id.* at 487.

²⁰¹ *Id.* at 475–77, 485–86.

Fed Chairman Paul Volcker and Governor Wayne Angell dissented from the *Citicorp* order, which the Fed adopted by a 3-2 vote.²⁰¹ Volcker and Angell stated that they supported broader securities powers for bank holding companies “as a matter of policy.”²⁰² However, they argued, “the interpretation adopted by the majority would appear to make feasible . . . the affiliations of banks with some of the principal underwriting firms or investment houses of the country.”²⁰³ In Volcker's and Angell's view, “Such a legal result . . . is inconsistent with the intent of Congress in passing the Glass-Steagall Act.”²⁰⁴ Volcker and Angell maintained that the Fed should not have issued the *Citicorp* order without “a fresh Congressional mandate.”²⁰⁵

Volcker decided not to seek a third term as Fed Chairman, and his inability to block the deregulatory outcome in *Citicorp* was evidently a factor in that decision.²⁰⁶ Volcker's dissent in *Citicorp* reflected his opposition to any “rush to deregulation” until Congress approved an “overall blueprint for change” that would preserve “the stability and impartiality” of the banking system and also prevent “conflicts of interest and undue concentrations of banking resources.”²⁰⁷ President Reagan appointed Alan Greenspan to succeed Volcker, in part because Greenspan was much more supportive of the Reagan Administration's agenda for deregulating the financial industry.²⁰⁸

The securities industry challenged the Fed's *Citicorp* order, but the Second Circuit upheld the Fed and the Supreme Court denied further review.²⁰⁹ The Second Circuit acknowledged that the *Citicorp* order

²⁰¹ *Id.* at 505. H. Robert Heller, Manuel Johnson, and Martha Seger voted in favor of the *Citicorp* order. *Id.* All three of those Governors were appointed by President Reagan. See *People*, FED. RES. HISTORY, <http://federalreservehistory.org/people> (last visited Aug. 9, 2017). Volcker was appointed by President Carter in 1979 and reappointed by President Reagan in 1983, while Angell was appointed by Reagan in 1986. See *id.*

²⁰² *Citicorp*, 73 FED. RES. BULL., at 505.

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.* at 506.

²⁰⁶ SILBER, *supra* note 91, at 259–62; see also Louis Uchitelle, *Volcker, Loud and Clear: Pushing for Stronger Reforms, and Regretting Decades of Silence*, N.Y. TIMES, July 11, 2010, at BU1 (reporting that Volcker's “reluctance to deregulate contributed in part to his departure” from the Fed.).

²⁰⁷ Robert A. Bennett, *A Banking Puzzle: Mixing Freedom and Protection*, N.Y. TIMES, Feb. 19, 1984, at A1 (quoting in part Volcker's testimony before a congressional committee); Uchitelle, *supra* note 206.

²⁰⁸ Nathaniel C. Nash, *Treasury Now Favors Creation of Huge Banks*, N.Y. TIMES, June 7, 1987, at A1.

²⁰⁹ *Sec. Ind. Ass'n v. Bd. of Governors of Fed. Reserve Sys.*, 839 F.2d 47, 69 (2d Cir.); *cert. denied* 486 U.S. 1059 (1988).

represented a significant step toward “dismantl[ing] the wall of separation installed . . . by the Glass-Steagall Act.”²¹⁰ However, like the D.C. Circuit in *Bankers Trust II*, the Second Circuit concluded that *Chevron* required judicial deference to the Fed’s “reasonable” interpretation of an “ambiguous” statute.²¹¹ Accordingly, the court observed, “Whether [George] Santayana’s notion that those who will not learn from the past are condemned to repeat it fairly characterizes the consequences of the [Fed’s] action is not for us to say.”²¹² The Second Circuit’s allusion to Santayana’s warning was tragically prescient, but unfortunately it did not alter the court’s deferential approach.

The Second Circuit determined that Section 20 of Glass-Steagall was “ambiguous” on the question of whether banks could affiliate with companies that carried on a securities business but were *not* “engaged principally” in underwriting or trading bank-ineligible securities.²¹³ Given that ambiguity, the Second Circuit held that the Fed was “reasonable” in concluding that banks could affiliate with such companies under the common ownership of bank holding companies.²¹⁴ The court also determined that the term “engaged principally” was “intrinsically ambiguous,” and the Fed was “reasonable” in finding that Glass-Steagall allowed a Section 20 subsidiary to derive five percent or less of its gross revenues from activities involving bank-ineligible securities.²¹⁵

Under Alan Greenspan’s leadership, the Fed steadily expanded the scope of its Section 20 orders.²¹⁶ In 1989, the Fed allowed Section 20 subsidiaries to underwrite and deal in all types of debt and equity securities, and the Fed also raised the revenue limit on bank-ineligible securities activities to ten percent.²¹⁷ The D.C. Circuit upheld the Fed’s order, again noting the judicial “deference” that courts owed to the Fed’s determinations.²¹⁸ By 1996, Section 20 subsidiaries controlled one-fifth of the debt underwriting market and two percent of the equity underwriting market in the United States.²¹⁹

²¹⁰ *Sec. Ind. Ass’n*, 839 F.2d at 49.

²¹¹ *Id.* at 52.

²¹² *Id.* at 49.

²¹³ *Id.* at 52–54.

²¹⁴ *Id.* at 60.

²¹⁵ *Id.* at 63, 67.

²¹⁶ Simon Kwan, *Cracking the Glass-Steagall Barriers*, ECON. LETTERS (Mar. 21, 1997).

²¹⁷ *Id.*

²¹⁸ *Sec. Ind. Ass’n v. Bd. of Governors of the Fed. Reserve Sys.*, 900 F.2d 360, 365 (D.C. Cir. 1990).

²¹⁹ Wilmarth, *Transformation*, *supra* note 25, at 318–19.

In 1996, the Fed raised the revenue limit for bank-ineligible securities activities to twenty-five percent, and in 1997 the Fed removed numerous “firewalls” that had imposed tight restrictions on cross-marketing and other transactions between bank holding companies and their Section 20 subsidiaries.²²⁰ In response to the Fed's liberalized Section 20 rules, large domestic and foreign banks acquired dozens of small and midsized securities firms.²²¹ By 1998, forty-five bank holding companies, including the twenty-five largest U.S. banks, had established Section 20 subsidiaries.²²²

The OCC pursued its own campaign to allow national banks to securitize residential mortgages and other loans directly, instead of relying on bank holding company affiliates.²²³ The OCC's campaign was part of its vigorous competition with Alan Greenspan's Fed for the position of deregulator-in-chief of the banking industry.²²⁴ The OCC and the Fed each wanted to secure the allegiance of the largest banking organizations by demonstrating that it was a “friendly regulator” and an unequivocal champion of deregulation.²²⁵

In 1987, the OCC confirmed the authority of Security Pacific

²²⁰ *Id.* at 319; Federal Reserve Board, *supra* note 197.

²²¹ Wilmarth, *Transformation*, *supra* note 25, at 319.

²²² *Id.*

²²³ Fein, *supra* note 5, § 1.06[E], at 1-31 to 1-35.

²²⁴ *Id.* at 1-34.

²²⁵ *Id.* (stating that the Fed relaxed its § 20 rules in 1996 and 1997 in an “attempt to regain favor as a friendly regulator and to outdo the OCC,” which had been in “the vanguard” of deregulatory efforts during the 1980s and 1990s); *id.* §§1.06[F] & [G] (explaining how the Fed urged Congress during the 1990s to grant broader securities and insurance powers to subsidiaries of bank holding companies, and to confirm the Fed's status as the “umbrella regulator” of those holding companies, while the OCC argued that Congress should provide broader powers to direct subsidiaries of national banks, which the OCC regulated); *see also* Arthur E. Wilmarth, Jr., *The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 REV. BANKING & FIN. L. 881, 933 (2012) (stating that the Fed and the OCC “each sought to attract the patronage of major banks by approving new activities and reducing regulatory requirements” during the 1990s); Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Risk to the Dual Banking System and Consumer Protection*, 23 ANNUAL REV. OF BANKING & FIN. L. 225, 277 n.203 (2004) [hereinafter Wilmarth, *OCC's Preemption Rules*] (describing how the Fed and the OCC fought over the issue of whether holding company subsidiaries or direct subsidiaries of national banks should be the primary recipients of broader securities and insurance powers, and how the Fed largely won that jurisdictional turf battle when Congress enacted GLBA).

National Bank to securitize residential mortgages that the bank had originated, and to sell private-label RMBS resulting from those securitizations.²²⁶ The securities industry sued the OCC and prevailed before a federal district court, but the Second Circuit overruled the district court and upheld the OCC's opinion.²²⁷ The district court determined that the bank's issuance and sale of RMBS was not a "mere sale of assets" and instead constituted a prohibited "underwriting" of "securities" under Section 21.²²⁸ The district court pointed out that (i) each securitization trust was "a separate entity from the bank," (ii) the pooled mortgages held by each trust had "a separate identity" from the bank's assets, (iii) the bank had "the sole choice of which mortgages it wants to shift to the trust," and (iv) the bank could, therefore, choose to "relegate to the trust those mortgages which it saw as most likely to be problems."²²⁹ Also, the bank would have "an interest in the success of the sales" of the RMBS, thereby tempting the bank to become "an advocate with an interest in supporting the sale of a particular security."²³⁰ After considering Glass-Steagall's purposes, the district court concluded that the OCC's opinion "does not take sufficient account of the role the bank may play in marketing the [RMBS]" or "the benefits that the bank hopes to gain" from selling the RMBS.²³¹

The Second Circuit rejected the district court's reasoning and upheld the OCC's opinion.²³² Applying "principles of deferential review," the Second Circuit agreed with the OCC that Security Pacific's sale of RMBS fell within the "business of banking" under 12 U.S.C. § 24(Seventh), as either a direct or "incidental" component of the bank's authority to sell mortgages it had originated.²³³ The court also agreed with the OCC that any activity falling within the "business of banking" under Section 24(Seventh), as amended by Section 16 of Glass-Steagall, could not be construed as a violation of Section 21 of Glass-Steagall.²³⁴

The RMBS at issue in *Security Pacific* were mortgage pass-through certificates, which represented "fractional undivided interests

²²⁶ See *Sec. Ind. Ass'n v. Clarke*, 703 F. Supp. 256, 257 (S.D.N.Y. 1988), *vacated and remanded*, *Sec. Ind. Ass'n v. Clarke (Security Pacific)*, 885 F.2d 1034 (2d Cir. 1989).

²²⁷ See *Sec. Ind. Ass'n*, 703 F. Supp. at 261; *Security Pacific*, 885 F.2d at 1052.

²²⁸ *Sec. Ind. Ass'n*, 703 F. Supp. at 259–60.

²²⁹ *Id.* at 259, 261.

²³⁰ *Id.* at 260–61.

²³¹ *Id.*

²³² *Security Pacific*, 885 F.2d at 1052.

²³³ *Id.* at 1044–49.

²³⁴ *Id.* at 1049–50.

in the pool of mortgage loans."²³⁵ In view of the certificates' pass-through structure, the OCC argued that the certificates were "legally transparent," and investors in the certificates were "informed purchasers" with "full disclosure of all material facts," including information about the "underlying loans."²³⁶ The Second Circuit agreed with the OCC that "the nature of the transaction makes it unlikely that [Security Pacific] will make unsound loans so as to encourage purchase of the certificates."²³⁷

Both the OCC and the Second Circuit contended that investors would be adequately protected because "the federal securities laws require full disclosure of all material facts concerning the [RMBS] and the offering."²³⁸ The Second Circuit declared that any "protection" for investors in the RMBS "must come from the securities law and the remedies they provide, not from the Glass-Steagall Act."²³⁹

The OCC and the Second Circuit proved to be completely mistaken in their assumptions that (i) bank sponsors of RMBS would *not* have financial incentives to originate or purchase bad mortgages for securitization, (ii) the offering materials for RMBS would provide full disclosures of all material facts to investors, and (iii) investors could therefore protect themselves through due diligence.²⁴⁰ Those mistaken beliefs had massive costs and far-reaching consequences.²⁴¹ As the securitization trend gained momentum after 2000, banks and other lenders originated huge volumes of poorly-underwritten, high-risk subprime and "Alt-A" mortgages.²⁴² The enormous fees that lenders could earn by originating and selling nonprime mortgages for securitization created perverse incentives and caused lenders to disregard sound underwriting principles and due diligence standards.²⁴³

²³⁵ *Id.* at 1036.

²³⁶ *Id.* at 1045, 1046 (quoting the OCC's opinion).

²³⁷ *Id.* at 1051.

²³⁸ *Id.* at 1046 (quoting the OCC's opinion). The Second Circuit noted that any investors who were concerned that the RMBS "might be based on bad mortgage loans . . . can turn to the SEC [registration statement] filing to assess such risks." *Id.* at 1052.

²³⁹ *Id.* at 1052.

²⁴⁰ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 1015–35.

²⁴¹ *Id.*

²⁴² *Id.*

²⁴³ The FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 42–45, 104–18, 213–28; MCLEAN & NOCERA, *supra* note 128, at 126–28, 134–37, 216–29; ATIF MIAN & AMIR SUFI, HOUSE OF DEBT: HOW THEY (AND YOU) CAUSED THE GREAT RECESSION, AND HOW WE CAN PREVENT IT FROM HAPPENING AGAIN 75–116 (2014); TAUB, *supra* note 121, at 228–33; ENGEL & MCCOY, *supra* note 153, at 25–41; Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 1015–35.

Building on their previous success with CMOs, securities broker-dealers and banks developed “structured-finance” RMBS that were divided into multiple tranches.²⁴⁴ The complexity of those RMBS made it very difficult for investors to evaluate the risks embodied in the various tranches. Banks and broker-dealers also re-securitized “mezzanine” tranches of RMBS (tranches with intermediate credit ratings) to create CDOs, and then repeated that process by securitizing “mezzanine” tranches of CDOs to create CDOs-squared.²⁴⁵ The objective of each structured-finance vehicle was to generate the highest possible number of tranches with “AAA” credit ratings so that they could be marketed to insurance companies, pension funds, mutual funds, GSEs, and other institutional investors.²⁴⁶ The complexity and opacity of CDO structures made it virtually impossible for investors to assess the risks of the re-securitized tranches of RMBS or CDOs that were included in the relevant asset pools.²⁴⁷

The OCC used its victory in *Security Pacific* to justify subsequent rulings that allowed national banks to securitize a wide range of consumer and commercial loans and other receivables.²⁴⁸ The OCC also permitted national banks to securitize loans that they did not originate but instead purchased from other lenders.²⁴⁹ In 1996, the OCC amended its regulations governing bank-eligible securities and authorized national banks to invest in “Type IV” and “Type V” securities, which included “marketable” private-label RMBS, ABS, CDOs, and commercial mortgage-backed securities (CMBS).²⁵⁰ Thus, the OCC provided carte blanche for a wide range of securitization activities by national banks, just as the Fed had done for Section 20 subsidiaries of bank holding companies.

²⁴⁴ FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 43–45, 71–73.

²⁴⁵ *Id.* at 71–73, 129–34.

²⁴⁶ *Id.* at 43–44, 118–21, 148–50; *Dark Side of Universal Banking*, *supra* note 29 at 1028–30.

²⁴⁷ ENGEL & MCCOY, *supra* note 153, at 43–53, 58–61; MCLEAN & NOCERA, *supra* note 128, at 120–24, 295–99; TAUB, *supra* note 121, at 45–46, 73–75, 156–60, 228–35; The FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 43–45, 68–73, 115–22, 127–34, 146–50, 221–29.

²⁴⁸ FEIN, *supra* note 5, § 13.02[A].

²⁴⁹ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 987.

²⁵⁰ FEIN, *supra* note 5, at §§ 13.02[A], 7.02[G], 7.02[H], 9.04[D].

The Fed's and OCC's orders spurred a rapid growth in securitization activities by banking organizations during the 1990s.²⁵¹ The total amount of outstanding private-label RMBS and other ABS increased from less than \$100 billion in 1990 to \$900 billion in 1999, and large banks accounted for a significant share of that market.²⁵² Securitization offered multiple benefits to banks in the form of reduced capital requirements, new sources of funding through the capital markets, greatly expanded fee income, and the ability to move credit risk off their balance sheets.²⁵³

After Congress passed GLBA, which removed all remaining restrictions on affiliations between banks and securities firms, the largest banks and securities broker-dealers established vertically integrated structures that included every step in the securitization chain from loan origination to the creation and marketing of CDOs and CDOs-squared.²⁵⁴ As that process unfolded, the total outstanding volume of private-label RMBS, CMBS, ABS, and CDOs continued to grow from \$1.6 trillion in 2001 to \$3 trillion in 2004 and \$5 trillion in 2006.²⁵⁵ It is now widely agreed that securitization of high-risk loans played a central role in fueling the toxic credit bubble that led to the financial crisis of 2007-09.²⁵⁶

3. *The Explosion of OTC Derivatives*

Over-the-counter (OTC) derivatives were the third major vehicle that large financial institutions and federal regulators used to break down the structural barriers between the banking industry and the securities and insurance sectors.²⁵⁷ Derivatives are financial contracts whose value is determined by reference to some underlying asset, obligation, index, or rate (the underlying), such as an equity stock, debt instrument, stock index, commodity, interest rate, or currency exchange rate.²⁵⁸ Derivatives are typically used either to hedge

²⁵¹ FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 35, 44–45.

²⁵² *Id.* at 44–45, fig.3.1; Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 984–91; Wilmarth, *Transformation*, *supra* note 25, at 388–90, 403.

²⁵³ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 984–85.

²⁵⁴ *Id.* at 973, 988–91, 1017–20, 1027–30.

²⁵⁵ STIJN CLAESSENS ET AL, SHADOW BANKING: ECONOMICS AND POLICY, 9, Fig.2 (2012) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2187661.

²⁵⁶ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 1002–50; *see also supra* notes 243, 247 and works cited therein.

²⁵⁷ Wilmarth, *Dark Side of Universal Banking*, at 980–981, 991–94, 1027–35, 1046–48.

²⁵⁸ The most widely-used types of derivatives are (i) a forward, in which the buyer is obligated to purchase, and the seller is required to deliver, some type of commodity or other physical asset at a future date, (ii) a swap, in which the parties

against various types of risks or to speculate about future changes in the value of the underlying.²⁵⁹ Exchange-traded derivatives are standardized contracts that are publicly traded on futures and options exchanges, while OTC derivatives are customized contracts that are privately negotiated between “dealers” (large financial institutions that specialize in creating and marketing OTC derivatives) and “end-users,” such as commercial and industrial firms or institutional investors.²⁶⁰

Exchange-traded futures and options based on changes in interest rates, currency exchange rates, and commodity prices became popular vehicles for risk management and speculation in the 1970s.²⁶¹ The volatility of interest rates, currency rates, and commodity prices increased significantly during that period in response to rising inflation and the breakdown of the Bretton Woods system of pegged exchange rates.²⁶² In 1974, Congress created the Commodity Futures Trading Commission (CFTC) to oversee markets for exchange-traded derivatives established pursuant to the Commodity Exchange Act (CEA).²⁶³ The CEA, as amended in 1974, prohibited off-exchange contracts for future delivery of commodities unless the contracts were settled by actual physical delivery.²⁶⁴ However, the 1974 legislation included the “Treasury Amendment,” which exempted a number of financial contracts that were not traded on futures or options

agree to exchange streams of payments based on the future values of an underlying asset, obligation, index, or rate, and (iii) an option, in which the option seller gives the option buyer the right, but not the obligation, to buy or sell the underlying at an agreed price on or before a specified future date. RONALD H. FILLER & JERRY W. MARKHAM, REGULATION OF DERIVATIVE FINANCIAL INSTRUMENTS (SWAPS, OPTIONS, AND FUTURES): CASES AND MATERIALS 1–9 (2014); Wilmarth, *Transformation*, *supra* note 25, at 333 n.485; *Over-the-Counter Derivatives Markets and the Commodity Exchange Act: Report of the President’s Working Group on Financial Markets*, PRESIDENT’S WORKING GRP. FIN. MKT. 1, 4–5 (1999), <https://www.treasury.gov/resource-center/fin-mkts/Documents/otcact.pdf> [hereinafter PWGFM, *Over-the-Counter Derivatives*].

²⁵⁹ FILLER & MARKHAM, *supra* note 258, at 24–27; Lynn A. Stout, *supra* note 16, at 7–8; GILLIAN TETT, FOOL’S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 12 (2009).

²⁶⁰ TETT, *supra* note 259 at 24–25; Wilmarth, *Transformation*, *supra* note 25, at 333 n.486.

²⁶¹ Wilmarth, *Transformation*, *supra* note 25, at 332.

²⁶² BERNSTEIN, *supra* note 92, at 246, 251, 304–05, 320–22; FILLER & MARKHAM, *supra* note 258, at 40–41; MADRICK, *supra* note 12, at 96–97; TETT, *supra* note 259, at 10–11.

²⁶³ Stout, *supra* note 16, at 18 n.61.

²⁶⁴ Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 722–24 (1999).

exchanges.²⁶⁵ When OTC derivatives emerged in the early 1980s, their status was highly uncertain under the 1974 legislation.²⁶⁶

Markets for OTC currency swaps and OTC interest rate swaps grew rapidly during the 1980s, and the largest U.S. banks and securities firms captured the lion's share of both markets.²⁶⁷ The CFTC suggested in 1987 that it might attempt to regulate OTC swaps, but the major swaps dealers threatened to move their business overseas if the CFTC did so.²⁶⁸ The CFTC "backed down" and issued a policy statement in 1989.²⁶⁹ The CFTC's 1989 policy statement declared that the agency would refrain from regulating "qualifying" OTC swaps that fell within a defined "safe harbor."²⁷⁰ To qualify for that "safe harbor," OTC swaps were required to have "individually tailored terms," could not be traded on or connected to "a clearing organization or a margin system," and could not be "marketed to the general public."²⁷¹

In 1992, Congress passed further amendments to the CEA, which expressly authorized the CFTC to exempt certain types of OTC swaps from regulation under the CEA.²⁷² The CFTC responded by issuing a regulation in 1993 that replaced its 1989 policy statement.²⁷³ The 1993 rule exempted OTC swaps from regulation under the CEA if the swaps were not "standardized as to their material economic terms" and if the parties to those swaps were "eligible swap participants," including regulated financial institutions, qualified business firms, state and local governments, institutional investors, and wealthy individuals.²⁷⁴ However, derivatives dealers and end-users continued

²⁶⁵ *Id.* at 767 n.251.

²⁶⁶ PWGFM, *Over-the-Counter Derivatives*, *supra* note 258 at 7–8, 24–26 (discussing the 1974 legislation, including the "Treasury Amendment"). In 1981, Salomon Brothers pioneered the first OTC currency swap, a \$210 million contract between IBM and the World Bank. Funk & Hirschman, *supra* note 16, at 690–91; TETT, *supra* note 259 at 11–12. In 1997, the Supreme Court held that the Treasury Amendment barred the CFTC from regulating OTC options to buy or sell foreign currency. *Dunn v. Commodity Futures Trading Comm'n*, 519 U.S. 465 (1997).

²⁶⁷ Funk & Hirschman, *supra* note 16, at 690–94 (explaining that "the swaps market in the 1980s–1990s [was] dominated by a small number of increasingly large commercial banks in competition with a small number of prominent investment banks").

²⁶⁸ *Id.* at 688. Stout, *supra* note 16, at 19.

²⁶⁹ Funk & Hirschman, *supra* note 16, at 696.

²⁷⁰ *Id.*

²⁷¹ Over-the-Counter Derivatives: Concept Release, 63 Fed. Reg. 26,114, 26,116 (May 12, 1998) [hereinafter 1998 CFTC Concept Release].

²⁷² *Id.* at 26,116–17.

²⁷³ *Id.* at 26,117.

²⁷⁴ *Id.* In addition, the exempted OTC swaps could not be "entered into or traded on or through a multilateral transaction execution facility." *Id.*

to have significant concerns about the precise scope and legally binding effect of the 1993 rule's exemptions for OTC swaps.²⁷⁵

Despite lingering uncertainties about the legal status of OTC swaps, the OCC moved aggressively to expand the authority of national banks to engage in derivatives transactions during the 1980s and 1990s.²⁷⁶ Saule Omarova has provided a comprehensive and insightful analysis of the OCC's campaign to expand the derivatives powers of national banks,²⁷⁷ and only a summary overview of that campaign will be presented here.

In 1987 and 1988, the OCC allowed national banks to enter into OTC swaps and exchange-traded derivatives based on interest rates, currency rates, and commodity price indexes for precious metals.²⁷⁸ Using a "look-through" approach, the OCC argued that those types of derivatives were comparable to discounting promissory notes and trading in foreign currencies and precious metals, which were activities expressly authorized for national banks under the definition of the "business of banking" in 12 U.S.C. 24 (Seventh).²⁷⁹

The OCC used a more aggressive "functional equivalency" analysis to permit national banks to engage in a much broader range of commodity-related derivatives between 1987 and 1992.²⁸⁰ The OCC used its "functional equivalency" approach to approve new derivatives activities by extrapolating from the OCC's previously authorized and purportedly comparable activities.²⁸¹ For example, the OCC asserted that commodity swaps were "functionally equivalent" to interest rate and currency swaps, which the OCC had previously authorized for

²⁷⁵ *H.R. 10 and the need for financial reform: Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services, U.S. House of Representatives* (1999) (Testimony of chairman Alan Greenspan); PWGFM, *Over-the-Counter Derivatives*, *supra* note 258, at 9–12; *see also infra* notes 646–56, 710–11 (describing concerns among derivatives dealers and end-users between 1994 and 1999 that the federal government might take action to regulate OTC derivatives).

²⁷⁶ Funk & Hirschman, *supra* note 16, at 697.

²⁷⁷ *See* Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the 'Business of Banking'*, 63 U. MIAMI L. REV 1041 (2009).

²⁷⁸ *Id.* at 1056.

²⁷⁹ *Id.* at 1058–10. *See generally* OCC's *Quarterly Report on Bank Trading and Derivatives Activities, Fourth Quarter 2007*, OFF. OF THE COMPTROLLER OF THE CURRENCY, <https://www.occ.treas.gov/topics/capital-markets/financial-markets/derivatives/dq407.pdf> (discussing derivatives activities).

²⁸⁰ Omarova, *supra* note 277, at 1060.

²⁸¹ *Id.* at 1060–61.

national banks.²⁸² To support its claim, the OCC argued that, for each type of swap, the dealer bank acted as a “financial intermediary on behalf of its customers, making and receiving payments,” and the bank also entered into hedging transactions so that “the only risk retained by the bank would be credit risk, the same risk that the bank assumed when it made a loan.”²⁸³ By focusing solely on credit risk, the OCC’s analysis “failed to take into account the full complexity of risks associated with commodity [swaps].”²⁸⁴

In the mid-1990s, the OCC used the “financial intermediary” concept to develop a “financial intermediation” theory of banking powers, which justified an almost limitless scope for the “business of banking” under the National Bank Act.²⁸⁵ The OCC’s “financial intermediation” theory asserted that the “business of banking” should “encompass virtually any modern form of financial intermediation, broadly understood as a financial activity for customers’ account[s] involving exchanges of payments and assumption or transfer of financial risk.”²⁸⁶ Under the OCC’s “financial intermediation” analysis, “the statutory concept of the ‘business of banking’ . . . effectively ceased to function as a potentially limiting device with respect to commercial banks’ activities and risk profile.”²⁸⁷

The OCC used its hyper-elastic concept of the “business of banking” to authorize an ever-expanding array of derivatives activities for national banks.²⁸⁸ For example, in 1993 and 1995, the OCC allowed national banks to hedge their exposures to commodity swaps by making or taking physical delivery of the underlying commodities, transferring documents of title, and engaging in other related activities, including “storing, transporting, obtaining, or disposing of such commodities.”²⁸⁹ The OCC argued that bank ownership and delivery of physical commodities for hedging purposes was a “logical outgrowth” of the authority of national banks to act as dealers for commodity swaps, even though the OCC acknowledged that banks were not allowed to purchase or own physical commodities for investment purposes.²⁹⁰

²⁸² *Id.* at 1060–63, 1065.

²⁸³ *Id.* at 1066 (quoting in part the OCC’s No-Objection Letter No. 90-1, Feb. 16, 1990).

²⁸⁴ *Id.* at 1073.

²⁸⁵ *Id.* at 1076.

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ *Id.*

²⁸⁹ *Id.* at 1078–79.

²⁹⁰ *Id.* at 1078 (quoting OCC Interpretive Letter No. 684, dated Aug. 4, 1995). From 2003 to 2006, the OCC relied on its earlier opinions allowing banks to own

A notable example of the OCC's step-by-step expansion of the derivatives powers of national banks occurred when the OCC proceeded from (i) allowing banks to offer equity-linked deposits, with payoffs based on stock indexes, to (ii) permitting banks to enter into equity swaps as hedges against their risk exposures to equity-linked deposits, and ultimately (iii) authorizing banks to buy equity stocks as hedges against their risk exposures to equity swaps.²⁹¹ In 1988, the OCC allowed Chase Manhattan National Bank (Chase) to offer certificates of deposit whose payment of "interest" was based on the performance of the Standard & Poor's (S&P) 500 index (equity-linked CDs).²⁹² The OCC declared that equity-linked CDs fell within the express authority of national banks to accept deposits, and it dismissed the relevance of Chase's use of a stock index to determine the amount of "interest" payable on those deposits.²⁹³ Similarly, the OCC assigned no legal significance to the fact that Chase invested the proceeds of equity-linked CDs in exchange-traded S&P 500 index futures and therefore assumed a significant stock market risk.²⁹⁴ Chase was required to pay depositors for any increase in the value of S&P 500 futures, and to absorb any losses if the value of S&P 500 futures declined, as Chase remained obligated to repay the depositors' originally invested principal when their CDs matured.²⁹⁵ The OCC fully recognized the stock market risk created by equity-linked CDs, and the OCC, therefore, allowed Chase to purchase long and short positions in S&P 500 futures to hedge against that risk.²⁹⁶

The mutual fund industry challenged the OCC's order, alleging that Chase's offering of equity-linked CDs and Chase's purchase of S&P 500 futures for hedging purposes violated the Glass-Steagall Act.²⁹⁷ However, a federal district court dismissed the lawsuit.²⁹⁸ The

physical commodities solely for hedging purposes to justify even more expansive orders. *Id.* at 1085–86. Those orders permitted national banks to engage in a broad range of activities involving physical commodities (including electricity, oil, natural gas, coal, and metals). *Id.* at 1085, 1093. The Fed followed suit by allowing several of the largest financial holding companies to engage in a wide variety of "complementary" activities involving physical commodities. *See id.* at 1085–87, 1090–96.

²⁹¹ *See id.* at 1077–87.

²⁹² *Id.* at 1063–64.

²⁹³ *Id.* The OCC also allowed national banks to offer CDs with interest rates based on the performance of commodity indexes, and to hedge their exposures by purchasing exchange-traded commodity index futures. *Id.* at 1063, 1066.

²⁹⁴ *Id.* at 1064.

²⁹⁵ *Id.*

²⁹⁶ *Id.* at 1063–65; *see also* Investment Co. Institute v. Ludwig (*ICI v. Ludwig*), 884 F. Supp. 4 (D.D.C. 1995).

²⁹⁷ *See ICI v. Ludwig*, 884 F. Supp. at 4–5.

district court agreed with the OCC that “the plain language of the [Glass-Steagall] Act simply does not encompass stock index futures” as either “stock” or “securities” that banks were barred from underwriting or trading.²⁹⁹ The district court was also strongly influenced by a 1995 Supreme Court decision, which accorded great deference to the OCC’s interpretation of the scope of the “business of banking” in another context.³⁰⁰

In *ICI v. Ludwig*, the OCC and the district court applied a literalistic and narrow reading of the meaning of “stock” and “securities” under the Glass-Steagall Act.³⁰¹ The OCC and the district court rejected the mutual fund industry’s attempt to use a functional and risk-based analysis to demonstrate that Chase was effectively engaging in “stock-trading” by offering equity-linked CDs and by investing in S&P 500 futures to hedge against the bank’s exposures to those CDs.³⁰² A functional and risk-based approach – similar to the analysis that the Supreme Court applied to Citibank’s “Commingled Investment Account” in *Camp* and Bankers Trust’s sale of commercial paper in *Bankers Trust I* – would almost certainly have resulted in a finding that Chase’s offering of equity-linked CDs and Chase’s investments in S&P 500 futures constituted a prohibited

²⁹⁸ *Id.* at 5.

²⁹⁹ *See id.* at 5.

³⁰⁰ *Id.* In *Nationsbank v. Variable Annuity Life Ins. Co. (VALIC)*, 513 U.S. 251 (1995), the Supreme Court upheld an OCC opinion that allowed national banks to sell annuities. The OCC’s opinion in *VALIC* stated that the sale of annuities was an activity within the banks’ “traditional role as financial intermediaries” and therefore qualified as an “incidental powe[r] . . . necessary to carry on the business of banking.” *Id.* at 257 (quoting the OCC’s opinion). The Supreme Court held that, under *Chevron*, the OCC’s opinion was entitled to “controlling weight” as a “permissible construction” of the National Bank Act. *Id.* at 257. The Court agreed with the OCC’s position that “the ‘business of banking’ is not limited to the enumerated powers in § 24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated.” *Id.* at 258, n.2. The Court stated that “the Comptroller’s discretion must be kept within reasonable bounds,” but the Court did not adopt any legal test to define the outer limits of those “reasonable bounds.” *Id.* Thus, *VALIC* “failed to articulate a clear principled standard of what constituted the ‘business of banking,’” and the OCC “interpreted *VALIC* as a full endorsement of the agency’s long-held broad view of the bank powers clause.” Omarova, *supra* note 277, at 1053.

³⁰¹ *See ICI v. Ludwig*, 884 F. Supp. at 5 (noting that “[t]he OCC relies on a strict reading” of “the plain language of the [Glass-Steagall] Act,” and accepting that approach).

³⁰² *Id.* (noting, without disagreement, the plaintiff’s claim that Glass-Steagall prohibited “stock-trading by banks for their own accounts,” but agreeing with the OCC that the court should reject the plaintiff’s “attempts to equate ownership of stock index futures to stock speculation through its analysis of the comparative risks of each investment”).

“underwriting” of “securities” and a forbidden “dealing” in “stock” under Glass-Steagall.³⁰³

The OCC’s opinion and the district court’s decision in *ICI v. Ludwig* were typical of the asymmetric analysis that federal banking agencies and most courts applied during the agency-driven deregulation of financial markets in the 1980s and 1990s.³⁰⁴ Federal agencies repeatedly used “functional equivalency” as a one-way ratchet to expand – but never to limit – the permitted activities of banking organizations.³⁰⁵ Most court decisions either endorsed the regulators’ approach or deferred to the regulators’ ultimate decisions under *Chevron*.³⁰⁶ As indicated in *ICI v. Ludwig*, the financial industry and federal regulators took full advantage of the fact that “there was no explicit provision in Glass-Steagall against trading in derivatives products.”³⁰⁷

In a 1994 opinion, the OCC declared that national banks could enter into equity swaps and equity index swaps to hedge their exposures to stock index futures resulting from equity-linked CDs.³⁰⁸ The OCC asserted that “swap contracts, are in some respects, direct descendants of traditional deposit contracts” because a bank and its customers exchanged streams of payments under swap contracts as they did under deposits.³⁰⁹ The OCC also argued that “equity swaps and equity index swaps are permissible for national banks as a financial intermediation activity,” and those swaps would also benefit banks by “expanding their customer base, and increas[ing] their revenues.”³¹⁰ Thus, the OCC’s authorization of equity swaps and equity index swaps relied on “functional equivalency” and “financial intermediation” theories and completely disregarded the additional

³⁰³ See *supra* notes 167–81 and accompanying text (discussing *ICI v. Camp* and *Bankers Trust I*).

³⁰⁴ See *supra* notes 116–19, 226–34, 280–84, 292–303, *infra* notes 308–11 and accompanying text (providing examples of rulings by federal agencies and courts during the 1980s and 1990s that used “functional equivalency” concepts to expand, but not to restrict, the powers of banks and bank holding companies); see also FEIN, *supra* note 5, §§ 1.05, 4.05[A] (explaining that judicial deference was an important factor in many court decisions upholding agency rulings that opened loopholes in Glass-Steagall’s and BHCA’s structural barriers).

³⁰⁵ See *id.*

³⁰⁶ See *id.*

³⁰⁷ TETT, *supra* note 259, at 17–18.

³⁰⁸ Office of the Comptroller of the Currency, Interpretive Letter No. 892 (Letter from Comptroller of the Currency John D. Hawke, Jr. to Rep. James A. Leach, Sept. 13, 2000), <http://www.occ.gov/static/interpretations-and-precedents/sep00/int892.pdf>.

³⁰⁹ *Id.*

³¹⁰ See *id.* (discussing OCC Interpretive Letter No. 652 (Sept. 13, 1994)).

stock market risks that banks would incur under equity swaps.³¹¹ The 1994 equity swap opinion also reflected the OCC's eagerness to give national banks every conceivable opportunity to expand their revenues.³¹²

In 2000, the OCC issued Interpretive Letter 892 (hereinafter IL 892), which authorized national banks to purchase equity stocks as physical hedges against their exposures to equity swaps and equity index swaps.³¹³ The OCC issued IL 892 after it secretly allowed three large national banks to buy equity stocks for hedging purposes.³¹⁴ Congressman Jim Leach, a co-sponsor of GLBA, became aware of the OCC's actions and strongly criticized the OCC.³¹⁵ The OCC issued IL 892 to justify what it had done.³¹⁶

IL 892 declared that the OCC's earlier opinions regarding equity-linked CDs, stock index futures, and equity swaps supported the OCC's view that national banks could invest in equity stocks for hedging purposes as part of the "business of banking."³¹⁷ IL 892 provides a striking illustration of how the OCC relied on its previous rulings expanding the scope of permissible banking activities to provide a "bootstrap" for authorizing new and even broader activities.³¹⁸ The OCC also invoked its "financial intermediation" theory and its "[h]edging risks" rationale to justify its decision allowing national banks to buy equity stocks as physical hedges against their exposures under equity derivatives.³¹⁹

IL 892 pointed out that national banks would "retain additional revenues . . . and enjoy substantial cost savings" by making direct purchases of equity stocks instead of entering into "mirror" hedging transactions with their broker-dealer affiliates.³²⁰ Through direct

³¹¹ *Id.*

³¹² *Id.*; see also Omarova, *supra* note 277, at 1069–72.

³¹³ Office of the Comptroller of the Currency, *supra* note 308, at 1–2.

³¹⁴ Michael Schroeder, *Leach Criticizes Bank Regulator on Stock Rule*, WALL ST. J., Sept. 11, 2000, at A38.

³¹⁵ *Id.*

³¹⁶ Office of the Comptroller of the Currency, *supra* note 308, at 1–2; Omarova, *supra* note 277, at 1079–80. Rep. Leach was particularly concerned that purchases of corporate stock by national banks could potentially result in "breaching the wall between banking and commerce." Office of the Comptroller of the Currency, *supra* note 308, at 1.

³¹⁷ *Id.* at 1–2.

³¹⁸ *Id.* at 5–7; Omarova, *supra* note 277, at 1060, 1072, 1079–80.

³¹⁹ Office of the Comptroller of the Currency, *supra* note 308, at 7–9; Omarova, *supra* note 277, at 1080.

³²⁰ Office of the Comptroller of the Currency, *supra* note, at 9–10. Before 2000, a national bank would typically hedge its exposure to a "long" equity swap by "entering into a mirror transaction" – usually a "short" equity swap – with a

purchases of equity stocks, national banks could eliminate the extra transaction costs associated with “mirror transactions” conducted by their broker-dealer affiliates.³²¹ Moreover, national banks would earn additional profits through “a reduction in net interest expense” because mirror transactions by nonbank affiliates were “funded at the borrowing rate of their holding companies, rather than the more favorable rate enjoyed by the banks.”³²²

IL 892 argued that national banks should be allowed to make the highest possible profits by conducting all of their derivative activities in-house instead of through broker-dealer affiliates.³²³ The OCC emphasized the significant cost-of-funding advantage that national banks enjoyed, compared with their parent holding companies and broker-dealer affiliates.³²⁴ National banks enjoyed that advantage because (i) they could obtain low-cost funding through their FDIC-insured deposits, (ii) they could secure emergency loans through the Fed’s discount window, and (iii) they could enter into interbank payments on Fedwire that were guaranteed by the Fed.³²⁵

Thus, IL 892 enabled national banks to reap additional profits from their cost-of-funding advantage, but the OCC conveniently ignored the fact that conducting derivatives-related activities inside national banks (instead of their broker-dealer affiliates) created a significantly higher risk of inflicting losses on the federal government and taxpayers.³²⁶ IL 892 reflected the OCC’s general policy of “achieving a positive outcome for the banks seeking an expansion of their derivatives powers,” as well as the OCC’s failure to consider “potential systemic risks” posed by the “complex derivatives businesses” of national

“nonbank affiliate.” *See id.* at 2. The nonbank affiliate would then hedge its exposure to the bank under the “short” equity swap by creating a “long” position through the purchase of equity stock. *Id.* at 2–3.

³²¹ *Id.* at 3.

³²² *Id.*

³²³ *Id.* at 3, 16.

³²⁴ *Id.* at 3.

³²⁵ Wilmarth, *Dodd-Frank's Inadequate Response*, *supra* note 68, at 1044; *see also* CARPENTER & MURPHY, *supra* note 5, at 3.

³²⁶ Wilmarth, *Dodd-Frank's Inadequate Response*, *supra* note 68, at 1045. The significant cost-of-funding advantage that banks enjoyed, compared to their holding company affiliates, was demonstrated in 2011, when the Fed allowed Bank of America (BoFA) to transfer a large volume of derivatives contracts from its Merrill Lynch broker-dealer subsidiary (Merrill) to its subsidiary national bank. Wilmarth, *Two-Tiered System*, *supra* note 194, at 349. “The derivatives transfer reportedly allowed BoFA -- which was then struggling with a host of problems -- to avoid contractual requirements to post \$3.3 billion of additional collateral with its derivatives counterparties . . . due to the fact that BoFA’s subsidiary bank was explicitly protected by the federal safety net and therefore held a significantly higher credit rating than Merrill.” *Id.*

banks.³²⁷

By permitting national banks to purchase equity stocks, IL 892 contravened the explicit terms of the fifth sentence of 12 U.S.C. § 24 (Seventh), as amended by Section 16 of the Glass-Steagall Act.³²⁸ The fifth sentence states: “Except as hereinafter provided or otherwise permitted by law, *nothing herein contained shall authorize the purchase by [a national bank] for its own account of any shares of stock of any corporation.*”³²⁹ IL 892 asserted that “the fifth sentence . . . is not a complete bar on bank purchases of stock.”³³⁰ According to the OCC, the fifth sentence is merely intended “to make clear” that the authorization for national banks to purchase “investment securities” under the second sentence of Section 24 (Seventh) does not provide an independent “source of authority for national banks to purchase *stock.*”³³¹

The OCC’s interpretation of the fifth sentence is completely undermined by the fourth sentence of Section 24 (Seventh), which was also amended by Section 16 of Glass-Steagall.³³² The fourth sentence defines “investment securities” as “marketable obligations *evidencing indebtedness* of any person . . . in the form of *bonds, notes, and/or debentures* commonly known as investment securities under such further definition . . . as may by regulation be prescribed by the [OCC].”³³³ Thus, the fourth sentence of Section 24 (Seventh) specifically defines “investment securities” to include *only* debt securities and to *exclude* stock. Congress, therefore, had no reason to add the fifth sentence *unless* Congress intended to prohibit national banks from buying *all* equity stocks in the absence of specific statutory permission. In fact, Congress has passed several laws granting specific authority for national banks to buy stock in designated classes of corporations.³³⁴

Congress’s repeated grants of specific, narrowly-defined authorities for stock investments by national banks plainly indicate –

³²⁷ Omarova, *supra* note 277, at 1105, 1106.

³²⁸ Banking Act of 1933, Pub. L. No. 73-66, §16, 48 Stat. 162, 185 (1933).

³²⁹ 12 U.S.C. § 24 (Seventh) (2008) (emphasis added).

³³⁰ Office of the Comptroller of the Currency, *supra* note 308, at 12.

³³¹ *Id.*

³³² 48 Stat. 162, 185.

³³³ 12 U.S.C. § 24 (Seventh) (emphasis added).

³³⁴ For example, Congress has passed statutes that expressly authorize national banks to invest in the stock of operating subsidiaries, financial subsidiaries, bank service corporations, bank premises corporations, small business investment companies, community development corporations, safe deposit companies, and agricultural credit corporations. FEIN, *supra* note 5, at § 7.05[B][1], [2], [3] & [5], [G][3], [N], [S], [T].

as confirmed by the terms of the fifth sentence – that national banks may *not* purchase *any other types of corporate stock* without express statutory permission.³³⁵ Thus, IL 892's interpretation of the fifth sentence flies in the face of the relevant statutory context and also runs afoul of the well-established canon against construing a statute in a way that would make it "meaningless" or mere "surplusage."³³⁶ IL 892 was not challenged in any lawsuit, and the courts have never considered the validity of the OCC's interpretation of the fifth sentence of Section 24(Seventh).³³⁷

The OCC's derivatives rulings reveal the intellectual gymnastics that the agency was willing to perform to enable national banks to offer the broadest possible range of OTC derivatives and other financial services to their customers.³³⁸ By acting as derivatives dealers, national banks could provide synthetic substitutes for a wide range of securities and futures contracts, including equity stocks, debt instruments, and exchange-traded options.³³⁹ OTC derivatives largely escaped regulation during the 1980s and 1990s because they occupied an "ambiguous position spanning the categories of futures, securities, and loans."³⁴⁰ Consequently, "regulators who were favorable to deregulation could happily exempt such contracts from existing rules."³⁴¹ OTC derivatives helped the largest banks and federal

³³⁵ Applying the canon of construction known as *expressio unius est exclusio alterius* (the special mention of one thing in a statute indicates an intent to exclude other similar things), courts have held that a federal agency cannot expand the boundaries established by specific and defined grants of authority in its governing statute. See *Independent Ins. Agents of America, Inc. v. Hawke (IIAA v. Hawke)*, 211 F.3d 638, 643, 644–45 (D.C. Cir. 2000), and cases cited therein.

³³⁶ See *id.* at 643–44, and cases cited therein. As shown above, the fifth sentence of Section 24(Seventh) would add nothing to what the fourth sentence already provides if the OCC's interpretation were accepted.

³³⁷ At the request of Congressman Leach, the U.S. General Accounting Office (GAO) reviewed IL 892 and accepted the OCC's opinion as a "reasonable interpretation of the bank powers clause." Omarova, *supra* note 277, at 1081. However, the GAO "did not scrutinize the fundamental assumptions built into the OCC's interpretation." *Id.* Except for *ICI v. Ludwig*, "the legal validity of the OCC's decisions expanding bank derivatives powers has not been challenged in court." *Id.* at 1064 n.98, 1105.

³³⁸ Omarova, *supra* note 277, at 1097–1104.

³³⁹ Funk & Hirschman, *supra* note 16; Wilmarth, *Transformation*, *supra* note 25, at 337–38; see also *Caiola v. Citibank, N.A.*, 295 F.3d 312, 315–18 (2d Cir. 2002) (describing Citibank's sale of equity swaps and cash-settled OTC options to plaintiff Caiola, which established "synthetic positions, . . . the values of which are pegged to the market prices of the related physical shares or options," and stating that the equity swaps and OTC options sold to Caiola created a "synthetic portfolio").

³⁴⁰ Funk & Hirschman, *supra* note 16, at 690.

³⁴¹ *Id.*

banking agencies to undermine Glass-Steagall by blurring “the boundary between . . . commercial and investment banking.”³⁴²

In the mid-1990s, J.P. Morgan & Co. (JPMC) introduced a new type of derivative, the credit default swap (CDS), which helped to break down BHCA's boundary wall separating banks from the insurance business.³⁴³ In 1995, JPMC persuaded the OCC and the Fed to allow banks to enter into CDS as dealers and end-users.³⁴⁴ JPMC also convinced the regulators that banks could reduce their capital requirements by purchasing CDS protection against the risk of defaults on their loans.³⁴⁵

In a CDS transaction, the “protection buyer” purchases protection against specified events of default on a designated bond or other debt instrument, while the “protection seller” provides that protection in return for the buyer's payment of periodic premiums.³⁴⁶ As Alan Blinder observed, “A CDS is an insurance contract posing as a derivative. . . . If the bond never defaults, which is the usual case, the seller wins and the buyer loses. But in the event of default, the seller loses big time. It's classic insurance.”³⁴⁷

JPMC did not stop with CDS contracts. In the late 1990s, JPMC's derivatives team created a more complex structure known as “BISTRO,” which was the first synthetic collateralized debt obligation (synthetic CDO).³⁴⁸ BISTRO brought together the worlds of derivatives and securitization.³⁴⁹

To create BISTRO, JPMC assembled a pool of \$9.7 billion of CDS, which provided protection against defaults on loans made by JPMC to more than 300 companies.³⁵⁰ JPMC bundled those CDS into

³⁴² *Id.* at 674; *see also id.* at 692 (“By disrupting the effectiveness of Glass-Steagall, swaps . . . contributed to its eventual formal repeal.”).

³⁴³ TETT, *supra* note 259, at 47–54.

³⁴⁴ *Id.*

³⁴⁵ *Id.* at 44–49 (noting that Bankers Trust experimented with the CDS concept in 1991, but it was JPMC that used CDS to “create a mass-market credit derivatives business”); *see also* MCLEAN & NOCERA, *supra* note 128 at 60–62.

³⁴⁶ TAUB, *supra* note 121, at 192–93; Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 993.

³⁴⁷ BLINDER, *supra* note 2, at 66; *see also* Mahoney, *supra* note 7, at 34 (“A typical CDS operates like an insurance contract.”); MCLEAN & NOCERA, *supra* note 128, at 60 (“A credit default swap is essentially an insurance policy against the possibility of default.”).

³⁴⁸ TETT, *supra* note 259, at 51.

³⁴⁹ *Id.* at 51–52.

³⁵⁰ *Id.* at 54–55.

a securitized pool managed by a synthetic CDO.³⁵¹ The CDO issued \$700 million of tranching CDO securities to investors, while JPMC retained \$9 billion of "super-senior" risk if the total volume of defaults on the pooled CDS exceeded \$700 million.³⁵² JPMC got rid of that "super-senior" risk by entering into credit derivatives with AIG Financial Products, a London subsidiary of the insurance giant AIG.³⁵³

BISTRO was a prime example of how banks used securitization and derivatives to accomplish large-scale tax avoidance and regulatory capital arbitrage. As was typical in securitization deals, JPMC established a "special purpose vehicle" (SPV) in an offshore tax haven to hold BISTRO's securitized CDS.³⁵⁴ Locating the SPV in a tax haven immunized the SPV's cash flows from taxation.³⁵⁵ In addition, the Fed and the OCC agreed to reduce JPMC's regulatory capital requirements by eighty percent for the corporate loans protected by BISTRO's pooled CDS, because JPMC obtained credit protection for its exposures on those CDS from AIG, a AAA-rated company.³⁵⁶ Thus, as Gillian Tett explained, "BISTRO pulled off a dance around the Basel [international bank capital] rules. The feat was so clever that some bankers started to joke that 'BISTRO' really stood for 'BIS Total Rip Off,' referring to the Bank of International Settlements (BIS), which had overseen the Basel Accord."³⁵⁷

BISTRO confirmed the ability of the largest financial institutions to avoid taxes and reduce their regulatory capital requirements by using securitization and derivatives.³⁵⁸ BISTRO also provided a template for Wall Street's subsequent creation of CDS and synthetic CDOs based on subprime mortgages and RMBS, instead of corporate loans.³⁵⁹ The BISTRO concept had disastrous effects when it was applied to the subprime mortgage market.³⁶⁰ CDS and synthetic CDOs enabled a wide range of financial institutions and other institutional investors to place multiple, overlapping bets on the performance of designated tranches of subprime RMBS. Those pyramids of bets collapsed, and greatly intensified the resulting losses

³⁵¹ *Id.* at 60–64.

³⁵² *Id.*

³⁵³ For detailed discussions of the BISTRO transaction, *see id.* at 51–56, 60–64, and MCLEAN & NOCERA, *supra* note 128, at 78–81.

³⁵⁴ TETT, *supra* note 259, at 54.

³⁵⁵ *Id.*

³⁵⁶ *Id.* at 63–64.

³⁵⁷ *Id.* at 64.

³⁵⁸ *Id.* at 57–61.

³⁵⁹ *Id.*

³⁶⁰ *Id.* at 60–63.

when borrowers defaulted on the underlying subprime mortgages.³⁶¹

The bank-friendly actions of the OCC and the Fed helped to promote a tremendous boom in OTC derivatives markets after 1985, just as they had done for securitization.³⁶² The aggregate notional value of OTC derivatives in global markets increased rapidly from \$7 trillion in 1989 to \$88 trillion in 1999 and \$595 trillion in 2007.³⁶³ The total notional value of credit derivatives grew at an even faster rate, “rising from only \$180 million in 1997 to \$1 trillion in 2001 . . . and \$58 trillion in 2007.”³⁶⁴ The top U.S. commercial bank dealers controlled a significant share of the global markets for OTC derivatives, as the combined notional value of their derivatives contracts grew from \$5 trillion in 1990 to \$38 trillion in 2000 and \$159 trillion in 2007, including \$14 trillion of credit derivatives.³⁶⁵

III. AN IDEOLOGY OF COMPREHENSIVE DEREGULATION LED TO THE ENACTMENT OF THE RIEGLE-NEAL ACT, GLBA AND CFMA

As described above in Part II, during the 1980s and 1990s large banks persuaded federal agencies and courts to open a number of loopholes in the legal barriers that separated banks from the securities and insurance sectors.³⁶⁶ However, those loopholes were subject to many restrictions and did not allow banks to establish full-scale affiliations with securities firms and insurance companies.³⁶⁷ Executives of big banks were far from satisfied with the limited victories they had achieved. To accomplish their long-range goal of building financial conglomerates similar to European universal banks, leaders of the big-bank lobby needed to convince Congress to pass three major pieces of legislation.

The first item on the big-bank agenda was to repeal Glass-Steagall’s and BHCA’s constraints on interstate expansion by banks

³⁶¹ MCLEAN & NOCERA, *supra* note 128, at 80–81, 120–24, 263–68; FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at xxiv–xxv, 142–46, 190–95; TETT, *supra* note 259, at 66–69, 94–103, 132–39; Wilmarth, *Dodd-Frank’s Inadequate Response*, *supra* note 68 at, 951, 964–67.

³⁶² Wilmarth, *The Dark Side of Universal Banking*, *supra* note 29, at 987–88, 991–93.

³⁶³ *Id.* at 991–92.

³⁶⁴ *Id.* at 993.

³⁶⁵ Wilmarth, *Transformation*, *supra* note 25, at 334 (providing figures for the top seven U.S. bank dealers in OTC derivatives in 1990 and 2000); OCC’s *Quarterly Report on Bank Trading and Derivatives Activities*, *supra* note 279, at graph 4 (providing figures for the top five U.S. bank dealers in 2007).

³⁶⁶ See *supra* Part II.

³⁶⁷ See *id.*

and bank holding companies.³⁶⁸ The second element was to repeal Glass-Steagall's and BHCA's prohibitions that prevented banks from establishing full-scale affiliations with securities firms and insurance companies.³⁶⁹ The final component was to insulate over-the-counter (OTC) derivatives from any substantive regulation by the CFTC or SEC.³⁷⁰

A. Efforts to Authorize Interstate Banking and to Repeal Glass-Steagall Did Not Succeed during the 1980s but Provided the Foundation for the Treasury Department's 1991 Deregulatory Plan

In January 1981, the outgoing Carter Administration issued a report calling for the phased removal of restrictions on interstate banking and branching.³⁷¹ With one relatively minor exception, Congress did not adopt President Carter's proposals.³⁷² However, Carter's proposals set the stage for an extensive debate throughout the 1980s regarding the potential benefits and risks of interstate banking.³⁷³

In March 1981, the banking industry called on the new Reagan Administration to remove Glass-Steagall's barriers to bank involvement in securities activities.³⁷⁴ The American Bankers Association (ABA) declared that its campaign to repeal Glass-Steagall was "gaining momentum" because of "a political drift toward deregulation."³⁷⁵ However, the ABA's proposals faced strong opposition from the securities industry and independent community banks.³⁷⁶

In December 1981, Treasury Secretary Donald Regan announced that the Reagan Administration would submit a proposal to Congress

³⁶⁸ See *infra* Parts III.A and III.B.

³⁶⁹ See *infra* Parts III.A and III.C.

³⁷⁰ See *infra* Part III.D.

³⁷¹ Wilmarth, *State Bank Powers*, *supra* note 64, at 1154 n.87.

³⁷² *Id.* (explaining that, in 1989, Congress adopted one of Carter's proposals by authorizing interstate acquisitions of failed banks with assets of \$500 million or more).

³⁷³ *Id.* at 1154–55 n.87 (describing unsuccessful efforts to pass interstate banking legislation during the 1980s); FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE, VOLUME I: AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S 129–30 (1997) (same) [hereinafter FDIC HISTORY], https://www.fdic.gov/bank/historical/history/235_258.pdf.

³⁷⁴ Jeff Gerth, *Bank Target: The Glass-Steagall Act*, N.Y. TIMES (Mar. 3, 1981), <http://www.nytimes.com/1981/03/03/business/bank-target-glass-steagall-act.html>.

³⁷⁵ *Id.*

³⁷⁶ *Id.*

for a phased repeal of Glass-Steagall.³⁷⁷ Secretary Regan declared that the Reagan Administration wanted to “remov[e] artificial barriers between commercial banking and investment banking” as part of the Administration’s broader campaign to eliminate “excessive and outmoded government regulation” and demolish “barriers hindering free market activity.”³⁷⁸ As a first step toward those goals, the Reagan Administration urged Congress to allow nonbank subsidiaries of bank holding companies to underwrite and deal in state and local revenue bonds and mutual fund shares, and to engage in a limited number of other securities activities.³⁷⁹

The largest U.S. banks eagerly supported the Carter and Reagan proposals for interstate banking and repeal of Glass-Steagall.³⁸⁰ Until he retired in 1984, Citibank chairman Walter Wriston was the banking industry’s “recognized visionary leader” in pushing for comprehensive deregulation.³⁸¹ Wriston joined Citibank in 1946 and rose through the ranks to become president in 1967 and chairman in 1970.³⁸² Wriston had an intense dislike for government regulation in general and the New Deal in particular.³⁸³ As a Wall Street economist noted, “There was something emotional about [Wriston’s] drive [for deregulation] . . . I felt Wriston wanted simply to dismantle the financial system as we knew it.”³⁸⁴ Wriston explained “his passion for breaking down old restraints on bank operations” in the following terms: “[m]y experience has been you either move forward or you die – it’s true in all biology.”³⁸⁵

Wriston dreamed of transforming Citibank (and its holding company, Citicorp) into a “global financial services corporation” that would “change the face of banking.”³⁸⁶ Wriston wanted Citibank to be an “all-around bank” that provided a “one-stop financial center” for its retail and institutional customers, much as Citibank’s predecessor (National City Bank) had done in the 1920s under Charles Mitchell’s leadership.³⁸⁷ As noted above, Wriston pioneered the use of large-

³⁷⁷ ‘Marketplace’ Era is at Hand For Financial Institutions, AM. BANKER, Dec. 16, 1981, 1981 WLNR 76809.

³⁷⁸ *Id.*

³⁷⁹ *Id.*

³⁸⁰ See Robert A. Bennett, *Sanford’s New Banking Vision*, N.Y. TIMES, Mar. 17, 1985, at F1 [hereinafter Bennett, *Sanford’s New Banking Vision*].

³⁸¹ *Id.*

³⁸² *Walter B. Wriston*, TUFTS, <http://dca.lib.tufts.edu/features/wriston/> (last visited Aug. 30, 2017).

³⁸³ Bennett, *Sanford’s New Banking Vision*, *supra* note 380.

³⁸⁴ MADRICK, *supra* note 12, at 10–11, 14, 19, 23 (quoting Albert Wojinlower).

³⁸⁵ Bennett, *supra* note 207.

³⁸⁶ CLEVELAND & HUERTAS, *supra* note 100, at 277–79, 308–09.

³⁸⁷ *Id.* at 156–58, 258–60, 276–79, 302–04, 308–09; MADRICK, *supra* note 12, at *continued . . .*

denomination, negotiable-rate CDs and Eurodollar deposits that enabled Citibank and other large banks to circumvent Regulation Q's restrictions on deposit interest rates in the 1960s.³⁸⁸

Wriston also developed a new type of loan – the floating-rate syndicated loan.³⁸⁹ This innovative form of credit helped Citibank to expand its lending to large corporations and foreign governments.³⁹⁰ Floating-rate loans provided credit at an agreed spread over the variable cost of Eurodollar funding in London, thereby shifting the risk of future changes in interest rates to the borrowers.³⁹¹ In addition, the process of syndicating a loan enabled Citibank to play a role similar to a “bond underwriter, negotiating the terms of a credit with the borrower and then arranging for the participation of other banks” in the syndicate.³⁹² By the early 1970s, floating-rate syndicated loans were the dominant source of bank credit for multinational corporations and foreign governments.³⁹³ Syndicated loans permitted Citibank and other large U.S. banks “to play the same international role that bond financing had played in the 1920s.”³⁹⁴

12–14, 20; see Wilmarth, *Prelude to Glass-Steagall*, *supra* note 4, at 1292–1300.

³⁸⁸ See *supra* notes 100–01 and accompanying text.

³⁸⁹ See James Grant, *Too Big to Fail?: Walter Wriston and Citibank*, HARV. BUS. REV. (1996), <https://hbr.org/1996/07/too-big-to-fail-walter-wriston-and-citibank>.

³⁹⁰ See *id.*

³⁹¹ See *id.*

³⁹² CLEVELAND & HUERTAS, *supra* note 100, at 267–68.

³⁹³ Ross P. Buckley, *A Tale of Two Crises: The Search for the Enduring Reforms of the International Financial System*, 6 UCLA J. INT'L L. & FOR. AFF. 1, 7 (2001).

³⁹⁴ CLEVELAND & HUERTAS, *supra* note 100, at 267–68; MADRICK, *supra* note 12, at 101–03. The syndicated loans arranged by Citibank and other large “money center” banks for less-developed countries (LDCs) during the 1970s and early 1980s proved to be as reckless and unsound as the foreign bonds that Citibank's and Chase's predecessors underwrote and sold during the 1920s. The large up-front fees that lead banks received for arranging syndicated loans created the same perverse incentives to disregard long-term risks as the large front-end profits that foreign bond underwriters reaped during the 1920s. CHERNOW, *supra* note 43, at 225–29, 237, 304, 637–48; FDIC HISTORY, *supra* note 373, at 191–201; MADRICK, *supra* note 12, at 101–09, 172–73; SILBER, *supra* note 91, at 218–27, 242–47; Wilmarth, *Transformation*, *supra* note 25, at 312–16, 378–81; see also Wilmarth, *Prelude to Glass-Steagall*, *supra* note 4, at 1297–1314) (describing National City's and Chase's sales of high-risk foreign bonds during the 1920s). The very bad performance of syndicated LDC loans arranged by money center banks during the 1970s and early 1980s should have provided a clear warning about their probable behavior if they succeeded in re-entering the securities underwriting business. See Martin Feldstein, *An Interview with Paul Volcker*, 27 J. ECON. PERSP. 105, 112–13 (2013) (quoting Paul Volcker's observation that the LDC lending crisis was “something like . . . the subprime mortgage thing” because, during the 1970s, “money was flowing through
continued . . .

Citibank earned handsome fees for acting as the “lead” bank in syndicated loans, and it soon began to make floating-rate syndicated loans in the United States to business firms, commercial real-estate ventures, energy projects, and local and state governments.³⁹⁵ Syndicated loans brought Citibank and other large U.S. banks closer to the investment banking model because “[t]he process of loan syndication is similar to the formation of an underwriting syndicate for publicly issued debt securities, and syndicated loans are often viewed by borrowers as a ‘substitute’ for underwritten bonds.”³⁹⁶

Wriston failed, however, when he attempted to build a mutual fund business at Citibank.³⁹⁷ As described above, the Supreme Court invalidated Citibank’s “Commingled Investment Account” in its 1971 *Camp* decision.³⁹⁸ Despite that setback, Wriston spearheaded the banking industry’s campaign to repeal Glass-Steagall until he retired in 1984, and his successors (John Reed and Sandy Weill) continued to lead that fight until Congress enacted GLBA in 1999.³⁹⁹

JPMC was probably the second most active participant in the banking industry’s assault on Glass-Steagall. After World War II, JPMC built up a substantial investment banking business in overseas markets, where Glass-Steagall’s limitations did not apply.⁴⁰⁰ Along with Citicorp and Bankers Trust, JPMC persuaded the Fed and the courts to allow bank holding companies to establish Section 20 subsidiaries that could underwrite and trade bank-ineligible

the big banks to Latin America in a way that arguably looked constructive for a while but was ultimately unsustainable”).

³⁹⁵ See Wilmarth, *Transformation*, *supra* note 25, at 378–79.

³⁹⁶ *Id.* at 378–81; see CLEVELAND & HUERTAS, *supra* note 100, at 268–71, 438 nn.31–32.

³⁹⁷ MADRICK, *supra* note 12, at 20.

³⁹⁸ See *supra* notes 168–75 and accompanying text.

³⁹⁹ See Wilmarth, *Citigroup*, *supra* note 22, at 72, 77, 134–35; see also MADRICK, *supra* note 12, 99–101, 106–09, 311–15; Richard W. Stevenson, *Financial Services Heavyweights Try Do-It-Yourself Deregulation*, N.Y. TIMES, Apr. 7, 1998, at A1.

⁴⁰⁰ CHERNOW, *supra* note 43, at 538–41, 593, 653–56, 704–05; see Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System before the Committee on Banking, Housing & Urban Affairs United States Senate (Dec. 1, 1987) (explaining that “foreign offices of U.S. banks and their foreign subsidiaries have been actively engaging abroad in a wide variety of securities activities”), https://fraser.stlouisfed.org/files/docs/historical/greenspan/Greenspan_19871201.pdf; TETT, *supra* note 259, at 16 (noting that JPMC “built up a good capital markets business” in its London branch because “Glass-Steagall didn’t apply overseas”); FEIN, *supra* note 5, at § 16.01 (providing a general overview of the authority of U.S. banks to engage in securities activities abroad through foreign branches and subsidiaries).

securities.⁴⁰¹

Lewis Preston, who led JPMC during the 1980s, was determined to remove Glass-Steagall's barriers so that JPMC could establish a major investment banking presence in the United States as well as foreign markets.⁴⁰² In 1984, Preston instructed JPMC's staff to produce an extensive critique of Glass-Steagall, entitled *Rethinking Glass-Steagall*.⁴⁰³ Alan Greenspan was then a director of JPMC, and he was "very instrumental in getting that document out."⁴⁰⁴ JPMC continued to play a prominent role in the attack on Glass-Steagall under the leadership of Preston's successor, Dennis Weatherstone.⁴⁰⁵

Along with Walter Wriston, Alan Greenspan was one of the strongest opponents of Glass-Steagall. Like Wriston, Greenspan had a deep aversion to government regulation and the New Deal.⁴⁰⁶ Greenspan was a close friend and follower of Ayn Rand from the early 1950s until her death in 1981, and he shared her libertarian philosophy and unwavering belief in laissez-faire capitalism.⁴⁰⁷ During the 1960s, Greenspan "wrote several essays for the [Ayn] Rand publication, *The Objectivist*," in which he "criticized both consumer protection and

⁴⁰¹ Funk & Hirschman, *supra* note 16, at 686–87; *see supra* notes 197–201, 209–20 and accompanying text (discussing the approval of Section 20 subsidiaries by the Fed and the courts).

⁴⁰² *See generally* J.P. MORGAN & CO. INC., *RETHINKING GLASS-STEAGALL: THE CASE FOR ALLOWING BANK HOLDING COMPANY SUBSIDIARIES TO UNDERWRITE AND DEAL IN CORPORATE SECURITIES* 30–42 (1984).

⁴⁰³ *Id.*

⁴⁰⁴ CHERNOW, *supra* note 43, at 654–56, 716 (quoting an unnamed JPMC "insider").

⁴⁰⁵ *Id.* at 716–17; MCLEAN & NOCERA, *supra* note 128, at 53–54; TETT, *supra* note 259, at 76.

⁴⁰⁶ MCLEAN & NOCERA, *supra* note 128, at 84–91, 103.

⁴⁰⁷ ENGEL & MCCOY, *supra* note 153, at 189–90; MADRICK, *supra* note 12, at 228; MCLEAN & NOCERA *supra* note 128, at 85. In April 1997, Greenspan received the "Adam Smith Award" from the Association of Private Enterprise Education. In his acceptance speech, Greenspan declared, "I have never lost sight of the fact that government regulation can undermine the effectiveness of private market regulation and can itself be ineffective in protecting the public interest." He argued that "[r]egulation by government unavoidably involves some element of perverse incentives," and "rapidly changing technology . . . is rendering much government bank regulation irrelevant." He predicted that "market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective government structures." Greenspan applauded the fact that "regulatory restraints against interstate banking and combinations of investment and commercial banking are being swept away under the pressures of technological change," and he assured his audience, "The future accordingly looks bright." Alan Greenspan, Chairman, Fed. Reserve, Remarks at the Annual Conference of the Ass'n of Private Enter. Educ.: *The Evolution of Banking in a Market Economy* (Apr. 12, 1997).

antitrust laws because they interfered with the free market.”⁴⁰⁸ Greenspan considered Rand “a stabilizing force” in his life, and she stood at his side when he took the oath of office as Chairman of the Council of Economic Advisers in 1974.⁴⁰⁹

Greenspan granted an interview to the *New York Times* in June 1987, shortly before he was nominated by President Reagan to succeed Paul Volcker as Chairman of the Fed.⁴¹⁰ In that interview, Greenspan advocated unrestricted nationwide banking, the repeal of Glass-Steagall, and the removal of BHCA’s barriers to acquisitions of banks by commercial and industrial firms.⁴¹¹ Greenspan’s positions were identical to policy proposals that Treasury Under Secretary George Gould announced in the same news article.⁴¹² In sharp contrast to Paul Volcker – who said in 1984 that he was concerned about a “rush to deregulation” that could produce an “undue concentration of banking resources”⁴¹³ – Greenspan assured the *Times*, “I do *not* have a fear of undue concentration of banking powers.”⁴¹⁴

In December 1987, Greenspan told the Senate Banking Committee that the Fed strongly supported a deregulation bill drafted by Senators William Proxmire (D-WI) and Jake Garn (R-UT).⁴¹⁵ The Proxmire-Garn bill would have repealed Glass-Steagall’s anti-affiliation provisions and allowed bank holding companies to establish securities subsidiaries that could engage in a full range of securities activities.⁴¹⁶ Greenspan praised the Proxmire-Garn bill for addressing “what is perhaps the single most important anomaly that now plagues our financial system—the artificial separation of commercial and investment banking.”⁴¹⁷ Greenspan advised the Committee that “repeal of Glass-Steagall would provide significant public benefits

⁴⁰⁸ MADRICK, *supra* note 12, at 228.

⁴⁰⁹ ENGEL & MCCOY, *supra* note 153, at 190.

⁴¹⁰ *See* Nash, *supra* note 208.

⁴¹¹ *Id.*

⁴¹² *Id.* (quoting proposals made by Greenspan and Gould). Gould’s proposal that the federal government should encourage the creation of five to ten megabanks by authorizing unrestricted nationwide banking triggered significant opposition, and that proposal did not advance further until the Treasury Department issued a comprehensive plan for financial deregulation in 1991, discussed below in Part III.B. *See also* Wilmarth, *Too Big to Fail*, *supra* note 47, at 981.

⁴¹³ Bennett, *supra* note 207 (quoting Volcker’s congressional testimony).

⁴¹⁴ *See* Nash, *supra* note 208 (emphasis added).

⁴¹⁵ *Legislative Proposals to Restructure Our Financial System: Hearing Before the Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. 91–92, 96–97 (1987) [hereinafter *Legislative Proposals*] (testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System).

⁴¹⁶ *Id.*

⁴¹⁷ *Id.* at 86.

consistent with a manageable increase in risk.”⁴¹⁸

Greenspan acknowledged that “securities activities are clearly risky,” as demonstrated by “the unprecedented decline in the stock market that occurred on October 19, 1987, and the subsequent market volatility.”⁴¹⁹ However, he assured the Committee that “potential risks from securities activities can be effectively managed.”⁴²⁰

Greenspan also admitted that “some large U.S. banks encountered problems” and suffered losses in their London operations during the U.K.’s “secondary banking crisis” in the mid-1970s and again in 1986, after the U.K. carried out its “big bang” deregulation of the London Stock Exchange.⁴²¹ Greenspan dismissed those problems as “‘start-up’ difficulties rather than long-term safety and soundness concerns.”⁴²² Greenspan recognized that “empirical studies *invariably* find that [securities] underwriting and dealing are *riskier* than the total portfolio of other banking functions.”⁴²³ However, he maintained, “there is evidence of some potential for *limited* diversification gains, or overall risk reduction, for banks being allowed increased securities powers.”⁴²⁴

Greenspan plainly understood that banks would face significant risks if they made a full-scale entry into the securities business.⁴²⁵ However, he advised the Senate Banking Committee that banks could be “effectively insulated from their securities affiliates through an appropriate structural framework” that included “institutional fire walls.”⁴²⁶ In his view, “one of the most important” firewalls in the Proxmire-Garn bill was a provision that would prohibit a bank from “being able to lend to, or purchase assets from, its securities

⁴¹⁸ *Id.* at 87

⁴¹⁹ *Id.* at 92.

⁴²⁰ *Id.*

⁴²¹ *Id.*

⁴²² *Id.* For descriptions of problems that U.S. and U.K. banks encountered in London’s financial markets during the “secondary banking crisis” of 1973 to 1975, and again after the “Big Bang” of 1986, see CHERNOW, *supra* note 43, at 701; RICHARD DALE, INTERNATIONAL BANKING DEREGULATION: THE GREAT BANKING EXPERIMENT 11–12, 34–35, 106–16 (1992); DAVIS, *supra* note 74, at 152–53, 229–30, 237–38; Wilmarth, *Transformation*, *supra* 25, at 325; U.S. DEP’T OF THE TREASURY, *supra* note 60, at XXI-12 through XXI-14.

⁴²³ *Legislative Proposals*, *supra* note 415, at 93 (emphasis added).

⁴²⁴ *Id.* (emphasis added).

⁴²⁵ *Id.* (“The Congress adopted the Glass-Steagall Act . . . because it believed that banks had suffered serious losses as a result of their participation in investment banking. The Congress also thought that bank involvement in the promotional aspects of the investment banking business would produce a variety of ‘subtle hazards’ to the banking system such as conflicts of interest and loss of public confidence.”).

⁴²⁶ *Id.* at 96.

affiliate.”⁴²⁷ He believed that a “straightforward prohibition on lending to securities affiliates” was needed to “limit the transfer of the risk of the securities activities to the federal safety net.”⁴²⁸

Greenspan emphasized the importance of a no-credit firewall in his 1987 testimony because he recognized that existing limitations on transactions between banks and their nonbank affiliates would *not* contain the risks resulting from affiliations with securities firms.⁴²⁹ As he explained, “Our experience indicates . . . that these limitations, embodied in sections 23A and 23B of the Federal Reserve Act, do not work as effectively as we would like and, because of their complexity, are subject to avoidance by creative interpretation, particularly in times of stress.”⁴³⁰ Thus, Greenspan recognized that (i) a repeal of Glass-Steagall could enable banks to transfer their federal safety-net subsidies and resulting cost-of-funding advantages to their securities affiliates through extensions of credit and purchases of assets, and (ii) Sections 23A and 23B would *not* be adequate to control such transfers of subsidies.⁴³¹

Greenspan’s insistence on strict firewalls to prevent transfers of safety-net subsidies proved to be short-lived. In May 1990, a coalition of big banks and supporting trade groups issued a report contending that legislation to repeal Glass-Steagall should not include additional “firewalls” between banks and their securities affiliates.⁴³² The big-bank coalition argued that existing laws, including Sections 23A and

⁴²⁷ *Id.* at 97.

⁴²⁸ *Id.* at 97–98.

⁴²⁹ *Id.* at 93–94.

⁴³⁰ *Id.*; see 12 U.S.C. §§ 371c & 371c-1 (codifying Sections 23A and 23B).

Greenspan agreed with provisions in the Proxmire-Garn bill that would allow “a securities affiliate . . . to borrow from its holding company parent.” Greenspan advised that “[t]he holding company is not protected by the federal safety net.” *Legislative Proposals*, *supra* note 415, at 98. Greenspan’s advice was *not* accurate in view of the decision by the Fed, FDIC and OCC to bail out the parent holding company of Continental Illinois and all of its subsidiaries and creditors in 1984. George C. Nuriisso & Edward Simpson Prescott, *Origins of Too-Big-to-Fail Policy*, 21–24, 33 (Fed. Reserve Bank of Cleveland, Working Paper No. 17–10, 2017); FIN. CRISIS INQUIRY COMM’N, PRELIMINARY STAFF REPORT: GOVERNMENTAL RESCUES OF “TOO-BIG-TO-FAIL” FINANCIAL INSTITUTIONS 6–8 (2010) [hereinafter FIN. CRISIS INQUIRY COMM’N (2010)]; FDIC HISTORY, *supra* note 373, at 235–36, 243–52. During the financial crisis of 2007–09, federal authorities again took extraordinary actions to protect Citigroup, Bank of America, and a number of other large financial holding companies (*including* their securities subsidiaries). Wilmarth, *Two-Tiered System*, *supra* note 194, at 256–66.

⁴³¹ *Legislative Proposals*, *supra* note 415.

⁴³² FEIN, *supra* note 5, at § 1.04[B]; Barbara Rehm, *Coalition Presses Congress to Stop Building ‘Firewalls’*, AM. BANKER, May 10, 1990 at 4, 1990 WLNR 1842348 [hereinafter Rehm (1990)].

23B of the Federal Reserve Act, would be sufficient to prevent conflicts of interest and other adverse effects of bank affiliations with securities firms.⁴³³

Greenspan quickly fell into line with the big-bank coalition's arguments. In testimony before the Senate Banking Committee in July 1990, Greenspan stated that the Fed was "reevaluating both the efficacy and desirability of substantial fire walls" between banks and their securities affiliates.⁴³⁴ He gave two reasons for the Fed's reassessment. First, the failure of Drexel Burnham in early 1990 "raised serious questions about the ability of fire walls to insulate one unit of a holding company from funding problems of another."⁴³⁵ The insolvency of Drexel's holding company quickly led to creditor runs on Drexel's broker-dealer subsidiaries and forced those subsidiaries into receivership.⁴³⁶ Second, Greenspan was concerned that "high and thick fire walls reduce synergies and raise costs for financial institutions, a significant problem in increasingly competitive financial markets."⁴³⁷

It is ironic, to say the least, that Greenspan used the Drexel episode—when firewalls failed—to argue for *weaker* firewalls between banks and their securities affiliates. It also seems clear that Greenspan, like the big banks, wanted to eliminate strong firewalls in order to increase the potential value of expected synergies between banks and their securities affiliates. In his 1990 testimony, Greenspan advised Congress that "more limited fire walls," such as the existing provisions of Sections 23A and 23B, would be sufficient as long as Congress allowed federal regulators to impose higher capital requirements and stricter regulatory standards on bank holding companies that owned broker-dealer subsidiaries.⁴³⁸ Greenspan argued that stronger capital requirements and supervisory standards would "go a long way to limit the transference of bank safety net subsidies to bank affiliates."⁴³⁹

⁴³³ FEIN, *supra* note 5, at § 1.04[B]; Rehm (1990), *supra* note 432.

⁴³⁴ Fed. Reserve Sys., *Statements to Congress*, 76 FED. RESERVE BULLETIN 731, 734 (1990) (statement by Alan Greenspan, Chairman, Board of Governors of the Fed. Reserve Sys., before the Comm. on Banking, Housing, and Urban Affairs, U.S. Senate, July 12, 1990).

⁴³⁵ *Id.*

⁴³⁶ *See id.*; *see also* Wilmarth, *Separation of Banking and Commerce*, *supra* note 29, at 1607 (explaining that "when Drexel Burnham declared bankruptcy in February 1990, following the collapse of the junk bond market, its problems quickly spread" to its broker-dealer subsidiaries, which the SEC was "obliged to liquidate . . . after they could not obtain even short-term credit from counterparties or banks").

⁴³⁷ Fed. Reserve Sys., *supra* note 434, at 734.

⁴³⁸ *Id.* at 437.

⁴³⁹ *Id.* at 436.

The banking industry responded with great enthusiasm to Greenspan's testimony. Representatives of big-bank trade associations hailed Greenspan's statement as "a bold and ingenious stroke" and "a refreshing insight" because he recognized that a "strict-firewalls approach" would be an "obstacle to efficiency in product and service integration."⁴⁴⁰ Other observers agreed that Greenspan's testimony "effectively undermined the firewall concept."⁴⁴¹

Greenspan's testimony in 1987 and 1990 should be remembered in the context of GLBA's final terms and the massive bailouts of financial holding companies during 2007–09.⁴⁴² Greenspan recognized in both 1987 and 1990 that banks would have strong incentives to transfer their safety-net subsidies to their securities affiliates.⁴⁴³ Greenspan's 1987 testimony highlighted the importance of strong firewalls (including a no-transfer-of-credit rule) to prevent the spread of subsidies.⁴⁴⁴ In contrast, his 1990 testimony focused on the need for high levels of capital and strong supervisory standards if strong firewalls were not imposed.⁴⁴⁵ As discussed below, GLBA relied primarily on Sections 23A and 23B to prevent the spread of safety net subsidies. In addition, Greenspan and the Fed granted frequent waivers of Section 23A and did *not* impose stringent capital requirements or tough regulatory standards on large diversified banks.⁴⁴⁶ The weak terms of GLBA and the lax regulatory policies of Greenspan's Fed resulted in a massive and costly expansion of the federal safety net during the decade after GLBA's passage.⁴⁴⁷

Congress did not pass the Proxmire-Garn bill in 1987 or 1988⁴⁴⁸,

⁴⁴⁰ Linda Corman, *Firewalls May Have Outlived Their Usefulness*, AM. BANKER, July 26, 1990 at 1, 1990 WLNR 1840266 (quoting Richard Whiting, general counsel of the Association of Bank Holding Companies, and Robert Dugger, chief economist of the ABA).

⁴⁴¹ *Id.*

⁴⁴² See *infra* Part III.C; Wilmarth, *Two-Tiered System*, *supra* note 194, at 256–73.

⁴⁴³ See generally *Legislative Proposals*, *supra* note 415; Fed. Reserve Sys., *supra* note 434.

⁴⁴⁴ *Legislative Proposals*, *supra* note 415, at 91.

⁴⁴⁵ Fed. Reserve Sys., *supra* note 434, at 736.

⁴⁴⁶ See *infra* text accompanying notes 606–20.

⁴⁴⁷ See *infra* notes 594–617 and accompanying text (discussing GLBA's reliance on Sections 23A and 23B and the Fed's frequent waivers of Section 23A after 2000); Wilmarth, *Turning a Blind Eye*, *supra* note 32, at 1328–40 (describing the Fed's record of regulatory laxity under Greenspan's leadership); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L. 893, 897–905, 917–18 (2011) (same).

⁴⁴⁸ See Sandra Suarez & Robin Kolodny, *Paving the Road to "Too Big to Fail": Business Interests and the Politics of Financial Deregulation in the U.S.*, POLITICS & SOCIETY 1, 15–21 (2010).

just as it failed to pass an earlier Senate bill sponsored by Senator Garn in 1984.⁴⁴⁹ On each occasion, the securities and insurance industries and independent community banks worked together to prevent a repeal of Glass-Steagall, and they received significant help from influential Democratic members of Congress.⁴⁵⁰ One of the most determined and effective defenders of Glass-Steagall was Rep. John Dingell (D-MI), whose father strongly supported passage of the Glass-Steagall Act as a Michigan congressman 1933.⁴⁵¹

After the stock market crashed in October 1987, the securities industry pointed out that Glass-Steagall played a highly beneficial role by preventing a contagious spillover of losses from securities firms to commercial banks.⁴⁵² In addition, big-bank advocates were severely embarrassed when Continental Illinois – which received a large federal bailout in 1984 – extended more than \$600 million of emergency loans to rescue its options trading subsidiary (First Options) during the crash.⁴⁵³ Continental's emergency loans exceeded the lending limit that the OCC established when it allowed Continental to acquire First Options in 1986.⁴⁵⁴ Members of Congress strongly criticized Continental, and the First Options fiasco helped to defeat the banking industry's campaign to repeal Glass-Steagall in 1987 and 1988.⁴⁵⁵

The largest banks persisted in their efforts to remove geographic and product-line barriers, and they soon received fresh support from the federal government.⁴⁵⁶ In 1991, the Treasury Department issued a

⁴⁴⁹ *Id.* at 17.

⁴⁵⁰ *See id.* at 15–21.

⁴⁵¹ *See id.* at 20. *See also* FEIN, *supra* note 5, at § 1.06[A]; Nash, *supra* note 208; Leslie Wayne, *Bank Barrier Resists Foes; Glass-Steagall Walls May Just Be Replaced*, N.Y. TIMES, Sept. 18, 1991; 77 CONG. REC. 3906-07 (1933) (remarks of Rep. Dingell).

⁴⁵² Robert Trigaux, *BRIEFING: Playing on Glass-Steagall Fears*, AM. BANKER, Nov. 23, 1987 at 1, 1987 WLNR 570383 (reporting that “‘Glass-Steagall Saved U.S. Again’ is emblazoned on large round buttons appearing in Washington now, a lapel message from the securities industry that the stock market fall of October was less of a catastrophe only thanks to the absence of commercial banks in the securities underwriting business”); *see also supra* text accompanying notes 72–74, 85 (citing evidence showing that Glass-Steagall played a positive role during the October 1987 stock market crash by shielding commercial banks from exposure to losses suffered by securities firms).

⁴⁵³ *See* Terry Atlas, *Lawmakers Take Continental to Task*, CHI. TR., Feb. 4, 1988, 1988 WLNR 1724293.

⁴⁵⁴ *Id.*

⁴⁵⁵ *See id.*; DALE, *supra* note 422, at 53–54; Trigaux, *supra* note 452; Robert Trigaux, *Revival of Continental's Woes Raises Doubts on New Powers*, AM. BANKER, Oct. 28, 1987, 1987 WLNR 567921.

⁴⁵⁶ Suarez & Kolodny, *supra* note 448, at 17–21 (describing continued efforts by
continued . . .

blueprint for comprehensive deregulation, entitled *Modernizing the Financial System*.⁴⁵⁷ The Treasury plan contained the same three proposals that Treasury Under Secretary George Gould floated in 1987 – nationwide banking and branching, the repeal of Glass-Steagall, and the removal of barriers to acquisitions of banks by commercial and industrial firms.⁴⁵⁸ As described below in Part III.B. and III.C., Congress enacted Treasury’s first two proposals and thereby paved the way for the creation of giant financial conglomerates that stretched across the nation and spanned all sectors of the financial industry.

B. In 1994, Congress Passed the Riegle-Neal Act, Which Adopted Treasury’s 1991 Proposal for Nationwide Banking and Branching

The first key proposal of the 1991 Treasury deregulation plan was to authorize unrestricted nationwide banking through interstate acquisitions of banks by bank holding companies as well as interstate branching.⁴⁵⁹ Treasury urged Congress to repeal Section 3(d) of BHCA, which allowed each state to determine the degree to which out-of-state bank holding companies could acquire banks within its borders.⁴⁶⁰ Beginning in 1975, states began to permit entry by out-of-state bank holding companies.⁴⁶¹ By 1991, thirty-four states allowed entry by bank holding companies located anywhere in the nation, subject to reciprocity requirements in twenty-two states.⁴⁶² Fourteen

large banks to persuade Congress to repeal Glass-Steagall during the late 1980s and early 1990s); Wilmarth, *Too Big to Fail*, *supra* note 47, at 979–80 (discussing unsuccessful efforts to persuade Congress to enact interstate banking legislation in the early 1990s).

⁴⁵⁷ See U.S. DEP’T OF THE TREASURY, *supra* note 60.

⁴⁵⁸ *Id.* at 49–61. For Gould’s 1987 proposals, see *supra* notes 411–12 and accompanying text. Congress has not yet adopted the Treasury plan’s third proposal, which would permit acquisitions of banks by commercial and industrial firms. However, GLBA allows financial holding companies to make “merchant banking” investments that could potentially undermine the separation of banking and commerce. Wilmarth, *Separation of Banking and Commerce*, *supra* note 29, at 1579–87. In addition, two provisions of GLBA allow the Fed to approve “complementary” activities for financial holding companies and preserve certain “grandfathered” powers for Goldman Sachs and Morgan Stanley. Based on those two provisions, the Fed has permitted Goldman Sachs, Morgan Stanley and several other financial holding companies to engage in commodities activities that are commercial in nature. See generally Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, 98 MINN. L. REV. 265 (2013).

⁴⁵⁹ Wilmarth, *Separation of Banking and Commerce*, *supra* note 29, at 1580.

⁴⁶⁰ *Id.*; Wilmarth, *Too Big to Fail*, *supra* note 47, at 962, 977–79.

⁴⁶¹ Wilmarth, *Too Big to Fail*, *supra* note 47, at 963–64.

⁴⁶² *Id.*

other states allowed entry by out-of-state bank holding companies only if their home states were located in a defined geographical region and offered reciprocal access.⁴⁶³ Treasury's plan called for a new federal statute that would remove all federal and state barriers to interstate acquisitions of banks by bank holding companies.⁴⁶⁴

Treasury also proposed an amendment to the McFadden Act (12 U.S.C. § 36), which would authorize national banks to establish branches on a nationwide basis either by merging with banks in other states or by opening *de novo* branches across state lines.⁴⁶⁵ This proposal represented a more radical change to existing law, because in 1991 the McFadden Act barred national banks and state member banks from opening branches across state lines.⁴⁶⁶

The Treasury plan argued that nationwide banking and branching would create stronger and safer banks through geographic diversification.⁴⁶⁷ The plan also contended that nationwide banking and branching would create a more efficient, competitive and profitable banking industry and would provide greater convenience to bank customers, including large corporations, residents of multistate urban areas, and travelers.⁴⁶⁸ The plan did not specifically promote the idea of nationwide megabanks.⁴⁶⁹ However, as I argued in a 1992 article, the plan clearly indicated Treasury's support for "a rapid consolidation of most of the banking industry into a small number of large nationwide banks."⁴⁷⁰

In the same article, I maintained that nationwide banking and branching would present serious potential risks to the U.S. financial system and economy for several reasons.⁴⁷¹ First, while large, geographically diversified banks might face lower risks of failure due to local or regional economic downturns, mergers between large banks would encounter significant challenges as a result of culture clashes

⁴⁶³ *Id.* at 964, 977–79.

⁴⁶⁴ U.S. DEP'T OF THE TREASURY, *supra* note 60, at 51.

⁴⁶⁵ *Id.* at 51–52.

⁴⁶⁶ Wilmarth, *Too Big to Fail*, *supra* note 47, at 963, 978–79. The McFadden Act did not prohibit interstate branching by state nonmember banks, but only four states allowed their banks to establish out-of-state branches in 1991. *Id.* at 963–64 n.16.

⁴⁶⁷ U.S. DEP'T OF THE TREASURY, *supra* note 60, at XVII-8, XVII-9.

⁴⁶⁸ *Id.* at XVII-9 through XVII-13.

⁴⁶⁹ *See id.* at 49–53

⁴⁷⁰ Wilmarth, *Too Big to Fail*, *supra* note 47, at 980–82. In 1987, as noted above, Treasury Under Secretary George Gould called for interstate banking legislation and the repeal of Glass-Steagall in order to promote the creation of "5 to 10 giant banks that would rival in size the largest banks in Japan, West Germany, Britain and France." Nash, *supra* note 208.

⁴⁷¹ *See generally* Wilmarth, *Too Big to Fail*, *supra* note 47, at 980–82.

and incompatible risk profiles.⁴⁷² During the 1980s stronger banks often experienced severe difficulties after absorbing weaker institutions, because losses and other problems from acquired institutions infected the combined organizations.⁴⁷³ Second, it was very doubtful whether executives could successfully identify and control the wide range of risks presented by complex financial giants.⁴⁷⁴ Third, Treasury's assertion that larger size would confer greater safety was contradicted by the fact that many large banks performed poorly during the 1980s and early 1990s.⁴⁷⁵ Eleven of the fifty largest U.S. banks either failed or required federal bailouts during that period.⁴⁷⁶ Fourth, empirical studies raised serious doubts about the claimed efficiency advantages of the largest banks, and many consumers and small businesses were not happy with the services provided and fees charged by big banks.⁴⁷⁷ Fifth, nationwide banks would present significant threats to competition in many markets for banking services, and antitrust laws were not likely to be effective in controlling those threats.⁴⁷⁸

Sixth, and most importantly, I argued that nationwide banking and branching would make the "too-big-to-fail" (TBTF) problem much worse by creating giant banks whose potential failures would pose much greater systemic threats to the U.S. banking system.⁴⁷⁹ Federal regulators invoked the TBTF rationale when they bailed out several

⁴⁷² *Id.* at 984.

⁴⁷³ *Id.* at 985.

⁴⁷⁴ *Id.* at 988.

⁴⁷⁵ *Id.* at 980.

⁴⁷⁶ Those failures and bailouts included First Pennsylvania, Continental Illinois, First City, MCorp, First RepublicBank, and Bank of New England. *Id.* at 989, 993–95; Wilmarth, *Transformation*, *supra* note 25, at 313–315; Arthur E. Wilmarth, Jr., *Too Good to Be True? The Unfulfilled Promises Behind Big Bank Mergers*, 1 STAN. J.L. BUS. & FIN. 1, 41–46 (1995) [hereinafter Wilmarth, *Too Good to Be True*]; FIN. CRISIS INQUIRY COMM'N (2010), *supra* note 430, at 6–9. Three prominent banking analysts concluded that the largest U.S. banks (generally those with more than \$10 billion in assets) had the lowest capital ratios, the weakest earnings, and the highest percentages of nonperforming loans in 1990. JAMES BARTH ET AL., *THE FUTURE OF AMERICAN BANKING* 25–56, 115 (1992).

⁴⁷⁷ Wilmarth, *Too Big to Fail*, *supra* note 47, at 1004–17, 1038–44. For additional analysis challenging claims about the allegedly superior performance of big banks, see Wilmarth, *Transformation*, *supra* note 25, at 257–407; Wilmarth, *Too Good to Be True*, *supra* note 476, at 14–61.

⁴⁷⁸ Wilmarth, *Too Big to Fail*, *supra* note 47, at 1018–38. For additional analysis of the threats to competition posed by nationwide megabanks see Wilmarth, *Transformation*, *supra* note 25, at 293–300; Wilmarth, *Too Good to Be True*, *supra* note 476, at 37–41.

⁴⁷⁹ Wilmarth, *Too Big to Fail*, *supra* note 47, at 994–1004; see also Wilmarth, *Transformation*, *supra* note 25, at 300–08.

large regional banks during the banking crisis of the 1980s and early 1990s, including Continental Illinois in 1984, First RepublicBank in 1988, and Bank of New England in 1991.⁴⁸⁰ Regulators protected those banks and their uninsured creditors to avoid the possibility of triggering creditor runs on big money center banks that faced severe threats to their survival.⁴⁸¹ James Barth, Dan Brumbaugh, and Robert Litan determined that “the largest banks, as a group, pose[d] the greatest risk to the FDIC” in 1990, and they identified several money center banks — including Citicorp, Chase Manhattan, Chemical, and Manufacturers Hanover — as institutions that had inadequate loan loss reserves and “very thin capital margins” at that time.⁴⁸² Federal regulators provided extensive forbearance and implicit support to Citicorp, the largest U.S. bank, which was severely undercapitalized and struggled with multiple problems during the late 1980s and early 1990s.⁴⁸³

In light of the grave threats that large U.S. banks faced during the 1980s and early 1990s, it was not surprising that the 1991 Treasury plan did *not* seek to abolish the TBTF policy.⁴⁸⁴ Instead, the Treasury plan recommended that the TBTF policy should be *codified* by incorporating a new “systemic risk exception” into federal law.⁴⁸⁵ That “exception” would allow Treasury and the Fed to determine jointly that uninsured depositors of a failing bank should be protected in order to prevent “systemic risk.”⁴⁸⁶ To justify the proposed codification of TBTF, Treasury cited the “most recent example” of protecting uninsured depositors at the Bank of New England, and Treasury also declared: “The government must *always* maintain the flexibility to protect the banking system and the economy in circumstances of genuine systemic risk.”⁴⁸⁷

In December 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA),⁴⁸⁸ which expanded the supervisory, enforcement, and resolution powers of federal banking

⁴⁸⁰ Wilmarth, *Too Big to Fail*, *supra* note 47, at 989, 993–94; FDIC HISTORY, *supra* note 394, at 235–36, 243–52, 373–78.

⁴⁸¹ *Id.*; see also FIN. CRISIS INQUIRY COMM’N (2010), *supra* note 430, at 6–10.

⁴⁸² BARTH, *supra* note 476, at 115, 32, 41–44, 54–56.

⁴⁸³ Wilmarth, *Too Good to Be True*, *supra* note 476, at 44–45 n.210. BARTH, *supra* note 476, at 32, 41, 54–56.

⁴⁸⁴ Wilmarth, *Too Big to Fail*, *supra* note 47, at 996.

⁴⁸⁵ U.S. DEP’T OF THE TREASURY, *supra* note 60, at 27.

⁴⁸⁶ *Id.*

⁴⁸⁷ *Id.* at 26 (emphasis added).

⁴⁸⁸ Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified at 12 U.S.C. Chapter 16); See Wilmarth, *Too Big to Fail*, *supra* note 47, at 979 (discussing FDICIA).

regulators. As proposed by the Treasury plan, FDICIA requires regulators to follow “prompt corrective action” and “early resolution” policies.⁴⁸⁹ Those policies are designed to force regulators to impose strict sanctions on undercapitalized banks and to close weak banks before they become insolvent.⁴⁹⁰

FDICIA also requires the FDIC to use the least costly method for resolving bank failures.⁴⁹¹ The “least-cost test,” which was included in the Treasury plan, is intended to stop the FDIC from protecting uninsured depositors in most failed banks.⁴⁹² However, as the Treasury plan recommended, FDICIA includes a “systemic risk exception” to the least-cost test.⁴⁹³ Under that exception, the Fed, FDIC and Treasury may jointly decide to protect uninsured creditors of a failed bank to “avoid or mitigate serious adverse effects on economic conditions or financial stability.”⁴⁹⁴ Thus, as I pointed out in my 1992 article, FDICIA “for the first time provide[d] a clear statutory basis for the ‘too big to fail’ doctrine.”⁴⁹⁵

FDICIA also contained a second significant expansion of the federal safety net, which directly benefited securities firms and other nonbanks. Section 473 of FDICIA amended Section 13(3) of the Federal Reserve Act by authorizing the Fed to provide emergency loans to nonbanks secured by almost any type of collateral that the Fed deemed to be satisfactory, including securities and other types of financial instruments.⁴⁹⁶ Prior to 1991, the Fed could not accept

⁴⁸⁹ Federal Deposit Insurance Corporation Improvement Act §§ 131(a), 143.

⁴⁹⁰ Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 327–57 (1993); see also U.S. DEP’T OF THE TREASURY, *supra* note 60, at 41 (recommending “prompt corrective action” for undercapitalized banks and “early resolution” for failing banks). As I have described in previous work, federal regulators expressly *declined* to apply FDICIA’s prompt corrective action rules when they used the first “stress test” to determine the capital adequacy of the 19 largest U.S. banks in early 2009. In contrast, regulators issued more than 1,400 prompt corrective action orders and other capital enforcement directives against smaller banks between 2008 and 2010. Wilmarth, *Two-Tiered System*, *supra* note 194, at 261, 269–70, 273–75.

⁴⁹¹ Federal Deposit Insurance Corporation Improvement Act of 1991 § 141.

⁴⁹² Carnell, *supra* note 490, at 363–64; Wilmarth, *Too Big to Fail*, *supra* note 47, at 995–96; see also U.S. DEP’T OF THE TREASURY, *supra* note 457, at 26–27 (recommending that “the FDIC should be required to use the least expensive resolution method” for failed banks, which would probably “result in more losses for uninsured depositors”).

⁴⁹³ U.S. DEP’T OF THE TREASURY, *supra* note 60, at 27.

⁴⁹⁴ Carnell, *supra* note 490 at 367–68; Wilmarth, *Too Big to Fail*, *supra* note 47, at 996 (quoting 12 U.S.C. § 1823(c)(4)(G)).

⁴⁹⁵ Wilmarth, *Too Big to Fail*, *supra* note 47, at 997.

⁴⁹⁶ FIN. CRISIS INQUIRY COMM’N (2010), *supra* note 430, at 3, 19.

securities as collateral for loans under Section 13(3).⁴⁹⁷ Goldman Sachs and other large securities firms lobbied for the amendment because of concerns created by the Fed's failure to rescue Drexel Burnham from bankruptcy in 1990.⁴⁹⁸ Senator Christopher Dodd (D-CT) sponsored the amendment to Section 13(3), and he explained that the amendment would permit the Fed "to make fully secured loans to securities firms in instances similar to the 1987 stock market crash."⁴⁹⁹

In 2008, the Fed relied on its expanded lending authority under Section 13(3) to provide massive amounts of financial support to large securities firms — including securities broker-dealers that were affiliates of major banks — as well as AIG and other nonbanks.⁵⁰⁰ Morgan Ricks has suggested (and I agree) that FDICIA's grant of "lender of last resort" authority to the Fed with regard to securities firms was a significant factor that encouraged the explosive growth of securities broker-dealers and their non-deposit liabilities (including commercial paper and repos) after 1991.⁵⁰¹

FDICIA did not include Treasury's proposal for nationwide banking and branching.⁵⁰² Community banks and their allies successfully defeated efforts by the George H.W. Bush Administration and big banks to incorporate that proposal in the 1991 legislation.⁵⁰³ As a result, Treasury's interstate banking recommendation remained an active agenda item when the Clinton Administration took office in early 1993.⁵⁰⁴

The Clinton Administration submitted an interstate banking bill to Congress in October 1993.⁵⁰⁵ Administration officials worked closely

⁴⁹⁷ See generally *id.* at 19.

⁴⁹⁸ *Id.*

⁴⁹⁹ *Id.* (quoting 137 Cong. Rec. S18,619 (daily ed. Nov. 27, 1991) (remarks of Sen. Dodd)); see also RICKS, *supra* note 112, at 197–99 (discussing the significance of FDICIA's expansion of the Fed's emergency lending authority under Section 13(3)); see also Wilmarth, *Transformation*, *supra* note 25, at 304 n.369 (same).

⁵⁰⁰ FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 46, at 286–87, 294–95, 349–50, 354, 395; FIN. CRISIS INQUIRY COMM'N (2010), *supra* note 430, at 19, 21–28; RICKS, *supra* note 112, at 96–101; see Wilmarth, *Two-Tiered System*, *supra* note 194, at 262–63. The Dodd-Frank Act limited, but did not repeal, the Fed's authority to make emergency loans to nonbank firms under Section 13(3). Wilmarth, *Dodd-Frank's Inadequate Response*, *supra* note 68, at 1001–03.

⁵⁰¹ RICKS, *supra* note 112, at 198–99, 32–37.

⁵⁰² Wilmarth, *Too Big to Fail*, *supra* note 47, at 976–77, 979 n.80.

⁵⁰³ *Id.* at 976–77; Stephen Labaton, *House Turns Down Banking Overhaul by 324-to-89 Vote*, N.Y. TIMES, Nov. 5, 1991, at A1 [hereinafter Labaton *House Turns Down*]; Stephen Labaton, *Lawmakers Still Split on Interstate Banking*, N.Y. TIMES, Nov. 25, 1991 at D3 [hereinafter Labaton, *Lawmakers Still Split*].

⁵⁰⁴ Robert M. Garsson, *Banking Lobby Gearing Up for Clinton-Era Victories*, AM. BANKER, Dec. 24, 1992, at 1, 1992 WLNR 2114795.

⁵⁰⁵ Union Leader Corp., *Interstate Banking Bill Hits Clinton's Desk*, N.H.

with the big-bank lobby to secure passage of Riegle-Neal in September 1994.⁵⁰⁶ Riegle-Neal authorized nationwide banking and branching, as the Treasury plan recommended.⁵⁰⁷ Community banks and consumer groups could not stop the legislation after the insurance industry saw “passage as inevitable, [and] dropped its opposition.”⁵⁰⁸ When President Clinton signed Riegle-Neal into law, he declared, “Our work is far from over,” and he promised to push Congress to approve further deregulation of the financial industry.⁵⁰⁹

Riegle-Neal greatly accelerated a wave of consolidation that was already sweeping through the banking industry. In 1995, big banks announced nine mergers that ranked among the fourteen largest U.S. bank mergers up to that time.⁵¹⁰ Seventy-four “megamergers” occurred between 1990 and 2005 in which both the acquiring and acquired banks held more than \$10 billion of assets.⁵¹¹ During the same period, the ten largest U.S. banks more than doubled their share of total U.S. banking assets from twenty-five percent to fifty-five percent.⁵¹² The three largest U.S. banking organizations in 2007 — Citigroup, BofA, and JPMC — expanded rapidly after 1990, and each bank held more than \$1.5 billion of assets at the end of 2007.⁵¹³ Wachovia, the fourth-largest bank, also grew quickly and held almost \$800 billion of assets at the end of 2007.⁵¹⁴

UNION LEADER, Sept. 15, 1994, 1994 WLNR 5510909.

⁵⁰⁶ *Id.*; see also Jack Scism, *NationsBank Chief Responsible for Bill*, GREENSBORO (NC) NEWS & RECORD, Nov. 14, 1994 at 7, 1994 WLNR 4939717 (reporting that (i) “NationsBank’s chief lobbyist, J. Mark Leggett, headed a group of six big banks that tirelessly promoted the [Riegle-Neal] legislation on Capitol Hill” in conjunction with “the Bankers Roundtable, a trade group for the nation’s largest banks”; and (ii) NationsBank’s CEO, Hugh McColl, built such a close friendship with President Clinton that one opponent called Riegle-Neal “an early Christmas present” for McColl).

⁵⁰⁷ Wilmarth, *Too Good to Be True*, *supra* note 476, at 3–4, 9–10; Robert M. Garsson, *President Clinton Signs Interstate Bill into Law, Saying It’s a First Step*, AM. BANKER, Sept. 30, 1994, at 2, 1994 WLNR 2195295; Union Leader Corp., *supra* note 505.

⁵⁰⁸ The Morning Call, Inc., *Clinton Signs Interstate Banking Bill*, ALLENTOWN MORNING CALL, Sept. 30, 1994, at A10, 1994 WLNR 1953028.

⁵⁰⁹ Garsson, *supra* note 507.

⁵¹⁰ Wilmarth, *Too Good to Be True*, *supra* note 476, at 11–12.

⁵¹¹ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 975–76; see also FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 52–53.

⁵¹² FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 52–53.

⁵¹³ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 976.

⁵¹⁴ *Id.*; see also FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 53 (reporting that assets of the five largest U.S. banking organizations, including Wells Fargo, more than tripled between 1998 and 2007, rising from \$2.2 trillion to \$6.8 trillion).

The consolidation trend transformed the U.S. banking industry into a two-tiered structure with a “barbell” shape.⁵¹⁵ A small group of giant megabanks occupied the top end of the barbell, and they controlled a substantial majority of the banking industry’s assets.⁵¹⁶ Several thousand smaller, community-oriented banks were clustered at the lower end of the barbell, and their share of the industry’s assets steadily declined.⁵¹⁷ As the largest banks exploded in size, they also achieved unprecedented political clout, as they showed when they convinced Congress to pass GLBA and CFMA.⁵¹⁸

C. In 1999, Congress Passed GLBA, Which Adopted the Treasury’s 1991 Proposal to Authorize Full-Scale Affiliations between Banks, Securities Firms, and Insurance Companies

The second central component of the 1991 Treasury deregulation plan was its proposal to repeal Glass-Steagall’s and BHCA’s anti-affiliation rules and to authorize financial holding companies that could own banks, securities firms, and insurance companies.⁵¹⁹ The Treasury plan argued that unrestricted affiliations between banks and other providers of financial services would create “a stronger, more diversified financial system that will provide important benefits to the consumer” and respond effectively to “market innovation.”⁵²⁰

Treasury’s 1991 report acknowledged that federal agency rulings already permitted banks and bank holding companies to engage “in a broad range of securities activities,” including securitization of loans as well as underwriting and dealing in bank-ineligible securities through Section 20 subsidiaries.⁵²¹ However, those agency rulings imposed “numerous restrictions,” such as “strict ‘firewall’ requirements” that imposed significant constraints on transactions between banks and their securities affiliates.⁵²² In Treasury’s view, the deregulation achieved through agency rulings was seriously flawed and incomplete because it had proceeded in “a piecemeal, inefficient,

⁵¹⁵ Wilmarth, *Transformation*, *supra* note 25, at 254.

⁵¹⁶ *Id.* at 251–54.

⁵¹⁷ *Id.* at 251.

⁵¹⁸ *Id.* at 220–21, 306–07; Julia Malone, “*The Buying of the President*”: *Big Donors Yield Big Influence, Study Says*, ATLANTA J. & CONST., Jan. 12, 1996 at A7, 1996 WLNR 2948804; *see also* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 7–11, 78–82, 89–92, 121–26, 133–37 (2010).

⁵¹⁹ U.S. Dep’t of the Treasury, *supra* note 60, at 55–56.

⁵²⁰ *Id.*

⁵²¹ *Id.* at XVIII-15.

⁵²² *Id.* at XVIII-16.

and often irrational manner.”⁵²³

Treasury’s 1991 report called on Congress to allow banks, securities firms, and insurance companies to establish full-scale affiliations under the common ownership of financial holding companies, “so that natural synergies c[ould] be realized.”⁵²⁴ Treasury predicted that businesses and consumers would benefit from “more financial vendors offering a greater variety of products at competitively lower prices.”⁵²⁵ In addition, financial holding companies would produce “a more stable stream of income,” thereby enhancing “the overall stability of financial markets.”⁵²⁶

Treasury’s report recognized that the “federal safety net cannot be extended to [nonbank affiliates] without eroding market discipline, exposing the taxpayer to additional losses, and unfairly subsidizing the activities of financial affiliates.”⁵²⁷ The report acknowledged that transfers of funds from a bank to its nonbank affiliates could produce a situation in which (i) the federal safety net was “exposed to losses from affiliates” and (ii) the “bank’s funding advantages from the safety net could ‘leak’ into affiliated financial activities.”⁵²⁸ Treasury, therefore, recommended the use of “firewalls” to separate banks from their nonbank affiliates.⁵²⁹

Treasury argued, however, that firewalls “should be kept to the minimum necessary to protect insured deposits and prevent [an] unfair funding subsidy,” and firewalls “should not restrict or impede operational, managerial, or marketing synergies between a bank and its financial affiliates.”⁵³⁰ In line with Greenspan’s 1990 testimony, Treasury’s 1991 report advised that the existing limits on affiliate transactions under Sections 23A and 23B of the Federal Reserve Act would be sufficient, particularly if regulators were given authority to impose additional “discretionary” restrictions on affiliate transactions.⁵³¹

FDICIA did not include Treasury’s financial holding company proposal.⁵³² The House Banking Committee incorporated much of Treasury’s proposal into its bill, but the House Energy and Commerce

⁵²³ *Id.* at XVIII-19.

⁵²⁴ *Id.* at XVIII-27 (alteration in original).

⁵²⁵ *Id.* at XVIII-32.

⁵²⁶ *Id.*

⁵²⁷ *Id.* at 58.

⁵²⁸ *Id.* at 59.

⁵²⁹ *Id.*

⁵³⁰ *Id.* at 60, XVIII-31.

⁵³¹ *Id.* at 59.

⁵³² *See generally* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat 2236 (1991).

Committee, led by Representative Dingell, imposed very strict limits on the securities and insurance activities that would be permissible for nonbank affiliates of banks.⁵³³ The resulting House bill was unacceptable to both Treasury and the big banks, and they abandoned their efforts to repeal Glass-Steagall's and BHCA's anti-affiliation rules in November 1991.⁵³⁴ The insurance industry and community banks worked together to stop the repeal legislation, while the securities industry was ambivalent and did little to support it.⁵³⁵

Big banks and their political allies focused on interstate banking legislation until Congress passed Riegle-Neal in September 1994.⁵³⁶ In early 1995, the big-bank lobby launched a new campaign to pass "financial modernization" legislation that would tear down Glass-Steagall's and BHCA's structural barriers.⁵³⁷ Prospects for passage seemed favorable after Republicans captured control of the House in the 1994 midterm elections, and after Representative Dingell lost his blocking position as chairman of the House Energy and Commerce Committee.⁵³⁸ However, the insurance industry and community banks succeeded in blocking financial modernization bills during 1995 and 1996.⁵³⁹

Congress also failed to pass financial modernization legislation in 1997 and 1998, but two major events occurred during those years that shifted the political landscape in favor of financial deregulation.⁵⁴⁰ First, after repeatedly losing legal challenges to federal agency rulings, large securities firms and insurance underwriters decided to join the big banks in pushing for repeal of Glass-Steagall's and BHCA's anti-affiliation rules.⁵⁴¹ Securities firms and insurance underwriters endorsed the financial holding company concept because it created a "two-way street" that would enable them to conduct banking activities

⁵³³ Suarez & Kolodny, *supra* note 448, at 21–22.

⁵³⁴ *Id.*

⁵³⁵ FEIN, *supra* note 5, at § 1.06[C]; Labaton, *House Turns Down*, *supra* note 503; Suarez & Kolodny, *supra* note 448, at 24; Leslie Wayne, *Bank Barrier Resists Foes: Glass-Steagall Walls May Just Be Replaced*, N.Y. TIMES (Sept. 18, 1991), <http://www.nytimes.com/1991/09/18/business/bank-barrier-resists-foes-glass-steagall-walls-may-just-be-replaced.html?mcubz=1>.

⁵³⁶ See generally FEIN, *supra* note 5, § 1.06(D).

⁵³⁷ See generally Keith Bradsher, *No New Deal for Banking; Efforts to Drop Depression-Era Barriers Stall, Again*, N.Y. TIMES (Nov. 2, 1995), <http://www.nytimes.com/1995/11/02/business/no-new-deal-for-banking-efforts-to-drop-depression-era-barriers-stall-again.html?pagewanted=all>.

⁵³⁸ FEIN, *supra* note 5, § 1.06(E).

⁵³⁹ Bradsher, *supra* note 537; FEIN, *supra* note 5, § 1.06(D)–(E); Suarez & Kolodny, *supra* note 448, at 26–28.

⁵⁴⁰ FEIN, *supra* note 5, § 1.06(F).

⁵⁴¹ See *id.*

on equal terms with bank holding companies.⁵⁴² The shift of securities firms and insurance underwriters to the pro-repeal side left insurance agents and community banks as the only major trade groups that opposed repeal.⁵⁴³

The second decisive event occurred in April 1998, when Travelers and Citicorp announced their decision to merge under the name of “Citigroup,” thereby creating the world’s biggest financial institution.⁵⁴⁴ Travelers was a major insurance company that controlled a large securities broker-dealer (Salomon Brothers), while Citicorp was the largest U.S. bank holding company.⁵⁴⁵ The Citigroup merger created the first “universal bank” that could offer comprehensive banking, securities, and insurance services in the United States since the 1930s.⁵⁴⁶

Citigroup’s co-leaders — Sanford (Sandy) Weill of Travelers and John Reed of Citicorp — declared that their new financial conglomerate would offer unparalleled convenience to their customers through “one-stop shopping” for a wide range of banking, securities, and insurance services.⁵⁴⁷ They also argued that Citigroup would have a superior ability to withstand financial shocks due to its broadly diversified activities.⁵⁴⁸ Sandy Weill proclaimed, “We are creating a model financial institution of the future. . . . In a world that’s changing very rapidly, we will be able to withstand the storms.”⁵⁴⁹ Thus, Citigroup’s founders cited the same anticipated benefits of universal banking that the 1991 Treasury report had trumpeted.

The creation of Citigroup was a very aggressive move that placed intense pressure on Congress to repeal Glass-Steagall’s and BHCA’s structural barriers. The proposed merger “challenge[d] both the statutory letter and regulatory spirit” of Glass-Steagall and BHCA.⁵⁵⁰ The sole source of statutory authority for the merger was “a temporary

⁵⁴² *See id.*

⁵⁴³ *Id.*; Suarez & Kolodny, *supra* note 448, at 26–28.

⁵⁴⁴ Wilmarth, *Citigroup*, *supra* note 22, at 70.

⁵⁴⁵ *See* Michael Siconolfi, *Travelers and Citicorp Agree to Join Forces in \$83 Billion Merger*, WALL ST. J., Apr. 7, 1998, at A1.

⁵⁴⁶ Wilmarth, *Citigroup*, *supra* note 22, at 70; Wilmarth, *Transformation*, *supra* note 25, at 220.

⁵⁴⁷ Steven Lipin & Stephen E. Frank, *The Big Umbrella: Travelers/Citicorp Merger – One-Stop Shopping is the Reason for Deal*, WALL ST. J., Apr. 7, 1998, at C14.

⁵⁴⁸ Wilmarth, *Citigroup*, *supra* note 22, at 70.

⁵⁴⁹ Yvette D. Kantrow & Liz Moyer, *Citi, Travelers: A Global Leader Takes Shape*, Am. Banker Apr. 7, 1998 at 1, 1998 WLNR 2763775; *see also* Siconolfi, *supra* note 545 (stating that Reed and Weill were “betting that the broad services of the huge new firm could weather any future market swoons”).

⁵⁵⁰ Wilmarth, *Citigroup*, *supra* note 22, at 74.

exemption in [BHCA], which allowed newly-formed bank holding companies to retain nonconforming assets for up to five years after their creation.”⁵⁵¹ However, as a banking lawyer noted, that temporary exemption was “intended to provide an orderly mechanism for disposing of impermissible activities, not warehousing them in hopes the law would change so you could keep them.”⁵⁵²

The Citigroup merger confronted Congress with a “Hobson’s choice” — either repeal Glass-Steagall’s and BHCA’s anti-affiliation rules or force Citigroup, within five years, to divest all of its activities that were not permitted by Glass-Steagall and BHCA.⁵⁵³ In blunter terms, the Citigroup deal put a gun to the head of Congress, and it did so with the full blessing of top government officials. Sandy Weill and John Reed consulted with Fed Chairman Alan Greenspan, Treasury Secretary Robert Rubin, and President Clinton before they announced the Citigroup merger.⁵⁵⁴ All three officials endorsed the merger.⁵⁵⁵ Based on those advance consultations, Reed told the press that Travelers and Citicorp were confident “there wasn’t a legal problem” in completing the merger.⁵⁵⁶ The Fed approved the merger in due course, and the D.C. Circuit upheld the Fed’s approval.⁵⁵⁷

The “advance clearance” that Travelers and Citicorp received from Clinton, Greenspan, and Rubin was “extraordinary” and, to my knowledge, unprecedented.⁵⁵⁸ The kid-gloves treatment that government leaders provided to Travelers and Citicorp demonstrated the “powerful influence” that big banks and Wall Street firms could

⁵⁵¹ Wilmarth, *Citigroup*, *supra* note 22, at 73; *see also* Wilmarth, *Transformation*, *supra* note 25, at 221 n.12 (discussing Section 4(a)(2) of BHCA, 12 U.S.C. § 1841(a)(2), which allows newly-organized bank holding companies to retain nonconforming assets for a two-year period and to request up to three one-year extensions of that period from the Fed).

⁵⁵² Barbara A. Rehm, *Megamerger Plan Hinges on Congress*, *Am. Banker* Apr. 7, 1998 at 1, WLNR 2763791 (quoting an unnamed banking lawyer).

⁵⁵³ Wilmarth, *Citigroup*, *supra* note 22, at 74.

⁵⁵⁴ *See id.*

⁵⁵⁵ MADRICK, *supra* note 12, at 311–13; Rehm, *supra* note 552; Wilmarth, *Citigroup*, *supra* note 22, at 74. Weill had approached Greenspan in connection with Travelers’ unsuccessful attempt to acquire JPMC in 1997, and Greenspan indicated to Weill at that time that the Fed would give Travelers the benefit of BHCA’s temporary exemption. MADRICK, *supra* note 12, at 309.

⁵⁵⁶ Rehm, *supra* note 552.

⁵⁵⁷ *Indep. Cmty. Bankers of Am. v. Bd. of Governors*, 195 F.3d 28, 31–32 (D.C. Cir. 1999) (upholding the Fed’s order approving the Citigroup merger because that order was in “literal compliance with § 4(a)(2)” of BHCA, and dismissing as irrelevant the likelihood that the merger would “put pressure on Congress to amend [BHCA]”).

⁵⁵⁸ Wilmarth, *Citigroup*, *supra* note 22, at 74.

wield in their dealings with politicians and regulators.⁵⁵⁹ As Jeff Madrick observed, the advance blessing for Citigroup provided “a stark example of the ease with which the powerful on Wall Street got the ear of key policymakers, and also how easily the Fed, through its rulings, could bypass the intentions of Congress.”⁵⁶⁰ For his part, Greenspan assured Reed and Weill, “I have nothing against size . . . [i]t doesn’t bother me at all.”⁵⁶¹

Citigroup and Weill promptly became the leading private-sector champions for repeal of the remaining obstacles to universal banking. Big banks, securities firms, and insurance companies joined with Citigroup in financing a campaign for GLBA’s passage that spent more than \$300 million on lobbying and political campaign contributions.⁵⁶² Greenspan and Rubin eagerly supported the financial industry’s efforts to get rid of the legal obstacles to universal banking.⁵⁶³ Greenspan argued that Glass-Steagall’s and BHCA’s anti-affiliation rules forced financial institutions “to take elaborate steps to develop and deliver new financial products in a manner that is . . . increasingly burdensome and serve[s] no useful public purpose.”⁵⁶⁴ In Greenspan’s view, those “archaic statutory barriers” threatened to “undermine the global dominance of American finance, as well as the continued competitiveness of our financial institutions.”⁵⁶⁵ He also hailed the benefits of “one-stop shopping” that universal banking would offer to businesses and consumers.⁵⁶⁶

Rubin similarly contended that an increasing “convergence” between the business models of large banks and securities firms made “any legal separation of commercial and investment banking increasingly awkward and artificial.”⁵⁶⁷ He warned Congress that

⁵⁵⁹ *Id.*; Wilmarth, *Transformation*, *supra* note 25, at 306.

⁵⁶⁰ MADRICK, *supra* note 12, at 313.

⁵⁶¹ *Id.* (quoting Greenspan).

⁵⁶² MADRICK, *supra* note 12, at 314–15; Wilmarth, *Citigroup*, *supra* note 22, at 74–75; Wilmarth, *Transformation*, *supra* note 25, at 306–07; Robert Scheer, *Privacy Issue Bubbles Beneath the Photo Op*, L.A. TIMES, Nov. 16, 1999, at B9.

⁵⁶³ MADRICK, *supra* note 12, at 312–15; Scheer, *supra* note 562.

⁵⁶⁴ *H.R. 10 and the Need for Financial Reform Before the H. Comm. on Banking and Financial Services*, 106th Cong. (1999) (statement of Alan Greenspan, Chairman, Board of Governors of Federal Reserve System).

⁵⁶⁵ *Id.*

⁵⁶⁶ *H.R. 10, the Financial Services Competitiveness Act of 1997 Before the H. Comm. on Banking and Financial Services*, 105th Cong. (1997) (statement of Alan Greenspan, Chairman, Board of Governors of Federal Reserve System).

⁵⁶⁷ *Financial Services Competitiveness Act Before the H. Comm. on Banking*
continued . . .

Glass-Steagall and BHCA imposed “unnecessary costs on the financial system” and could “conceivably impede safety and soundness by limiting revenue diversification.”⁵⁶⁸ Rubin was confident that universal banks would provide “more integrated, convenient financial services to consumers and communities.”⁵⁶⁹ He acknowledged “the legitimacy of the concerns that led to [the] enactment of Glass-Steagall.”⁵⁷⁰ However, he believed those concerns could be “adequately addressed” by Sections 23A and 23B of the Federal Reserve Act as well as strong capital and regulatory standards.⁵⁷¹

Thus, Greenspan, Rubin, and the Clinton Administration enthusiastically embraced the perceived benefits of universal banking and worked hard to repeal Glass-Steagall’s and BHCA’s anti-affiliation rules. Rubin was a former co-chief executive of Goldman Sachs, and he maintained an extensive network of relationships with leaders of major banks and securities firms.⁵⁷² President Clinton maintained close friendships with leading financiers (including Sandy Weill and Hugh McColl), and he welcomed the political contributions his campaigns received from big banks, Wall Street firms, and their trade associations.⁵⁷³ In May 1996, Clinton was the featured guest at a political fundraising event for leading bankers, which was held at the White House and hosted by the Democratic National Committee.⁵⁷⁴

and Financial Services, 104th Cong. (1995) (statement of Robert Rubin, Secretary, U.S. Dep’t of Treasury).

⁵⁶⁸ *Id.*

⁵⁶⁹ *Id.*

⁵⁷⁰ *Id.*

⁵⁷¹ *Id.*

⁵⁷² Wilmarth, *Blind Eye*, *supra* note 32, at 1409–11; Wilmarth, *Citigroup*, *supra* note 22, at 101.

⁵⁷³ JACOB S. HACKER & PAUL PIERSON, WINNER-TAKE-ALL POLITICS: HOW WASHINGTON MADE THE RICH RICHER--AND TURNED ITS BACK ON THE MIDDLE CLASS 247–50 (2010); JOHNSON & KWAK, *supra* note 518, at 93–104, 185–87; MADRICK, *supra* note 12, at 287, 313–15; Malone, *supra* note 518; Scheer, *supra* note 562; Scism, *supra* note 506. Rubin and Greenspan did have a significant jurisdictional battle over which federal agency should be given primary authority to regulate the new universal banks. Rubin argued that national banks should be allowed to conduct expanded powers through directly-owned financial subsidiaries, which would be regulated by the OCC (an autonomous unit within the Treasury Department). In contrast, Greenspan contended that broader powers should be granted only to nonbank subsidiaries of financial holding companies, which the Fed would regulate. GLBA’s final terms granted only limited powers to financial subsidiaries of national banks. In contrast, GLBA gave significantly broader powers to nonbank subsidiaries of financial holding companies and also gave the Fed primary authority to determine the scope of those powers. Suarez & Kolodny, *supra* note 448, at 27–31; Wilmarth, *OCC’s Preemption Rules*, *supra* note 225, at 277 n.203.

⁵⁷⁴ Stephen Labaton, *A Clinton Social with Bankers Included a Leading*

continued . . .

Top executives from several of the nation's largest banks attended the fund-raiser, along with Clinton, Rubin, other senior Treasury officials, and Comptroller of the Currency Eugene Ludwig (the senior regulator of national banks).⁵⁷⁵ The event included a discussion of strategies for repealing Glass-Steagall.⁵⁷⁶

Congress approved GLBA in November 1999, due in large part to the Clinton Administration's strong backing as well as the unified support of big banks, securities firms, and insurance underwriters.⁵⁷⁷ Insurance agents and community banks strongly opposed the legislation, and Republicans and Democrats disagreed over the standards that financial holding companies should be required to satisfy under the Community Reinvestment Act.⁵⁷⁸ As a result, final passage of GLBA did not come easily.⁵⁷⁹

In October 1999, Citigroup hired Robert Rubin as its new co-chairman in the midst of prolonged political and financial debates over GLBA.⁵⁸⁰ Rubin's stature as a former Treasury Secretary provided a "highly visible public endorsement" for Citigroup's campaign to repeal Glass-Steagall.⁵⁸¹ A few weeks later, when final negotiations on GLBA "appeared to reach an impasse," Senator Phil Gramm (R-TX) arranged for Sandy Weill "to help broker a last-minute compromise between Republican congressional leaders and the Clinton Administration, thereby securing [GLBA's] passage."⁵⁸²

During the congressional debates over GLBA, supporters of the legislation repeated the claims previously made by the 1991 Treasury report — and by Greenspan and Rubin — that the new financial holding companies would (i) "earn higher profits based on favorable economies of scale and scope," (ii) "achieve greater safety by diversifying their activities," (iii) offer "one-stop shopping" that would provide "increased convenience and lower costs for businesses and consumers," and (iv) "compete with foreign universal banks" more

Regulator, N.Y. TIMES, Jan. 25, 1997, at 8.

⁵⁷⁵ *Id.*

⁵⁷⁶ *Id.*

⁵⁷⁷ Wilmarth, *Citigroup*, *supra* note 22, at 73–75; Wilmarth, *Transformation*, *supra* note 25, at 306–07.

⁵⁷⁸ Daniel J. Parks, *Financial Services Overhaul Bill Clears After Final Skirmishing Over Community Reinvestment*, 57 CONG. Q. WKLY. REP. 2654, 2654 (1999).

⁵⁷⁹ Daniel J. Parks, *United at Last, Financial Industry Pressures Hill to Clear Overhaul*, 57 CONG. Q. WKLY. REP. 2373, 2373 (1999); Suarez & Kolodny, *supra* note 448, at 27–31.

⁵⁸⁰ Wilmarth, *Citigroup*, *supra* note 22, at 75.

⁵⁸¹ *Id.*; Wilmarth, *Transformation*, *supra* note 25, at 306.

⁵⁸² Wilmarth, *Transformation*, *supra* note 25, at 306–07.

effectively.⁵⁸³ GLBA's supporters also argued that the legislation was needed to sweep away the "inefficient and costly" and potentially "unstable" loopholes that federal agency rulings had created, and to replace those loopholes with a clear, definitive legal framework authorizing full-scale affiliations between banks, securities firms, and insurance companies.⁵⁸⁴

When he signed GLBA into law, President Clinton declared, "This is a very good day for the United States. . . . [W]e have done right by the American people and . . . we have increased the chances of making the next century an American century."⁵⁸⁵ At the signing ceremony, Treasury Secretary Lawrence Summers similarly proclaimed, "With this bill, the American financial system takes a major step forward towards the 21st century. . . . I believe we have found the right framework for America's future financial system."⁵⁸⁶

Phil Gramm, whose free-market zeal matched Greenspan's, boasted at the signing ceremony that GLBA was "a deregulatory bill."⁵⁸⁷ Gramm noted that "when Glass-Steagall became law, it was believed that government was the answer. . . . We are here to repeal Glass-Steagall because we have learned that government is not the answer."⁵⁸⁸ A few months after GLBA's passage, Gramm described Wall Street as "the very nerve center of American capitalism . . . to

⁵⁸³ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 973 (summarizing arguments of GLBA's supporters); *see* S. Rep. No. 106-44, at 4-6 (1999); 145 Cong. Rec. S13,783-84 (daily ed. Nov. 3, 1999) (remarks of Sen. Gramm).

⁵⁸⁴ 145 Cong. Rec. S13,783 (daily ed. Nov. 3, 1999) (remarks of Sen. Gramm); *see also* 145 Cong. Rec. S13,888 (daily ed. Nov. 4, 1999) (remarks of Sen. Reed, stating that GLBA would provide an "important ratification" of prior developments, and would "allow our financial institutions to be more efficient and more effective"); 145 Cong. Rec. S13,990 (daily ed. Nov. 4, 1999) (remarks of Sen. Bryan, stating that GLBA would provide "a new regulatory model, a new framework" to replace earlier court decisions and agency rulings); 145 Cong. Rec. S13,907 (daily ed. Nov. 4, 1999) (remarks of Sen. Lieberman, stating that GLBA would establish a "rational financial structure" to replace "regulatory loopholes").

⁵⁸⁵ Press Release, Bill Clinton, President, Statement by President Bill Clinton at the Signing of the Financial Modernization Bill (Nov. 12, 1999).

⁵⁸⁶ *Id.*

⁵⁸⁷ *Id.*

⁵⁸⁸ *Id.*; *see also* Eric Lipton & Stephen Labaton, *A Deregulator Looks Back, Unswayed*, N.Y. TIMES (Nov. 17, 2008)

<http://www.nytimes.com/2008/11/17/business/economy/17gramm.html> (describing Gramm, a former economics professor at Texas A&M, as a "fierce opponent of government intervention in the marketplace," and quoting a fellow Senator's description of Sen. Gramm as a "true dyed-in-the-wool, free-market guy . . . very much a purist") (quoting former Senator Peter Fitzgerald (R-IL)).

me, that's a holy place."⁵⁸⁹

In contrast to the rosy predictions of GLBA's supporters, GLBA's opponents argued that "the new universal banks permitted by GLBA were likely to generate financial risks and speculative excesses similar to those that occurred during the 1920s."⁵⁹⁰ Opponents contended that regulators would almost certainly protect the new universal banks as institutions that were TBTF.⁵⁹¹ Opponents also warned that "removal of Glass-Steagall's constraints might ultimately cause a financial crisis similar in magnitude to the Great Depression."⁵⁹²

GLBA's supporters acknowledged that GLBA should protect the federal safety net from the potential risks of securities and insurance activities, and should also prevent banks from transferring their safety-net subsidies to their securities and insurance affiliates.⁵⁹³ To accomplish those goals, GLBA relied primarily on "firewalls" resulting from (i) the separate corporate identities of banks and their nonbank affiliates, and (ii) the restrictions on affiliate transactions under Sections 23A and 23B of the Federal Reserve Act.⁵⁹⁴ However, as Joseph Stiglitz subsequently explained, the firewall arguments of GLBA's supporters relied on "an obvious intellectual inconsistency."⁵⁹⁵ If insured banks and the federal safety net needed

⁵⁸⁹ Lipton & Labaton, *supra* note 588 (quoting Gramm's remarks at a Senate hearing in April 2000).

⁵⁹⁰ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 974 (summarizing arguments made by GLBA's opponents).

⁵⁹¹ *Id.* (same).

⁵⁹² *Id.* (same); see 145 Cong. Rec. S13,871–74 (daily ed. Nov. 4, 1999) (remarks of Sen. Wellstone); 145 Cong. Rec. S13,896–97 (remarks of Sen. Dorgan); 145 Cong. Rec. H11,530, H11,542 (daily ed. Nov. 4, 1999) (remarks of Rep. Dingell).

⁵⁹³ See, e.g., S. REP. NO. 106-44, at 7–8 (1999) (stating that "[t]he deposit insurance funds must be adequately insulated from paying the losses of firms which are affiliated with insured banks."); H.R. REP. NO. 106-74, at 134–35 (1999).

⁵⁹⁴ Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1692, 1696–97, 1707 (2011); Wilmarth, *Transformation*, *supra* note 25, at 454–57; see S. REP. NO. 106-44, at 7–8 (1999) (citing the "safeguards" provided by GLBA's requirement that securities and insurance activities must be conducted in separate nonbank subsidiaries within "the holding company structure"); *id.* at 66 ("Additional Views" of nine Democratic Senators, expressing confidence in the "strict limits" provided by Sections 23A and 23B); 145 Cong. Rec. S13,783-84 (daily ed. Nov. 3, 1999) (remarks of Sen. Gramm); *id.* at 13,881 (daily ed. Nov. 4, 1999) (remarks of Sen. Schumer).

⁵⁹⁵ JOSEPH E. STIGLITZ, *THE ROARING NINETIES: A NEW HISTORY OF THE WORLD'S MOST PROSPEROUS DECADE* 160 (2003).

to be shielded from the risks posed by securities and insurance affiliates, “what were the benefits of integration?”⁵⁹⁶ If, on the other hand, Congress established only weak “Chinese walls” in order to promote desirable “economies of scope” across financial holding companies, that approach would obviously increase the risks to the FDIC and taxpayers and would also enable banks to transfer safety-net subsidies to their affiliates.⁵⁹⁷

In 1995, Paul Volcker warned Congress that regulators would probably be forced to extend the federal safety net to protect large securities firms if they were allowed to affiliate with large banks.⁵⁹⁸ In testimony before the House Banking Committee, Volcker said:

[I]t is obvious that if you had a large investment bank allied with a large [commercial] bank, the possibility of a systemic risk arising is evident. . . . It may be even evident with the investment bank alone. We are trying to keep them out of the so-called safety net now, but certainly you cannot keep them out if they are combined with a banking institution.⁵⁹⁹

GLBA’s supporters ignored Stigler’s paradox and Volcker’s warning, and Congress adopted the “limited” firewall approach, as Greenspan and Rubin had advocated.⁶⁰⁰ In contrast, Senator Paul Wellstone (D-MN), a strong opponent of GLBA, warned that the firewalls remaining after Glass-Steagall’s repeal would be “weak” and would probably disappear during a future financial crisis.⁶⁰¹ Wellstone pointed out that Glass-Steagall was “one of several stabilizers” designed to prevent a second Great Depression, and GLBA would “repeal that stabilizer without putting any comparable safeguard in place.”⁶⁰²

Saule Omarova has shown just how porous and ineffective the

⁵⁹⁶ *Id.* at 159–61.

⁵⁹⁷ *Id.*

⁵⁹⁸ SILBER, *supra* note 91, at 275, 419 n.5 (quoting Volcker’s testimony before the House Committee on Banking and Financial Services in April 1995).

⁵⁹⁹ *Id.*

⁶⁰⁰ See *supra* notes 434–39, 571 and accompanying text (discussing Greenspan’s and Rubin’s recommendation for “limited” firewalls); Wilmarth, *Transformation*, *supra* note 25, at 457 (questioning “whether regulators and lobbyists for the financial services industry actually believed in the virtues of corporate separation during the 1990s, or whether they simply viewed the ‘firewall’ argument as a convenient tool to help persuade Congress that [GLBA] would not create undue risks.”).

⁶⁰¹ 145 CONG. REC. S13,872 (daily ed., Nov. 4, 1999) (remarks of Sen. Wellstone).

⁶⁰² *Id.*

Section 23A firewall proved to be.⁶⁰³ Section 23A is *not* an absolute barrier to the transfer of safety-net subsidies because it permits banks to transfer *some* of their cost-of-funding advantages to their affiliates.⁶⁰⁴ Under Section 23A, a bank may extend credit to, and may purchase assets from, its nonbank affiliates as long as the bank complies with specified quantitative limits, collateral requirements, and qualitative conditions.⁶⁰⁵ The scope of Section 23A is limited by a number of statutory exemptions, which provide interpretive challenges and opportunities for arbitrage.⁶⁰⁶ In addition, the Fed possessed broad, unilateral, authority to waive Section 23A's requirements until 2010.⁶⁰⁷ Thus, as Alan Greenspan admitted in his 1987 testimony, the "complexity" of Sections 23A and 23B made both statutes vulnerable "to avoidance by creative interpretation, particularly in times of stress."⁶⁰⁸

The first acid test of the post-GLBA firewalls occurred during the terrorist attacks on the World Trade Center on September 11, 2001.⁶⁰⁹ When the attacks threatened to disrupt financial markets on Wall Street, the Fed flooded the financial markets with liquidity by purchasing \$150 billion of government securities and by extending more than \$45 billion of discount window loans to banks.⁶¹⁰ The Fed also "suspended" Section 23A's limits on affiliate transactions and

⁶⁰³ See Omarova, *supra* note 594, at 1688–89.

⁶⁰⁴ *Id.* at 1690.

⁶⁰⁵ *Id.* at 1692–94.

⁶⁰⁶ *Id.* at 1697–1700, 1706–09; Wilmarth, *Transformation*, *supra* note 25, at 456.

⁶⁰⁷ Omarova, *supra* note 594, at 1701. Section 23B requires affiliate transactions to be conducted on arm's-length, market-based terms, but Section 23B does not impose additional quantitative limits on affiliate transactions); *id.* at 1693–94; see also CARPENTER & MURPHY, *supra* note 5, at 23–25 (discussing Sections 23A & 23B). The Dodd-Frank Act limited, but did not abolish, the Fed's authority to grant exemptions and waivers from Section 23A's requirements. Omarova, *supra* note 594, at 1701, 1766–68.

⁶⁰⁸ *Legislative Proposals to Restructure our Financial System, Before the Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. 20 (1987) (statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System); see also *supra* notes 434–41 above and accompanying text (discussing the context of Greenspan's 1987 testimony); see also Wilmarth, *Transformation*, *supra* note 25, at 456 (noting that "regulators and analysts have acknowledged that . . . the restrictions in Sections 23A and 23B are complicated and difficult to enforce").

⁶⁰⁹ Arthur E. Wilmarth, Jr., *Subprime Crisis Confirms Wisdom of Separating Banking and Commerce*, 27 BANKING & FIN. SERVS. POL'Y REP. 1, 9 (2008) (following the terrorist attacks on September 11, 2001, the Board suspended Section 23A's restrictions on affiliate transactions between large banks and their securities affiliates).

⁶¹⁰ FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 60.

“urged major banks to make large transfers of funds to their securities affiliates.”⁶¹¹ In my 2002 article, I suggested that the Fed’s Section 23A waivers on 9/11 indicated that “the [Fed] views the survival of major financial conglomerates as an indispensable element of its broader mission to preserve market stability. Market participants therefore have strong reasons to expect that the TBTF policy will be applied to all important subsidiaries of leading financial holding companies.”⁶¹²

As Saule Omarova has shown, the Fed subsequently acted in precisely the way I anticipated in 2002. The Fed repeatedly waived Section 23A’s restrictions to assist large financial institutions as they expanded and consolidated their operations between 2000 and 2007.⁶¹³ The Fed granted even broader waivers of Section 23A’s limitations after the financial crisis began in mid-2007, so that major banks could rescue their threatened securities affiliates and MMMFs.⁶¹⁴ The Fed’s extraordinary waivers after mid-2007 permitted “massive transfers of funds” from large banks to their nonbank affiliates in ways that “purposely exposed banks to risks associated with their affiliates’ nonbanking business and transferred [the] federal subsidy outside the [banking] system.”⁶¹⁵

The Fed’s large-scale waivers of Section 23A after the financial

⁶¹¹ Wilmarth, *Transformation*, *supra* note 25, at 456–57, 472; *see also Report from the President: Responding to September 11 and Future Prospects for the New York Regional Economy, in 2001 Annual Report*, FED. RES. BANK OF N.Y. 1, 3, 7–9 (2001), <https://www.newyorkfed.org/medialibrary/media/aboutthefed/annual/annual01/report.pdf> (describing how the New York Fed “stave[d] off a potential liquidity crisis that could have posed a systemic risk” on 9/11 by (i) “inject[ing] tens of billions of dollars into the financial system through discount window loans [that reached \$46 billion on September 12, 2001,]” and “open market operations” in which the Fed purchased Treasury bonds from primary dealers, and (ii) providing “appropriate flexibility” under Section 23A, which allowed banks to “extend credit” to their securities affiliates in view of “the difficult conditions in government securities and money markets”).

⁶¹² Wilmarth, *Transformation*, *supra* note 25, at 473.

⁶¹³ Omarova, *supra* note 594, at 1706–29. For example, in 2006 the Fed granted waivers under Section 23A that enabled Citigroup to transfer more than \$17 billion of subprime mortgages from its nonbank mortgage lending subsidiaries to Citibank, its flagship bank. Those transfers significantly increased Citibank’s losses from subprime mortgages after the financial crisis broke out in mid-2007. *Id.* at 1712–17.

⁶¹⁴ *See id.* at 1729–50. In addition, the Fed approved broad waivers of Section 23A to help Goldman Sachs and Morgan Stanley convert to financial holding companies, and to enable GMAC to provide vehicle financing to General Motors’ customers in conjunction with the federal government’s rescue of General Motors. *Id.* at 1750–61.

⁶¹⁵ *Id.* at 1762–63.

crisis broke out were part of a comprehensive series of rescue measures that bailed out large financial conglomerates in the banking, securities, and insurance sectors.⁶¹⁶ Those bailouts “turned to ashes” the promises made by Citigroup’s founders – and by GLBA’s supporters – that Glass-Steagall’s repeal would usher in a new era of greater economic prosperity and financial stability while avoiding any extension of the federal safety net beyond the traditional banking system.⁶¹⁷ GLBA’s opponents proved to be highly prescient when they warned that TBTF bailouts of large financial conglomerates would almost certainly occur if Congress repealed Glass-Steagall. On the evening when the House of Representatives passed GLBA, Congressman Dingell declared:

[W]hat we are creating now is a group of institutions which are too big to fail. . . . Taxpayers are going to be called upon to cure the failures we are creating tonight, and it is going to cost a lot of money, and it is coming. Just be prepared for those events.⁶¹⁸

In the aftermath of the financial crisis, two leading proponents of universal banking admitted that TBTF bailouts were the price that society must pay to secure the elusive benefits of global universal banks. In a private interview, Robert Rubin stated: “Too big to fail isn’t a problem with the system. It *is* the system. You can’t be a competitive global financial institution serving global corporations of scale without having a certain scale yourself. The bigger multinationals get, the bigger financial institutions will have to get.”⁶¹⁹

In testimony before a House of Lords subcommittee in 2014, HSBC chairman Douglas Flint acknowledged that universal banks received an “implicit subsidy” during the financial crisis.⁶²⁰ The public “subsidy” for universal banks resulted from the fact that “investment banking operations were alongside society’s deposits,

⁶¹⁶ See Wilmarth, *Two-Tiered System*, *supra* note 194, at 256–73; Wilmarth, *Dodd-Frank’s Inadequate Response*, *supra* note 68, at 957–59, 978–79, 1041–42.

⁶¹⁷ Wilmarth, *Citigroup*, *supra* note 22, at 70–72, 132–37.

⁶¹⁸ 145 CONG. REC. H11,542 (daily ed. Nov. 4, 1999) (remarks of Rep. Dingell); *see also* 145 CONG. REC. S13, 896–97 (daily ed. Nov. 4, 1999) (remarks of Sen. Dorgan, expressing a similar warning).

⁶¹⁹ DAVID ROTHKOPF, *POWER, INC., THE EPIC RIVALRY BETWEEN BIG BUSINESS AND GOVERNMENT—AND THE RECKONING THAT LIES AHEAD* 266 (2012) (quoting an undated private interview with Mr. Rubin).

⁶²⁰ Wilmarth, *The Financial Industry’s Plan for Resolving Failed Megabanks Will Ensure Future Bailouts for Wall Street*, 50 GA. L. REV. 43, 78 (2015) [hereinafter Wilmarth, *Financial Industry’s Plan*] (quoting Douglas Flint’s testimony on Oct. 21, 2014, before Subcommittee A (Economic & Financial Affairs) of the Select Committee on the European Union of the U.K. House of Lords).

[and] there was an implicit underwriting of the debt within the [combined] operation because one would not risk the systemic panic that would happen if people thought their deposits were at risk.”⁶²¹ According to Flint, that “subsidy” is an inevitable charge that “society” must pay to maintain a financial system that includes large universal banks: “At the end of the day, the burden of failure [of a universal bank] rests with society. Whether you take it out of society’s future income through taxation or whether you take it out through their pensions or savings, society is bearing the cost.”⁶²²

I have argued elsewhere that we must reject the TBTF “price” of universal banks, or we will continue to pay that price during future financial crises.⁶²³ For present purposes, it is sufficient to note that GLBA’s supporters assured the American people that they would *not* pay such a price, while GLBA’s opponents correctly predicted that TBTF bailouts of financial holding companies were virtually certain to occur if Congress repealed Glass-Steagall.⁶²⁴

D. Congress Enacted CFMA to Provide “Legal Certainty” for OTC Derivatives

The final element of the deregulation campaign pursued by large financial institutions was to insulate their OTC derivatives activities from substantive regulation by the CFTC or SEC.⁶²⁵ Markets for OTC derivatives expanded rapidly during the 1990s, and those markets became much larger in volume than markets for exchange-traded derivatives.⁶²⁶ The largest U.S. banks and securities dealers controlled about forty percent of the global OTC derivatives market in 1998.⁶²⁷ Derivatives activities produced \$46 billion of revenues for U.S. bank dealers between 1996 and 2000 and accounted for six percent of the total revenues of the seven largest bank dealers during that period.⁶²⁸ However, as described above, the ability of OTC derivatives to escape

⁶²¹ *Id.* (same).

⁶²² *Id.* at 64 (same).

⁶²³ See Wilmarth, *Citigroup*, *supra* note 22, at 132, 136–37.

⁶²⁴ See Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 973–75.

⁶²⁵ See *infra* notes 651–54, 667, 711, 746–55 and accompanying text.

⁶²⁶ PWGFM, *Over-the-Counter Derivatives*, *supra* note 258, at 4 (stating that the total notional value of OTC derivatives reached \$80 trillion in 1998, compared with \$13.5 trillion for exchange-traded futures and options); see also Wilmarth, *Transformation*, *supra* note 25, at 334 n.489 (stating that the total notional value of OTC derivatives grew from \$7 trillion in 1989 to \$88 trillion at the end of 1999).

⁶²⁷ Alan Greenspan, Chairman, Fed. Res., *Financial Derivatives: Remarks Before the Futures Industry Association* (Mar. 19, 1999).

⁶²⁸ Wilmarth, *Transformation*, *supra* note 25, at 337.

most types of regulation depended on a tenuous exemption approved by the CFTC in 1993.⁶²⁹

The explosive growth of derivatives markets after the mid-1980s was accompanied by numerous warning signs about their risks.⁶³⁰ The first danger signal occurred when “portfolio insurance” failed during the stock market crash of October 1987.⁶³¹ Portfolio insurance was a derivatives-based hedging strategy that was “designed to protect a stock portfolio from dropping below a prespecified floor value.”⁶³² Portfolio insurance used short sales of exchange-traded stock index futures to offset declines in stock prices.⁶³³ Portfolio insurance was the harbinger of a “brave new world of synthetic instruments [based on] dynamic trading strategies.”⁶³⁴

Portfolio insurance had “all the potential pitfalls of any hedging strategy,” because it depended on accurate predictions of future market volatility as well as a “liquid” market.⁶³⁵ When the stock market began to crash in October 1987, portfolio insurance triggered huge volumes of sell orders for stock index futures, and liquidity quickly disappeared in the futures markets.⁶³⁶ There was very little buyer demand for stock index futures, and the collapse of prices for stock index futures helped to drive down prices in the stock market.⁶³⁷ “Many observers, including the Brady Commission, concluded that portfolio insurance increased the severity of the crash by magnifying selling pressures in both the stock market and the futures markets.”⁶³⁸

During the 1990s, numerous scandals and large trading losses connected to OTC derivatives raised even greater public concerns.⁶³⁹ The Fed’s unexpected decision to increase short-term interest rates in

⁶²⁹ See *supra* notes 273–75 and accompanying text (discussing the CFTC’s 1993 exemption rule).

⁶³⁰ Kent Cherny & Ben R. Craig, *Reforming the Over-the-Counter Derivatives Market: What’s to Be Gained?*, CLEVELAND FED. RESERVE (July 7, 2010) <https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/economic-commentary-archives/2010-economic-commentaries/ec-201006-reforming-the-over-the-counter-derivatives-market-whats-to-be-gained.aspx>.

⁶³¹ Mark Carlson, *A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response* 1, 15–16 (Nov. 2006), <https://www.federalreserve.gov/pubs/feds/2007/200713/200713pap.pdf>.

⁶³² RICHARD BOOKSTABER, *A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION* 9 (2007).

⁶³³ *Id.* at 9–11; Carlson, *supra* note 631, at 16.

⁶³⁴ BOOKSTABER, *supra* note 632, at 11.

⁶³⁵ *Id.* at 14.

⁶³⁶ Carlson, *supra* note 631, at 16.

⁶³⁷ BOOKSTABER, *supra* note 632, at 14–31.

⁶³⁸ Wilmarth, *Transformation*, *supra* note 25, at 341.

⁶³⁹ Bruce G. Carruthers, *Diverging Derivatives: Law, Governance and Modern Financial Markets*, 41 J. OF COMPARATIVE ECON. 386, 386–400 (2013).

1994 inflicted large losses on a wide variety of institutional investors who bought highly-leveraged OTC interest-rate derivatives from bank dealers.⁶⁴⁰ Gibson Greetings, Procter & Gamble, and several other companies sued Bankers Trust, alleging that the bank sold them complex interest-rate derivatives without disclosing the embedded risks.⁶⁴¹ Bankers Trust paid more than \$250 million to settle those lawsuits and to cover civil penalties assessed by the CFTC and SEC.⁶⁴² Similarly, Orange County, California sued Merrill Lynch after losing \$1.6 billion on highly-leveraged interest-rate derivatives purchased from Merrill.⁶⁴³ Merrill ultimately paid \$470 million to settle civil, criminal, and SEC claims related to the Orange County debacle.⁶⁴⁴ In 1995, Barings Bank, a prominent U.K. investment bank, failed after losing more than \$1.4 billion on speculative derivatives trades made by Nicholas Leeson, the general manager of Barings' Singapore subsidiary.⁶⁴⁵

The foregoing events and other derivatives-related problems attracted the attention of policymakers. The U.S. General Accounting Office issued a study warning that OTC derivatives could create serious systemic hazards due to the high concentration of OTC derivatives exposures within a small group of large banks and securities firms, as well as regulatory gaps and weaknesses.⁶⁴⁶ Members of Congress introduced four bills calling for stronger regulation of OTC derivatives.⁶⁴⁷

In response to this threat of federal regulation, the International Swaps and Derivatives Association (ISDA) and its allies sprang into action. ISDA represented the major banks and securities firms that were large dealers in OTC derivatives, as well as leading corporate

⁶⁴⁰ Buttonwood, *The 1994 Effect: What happens When Interest Rates Eventually Rise?*, ECONOMIST BLOG (Mar. 22, 2011), https://www.economist.com/blogs/buttonwood/2011/03/interest_rate_risk.

⁶⁴¹ Carruthers, *supra* note 639, at 394.

⁶⁴² See Wilmarth, *Transformation*, *supra* note 25, at 362.

⁶⁴³ See *id.* at 364–65.

⁶⁴⁴ *Id.* at 364. For a detailed account of the scandals and lawsuits surrounding the sale of leveraged interest-rate derivatives by Bankers Trust and Merrill Lynch see FRANK PARTNOY, *INFECTIOUS GREED; HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS* 49–61, 112–29, 163–71 (Henry Holt, 1st ed., 2003).

⁶⁴⁵ PARTNOY, *supra* note 644, at 228–29, 240–44; Wilmarth, *Transformation*, *supra* note 25, at 351.

⁶⁴⁶ Henry C.K. Liu, *OTC Derivatives Market Reform* (Nov. 24, 2009), <http://www.henryckliu.com/page211.html>; see also Wilmarth, *Transformation*, *supra* note 25, at 332–35, 354, 368 (discussing findings made by the GAO and other analysts concerning the risks created by OTC derivatives).

⁶⁴⁷ MCLEAN & NOCERA, *supra* note 128, at 66–68; PARTNOY, *supra* note 644, at 141–54; TETT, *supra* note 259, at 36–37.

end-users and institutional investors.⁶⁴⁸ ISDA's chairman, Mark Brickell, was a JPMC executive.⁶⁴⁹ Brickell had unlimited faith in the wisdom of markets, and he once said, "I am a great believer in the self-healing power of markets. . . [m]arkets can correct excess far better than any government. Market discipline is the best form of discipline there is."⁶⁵⁰

Brickell and ISDA launched a "tenacious campaign" to block any regulation of OTC derivatives, and ISDA's efforts received strong support from the Clinton Administration and Alan Greenspan.⁶⁵¹ ISDA and other big-bank trade associations argued that regulation of OTC derivatives would impose unwarranted costs and stifle innovations in risk management by financial institutions.⁶⁵² Echoing ISDA's themes, Greenspan warned Congress against passing legislation that would create "a regulatory regime that is itself ineffective and that diminishes the effectiveness of market discipline."⁶⁵³ ISDA blocked all four proposed bills dealing with OTC derivatives, thereby achieving "one of the most startling triumphs for a Wall Street lobbying campaign in the twentieth century."⁶⁵⁴

Derivatives problems persisted, however. Dealers and end-users suffered significant derivatives-related losses during the Mexican and East Asian crises of 1995 and 1997.⁶⁵⁵ For example, JPMC paid almost \$600 million to settle lawsuits brought by several Korean banks and securities firms after they incurred large losses on OTC currency swaps they bought from JPMC.⁶⁵⁶

In 1998, a new regulatory threat appeared. At a contentious meeting in April, CFTC Chairman Brooksley Born received strong warnings from Greenspan, Rubin, and SEC Chairman Arthur Levitt not to proceed with her plan to consider new regulations for OTC

⁶⁴⁸ Statement Submitted on Behalf of The International Swaps and Derivatives Association, Inc. To the Subcommittee of Risk Management and Specialty Crops, Committee on Agriculture, United States House of Representatives (May 20, 1999) (submitted by Joseph P. Bauman), 1999 WL 321621.

⁶⁴⁹ TETT, *supra* note 259, at 28–29, 36–39.

⁶⁵⁰ *Id.* at 31–32 (quoting Brickell).

⁶⁵¹ MCLEAN & NOCERA, *supra* note 128, at 64, 66–68.

⁶⁵² PARTNOY, *supra* note 644, at 141–54.

⁶⁵³ TETT, *supra* note 259, at 38–40 (quoting Greenspan's testimony in 1994).

⁶⁵⁴ MCLEAN & NOCERA, *supra* note 128, at 64, 66–68; *see also* PARTNOY, *supra* note 644, at 141–54; *see also* TETT, *supra* note 259, at 38–40.

⁶⁵⁵ Wilmarth, *Transformation*, *supra* note 25, at 311, 346.

⁶⁵⁶ *Id.* at 365. For additional discussion of derivatives-related problems that occurred between 1995 and 1997, *see* PARTNOY, *supra* note 644, at 228–29, 235–61.

derivatives.⁶⁵⁷ Despite that warning, the CFTC issued a “Concept Release” in May 1998.⁶⁵⁸ The Concept Release requested public comment on whether the CFTC should consider issuing new rules for OTC derivatives.⁶⁵⁹

The Concept Release stated that the CFTC did not have any “preconceived result in mind.”⁶⁶⁰ However, the CFTC pointed out that “the explosive growth in the OTC market in recent years has been accompanied by an increase in the number and size of losses even among large and sophisticated users” of derivatives.⁶⁶¹ Those losses and other problems indicated “the need to review the current exemptions” for OTC derivatives under the CFTC’s 1993 rule, and to consider whether the CFTC should modify those exemptions in order “to enhance the fairness, financial integrity, and efficiency of this market.”⁶⁶²

Rubin, Greenspan, and Levitt responded to the Concept Release by issuing a “blistering” joint statement.⁶⁶³ The three officials expressed “grave concerns” about the Concept Release, and they “seriously question[ed] the CFTC’s jurisdiction in this area.”⁶⁶⁴ The three officials were “very concerned” that the Concept Release would “increase the legal uncertainty concerning certain types of OTC derivatives.”⁶⁶⁵

Despite the strong opposition voiced by Rubin, Greenspan, and Levitt, Brooksley Born refused to withdraw the CFTC’s Concept Release.⁶⁶⁶ ISDA and its allies immediately began to lobby Congress for legislation that would impose a moratorium on the CFTC’s authority to regulate OTC derivatives.⁶⁶⁷ The Treasury, Fed, and SEC

⁶⁵⁷ See Peter S. Goodman, *Taking a Hard New Look at a Greenspan Legacy*, N.Y. TIMES (Oct. 8, 2008), <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?mcubz=>.

⁶⁵⁸ 1998 CFTC Concept Release, *supra* note 271.

⁶⁵⁹ *Id.*

⁶⁶⁰ *Id.* at 26,114.

⁶⁶¹ *Id.* at 26,119.

⁶⁶² *Id.*; see also *supra* notes 273–75 and accompanying text (discussing the CFTC’s 1993 exemption rule).

⁶⁶³ Anthony Faiola et al., *What Went Wrong*, WASH. POST (Oct. 15, 2008), <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/14/AR2008101403343.html>; see also MCLEAN & NOCERA, *supra* note 128, at 105–06.

⁶⁶⁴ Joint Statement by Treasury Secretary Robert E. Rubin, Federal Reserve Chairman Alan Greenspan and Securities and Exchange Commission Chairman Arthur Levitt (May 7, 1998), 1998 WL 240809.

⁶⁶⁵ *Id.*

⁶⁶⁶ See, e.g., Faiola et al., *supra* note 663.

⁶⁶⁷ See, e.g., *id.*; see also MCLEAN & NOCERA, *supra* note 128, at 106.

eagerly supported the proposed moratorium. At a Senate hearing in July 1998, Treasury Deputy Secretary Lawrence Summers declared that the “dramatic growth of the [OTC] market in recent years is testament not merely to the dynamism of modern financial markets but to the benefits that derivatives provide for American businesses.”⁶⁶⁸ Summers argued that the CFTC’s Concept Release “cast the shadow of regulatory uncertainty over an otherwise thriving market” and created “the risk that the U.S. will see its leadership position in derivatives erode” as dealers and end-users moved their derivatives activities to foreign countries.⁶⁶⁹ He maintained that there was “no clear evidence of a need for additional regulation of the institutional OTC derivatives market,” because “parties to these kinds of contract[s] are largely sophisticated financial institutions that would appear to be eminently capable of protecting themselves from fraud and counterparty insolvencies and . . . are already subject to basic safety and soundness regulation under existing banking and securities laws.”⁶⁷⁰

Greenspan testified at the same Senate hearing, and he fully concurred with Summers’ views.⁶⁷¹ Greenspan contended that “aside from safety and soundness regulation of derivatives dealers under the banking or securities laws, regulation of derivatives transactions that are privately negotiated by professionals is unnecessary.”⁶⁷² To support that claim, Greenspan declared:

Professional counterparties to privately negotiated contracts . . . have demonstrated their ability to protect themselves from losses from fraud and counterparty insolvencies. They have managed credit risks quite effectively through careful evaluation of counterparties, the setting of internal credit limits, and judicious use of netting and collateral agreements. In particular, they have insisted that dealers have financial strength sufficient to warrant a credit rating of A or higher.⁶⁷³

⁶⁶⁸ Treasury Deputy Secretary Lawrence H. Summers Testimony Before the Senate Committee on Agriculture, Nutrition, and Forestry on the CFTC Concept Release (July 30, 1998), 1998 WL 459547.

⁶⁶⁹ *Id.*

⁶⁷⁰ *Id.*

⁶⁷¹ *See, e.g.*, Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Before the Committee on Agriculture, Nutrition, and Forestry (July 30, 1998), 1998 WL 427687 (F.R.B.).

⁶⁷² *Id.*

⁶⁷³ *Id.* SEC Chairman Arthur Levitt also testified at the July 1998 Senate hearing. He praised OTC derivatives as reflections of “the unique strength and

Two months later, the crisis surrounding Long-Term Capital Management (LTCM) revealed that Summers' and Greenspan's faith in the effectiveness of market discipline for OTC derivatives was completely unfounded.⁶⁷⁴ LTCM, a prominent hedge fund, was founded in 1994 by "a dazzling array of partners," including Nobel Prize laureates Myron Scholes and Robert Merton.⁶⁷⁵ Together with Fischer Black, Scholes and Merton pioneered "the modern option pricing and risk management theories" that underlay much of the OTC derivatives market.⁶⁷⁶ LTCM's other founders included former Fed vice chairman David Mullins and John Meriweather, the leader of Salomon Brothers' "legendary" bond-trading team during the 1980s.⁶⁷⁷ Meriweather recruited several members of that team to join him at LTCM.⁶⁷⁸

LTCM produced large profits between 1994 and 1997 by using highly-leveraged, speculative trading strategies that relied heavily on OTC derivatives.⁶⁷⁹ LTCM's profits "caused the fund's investors, lenders, and counterparties to ask few questions about the risks inherent in its capital position and trading strategy."⁶⁸⁰ In early 1998, LTCM held about \$5 billion in equity capital, while "its huge investment portfolio included \$125 billion of securities, including large amounts of debt securities borrowed from commercial and investment banks under repurchase agreements and derivatives having aggregate notional values of \$1.25 trillion."⁶⁸¹

LTCM's "primary strategy" during 1998 was to make

innovation of American capital markets," and he argued that Congress should block any attempt by the CFTC to regulate OTC derivatives because "imposition of new regulatory costs also may stifle innovation and push transactions offshore." Testimony of Chairman Arthur Levitt Before the Senate Committee on Agriculture, Nutrition, and Forestry, concerning the Regulation of the Over-the-Counter Derivatives Market and Hybrid Instruments (July 30, 1998), 1998 WL 468780 (S.E.C.).

⁶⁷⁴ Wilmarth, *Transformation*, *supra* note 25, at 346–49, 358–61, 370–72.

⁶⁷⁵ *Id.* at 346.

⁶⁷⁶ *Id.*

⁶⁷⁷ *Id.*

⁶⁷⁸ *Id.*; see also PARTNOY, *supra* note 644 at 86, 110–11 (describing LTCM's formation); see also Opening Statement of Chairwoman Marge Roukema, Financial Institutions and Consumer Credit Subcommittee of the House Committee on Banking and Financial Services (Mar. 24, 1999) 1999 WL 179223 (stating that "LTCM was considered to be the Cadillac of Hedge Funds. It had star quality.").

⁶⁷⁹ Wilmarth, *Transformation*, *supra* note 25, at 346.

⁶⁸⁰ *Id.* at 346–47.

⁶⁸¹ *Id.*; see also DEP'T OF TREAS. ET AL., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 11–12, 14–16, 30–31 (1999) [hereinafter PWGFM, *Hedge Funds*] (describing LTCM's financial position in 1998).

“‘convergence-arbitrage’ trades, in which it sought to take advantage of . . . pricing discrepancies between higher-risk, private-sector debt securities and lower-risk government bonds in both domestic and overseas markets.”⁶⁸² LTCM expected that global market conditions would improve in 1998, due to the positive effects of rescue programs organized by the International Monetary Fund (IMF) and major industrial nations for East Asian countries that encountered severe difficulties in 1997.⁶⁸³ LTCM believed that credit spreads between risky and “safe” bonds would narrow in 1998, and the fund also “aggressively sold equity options because it believed that volatility in the equity markets would decline.”⁶⁸⁴ The fund's traders based their trading positions on “value at risk” (VAR) models derived from Scholes’ and Merton’s theoretical work.⁶⁸⁵ LTCM’s models indicated that disruptive events like a sovereign bond default or a stock market crash were very unlikely to occur in 1998.⁶⁸⁶

In August 1998, Russia devalued the ruble and defaulted on debt owed to foreign creditors.⁶⁸⁷ The IMF did not intervene with a rescue package, as many market participants expected.⁶⁸⁸ Russia’s devaluation and debt default “triggered a global ‘flight to quality’ as investors frantically sought to buy ‘safe’ and highly liquid securities (especially U.S. treasury bonds) while unloading their positions in illiquid, high-risk securities or related derivatives. Yield spreads between high-risk and low-risk debt securities widened dramatically, and the volatility of equity markets soared.”⁶⁸⁹ Those events dealt “a fatal blow to LTCM’s ‘convergence’ strategy” and doomed the fund.⁶⁹⁰ Scholes later admitted that “the VAR models used by LTCM and other major financial institutions had failed to anticipate the ‘liquidity risk’ that suddenly appeared in August 1998.”⁶⁹¹

By mid-September, LTCM had lost \$4.4 billion of its capital and

⁶⁸² Wilmarth, *Transformation*, *supra* note 25, at 347.

⁶⁸³ *Id.* at 310–12, 312 n.391, 347.

⁶⁸⁴ *Id.* at 347.

⁶⁸⁵ *Id.*

⁶⁸⁶ *Id.*; see also PWGFM, *Hedge Funds*, *supra* note 681, at 11–12, 15–16 (describing LTCM’s trading strategy in 1998).

⁶⁸⁷ Wilmarth, *Transformation*, *supra* note 25, at 236, 312 n.391, 347–48.

⁶⁸⁸ *Id.*

⁶⁸⁹ *Id.* at 348.

⁶⁹⁰ *Id.*

⁶⁹¹ *Id.*; see also Rüdiger Fahlenbach, et al., *This Time Is the Same: Using Bank Performance in 1998 to Explain Bank Performance During the Recent Financial Crisis* 7–8 (Charles A. Dice Center Working Paper 2011-10, June 2011), <http://ssrn.com/abstract=1779406> (describing the global financial crisis triggered by Russia's devaluation and default).

appealed to the Fed for help.⁶⁹² The Fed concluded that “a failure by LTCM to fulfill its derivatives contracts and securities repurchase agreements could paralyze global financial markets” by setting off a “chain reaction of failures among large [derivatives] dealers” as well as panicked, “fire-sale” liquidations of securities and other financial assets connected to OTC derivatives.⁶⁹³ Federal regulators also determined that a number of major banks and securities firms had engaged in “herd behavior” by attempting to copy LTCM’s trades, and those institutions were exposed to the same types of losses that crippled LTCM.⁶⁹⁴ Regulators feared that LTCM’s failure could create a systemic crisis in global financial markets and could threaten the survival of large banks and securities firms.⁶⁹⁵

To forestall such a crisis, the Fed took the extraordinary action of cutting short-term interest rates three times in seven weeks.⁶⁹⁶ The Fed also arranged an emergency rescue of LTCM by fourteen of the largest U.S. banks and securities firms.⁶⁹⁷ The rescue group injected \$3.6 billion of new capital into LTCM in return for ninety percent of the fund’s equity.⁶⁹⁸ The LTCM debacle confirmed “prior warnings that the rapid growth of OTC derivatives would aggravate systemic risk in the financial markets.”⁶⁹⁹ The LTCM crisis also demonstrated that neither regulators nor market participants understood the location, magnitude, or potential correlations of LTCM’s risk exposures in OTC derivatives.⁷⁰⁰ The near collapse of AIG in 2008 revealed the same type of risk assessment failures by regulators and market participants.⁷⁰¹

The 1998 financial crisis inflicted severe losses on Citigroup, BofA, Bankers Trust, and a number of other domestic and foreign financial conglomerates.⁷⁰² Given the weakened condition of large

⁶⁹² Wilmarth, *Transformation*, *supra* note 25, at 348.

⁶⁹³ *Id.* at 370–72.

⁶⁹⁴ *Id.* at 349.

⁶⁹⁵ MCLEAN & NOCERA, *supra* note 128, at 106–07; PARTNOY, *supra* note 643, at 251–63 (describing LTCM’s plight and the potential consequences of LTCM’s failure); Wilmarth, *Transformation*, *supra* note 25, at 348–49, 370–71 (same).

⁶⁹⁶ Wilmarth, *Transformation*, *supra* note 25, at 236–37.

⁶⁹⁷ *Id.* at 348, 371.

⁶⁹⁸ *Id.*

⁶⁹⁹ *Id.* at 372; *see also* PWGFM, *Hedge Funds*, *supra* note 681, at 12–14, 17–21 (describing the concerns about systemic risk that led to the rescue of LTCM).

⁷⁰⁰ MCLEAN & NOCERA, *supra* note 128, at 107; PWGFM, *Hedge Funds*, *supra* note 681, at 14–16; Wilmarth, *Transformation*, *supra* note 25, at 348–49, 358–59, 376–77; *see also* PARTNOY, *supra* note 644, at 228–29.

⁷⁰¹ FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 139–42, 243–44, 265–74, 346–52, 376–79.

⁷⁰² Wilmarth, *Transformation*, *supra* note 25, at 348–49, 375–77.

financial institutions and the highly-stressed circumstances in many financial markets, the Fed felt obliged to take extraordinary measures to prevent the crisis from becoming a full-fledged global financial panic.⁷⁰³

In my view, the 1998 crisis should be viewed as a precursor and dress rehearsal for the global financial crisis of 2007–09. However, market participants and policymakers failed to apply the lessons they should have learned from the 1998 crisis, and they did not build adequate defenses to deal with the next decade’s crisis. A 2011 study determined that large banks and securities firms that suffered the greatest declines in stock market value during the 1998 crisis also recorded the worst stock market performances in 2007 and 2008.⁷⁰⁴ Thus, large financial institutions that incurred severe losses in 1998 “d[id] not appear to subsequently alter the[ir] business model or to become more cautious regarding their risk culture” prior to the outbreak of the global financial crisis in 2007.⁷⁰⁵ The extraordinary measures that the Fed took in 1998 to stabilize financial markets and to help rescue LTCM may have caused large banks and securities firms to believe that they did not need to change their business models or risk profiles.⁷⁰⁶ They may well have expected that the Fed would intervene to protect major financial firms during any similar future crisis.⁷⁰⁷

Similarly, the Financial Crisis Inquiry Commission determined that the 1998 financial crisis (i) did not persuade large financial institutions to make any significant changes in the high-risk strategies that caused them to incur severe losses in 1998, and (ii) did not cause financial regulators to insist on such changes by the institutions they

⁷⁰³ *Id.* at 236–37, 348–49, 370–72, 375–77, 470–71 (discussing the Fed’s responses to the severe threats to financial stability created by the 1998 crisis); *see also* PWGFM, *Hedge Funds*, *supra* note 681, at 12–14, 17–21 (same).

⁷⁰⁴ *See* Fahlenbach et al., *supra* note 691, at 12–14 (explaining that the worst performers during both periods were institutions that grew faster, operated with higher leverage, and relied more heavily on short-term financing).

⁷⁰⁵ *Id.* at 25 (alteration in original).

⁷⁰⁶ *See id.* at 15.

⁷⁰⁷ *See id.* (finding that the connection between bad performance in 1998 and similarly poor performance in 2007–08 was stronger among large financial institutions, suggesting that big institutions assumed they were TBTF and “felt less compelled to change their business model after the 1998 crisis, because they were reasonably certain to receive federal assistance during the next crisis”); *see also* FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 58 (quoting prominent bankruptcy attorney Harvey Miller, who stated that market participants “expected the Fed to save Lehman [in 2008], based on the Fed’s involvement in LTCM’s rescue”).

supervised.⁷⁰⁸ A reasonable observer might well conclude that the 1998 crisis was the dead canary in the mine, or the tree falling in the forest, that advocates of “financial modernization” were determined neither to see nor hear.

Someone who knew nothing about the politics of OTC derivatives might reasonably assume that the LTCM debacle would have caused the Clinton Administration and Congress to join with Brooksley Born in crafting new regulations to control the risks of OTC derivatives. Of course, nothing like that happened. Only a few policymakers publicly agreed with Born that LTCM’s collapse demonstrated the need for new rules governing OTC derivatives.⁷⁰⁹ Opponents of stronger regulation dismissed any connection between LTCM’s failure and either (i) LTCM’s enormous positions in OTC derivatives or (ii) the absence of regulation for OTC derivatives.⁷¹⁰ The derivatives lobby “besieged Congress with appeals” to block the CFTC from adopting any new regulations for OTC derivatives, and Congress quickly imposed a temporary moratorium on such measures.⁷¹¹

⁷⁰⁸ FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 56–59, 60–61.

⁷⁰⁹ Faiola, *supra* note 663; Goodman, *supra* note 657.

⁷¹⁰ *Id.*; MCLEAN & NOCERA, *supra* note 128, at 107–08. *Compare* Testimony of Brooksley Born, Chairperson, Commodity Futures Trading Commission, Before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises of the Committee on Banking and Financial Services (Mar. 25, 1999), 1999 WL 191046 (stating “[t]he LTCM episode demonstrates the unknown risks that the OTC derivatives market may pose to the U.S. economy and to financial stability around the world. It illustrates the lack of transparency, excessive leverage, and insufficient prudential controls in this market as well as the need for greater coordination and cooperation among domestic and international regulators.”), *with* Coalition of OTC Derivatives Dealers, Testimony of a Coalition of Investment and Commercial Banks regarding Commodity Exchange Act Reauthorization before the Subcommittee on Risk Management, Research and Specialty Crops, United States House of Representatives (May 20, 1999), 1999 WL 321618 (contending that “[n]o case has been made that additional specific regulation of [OTC derivatives dealers] is necessary or would provide any significant benefit. Market discipline has generally had a significant positive impact on participants in these markets. Although the events of last year demonstrate that there have been private sector lapses in credit risk management discipline, these weaknesses were not in any way associated with the presence or absence of federal oversight.”), *and* Opening Statement of Senator Dick Lugar, Senate Agriculture Committee CFTC Hearing (Dec. 16, 1998), 1998 WL 876994 (stating that “I find little evidence to suggest that LTCM’s troubles arose primarily from the firm’s use of swaps. Excessive leverage and lax lending standards seem to have played a more significant role.”).

⁷¹¹ *See* FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 47–48; MCLEAN & NOCERA, *supra* note 128, at 107–08; Stout, *supra* note 16, at 20–21; Opening

Congress requested reports on the LTCM crisis and the regulation of OTC derivatives from the President's Working Group on Financial Markets (PWGFM or the Working Group).⁷¹² The Working Group included the heads of the Treasury, Fed, SEC, and CFTC.⁷¹³ Before the Working Group issued its reports, Greenspan staked out his position in a speech he presented to a derivatives trade group in March 1999.⁷¹⁴ In that speech, Greenspan declared that OTC derivatives represented "[b]y far the most significant development in finance during the past decade."⁷¹⁵ He praised OTC derivatives for "enhanc[ing] the process of wealth creation" by creating the "ability to differentiate risk and allocate it to those investors most able and willing to take it."⁷¹⁶ He also lauded "the profitability of derivative products" for boosting the earnings of major banks and for contributing to "the significant gain in the overall finance industry's share of American corporate output during the past decade."⁷¹⁷

Greenspan acknowledged that losses from derivatives "rose to record levels in the third quarter of 1998."⁷¹⁸ However, he argued, "[d]erivative instruments were bystanders [and] were scarcely the major players" during the 1998 crisis.⁷¹⁹ He also contended that "there are fundamental strengths in [the derivatives] markets," and "there has not been a significant downturn in the economy overall that has tested the resilience of derivatives markets."⁷²⁰ Greenspan's speech never specifically mentioned either LTCM or the emergency rescue of LTCM arranged by the Fed.⁷²¹

Statement of Senator Dick Lugar, *supra* note 710; Faiola et al., *supra* note 663.

⁷¹² See PWGFM, *Hedge Funds*, *supra* note 681; PWGFM, *Over-the-Counter Derivatives*, *supra* note 258.

⁷¹³ See PWGFM, *Hedge Funds*, *supra* note 681, at 1; PWGFM, *Over-the-Counter Derivatives*, *supra* note 258, at 1.

⁷¹⁴ See Greenspan, *supra* note 627.

⁷¹⁵ *Id.*

⁷¹⁶ *Id.*

⁷¹⁷ *Id.*

⁷¹⁸ *Id.*

⁷¹⁹ *Id.*

⁷²⁰ *Id.*

⁷²¹ See generally, Greenspan, *supra* note 627 (making no mention of LTCM or its rescue). As indicated *supra* in the text accompanying notes 718–20, Greenspan's speech included a few general references to the OTC derivatives crisis of 1998. Greenspan also admitted that the standard VAR models used by derivatives dealers and end-users did not predict the losses that they incurred during the East Asian and Russian crises of 1997–98. Greenspan noted that VAR models did not capture "the extreme negative tail that reflects the probability of occurrence of a panic." However, he rejected the idea that regulators should "abandon models-based approaches to regulatory capital and return to traditional approaches based on regulatory risk management schemes." Instead, he recommended "incentives for

continued . . .

Given the substance and tone of Greenspan's speech, it is not surprising that both of the Working Group's reports minimized the role played by derivatives in LTCM's failure, and the second report recommended a sweeping deregulation of OTC derivatives.⁷²² The Working Group's first report, issued in April 1999, assigned primary blame for LTCM's "near collapse" to its "excessive leverage," and the report described LTCM's massive positions in OTC and exchange-graded derivatives only in general terms, with relatively few details.⁷²³ The report focused mainly on LTCM's "opaqueness and low degree of external monitoring," which resulted from (i) the "minimal scrutiny" of LTCM's risk profile and trading strategies by investors, creditors, and counterparties, and (ii) the "minimal information" that LTCM provided to those parties.⁷²⁴

The Working Group determined that "none of [LTCM's] investors, creditors, or counterparties provided an effective check on its overall activities."⁷²⁵ The report also concluded that "[t]he risk management weaknesses revealed by the LTCM episode were not unique to LTCM" and also occurred, "albeit to a lesser degree, in . . . investment and commercial banks."⁷²⁶ Thus, the Working Group's first report revealed that market discipline failed to restrain excessive risk-taking by LTCM and also failed to protect leading banks and securities from suffering heavy losses.⁷²⁷ Nevertheless, the Working Group declared that market discipline should remain the "primary mechanism that regulates risk-taking by firms in a market economy."⁷²⁸ In the Working Group's view, "market discipline of risk-taking is the rule and government regulation is the exception. . . . Any resort to government regulation should have a clear purpose and should be

banks to enhance their risk modeling procedures[.]" *Id.* In his 1999 derivatives speech, as on so many other occasions, Greenspan expressed a strong preference for a supervisory approach that relied primarily on the internal risk management procedures of banks as well as market discipline. *Id.*; see also Alan Greenspan, Remarks at the International Conference of Banking Supervisors (June 13, 1996) (stating that "the same technology and innovation that is driving supervisors to focus on [bank] management processes will, through the development of market structures and responses, do much of our job of ensuring safety and soundness. We should be careful not to impeded the process.").

⁷²² See generally PWGFM, *Hedge Funds*, *supra* note 681 (discussing LTCM); PWGFM, *Over-the-Counter Derivatives*, *supra* note 258 (urging Congress to deregulate OTC derivatives).

⁷²³ PWGFM, *Hedge Funds*, *supra* note 681, at 11–12, 14–18.

⁷²⁴ *Id.* at 14–15.

⁷²⁵ *Id.* at 16.

⁷²⁶ *Id.* at 16, 31.

⁷²⁷ See *id.* at 14–16.

⁷²⁸ *Id.* at 25.

carefully evaluated in order to avoid unintended outcomes.”⁷²⁹

The Working Group's first report acknowledged that LTCM “held very substantial OTC derivatives positions related to reference assets that were not actively traded” and for which there “was little liquidity . . . even under normal circumstances.”⁷³⁰ The report also pointed out that LTCM's counterparties would have faced significant losses if LTCM had defaulted on OTC derivatives that were “illiquid” and “difficult to hedge or liquidate.”⁷³¹ However, the report did not recommend any new substantive rules to address the risks created by high concentrations of illiquid OTC derivatives held by either dealers or end-users.⁷³²

The Working Group's strong ideological commitment to market discipline — in the face of abundant evidence showing that such discipline failed in 1998 — helps to explain why its first report did not recommend any new substantive controls for OTC derivatives. Instead, the report recommended measures to “constrain excessive leverage” through enhanced disclosures and improved risk management practices.⁷³³ In keeping with the Working Group's distaste for substantive regulation, the report rejected any “direct constraints on leverage” and instead called for better “credit-risk management.”⁷³⁴

The Working Group's second report, issued in November 1999, urged Congress to approve a comprehensive deregulation of OTC derivatives.⁷³⁵ In cover letters addressed to congressional leaders, the Working Group lauded the benefits of OTC derivatives and warned that the dominant position of U.S. derivatives dealers would be threatened unless Congress removed the “cloud of legal uncertainty” that surrounded OTC derivatives:

⁷²⁹ *Id.* at 25, 26.

⁷³⁰ *Id.* at 18.

⁷³¹ *Id.* at 18, 19, 20–21.

⁷³² *See id.* at 29–40.

⁷³³ *Id.* (explaining that PWGFM's proposals included: (i) requiring hedge funds to provide “more frequent and meaningful information” to the public; (ii) requiring publicly-traded companies to disclose additional information about their “material financial exposures to significantly leveraged institutions”; (iii) encouraging financial institutions to improve their risk management policies and practices; (iv) adopting “more risk-sensitive but prudent approaches to capital adequacy”; and (v) empowering the Treasury, SEC, and CFTC to obtain information about the risks of “unregulated affiliates” of securities broker-dealers and futures commission merchants.); *id.* at 39 n.23 (stating Greenspan did not endorse the last of those proposals).

⁷³⁴ *Id.* at 24.

⁷³⁵ PWGFM, *Over-the-Counter Derivatives*, *supra* note 258.

One of the most dramatic changes in the world of finance during the past fifteen years has been the extraordinary development of the markets for financial derivatives. Over-the-counter derivatives have transformed the world of finance, increasing the range of financial products available to corporations and investors and fostering more precise ways of understanding, quantifying, and managing risk . . .

A cloud of legal uncertainty has hung over the OTC derivatives markets in the United States in recent years, which, if not addressed, could discourage innovation and growth in these important markets and damage U.S. leadership in these arenas by driving transactions off-shore.⁷³⁶

The Working Group called on Congress to exclude OTC derivatives between “sophisticated counterparties” from regulation by the CFTC under the CEA, whether the transactions were completed through privately-negotiated transactions or electronic trading systems or other clearing systems.⁷³⁷ The report also recommended exemptions from CFTC regulation for most “hybrid instruments,” including deposits or securities that contained features similar to swaps, forwards, options, or futures.⁷³⁸ The Working Group declared that the proposed exemptions were essential to remove “legal uncertainty” about OTC derivatives and to “provide a permanent clarification of the legal status of these instruments.”⁷³⁹

Echoing arguments previously made by Greenspan and Summers, the Working Group’s second report contended that “sophisticated counterparties” in OTC derivatives transactions did not need regulatory protection because most dealers were already subject to adequate supervision by bank regulators, the SEC, or the CFTC.⁷⁴⁰ The report also maintained that “[m]ost OTC derivatives are not susceptible to manipulation” because their payoffs were based on an underlying “rate or price determined by a separate, highly liquid market.”⁷⁴¹ The report further claimed that derivatives did not affect prices in other markets because “prices established in OTC derivatives

⁷³⁶ *Id.* (including text of cover letters from the Working Group to Speaker of the House J. Dennis Hastert and Vice President Al Gore (as President of the Senate)).

⁷³⁷ *Id.* at 2, 15–19.

⁷³⁸ *Id.* at 2, 28–29.

⁷³⁹ *Id.* at 1–2, 12–13.

⁷⁴⁰ *Id.* at 15–16.

⁷⁴¹ *Id.* at 16.

transactions do not serve a significant price discovery function.”⁷⁴² The Working Group's conclusions that OTC derivatives did not need to be regulated, could not be used for manipulative purposes, and would not affect prices in related markets proved to be very grave miscalculations.

Like its first report, the Working Group's second report stated that regulators should rely on “private counterparty discipline” as the “primary mechanism” for ensuring that OTC derivatives dealers did not create “systemic risk.”⁷⁴³ Despite the first report's conclusion that market discipline failed to restrain highly-leveraged and speculative risk-taking by LTCM, the second report asserted that “private counterparty credit risk management has been employed effectively by both regulated and unregulated dealers of OTC derivatives, and the tools required by federal regulators [to supplement market discipline] already exist.”⁷⁴⁴ Except for two brief references, the Working Group's second report did not mention LTCM and did not contain any discussion of lessons learned from the LTCM crisis.⁷⁴⁵ It appeared that members of the Working Group had already expunged the LTCM fiasco from their collective memories.

Armed with the support provided by the Working Group's second report, the derivatives industry and its political allies mounted a successful campaign to enact CFMA.⁷⁴⁶ The only significant question

⁷⁴² *Id.*

⁷⁴³ PWGFM, *Hedge Funds*, *supra* note 681, at 25; PWGFM, *Over-the-Counter Derivatives*, *supra* note 258, at 34.

⁷⁴⁴ PWGFM, *Over-the-Counter Derivatives*, *supra* note 258, at 34. The Working Group qualified its reliance on market discipline only in one respect, by repeating the recommendation from its first report that the Treasury, SEC, and CFTC should receive broader authority to obtain information from “unregulated affiliates” of securities broker-dealers and futures commission merchants. *Id.* at 16, n.40, 34–35 (noting that Greenspan declined to endorse the Working Group's recommendation).

⁷⁴⁵ *Id.* at 16 n.40, 34–35 (referring briefly to the PWGFM's first report on LTCM and hedge funds).

⁷⁴⁶ Faiola et al., *supra* note 663; Lipton & Labaton, *supra* note 588; *see also* Regulation of Derivatives, Before the S. Comm. On Agric., Nutrition & Forestry, 106th Cong. (2000) (statement of Richard E. Grove, Chief Executive Officer, International Swaps & Derivatives Association, Inc.) (stating “ISDA believes that the [PWGFM] Report should serve as a catalyst for the enactment of bipartisan legislation in 2000 to . . . clarify that swaps transactions generally are not subject to regulation under the CEA”); 146 CONG. REC. E1939–41 (daily ed. Oct. 25, 2000) (remarks of Sen. Harkin) (reprinting letters of support for CFMA from a wide range of large banks and securities firms, financial industry trade groups, and corporate

continued . . .

was how broad the scope of CFMA's deregulation should be. Senator Phil Gramm was not satisfied with the bills that emerged from House and Senate committees.⁷⁴⁷ Those bills excluded OTC derivatives from regulation by the CFTC, but Gramm was greatly concerned that the SEC might attempt to regulate OTC derivatives.⁷⁴⁸ Gramm put an extended hold on the legislation until congressional leaders and the Clinton Administration agreed on a final bill that was acceptable to him.⁷⁴⁹ Under CFMA's final version, OTC derivatives entered into by financial institutions, corporate end-users, institutional investors, or wealthy individuals were excluded from all substantive regulation by either the CFTC or SEC.⁷⁵⁰ In addition, OTC derivatives were protected from regulation under state laws.⁷⁵¹ The CFTC and SEC retained only a very limited authority to bring enforcement actions for fraud or manipulation on a case-by-case basis.⁷⁵²

The Working Group strongly endorsed the final version of CFMA. The Working Group praised CFMA for preserving the "competitive position" of the United States in OTC derivatives markets, and for "providing legal certainty and promoting innovation, transparency and efficiency in our financial markets."⁷⁵³

Senator Gramm agreed that CFMA would provide "legal certainty" for OTC derivatives.⁷⁵⁴ In addition, he argued, CFMA "completes the work of [GLBA]" and "protects financial institutions from over-regulation."⁷⁵⁵ Gramm declared that GLBA and CFMA had dismantled the post-New Deal system of financial regulation and established a new regime of comprehensive deregulation, which would enable U.S. financial institutions to dominate global financial markets:

end-users).

⁷⁴⁷ Faiola et al., *supra* note 663.

⁷⁴⁸ *Id.*; Garver, *Armey Pushes for Compromise on Swaps*, AM. BANKER (Sept. 27, 2000), <https://www.americanbanker.com/news/armey-pushes-for-compromise-on-swaps>; Lipton & Labaton, *supra* note 588.

⁷⁴⁹ Faiola et al., *supra* note 663; Garver, *supra* note 748; Lipton & Labaton, *supra* note 588.

⁷⁵⁰ FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 48; Stout, *supra* note 16, at 21–22.

⁷⁵¹ FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 48.

⁷⁵² Faiola et al., *supra* note 663; FIN. CRISIS INQUIRY COMM'N (2011), *supra* note 12, at 48. For additional discussions of CFMA's scope and impact, *see* 146 CONG. REC. S11,866–68 (daily ed. Dec. 15, 2000) (remarks of Sen. Gramm); 146 CONG. REC. S11,896 (daily ed. Dec. 15, 2000) (remarks of Sen. Harkin); 146 CONG. REC. S11,924–27 (daily ed., Dec. 15, 2000) (remarks of Sens. Lugar and Gramm).

⁷⁵³ 146 CONG. REC. S11,897 (daily ed. Dec. 15, 2000) (remarks of Sen. Harkin) (reprinting letter dated Dec. 15, 2000, from Treasury Secretary Summers, SEC Chairman Levitt, Fed Chairman Greenspan, and CFTC Chairman William Rainer).

⁷⁵⁴ 146 CONG. REC. S11,866 (daily ed. Dec. 15, 2000) (remarks of Sen. Gramm).

⁷⁵⁵ *Id.*

Taken together with the Gramm-Leach-Bliley Act, the work of this Congress will be seen as a watershed, where we turned away from the outmoded Depression-era approach to financial regulation and adopted a framework that will position our financial services industries to be world leaders into the new century.⁷⁵⁶

IV. CONCLUSION

Riegle-Neal, GLBA and CFMA were highly consequential laws. Those three laws allowed large banks to become much bigger and more complex, and to undertake a much wider array of high-risk activities. They transformed the U.S. financial industry from a decentralized system of independent financial sectors, with specialized financial institutions, into a highly consolidated industry dominated by large financial conglomerates. The big-bank lobby and its political allies secured passage of Riegle-Neal, GLBA, and CFMA through a carefully-planned campaign, and not by accident. All three laws reflected an ideology of comprehensive deregulation, and they provided a blueprint for light-touch supervision based on a declared faith in the wisdom and self-healing properties of untrammelled financial markets.

The prevailing ideology of deregulation was clearly articulated in the 1991 Treasury report as well as public interviews, speeches, and testimony by policymakers like Phil Gramm, Alan Greenspan, Robert Rubin, and Lawrence Summers, and financial industry leaders like Walter Wriston and Sandy Weill. The ideology of deregulation was not consistent, and it was arguably disingenuous. Policymakers and industry leaders recognized that large financial conglomerates were likely to benefit from (i) transfers of federal safety-net subsidies from conglomerate-owned banks to their securities and insurance affiliates, and (ii) the TBTF subsidy. However, whenever Congress or federal regulators faced a choice between limiting the spread of public subsidies or granting more profit-making opportunities to big banks and Wall Street, the big banks and Wall Street almost always prevailed.⁷⁵⁷

The ideology of deregulation clearly served the interests of large financial institutions, and their power and influence grew in response to all three statutes. Riegle-Neal enabled the largest banks to expand

⁷⁵⁶ *Id.*

⁷⁵⁷ *See supra* notes 220, 434–41, 527–31, 571, 593–602, 619–22 and accompanying text.

throughout the nation, thereby increasing their political advantage over smaller banks, securities firms, and insurance companies.⁷⁵⁸ Major securities firms and insurance companies joined the campaign to enact GLBA when they realized they could not prevent big banks from extending their reach into securities and insurance markets. All three financial sectors supported CFMA because it allowed the largest financial institutions to conduct their OTC derivatives businesses free of any substantive regulation. The enactment of GLBA and CFMA in consecutive years showed just how powerful the emerging financial conglomerates had become.⁷⁵⁹

I disagree with scholars who contend that GLBA and CFMA did not play important roles in promoting the reckless credit boom that led to the financial crisis. Those analysts maintain that GLBA and CFMA merely ratified what federal regulators and courts had already done in permitting large financial institutions to expand the scope of their financial activities before 1999.⁷⁶⁰ As discussed above in Part II.B, regulators and courts issued rulings during the 1980s and 1990s that opened loopholes in Glass-Steagall's and BHCA's structural barriers and granted exemptions from regulation for OTC derivatives.⁷⁶¹ However, those loopholes and exemptions rested on highly contestable legal interpretations and could have been reversed by either regulators or the courts. In addition, the drafters of the 1991 Treasury plan and advocates for GLBA and CFMA argued that the loopholes and exemptions were incomplete, burdensome, inefficient, and unacceptable.⁷⁶²

The proponents of GLBA and CFMA declared that both statutes were urgently needed to provide "legal certainty" for a deregulated regime of universal banking that could (i) incorporate all types of financial activities within a "one-stop shopping" platform, and (ii) offer a full range of OTC derivatives without any substantive regulation by the CFTC or SEC.⁷⁶³ It is highly unlikely that the largest financial institutions and their trade associations would have pursued a twenty-year legislative campaign, involving hundreds of millions of dollars in lobbying expenses and political campaign contributions, if they had viewed GLBA and CFMA as insignificant laws. The

⁷⁵⁸ See *supra* note 505–18 and accompanying text.

⁷⁵⁹ See *supra* notes 536–43, 577–89, 746–56 and accompanying text.

⁷⁶⁰ See Mahoney, *supra* note 7, at 17–18, 27–29, 34–38; Markham, *supra* note 7, at 1082, 1118–28, 1134; Wallison, *supra* note 7, at 5–14; White, *supra* note 7, 940–46.

⁷⁶¹ See *supra* Part II.B.

⁷⁶² See *supra* note 521–24, 562–69, 584–88, 736–39, 746–56 and accompanying text.

⁷⁶³ See *supra* notes 562–69, 583–88, 736–39, 746–56 and accompanying text

evidence clearly points to the contrary conclusion: namely, that big banks and Wall Street firms viewed GLBA and CFMA as essential components of their strategy to build giant financial conglomerates that could dominate domestic and global financial markets by exploiting their TBTF status and associated public subsidies.⁷⁶⁴

One very tangible way to confirm the significance of GLBA and CFMA is to see how quickly the financial industry changed in response to those statutes. GLBA expanded the previously-authorized securities and insurance activities of banking organizations by allowing banks to establish full-scale affiliations with securities firms and insurance companies.⁷⁶⁵ GLBA's first major dividend for big banks was to validate Citigroup's universal banking strategy.⁷⁶⁶ Without GLBA, Citigroup would have been forced to divest major segments of its nonbanking activities, and other banks could not have copied Citigroup's business model. GLBA created a second immediate benefit for big banks by permitting them to convert their limited Section 20 securities subsidiaries into full-service securities broker-dealers with many fewer operational constraints.⁷⁶⁷ A year after GLBA's enactment, a federal regulator observed, "Loopholes cost money . . . A top bank told me [GLBA] was a major boost to their bottom line."⁷⁶⁸

GLBA's endorsement for Citigroup's universal banking model quickly led to the creation of similar financial conglomerates. In 2000, Credit Suisse and UBS acquired large U.S. securities firms (Donaldson, Lufkin & Jenrette and Paine Webber), and Chase merged with JPMC to form a commercial and investment banking giant.⁷⁶⁹ Meanwhile, Deutsche Bank completed its acquisition of Bankers Trust (a U.S. bank with significant investment banking activities) in 1999.⁷⁷⁰

The top securities firms responded to the emergence of universal banks with their own consolidation and diversification strategies. Morgan Stanley merged with Dean Witter in 1997, while the four other major securities firms — Merrill Lynch, Goldman Sachs,

⁷⁶⁴ See *supra* Parts III.A, III.C, and III.D.

⁷⁶⁵ CARPENTER & MURPHY, *supra* note 5, at 15–20; Wilmarth, *Transformation*, *supra* note 25, at 219–20.

⁷⁶⁶ See Wilmarth, *Citigroup*, *supra* note 22, at 74–75.

⁷⁶⁷ Barbara Rehm, *No Merger Wave, But Money Saved*, AM. BANKER (Nov. 7, 2000) 2000 WLNR 2817824.

⁷⁶⁸ *Id.* (quoting an unnamed "federal regulator").

⁷⁶⁹ See Wilmarth, *Transformation*, *supra* note 25, at 252n.153, 323; see also Dunstan Prial, *Merger is Rich in Banking Heritage Chase Manhattan, J.P. Morgan Tie Knot*, ST. LOUIS POST DISPATCH, Sept. 14, 2000, at C1.

⁷⁷⁰ Wilmarth, *Transformation*, *supra* note 25, at 376–77; Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 977.

Lehman Brothers, and Bear Stearns — also grew rapidly in the late 1990s and early 2000s.⁷⁷¹ By 2004, the “Big Five” securities firms held combined assets of \$2.5 trillion, compared with \$4.7 trillion of assets held by the five largest U.S. banks.⁷⁷²

The four largest securities firms (all except Bear Stearns) complemented their securities activities with deposit-taking and lending by acquiring FDIC-insured thrifts and industrial banks (institutions that were *not* subject to BHCA’s ownership restrictions).⁷⁷³ Deposit-taking and lending allowed securities firms to obtain low-cost, government-subsidized funding and to compete more directly with large banks by providing credit to consumers and businesses. By 2006, the four largest securities firms had become “de facto universal banks.”⁷⁷⁴ Meanwhile, CFMA enabled leading banks and securities firms to deal in an extensive array of OTC derivatives, including CDS and synthetic CDOs.⁷⁷⁵

As I have shown in previous work, a group of eighteen domestic and foreign financial conglomerates “dominated global and U.S. markets for securities underwriting, securitizations, structured financial products, and OTC derivatives” by 2007.⁷⁷⁶ That group (which I have called the “big eighteen”) included the four largest U.S. banks (BofA, Citigroup, JPMC, and Wachovia), the “Big Five” U.S. securities firms, the largest U.S. insurer (AIG), and eight foreign universal banks (Barclays, BNP Paribas, Credit Suisse, Deutsche Bank, HSBC, RBS, Société Générale, and UBS).⁷⁷⁷ The “big eighteen” became the “epicenter” of the global financial crisis, as they accounted for three-fifths of the \$1.5 trillion of worldwide losses recorded by financial institutions from mid-2007 through the spring of 2010.⁷⁷⁸ Of the “big eighteen,” only Lehman failed outright, but twelve other institutions received massive amounts of financial assistance from government authorities in the United States, United

⁷⁷¹ See FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 55, 65–66, 150–51; Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 977.

⁷⁷² FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 150–51.

⁷⁷³ Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 977–80, 983–84.

⁷⁷⁴ *Id.* at 978; see also FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 56 (describing the “convergence of banks and securities firms” that enabled them to “compete directly” by the late 1990s).

⁷⁷⁵ See Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 991–94; see also FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 48–51; Stout, *supra* note 16, at 21–23.

⁷⁷⁶ Wilmarth, *Flawed and Inadequate Response*, *supra* note 68, at 966, n.45.

⁷⁷⁷ *Id.*; see also Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 975–94.

⁷⁷⁸ Wilmarth, *Flawed and Inadequate Response*, *supra* note 68, at 966–78.

Kingdom (UK), and European Union (EU).⁷⁷⁹

The ten American members of the “big eighteen” could never have achieved their size and scope in 2007 without the enactment of at least one of the three statutes (Riegle-Neal, GLBA, and CFMA) discussed in this article. Similarly, the eight foreign universal banks greatly expanded their size and scope in the UK, EU, and the United States in response to deregulation that occurred in all three regions.⁷⁸⁰ As Barry Eichengreen has observed, “[t]he result of [Riegle-Neal, GLBA, and CFMA] was a massive increase in the size, complexity, and leverage of US financial institutions. . . . [¶] And what was true of banks in the United States was similarly true of banks elsewhere, notably in Europe.”⁷⁸¹

A second way to confirm the very significant impact of GLBA and CFMA is to consider the explosive growth that occurred in markets for “shadow bank deposits,” securitization, and OTC derivatives after 2000. The volume of outstanding MMMFs increased from \$1.8 trillion in 2000 to \$3.8 trillion in 2007, and the commercial paper market grew from \$1.3 trillion to \$2 trillion during the same period.⁷⁸² Outstanding repos at securities broker-dealers (including affiliates of banks) rose from \$2.5 trillion to \$3.5 trillion between 2002 and 2007, while outstanding structured-finance securities issued in private-label securitizations expanded from \$1.6 trillion to \$5 trillion between 2001 and 2006.⁷⁸³ Most dramatically, the aggregate notional values of OTC derivatives in global markets exploded from \$95 trillion in 2000 to \$673 trillion in mid-2008, with U.S. financial institutions accounting for about two-fifths of that market.⁷⁸⁴ It seems highly improbable that

⁷⁷⁹ *Id.* at 957–59, 977–79; see also Wilmarth, *Two-Tiered System*, *supra* note 194, at 257–68 (providing additional details on the financial assistance given by U.S. authorities to the largest banks, securities firms, and AIG).

⁷⁸⁰ David T. Llewellyn, *Universal Banking and the Public Interest: A British Perspective*, in UNIVERSAL BANKING: FINANCIAL SYSTEM DESIGN RECONSIDERED 161–204 (Anthony Saunders & Ingo Walter eds., 1996) (discussing the impact of the UK’s deregulation in 1986–87, including the London Stock Exchange’s “Big Bang” reforms, which permitted the formation of universal banks in the UK); see also DALE, *supra* note 422, at 106–16; 156–72 (discussing the impact of the UK’s deregulation as well as the EU’s similar deregulation pursuant to the Second Banking Directive); Wilmarth, *Dark Side of Universal Banking*, *supra* note 29, at 976–77 (same).

⁷⁸¹ EICHENGREEN, *supra* note 1, at 73.

⁷⁸² See *supra* notes 122, 129 and accompanying text.

⁷⁸³ See *supra* notes 130, 133, 255 and accompanying text.

⁷⁸⁴ FIN. CRISIS INQUIRY COMM’N (2011), *supra* note 12, at 48–51; see also *supra* notes 362–65, 625–28 (describing the rapid growth of the OTC derivatives market and the significant shares of that market held by the largest U.S. banks and securities firms).

such dramatic growth could have occurred in all of those markets without the far-reaching deregulation authorized by GLBA and CFMA.⁷⁸⁵

John Reed and Sandy Weill, who co-founded Citigroup, subsequently renounced their brainchild.⁷⁸⁶ Reed apologized in 2009 for his role in creating Citigroup and said that Congress made a mistake when it repealed the Glass-Steagall Act in 1999.⁷⁸⁷ In a 2013 interview, Reed explained that “the greatest problem [in Citigroup] was of clashing cultures” between traders and commercial bankers.⁷⁸⁸ As the trading culture expanded, it was “infectious” and became the “more dominant” ethos within Citigroup.⁷⁸⁹ The trading culture “made risk harder to control,” and the complexity of Citigroup made it “harder to manage.”⁷⁹⁰ Paul Volcker agreed with Reed that the “cleavage between the culture on the investment banking side of the house and the traditional lending side of the house” was a “major worry” caused by universal banks.⁷⁹¹

In a 2010 interview, Sandy Weill defended his role as the “Shatterer of Glass-Steagall.”⁷⁹² However, his views had changed two years later.⁷⁹³ During a CNBC interview in 2012, Weill declared that policymakers should “split up investment banking from banking, have banks be deposit takers, have banks make commercial loans and real estate loans, have banks do something that’s not going to risk the taxpayer dollars, that’s not too big to fail.”⁷⁹⁴ He recommended that universal banks should be “broken up so that the taxpayer will never be at risk, the depositors won’t be at risk, the leverage of the banks will be something reasonable,” and so that independent investment banks could “make some mistakes” without causing systemic crises.⁷⁹⁵

Charles Mitchell, who built the first big universal bank at National City (Citigroup’s predecessor) during the 1920s,⁷⁹⁶ subsequently

⁷⁸⁵ EICHENGREEN, *supra* note 1 at 70–76; Stout, *supra* note 16, at 22–29.

⁷⁸⁶ Wilmarth, *Citigroup*, *supra* note 22, at 134–36.

⁷⁸⁷ John Authers, *Culture Clash Means Banks Must Split, Says Former Citi Chief*, FIN. TIMES (Sept. 8, 2013), <https://www.ft.com/content/2cfa6f18-1575-11e3-950a-00144feabdc0>.

⁷⁸⁸ *Id.*

⁷⁸⁹ *Id.* (quoting Reed).

⁷⁹⁰ *Id.* (quoting Reed).

⁷⁹¹ Feldstein, *supra* note 394, at 116 (quoting Volcker).

⁷⁹² Katrina Brooker, *Citi’s Creator, Alone With His Regrets*, N.Y. TIMES (Jan. 2, 2010), <http://www.nytimes.com/2010/01/03/business/economy/03weill.html>.

⁷⁹³ Kevin Wack, *Weill Puts Glass-Steagall Back on Washington’s Agenda*, AM. BANKER, (July 26, 2012), at 1.

⁷⁹⁴ *Id.* at 2 (quoting Weill’s statements during his CNBC interview).

⁷⁹⁵ *Id.* (same).

⁷⁹⁶ Wilmarth, *Prelude to Glass-Steagall*, *supra* note 4, at 1296–1300.

decided that Glass-Steagall served the public interest by separating commercial banks from securities firms. In testimony before the Federal Monopoly Committee in December 1939, Mitchell praised Glass-Steagall as a “great ‘step’ of progress,” even though he had opposed its enactment in 1933.⁷⁹⁷ Mitchell told the Committee, “I am convinced today that if we had gone along with the development of the securities affiliates [of commercial banks] it would have resulted in [a] monopoly.”⁷⁹⁸

The recantations of Reed, Weill, and Mitchell highlight a number of reasons for restoring structural barriers similar to Glass-Steagall and the pre-1999 BHCA. Separating banks from the capital markets would end the culture clash between banking and trading, and it would also eliminate conflicts of interest that make it impossible for universal banks to act as impartial allocators of credit and unbiased providers of investment advice. Separation would stop financial conglomerates from extending their safety-net subsidies and TBTF guarantees into the capital markets, thereby distorting prices and promoting excessive risk-taking in those markets. Restoring Glass-Steagall and the pre-1999 BHCA would prevent financial conglomerates from dominating many sectors of our financial markets by exploiting their public subsidies and leveraging their unfair cost-of-funding advantages. Whenever we hear policymakers and financial industry leaders proclaiming their devotion to “free” financial markets and “market discipline,” we must remember that our post-GLBA financial system seriously undermines those principles.⁷⁹⁹

This article does not include detailed recommendations for proposed reforms to address the problems created by Riegle-Neal, GLBA, and CFMA. I have discussed possible reforms in previous work,⁸⁰⁰ and I plan to develop a more complete set of potential reforms in future work. There are at least two approaches that a new regime of structural separation could adopt. The first, which I call “external Glass-Steagall,” would require a complete separation between banks and the capital markets, similar to the original Glass-Steagall Act. The first approach would break up existing financial conglomerates and prevent the formation of new ones.

The second approach, which I call “internal Glass-Steagall,” would require financial conglomerates to structure their subsidiary banks as

⁷⁹⁷ Editorial, *Mitchell Terms Bank Act of ‘33 Progress Step*, N.Y. HERALD TRIB., Dec. 15, 1939, at 35 (summarizing and quoting Mitchell’s testimony).

⁷⁹⁸ *Id.* (quoting Mitchell’s testimony).

⁷⁹⁹ See Wilmarth, *Citigroup*, *supra* note 22, at 132, 136–37; Wilmarth, *Financial Industry’s Plan*, *supra* note 620, at 76–81, 86.

⁸⁰⁰ See, e.g., Wilmarth, *Two-Tiered System*, *supra* note 194, at 342–70.

FDIC-insured “narrow banks,” which would be strictly separated from their nonbank affiliates. Among other restrictions, conglomerate-owned banks could not make any loans or other transfers of funds to their nonbank affiliates, except for the payment of lawful dividends to their parent holding companies.⁸⁰¹ An “internal Glass-Steagall” approach would not force financial conglomerates to break up, but it would seek to prevent conglomerate-owned banks from transferring their federal safety-net subsidies to their nonbank affiliates. This approach is similar to “ring-fencing” legislation that the UK adopted after the financial crisis.⁸⁰² An “internal Glass-Steagall” approach would raise important questions regarding the ability and willingness of regulators to establish and enforce strong firewalls that would be effective in preventing the spread of public subsidies from conglomerate-owned banks to their nonbank affiliates.

At a minimum, as I will discuss in future work, a restoration of Glass-Steagall-style structural reforms must accomplish two goals. First, in order to shrink the shadow banking system and reduce the threat of creditor “runs” in that system, reforms must prohibit nonbanks from offering deposit substitutes: namely, debt instruments with very short terms that are payable at par, such as short-term repos and MMMFs with fixed NAVs of one dollar per share.⁸⁰³ Second, reforms must establish a strict separation between FDIC-insured banks and the capital markets, based on either an “external” or “internal” Glass-Steagall approach. Those reforms must include a prohibition that would bar FDIC-insured banks from entering into derivatives except for those that provide bona fide hedges against risk exposures arising out of traditional banking activities.⁸⁰⁴ Without such a prohibition, banks would be able to circumvent any structural reforms by using derivatives to create synthetic substitutes for securities, futures, options, and insurance (as shown above in Part II.B.3).

⁸⁰¹ *Id.* at 345–52.

⁸⁰² FIN. STABILITY BD., STRUCTURAL BANKING REFORMS: CROSS-BORDER CONSISTENCIES AND GLOBAL FINANCIAL STABILITY IMPLICATIONS 1, 6 (2014), http://www.fsb.org/wp-content/uploads/r_141027.pdf; *see also* Caroline Binham & Emma Dunkley, *Regulators get ready to authorise 'ringfenced' banks*, FIN. TIMES (Aug. 18, 2017) (explaining that the UK's "ringfencing" rules will require large UK banks "to split their 'core' retail services, such as deposit-taking, from their riskier investment banking units"), <https://www.ft.com/content/5ca81a48-8372-11e7-a4ce-15b2513cb3ff?sharetype=share>.

⁸⁰³ *See generally* RICKS, *supra* note 112, at 223–47 (proposing the same fundamental reform).

⁸⁰⁴ Wilmarth, *Two-Tiered System*, *supra* note 194, at 344–46.