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I. INTRODUCTION

This Article explores the issues associated with the dismantling or break-up of financial conglomerates. Financial conglomerate refers to a holding company regulated as a financial holding company under banking law, which owns subsidiaries involved in other financial operations.[1] Many securities firms, which are regulated as broker–dealers, operate within the conglomerate structure. Indeed, the financial conglomerate typifies finance today because it offers a retail or wholesale customer the complete range of financial services. The subject of the break-up is timely because financial conglomerates were at the center of the recent financial crisis, and in many cases, required massive government aid to stay afloat.[2] The conglomerates are the subject of ongoing legislative and regulatory reforms, which include proposals suggesting their partial break-up.[3] In addition, because the financial crisis was worldwide and because the financial conglomerates operate internationally, the issue of regulating them better, or breaking them up, is a topic of international financial debate.

In the debate over financial conglomerates, it is useful to consider the arguments for and against their break-up in order to appreciate the difficulty of this topic and to help inform the related policy debates. This Article argues that a break-up may make the most sense because of the economic and political threats represented by the financial

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1. *See infra* subpart II.A.
2. *See infra* subpart II.B.
3. *See infra* subpart II.C.

conglomerates. As will be explained,[4] the conglomerates cannot be managed successfully to prevent negative effects on the financial system or the economy, and they represent a politically unhealthy dominance of large finance and an associated "elite." The difficult question is how to accomplish this break-up, given that the conglomerates have become part of the financial status quo. This Article explores various break-up options, including a spin-off of certain activities and the imposition of size limitations, while recognizing that, given the domestic and international preference for the status quo, the conglomerates will be subject only to heightened regulation.

Part II of this Article briefly describes the financial conglomerate and its origin as well as the impetus for the break-up discussions, which is the failure or near failure of the conglomerates during the financial crisis. This Part also discusses the evolving approach of the Obama Administration to the problems in the financial conglomerate, which included the concept of a partial break-up. Part III addresses several salient problems arising in financial conglomerates: systemic risk; risk management; commoditization and opaqueness of financial products and services; compensation policies; conflicts of interest; and government support and politics. Part IV analyzes whether these problems weigh in favor of a break-up of the conglomerate, particularly in light of the global operations of the conglomerates and international regulatory efforts relating to them. Part V explores the ways in which a break-up could be accomplished, again within the context and constraints of global reform efforts. Part VI concludes with the observation that, while the economic and political dangers posed by the conglomerates argue for their break-up, the political reality is that they will continue in existence.

II. THE FINANCIAL CONGLOMERATE, THE CRISIS, AND THE BREAK-UP PROPOSAL

A. The Financial Conglomerate

The financial conglomerate is generally a publicly traded holding company with subsidiaries (and subsidiaries of these subsidiaries) devoted to different financial activities, such as commercial banking, securities brokerage and trading, investment advising, and insurance. The largest financial institutions in the United States and in Europe are financial conglomerates.[5] They may specialize in one group of financial

4. *See infra* Part IV.

5. For example, the top five existing U.S. banking groups, JP Morgan Chase, Bank of America, Citibank, Wells Fargo, and Wachovia (the latter two are now combined) have over one-half of the

activities more than another, often reflecting the financial activity of their origins. For example, although both firms engage in other financial activities, Goldman Sachs is primarily a securities firm, while JP Morgan Chase is primarily a banking firm.[6]

The growth of the financial conglomerate in the United States over the past thirty years has been told and retold.[7] Conglomerates existed before the Great Depression and the ensuing Glass–Steagall Act, which led to their break-up,[8] although U.S. finance was much simpler then. The conglomerate resurfaced during the 1970s and the 1980s as the three major financial sectors—commercial banking, investment banking, and insurance—began to overlap, to compete with each other, and eventually to consolidate.[9] Conglomeration received its stamp of legal approval in 1999 with the Gramm–Leach–Bliley Act (Gramm–Leach–Bliley),[10] which produced the new legal structure of the financial holding company whose subsidiaries could engage in diverse financial activities.[11]

Generally, the financial conglomerate is a reality in Europe, and to some extent, Asia with the "universal bank," which engages in diverse

consolidated, as well as the domestic, assets of U.S. bank groups. *See* Release, Fed. Reserve, Insured U.S.-Chartered Commercial Banks That Have Consolidated Assets of $300 Million or More, Ranked by Consolidated Assets (Dec. 31, 2009), *available at* http://www.federalreserve.gov/releases/lbr/20091231/lrg_bnk_lst.pdf. With respect to investment banking or securities activities, one sees similar names as well as the firms historically specializing in them. *See Investment Banking League Table*, FT.COM, Dec. 20, 2009, *available at* http://www.ft.com/ibleague (listing the top institutions as JP Morgan, Bank of America Merrill Lynch, Goldman Sachs, Morgan Stanley, Citigroup, Credit Suisse, Deutsche Bank, UBS, Barclays Capital, and Royal Bank of Scotland). For considerable data on the growth and the size of financial conglomerates, see Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 975–81 (2009). It is true that, as economic production has shifted to countries like China, the largest world financial institutions are no longer concentrated in Western countries. *See* Steven Bernard et al., *The Decade for Global Banks*, FT.COM, Mar. 22, 2009, *available at* http://www.ft.com/cms/s/0/ea450788-1573-11de-b9a9-0000779fd2ac.html.

6. *Compare* GOLDMAN SACHS, GOLDMAN SACHS 2009 ANNUAL REPORT 2 (2010), *available at* http://www2.goldmansachs.com/our-firm/investors/financials/current/annual-reports/2009-complete-annual.pdf (pointing out that nearly all the revenue came from securities-related activities), *with* JPMORGAN CHASE & CO., 2009 COMPLETE ANNUAL REPORT 7 (2010), *available at* http://investor.shareholder.com/jpmorganchase/annual.cfm (showing diversity of its revenue stream, with much concentration in commercial and consumer banking activities).

7. *See generally* Wilmarth, *supra* note 5; *see also* 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.

8. For a brief, non-technical review of the Glass–Steagall Act provisions and their effect, see LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS 41–42 (3d ed. 2008).

9. *See* Wilmarth, *supra* note 5, at 222–23.

10. Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12, 15, and 19 U.S.C.).

11. *See* 12 U.S.C. § 1843(k), (l) (2006).

financial activities, not just commercial banking.[12] However, non-U.S. conglomerates traditionally emerged in countries with bank-centered finance and were weighted more to banking and insurance. Thus, it is accurate to say that the financial conglomerate as it exists today is really something of a U.S. creation because it links together commercial banking, retail banking, and to a lesser extent, insurance with the highly developed securities activities of an investment bank. Indeed, European conglomerates, like UBS, Credit Suisse, and Deutsche Bank, have over time become more like U.S. financial conglomerates as they have developed their securities activities.[13] However, any reform of conglomerates should be an international effort because they are a global phenomenon.

The financial conglomerate could be viewed as the product of financial or economic logic. Since financial activities all involve raising funds for companies, helping people invest, and assessing risk in that context (e.g., banks take deposits and make loans, investment banks raise funds from investors for companies, insurance companies helps companies and individuals pool funds to deal with risks), there is no obvious reason why these related activities should be kept entirely separate and not take advantage of natural synergies.[14] Moreover, a conglomerate can offer a retail customer or a sophisticated company, a range of financial products on a national and international basis.[15] These were the justifications leading to Gramm–Leach–Bliley.

Prior to the financial crisis, there was a diverse regulatory structure for financial conglomerates. Conglomerates centered on commercial banking, like JP Morgan Chase, Bank of America, and Citigroup, were regulated by the Board of Governors of the Federal Reserve System (the Federal Reserve) as financial holding companies. Investment banking groups, like Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns, were regulated as "consolidated supervised entities" by the Securities and Exchange Commission (SEC).[16]

12. *See generally* FRANKLIN ALLEN & DOUGLAS GALE, COMPARING FINANCIAL SYSTEMS 3–49 (2000).

13. UBS is illustrative in this respect. It became more like a U.S. financial conglomerate by acquiring a U.S. broker–dealer, Paine Webber. *See* UBS, ANNUAL REPORT 2009 22 (2010), *available at* http://www.ubs.com/1/e/investors/annualreporting/2009.html (section entitled "The making of UBS").

14. *See generally* FRANKLIN R. EDWARDS, THE NEW FINANCE: REGULATION AND FINANCIAL STABILITY 4–9 (1996) (discussing some of these issues).

15. For this point, see *Implications of the "Volcker Rules" for Financial Stability: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2010) (prepared written statement of Hal S. Scott, Nomura Professor of Int'l Fin. Systems, Harvard Law Sch., & Dir., Comm. on Capital Mkts. Regulation) [hereinafter Statement of Hal S. Scott], *available at* http://www.capmktsreg.org/pdfs/2010-Feb-4_Testimony_of_Hal_S_Scott.pdf.

16. For a critical review of this program, see OFFICE OF INSPECTOR GEN., U.S. SEC. & EXCH.

Insurance groups, like the American International Group (AIG), were regulated primarily by state insurance commissions and other financial regulators, and it is unclear whether any regulator had a systematic view of all of their activities and operations.[17] Moreover, at the level of subsidiaries engaged in specific financial activities, there is the system of "functional regulation," meaning that each subsidiary is overseen by a regulator whose traditional responsibilities include specific financial activities (e.g., the SEC for broker–dealers).[18] As a result of the financial crisis, many investment banking groups failed or were absorbed into other conglomerates; the remaining groups, including Goldman Sachs and Morgan Stanley, elected to become bank, and then financial, holding companies.[19]

B. The Financial Conglomerate in the Crisis

Financial conglomerates were at the center of the financial crisis. There is no need to review this subject in any detail, for it has been discussed in many articles, books, and conferences.[20] Nearly all conglomerates were hurt by their sponsorship and holdings of mortgage-backed securities, whose value declined precipitously as housing prices stalled. The investment bank groups, which were highly leveraged and reliant upon short-term funding, suffered first, with Bear Stearns and Lehman failing, Merrill Lynch rushing into the arms of Bank of America, and Goldman Sachs and Morgan Stanley seeking the protective umbrella of bank holding company status.[21] The federal government had to provide extraordinary emergency assistance to the

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COMM'N, REPORT NO. 446-A, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITIES PROGRAM (2008), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf.

17. For the basics of insurance regulation, see U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 61–72 (2008).

18. Functional regulation was made official by Gramm–Leach–Bliley, *see* 12 U.S.C. § 1844(c)(2)(B) (2006), but was the historical approach of U.S. financial regulation.

19. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 21, 2008), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20080921a.htm (announcing that Goldman Sachs and Morgan Stanley had been permitted to become bank holding companies on an emergency basis).

20. Including other books and articles mentioned herein, there is an excellent collection of essays in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM (Viral V. Acharya & Matthew Richardson eds., 2009).

21. For one account (among many) of the collapse of the investment banks, see NORMAN S. POSER & JAMES A. FANTO, BROKER–DEALER LAW AND REGULATION § 1.02[A] (4th ed. 2007 & Supp. 2010). For a journalistic account of the crisis, see ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS—AND THEMSELVES (2009).

commercial banking conglomerates, such as Citigroup and Bank of America, as well as to the insurance conglomerate AIG due to its trading activities in derivatives associated with mortgage-backed securities. No financial conglomerate emerged unscathed during the crisis, although some performed better than others.[22] But it should not be overlooked that, in those extraordinary days during September and October 2008, the federal government supported all the conglomerates in numerous ways, and not simply through access to loans from the Federal Reserve's discount window and the capital injections that the institutions received through the Troubled Asset Relief Program.[23]

Following the Bush Administration's approach (and the approach of concerned governments worldwide with respect to their own financial conglomerates), the Obama Administration first sought to stabilize the financial conglomerates (as opposed to other kinds of financial institutions), which meant preventing further collapses.[24] Thus, it reworked the capital support for the conglomerates and other financial institutions, re-designating such support as the Capital Purchase Program, and naming the program the Financial Stability Plan; it continued the extraordinary support to several particularly troubled conglomerates, such as Citigroup and Bank of America.[25] It then oversaw the rehabilitation of the conglomerates through conducting conglomerate-wide stress tests and trying to remove "legacy" assets from their books.[26] These activities, again conducted on a global basis,

22. *See, e.g.*, *First Public Hearing of the FCIC: Hearing Before the Financial Crisis Inquiry Commission* (2010) (statement of Brian T. Moynihan, Chief Executive Officer & President, Bank of Am.) [hereinafter Statement of Brian T. Moynihan], *available at* http://www.fcic.gov/hearings/pdfs/2010-0113-Moynihan.pdf (asserting that bank groups were the strongest in the crisis, while the overleveraged investment banks experienced the most problems).

23. Again, for a discussion of these actions, see POSER & FANTO, *supra* note 21, at 1-20 to 1-21. For example, among other actions, the SEC restricted short-selling of the stock of major financial institutions and the Federal Deposit Insurance Corporation (FDIC) guaranteed newly-issued senior unsecured debt of FDIC-insured institutions and of bank and financial holding companies.

24. For a good review of the U.S. and foreign programs to stabilize financial institutions, see FABIO PANETTA ET AL., MONETARY & ECON. DEP'T, BANK FOR INT'L SETTLEMENTS, PAPER NO. 48, AN ASSESSMENT OF FINANCIAL SECTOR RESCUE PROGRAMMES (2009). By contrast, U.S. bank failures skyrocketed during this time. For example, 140 banks failed in 2009 and 127 have failed as of Sept. 29, 2010, whereas only 3 failed in 2007 and 25 failed in 2008. *See* Federal Deposit Insurance Corporation, Historical Statistics on Banking: Failures and Assistance Transactions, http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30 (last visited Sept. 29, 2010).

25. For a summary of all the actions taken under this Plan, see U.S. Dep't of the Treasury, FinancialStability.gov, http://www.financialstability.gov (last visited Sept. 29, 2010).

26. On the stress tests, see BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: DESIGN AND IMPLEMENTATION (2009) [hereinafter DESIGN AND IMPLEMENTATION] (discussing the method of the stress test); BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: OVERVIEW OF RESULTS (2009), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf (discussing results).

proved successful insofar as the financial sector stabilized in mid-2009. Indeed, many conglomerates returned to profitability, although primarily as a result of activities that fell under the investment banking part of their business, such as proprietary trading.[27] And, as has been well publicized, compensation in the conglomerates has returned to extraordinary levels.[28] The U.S. financial sector has also become even more concentrated in the remaining financial conglomerates.[29]

C. The Break-Up Proposal in the Context of Reforms

In its first year, the Obama Administration refrained from disturbing the status quo of the financial sector, which meant maintaining the dominance of the financial conglomerate. In particular, it proposed reforms to the specific problems that emerged during the crisis. Notably, this approach was generally in line with the international responses to the crisis.[30] For example, in a financial reform plan that was the basis for its proposed legislation, the Obama Administration suggested: (1) enhancing the risk management in financial firms; (2) addressing risks that turned out to be more significant than previously thought (e.g., liquidity risk); (3) increasing and modifying capital requirements to address the problems (e.g., higher capital charge for asset-backed securities); (4) aligning compensation in the financial industry to correspond with the risks; (5) establishing a resolution procedure for the conglomerates; (6) developing more transparency and market structure for opaque securities and other financial products (i.e., the kind that are in the conglomerate); (7) bringing relatively unregulated financial institutions (or "shadow banking") within the regulatory system; and (8) reforming credit rating agencies on which financial firms rely.[31] The Obama Administration proposed several

Removing legacy or bad assets from conglomerate books involved a program called the Public-Private Investment Program (PPIP) pursuant to which the federal government and private investors would set up investment funds, also supported by government loans, to purchase these assets. For a description of this program, see U.S. Dep't of the Treasury, Road to Stability: Public–Private Investment Program, http://www.financialstability.gov/roadtostability/publicprivatefund.html (last visited Sept. 27, 2010).

27. The remaining conglomerates had a source of cheap money from the Federal Reserve and had fewer competitors. *See, e.g.*, JPMORGAN CHASE & CO., *supra* note 6, at 53 (presenting break-down in activities).

28. *See, e.g.*, ANDREW M. CUOMO, OFFICE OF THE ATTORNEY GEN., STATE OF N.Y., NO RHYME OR REASON: THE 'HEADS I WIN, TAILS YOU LOSE' BANK BONUS CULTURE (2009) (explaining how compensation in financial services firms remains high despite their enormous losses in 2007 and 2008).

29. There are simply fewer conglomerates (e.g., JP Morgan acquired Bear Stearns, and Bank of America combined with Merrill Lynch).

30. *See* PANETTA ET AL., *supra* note 24.

31. *See* U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION:

innovative reforms, such as the creation of a systemic risk oversight board, which would be on the lookout for risks that could upset the financial system, and the creation of a consumer financial protection agency, which would protect consumers from improper financial products and terms.[32]

The reform proposal included suggestions that a financial conglomerate could be reduced in size or limited in its activities, if it posed risks to the financial system.[33] In a certain respect, this suggestion was a standard bank regulatory approach where regulators would take action only when some attribute of an institution threatened to cause it to fail or otherwise adversely affect the financial system.[34] Initially, this is as far as the Obama Administration went with respect to dismantling the financial conglomerate, apart from the proposal for a new resolution process for conglomerates.

However, after a year in office, the Obama Administration began making reform proposals that had the potential to result, indirectly or directly, in a break-up, or at least a size reduction, of financial conglomerates. It is not entirely clear what led to the Obama Administration's change of heart, although the perception that the financial conglomerates were resisting any reform and returning to their free-spending ways with respect to compensation may have affected policy-makers in the Executive Branch. First, it proposed a yearly tax or fee on the largest financial institutions, specifically those with $50 billion in assets and those that own an insured financial institution or a broker–dealer, as a way of funding the expenses of the financial system rescue that would not otherwise be recouped from banks.[35] The proposed fee, .15%, would be assessed on conglomerates' total assets, minus the strongest capital (known as Tier 1)[36] and minus federally-

REBUILDING FINANCIAL SUPERVISION AND REGULATION 10–18 (2009) [hereinafter FINANCIAL REGULATORY REFORM].

32. *See id.* at 10, 14–15. This reform plan also had an international component, which demonstrated the Obama Administration's recognition that, because conglomerates were international in scope, reforms affecting them had to be accomplished through international efforts. *See id.* at 16. Certain aspects of the reform proposal are discussed in James A. Fanto, *Financial Regulation Reform: Maintaining the Status Quo*, 35 BROOK. J. INT'L L. 635 (2010).

33. *See* FINANCIAL REGULATORY REFORM, *supra* note 31, at 24–25.

34. Indeed, the reform plan references the prompt corrective action regime in place for federally-insured banks. *See id.* at 24; *see also* 12 U.S.C. § 1831*o* (2006).

35. *See* Press Release, The White House, President Obama Proposes Financial Crisis Responsibility Fee to Recoup Every Last Penny for American Taxpayers (Jan. 14, 2010), *available at* http://www.whitehouse.gov/the-press-office/president-obama-proposes-financial-crisis-responsibility-fee-recoup-every-last-penn (with hypertext link to Fact Sheet on the Financial Crisis Responsibility Fee). The Obama Administration estimates that the fee would be in place for at least ten years.

36. *See* 12 C.F.R. pt. 225, app. A, II.A.1 (2010).

insured deposits or insurance reserves in the case of an insurance conglomerate. The fee is thus an explicit tax on overall size and the non-deposit leverage of conglomerates and arguably explicitly targets those, like the investment banking-dominated conglomerates Goldman Sachs and Morgan Stanley, where securities activities, rather than commercial banking, are paramount.[37]

Second, the Obama Administration proposed the Volcker Rule, named after Paul Volcker, the former Federal Reserve head and a current economic advisor to President Obama.[38] Under this rule, any insured financial institution or financial conglomerate regulated as a bank or financial holding company (i.e., since the market meltdown, literally all the conglomerates) could not sponsor or invest in a hedge fund or private equity fund or engage in proprietary trading.[39] With respect to the latter restriction, the proposal clarifies that neither an insured bank nor a financial holding company can operate a trading desk organized to speculate with the firm's own money on commodities, securities, options, derivatives, or other financial instruments.[40] This proprietary trading is distinguished from market-making and hedging operations of the firm, which are principal activities, but are primarily designed to serve customers of the conglomerate. The justification for this restriction, which would clearly require legislative change because these activities are allowed under Gramm–Leach–Bliley,[41] is that it is

37. Indeed, the Obama Administration estimated that 60% of the fee would be paid by the ten largest conglomerates. *See* The White House, Fact Sheet on the Financial Crisis Responsibility Fee, http://www.whitehouse.gov/sites/default/files/financial_responsibility_fee_fact_sheet.pdf (last visited Sept. 27, 2010).

38. *See* Press Release, The White House, President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers (Jan. 21, 2010), *available at* http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e.

39. *See* U.S. Dep't of the Treasury, "Volcker Rule" Proposed Language (2010) [hereinafter Proposed Language], *available at* http://static.reuters.com/resources/media/editorial/20100304/VolckerRule.doc (proposing addition of new §§ 13 and 13a to the Bank Holding Company Act). "Sponsoring" a fund is distinguished in the proposed rule from advising a fund and refers to directing and controlling the fund (or sharing the same name for corporate and marketing purposes). *See id.* (proposed § 13(f)(3)). There are exceptions with respect to small business and other funds. The proposed rule would also restrict certain relationships between the covered party and hedge or private equity funds that the covered party is only advising, rather than sponsoring.

40. *See id.* (proposed § 13(a), (f)(1)); *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2010) (statement of Neal S. Wolin, Deputy Sec'y, U.S. Dep't of the Treasury) [hereinafter Statement of Neal S. Wolin], *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=54b42cc0-7ecd-4c0d-88c0-65f7d2002061&Witness_ID=a2a802ec-6db7-4748-a73f-902b35d0e51d (at 4). There are exceptions to this ban on proprietary trading for trading in U.S. government and related obligations and for trading conducted outside the U.S. by a foreign company not controlled by any U.S. company.

41. *See* 12 U.S.C. § 1843(k)(4)(H) (2006).

inappropriate, for issues of risk and equity, for the implied government guarantee to a financial holding company to be used for proprietary trading.[42] The restriction on a firm's sponsoring and investing in hedge funds and private equity funds is justified on the grounds that these activities are often the functional equivalent of proprietary trading, that they pose particular risks to the financial conglomerate,[43] and that they pose too many potential conflicts of interest.[44] While the actual language of the Volcker Rule appeared to apply the prohibitions only to insured banks and bank or financial holding companies, which suggested that a conglomerate could simply shift these activities to a subsidiary of a holding company, legislation that was introduced in the Senate required a spin-off from the conglomerate of proprietary trading and hedge and private equity fund sponsorship and investing.[45]

While proposing the Volcker Rule, the Obama Administration also put forward a size limit on regulated financial conglomerates (i.e., bank or financial holding companies). Under current law, there is a limit on the amount of national deposits that a bank group may have (10%), but it only prohibits an acquisition that would take the group over the limit, not to internal growth.[46] The Obama Administration suggested that another size limitation should be imposed on all financial institutions, not just commercial banks and bank or financial holding companies, but keyed it to "total consolidated liabilities."[47] This restriction would again

42. *See* Statement of Neal S. Wolin, *supra* note 40, at 3; *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2010) (statement of Paul A. Volcker, Chairman, President's Econ. Recovery Advisory Bd.) [hereinafter Statement of Paul A. Volcker], *available at* http://banking.senate.gov/public/ index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=54b42cc0-7ecd-4c0d-88c0-65f7d2002061&Witness_ID=091f5a89-dec4-4905-9fa1-678bfbec823a (at 1–2).

43. *See* Statement of Neal S. Wolin, *supra* note 40, at 3; Statement of Paul A. Volcker, *supra* note 42, at 1–2.

44. *See* Statement of Neal S. Wolin, *supra* note 40, at 4; Statement of Paul A. Volcker, *supra* note 42, at 4. This criticism applies as well to proprietary trading. The Volcker Rule would also require the application of capital and other requirements to nonbank financial companies that are engaged in proprietary trading and sponsoring or investing in hedge or private equity funds. *See* Proposed Language, *supra* note 39 (proposed § 13(e)(1)).

45. *See* PROP Trading Act, S. 3098, 111th Cong. (2010), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3098is.txt.pdf (see proposed § 6(h)(2) of the Bank Holding Company Act). It does this essentially by having the prohibition reach the banking institution, the holding company, and any affiliates or subsidiaries of them. Among other differences, this proposed Act would be self-executing (i.e., it would go into effect no later than two years after enactment), whereas the Volcker Rule would require implementation by federal banking regulators to take effect. The Volcker Rule was enacted as Title VI of Dodd–Frank. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, §§ 601–28, 124 Stat. 1376, 1596–1641 (July 21, 2010).

46. *See* 12 U.S.C. § 1842(d)(2)(A) (2006).

47. *See* Proposed Language, *supra* note 39 (proposed § 13a(a)).

be triggered by an acquisition, not internal growth, and would ban any acquisition where the resulting group's total consolidated liabilities exceeded 10% of aggregate consolidated liabilities of all U.S. financial institutions.[48] The additional size limitation was justified on the grounds that financial conglomerates were funding themselves more through non-deposit liabilities than deposits, and so a size limitation had to focus on this kind of funding, and that the failure of large financial companies caused considerable externalities.[49] The Obama Administration recognized that, in this proposal as well as in the break-up suggestion, it was running against the historical trend in other countries that have large financial conglomerates engaged in all kinds of activities. However, it appeared to believe that other countries would be receptive to these activities and size limitations.

Thus, the Obama Administration introduced the ideas of a break-up and size limitation on financial conglomerates as debates over financial reform legislation began in earnest, and as this legislation began to make its way through Congress in the first half of the 2010.

III. PROBLEMS IN THE FINANCIAL CONGLOMERATE

This Part identifies and briefly discusses the problems that have been associated with financial conglomerates, particularly in the crisis of 2008–2009. As will be clear, the problems often (although not exclusively) arise from securities activities undertaken within a conglomerate, including: (1) systemic risk; (2) risk management; (3) commoditization vs. opaqueness of financial products; (4) compensation policies; (5) conflicts of interest; and (6) government support and politics. The goal here is not to examine them exhaustively, but to highlight them in order to set the stage for an analysis about the need to break-up the conglomerates.

A. Systemic Risk

This problem refers to the fact that the financial system is threatened with collapse because of the failure of a financial institution, which will start a chain of failures of other institutions and a paralysis of financial

48. *Id.* (proposed § 13a(a)). Liabilities would be essentially defined as total risk-weighted assets minus regulatory capital. *Id.* (proposed § 13a(c)). The size limitation would reach any nonbank financial company that might fall under Federal Reserve regulation through current reforms. Absolute size limitations on financial conglomerates did not survive in Dodd–Frank, which simply ordered a study of the need for them. *See* § 123, 124 Stat. at 1412.

49. *See* Statement of Neal S. Wolin, *supra* note 40, at 4–5.

activity leading to the collapse of the system.[50] As seen during the crisis, the realization of this risk can have a devastating effect upon the larger economy when it brings all financial transactions to a halt: financial participants worry about their own and their counterparties' exposures to the troubled firm and to potential other problem firms. Systemic risk is particularly associated with financial conglomerates because given their size and diversity of activities, they are engaged in so many financial activities and are so interconnected in the financial system with many counterparties that their failure is presumed to have a systemic effect.[51] Systemic risk is no longer an academic issue because it appeared in the crisis with the collapse of Bear Stearns, the bankruptcy of Lehman Brothers, and a subsequent run on other major conglomerates (e.g., AIG, Bank of America, Citigroup, Merrill Lynch), which in turn led to extraordinary government efforts to sustain other conglomerates in danger of collapse and to stand behind any other whose collapse could have a systemic effect.[52] Indeed, the government's stress testing of them in the spring of 2009 was to assure other financial participants that they were safe to deal with.[53]

B. Risk Management

Risk management encompasses the assessment of risks in a financial institution and the management of them so as to prevent their realization and to be prepared for their impact.[54] The problem of risk management in financial conglomerates is related to that of systemic risk. Since a financial conglomerate's activities and investments are numerous, diverse, and complex, the risks associated with them are difficult, if not impossible, properly to assess and control. If the risks cannot be adequately identified and prepared for, the conglomerate will not be

50. *See* PETER S. ROSE & SYLVIA C. HUDGINS, BANK MANAGEMENT & FINANCIAL SERVICES 492 (7th ed. 2008).

51. *See* GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 60–79 (2004) (discussing how characteristics of large banks, particularly their dealings only with other large financial institutions, have increased the systemic risk and thus the probability of a government bailout to prevent its realization).

52. *See* Viral V. Acharya et al., *A Bird's-Eye View: The Financial Crisis of 2007–2009: Causes and Remedies*, *in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 1, 2–7 (Viral V. Acharya & Matthew Richardson eds., 2009) (arguing that the systemic crisis actually began in the summer of 2007 with the collapse of the subprime market).

53. *See* DESIGN AND IMPLEMENTATION, *supra* note 26, at 3–4.

54. The discussion in this subpart draws on two of my articles: *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731 (2009); *Stress Testing and Scenario Analysis in Risk Management: Preparing for the Worst*, *in* THE PANIC OF 2008, at 77–93 (Lawrence Mitchell & Arthur Wilmarth eds. 2010).

ready for their realization, which could lead to the institution's failure and, in turn, to systemic risk.[55]

The financial crisis exposed serious problems with risk management and its supervision in financial conglomerates and raised the important question whether the conglomerates have become so big and complex that their risks cannot be managed. Modeling techniques for measuring risk proved to be inadequate in predicting losses from activities and investments, especially in asset-backed securities and related financial instruments. However, this turned out to be fatal because the financial position of a financial conglomerate depends upon the models that help establish the amount of capital that an institution needs as a protection against its risks (i.e., capital is risk-based). Risk modeling is supplemented by judgmental exercises, such as stress testing and scenario analysis, which anticipate the effects on an institution from an extremely bad event. But these exercises were often neglected and, in any event, they raise epistemological and behavioral issues with respect to the conglomerate: does the complexity of these institutions make adequate stress testing or scenario analysis impossible?[56] Will risk managers, executives, and regulators ever adequately play out the necessary scenarios and then respond to adverse results in good times? The evidence from conduct in the conglomerates before the financial collapse suggests otherwise.[57]

C. Commoditization and Opaqueness

Financial services are under constant price pressure because many financial products become standardized and thus commodities, which

55. *See also First Public Hearing of the FCIC: Hearing Before the Financial Crisis Inquiry Commission* (2010) (statement of Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n) [hereinafter Statement of Mary L. Schapiro], *available at* http://www.fcic.gov/hearings/pdfs/2010-0114-Schapiro.pdf (at 10–11); *First Public Hearing of the FCIC: Hearing Before the Financial Crisis Inquiry Commission* (2010) (statement of Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp.) [hereinafter Statement of Sheila C. Blair], *available at* http://www.fcic.gov/hearings/pdfs/2010-0114-Bair.pdf (at 26–27).

56. *See* Fanto, *Anticipating the Unthinkable*, *supra* note 54, at 739–45.

57. *But see First Public Hearing of the FCIC: Hearing Before the Financial Crisis Inquiry Commission* (2010) (statement of Lloyd C. Blankfein, Chairman and CEO, The Goldman Sachs Group, Inc.) [hereinafter Statement of Lloyd C. Blankfein], *available at* http://www.fcic.gov/hearings/pdfs/2010-0113-Blankfein.pdf (at 12) (explaining the strengths of Goldman Sachs's risk management and the problems of risk management in the industry, but cautioning that in reforms, "[w]e should resist a response . . . that is solely designed around protecting us from the 100-year storm"). On the other hand, others would advocate that preparation for the unlikely event is the goal of risk management. *See, e.g.*, *International Insurance Society Roundtable on Risk Management After the Crisis*, 21 J. APPLIED CORP. FIN., Sept. 2009, at 28, 37–38 (remarks of Prem Watsa, chairman and CEO of Fairfax Financial Holdings in Canada).

reduces their profit margin. Therefore, there is constant pressure on financial firms, including conglomerates, to respond to the commoditization by extending products to new customers and by inventing and capitalizing on new products and services.[58] A related development is for financial firms to offer products and services to institutional investors in non-standardized areas in opaque trading venues. However, this movement of commoditization and opaqueness can pose a danger to a financial firm if it extends products beyond an appropriate customer base or if it engages in opaque products that are not easily regulated, either by the firm itself or by regulators.[59] Certainly, the tremendous growth of asset-backed securities and related financial instruments can be explained by both commoditization and opaqueness. Financial conglomerates engaged in making home loans to lower-quality borrowers and then produced asset-backed securities based on these loans, with all of their permutations (CDOs, CDOs^2), complicated tranche structures and offering vehicles (SIVs), which were offered privately and traded off exchanges in dealer markets.[60] When housing prices stalled, these activities created enormous losses for the conglomerates. The losses were exacerbated by the opaque nature of many of the products leading to the inability of conglomerates, their counterparties, and regulators to value them.[61]

D. Compensation Policies

It is undisputed that compensation policies in financial services and in financial conglomerates have been short term in nature and rewarded short-term performance. How this situation came about is a complicated story covered by other contributions to this symposium.[62] Certainly,

58. *See generally* ROBERT E. LITAN & JONATHAN RAUCH, AMERICAN FINANCE FOR THE 21ST CENTURY 52–62 (1998).

59. *See generally* Simon Johnson & James Kwak, *Finance: Before the Next Meltdown*, DEMOCRACYJOURNAL.ORG, Summer 2009, at 19, *available at* http://www.democracyjournal.org/pdf/13/JohnsonKwak.pdf.

60. *See* Anthony Saunders et al., *Enhanced Regulation of Large, Complex Financial Institutions*, *in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 139–48 (Viral V. Acharya & Matthew Richardson eds., 2009).

61. *See also* Statement of Sheila C. Bair, *supra* note 55, at 4–5 (observing that only financial conglomerates could participate in the securitization process that was at the heart of the crisis and that fell between traditional banking and investment banking and that they are also the kinds of institutions involved in innovation (which does not always make financial sense) and with the capital to act as dealers in non standardized financial products).

62. *See* Frederick Tung, Professor, Emory Univ. Sch. of Law, Compensation, Cartels, and Competition: A Political Economy of the Financial Stability Board and its Principles for Sound Compensation Practices, Remarks at the 23rd Annual Symposium of the Corporate Law Center of the University of Cincinnati College of Law (Mar. 5, 2010).

there are many causes to these compensation policies, such as the increasing fee nature of financial services[63] and the transformation of financial firms from partnerships to publicly traded corporations, with the latter business form allowing firm employees to move easily from firm to firm.[64] Yet this short-term nature of compensation creates significant risks in financial firms because it encourages employees to pursue high risk activities that will lead to short-term results regardless of their long-term effects. This problem is magnified in a financial conglomerate, as the financial crisis demonstrated, for the risks of compensation policies explode when all employees are pursuing short-term gains. Again, the example of the asset-backed securities comes to mind: loan officers had an incentive to make loans quickly and without regard for the quality of borrowers; bank officers wanted to move the loans off their books; the employees of securities firms packaged them into pools and sold off pool-based securities in diverse instruments, tranches and derivatives; and brokers and investment advisers were paid for moving the securities and financial instruments into portfolios.[65] The list could go on and on.

E. Conflicts of Interest

Conflicts of interest have long been a problem in financial services. Traditionally, the conflict question concerned a financial firm benefitting one client at the expense of another.[66] That concern remains strong, as seen in the news concerning Goldman Sachs's favoring certain clients over others with respect to its market analysis.[67] Yet the conflict issue is again magnified in the financial conglomerate first because firms are involved in so many financial activities with so many different clients. Second, the conflicts issue has grown in importance on account of the enormous expansion of the principal activities of a

63. *See* INST. OF INT'L. FIN., FINAL REPORT OF THE IIF COMMITTEE ON MARKET BEST PRACTICES: PRINCIPLES OF CONDUCT AND BEST PRACTICE RECOMMENDATIONS 58–62 (2008).

64. *See* Alan D. Morrison & William J. Wilhelm, Jr., *The Demise of Investment Banking Partnerships*, 63 J. FINANCE 311 (2008). And firms like this "free agent" structure, which allows them considerable flexibility with respect to retaining, or getting rid of, employees. *See* Statement of Mary L. Schapiro, *supra* note 55, at 18.

65. *See* Gian Luca Clementi et al., *Rethinking Compensation in Financial Firms*, *in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 197, 203–06 (Viral V. Acharya & Matthew Richardson eds., 2009).

66. *See, e.g.*, Washington Steel Corp. v. TW Corp., 602 F.2d 594 (3d Cir. 1979), *abrogated by* Clark v. K-Mart Corp., 979 F.2d 965 (3rd Cir. 1992) (case involving a bank funding a takeover of a longstanding client).

67. *See* Susanne Craig, *Goldman's Trading Tips Reward its Biggest Clients*, WALL ST. J., Aug. 24, 2009, at A1.

conglomerate, which is no longer just a market maker in exchange-traded securities, over-the-counter (OTC) securities, derivatives, and commodities, but is an active investor side-by-side with its clients.[68] Given that proprietary trading and investing activities demand significant capital, it is no surprise that they occur primarily in financial conglomerates. Therefore, in many ways, financial conglomerates have evolved from being client-centered firms to employee-centered firms and to a lesser extent shareholder-centered firms. When coupled with such factors as the short-term nature of compensation and the diversity of activities in firms, this development produces too great an incentive for information to drift over the compliance and other control systems that firms have put in place to protect clients. Again, the best example of this is the recent SEC lawsuit brought against Goldman Sachs for favoring itself and one investor in the structuring and sale of synthetic collateralized debt securities.[69]

F. Government Support and Politics

As was clear after the Lehman Brothers collapse, the federal government did not allow any other financial conglomerate to fail and provided them with numerous federal subsidies and an implicit federal guarantee.[70] Thus, counterparties and creditors of the conglomerates are no longer concerned about default risk in them for the conglomerates have become "too big to fail."[71] This means that conglomerates receive a subsidy from the federal government, in the form of lower cost of capital, and are not subject to an important level of creditor or counterparty discipline, which makes a firm pay for its default risk (i.e., creditors believe that they will always be paid off by the government). This subsidy also distorts the market for financial services because financial firms that are not conglomerates do not benefit from it, putting them at a competitive disadvantage in relation to the conglomerates.[72]

68. *See* Statement of Paul A. Volcker, *supra* note 42, at 4.

69. *See* Complaint, SEC v. Goldman Sachs & Co., No. 1:10-cv-03229-BSJ-MHD (S.D.N.Y. filed Apr. 16, 2010). Goldman eventually settled the lawsuit for $550 million. *See* SEC v. Goldman, Sachs & Co., Litig. Release No. 21,592 (July 15, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21592.htm.

70. *See* Acharya et al., *supra* note 52, at 43–45.

71. *See* David A. Moss, *An Ounce of Prevention: Financial Regulation, Moral Hazard, and the End of "Too Big to Fail,"* HARV. MAG., Sept.–Oct. 2009, at 25, 27. Of course, there is the risk that the government supporting the conglomerates can fail, which is the ultimate default risk. Perhaps in light of the sovereign debt crisis in Greece and in Europe, it is not entirely far-fetched to say that the guarantee of the U.S. government behind U.S. conglomerates is not failsafe, for a default by the U.S. is not outside the realm of possibility.

72. *See* Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., Remarks at the Independent

This government support also makes the financial conglomerate a political issue, for it has become clear that the government favors certain firms in the financial industry and those associated with these firms. Employees in financial conglomerates, who already benefit from high compensation, receive a direct wealth transfer from the federal government, and thus from U.S. citizens outside the conglomerates, when their firms are propped up. Those citizens, many of whom are suffering the effects of the economic downturn, are asked to fund this transfer not as a result of any positive benefit to themselves, but the justification is to prevent the loss of the status quo—the subsidy prevents the financial system from collapsing.[73] This justification has not been politically convincing during a time of economic hardship because it is not psychologically convincing (i.e., it tells people to suffer, while employees in conglomerates, who contributed to the financial collapse, continue to receive extraordinary compensation).[74]

Indeed, as Simon Johnson has argued, the financial crisis revealed that those associated with and supportive of financial conglomerates constitute an oligarchy that has captured the federal government, specifically Congress and the Executive Branch, in general and financial regulators in particular.[75] As is customary for elites, the power of the financial elite is partly based upon an ideology that justifies its privileged position in terms of the public benefits it confers.[76] In this case, the ideology is that as a natural development of financial services,

Community Bankers of America 2010 National Convention and Techworld (Mar. 19, 2010) (transcript available at http://www.fdic.gov/news/speeches/chairman/spmar1910.html) (explaining that financial conglomerates have a lower cost of funds because of the "too big to fail" implicit government guarantee).

73. For a typical justification from this perspective, see Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Preserving a Central Role for Community Banking, Address at the Independent Community Bankers of America 2010 National Convention and Techworld 3 (Mar. 20, 2010) (transcript available at http://www.federalreserve.gov/newsevents/speech/bernanke20100320a.pdf).

74. It could be argued that this justification violates individuals' basic notions of fairness. *See* JONATHAN BARON, THINKING AND DECIDING 412–13 (2000).

75. Johnson, a professor of economics at MIT and former chief economist of the International Monetary Fund, and James Kwak, a law student at Yale, operate a well-known blog, the Baseline Scenario, where they regularly advocate this position in light of the financial crisis and financial reform. Simon Johnson & James Kwak, The Baseline Scenario, http://baselinescenario.com (last visited Sept. 30, 2010). *See also* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (2010).

76. *See* PIERRE BOURDIEU, RAISONS PRATIQUES: SUR LA THÉORIE DE L'ACTION 229–33 (1994); *see also* Adair Turner, Chairman, Fin. Servs. Authority, After the Crises: Assessing the Costs and Benefits of Financial Liberalisation: 14th Chintaman Deshmukh Memorial Lecture, Reserve Bank of India, Mumbai 9 (Feb. 15, 2010) (transcript available at http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/ISRT12022010.pdf) (discussing ideology of financial innovation and expansion, which benefitted certain firms and their employees).

financial conglomerates are raising everyone's wealth through their products and contribution to economic growth and stability, which then explains the elite's deserved, albeit outsized, status and compensation.[77] However, the financial crisis discredited this ideology and revealed it for what it is—a self-interested justification for the elite's wealth extraction. This revelation of the financial elite's political power and the emptiness of its ideology has produced a politically explosive situation, as exemplified by the populist hostility to the financial bailout, the Federal Reserve and other financial regulators, the Obama Administration,[78] and the established members of Congress from both political parties.[79]

IV. THE ARGUMENTS FOR AND AGAINST A BREAK-UP OF THE FINANCIAL CONGLOMERATES

This Part considers arguments for and against a break-up of the financial conglomerates. It focuses on whether a break-up is the best way to deal with the problems identified in the preceding Part or whether a less extreme solution can resolve them. Given the complexity of the issue, the following discussion is intended to explore whether the overall analysis points in a particular direction. Moreover, the analysis will also take into consideration international constraints or preferences that argue in favor of or against a break-up.

A. Systemic Risk

An argument for a break-up is that the systemic risk from the "too big" and "too interconnected" conglomerates is simply too great and will get worse as their size grows, which occurs with each financial crisis when they combine into even larger conglomerates. The government is forced into a cycle, in which it must periodically bail out financial conglomerates to prevent a systemic collapse, but, by preserving the conglomerates, this bailout makes future bailouts almost certain when a new product or activity leads to the next collapse of the conglomerates. Thus, rather than being a source of strength through its diversified structure, a financial conglomerate is prone to instability from even

77. For a typical statement in this regards, see *First Public Hearing of the FCIC: Hearing Before the Financial Crisis Inquiry Commission* (2010) (statement of Jamie Dimon, Chairman of the Board and Chief Executive Officer, JP Morgan Chase & Co.), *available at* http://www.fcic.gov/hearings/pdfs/2010-0113-Dimon.pdf (at 6).

78. *See, e.g.*, Brody Mullins & Jean Spencer, *Obama To Keep Goldman Funds*, WALL ST. J., Apr. 22, 2010, at A5.

79. *See* Dylan Ratigan, *Is Your Senator a Bankster?*, THE HUFFINGTON POST, May 7, 2010, http://www.huffingtonpost.com/dylan-ratigan/is-your-senator-a-bankste_b_567907.html.

small problems in financial products and activities, and this instability has dire consequences for the financial system as a result of its size and interconnectedness.[80] The only reasonable policy choice is to reduce the size and the number of activities of conglomerates.[81]

The powerful counterargument would be that enhanced regulation, in particular the reforms in current proposed legislation, will adequately take care of the systemic risk posed by the conglomerates without losing the benefits from these institutions. These reforms include establishing a Financial Stability Oversight Council, enhancing the Federal Reserve's oversight of a new category of "Tier 1" institutions that includes conglomerates, and creating a special resolution regime for these institutions. The Oversight Council would be an early warning system for risks that could destabilize financial institutions and result in systemic risk.[82] With the help of this Oversight Council, the Federal Reserve would have the power to monitor closely financial conglomerates for the impact of developing risks, much as it did during the stress tests, and to take preventive action.[83] Moreover, if a conglomerate is irretrievably damaged, a new resolution process, modeled on the current resolution procedure for banks, will allow the Treasury to orchestrate a takeover of a conglomerate with alternatives for its sale or orderly wind-up, rather than having the government faced with the alternatives of bailout or bankruptcy.[84] The wind down can be aided by a plan, established by the conglomerate beforehand with the

80. This is related to the argument, associated with the work of Hyman P. Minsky, that contemporary finance and financial institutions are unstable and prone to excesses in times of economic expansion, which lead to government bailouts. *See* HYMAN P. MINSKY, STABILIZING AN UNSTABLE ECONOMY 77–106 (2008); Jan Kregel, *Is This the Minsky Moment for Reform of Financial Regulation?*, 2–3 (Levy Inst. of Econ. of Bard Coll., Working Paper No. 586, 2010). Of course, smaller financial institutions can pose a systemic threat as well if they are also interconnected, although their failure is easier to deal with. *See, e.g.*, ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000).

81. This would also mean doing the same for any unregulated financial institutions whose size and diversity of activities similarly threaten financial stability.

82. The problem with writing about financial reform when this Article was originally composed (spring of 2010) is that the legislation was being discussed and changed at that time. Accordingly, the Article generally refers only to the Senate reform legislation that eventually resulted in the passage of Dodd–Frank, not to other legislative proposals or to Dodd–Frank itself. On the Council, see Restoring American Financial Stability Act of 2010, S. 3217, Amendment No. 3739, 111th Cong. §§ 111–21 (Apr. 29, 2010), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-111s3217AS/pdf/BILLS-111s3217AS.pdf [hereinafter, "S. 3217"]. The Oversight Council was implemented in Title I of Dodd–Frank. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, §§ 111–23, 124 Stat. 1376, 1392–1412 (July 21, 2010).

83. *See* S. 3217, *supra* note 82, §§ 115, 165. Title I of Dodd–Frank adopted this enhanced regulatory role of the Federal Reserve for systemically important firms. *See* Dodd–Frank §§ 111–23.

84. *See* S. 3217, *supra* note 82, §§ 201–211. The new resolution authority appears in Title II of Dodd–Frank. *See* Dodd–Frank §§ 201–17.

consultation of regulators, for its liquidation.[85] This approach of an oversight board for systemic risk, with a resolution authority for conglomerates, is the favored one in the global financial community and among non-U.S. financial regulators.[86]

Questions remain as to whether the Oversight Council will, in good times, have the foresight to detect the risks that matter and possess the will to direct the Federal Reserve to rein in the conglomerates, who will argue that restrictions on their activities do not make sense.[87] The new resolution regime provides a final barrier to systemic risk if a conglomerate fails, but one cannot help but wonder how it will work in practice if, as the recent crisis has demonstrated, numerous financial conglomerates will likely be failing at the same time because of their collective involvement in certain activities and they will have operations in numerous jurisdictions. Then, in a situation of international systemic risk, the federal government will have the choice again between a nationalization of numerous financial conglomerates and a bailout of them—a choice that the financial reform is intended to remove.[88] By contrast, a break-up of the conglomerates prevents them from having this systemic effect.

B. Risk Management

With regard to risk management, the argument for the break-up is that

85. *See id.* § 115(d). This is known as a "living will" for a conglomerate. *See generally* Robert E. Litan, *Whither Financial Reform?*, ECONOMIST'S VOICE, Oct. 2009, at 1, 4; Emilio Avgouleas et al., *Living Wills as a Catalyst for Action* (Duisenberg Sch. of Fin., Policy Paper No. 4, 2010).

86. *See, e.g.*, European Parliament, Comm. on Econ. & Monetary Affairs, *Draft Report on the Proposal for a Council Regulation Entrusting the European Central Bank with Specific Tasks Concerning the Functioning of the European Systemic Risk Board* (Feb. 10, 2010), *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&mode=XML&language=EN&reference=PE438.515; *Commission Communication: European Financial Supervision*, COM (2009) 252 final (May 27, 2009), *available at* http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf; *see also* BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP (2010), *available at* http://www.bis.org/publ/bcbs162.pdf.

87. *See, e.g.*, Statement of Mary L. Schapiro, *supra* note 55, at 11 (warning against being too confident in consolidated supervision with respect to these complex firms).

88. The legislative package in fact provides for emergency guarantees to, among other institutions, financial conglomerates to be provided by the FDIC during times of "severe economic distress." *See* S. 3217, *supra* note 82, § 1155 (entitled "Emergency Financial Stabilization"). On the other hand, the costs of systemic risk can be assessed ex ante and thus imposed upon financial conglomerates. *See, e.g.*, Viral V. Acharya et al., *Measuring Systemic Risk* (Fed. Reserve Bank of Cleveland, Working Paper No. 10-02, 2010), *available at* http://www.clevelandfed.org/research/workpaper/2010/wp1002.pdf (coming up with a measure of a conglomerate's contribution to this risk, which can be used for assessing costs ex ante and which is different from the costs of a bank's failure (i.e., to its liabilities)).

the complexity and interconnections of the conglomerates, particularly in light of the pressures for financial innovation and the skewed incentives of compensation, make risk management in them a Herculean and ultimately an impossible task. Moreover, given all the problems with risk management relating to the limitations of risk models, failure to engage in stress testing and scenario analysis, governance failures, and limitations on regulatory oversight,[89] risk management will inevitably break down, causing a systemic problem.[90] One could rationally try to deal with risk management problems by being very conservative with respect to the regulation of conglomerates, which would mean imposing capital requirements far beyond what risk models require.[91] But this would generate opposition from the financial industry and would be difficult to defend when times are good. From a pragmatic perspective, it makes sense just to break-up the conglomerates into smaller parts that risk management can effectively manage.

But the break-up of conglomerates could be seen as a gross overreaction to the recent failings of risk management. Proponents of this activity could argue that risk management, as every human endeavor, is improved through the useful experience of failure. Risk models have been ameliorated (e.g., by using better data, inputting more factors); stress testing and scenario analysis are now seriously being used; and regulators are insisting that directors and high-level executives pay attention to risk management.[92] Moreover, as one would expect, risk management specialists have responded to the crisis by correcting risk management failures or lacunae that were exposed. For example, attention is now being given to liquidity risk, and the methods to address it, such as having longer-term funding and contingent capital,[93] are being implemented by conglomerates.[94] As a result of risk management

89. *See supra* subpart III.B.

90. *See* Viral V. Acharya et al., *Manufacturing Tail Risk: A Perspective on the Financial Crisis of 2007–2009*, *in* 4 FOUNDATIONS AND TRENDS IN FINANCE (forthcoming 2010) (contending that the crisis arose because financial conglomerates "gamed" the risk capital system by holding asset-backed securities that required little capital because their risk was not recognized, or by providing guarantees to special investment vehicles holding such securities, pushed on by employees who were paid for these investment that were high performing, since their risk was hidden).

91. *See, e.g.*, Peter Boone & Simon Johnson, *The Doomsday Cycle*, CENTREPIECE, Winter 2009/2010, at 10 (arguing for tripling capital requirements of large firms).

92. For a general discussion of the need for improvements to risk management, see GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 41 (2009). *See also* BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE (2010), *available at* http://www.bis.org/publ/bcbs168.pdf (discussing ways to enhance oversight of risk management).

93. Contingent capital means debt financing that, in certain circumstances (e.g., near insolvency by a conglomerate), converts automatically to equity.

94. *See, e.g.*, BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS,

improvements, overall capital requirements for conglomerates are being raised to ensure that there is no repeat of the financial crisis.[95] Furthermore, this focus on improving risk management in conglomerates is being done in a way coordinated with international financial regulators, in particular through the Basel Committee on Banking Supervision of the Bank for International Settlements. In sum, because reasonable, global steps to improve risk management problems in conglomerates are being taken, a break-up of the conglomerate on risk management grounds is not justified and flies in the face of international financial regulation.

C. Commoditization and Opaqueness

The argument for a break-up with respect to commoditization and financial innovation is that financial conglomerates, in good times, will invariably extend too far into commoditized products and develop risky innovative products. Once again, risk management will be unable to deal with the risks arising from these activities, particularly with respect to the new products that have not been adequately tested, and financial conglomerates will suffer as a result because of their size and interconnection.[96] Accordingly, at the very least, the parts of the conglomerate most involved in financial innovation and opaque markets—generally, although not exclusively, the securities subsidiaries—should be spun off from the conglomerates so that the damaging effects from the innovations do not affect the rest of the firm. As for the risks involved in the inappropriate spread of "commoditized" products like high risk mortgages, shrinking the firm's size could address the fallout from these practices, which of course should also be regulated.

The major counterargument against a break-up would be that it needlessly sacrifices the economies of scale and scope that come from commoditization and financial innovations in financial conglomerates.

PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION (2008), *available at* http://www.bis.org/publ/bcbs138.pdf?noframes=1; Interagency Policy Statement on Funding and Liquidity Risk Management, 75 Fed. Reg. 13,656 (Mar. 22, 2010).

95. *See, e.g.*, BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR (2009), *available at* http://www.bis.org/publ/bcbs164.pdf?noframes=1 (discussing ways to enhance capital requirements). Title I of Dodd–Frank both enhanced the capital requirements for financial conglomerates and the Federal Reserve's prudential regulation of them, particularly with respect to matters such as risk management. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, §§ 111–76, 124 Stat. 1376, 1392–1442 (July 21, 2010).

96. *See* Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333 (1989).

For example, financial innovations, like securitization or securities trading technology, may at first be restricted, but eventually are distributed widely and adapted to broader contexts and more customers through the conglomerate. Moreover, a break-up would undermine the financial conglomerates' potential to develop products dealing with risks that could be important for ordinary individuals.[97] An improved risk management should be able deal with the risks posed by new products (so long as there is adequate testing of them) and with those arising from a widespread extension of existing products. It might be more sensible, then, to support a proposal such as that for a publicly funded "National Institute of Finance," which would study the effects and risks of innovative financial products.[98] It is likely that one's views on improvements to risk management in the financial conglomerate will mirror one's outlook on how to deal with the risks posed by commoditization and opaqueness, and the global approach is in favor of a risk management solution.

D. Compensation Policies

The short-term nature of compensation in financial services, when combined with the size, interconnectedness, complexity, innovations, and risk management failures of financial conglomerates, is a recipe for disaster that ensures they will periodically collapse. Compensation reforms cannot correct the problem because compensation will be tied to risk models, which imperfectly capture risk and which in any event can be gamed by employees. Moreover, the corporate form of the financial conglomerate, as opposed to the former partnership form, makes a long-term model of compensation for employees difficult to formulate.

In addition, compensation policies in financial conglomerates are based on a finance model of human nature, the self-interested, profit-maximizing individual. This model reinforces the short-term perspective because it instructs individuals to focus on the self, as

97. *See* ROBERT J. SHILLER, THE NEW FINANCIAL ORDER: RISK IN THE 21ST CENTURY 107–85 (2003) (discussing potential new financial products).

98. *See, e.g.*, *Hedge Funds and the Financial Market: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. (2008) (prepared written statement of Andrew W. Lo, Professor, Mass. Inst. of Tech. Sloan Sch. of Mgmt.), *available at* http://oversight.house.gov/images/stories/documents/20081113101922.pdf (recommending the creation of a Capital Markets Safety Board). The proposed Financial Stability Oversight Council discussed above would also have this purpose. For a bill to create a National Institute of Finance, see National Institute of Finance Act of 2010, S. 3005, 111th Cong. (2010). Title I of Dodd–Frank did create an Office of Financial Research within the U.S. Treasury Department, which would gather information on financial institutions and financial trends. *See* §§ 151–56, 124 Stat. at 1412–20.

opposed to institutions or organizations.[99] This approach is now over-determined because it is the result of many causes, including teaching in business schools and the primacy of the economic approach in policy-making, and it will not change easily.[100] In other words, any compensation reforms in the conglomerate will likely be undermined by the tenacity of this model. This can be seen in the case of compensation policies in the conglomerates following the financial crisis, which have generally returned to prior practices, and with those in conglomerates being unable to understand why there is any objection to their compensation practices.[101] Given the intractability of the compensation problem, the only sensible way to address the dangers from compensation practices in financial conglomerates is to keep the institutions small.

Once again, one could argue that a break-up is unnecessary to deal with the problem in compensation policies, because financial firms, trade organizations, and regulators are revising them to address their short-term nature. For example, compensation reforms propose longer vesting and holding periods for equity compensation, clawbacks for a certain part of the compensation if the results of transactions underperform in the long term, and a ban on guaranteed bonuses.[102] The reform efforts are ongoing and, like the risk management improvements, need time to come to fruition.[103] Moreover, compensation arrangements that are more long term in nature are possible in the corporate form, and thus the fact that financial conglomerates are no longer partnerships has no bearing on the compensation question.[104] The flaws in the agency

99. *See, e.g.*, MICHAEL C. JENSEN, FOUNDATIONS OF ORGANIZATIONAL STRATEGY 51–102 (1998).

100. *See, e.g.*, Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACAD. MGMT. LEARNING & EDUC. 75, 76–77 (2005); Dennis A. Gioia, *Business Education's Role in the Crisis of Corporate Confidence*, 16 ACAD. MGMT. EXECUTIVE 142, 143 (2002).

101. *See* CUOMO, *supra* note 28.

102. For a summary of the reform efforts with respect to compensation in financial services, see STEERING COMM. ON IMPLEMENTATION, INST. OF INT'L FIN., REFORM IN THE FINANCIAL SERVICES INDUSTRY: STRENGTHENING PRACTICES FOR A MORE STABLE SYSTEM (2009), *available at* http://www.fide.org.my/publications/reports/0010_rep_20091214.pdf. I was a member of the Advisory Panel on the compensation part of this report.

103. Reform efforts are also being undertaken by financial regulators. *See, e.g.*, Incorporating Employee Compensation Criteria into the Risk Assessment System, 75 Fed. Reg. 2823 (Fed. Deposit Ins. Corp. proposed Jan. 19, 2010). Title IX of Dodd–Frank included compensation reforms, which generally dealt with compensation in all public companies, not just financial conglomerates. *See* §§ 951–57, 124 Stat. at 1899–1906. Section 956 of this Title did direct federal financial regulators to issue regulations or guidelines that would require financial institutions to disclose their compensation arrangements so that the regulators could determine whether those arrangements pose undue risks to the institutions. *See id.* § 956, 124 Stat. at 1899–1900.

104. *See, e.g.*, Roger Martin, *The Age of Customer Capitalism*, HARV. BUS. REV., Jan.–Feb. 2010,

model are overblown because employees' self-interest can be linked to the long-term well-being of their institution. Although there is an international concern about the dangers of compensation policies in financial conglomerates, the international approach—as seen in the Institute of International Finance report—is to correct them, not to break-up conglomerates in an attempt to remedy the problem.[105]

E. Conflicts of Interest

Either one believes that the conflicts of interest can be adequately dealt with by compliance and risk management systems in financial conglomerates or that they cannot. In the latter case, a spin-off of at least the conglomerate's proprietary activities would be the solution. Beliefs matter here because evidence of these conflicts is not easy to obtain in the absence of clear case of insider trading or self-dealing. This is why the recent SEC enforcement action against Goldman Sachs is interesting because it exposes the kind of conflict typical in a conglomerate, where a firm is both an intermediary in transactions and taking a principal position in them.[106] It is likely that the international regulatory perspective, so bound to a risk management approach, would accept a compliance-based solution for this problem, rather than the necessity of a break-up.[107]

F. Government Support, Markets and Politics

A break-up of the financial conglomerate will not dislodge overnight the financial elite, for the ideology sustaining this class has many sources of support and is deeply ingrained in the political fabric.[108] However, the conglomerates provide power and resources to the elite for, with their diverse financial activities, they are the paradigm of

at 58, 64–65 (discussing executive compensation with long post-retirement vesting period).

105. *See, e.g.*, BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, COMPENSATION PRINCIPLES AND STANDARDS ASSESSMENT METHODOLOGY (2010), *available at* http://www.bis.org/publ/bcbs166.pdf (discussing principles to guide compensation practices in financial institutions); FIN. STABILITY BD., THEMATIC REVIEW ON COMPENSATION (2010), *available at* http://www.financialstabilityboard.org/publications/r_100330a.pdf (summarizing compensation reform efforts in different countries).

106. *See supra* note 67 and accompanying text.

107. *See, e.g.*, ORG. FOR ECON. CO-OPERATION & DEV., THE FINANCIAL CRISIS: REFORM AND EXIT STRATEGIES 36 (2009) (discussing control procedures to restore confidence in financial institutions).

108. *See supra* note 100 and accompanying text; *see also* GERALD F. DAVIS, MANAGED BY THE MARKETS: HOW FINANCE RESHAPED AMERICA (2009) (discussing how finance has permeated throughout American life).

finance, a training ground and a financial support of the elite and a bastion around which other financial institutions (and seats of financial power, like hedge funds and private equity funds) radiate and draw resources. They are also the most direct way in which the financial elite receive government support. The concern is that, as these institutions continue to grow to enormous size, they will distort political life because they will buy off politicians, the Executive Branch, and regulatory agencies with their followers.[109] Therefore, a break-up is the only way to help take back political control from the financial elite, short of a political upheaval. Moreover, a break-up that would remove the implicit government guarantee from the conglomerates and the support for the financial elite would produce a more competitive market for financial services.

By contrast, a break-up may be seen as an overreaction to these market and political concerns, the latter of which might be exaggerated in any event. Certainly, a renewed focus on antitrust in financial services could deal with inappropriate market power by the financial conglomerates.[110] Moreover, as noted earlier,[111] the financial conglomerates are not just a product of government support and political domination because there is an economic logic to them and thus there will be costs to their break-up that might exceed the benefits. The conglomerates have scale and scope economies from their size and diverse services, and many of them performed better than less diversified firms, such as investment banks, during the crisis.[112] In other words, one can no longer ignore the economic reality of large financial firms than one can deny the economic justifications for large firms in general. The answer is not to break them up, but to make them pay for the implicit government guarantee, such as by a fee assessed against conglomerates, which has been suggested by the Obama Administration.

Moreover, financial conglomerates are global and the dominant form of financial firms outside the U.S. To break up U.S. conglomerates or to reduce their size would hurt the U.S. financial industry in favor of either

109. *See* Simon Johnson, *The Quiet Coup*, THE ATLANTIC, May 2009, *available at* http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/7364/ (Johnson likens the conglomerates to oligarchies in lesser developed countries that have captured the government).

110. This point is even made by Simon Johnson. *See* Posting of Simon Johnson to N.Y. Times Economix, http://economix.blogs.nytimes.com/2010/01/21/an-antitrust-investigation-of-the-banks/ (Jan. 21, 2010, 7:17 AM).

111. *See supra* note 14 and accompanying text.

112. *See* David C. Wheelock & Paul W. Wilson, *Are U.S. Banks too Large?*, (Fed. Reserve Bank of St. Louis Research Div., Working Paper No. 2009-054B, 2009), *available at* http://research.stlouisfed.org/wp/2009/2009-054.pdf (discussing scale and scope economies among large financial institutions); *see also* Statement of Brian T. Moynihan, *supra* note 22, at 10.

foreign financial firms or unregulated firms.[113] Despite the setback of the financial crisis, finance has been a source of strength and expertise in the U.S. economy. It makes no sense to take unnecessary actions that might hurt an industry and have lasting effects on U.S. economic competitiveness.[114]

Finally, the political story of an elite benefitting from finance and controlling U.S. political life may be overblown and even dangerous in its own right. In many ways, finance has been liberating in ensuring that resources flow without political favoritism to those with new ideas and the best prospects. If anything, the problem has been that finance has not gone far enough to deal with all the risks facing ordinary people.[115] The existence of financial elite (and of its compensation) represents nothing more than the reality of economic gains from expertise in a society in which finance plays a significant role.[116] Moreover, the elite are hardly a closed one; it is ethnically diverse and open to anyone who has the willingness to obtain the necessary expertise. In other words, financial elites appear attractive when contrasted with elite status based on characteristics like birth and hereditary wealth.[117]

G. Summary

Looking over this Part's discussion of potential solutions to the problems associated with the financial conglomerate, there are clearly strong pressures against their break-up. Indeed, the inclination of the financial industry and regulators, both inside and outside the U.S., is to maintain the status quo of the financial conglomerate, while improving its internal compliance and external supervision. The improvements will essentially consist of adjustments to existing technocratic frameworks, such as capital requirements, risk management, and compensation policies and design. By contrast, if one is fundamentally skeptical about the adequacy of the technocratic solutions and concerned about social upheavals triggered by the privileged position of the financial

113. *See* Statement of Hal S. Scott, *supra* note 15, at 22.

114. *See generally* RAGHURAM G. RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS 201–225 (2003) (explaining how economic policies can reverse the economic fortunes of countries). *But see* Turner, *supra* note 76, at 3, 12 (questioning whether increased financial innovation has increased economic growth).

115. *See* SHILLER, *supra* note 97.

116. *See generally* Thomas Philippon & Ariell Reshef, *Wages and Human Capital in the U.S. Financial Industry: 1909–2006* (Nat'l Bureau of Econ. Research, Working Paper No. 14644, 2009) (finding an expertise explanation for financial industry compensation, but also finding excess rents and unsustainable nature of this compensation).

117. *See* RAJAN & ZINGALES, *supra* note 114, at 68–92.

conglomerate and its employees, as well as the repeated economic upheavals caused by the conglomerates, a break-up and size reduction may be the only sensible answer to the problems posed by these financial institutions.

V. BREAK-UP ALTERNATIVES

If, in light of the preceding Part's discussion regarding the problems in conglomerates, one concludes that a break-up of them is the best solution to address one or more of the problems, it is useful to consider different options for a break-up. But it should be recognized that the political situation is different from what it was in early 2009, when financial conglomerates were weakened and in need of government support, and when the federal government had a somewhat free hand with respect to them. Now that the financial system has stabilized and most of the major financial conglomerates have paid back the capital infusions from the government, they are mobilized to respond to legislative and regulatory proposals that would affect them.[118] Thus, any effort to break-up financial conglomerates will meet with resistance. This outcome is likely for the better because financial reform legislation should not happen in a panic or rush, but should be informed by an active debate of all interested parties so long as all options are seriously considered and the political power of the conglomerates does not dictate the results.[119] Moreover, since financial conglomerates operate globally, how a particular option is viewed by foreign regulators, foreign institutions, and international bodies must be taken into account. The

118. *See, e.g.*, Robin Sidel & Damian Paletta, *Mr. Dimon Goes to Washington*, WALL ST. J., Apr. 7, 2010, at A1. The article discusses lobbying efforts by JP Morgan CEO James Dimon and his firm. Part of their efforts is to offer explanations for the financial crisis, such as the influx of overseas funds and the government policies promoting low-cost home mortgages, that excuse the financial conglomerates from most of the blame for the financial crisis. *See, e.g.*, Statement of Lloyd C. Blankfein, *supra* note 57, at 7 (blaming the crisis on an unreasonable market panic). And defenders of the financial conglomerates have emerged in full force in the academy, particularly from prestigious institutions. *See, e.g.*, Statement of Hal S. Scott, *supra* note 15.

119. The problem, however, is that there is evidence that, through campaign contributions, the financial conglomerates have put certain options off the table in the financial reform, such as size limitations to them. *See* Posting of Simon Johnson to The Baseline Scenario, http://baselinescenario.com/2010/05/07/falling-back-on-waterloo/ (May 7, 2010, 9:56 AM) (discussing the defeat of the Brown–Kaufman amendment to the Senate financial reform bill, which was to limit the size of the conglomerates). For this amendment, see Safe, Accountable, Fair, and Efficient Banking Act of 2010, S. 3241, 111th Cong. (2010) (among other proposed reforms, limiting to 10% the amount of national deposits any banking institution to have, imposing a 6% leverage ratio on financial firms, limiting nondeposit liabilities of any financial firm to 2% of gross domestic product, and requiring regulators to take immediate action, through the sale of assets or reduction of activities, to bring a firm into compliance with the rules, with no discretion to regulators to waive the requirements).

options that will be considered below are as follows: (1) a gradual break-up of the conglomerates; (2) a spin-off of the certain parts of the conglomerates; (3) a return to Glass–Steagall's separation between commercial and investment banking; and (4) a separation between retail and wholesale banking.[120]

A. Gradual Break-up: Making Financial Conglomerates Expensive

This option means enhancing the regulation of financial conglomerates to deal with their systemic risk and making them pay for the implicit government guarantee. In time, this would drive up their costs to an appropriate level and may prove to be too expensive for the conglomerates to operate in their current form. In other words, the option would be a gradual, market-based transformation of the status quo that would not upset financial institutions in these still fragile times. This appears to be the Obama Administration's preference, as it has proposed general size limitations on conglomerates, as well as fees on them for recovery of government funds.[121] Moreover, this approach is consistent with current regulatory initiatives of many federal regulators, which are imposing more onerous requirements upon conglomerates to address the problems highlighted earlier.[122] In addition, because reform is being proposed with respect to many of the unregulated markets, such as over-the-counter derivatives, where conglomerates operate, the conglomerates will incur enhanced costs on their activities.[123] Furthermore, as noted throughout this Article, this approach has the advantage of support from international financial regulatory bodies, such as the Basel Committee on Banking Supervision, and would mirror the current international approach with respect to the conglomerates, which is to regulate them more strictly.

120. For an excellent consideration of these and other alternatives, see Ingo Walter, *The New Case for Functional Separation in Wholesale Financial Services* 26–32 (July 30, 2009) (unpublished manuscript, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1442148).

121. *See supra* notes 35–49 and accompanying text.

122. The regulations impose higher capital requirements upon conglomerates, heightened risk management procedures, and higher fees to address various problems. *See supra* notes 94, 103 and accompanying text; *see also* Stephen Joyce, *Regulators Already Working to Implement Key Aims of Pending Financial Reform Bills*, 22 Bankr. L. Rep. (BNA) 483 (Apr. 8, 2010) (discussing financial regulators' current initiatives).

123. *See, e.g.*, S. 3217, *supra* note 82, at Title VII (entitled "Wall Street Transparency and Accountability"). Title VII of Dodd–Frank in fact imposed considerable regulation on over-the-counter swap markets. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, §§ 711–54, 124 Stat. 1376, 1641–1754 (July 21, 2010). In effect, the approach of Dodd–Frank is in line with this gradual break-up approach because it imposes new regulatory costs upon the conglomerates.

The problem with this option is that it may not end conglomerates because they will be able to water down the legislation, reducing the costs imposed on them, which means that they will not pay entirely for the implicit government support. Any legislation that passes (such as Dodd–Frank) will require implementing regulations that leave considerable discretion to financial regulators, particularly with respect to such matters as capital requirements and related risk management.[124] It is likely that, when the economy improves, conglomerates can convince the regulators, who often come from the conglomerates and hope to return to employment with them, that strict regulatory restrictions should be loosened or dropped.[125] Therefore, the risk of the gradualist approach is that financial conglomerates endure despite changes to the laws and regulations.

B. Spin-Off of the "Dangerous" Parts of Conglomerates

Under this approach, there would be an effort to identify the most troubling parts of a conglomerate with respect to the problems discussed earlier and then to require that these parts be spun off from the institution.[126] A version is the Volcker Rule, which would require that a financial conglomerates spin off proprietary trading operations, hedge funds, and private equity fund sponsorship and investments.[127] Another version of this approach is the recent proposal to bring dealing in over-the-counter derivatives and swaps by conglomerates onto organized markets, with prudential requirements for dealers, which might have the effect of separating this activity from them.[128]

A difficulty with this approach is to decide which parts of the financial conglomerates are the most troubling and which problem one is addressing by the divestment, for it will determine the spin-off strategy. That is, is the goal to address systemic risk, risk management, commoditization, compensation policies, conflicts of interest, or government support and politics, or some combination of them? For example, although the Volcker Rule has been justified on grounds of systemic risk and risk management, it also appears to be grounded in political concerns: a response to the suspicion that financial

124. The current Senate bill is replete with such discretion. *See id.* § 165 (describing the Federal Reserve's enhanced regulation of Tier 1 institutions).

125. Arguably, this is what happened with respect to financial regulation before the financial crisis.

126. *See, e.g.*, Walter, *supra* note 120, at 31.

127. *See supra* notes 38–45 and accompanying text.

128. *See supra* note 123 and accompanying text.

conglomerates are using the implicit government subsidy to subsidize their own trading and to enrich their employees and shareholders.[129] But if the purpose of the spin-off is not clearly identified, it will be more controversial and its implementation more difficult. Again to use the Volcker Rule as an example, while financial firms have raised (and continue to raise) the difficulty of separating proprietary from client based market making,[130] the response of the proponents is simply to push the hard decisions off on financial regulators.[131] If the main purpose of a spin-off is to prevent systemic risk, other operations of the conglomerate might also be targeted, such as securitized lending, the creation of exotic financial products, and leveraged lending.[132] Moreover, if the spun-off activities are dangerous on their own, they need additional regulation.[133]

International support for the spin-off approach is uncertain, and, if it exists, it may exist for the wrong reasons. On the one hand, the financial conglomerate is the norm outside the United States; therefore, any effort to break it up, directly or indirectly, is likely to encounter foreign resistance. On the other hand, foreign financial regulators might be supportive of a spin-off, such as with respect to hedge fund and private equity fund operations. But their support might arise from the fact that these operations are an Anglo-American invention and not well-established in Europe.[134]

C. Return to Glass–Steagall

As many have now noted,[135] the period of Glass–Steagall's separation of commercial and investment banking was a period of considerable stability in finance. Accordingly, another approach would reinstate that

129. *See* Statement of Paul A. Volcker, *supra* note 42, at 1–2.

130. *See* Statement of Hal S. Scott, *supra* note 15, at 11–12.

131. *See* Statement of Paul A. Volcker, *supra* note 42, at 4.

132. *See* Statement of Hal S. Scott, *supra* note 15, at 9–10 (discussing financial activities that were at the heart of the crisis).

133. This is, in fact, the approach of the current reform legislation, which would bring more financial activities, such as swaps and over-the-counter derivatives, into regulatory jurisdiction and would regulate hedge fund advisors, as well as non-regulated firms whose failure would create systemic risk. *See* S. 3217, *supra* note 81, at Title IX, Title IV.

134. There is a certain truth to the perception that, while hedge funds did not cause the financial crisis, the crisis has been used as an excuse in the United States and in Europe to extend regulation to this part of the financial industry. *See, e.g.*, FIN. STABILITY BD., OVERVIEW OF PROGRESS IN IMPLEMENTING THE LONDON SUMMIT RECOMMENDATIONS FOR STRENGTHENING FINANCIAL STABILITY 10–11 (2009).

135. *See, e.g.*, Moss, *supra* note 71, at 25; Martin Mayer, *Glass–Steagall in our Future: How Straight, How Narrow*, 6–7 (Ind. State Univ. Networks Fin. Inst., Policy Brief No. 2009-PB-07, 2009), *available at* http://ssrn.com/abstract=1505488; Walter, *supra* note 120, at 3.

law, essentially putting the genie back into the bottle and returning to a situation in financial services where investment banking, commercial banking, and insurance would be completely separate.[136] For example, a commercial bank could not engage in investment banking or be in an affiliated group with a broker–dealer. This approach would not have to exclude other reforms that were not part of Glass–Steagall, such as extending regulation to unregulated "Tier 1" firms and establishing a systemic risk regulator.

This approach is likely to be difficult to accomplish from theoretical, practical, and political perspectives. The theoretical justification for Glass–Steagall's repeal—that it makes no economic sense to separate activities that are all financial—has not changed. Moreover, during the years when Glass–Steagall was in force, issues of line-drawing constantly surfaced, and the results often seemed artificial. Furthermore, as securities markets have developed, the domain of commercial banking has become smaller, as was seen with the growth of loan securitizations. Thus, to reinstate Glass–Steagall would be to put commercial banking in an untenable position.[137] In addition, because different financial areas have grown together and intertwined before and after the repeal of the Act, it would now be an enormous and costly task to unravel them. From a political perspective, it took almost twenty years to marshal the political forces to repeal Glass–Steagall and similar political support for reinstating it does not exist. Finally, there will be almost no international support for this approach because the norm in developed countries is to combine in one firm, not to separate, financial services.

D. Public Utility Approach

This approach would be to restructure and to reduce the size of the financial conglomerates in a novel way by separating out and thus creating "public utility" or retail financial institutions that would provide commodity financial services and "plain vanilla" products to consumers and small businesses in banking advice, brokerage advice, investment advice, and insurance.[138] The deposits of only these institutions would

136. *See, e.g.*, Thomas Frank, *Bring Back Glass–Steagall*, WALL ST. J., Jan. 13, 2010, at A21.

137. *But see* Walter, *supra* note 120, at 30–31 (arguing that reinstatement of Glass–Steagall could make economic sense). And, in fact, Dodd–Frank does not separate commercial and investment banking.

138. For related proposals, see Emilios Avgouleas, *The Reform of 'Too-Big-To-Fail' Bank: A New Regulatory Model for the Institutional Separation of 'Casino' from 'Utility' Banking* (Feb. 14, 2010) (unpublished manuscript, available at http://ssrn.com/abstract=1552970); Walter, *supra* note 120, at 31.

be insured by the federal government, and these firms alone should benefit from an implicit government guarantee. The wholesale side of financial conglomerates, which would involve market-making in exchange and off-exchange financial products, securities underwriting, insurance underwriting, and structuring of asset securitizations, would essentially operate separately from the retail institutions. The deposits of these institutions would not be federally insured, but the institutions would still be subject to federal oversight and to a resolution regime. Reducing the size of financial conglomerates could be combined with this approach.[139]

Of course, this approach, like the return to Glass–Steagall, raises line-drawing issues—such as determining which activities would be allowed in the retail institutions. Once again, one suspects that this wholesale/retail approach with size limitations would not be popular abroad, given that foreign financial conglomerates have traditionally combined wholesale and retail activities. But it is possible that foreign policy makers may become more receptive to some aspects of this approach, because they, too, have experienced firsthand the tremendous costs that the collapse of financial institutions have imposed upon their governments.[140] Moreover, other countries may be eager to rein in financial conglomerates with a securities orientation because their home-grown conglomerates have traditionally been more bank-centered.

VI. CONCLUSION

The overall conclusion of the Article is that, while many of the problems in the financial conglomerates argue for their break-up, the practical and political reality, including the orientation of international financial regulation, is that the conglomerates will endure. That is, these firms appear to pose a significant economic and political risk to this country. Because they cannot be effectively risk managed, especially in light of their products and short-term compensation, they run the risk of repeated failure, which exposes the government and taxpayers to potential costs associated with the bailouts necessary to avoid systemic risks. The bailouts coupled with the visibility of the extraordinary rewards for a financial elite working in and controlling conglomerates,

139. This would involve setting firm limits on the size of either a retail or wholesale conglomerate out of concern that the failure of any one (and certainly of more than one) can almost bankrupt a country. Indeed, a model of such an approach is the SAFE Act, which was defeated as an amendment to S. 3217. *See supra* note 119 and accompanying text. Again, Dodd–Frank did not accept this approach.

140. One thinks of the situation in Iceland, where the collapse of financial institutions has bankrupted the country.

regardless of a firm's performance, and with the accompanying conflicts of interest have stirred up political opposition to the firms. Therefore, although it may make the most economic and political sense to combine firm limits on conglomerates' size with a spin-off or separation of certain activities, the status quo of the conglomerates will likely prevail, although they will in the short term be regulated more closely, both domestically and internationally, and have to pay more for their implicit government guarantee.