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FEDERALISM AND FINANCIAL SERVICES

JOHN S. BARRY

The financial services industry has changed significantly over the past 60 years, but federal and state laws have not. Now that Congress is seriously considering changing how commercial banks, investment banks, and insurance companies interact, it is important to recognize that the industry no longer can be defined as it once was. The current regulatory approach is based on clearly defined institutions that provide specific and easily identifiable products. Today, however, the distinction between financial services and other commercial activities is less clear than it once was. A new paradigm for overseeing and deregulating this changing industry is needed.

The first step Congress should take in defining this new paradigm is to distinguish between the limited and expressed responsibilities of the federal government and the residual responsibilities of the states—an issue that has been debated since the United States was founded. The U.S. Constitution was written and adopted precisely because the proper balance between the state and federal governments had not been clearly established by the Articles of Confederation. In the current realm of financial services, the debate centers on two key questions:

- **What** is the proper balance between state sovereignty and the federal government's constitutional duty to ensure free interstate commerce?
- **How** can the delicate balance between these two levels of government be maintained to protect individual liberty while promoting economic prosperity through a free and open financial services market?

Financial services firms depend on sophisticated networks of transactions and deposits that cross state lines and even extend outside the United States. Defining the proper role for the states and the federal government in overseeing such a diverse economic sector will not be easy, but it is necessary if Congress is to facilitate the integration and modernization of financial services.

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Legal tests can help Members of Congress uncover protectionist intent, discriminatory effects, or extraterritorial overreach in a financial activity; determine the proper responsibilities of state and federal regulators; and offer a sound course of action. Specifically, these tests should examine:

1. **Legal precedent.** Do the Constitution or statutes passed pursuant to it serve as legal prece-

dent for prohibiting state action in a given field?

2. **Historical pattern of regulation.** Has the industry or activity historically been regulated at the federal, state, or local level?
3. **Technological complexity and "network externalities"** (costs and benefits that accrue to groups not directly responsible for deregulation). In sophisticated modern markets (especially complex, interlocking national networks), are there negative effects associated with state-by-state regulation?
4. **Interstate scope.** Is the industry or activity clearly interstate in nature and scope?
5. **Level of interstate spillover.** Will state actions result in "substantial spillover effects" that adversely affect interstate commerce?
6. **National need.** Is there a clear and overriding national need for congressional action?

State and federal policymakers should use these legal tests to help strike the proper balance between state sovereignty and federal oversight of interstate commerce. As these tests are applied to the financial services industry, it should become clear that, in general:

- **The federal government has the constitutional responsibility to oversee the commerce of financial services.** The commercial aspect of financial services firms involves activities that are necessary to ensure that they function as safe, sound institutions. Commercial activities of financial services firms necessitate intricate interstate networks, create extensive interstate spillovers, and are the backbone of the nation's monetary system.
- **The states should retain the right to regulate the business aspects of the financial services industry.** The business or industry of financial services involves the actual products sold to the public. These may be annuities, insurance policies, checking or savings accounts, or securities. In any case, the sale of the actual product and the actual delivery of that product can be pinned to specific geographic locations. Therefore, it is appropriate that states regulate the business or industrial activity of financial service firms within their borders.
- **The federal government has the constitutional responsibility to ensure interstate commerce.** Specifically, the federal government should retain the right to preempt state regulations *proscriptively* when they interfere with interstate commerce. This does not mean, however, that the federal government has the right or responsibility to promulgate such regulations *prescriptively.*

Although the business and commerce of financial services cannot be separated entirely from each other in practice, such a distinction is necessary if Congress is to define the proper roles for the federal and state governments in overseeing these activities. Given the current division of entrenched regulatory power, this will not be easy. But if Members of Congress follow the principle and process of federalism, the American financial services industry can enter the 21st century renewed, reinvigorated, and unburdened by outmoded constraints.

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The American financial services industry has changed significantly over the past 60 years. New products, such as mutual funds, variable rate annuities, and derivatives, are now available; the distinctions between savings accounts, life insurance policies, stock funds, and other forms of financial investment are becoming increasingly blurred; and products are being marketed through new forms of technology, such as the Internet. The result is the world's most advanced, liquid, and yet stable financial system.

But federal and state laws have not kept pace with the evolution of the financial services industry since 1933. They still are based on the continued separation of commercial banking, investment banking, insurance provision, and all other commercial activity. Consequently, different rules and regulatory agencies govern similar financial firms and nearly identical financial products.

To facilitate modernization in the financial services sector, Congress has attempted many times over the past decade to overhaul the Banking Act of 1933, the so-called Glass–Steagall Act that established a restrictive regulatory regime separating investment and commercial banking activities. None of these efforts—including the Financial Services Competition Act (H.R. 10), introduced by House Banking Committee Chairman James Leach (R–IA) in 1997—has proved successful. The banking, insurance, and securities industries remain separate from other commercial activities.

In the past, strong opposition from different industries stopped integration. Today, a tentative consensus has emerged among insurance companies, commercial banks, and investment banks that will make reform and integration more likely. However, one significant hurdle must first be cleared: deciding jurisdictional roles and responsibilities. Does the federal government have the jurisdiction to regulate individual sectors of the financial services industry, or does this power lie with the states? Should the states retain the right to regulate the sale of insurance products? Until such questions are answered, legislation to facilitate financial services modernization cannot move forward.

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The debate over the proper balance between states' rights and the power of the federal government is older than the country itself. The Constitution was written, and ultimately adopted, in the

belief that a proper balance had not been achieved under the Articles of Confederation, which governed the new nation until 1789. Since then, the courts and legislative bodies have debated the proper scope of federal and state action. Indeed, many of today's pressing issues, such as welfare reform, environmental regulation, and education, have at their core the question of just how the jurisdiction of the states vis-à-vis the federal government should be defined.[1] Finding the proper balance between state sovereignty and the federal government's constitutional duty to ensure free interstate commerce involves protecting individual liberty as well as promoting economic prosperity through open markets.

The financial services industry is changing rapidly, regardless of Congress's inability to pass modernization legislation.[2] Technology and industry innovations are leading the market to greater integration of all financial services. Yet the entire U.S. regulatory structure is based on laws enacted during the 1930s. Federal regulators have worked within this structure to respond to changes, but fundamental reform cannot proceed without legislative action to change the structure of government oversight. Indeed, fundamental reform of the financial services system—the oldest and most extensive system of regulation on the books—will be difficult. It will bring into question every aspect of financial regulation, including federal deposit insurance, socially oriented rules, and derivatives regulation. However, these important issues must be set aside to address the question of dual jurisdiction.

To understand the importance of dual jurisdiction, one must understand the concept of federalism and how to apply that concept to commerce and the financial services industry. Federalism "concerns the constitutional structure of federal–state relationships and the ability to check and balance each other's movements."[3] In the U.S. Constitution, only few and enumerated powers are given to the federal government, such as coinage, national defense, international affairs, and interstate commerce. All other public responsibilities are reserved for the states. For federalism to work in practice, jurisdiction over public endeavors not specifically delimited in the Constitution must always reside with the level of government closest to those affected. It is important, then, for lawmakers to understand how the provision of different aspects of financial services affects different populations in order to determine whether state or federal jurisdiction is more appropriate.

As lawmakers analyze the issue of financial services modernization, it is important that they distinguish between the business of financial services and the commerce of financial services. The business of financial services is the actual sale of financial products, whereas the commerce of financial services involves those activities that bring a firm's products to market. Although these two categories of activity overlap in today's market, the distinction provides a framework within which to establish the parameters of state and federal jurisdiction in the oversight of financial services. Specifically:

- **Congress should ensure that oversight of the *business* of financial services falls within the jurisdiction of the states.** For example, usury and other interest rate regulations, including mandated insurance coverage, clearly affect the business of financial services and therefore should be regulated by the states. The imposition of restrictions at the state level would not affect residents of other

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1. For additional information, see Adam D. Thierer, "Electricity Deregulation and Federalism: How Congress and the States Can Work Together to Deregulate Successfully," Heritage Foundation *Backgrounder* No. 1125, June 23, 1997, and *The Delicate Balance: Economic Federalism at the Dawn of the 21st Century* (Washington, D.C.: The Heritage Foundation, forthcoming). The author is indebted to Adam Thierer for his extensive work in this area.
2. John S. Barry, "Creating a Financial Services Industry for the 21st Century: Tear Down the Walls," Heritage Foundation *Talking Points* No. 14, June 5, 1996.
3. Douglas Seay and Robert E. Moffit, "Transferring Functions to the States," in Stuart M. Butler and Kim R. Holmes, eds., *Mandate for Leadership IV: Turning Ideas Into Actions* (Washington, D.C.: The Heritage Foundation, 1997), p. 89.

states directly; therefore, there is little need for federal action.

- **Congress should ensure that oversight of the *commerce* of financial services falls within the jurisdiction of the federal government.** For example, capital adequacy, portfolio limitations, and the internal product mix offered by a financial services company are intricate aspects of that firm's commerce and of how it supports its activities and brings products to market. Today, these activities involve international transactions; therefore, the federal government should oversee them.

HISTORICAL BALANCE OF FEDERAL AND STATE JURISDICTION

When the Founders convened in Philadelphia 210 years ago, they embarked on a 17-week political experiment that led to the adoption of the U.S. Constitution, which is still the "supreme Law of the Land." This, however, was not their first attempt to establish a guiding document or a basic form of political organization for the American polity. That distinction belongs to the Articles of Confederation, which governed the states for the decade between the American Revolution and ratification of the Constitution in 1789.[4] Understanding why the Founders were compelled to abandon the Articles of Confederation is important to any discussion of the balance between federal and state jurisdictions, and the role of federalism in regulating commerce.

Weaknesses of the Articles of Confederation

In theory, the Articles of Confederation that bound the 13 colonies after the Revolution established an appealing form of decentralized government and guaranteed to the states that a despotic national power similar to the one they had just defeated could not gain control of the new nation and trample their rights. The Articles offered the sovereign states a loose federation under a national Congress that had very limited power.

In fact, the Articles prohibited almost any federal action, including beneficial action. Even raising enough money to ensure adequate military forces to protect the new nation was problematic. In addition, coinage and currency problems prevented the development of an efficient monetary system, the federal government was given no authority to sign commercial treaties or agreements with other nations to ensure free and fair trade with the individual states, there were no plans for a federal judiciary, and there was no executive power to deal with such issues.

Perhaps the most threatening development during the Confederation period was the rise of state protectionism. It is clear from their writings that the Founders hoped the United States would develop into a peaceful, well-integrated nation, but the Articles allowed the rise of factionalism and protectionism that "prevented the emergence of full nationhood"[5] and discouraged the development of robust interstate commerce. The states came to view themselves as miniature kingdoms that could promote their own commercial interests at the expense of citizens in other states and regions. The federal government was essentially powerless to stop such protectionism because the Articles of Confederation had not established a role for the federal government in preventing such undesirable state action. As a result of this dysfunctional system of political organization, trade and commerce suffered.

Historian John Fiske summarized how these anti-competitive actions were conducted by the states in his 1888 book, *The Critical Period in American History*:

> [T]he different states with their different tariff and tonnage acts, began to make commercial war upon one another. No

4. The Articles of Confederation were adopted on November 15, 1777.
5. Kermit L. Hall, William M. Wiecek, and Paul Finkelman, eds., *American Legal History: Cases and Materials* (New York, N.Y.: Oxford University Press, 1996), p. 80.

> sooner had…three New England states virtually closed their ports to British shipping than Connecticut threw hers wide open, an act which she followed by laying duties upon imports from Massachusetts. Pennsylvania discriminated against Delaware, and New Jersey, pillaged at once by both her greater neighbors, was compared to a cask tapped at both ends.[6]

Frederic A. Ogg and P. Orman Ray aptly summarized the overall effects of the Confederation period in their 1932 textbook, *Essentials of American Government*:

> The consequences were disastrous. No money for national use could be raised from tariff duties; no uniform commercial policy could be adopted; and the states laid duties, granted favors, and set up barriers as their individual interests dictated, sacrificing by their jealousies and bickerings splendid opportunities for advancing the new nation's trade, wealth, and prosperity. Enmeshed in a network of duties and tolls, trade languished; healthy commercial competition gave way to downright commercial warfare.[7]

In fact, Clarence B. Carson has argued, "It is even doubtful that what existed under the Articles was a general government at all."[8] That is, there were no restrictions on state action that imposed unjustifiable burdens on interstate commerce. States were free to act as they wished, without regard to the concerns and rights of citizens in other states. Legal scholar Gerald Gunther has argued that "The poor condition of American commerce and the proliferating trade rivalries among the states were the immediate provocations for the calling of the Constitutional Convention."[9] In *The Federalist Papers*, James Madison, Alexander Hamilton, and John Jay clearly articulated the frustrations encountered by the Founders in trying to create a new constitutional framework. In *Federalist* No. 22, for example, Hamilton noted that

> The interfering and unneighborly regulations of some states, contrary to the true spirit of the Union, have, in different instances, given just cause of umbrage and complaint to others, and it is to be feared that examples of this nature, if not restrained by a national control, would be multiplied and extended till they become not less serious sources of animosity and discord than injurious impediments to the intercourse between the different parts of the Confederacy.[10]

Federal regulation of interstate commerce was supported even by the most ardent anti-Federalists. Jackson Turner Main noted that "One power which most Antifederalists were willing to concede to Congress was control over commerce.… [W]hatever opposition there had been to amending the Articles in this regard seems to have almost vanished."[11]

Delicate Balance of Dual Jurisdiction Established in the Constitution

The members of the state delegations that met in Philadelphia in May 1787 to draft the Constitution recognized that something would be gained by sacrificing a small degree of autonomy over

6. John Fiske, *The Critical Period of American History* (New York, N.Y.: Houghton Mifflin, 1916), p. 145.
7. Frederic A. Ogg and P. Orman Ray, *Essentials of American Government* (New York, N.Y.: Appleton-Century-Crofts, Inc., 1950), p. 10.
8. Clarence B. Carson, *A Basic History of the United States, Volume 2: The Beginning of the Republic 1775–1825* (Wadley, Ala.: American Textbook Committee, 1991), p. 62.
9. Gerald Gunther, *Constitutional Law* (Westbury, N.Y.: The Foundation Press, Inc., 1991), p. 93.
10. Clinton Rossiter, ed., *The Federalist Papers* (New York, N.Y.: Mentor, 1961), pp. 144–145.
11. Jackson Turner Main, *The Antifederalists: Critics of the Constitution, 1781–1788* (New York, N.Y.: W. W. Norton and Company, 1961), pp. 181–182.

interstate commercial activity. As constitutional historian Leonard W. Levy argues, the lesson of the Confederation period was that "excessive localism was incompatible with nationhood."[12] Consequently, the Founders included provisions in the Constitution to allow the federal officials certain recourses to end factionalism and state-based protectionism and promote the development of a more integrated nation. Specifically:

- **The Commerce Clause** (Article I, Section 8, Clause 3) gives Congress the power "To regulate Commerce with foreign Nations, and among the several States, and with Indian Tribes."
- **The Coinage Clause** (Article I, Section 8, Clause 5) gives Congress the power "To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures." Whether this particular clause also gave the federal government the right to create a central bank became the subject of heated debate during the 19th century; at the very least, however, it ensures efficient interstate commerce and foreign trade.[13]
- **The Necessary and Proper Clause** (Article I, Section 8, Clause 18) allows Congress "To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof."
- **The Regulation and Taxation Clauses** (Article I, Section 9, Clauses 5 and 6) ensure that "No Tax or Duty shall be laid on Articles exported from any State" and "No Preference shall be given by any Regulation of Commerce or Revenue to the Ports of one State over those of another: nor shall Vessels bound to, or from, one State, be obliged to enter, clear, or pay Duties in another."
- **The Importing and Exporting Clauses** (Article I, Section 10, Clauses 2 and 3) prohibit states from engaging in specific activities: "No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports" or "lay any Duty of Tonnage…."
- **The Supremacy Clause** (Article VI, Clause 2) clarifies that when a state law conflicts with national laws, federal law (as long as it is constitutional itself) prevails: "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof…shall be the supreme Law of the Land…."

The combined effect of these provisions is a clear declaration by the Founders that state-by-state protectionism would not be tolerated. Furthermore, the rights of individual consumers, which could be threatened by oppressive and unjustifiable state actions adversely affecting interstate commerce, could be protected by Congress and the courts.

The Founders also went to great lengths to ensure that the power of the federal government would not become overly burdensome. In the Constitution, the Bill of Rights, and supporting writings like *The Federalist Papers*, they emphasized that local control was almost always preferable to federal regulation. Consequently, they listed only a handful of enumerated powers for the federal government in the Constitution; they left the remaining rights and responsibilities largely to the states or, more important, to the people directly. As Madison explained in *Federalist* No. 39, "[federal] jurisdiction extends to certain enumerated objects only, and leaves to the several States a residuary and inviolable sovereignty over all other objects."[14] And in *Federalist* No. 45, he argued

12. Leonard W. Levy, "Introduction: The Making of the Constitution, 1776–1789," in Leonard W. Levy, ed., *Essays on the Making of the Constitution* (New York, N.Y.: Oxford University Press, 1987), p. xix.

13. In *Federalist* No. 42, James Madison notes, "It must be seen at once that the proposed uniformity in the *value* of the current coin might be destroyed by subjecting that of foreign coin to the different regulations of different States." Rossiter, ed., *The Federalist Papers*, p. 269. Therefore, Clause 5 was intended not necessarily to create a federal monopoly in the issuance of money, but rather to ensure open interstate and international commerce.

that "The powers delegated by the proposed Constitution to the federal government are few and defined. Those which are to remain in the State governments are numerous and indefinite."[15] Specifically, the Constitution established:

- **Senate appointments by state legislatures.** In Article I, Section 3, the States were given a direct role in constraining the powers of the federal government through their ability to appoint members of the Senate, as well as through their veto power over proposed amendments to the Constitution.[16]
- **States' powers.** The Tenth Amendment made it clear that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."
- **The Uniformity clause.** In Article II, Section 8, before enumerating the powers of Congress, the Founders specified that "all Duties, Imposts and Excises shall be uniform throughout the United States." One reason they included this provision was to avoid discriminatory taxation. However, this phrase reaffirms the fundamental principle of federalism: that the federal government should pass no law that is not justified by the national need or relevant to the national population. In other words, Congress is denied the power to enact legislation that affects only a certain geographic region of the country.

The Founders realized that unconstrained state action and commercial regulation could infringe upon the rights of individual Americans, which were preeminent and given special note in the Ninth and Tenth Amendments. According to the Ninth Amendment, "The enumeration in the Constitution of certain rights shall not be construed to deny or disparage others retained by the people." And the Tenth Amendment specifies unambiguously that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the states respectively, or to the people." However, James Madison, after noting in *Federalist* No. 39 that the states were to retain the great majority of public powers, reiterated the importance of an impartial federal authority vested in Congress to arbitrate disputes between the states to encourage national harmony:

> [I]n controversies relating to the boundary between two jurisdictions, the tribunal which is ultimately to decide is to be established under the general government.... The decision is to be impartially made, according to the rules of the Constitution.... Some such tribunal is clearly essential to prevent an appeal to the sword and a dissolution of the compact; and that it ought to be established under the general government rather than under the local governments, or to speak more properly, that it could be safely established under the first alone, is a position not likely to be combated.[17]

In essence, the Constitution established a delicate balance between the federal and state jurisdictions for regulation of interstate commerce. Neither extreme—absolute federal preemption or complete state control of national commercial activity—would be tolerated. To ensure that the rights of individuals are protected from unjustifiable state action that interferes with the free flow of interstate commerce and the voluntary interaction of producers and consumers across state boundaries, local control would be tempered by a small degree of federal oversight. As Gerald Gunther aptly summarized, "Stronger [national]

14. Rossiter, ed., *The Federalist Papers*, p. 245.
15. *Ibid.*, p. 292.
16. The state appointment of Senators was amended in 1913 with adoption of the Seventeenth Amendment, which instituted direct election of U.S. Senators by the people. This was the result of a populist movement of the day, and was regarded by many as a blow to the power of the states.
17. Rossiter, ed., *The Federalist Papers*, pp. 245–246.

government was necessary, but government must not become too powerful: these were dominant concerns to the Framers, and the Constitution reflects their effort to accommodate these needs and risks."[18]

The Supreme Court and the Commerce Power

For years after the adoption of the Constitution, the delicate balance between state and federal jurisdiction was preserved and protected by fairly sensible applications of the Commerce Clause in Supreme Court cases. Chief Justice John Marshall, who served from 1801 to 1835, authored a number of important decisions that applied the constitutional balance to difficult commercial disputes. In such noted cases as *McCulloch* v. *Maryland* (1819), *Cohens* v. *Virginia* (1821), *Gibbons* v. *Ogden* (1824), *Brown* v. *Maryland* (1827), *Willson* v. *Blackbird Creek Marsh Co.* (1829), and *Weston* v. *Charleston* (1829), Marshall preserved the balance by striking down state actions that unduly affected interstate commerce.

For example, in *Gibbons* v. *Ogden*, the first and most important case dealing directly with the reach of the Commerce Clause, Marshall authored a unanimous decision that struck down a New York law granting a steamboat operator monopoly use of the Hudson River. Marshall and the Court held in favor of Thomas Gibbons, who was represented by noted statesman Daniel Webster. The Court agreed with Webster's reasoning during argumentation that where state laws regarding interstate commerce came into conflict with national laws or constituted a significant barrier to interstate commerce, federal action (either judicial negation or congressional action) was required to settle the matter. Significantly, Marshall further noted that for the Commerce Clause to have its intended effect—the restriction of state protectionism—the term "commerce" would have to be defined to include more than just simple goods transported across state boundaries. It would have to include other activities and entities, such as steamboats and the individuals they transported.

Marshall's opinion in *Gibbons* v. *Ogden* remains somewhat controversial in its application of the Founders' balance,[19] but legal and economic experts agree that its significance in assisting the development of a vibrant American commercial sector should not be underestimated or unappreciated. As legal scholars Ezra Parmalee Prentice and John G. Egan noted in their seminal 1898 study, *The Commerce Clause of the Federal Constitution*:

> In reading that momentous decision, apprehending, as we do now, the interests which were at stake…one cannot help pausing to wonder what might have been the result had that decision been in any way different from what it was. Had the utterance of the court upon the powers of the States been more ambiguous; had the expression upon the relation of the States to the Federal government been avoided, and the element of nationality involved been less explicitly disclosed and asserted; had it been allowed to cripple the commercial power of the nation in any way—where would the influence of that decision have led us now?[20]

Although the general thrust of most Marshall-era decisions mimicked that of *Gibbons* v. *Ogden*, some feared the pro-nationalist forces might be moving too far. Balance was restored under the guidance of Chief Justice Roger Brooke Taney, who served from 1835 to 1864. A number of important decisions were handed down that further clarified how the Founders' balance applied as national commercial markets grew larger and the number of states in the Union multiplied. The key Taney-era cases were *New York* v. *Miln* (1837), *Bank of*

18. Gunther, *Constitutional Law*, p. 65.

19. For a critique of Marshall's reasoning in the case, see Raoul Berger, "The Commerce Clause," in *Federalism: The Founders' Design* (Norman, Okla.: University of Oklahoma Press, 1987), pp. 120–157.

20. Ezra Parmalee Prentice and John G. Egan, *The Commerce Clause of the Federal Constitution* (Chicago, Ill.: Callaghan and Company, 1898), p. 16.

Augusta v. *Earle* (1839), *Swift* v. *Tyson* (1842), the License Cases (1847), the Passenger Cases (1849), *Genesee Chief* v. *Fitzhugh* (1852), and *Cooley* v. *Board of Wardens of the Port of Philadelphia* (1852).

The *Cooley* decision may have been the most important Commerce Clause-related decision of the Taney era. In *Cooley*, the Court upheld a Pennsylvania law regulating vessels entering or exiting the port of Philadelphia on the grounds that the matter was local in nature. The Court went on to argue that while such a law could stand, other laws and issues that were clearly national in scope could not stand the interstate commerce test. The decision came to be known as the "Cooley Doctrine of selective exclusiveness." That is, in select commercial areas where national uniformity is needed, Congress has the right to act if it desires to do so. However, if the commercial activity is not national in character, the states are free to act. Prentice and Egan summarize the *Cooley* Doctrine as follows:

> In matters admitting uniform regulation throughout the country and affecting all the States, the inaction of Congress is to be taken as a declaration of its will that commerce shall be "free and unrestricted" so far only as concerns any general regulation by the States.... On the other hand, in matters of local nature, such as are auxiliary to commerce rather than part of it, the inaction of Congress is to be taken as an indication that for the time being, and until it sees fit to act, they may be regulated by State authority.[21]

Although the Taney Court did lean toward state sovereignty over commercial affairs before allowing or encouraging federal action, Court decisions of this time continued to uphold the delicate balance established in the Constitution between the two goals of state sovereignty and the nation's commercial development. University of Missouri–St. Louis professor of history and education Walter Ehrlich notes that,

> Contrary to popular misconception, then, Taney did not reverse the Marshall trend and institute radical agrarian egalitarianism and state sovereignty. On the contrary, he preserved and redefined the main lines of Marshall's constitutional law, opened economic opportunities for many Americans, and retained a strong national power redefined to accommodate a judicious dual sovereignty.[22]

In this sense, the Founders' delicate balance between unfettered, nationally enforced capitalism and outright state-based control was being preserved through the evolution of American common law court cases.

The trend set by the Taney Court of enforcing the balance in the Constitution between federal and state action lasted generally until the time of the New Deal. Although the federal government created a handful of new powers for itself in the post-Civil War Reconstruction years, for the most part the Founders' delicate balance was preserved. But as the New Deal ushered in an era of government activism, a new form of constitutional jurisprudence evolved that viewed the Fourteenth Amendment (which denied states the right to "make or enforce any law which shall abridge the privileges or immunities of citizens of the United States"), the Commerce Clause, and other clauses of the Constitution as tools for the transfer of power from the states and the people to the federal government.

"The result," argues legal scholar David Bernstein, "was a revolution in the American constitutional system, which was transformed from a system in which strict limits were placed on the powers of the national government to one in which the national government's powers were almost limitless, particularly in the commercial

21. *Ibid.*, pp. 27–28.

22. Walter Ehrlich, "Roger Brooke Taney," in Kermit L. Hall, ed., *The Oxford Companion to the Supreme Court of the United States* (New York, N.Y.: Oxford University Press, 1992), p. 859.

sphere."[23] Dr. David Forte, professor of law at Cleveland State University, concurs: "Subsequent to 1938, any real judicial concern for maintaining the federal system quickly evaporated. Through a virtually unlimited definition of the Commerce Power, and especially through an unrestrained use of the Spending and Police Powers, Congress was able to supplant the states as the primary policy making force in the country."[24]

As Supreme Court Justice Clarence Thomas noted in a recent decision regarding the post-New Deal contortion of Commerce Clause jurisprudence, "from the time of the ratification of the Constitution to the mid-1930's, it was widely understood that the Constitution granted Congress only limited powers, notwithstanding the Commerce Clause…. To be sure, congressional power pursuant to the Commerce Clause was alternatively described less narrowly during this 150-year period."[25] Once the New Deal jurisprudence became commonly accepted, however, this narrow, pre-New Deal definition of federal authority lost favor among intellectuals and policymakers. The result was a series of Supreme Court cases that upset the delicate constitutional balance and served as catalysts for further augmentation of federal power at the expense of the states and individual citizens. The Court was seen as reading too much into legal phrases and terms of art, such as "interstate commerce," "commerce between the states," and "affecting other states."

Most notably, the Court came to equate commerce with manufacturing and production. But manufacturing and production give birth to commerce and trade; the first actions necessarily precede the latter. As legal historian and federalism expert Raoul Berger has argued, "the Founders conceived of 'commerce' as 'trade,' the interchange of goods by one State with another."[26] Chief Justice Melville Weston Fuller argued in the 1895 case of *United States* v. *E.C. Knight Co.* that "Commerce succeeds to manufacture, and is not a part of it."[27]

Yet, despite Chief Justice Fuller's admonition, the courts and Congress abandoned the constraints imposed on the federal government by the Constitution and decided to apply their own judgments to matters of commercial regulation by broadly interpreting the meaning of "interstate commerce." They wandered far from the course charted by the Framers, and the result was the twisted legal reasoning found in such New Deal-era cases as *U.S.* v. *Butler* (1936),[28] *N.L.R.B.* v. *Jones & Laughlin Steel Co.* (1937),[29] *United States* v. *Darby* (1941),[30] *Wickard* v. *Filburn* (1942),[31] and subsequent decisions.[32]

The *Wickard* case is the most important of these because it established the "indirect effects" test as the new standard of Commerce Clause review. This test effectively meant that any conceivable

23. David Bernstein, "Equal Protection for Economic Liberty: Is the Court Ready?" Cato Institute *Policy Analysis*, October 5, 1992, p. 5.

24. David F. Forte, "Conservatism and the Rehnquist Court," Heritage Foundation *Lecture* No. 438, June 12, 1992, p. 4.

25. Justice Clarence Thomas, concurring opinion, *United States* v. *Lopez*, 115 S.Ct. 1624 (1995).

26. Raoul Berger, "Judicial Manipulation of the Commerce Clause," *Texas Law Review*, Vol. 74, No. 4 (March 1996), p. 703.

27. Justice Melville Weston Fuller, *United States* v. *E. C. Knight Co.*, 156 U.S. 1 (1895).

28. 297 U.S. 1 (1936).

29. 301 U.S. 1 (1937).

30. 312 U.S. 100 (1941).

31. 317 U.S. 111 (1942).

32. For a thorough discussion of modern expansionist Commerce Clause jurisprudence, see Richard Epstein, "The Proper Scope of the Commerce Power," *Virginia Law Review*, Vol. 73, No. 8 (November 1987), pp. 1387–1455.

form of economic activity, no matter how local in character, could be construed as having at least some sort of marginal or incidental impact on interstate commerce, and thus brought under federal control. Therefore, manufacturing and all other industrial activity related in any way to commerce subsequently fell under federal jurisdiction.

Wickard and other New Deal Commerce Clause cases dealt the American system of dual sovereignty a nearly fatal blow. Contributing to this problem was the Supreme Court's 1985 decision in *Garcia* v. *San Antonio Municipal Transit Authority*.[33] In *Garcia*, which was written by Justice Harry Blackmun, the Court said that the best protection against potential federal overreach was the electoral process, which allows the states representation in Congress. Thus, the Court concluded, "State sovereign interests…are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power."[34] With *Garcia*, the Court essentially abandoned any notion that it had a legitimate refereeing role in the protection of federalism and left all decisions regarding the proper scope of the Commerce Clause to Congress.

However, a possible shift in the Supreme Court's thinking on federalism issues appears to have taken place in the past few years. In such cases as *Gregory* v. *Ashcroft* (1991),[35] *New York* v. *United States* (1992),[36] *U.S.* v. *Lopez* (1995),[37] and *Printz* v. *United States* (1997),[38] the Court has handed down decisions that breathe new life into more traditional definitions of federalism. In *Gregory* v. *Ashcroft*, for example, Justice Sandra Day O'Connor noted for the Court that "[E]very schoolchild learns [that] our Constitution establishes a system of dual sovereignty between the States and the Federal Government. This Court also has recognized this fundamental principle."[39] And in *New York* v. *United States*, Justice O'Connor wrote that "States are not mere political subdivisions of the United States. State governments are neither regional offices nor administrative agencies of the Federal Government."[40]

A GENERAL THEORY OF COMMERCIAL FEDERALISM

The late 1980s and early 1990s have also witnessed interest within the legislative branch in finding new ways to grant the states flexibility or relief from the growing burden of federal mandates. In addition to efforts to use block grants, Congress passed the Unfunded Mandates Reform Act of 1995 to decrease the costs that Congress and federal agencies can impose on state or local governments, and to review more closely any rules that might have an impact on lower levels of government.

As Congress attempts to regain the proper balance between the sometimes conflicting principles of commercial efficiency and federalism in order to integrate the financial services industry, it faces many of the questions and dilemmas that the Founders encountered over 200 years ago and that the judiciary has struggled with ever since. Its task is made somewhat easier, however, by the fact that even though the Founders could not have envisioned the technologies and industries of modern America, the framework they created still applies

33. 469 U.S. 528 (1985).
34. 469 U.S. 528 (1985).
35. 501 U.S. 452 (1991).
36. 505 U.S. 144 (1992).
37. 115 S.Ct. 1624 (1995).
38. U.S. 95-1478 (1997).
39. Justice Sandra Day O'Connor, *Gregory* v. *Ashcroft*, 501 U.S. 452 (1991).
40. Justice Sandra Day O'Connor, *New York* v. *United States*, 505 U.S. 144 (1992).

to modern markets—from telecommunications to electricity to financial services.

Generally, each branch of the national government is charged with upholding the Constitution. This is a point made by then-Attorney General Edwin Meese III in a 1986 speech at Tulane University: "Yet if law, as Thomas Paine once said, is to remain 'King' in America, we must insist that every department of our government, every official, and every citizen be bound by the Constitution."[41] Thus, it is the duty of Congress to uphold the constitutional delimitation of powers even if the Supreme Court goes astray in its judicial interpretation.

Specifically, Congress is within its rights to exercise control over state activity in order to prohibit state-based protectionism and to protect the rights of individual consumers who hope to benefit from vigorous interstate commerce. Several different tests can be employed to help Congress make appropriate decisions and not overreach this authority. These tests attempt to preserve the delicate balance of dual jurisdictions enshrined in the Constitution by the Founders and explained in early constitutional jurisprudence handed down by the Supreme Court. They do not give credence to modern arguments that virtually all human activity can qualify as interstate commerce.

Constitutional Imperatives. These tests rest on three constitutional imperatives or core values that caused the Founders to abandon the Articles of Confederation and include the Commerce Clause in the new Constitution. Under the Constitution, the federal government would:

- **Prohibit protectionism.** States and localities should not be allowed to implement statutes or regulations that establish explicit protectionist barriers to the free flow of commerce across interstate boundaries.
- **Prohibit discrimination.** States or localities should not be allowed to implement statutes or regulations that unfairly discriminate against the goods or services of out-of-state interests in favor of in-state interests.
- **Prohibit extraterritorial jurisdiction.** States or localities should not be allowed to exercise authority beyond their geographical boundaries.

It is important to note that all three of these core interstate-protection imperatives are negative or proscriptive in nature. In other words, the federal government retains the right to prevent state protectionism, discrimination, and extraterritorial jurisdiction, but does not have the right to establish laws prescriptively in place of preempted state laws. The federal government possesses only those active or prescriptive powers specifically enumerated in the Constitution. In all other cases, the federal role is one of negation or proscription.

In a sense, these three imperatives are all that is needed to determine whether federal intervention is justified. Tests to determine the application of these imperatives can help Congress uncover protectionist intent, discriminatory effects, or extraterritorial overreach and then offer a course of action. If it can be shown that states or localities are acting on protectionist policies, then some limited form of federal intervention may be justified under the Commerce Clause. As Daniel A. Farber and Robert E. Hudec of the University of Minnesota Law School have warned, "No matter how a legal test is articulated, it cannot satisfactorily resolve the tensions between local autonomy and free trade in all conceivable cases. In the end, the law must have a certain irreducible messiness in dealing with such fundamental tensions."[42]

The Constitutional Test. The Constitution is the ultimate source to determine proper jurisdic-

41. Edwin Meese III, "The Law of the Constitution," speech delivered October 21, 1986, at Tulane University, as reprinted in *Who Speaks for the Constitution? The Debate over Interpretive Authority* (Washington, D.C.: The Federalist Society, 1992).

42. Daniel A. Farber and Robert E. Hudec, "Free Trade and the Regulatory State: A GATT's Eye View of the Dormant Commerce Clause," *Vanderbilt University Law Review*, Vol. 47 (October 1994), p. 1438.

tion. Thus, the following test must be met before considering the other five public policy tests.

Do the Constitution and statutes passed pursuant to it, or established and tested judicial precedents, prohibit state action in a given field? The answer to this question should be fairly straightforward, but the issue could be complicated by the fact that a corrupt body of constitutional jurisprudence from the past century allowed the Commerce Clause to be violated by both federal and state officials. In such situations, Congress should be governed by the original intent of the Constitution, not by bad court decisions. When states or localities establish barriers to interstate commerce or act in a way that discourages the free flow of commerce, Congress can, within its constitutionally defined powers, proscribe the state or local policies that discriminate against interstate commerce. However, it has no power to take more affirmative or prescriptive steps (unless the Constitution explicitly enumerates such actions[43]) to force states and localities to do more than cease their anti-commercial activities.

The Public Policy Tests. If the Constitution does not speak clearly to the proper jurisdiction of a specific responsibility, then five further public policy tests may be applied.

1. **Has the industry or activity historically been regulated at the federal, state, or local level?** This test provides a principled and practical guideline for handling jurisdictional questions. However, as with legal precedence, improper past regulation may need to be overcome.
2. **In sophisticated modern markets (especially complex, interlocking national networks), are there negative effects associated with state-by-state regulation?** Many industries today rely on an intricate network of wires, communication lines, and satellites to deliver their products to consumers and to conduct business. Deregulating part of these networks may have a negative impact on the rest of the network that affects residents in another state. This is an *externality*: a cost or benefit that accrues to a group of individuals not directly responsible for the deregulation. Thus, by definition, these networks are national, international, or even global. Wherever oversight or deregulation of such industries is considered, such technological considerations require at least some minimal federal guidance.
3. **Is the industry or activity at issue clearly interstate in nature and scope?** The mere fact that a state or local activity may involve anticompetitive consequences does not justify federal intervention. The key question is whether the particular activity or industry is truly interstate in scope. As legal scholar Richard Epstein of the University of Chicago Law School notes, "It is…the nature of the transaction, rather than its location, that stamps it as a part of interstate commerce."[44]
4. **Will state-by-state actions result in "substantial spillover effects" that adversely affect interstate commerce?** This test is closely related to the interstate scope test in that it concerns the nature of the interstate activity but asks whether the state's policies have a discriminatory impact on interstate commerce by effectively prohibiting firms in one state from doing business in another state.
5. **Is there a clear and overriding national need for congressional action within the terms of the Constitution?** The constitutionally enumerated powers of the federal government, such as national security and trade, patent and trademark protection, maintenance of a sound monetary system, and the formation of uniform bankruptcy laws, remain the only real

43. For example, the Constitution (for better or worse) explicitly grants the federal government the right to establish a federal monopoly over first-class postal delivery, to establish a system of patents and trademarks, and to establish a uniform bankruptcy statute.

44. Epstein, "The Proper Scope of the Commerce Power," p. 1403.

"national needs" over which Congress should exercise complete control. If an issue cannot pass the hurdles set out in the other five tests, it is doubtful that any genuine national need for federal intervention can be argued. If these hurdles are cleared, however, and Congress can claim a justifiable "national need," then it should exercise at least some limited jurisdiction.

Proponents of federal action must consider these questions before initiating actions that supersede or preempt state and local authority. Clearly, most of the economic and social activities currently undertaken by the federal government do not meet this requirement. Only a small handful (primarily of an economic nature) qualify for some degree of federal regulation.

HOW THE GENERAL FRAMEWORK APPLIES TO FINANCIAL SERVICES

By examining the applicability of these six tests to the financial services industry, it is possible to gain a better appreciation and understanding of the role of the states and Congress in the process.

Legal Precedent and Historical Regulatory Forum

The first tests of jurisdiction involve the evaluation of legal precedents and historic regulatory institutions that affect the financial services industry. Specifically, the legal precedents and historic regulatory structure affecting three segments of this industry—commercial banking, insurance, and securities—must be examined.

Commercial Banking. Since the nation's founding, the history of commercial banking regulation has been one of dual state and federal regulation. As the late British scholar Vera Smith noted in her definitive study of central banking, *The Rationale of Central Banking and the Free Banking Alternative*:

> The distribution of powers between the Federal and the State authorities left legislative control in banking matters in the hands of both. The country started off with a natural dislike of centralised institutions and a jealous regard for individual State rights. Nevertheless, the need for funds in the War of Independence impelled the Federal Government to take the first initiative in the banking sphere in the promotion of the Bank of North America [in 1781].[45]

The proper role of the federal government in financial regulation occupied many of the great minds of the founding period: Alexander Hamilton and George Washington promoted the legitimacy of a national bank, for example, while Thomas Jefferson and James Madison thought the bank was unconstitutional.[46] The debate would continue through most of the 19th century. Typically, states maintained tight control over banking by restricting entry and setting strict operating regulations.[47] As a result, banks were small and very limited in operation, often doing business out of a single retail store, and interstate banking operations were almost nonexistent. With the banking system highly decentralized and regulation haphazard, more than 22,000 commercial banks were in operation by 1914.

For its part, the federal government tried twice during the 19th century to establish a national banking system. But as with the Bank of North America in 1781 and the First National Bank in 1791, these attempts coincided with major wars during which the federal government needed a ready source of credit to finance its wartime activities.

The Second Bank of the United States was established in 1816 after a rash of banking runs following the British invasion of Washington, D.C., in 1814.[48] However, it immediately drew

45. Vera Smith, *The Rationale of Central Banking and the Free Banking Alternative* (Indianapolis, Ind.: Liberty Press, 1990), p. 42.

46. Richard E. Ellis, "*McCulloch* v. *Maryland*," in Hall, ed., *The Oxford Companion to the Supreme Court of the United States*, pp. 536–537.

47. See Smith, *The Rationale of Central Banking.*

criticism from the states, some of which initiated punitive taxation of its activities within their borders. This practice led to John Marshall's famous ruling in *McCulloch* v. *Maryland*,[49] which justified extensive federal intervention in the economy. It is important to remember, however, that the case centered around the proper role of the federal and state governments in regulating financial services. Specifically, Marshall ruled—on behalf of a unanimous Court—that Congress had acted within its "incidental or implied powers" under the Constitution in creating the Second Bank of the United States; the Bank was "necessary and proper" in order for Congress to conduct its enumerated constitutional powers, and thus was constitutional.[50]

The national bank was short-lived, however. In 1832, President Andrew Jackson vetoed a bill to recharter the Second Bank of the United States on the grounds that it was unconstitutional and violated the rights of the states. Jackson's veto was sustained by a recovering economy and a sympathetic Congress, despite the legal precedent set by Marshall in *McCulloch*. The abolition of the Second Bank marked the beginning of the "free banking era" that lasted until 1863.

In 1864, the financial hardships of the Civil War led to passage of the National Bank Act. This law did not specifically establish a central bank, but instead instituted a federal chartering process whereby banks could charter as national banks and issue a new uniform national currency. The Act was complemented in 1865 by a federal statute that imposed a 10 percent tax on all state bank notes to force existing state-chartered banks to recharter as national banks.[51] The constitutionality of the punitive tax was upheld by the Supreme Court in 1869 in *Veazie Bank* v. *Fenno*. The opinion of the majority was based on the constitutional right of Congress to "coin money, regulate the value thereof, and of foreign coin" (Article I, Section 8, Clause 5).[52] *Veazie* can be seen as a completion of *McCulloch*, which granted the federal government the upper hand in the regulation of commercial banking.

The Federal Reserve Act of 1913 created the central bank that has lasted to the present day, ending a century-long battle between advocates of pure states' rights and supporters of federal power. The Federal Reserve Act led to a major consolidation in the banking industry between 1914 and 1933. This consolidation and the rash of bank failures between 1929 and 1933 led to a dramatic decrease in the number of banks. The panic caused by bank failures and consolidations led to the Banking Act of 1933 (commonly known as the Glass–Steagall Act) and the establishment of a restrictive regulatory regime that continues to govern the commercial banking industry today. Specifically, Glass–Steagall separated investment and commercial banking activities, created a federal deposit insurance system, limited interest on checking deposits, began the regulation of bank holding companies, and liberalized bank branching restrictions.[53] The result of this legislation, together with the Federal Reserve Act of 1913 and the dual banking system that emerged from the 19th century, is today's banking industry, with state or nationally chartered commercial banks that are focused solely on demand deposit accounts and debt issuance.

The theory of "separation banking" embodied in the Glass–Steagall Act has continued to drive fed-

48. Jonathan R. Macey and Geoffrey P. Miller, *Banking Law and Regulation* (Boston, Mass.: Little Brown and Company, 1992), p. 8.

49. 17 U.S. 316 (1819).

50. Chief Justice John Marshall, *McCulloch* v. *Maryland*, 1819.

51. Macey and Miller, *Banking Law and Regulation*, p. 11.

52. Augustus M. Burns III, "*Veazie Bank v. Fenno*," in Hall, ed., *The Oxford Companion to the Supreme Court of the United States*, p. 895.

53. George J. Benston, *The Separation of Commercial and Investment Banking: The Glass–Steagall Act Revisited and Reconsidered* (New York, N.Y.: Oxford University Press, 1990), pp. 6–10.

eral regulation for 60 years.[54] Each time the market has established a legal connection between banking and another financial or commercial sector, the government has stepped in with new regulations to prevent such a relationship. For example, the Bank Holding Company Act of 1956 was passed in response to the emergence of umbrella companies that owned legally separate investment and commercial banks, often across state lines.

In addition to regulating the products offered by banks, government agencies control many of their direct financial activities. The Federal Deposit Insurance Corporation (FDIC) subjects banks to tight financial control. FDIC investigators have the right to monitor and audit a bank's books to ensure that its investment strategies are "sound enough" to protect depositors. The Board of Governors of the Federal Reserve requires banks to maintain minimum cash reserves. This regulation controls the money supply, but it also ensures the liquidity of individual banks. Federal regulators also control entry to and exit from the banking business and can require banks to invest a specific amount of their capital in local communities; until recently, they even controlled the placement of automated teller machines (ATMs).

Although nearly all banks are members of the Federal Deposit Insurance system and the Federal Reserve System, and therefore are subject to some degree of federal regulation, there is a major divide between state and federal regulation of commercial banking. There is a great redundancy in the system as regulators at the state and federal levels are responsible for oversight of the same activity, albeit through different institutions.

Insurance. The history of the insurance industry is much more straightforward than that of commercial banking. States have maintained the right to regulate insurance ever since such regulation was introduced in 1858. Before the Great Depression, it was a matter of *de facto* constitutional authority. In fact, state regulation was so entrenched that the system was maintained even though insurance companies pressed for federal regulation of interstate insurance sales shortly after the Civil War.[55]

The *de facto* constitutional limits on federal action remained in place until 1944, when the Supreme Court ruled in *South-Eastern Underwriters Association* v. *United States* that insurance contracts were interstate commerce and therefore subject to federal antitrust law and federal regulation. This ruling was an outgrowth of the activist Court that emerged during the late 1930s.[56] However, the insurance industry and insurance agents already were a formidable political force. As recounted by Alan Gart, president of the financial consulting firm of Alan Gart, Inc., "Congress and President Roosevelt quickly approved the McCarran–Ferguson Act in 1945 (under intense insurance industry lobbying and state insurance regulatory pressures)."[57] The McCarran–Ferguson Act established the states as the primary regulators of insurance. "Among major financial institutions in the United States," according to Jonathan R. Macey, professor of law at Cornell University, and Geoffrey P. Miller, professor of law at New York University, "only insurance firms are subject to plenary state regulation. Not only has the federal government eschewed regulation, but it has affirmatively

54. George J. Benston, "Federal Regulation of Banking: Historical Overview," in George G. Kaufman and Roger C. Kormendi, *Deregulating Financial Services: Public Policy in Flux* (Cambridge, Mass.: Ballinger Publishing Company, 1986), pp. 1–47.

55. Philip L. Merkel, "Going National: The Life Insurance Industry's Campaign for Federal Regulation After the Civil War," *Business History Review*, Vol. 65 (Autumn 1991), pp. 528–553.

56. Melvin I. Urofsky, "*United States* v. *South-Eastern Underwriters Association*," in Hall, ed., *The Oxford Companion to the Supreme Court of the United States*, p. 806.

57. Alan Gart, *Regulation, Deregulation, Reregulation: The Future of the Banking, Insurance, and Securities Industries* (New York, N.Y.: John Wiley & Sons, Inc., 1994).

declared a policy of *not* regulating the business of insurance."[58] In other words, states have retained residual rights to regulation:

> In the general regulatory area, it appears that a state will be held to have "regulated" the business of insurance to preclude federal regulation, either when the state has adopted effective regulations that are specifically concerned with the subject matter, even if the state's regulations are not as stringent as the federal regulations, or when the state has regulated the business comprehensively enough to occupy the field of insurance regulation, even if the state does not have a specific regulation directed to the matter the federal government is attempting to control.[59]

States typically regulate life insurance companies by (1) setting minimum reserve requirements and (2) specifying classes of securities in which insurance companies may invest.[60] Both forms of regulation aim to protect the solvency of life insurance companies and thereby protect their policyholders. This is important for individual investors who have a significant portion of their retirement savings tied up in an insurance policy.

More direct regulations are used by the states to control the sale of property and casualty insurance. These regulations typically take the form of direct premium price controls; their purpose is consumer protection—specifically, the solvency of insurance companies, the maintenance of low premium rates, and the prevention of premium discrimination.[61] In all cases, states retain the right to define what is or is not an insurance product. This allows them to govern the sales of all financial firms selling both life and property/casualty products.

Securities. Regulation of the securities industry[62] is driven by the concept of disclosure. The principle of disclosure, outlined originally in the Securities Act of 1933, is the public availability of a minimal amount of information concerning companies that offer public shares of stock. Individuals, having been given this basic information, are left to bear the risk of any investment choice they make. Another major class of securities regulation applies directly to investment banks and securities dealers who underwrite and distribute shares of ownership. The regulations are intended to prevent insider trading and the use of proprietary information to conduct transactions in publicly accessible markets. It is clear, therefore, that the driving principle behind most securities regulation is maintenance of an open and level playing field.

The federal agency with the primary responsibility for enforcing securities laws is the Securities and Exchange Commission (SEC).[63] Created by the Securities Exchange Act of 1934, the SEC processes and makes available all required disclosures of publicly held companies, oversees all investment and brokerage companies, and monitors insider trading and antifraud activity. In line with the principle of disclosure that drives securities regulation, the SEC's power—like that of a sports referee—is to ensure that market participants fol-

58. Jonathan R. Macey and Geoffrey P. Miller, *Costly Policies: State Regulation and Antitrust Exemption in Insurance Markets* (Washington, D.C.: AEI Press, 1993), p. 1.

59. *Ibid.*, p. 25.

60. Mark Pauly, Howard Kunreuther, and Paul Kleindorfer, "Regulation and Quality Competition in the U.S. Insurance Industry," in Jorg Finsinger and Mark Pauly, eds., *The Economics of Insurance Regulation: A Cross-National Study* (New York, N.Y.: St. Martin's Press, 1986), pp. 65–107.

61. Banks McDowell, *Deregulation and Competition in the Insurance Industry* (New York, N.Y.: Quorum Books, 1989).

62. For a concise history of the securities industry, see Gart, *Regulation, Deregulation, Reregulation*, pp. 249–287. See also Jeffrey B. Little and Lucien Rhodes, *Understanding Wall Street* (New York, N.Y.: Liberty Hall Press, 1991).

63. The Commodity Futures Trading Commission (CTFC) is responsible for regulating the issuance of and trade in futures contracts and other derivatives. By and large, it follows the same principles of disclosure and fair-play rules as the SEC.

low the rules rather than to prescribe how a company may or may not act.[64] While the reach of these fair-play rules may be overextended at times, the SEC is generally considered to be the least restrictive of all financial services regulators.

Overall, the states play a supporting role in the regulation of securities. Rules and regulations promulgated at the state level typically supplement or duplicate federal regulations.[65] They also tend to follow the same pattern as federal regulations, placing a heavy emphasis on disclosure and the prevention of fraud and insider trading. The typical difference is one of emphasis: The SEC tends to concentrate on security exchanges, while state regulations concentrate on the registration and supervision of brokerage and investment firms. This is largely in line with the paradigm of commercial federalism put forth in this paper. Securities regulation, in many respects, can serve as a model for rules governing other financial institutions and transactions.

The legal precedent and historical regulatory forum tests both lead to a system of dual regulation in the financial services industry. Regulation of commercial banking historically has been conducted by the federal government and by the states. Oversight of insurance has been maintained at the state level, while regulation of the securities industry has been centralized at the national level. Therefore, as the financial services industry continues to integrate and modernize, the historical context and legal precedent tests reveal that a mix of federal and state oversight is most appropriate, although perhaps not along the same lines as in the past.

Network Externalities and Technological Complexity

The business of financial services is complex, fast-paced, and incredibly detailed. The entire industry depends on an intricate, interstate (indeed, international) network to complete transactions and conduct business on a daily basis. This is true at both the retail and wholesale levels. At the retail level, stock sales, wire transfers, credit references, and ATM transactions all may depend on a vast network of financial firms and systems.

Take, for example, a simple stock transaction. An individual investor enters a buy order at his computer in Des Moines, Iowa, for 200 shares of NationsBank, which is headquartered in Charlotte, North Carolina. The request travels over the Internet to Morgan Stanley's investment banking office in Chicago, Illinois. If the customer's request is not matched within the brokerage firm's computer system by a complementary sell order (for example, from South Bend, Indiana), it is sent on to Morgan Stanley's New York office, and then on to the New York Stock Exchange's computer system. Once the trade has been completed on the floor of the stock exchange, the process is reversed and the investor is notified that his transaction is complete. This simple stock purchase involves action in four separate states (not including the many states through which the transaction passes as it travels over the Internet).

How complex is the entire process? *The Wall Street Journal* recently reported that the New York Stock Exchange computer system is equipped to handle 375 transactions every second.[66] On a typical day, more than 575 million shares of stock change hands on the New York Stock Exchange. Another 500 million shares are traded on the NASDAQ market.

Wholesale financial services activities are even more dependent on intricate interstate networks to clear paper checks, balance portfolios, float liquidity to investment houses, and balance geographic risk in insurance pools. Every night, banks lend each other enough money to meet Federal Reserve requirements. This means that every bank in the United States, every night, must balance its books,

64. See David L. Ratner, *Securities Regulation: In a Nutshell* (St. Paul, Minn.: West Publishing Co., Inc., 1996).

65. *Ibid.*, p. 8.

66. Raju Nariseti, Thomas E. Weber, and Rebecca Quick, "How Computers Calmly Handled Stock Frenzy," *The Wall Street Journal*, October 30, 1997, p. B1.

contact the Federal Reserve system, borrow (or lend) the appropriate balances, and then close until the next morning.[67]

In addition, and perhaps more than in any other industry, the sale of financial services does not require a large physical presence at the firm level. It is no longer necessary to conduct financial services at a bank branch or through an insurance agent. No-point delivery means that financial firms can offer their services and products across state lines more easily than most other industries. Banking on the Internet has become normal business practice, and most credit card banks are located in a few key states, although they market and sell their cards literally all over the world. As Eli Noam, professor of business at Columbia University, notes:

> This means that a network ceases to be a territorial concept and becomes a group concept. It becomes a functional rather than spatial arrangement. The concept of "intrastate" will become a relatively meaningless concept in this environment.… The network has become the market, and the market exists in no physical location.[68]

Consistent with the Constitution and American legal precedent, such interstate networks fall within the context of the Commerce Clause and are, therefore, at least under partial federal control. In fact, much of the case history discussed above involves networks—often networks that were employed or created by emerging technologies. *Gibbons* v. *Ogden* involved a dispute between operators of competing steamships (a new technology at the time), both of whom wanted to operate on the Hudson River, part of the country's waterway network. In 1886, the Supreme Court tackled the rising technology of interstate railways by deciding in *Wabash, St. Louis & Pacific Railway Co.* v. *Illinois* that the federal government had the jurisdiction to regulate rates because the railway system constituted an interstate commercial network.[69] In both cases, the determining factor in favor of federal regulation was the existence of a commercial network. Thus, the Court during the 19th century expanded federal jurisdiction but always limited such jurisdiction to the act of commerce. It was not until the New Deal era that federal regulation, through the Commerce Clause, was applied to activities that were *affected* by acts of commerce.

Consider another network industry that was deregulated recently: the aviation industry. Imagine what would have happened had the states been allowed to deregulate this industry—using separate schedules and plans—in the late 1970s. If one state had deregulated the market completely while its surrounding neighbors kept their markets closed, the efficient and safe routing of air traffic might have been adversely affected. Furthermore, each state undoubtedly would have sought to protect its own in-state carriers and structure the deregulation process to ensure that certain routes and services were preserved, regardless of the carriers' inefficiencies.

Instead, the federal government, led by congressional Democrats and the Carter Administration, undertook a comprehensive and radical program that deregulated the aviation market completely and on a rapid timetable. The results have been extremely beneficial for consumers. Robert Crandall, senior fellow at the Brookings Institution in Washington, D.C., and Jerry Ellig, senior research

67. For a succinct description of federal funds operations, see Duane B. Graddy, Austin H. Spencer, and William H. Brunsen, *Commercial Banking and the Financial Services Industry* (Reston, Va.: Reston Publishing Company, 1985), pp. 404–407. Note also that a bank's overnight operations are complicated by the fact that ATM machines are available 24 hours a day, and a bank's portfolio may change in value because of activities in foreign markets.

68. Eli Noam, "The Federal-State Friction Built into the 1934 Act and Options for Reform," in Paul Teske, ed., *American Regulatory Federalism and Telecommunications Infrastructure* (Hillsdale, Mich.: Lawrence Erlbaum Associates, 1995), p. 118.

69. This case led to the creation in 1887 of the Interstate Commerce Commission. However, the Court held in the *Wabash* case that every railway line was part of an interconnected, interdependent, and interstate commercial network, and therefore subject to federal oversight.

fellow at the Center for Market Processes at George Mason University in Virginia, have noted that airline deregulation has saved consumers almost $20 billion since 1977 while improving overall safety and encouraging industry innovation.[70] Would deregulation have unfolded as smoothly, and would it have been so beneficial to consumers, if each state had been allowed to establish its own rules and time frame for deregulation? It seems highly unlikely. Many states undoubtedly would have tried to preserve inefficient routes and carriers located within their borders. In any event, a fair degree of federal oversight would have been needed to coordinate interstate air traffic and activity.

The network externalities and technological complexity tests both lead to the conclusion that the federal government should play a dominant role in overseeing financial services. Commerce in financial services depends heavily on an integrated interstate network. Because of modern technology, this is true now more than ever. Therefore, it is important that individual state regulations not be allowed to destroy the interstate network on which the industry depends.

Substantial Interstate Scope and Spillover Effects

The financial services industry clearly has two extensive spillover effects that reach across state lines. The first, which may be termed horizontal spillover, is the intra-industry provision of financial services across geographic boundaries. For example, most American commercial banks are connected through a highly advanced ATM network. This allows a customer of one bank to use the ATM of any other bank in the world. Wire transfers are another basic example of the financial services industry's interstate scope. Security transactions on any market require that funds be wired from one account to another. Finally, the financial stability of any financial services company, including an insurance firm, relies on a diversified portfolio. Thus, although one firm may retail its services and products only locally, the business of all financial service firms is national (indeed, international) in scope.

Vertical spillover effects are those between the financial services industry and businesses in other industries. Every company in the United States depends on responsive financial services on a daily basis. Whether it is raising the capital needed to enter a new market or simply using a checking account to accommodate daily accounts payable, financial service is the oil that allows American commerce to run smoothly. Therefore, smooth and accurate flow of financial resources across state lines is necessary for all American companies.

As Richard J. Pierce, professor of law at George Washington University, argued in a 1984 study for the Administrative Conference of the United States:

> It is in the national interest to permit each state to adopt its own regulatory policy to the extent that such state decisions affect only, or predominately, the interests of state residents. States should not be permitted, however, to make regulatory decisions that create substantial interstate spillovers…. Congress has the power under the Supremacy Clause to limit the ability of each state to adopt regulatory policies that create substantial interstate spillovers.[71]

National Need

The safety and soundness of the financial services industry is one of the driving forces behind regulation by all levels of government. Because there is such extensive horizontal and vertical spillover, the entire American economy depends on a sound financial system. This stability, in turn, depends on diversification. Case after case of fail-

70. Robert Crandall and Jerry Ellig, *Economic Deregulation and Customer Choice: Lessons for the Electric Industry* (Fairfax, Va.: Center for Market Processes, 1997), pp. 34–47.

71. Richard J. Pierce, *Regulation, Deregulation, Federalism and Administrative Law,* Report to the Administrative Conference of the United States, October 1984, p. 74.

ure in the financial services industry demonstrates that firms with geographic and product diversification are much more stable and secure than non-diversified firms. A study by University of Chicago economists Randall S. Kroszner and Raghuram G. Rajan, for example, found that financial institutions that had diversified before passage of the Glass–Steagall Act failed at a lower rate than the specialized institutions.[72]

Other studies have noted that banks located in states that restrict geographically diverse financial activities fail at a greater rate than those in states with more lenient regulations. For example, a 1994 U.S. General Accounting Office report noted that Continental Bank "was restricted by state law to a physical presence in Chicago where it was headquartered." Therefore, when the bank experienced asset difficulties, it could not depend on a diverse deposit base for stability. On the other hand, Bank of America, which experienced similar asset difficulties, "was able to work out its problems without requiring FDIC assistance. One market participant attributed Bank of America's ability to do this to its large retail network, which provided a stable source of funds and revenues on which the bank could rely while resolving its troubles."[73] Similarly, John Hood, president of the John Locke Foundation, notes that between 1960 and 1980, "there were only 17 bank failures in those states [that allowed geographic diversification], compared with 45 failures in the states that allowed limited regional branching and 66 failures in the states that prohibited branching altogether."[74]

The lesson from all of these studies is that diversification—both geographically and within a company's portfolio—is necessary for a safe and sound financial sector. Moreover, because a sound and secure financial services industry is a strategic national need, it is within the interest and purview of the federal government to act. But such diversification is impossible today in light of the firewalls that exist between banks, securities firms, insurance companies, and other commercial companies. It also is difficult (if not impossible) with 50 different sets of insurance regulations on the books in the different states. Therefore, as Wendell L. Willkie II, former general counsel at the U.S. Department of Commerce, and Alden F. Abbott, former counselor to the Department's general counsel, argued in 1992:

> The federal government should only regulate when there is a demonstrated national need, such as when a state law imposes substantial economic burdens on out-of-state consumers and producers greater than any benefits that may be bestowed on in-state citizens.... [T]he principle must only be applied where state action results in a major negative effect on commerce.[75]

There clearly is a demonstrated need for federal oversight of the financial services industry to protect portfolio and geographic diversification. Specifically, the federal government should preserve the freedom of interstate commerce by restraining any form of state-by-state protectionism.

HOW TO FACILITATE FINANCIAL MODERNIZATION

It is clear, both in the light of history and from an industry perspective, that oversight of financial

72. Randall S. Kroszner and Raghuram G. Rajan, "Is the Glass–Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933," *American Economic Review*, Vol. 84, No. 4 (September 1994), pp. 810–832. See also Eugene White, "Before the Glass–Steagall Act: An Analysis of the Investment Banking Activities of National Banks," *Explorations in Economic History*, Vol. 23 (1986), p. 40.
73. U.S. General Accounting Office, *Interstate Banking: Benefits and Risks of Removing Regulatory Restrictions*, GAO/GGD–94–26, November 1993, p. 76.
74. John Hood, "Charlotte, the Queen of Southern Banking," *Policy Review*, January/February 1996, pp. 10–11.
75. Wendell L. Willkie II and Alden F. Abbott, "Who Should Regulate Business? Assessing the Federal–State Balance of Power," Washington Legal Foundation *Critical Legal Issues: Working Paper Series* No. 48, August 1992, pp. vi–vii.

services is a responsibility shared by the national and state governments. There are roles within the American system of government for regulation and deregulation at all levels, and defining them is important and difficult. The activities of the financial services sector can be divided roughly into two parts: (1) the commerce of financial services and (2) the business of selling a financial product or service to consumers. One part cannot be separated from the other in practice, but the distinction is nonetheless essential to any definition of the proper roles of the federal and state governments in overseeing financial services.

The commercial activities of financial services firms involve activities necessary for them to function as safe and sound institutions, such as wire transfers, overnight borrowing from the Federal Reserve, stock and bond transactions, and portfolio diversification. In other words, it is the commercial activities of financial services firms that necessitate an intricate interstate network, create extensive interstate spillovers, and create the backbone of the nation's monetary system. Therefore, these activities should be subject to federal oversight.

The business (or industry) of financial services refers to the actual product being sold to the public. This may be an annuity, an insurance policy, a checking or savings account, or a security issue. In any case, the actual product being sold and the actual delivery of that product can be pinned to a specific geographic location. It is therefore proper for states to regulate the business or industrial activity of financial service firms. More specifically, a state has the right to regulate the sale of financial services (as compared to the business of financial services) to its resident individuals and businesses.

The responsibility for some financial services regulations at the state level, however, does not necessarily preclude federal action. Specifically, the federal government should retain the right to preempt *proscriptively* a state regulation that interferes with interstate commerce. This does not mean, however, that the federal government has the right or responsibility to promulgate such regulations *prescriptively.* In other words, it is the right of the federal government to preempt existing state laws that prevent interstate commerce. However, the federal government does not have the right to promulgate similar regulations or replace existing state laws with new federal laws.

Several alternative methods to preserve state autonomy when constitutionally permissable but encourage uniformity among the states have been used over the years. Examples include the Uniform Commercial Code, the Uniform Motor Vehicle Code, and the "home state exporting" framework used in corporate chartering.[76] Alternatively, the federal government may set parameters within which states are free to act. This is akin to setting an upper and/or lower boundary on the independent actions that a state may take in given areas. In each case, the federal government plays, at most, a facilitating role.

Thus, a dual system of regulation emerges along constitutionally delimited lines. States have the right to establish regulations that are local in nature, affect only consumers or interests located within the state, and do not interfere with interstate commerce. The federal government, on the other hand, has the right to establish regulations that are in the national interest, apply to activities of interstate commerce, and affect complex, interlocking, national networks. Additionally, the federal government has the right (and responsibility) to preempt proscriptively an otherwise properly delimited state law or regulation that constitutes a barrier to interstate commerce.

In some areas of financial service regulation, this paradigm calls for a shift in the responsibilities currently held by the federal and state governments. Specifically, many federal regulations affecting the product of financial services, such as community reinvestment and anti-redlining measures, would be shifted to the states. Likewise, many regulations now promulgated by the states,

76. For more information on "home state exporting," see Roberta Romano, "Empowering Investors: A Market Approach to Securities Regulation," *Yale Law Journal*, June 1998 (forthcoming).

such as restrictions on what structure an insurance company may take, would be shifted to the federal government. The key is to reconstitute an antiquated regulatory structure to match the modern financial services industry without destroying the delicate balance of federalism created by the Founders.

The primary applications of financial regulations and their proper regulatory jurisdiction are outlined below. In Chart 1, the areas are summarized in a financial regulatory responsibility matrix. Each area is aligned by jurisdiction according to the proper role for the states and federal government in that area. Each area also is aligned by a timetable for action based on the timeliness of reform in that area. In some cases, an area's appearance on the timetable is subjective. In other cases, reform in a particular area necessarily proceeds from or follows a reform in another area.

It is also important to remember that just because a particular regulation or oversight responsibility is listed on the matrix does not mean that such a regulation is beneficial or even necessary. Clearly, the financial services industry would function more efficiently if many current regulations were eliminated altogether. Therefore, the placement of various items on the matrix simply indicates what level of government should address each regulation, whether through continued oversight, reform, or outright elimination.

Responsibilities Under State Jurisdiction

Social regulations. The Community Reinvestment Act (CRA) of 1977, fair lending regulations, and anti-redlining measures were designed to achieve social ends, such as antidiscriminatory lending and the fostering of neighborhood revitalization. They typically attempt to reach these goals by outright restriction of discriminatory lending or, in the case of the CRA, by basing expansion or branching approval at least in part on an institution's community investment record. Unfortunately, most of these regulations have been ineffective and burdensome to financial institutions. CRA, in particular, is ineffective in fostering community reinvestment and extremely costly to financial institutions, and therefore to consumers.[77] These regulations should be eliminated at the federal level where most currently are enforced. Under this new paradigm, these laws should be the responsibility of state and local governments, since they affect the industry of banking (that is, the product and its delivery). These regulations also serve the local end of community development, not a national need.[78]

Again, the responsibility for social regulations at the state level does not preclude all federal action. Specifically, the federal government should retain the right to preempt *proscriptively* those state regulations that interfere with interstate commerce. This does not mean that the federal government has the right or responsibility to promulgate such social regulations *prescriptively*. In other words, it is the right of the federal government to preempt existing state laws that prevent interstate commerce, but the federal government does not have the right to promulgate social regulations or replace existing state laws with federal law.

Usury and other interest rate regulations. Usury laws have been in existence as long as the practice of lending money. Typically, these statutes take the form of simple interest rate ceilings on loans to protect consumers from extremely

77. See James Berkovec, Glenn Canner, Stuart Gabriel, and Timothy Hannan, "Race Redlining, and Residential Mortgage Loan Performance," presentation at the *Conference on Information and Screening in Real Estate Finance*, Federal Reserve Bank of Philadelphia, March, 1994; Hal S. Scott, "The Reinvented Community Reinvestment Act," Heritage Foundation *Lecture* No. 516, February 12, 1995; and Jonathan A. Neuberger and Ronald H. Schmidt, "A Market-Based Approach to CRA," Federal Reserve Bank of San Francisco, *FRBSF Weekly Letter* No. 94–21, May 27, 1994.

78. With regard to racial discrimination, state action clearly is governed by the Fourteenth Amendment to the Constitution. However, within these bounds, it should be left to the states to determine the level of regulation they wish to impose on the business of financial services.

high credit costs. Alternatively, interest rate ceilings have been placed on deposit accounts to prevent competition among banks, which is believed to lead to unstable financial institutions. In any case, usury and interest rate regulations, like social policies, affect the product of banking and should be the responsibility of state officials. However, any interest rate regulations imposed by states must be imposed without regard to the structure of individual financial services firms. What applies to one firm must apply to all others, and all firms must receive equal treatment under the law.

Insurance premium restrictions. State regulation of insurance premiums typically takes the form of direct premium price controls. The purpose of these regulations is consumer protection—specifically, the maintenance of low premium rates and prevention of premium discrimination. As with usury and interest rate regulation, insurance premium restrictions relate directly to the product and sale of insurance. Therefore, states should maintain the right, if they so desire, to set insurance premium restrictions. However, these restrictions must apply uniformly to all financial services firms that sell insurance products within a state,

Chart 1 B 1160

Financial Regulatory Responsibility Matrix

Jurisdiction

Exclusive Federal Control

Shared Responsibilities

Exclusive State / Local Control

Timetable for Action

Short-term (1-2 years)

Mid-term (2-5 years)

Long-term or Ongoing Oversight

Financial Integration

Portfolio Limitation

Deposit Insurance

CRA and other social issues

Premium Restriction

Capital Adequacy

Mandated Insurance Coverage

Chartering

Usury & Interest Rate Controls

Antitrust

Securities Disclosure

Direct Product Restriction

Supervision

Monetary Control

regardless of the firm's corporate structure or geographic scope of operations.

Mandated insurance protection. All states require automobile owners to obtain at least liability automobile insurance coverage. Likewise, most states require new homeowners to purchase private mortgage insurance (PMI). These mandates are intended to protect individuals in case of accident, financial difficulty, or other unforeseen occurrence. However, they also serve to protect financial companies that offer home mortgages, drivers who are involved in accidents through no fault of their own, and other "secondary" parties. In all cases, mandated insurance protection has to do with the product and sale of financial services; it is properly the responsibility of the states. Despite recent attempts by some Members of Congress to mandate the expiration of PMI after a specified amount of time, it is the responsibility of individual states to enact such provisions, if necessary.

Basic product prohibition and similar regulations. State and local governments have enacted numerous regulations to prohibit the sale of certain products or services. The most obvious are zoning restrictions that prohibit commercial firms from physically locating in residential neighborhoods. Many states in the past have imposed taxes or other burdens on specific industries or companies to prevent their entrance into local markets. For example, government-created monopolies (such as those created by limiting the number of taxicabs in operation) have prevented entrepreneurs from competing with entrenched interests. Licensing laws also are used to protect existing firms from competition. All of these laws unduly burden local consumers and are at odds with the principle of individual liberty.[79] Insofar as such restrictions are limited to the product and sale of financial services and affect all firms in a similar manner, their imposition should be left to the various states.

Responsibilities Under Mixed State and Federal Jurisdiction

Chartering. The current dual charter system for commercial banks and other financial services firms does not need to be changed. It should be recognized that states must apply any rules they promulgate to all financial services firms operating within their boundaries, whether they are state or nationally chartered or even chartered in another state. A firm's decision to charter as a state or federal institution will be less significant under this new paradigm than under the current system, because all regulations promulgated at the state level must apply to all financial services firms operating within that state.

Securities disclosure rules. The federal government has a role to play in prescribing a minimum level of disclosure by publicly held firms. Securities markets depend on a free global flow of capital to ensure liquidity and efficiency. Thus, all potential investors should expect a minimum standard of information to be disclosed from publicly available firms. States may wish to impose additional strict disclosure standards on firms located within their boundaries that wish to offer public shares of ownership. However, these rules and regulations would be imposed in addition to federally established guidelines. This mix of federal and state regulation already exists within the securities industry, so no significant change is necessary. The emphasis on disclosure should be maintained and even extended to other areas of financial services.

Supervision of financial services firms. General supervision of financial services firms requires cooperation between the state and federal governments. Each level of government obviously will require reporting by financial services firms, but these reports should be no more intrusive than necessary for the appropriate level of government to oversee the activities under its jurisdiction. Moreover, such reports

79. Clint Bolick, *Grassroots Tyranny: The Limits of Federalism* (Washington D.C.: Cato Institute, 1993), pp. 141–152.

should be based on the standard disclosure principles in today's securities industry. The availability of such information will reduce the need for other, more direct regulations.

Responsibilities Under Federal Jurisdiction

Monetary authority. Article I of the Constitution specifies that Congress has the power to coin money and regulate its value. Thus, the federal government retains the right to conduct monetary policy by whatever means it deems most efficient. A lively debate at the federal level can focus on the most efficient means and whether free banking is desirable.[80] The worst of all possible alternatives would be for the individual states to establish separate central banks and enforce independent monetary policies.

Capital adequacy. Regulations that mandate minimum capital requirements are associated intrinsically with the commerce of financial services. Minimum capital requirements are one factor used by financial services firms to determine their portfolio allocations, lending practices, and market exposure. Moreover, capital requirements intrinsically are tied to overnight lending between financial services firms that depend on the federal funds rate. This is a key lever used by the Federal Reserve Board to control monetary policy. Therefore, oversight of capital adequacy, as an integral part of monetary policy, should be within the jurisdiction of the federal government. The existence of capital requirements also is a significant aspect of ensuring financial safety and soundness—an overriding national need.

Deposit insurance. The current system of issuing deposit insurance for commercial banks is based at the federal level, specifically within the FDIC. As with most bank regulation of that era, federal deposit insurance was predicated on an ability to define a bank and a deposit clearly. Today, the line between a typical bank deposit and a money market mutual fund investment is nearly indistinguishable. Both the role of deposit insurance and the government's role in providing such insurance need to be reevaluated. The current system, as designed, depends on a diverse geographic mix of institutions for its stability; for this reason, federal oversight should be maintained.

Antitrust regulation. The desirability of government antitrust policy is likewise debatable. However, if there is to be such regulation of financial service firms, the federal government logically should maintain control. This is the precedent set in most areas of financial services.[81] The exception is the insurance industry. The McCarran–Ferguson Act specifically exempts states and insurance companies from federal antitrust statutes, presumably to give states more flexibility to set "consumer friendly" insurance regulations.[82] As the financial services industry moves toward integration and deregulation, these state-by-state regulations are not only unnecessary, but a major hindrance. If federal policy changes and commercial banks, investment banks, and insurance concerns integrate and merge with other commercial companies, a uniform antitrust policy will be essential. Moreover, these financial antitrust regulations should be brought into line with general antitrust statutes.

Portfolio limitations. Similar to capital adequacy rules, regulations that restrict a firm's portfolio in any way are associated intrinsically with the commerce of financial services. Therefore, it is

80. For a thorough treatment of free banking, see George A. Selgin, *The Theory of Free Banking: Money Supply Under Competitive Note Issue* (Totowa, N.J.: Rowman and Littlefield, 1988).

81. For a discussion of antitrust regulations in the commercial banking industry, see Macey and Miller, *Banking Law and Regulation*, pp. 442–488. For a brief treatment of regulations guiding the securities industry, see Ratner, *Securities Regulation*, pp. 204–207.

82. For a complete discussion, see Macey and Miller, *Costly Policies.*

proper for the federal government to regulate this aspect of financial services.

Internal activity restrictions, including commercial/financial integration. The freedom of firms to structure their activities as they see fit is essential in a competitive and open financial services market. It is an integral part of the commerce of financial services. Therefore, there is a natural distinction between federal and state jurisdiction. States maintain the right to regulate financial service products (regardless of the structure of the firms offering those products), and the federal government retains the right to regulate the structure of financial services firms (regardless of what products they offer). The right to regulate the allowable structure of financial services firms includes the ability of those firms to integrate with non-financial firms.

Prevention of barriers to interstate commerce. The Constitution charges the national government with ensuring free and open interstate commerce. This includes the power to preempt state laws that significantly interfere with the ability of commercial firms to conduct business across state lines. However, it does not include the right prescriptively to promulgate laws or regulations that are not national in scope, do not apply to activities of interstate commerce, and do not affect complex, interlocking, national networks. In other words, unlike the other federal responsibilities listed above, this power is residual and should be applied only when otherwise constitutionally granted activities of the states interfere significantly with interstate commerce.

CONCLUSION

The financial services industry has changed substantially over the past 60 years, but federal and state laws have not. Now that Congress is seriously considering changing how commercial banks, investment banks, and insurance companies interact, it is important to recognize that the industry no longer can be defined as it once was. The current regulatory approach is based on defined institutions that provide specific, easily identifiable products. Each classification of institution has a separate regulator, based either at the federal or the state level. However, the distinction between institutions today is increasingly blurred. A new paradigm is necessary.

Specifically, the industry of financial services should be viewed as a two-part process: the business of financial services (the actual product) and the commerce of financial services. This distinction can help to clarify the role of government oversight generally and the specific and constitutional roles of the national and state governments specifically. Defining these new lines of distinction and assigning responsibility will be difficult, especially given the current division of entrenched regulatory power. If the United States is to be assured of a strong financial services industry as it enters the 21st century, however, integration must be facilitated and accomplished with the clear understanding that a constitutional balance of responsibility and authority is essential.

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