A History of Financial Regulation in the USA from the Beginning Until Today: 1789 to 2011

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A history of financial regulation in the USA from the beginning until today: 1789 to 2011

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10.1 Introduction

In the USA today, the system of financial regulation is complex and fragmented. Responsibility to regulate the financial services industry is split between about a dozen federal agencies, hundreds of state agencies, and numerous industry-sponsored self-governing associations. Regulatory jurisdictions often overlap, so that most financial firms report to multiple regulators; but gaps exist in the supervisory structure, so that some firms report to few, and at times, no regulator. The overlapping jumble of standards, laws, and federal, state, and private jurisdictions can confuse even the most sophisticated student of the system. At times, it can be unclear exactly who regulates whom, what rules apply in which instances, and where to turn for a resolution of these questions. This confusion occasionally inhibits innovation in the financial services industry and investments in some sectors of the economy. At other times, this confusion enables firms and investors to fly under the radar and profit from regulatory arbitrage. Whether this confusion promotes economic growth or causes economic instability is an open question.

How this confusion arose can be explained. The history of financial regulation is long but well documented. Responsibility for overseeing the financial services industry evolved in the USA during the last two centuries. Debate about how to regulate financial activity began at the Constitutional Convention in 1787 and continued unabated for two centuries. The political debate dictated the structure of the financial system; scholars have long noted this fact. An example comes from Jacob Viner’s address at the American Economic Association’s annual meeting in 1936. Viner (1936) argued that America’s fragmented financial system,
[... ] has deep roots in our history, in our regional diversities, and local loyalties. Its persistence is due to the support it derives from state jealousy of encroachments on state autonomy, from agrarian and small-town jealousy of the metropolitan areas, and from the nation-wide fear of undue concentration of financial power in the great metropolitan centers, and especially fear of Wall Street domination.

This chapter summarizes that history. Section 10.2 briefly describes the foundations of the financial system in the eighteenth and nineteenth centuries. The story begins with the United States Constitution, which establishes the parameters of the debate. Section 10.3 examines the response of the system to financial crisis in the early decades of the twentieth century, focusing on the creation of the Federal Reserve System. Section 10.4 examines the reform of the system in response to the financial crises of the Great Depression of the 1930s. Sections 10.5 and 10.6 discuss the creation of the modern financial system from
the 1940s through the 1990s. Section 10.7 discusses attempts to plug leaks that arose in the modern financial system during the first decade of the twenty-first century.

To illuminate the information in our narrative, three tables appear at the end of our essay. Table 10.1 lists the government agencies that oversee financial markets today (or oversaw financial activity in the past). The columns of the table indicate the legislation that authorized the agency (and major revisions), the purpose of the agency, and (some of) its major data collections. Table 10.2 lists the principal non-governmental organizations that set standards for financial markets. Table 10.3 lists the principal laws that influenced the regulation of financial markets over the last 200 years, with a focus on legislation since the founding of the Federal Reserve System in 1913. Of course, in constructing these tables, choices had to be made, because publishing complete lists would be prohibitive. In this regard, the authors decided to exclude information about hundreds of state agencies and...
thousands of state laws and to exclude references to the 12 Federal Reserve District banks.

To illuminate the story that we tell, we reproduce as Figure 10.1 a figure previously published in January 2009 by the General Accounting Office of the United States (United States, 2009). This figure is a useful depiction of the history of the system. The figure begins in 1860s, at the time of the US Civil War. But the complexity of financial regulation in the USA begins before that date. Understanding why requires a discussion of the founding of our nation.

10.2 Constitutional foundations of our financial system

At the Constitutional Convention in 1787, delegates debated how to regulate financial activity. Some delegates advocated the creation of a national currency and a national bank. Others opposed those proposals, arguing that the regulation of financial activity should be left to state governments. Bitter divisions engendered broad compromises. These appear in the portion of the Constitution that delineates powers of the federal legislature. Article 1, Section 8 provides Congress with powers to

- Borrow money on the credit of the USA
- Coin money, regulate the value thereof, and of foreign coin
- Regulate commerce with foreign nations and among the several states
- Establish uniform laws on the subject of bankruptcies throughout the USA.

In 1791, Congress chartered the First Bank of the United States to handle the financial needs of the federal government and the credit and coinage of the nation. In 1811, the charter expired, and by one vote Congress defeated the bill reauthorizing the institution. In 1816, Congress chartered the Second Bank of the United States, whose charter expired in 1836. These charters expired because politicians disagreed about the federal government’s role in financial regulation. Politicians from northern industrial states favored federal – centralized – rather than state government. Politicians from southern and western states feared financial conglomerates and favored regulating financial activity through state legislatures. Their opposition prevented the establishment of a central bank, a uniform fiat currency, or uniform nationwide regulations for financial institutions (Dewey, 1902; Hammond, 1991; Myers, 1970; Russell, 1991).

State governments filled these gaps. State courts enforced financial contracts. States chartered corporations to provide financial services, particularly banks, and

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1 The authors would be interested to hear readers’ thoughts about our decisions, particularly what information should have been excluded and what information should have been added in its place.
regulated their behavior. The profitability of these charters created problems with political corruption, which were mitigated when states adopted general incorporation and free banking laws, enabling anyone meeting specific criteria to obtain a charter and open a bank. By the mid-1830s, financiers had little difficulty chartering banks. Banks opened in large numbers. Each bank issued its own currency, which traded at an exchange rate that reflected the bank’s reputation and risk of default. State governments left bank regulation to market forces. About half of all banks failed. Most failures occurred within a few years of the opening of an institution. Average longevity for financial firms appears to have been about five years. Because of these characteristics, financial historians refer to this era, from the expiration of the Second Bank of the United States to the Civil War, as one of wildcat banking (Dwyer, 1996; Rockoff, 1974).

The Civil War provided an opportunity to reform the financial system, because southern politicians who opposed federal regulation of financial markets withdrew from Congress. In their absence, Congress passed the National Currency Act (ch. 58, 12 Stat. 665; February 25, 1863) establishing a national currency printed by the US Treasury and issued by commercial banks (Friedman and Schwartz, 1971; Hammond, 1993; White, 1982). A bank could issue notes in proportion to the value of the capital that the bank deposited with the Treasury. To discourage the circulation of privately printed currencies, the Act taxed currencies of all other types, effectively forcing them out of circulation. One year later, Congress passed the National Banking Act (ch. 106, 13 Stat. 99; June 3, 1864), which established a system for issuing federal charters to commercial banks and authorized the Office of the Comptroller of Currency to supervise those banks. The Comptroller’s annual reports created a systematic national data collection covering a large swath of the banking industry. The act established a pyramid structure of reserves cities which shaped the financial landscape of the USA during the decades that followed.

The second panel of Figure 10.1 depicts the regulatory landscape after the passage of the National Banking and Currency Acts. The Office of the Comptroller of Currency (OCC) appears as the sole federal regulator of financial activity. The governments of the 36 states regulated financial activities within their borders, typically under a Superintendent of Banks or similar agency regulating commercial banks, trust companies, and building and loan corporations. Many states also possessed (or soon established) an agency that regulated insurance companies.

10.3 Responses to financial panics, 1890 to 1930

In the decades between the Civil War and World War I, financial panics occurred frequently, including major panics in 1873, 1893, and 1907 (Jalil 2011, 2012). After
these panics, legislators (both federal and state) debated reforming financial regulation. The panics of the 1890s contributed to the passage of the Bankruptcy Act of 1898 (July 1, 1898, ch. 541, 30 Stat. 544). The act established federal procedures for court-supervised liquidation of corporations unable to pay creditors, but left the liquidation of commercial banks in the hands of state bank supervisors and the Office of the Comptroller of Currency.

The panic of 1907 inspired further reform. An attempt to corner the market on the stock of the United Copper Company failed, and the banks that had lent money to the speculators sustained substantial losses. Depositor runs on these institutions spread rapidly to associated banks and trust companies, culminating in the collapse of the Knickerbocker Trust Company, New York City’s third-largest trust institution. In turn, Knickerbocker’s failure provoked a nationwide run on bank deposits (Sprague, 1910). In the absence of a central bank, the famous financier J. P. Morgan interceded by convincing New York’s bankers to pledge funds to shore up depositories beset by the cash crunch. One year later, Congress established a commission, chaired by Senator Nelson Aldrich, to investigate the crisis and propose solutions. The commission studied financial systems in numerous nations. Its exhaustive report inspired the creation of the Federal Reserve System. The environment was ripe for this proposal thanks to the findings of the Pujo Commission, which publicly uncovered the connections between influential Wall Street financiers and major industries in the USA (United States FRASER, 2011).

The Federal Reserve continued the compromise between advocates of local and national regulation. The system consists of 12 district banks, each of which originally acted as the central bank for a region of the nation, with a board of directors located in Washington, DC, which coordinated (but did not control) the activities of the system. Federal Reserve district banks possessed authority to conduct monetary policy – including discount lending and open market operations – at its own discretion under rules different from today. Then, Federal Reserve banks could only purchase (or loan money on the security of) what is now known as short-term commercial paper. Federal Reserve banks did not deal in overnight loans among private banks (federal funds) or US government securities, which are the principal monetary policy levers today (Richardson and Troost, 2009; Carlson, Mitchener, and Richardson 2011).

District banks also supervised the commercial banks that joined the system. The Federal Reserve Act required all nationally chartered banks to join the system, putting them under a dual system (Fed and OCC) of regulation and examination. State chartered banks could also join, if they fulfilled all federal regulations – such as levels of required reserves and restrictions on risky investments – which tended to be stricter than those imposed by state statutes (Meltzer 2003, 2009).
The third panel in Figure 10.1 depicts the regulatory landscape after the creation of the Federal Reserve in 1913. State governments continued to be the principal regulators of financial activity. State courts enforced most financial contracts. State legislators chartered most financial corporations. State regulators supervised roughly two out of three commercial banks and all other financial institutions, including insurance companies, trust companies, mutual savings banks, credit unions, mortgage originators, and building and loan societies (White 1981, 1983). Some states even dabbled in state-run deposit insurance programs (Chung and Richardson, 2006).

An array of private entities also supervised financial intermediation. Clearing houses operated in nearly one hundred cities. Banks that belonged to clearing houses had to obey their rules regarding reserves, risk, and regular inspections. State banking associations and the American Banking Association imposed codes of conduct on the behavior of members. Financial conglomerates—some of which began to form bank holding companies—began to purchase shares of stock in large numbers of banks and place directors on the banks’ boards. Rating agencies (e.g., Moody’s) and business information providers (e.g., Rand McNally) began to collect and disseminate balance sheet information from most banks operating in the USA. Stock exchanges operated in dozens of cities; some, such as New York, possessed several. Exchanges regulated transactions in equity, bond, and futures markets, ensuring that those who bought and sold in those venues fulfilled the terms of their contracts.²

The fourth panel of Figure 10.1 depicts further changes in the regulatory landscape during the 1910s and 1920s. On September 21, 1922, Congress passed the Grain Futures Act (ch. 369, 42 Stat. 998, 7 U.S.C. § 1), which established the Grain Futures Administration (GFA). The GFA supervised trading of commodities futures contracts. The City of Chicago challenged the constitutionality of the Act, which was upheld by the Supreme Court in Board of Trade of City of Chicago v. Olsen, 262 US 1 (1923). The Supreme Court had ruled against an earlier version (the Futures Trading Act of 1921) in Hill v. Wallace, 259 U.S. 44 (1922). These court cases illuminate the political tension generated by the federal government’s increasing attempts to regulate—and at times shape—the financial markets.

The government’s broadest intervention at the time may have been in agricultural credit. In 1916, Congress passed the Federal Farm Loan Act. This act established a Federal Farm Loan Board to supervise twelve Federal Intermediate Credit Banks. These banks extended short-term, seasonal loans to

² One of the contemporary descriptions of the US financial system appears in Rand McNally Bankers Directory, which was published biannually, in January and July, beginning in the 1890s.
farms, ranches, and companies that processed agricultural products. Funds for these loans came from bonds with similar maturities sold on securities markets in major cities. The Farm Loan Act also established Federal Land Banks and National Farm Loan Associations. These organizations raised funds for farm mortgages by selling mortgage-backed bonds in cities with sizeable securities markets. Capital for the land banks and intermediate credit banks came from the US Treasury and from farmers who were the customers, who were required to purchase stock in the corporations (Spahr, 1932).

The federal government’s intervention into farm lending coincided with the rapid expansion of agricultural production in the Great Plains and western states. This expansion led to the creation of new banks, businesses, and even towns that served as conduits for farm commodities. The expansion continued throughout World War I and for several years afterward, until climatic shocks (particularly droughts) reduced crop yields and international competition (particularly from European farms put back into production after the war) lowered crop prices. The ensuing contraction of farm incomes impeded the repayment of agricultural loans, contributing to the failure of thousands of small banks that operated in farm communities (Alston et al., 1994).

While the US Congress debated a wide array of financial reforms during the 1920s, the most important legislation was the McFadden Act of 1927 (Preston, 1927). The Act’s provisions fell into three groups. First, it extended the life of the Federal Reserve System. The Act extended indefinitely the original twenty-year charters of Federal Reserve Banks. Second, the McFadden Act revised national banking laws to conform with legal rulings, administrative decisions, and current business practices. Third, the McFadden Act expanded national banks’ authority to operate branches. Before the Act, national banks could not operate branch facilities except in a few special circumstances. After the Act, national banks could operate branches in the same city as their headquarters to the same extent as state-chartered banks under state law, but could not branch outside their home city or across state lines. While the McFadden Act had broad effects, it is remembered primarily for its impact on branch banking, which persisted for nearly 70 years, until modified by the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 (Rajan and Ramcharan, 2011).

Some of these changes appeared merely technical, such as allowing subordinate officers to sign reports to the Comptroller of Currency, rather than only the president or cashier (CEO and CFO) of the bank. Others provided firm legal footing for services increasingly offered by national banks, such as investment departments which marketed bonds and similar securities and trust departments which served as custodians for customers’ financial assets.
10.4 Policy responses to the Great Depression

Thousands of banks failed during the contraction beginning in 1929 and continuing until March 1933 (Richardson, 2007; Richardson and Troost, 2009). While the Federal Government made a few attempts to address the financial calamity during the years of 1930–1932, their efforts proved to be too little and too late. In early 1933, the public lost faith in banks in general. Depositors fled from the financial system, forcing twenty-eight states to close all financial institutions and eventually forcing the president to declare a national banking holiday, which shut down all financial institutions for seven business days before gradually resuscitating the financial system. In response to this disaster, the federal government changed the structure of financial regulation (Galbraith, 1954; White, 1990).

On January 22, 1932, Congress passed an act (c. 8, 47 Stat. 5) chartering the Reconstruction Finance Corporation (RFC) and authorized the RFC to extend loans to all financial institutions in the USA, including state-chartered banks lacking links to the Federal Reserve, and to accept as collateral an array of assets, as long as the RFC’s leaders deemed the loans to be “amply” secured. The RFC’s mandate emphasized loaning funds to solvent but illiquid institutions, whose assets appeared to have sufficient long-term value to pay all obligations, but which in the short run could not be sold at a price high enough to repay current creditors. The RFC also loaned funds to the receivers of banks in liquidation, which enabled receivers to repay depositors as soon as possible, and repay the RFC in the future, when assets could be sold at higher prices. The RFC also loaned funds to Federal Land Banks, which financed farm mortgages, and Federal Intermediate Credit Banks, which financed seasonal agricultural lending. The RFC also advanced funds to railroads, which indirectly aided banks, since numerous banks possessed portfolios of railroad bonds, which declined in value as rail traffic declined during the Depression, and to insurance companies, which also aided banks, since banks often purchased insurance on the values of their bond portfolios.

The Reconstruction Finance Corporation was a quasi-public corporation, staffed by professionals recruited outside of the civil service system, but owned by the federal government, which appointed the corporation’s executive officers and board of directors. The RFC’s initial capital came from $500 million in stock sold to the US Treasury. The RFC raised an additional $1.5 billion by selling bonds to the Treasury, which the Treasury in turn sold to the public. In the years that followed, the RFC borrowed $51.3 billion from the Treasury and $3.1 billion directly from the public. All of the RFC’s obligations were guaranteed by the federal government (Jones, 1951). On July 21, 1932, an amendment authorized the RFC to loan funds to states and localities for self-liquidating public relief projects, such as the construction of utilities and bridges, whose construction costs would be repaid by user
charges and tolls. The amendment also authorized the RFC to loan funds to states and localities to provide relief for the unemployed, when those loans could be repaid by future tax receipts.  

On February 27, 1932, Congress passed the Banking Act of 1932. The Banking Act of 1932 expanded the Federal Reserve’s lending powers, allowing Federal Reserve district banks to loan funds to member banks on the security of a broad range of assets equivalent to the assets accepted by the RFC. Loans secured by collateral previously ineligible for rediscount had to be approved by a minimum of five members of the Federal Reserve Board and had to pay a rate at least 1% above the prevailing discount rate. Federal Reserve districts could also loan funds to individuals, firms, and corporations, under restrictions mentioned above, and with the added stipulation that the borrowers prove that they had applied for but could not obtain credit from commercial banks in their own communities.

Congress passed the Emergency Banking Relief Act on March 9, 1933, in the week following Franklin Roosevelt’s inauguration, in the midst of the national banking holiday, to facilitate reopening the nation’s banks. Herbert Hoover’s subordinates in the Department of Treasury and the Reconstruction Finance Corporation wrote the Act, which sat on Herbert Hoover’s desk for many months to be used as a last resort in dire circumstances. Hoover never implemented the plan, although the economic crisis deepened during the months after his electoral defeat. During the interregnum, currency and gold fled from the USA. Bank runs swept the nation. Governors of more than twenty states declared financial holidays. Franklin Roosevelt implemented the disaster plan immediately after his inauguration. The Emergency Banking Relief Act clarified the Federal Government’s authority to act during a national financial emergency under legal authority created by the Trading with the Enemy Act which Congress passed during World War I.

The Emergency Banking Act contained five titles. Title I authorized the President to declare an emergency, during which he could control the national finances and foreign exchange of the USA, prohibit the hoarding and export of gold, and dictate which banks would reopen, merge, or remain closed. Title II authorized the Comptroller of the Currency to seize and operate any bank in the USA. The

4 To accomplish its goals, the RFC established several subsidiary and allied corporations. These include the Metals Reserve Company, the Defense Plant Corporation (DPC), Defense Homes Corporation (DHC), War Damage Corporation (WDC), Rubber Reserve Company (RRC), Electric Home and Farm Authority (EHFA), Lafayette Building Corporation (LBC), and Federal Facilities Corporation (FFC). Many of these agencies played important roles in financing economic expansion during World War II. In 1953, Congress passed an act that disbanded the RFC, transferring most of its functions to the Treasury Department effective June 1954, to wind down its affairs. Treasury completed that task in 1954. Vestiges of the RFC survive in the federal bureaucracy today. Successor agencies include the National Science Foundation, General Services Administration, and the Office of Defense Lending.

5 Senator Carter Glass and Representative Henry Steagall coauthored the legislation, which was initially called the Glass–Steagall Act, until that label became the universal appellation for the act that Senator Glass and Representative Steagall cosponsored in the summer of 1933.
Comptroller used this authority to appoint conservators for banks deemed unfit to resume operations but with the potential to recover. Title III authorized national banks to issue preferred stock, to pay dividends not exceeding 6% per year and did not subject holders to double liability (Macey and Miller, 1992; Grossman, 2001). The Reconstruction Finance Corporation could purchase preferred stock, and during the years that followed did so in large quantities. Title IV greatly expanded the range of eligible collateral Federal Reserve Banks could use for Federal Reserve notes. Fed banks also received expanded lending powers, allowing loans to member banks under “exceptional and exigent circumstances” whenever the loan was secured to the satisfaction of the Federal Reserve Bank. Title V of the Act contained three sections. Section 1 allowed Federal Reserve banks to convert debt instruments of the US federal government into currency at par value and to convert any circulating liability of a commercial bank (e.g., check, draft, or banker’s acceptance) into cash at 90% of its apparent value. Section 2 authorized Federal Reserve banks to make unsecured loans to member banks at a rate at least 1% above the discount rate. Section 3 authorized Federal Reserve banks to loan funds to any individual or corporation for 90 days if the loan was secured by US government securities. On March 24, 1933, an amendment expanded these powers, enabling Federal Reserve banks to loan funds directly to non-member banks and trust companies for the duration of the existing emergency.

On June 16, 1933, the Banking Act of 1933 (Pub.L. 73-66, 48 Stat. 162) became law (Flood, 1992). Congress had considered progenitors of the legislation during preceding years. The final act merged in conference the two bills introduced by Carter Glass in the Senate and Henry Steagall in the House. Congress approved the Act on June 13 and the President signed it on June 16. The final bill contains most of the provisions proposed by Senator Glass, with the exception of branch banking, which Steagall opposed, and the addition of deposit insurance, which Steagall advocated.

The Glass–Steagall Act contained several provisions which shaped the financial landscape in the USA during the next decades. First, the act established nationwide deposit insurance, replacing the temporary insurance fund established by the Emergency Banking Act. This provision created the Federal Deposit Insurance Corporation (FDIC), under the management of a board of directors appointed by the President. The corporation’s capital came from the US Treasury, Federal Reserve District Banks, and banks that joined the insurance system. All banks that belonged to the Federal Reserve had to join the deposit insurance system. Non-member banks could join the system by subscribing to stock in the association. Those that joined had to meet the requirements for Federal Reserve membership by July 1, 1936. This provision, in effect, induced all FDIC-insured banks to join the Federal Reserve System. Carter Glass – the legislative proponent of this provision – had
intended this to happen. He hoped to induce all state-chartered banks to join the Federal Reserve, which would have effectively ended the dual banking system (Flood, 1992, pp. 70–71). All insured banks could be charged assessments, if the stock of the corporation proved insufficient to cover required insurance payouts. The FDIC insured all deposits up to $10,000 and of larger deposits, 100% of the first $10,000, 75% of the next $40,000, and 50% of any deposit over $50,000.

Second, the act separated commercial from investment banking. The act required commercial banks to sell their securities affiliates within one year and restricted their bond departments to the purchase and sale of securities on the order of and for the account of customers. Underwriting investment securities was prohibited. Interlocking directorates between commercial banks and securities companies was also forbidden. Firms engaged in selling securities were prohibited from taking deposits one year after the enactment of the law (i.e., after June 16, 1934). The use of bank credit for the purchase of securities and speculation in securities markets was restricted. The Federal Reserve received powers to prevent member banks from extending loans for investment in securities markets.

These provisions were motivated, in part, by Congressional investigations of the causes of the Wall Street Crash of 1929 and the collapse of the commercial banking system from the fall of 1930 through the winter of 1933. These hearings came to be known by the name of the chief counsel, Ferdinand Pecora, hired to pursue the investigations and write the final report. Pecora personally interviewed an array of high profile witnesses, including some of the most influential financiers in the USA. His efforts illuminated abusive practices and conflicts of interest on the part of banks, bank holding companies, and their financial affiliates. The worst abuses included the underwriting of unsound securities to pay off defaulted bank loans, insider trading, and fraudulent manipulation of securities prices. These revelations garnered widespread media attention. The ensuing public outcry galvanized support for banking reforms during the 1930s (Pecora, 1939; Perino, 2010).

Third, the Banking Act of 1933 imposed stricter regulations on financial institutions. Some of these regulations sought to reduce conflicts of interest among officers and directors. For example, the act prohibited officers and directors of member banks from borrowing from their own institutions and required them to report all borrowing from all other organizations. The act also prohibited officers and directors of member banks from associating with corporations that loaned funds on the security of stocks and bonds. Officers and directors of federally insured banks also had to conform to these regulations.

Other regulations sought to alter conditions that engendered bank failures, particularly among small banks. One example is an increase in minimum capital requirements. Another example was the prohibition of payments on demand deposits, which legislators expected would reduce the cost of funds for commercial banks.
and encourage depositors to place more of their funds in time deposits (i.e., savings accounts and certificates of deposit), providing commercial banks with a stable source of funds that was less subject to panics and runs. Additional examples were the restriction upon the use of bank credit for speculation, authorization of statewide branch banking, federal supervision of group banking, modification of double liability, and increased authority of bank examiners.

Another restriction was the prohibition of private banking. Private bankers were individuals (or partnerships) that accepted demand deposits. The act required private bankers, after one year, to surrender either their deposit business or their dealing in investment securities. If they elected to conduct a deposit business, the law required them to submit to periodic examination by the Comptroller of the Currency.

Two years later, the Banking Act of 1935 contained two key sections. Title I modified deposit insurance so that the FDIC insured the first $5,000 of all deposits and nothing over that amount. The FDIC collected an annual assessment of 1/12 of 1% of all deposits in insured banks with no provision for collecting “special assessments” to cover periodic losses. Insured state chartered banks with deposits over $1,000,000 were still required to join the Federal Reserve System, but the deadline for doing so was pushed from 1936 back to 1942. Banks with deposits less than $1,000,000 were no longer required to join the Fed. Those that had joined were given the option to depart, but only 50 of the roughly 7,500 banks that joined the system chose to leave it.

While Title I made minor modifications to the FDIC, Title II made major changes to the structure of the Federal Reserve System. These changes centralized control of supply of money and credit in the hands of the Federal Reserve Board of Governors (the “Board”). Title II gave the Board the power to approve governors and vice-governors of the twelve district banks. The Board also received the authority to set discount rates and establish lending policies. The act provided that “subject to such regulations as to maturity and other matters as the Federal Reserve Board may prescribe,” a Federal Reserve Bank might discount any commercial, agricultural, or industrial paper for member banks, and might make advances to member banks secured by “any sound asset.” The act also permitted the Federal Reserve to purchase securities issued or guaranteed by the US government.

The new Board dominated a new Federal Reserve Open Market Committee (FOMC), consisting of the seven members of the Board, the President of the Federal Reserve Bank of New York (FRB-NY), and the presidents of four other Federal Reserve districts on a rotating basis. Title II gave the FOMC the authority to establish policies pertaining to the purchase of securities in the open market. The decisions of the FOMC became binding on Federal Reserve banks, which in the past, needed to participate in programs of open-market purchases and sales.
recommended by the Federal Reserve Board. Other Depression-era legislation dealt with deposit-taking institutions other than banks, such as savings and loans and credit unions. These organizations differed in the types of deposits that they accepted and the types of assets that they held. Commercial banks accepted deposits payable upon demand and provided customers with the opportunity to circulate those liabilities by writing checks. Commercial banks invested the preponderance of their short-term liabilities in short-term commercial loans, providing credit (often seasonal) to manufacturers, wholesalers, retailers, and farmers. Savings and Loans accepted only savings deposits and invested the bulk of these long-term liabilities in long-term investments like home mortgages. Credit Unions did not accept deposits. Instead, members of credit unions (and related entities such as mutual savings banks and building and loan societies) held stock in a non-profit credit cooperative. The cooperative typically treated the shares of stock like savings accounts, allowing members to buy and sell shares just like individuals deposited and withdrew funds from commercial banks. In 1934, Congress passed the National Housing Act, which established the Federal Savings and Loan Insurance Corporation (FSLIC), which insured deposits in savings and loans (S&Ls) and regulated the S&L industry. Congress also passed the Federal Credit Union Act, which established the Bureau of Federal Credit Unions to insure and regulate member-owned credit cooperatives (Wheelock, 2008).

The federal government’s intervention into mortgage markets expanded in 1932, when the Congress passed the Federal Home Loan Bank Act. The act created the Federal Home Loan Bank Board to oversee twelve government-backed banks with the authority to purchase mortgages loans issued by originators – primarily building and loan and savings and loan organizations – operating within their jurisdiction (Quigley, 2006). In 1938, federal government intervened in mortgage markets again, when Congress amended the National Housing Act to create the Federal National Mortgage Association (FNMA), colloquially known as Fannie Mae. Fannie Mae operated as a government sponsored entity whose mission was to purchase home loans originated by commercial banks and mortgage brokers, create a liquid second mortgage market, reduce the cost of home ownership, and encourage middle-class home ownership. Fannie Mae principally purchased mortgages insured by the Federal Housing Administration (FHA). For thirty years, Fannie Mae was the preponderant purchaser of mortgages, exercising a virtual monopoly over the secondary mortgage market (Fabozzi and Modigliani, 1992).

Another series of acts regulated stock exchanges and securities markets. In 1933, Congress passed the Securities Act, which established federal regulation of securities issues. In 1934, Congress passed the Securities Exchange Act which established the Securities and Exchange Commission (SEC) to regulate the issuance, purchase, and sale of securities, particularly equities and debt instruments. The act
required all public companies to submit periodic financial statements under penalty of perjury. In 1936, Congress passed the Commodity Exchange Act (ch. 545, 49 Stat. 1491, enacted June 15, 1936) which required all commodities futures and options to be traded on organized exchanges; see Stassen (1982) for a legislative history. To regulate those exchanges, the legislation established the Commodity Exchange Commission (CEC). This organization absorbed and assumed the legal authority of the Grain Futures Administration (GFA), which had been established in 1922.

10.5 Constructing the modern financial system, 1940 to 1980

Financial markets operated calmly from the 1940s through the 1980s. Institutions created in the wake of the New Deal held significant sway over the financial world and regulatory practices during this period.

One of the hallmarks of the SEC’s oversight of securities markets was the preference for industry self-regulation. While the SEC has authority to create accounting standards for publicly traded companies, it often defers to private accounting standards boards such as the Financial Accounting Standards Board (FASB) and its predecessors (Moehrle et al., 2002). The most prominent example of this tradition is the FASB, which sets the Generally Accepted Accounting Principles (GAAP) for the industry. In 1972, the American Institute of Certified Public Accountants (AICPA) issued a report calling for an end to the Accounting Principles Board (APB) and the creation of a fully independent FASB (Seidler, 1972).

The Financial Accounting Standards Board sets the Generally Accepted Accounting Principles in the USA. A five-tiered hierarchy of rulings and opinions make up GAAP:

1. Category A, the highest category
   (a) FASB-issued statements
      ● Statements of Financial Accounting Standards (SFAS)
      ● Financial Accounting Standards Board Interpretations (FINs)
   (b) APB-issued statements
      ● Accounting Principles Board Opinions

6 Whereas the members of the APB were part-time, unpaid members who worked for firms as accountants, members of the FASB are paid to work full-time devising standards. This set of distinctions is the intended source of independence, though Meyer concludes from his examination of APB Opinions that the APB was not systematically influenced by the connections between members and their “external constituencies” (Meyer, 1974). Seidler points out that members may be influenced on an industry and national level rather than an individual and company level, and that this influence would not be broken when transitioning to the FASB (Seidler, 1972).
(c) AICPA Committee on Accounting Procedure (CAP) statements (APB’s predecessor)
   ● Accounting Research Bulletins (ARBs)
2. Category B
   (a) FASB Technical Bulletins (FTB)
      ● Created by FASB staff, rather than the actual board
   (b) AICPA Industry Audit and Accounting Guides
      ● Created by committees and task forces in AICPA
   (c) AICPA Statements of Positions (SOPs)
      ● Created by AICPA Accounting Standards Executive Committee (AcSEC)
3. Category C
   (a) Consensus positions of FASB’s Emerging Issues Task Force (EITF)\(^1\)
   (b) AcSEC practice bulletins
4. Category D
   (a) AICPA Accounting Interpretations (AINs)
   (b) FASB Staff Implementation Guides
   (c) “[P]ractices that are widely recognized and prevalent either generally or in the industry” (Moehrle et al., 2002; AICPA 2000)
5. Category E
   (a) Catchall encompassing all other written sources of accounting authority (Moehrle et al., 2002; AICPA 2000).

The Norwalk Agreement with the International Accounting Standards Board (IASB) marked a shift in FASB goals. Issued September 18, 2002 (FASB website), the Norwalk Agreement made the alignment of US GAAP with international standards a priority for the FASB.

From the 1940s through the 1980s, practices of the FDIC influenced bank behavior. Banks insured by the FDIC must submit a Report of Condition and Income, also known as a Call Report, each quarter. The FDIC is responsible for maintaining and correcting these data, as well as making them available for the public. This responsibility is set down in the Federal Deposit Insurance Act of 1950. The bank’s Call Report must follow Federal Financial Institutions Examination Council (FFIEC) and FASB rules, as enforced by the FDIC. FFIEC was created by the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (US FFIEC 2011) and is tasked with creating uniform principles and standards across the several financial regulatory bodies such as the Fed, the OCC, and the FDIC. These data from “insured national and state nonmember commercial banks and state-chartered savings banks,” are the principal source of information on the banking system available to the public and are often used by regulators as a measure of the system (FDIC website).
When a bank fails, the FDIC has a few standard procedures for resolution. Typically, the FDIC will either perform a deposit payoff, a purchase and assumption (P&A), or open bank assistance. There are two types of deposit payoff. In a straight deposit payoff, the FDIC pays insured depositors up to the limit. In an insured deposit transfer, “insured deposits and secured liabilities of a failed bank or thrift are transferred to a healthy institution, and service to insured depositors is uninterrupted” (US FDIC 2012). The main alternative is a purchase and assumption (P&A). A P&A resembles an assisted merger in that a failed financial institution is absorbed by a healthy one (James, 1991). The FDIC auctions a package of assets from the failed institution and replaces them on the balance sheets with “good” assets (Glaessner and Mas, 1995). To determine which method to employ in failure resolution, the FDIC estimates the cost of covering uninsured depositors of the failed institution, plus FDIC administrative costs of executing a payoff and liquidation and sees whether it can find bidders among healthy institutions willing to cover those costs to absorb the failed institution. P&A is typically preferred, mainly because payoff and liquidation leads to a loss of going-concern value (Buck, 1984). The Dodd–Frank Act will change resolution requirements – in particular through the introduction of orderly liquidation authority (OLA) for systemically important financial institutions – but these rules are still being implemented.

In 1974, Congress amended the Commodities Exchange Act and created the Commodity Futures Trading Commission (CFTC). The CFTC succeeded the Commodity Exchange Commission, as seen in the sixth panel of Figure 10.1. The CFTC consists of five commissioners appointed by the President and confirmed by the Senate. The CFTC has the “authority to regulate futures trading in all goods, articles, services, rights, and interests traded for future delivery” (Michigan, 1975). To that end it has power of injunction, giving it authority to pursue its own matters. The CFTC is also granted power to take special action in emergencies to maintain order (Michigan, 1975). The proximate cause of the creation of the CFTC was the leap in prices in 1973 attributed to the action of speculators (Michigan, 1975). In order to ease passage of the CFTC Act, some issues were left for the Commission to decide. Among these issues were the regulation of option trading in previously unregulated futures commodities, time-stamping, and regulation of whether to permit futures commission merchants (FCMs) to dual trade – “trading for their own accounts as well as for the accounts of their customers” (Michigan, 1975).

Other new regulations and regulatory agencies were created in the 1970s. The Employment Retirement Income Security Act (ERISA) was passed to protect retirees. ERISA also created the Pension Benefit Guaranty Corporation (PBGC),

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7 Open bank assistance has not been used since the 1992 implementation of least cost analysis (US FDIC, 2012).
to encourage the continuation and maintenance of private-sector defined benefit pension plans, provide timely and uninterrupted payment of pension benefits, and keep pension insurance premiums at a minimum” (US PBGC, 2012). The PBGC acts to implement data collection and disclosure requirements mandated in ERISA (US DoL, 2008). The PBGC publishes statistics on its programs annually in its Pension Insurance Data Book since 1996 (US PBGC, 2009).

The Employment Retirement Income Security Act of 1974 (ERISA) was designed to aid and protect retired workers. It required retirement plans to disclose information to participants, provide a system by which participants can file grievances and appeals, and set minimum standards (US DoL, 2011). Some information required by ERISA includes “corporate plan sponsors provide participants with audited annual reports, summaries of plan descriptions, and other disclosures” (Langbert, 1994). ERISA also asserted the right of retirement plan participants to sue their plan providers for delivery of services (DoL website). Additionally, ERISA marked a movement in setting retirement standards from the state to the federal level. ERISA superseded state laws on employee benefits and gave jurisdiction over disputes regarding employee benefit claims to the federal courts (Langbert, 1994). Over time, several amendments to ERISA have been passed, including the Consolidated Omnibus Budget Reconciliation Act of 1974 (COBRA), the Health Insurance Portability and Accountability Act (HIPAA), the Newborns’ and Mothers’ Health Protection Act, the Mental Health Parity Act, and the Womens’ Health and Cancer Rights Act (DoL website). COBRA continues a participant’s health coverage for a limited time after loss of a job and HIPAA provides protections for workers who “might otherwise suffer discrimination in health coverage based on factors that relate to an individual’s health” (DoL website). HIPAA is an important example of regulatory data standardization. Administrative Simplification provisions “required HHS to adopt national standards for electronic health care transactions and code sets, unique health identifiers, and security” (US DHHS, 2012).

The Home Mortgage Disclosure Act (HMDA) of 1975 was initially implemented to help discern whether depository institutions were reinvesting in their local communities. Financial institutions covered by HMDA were required to report aggregates of dollars and locations. The required information did not include racial or other demographic data on loan applications. This model prevailed from HMDA’s passage to the 1989 Financial Institutions Reform, Recovery, and Enforcement Act

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8 Other pieces of legislation that affected ERISA include the Tax Equity and Fiscal Responsibility Act, the Retirement Equity Act, the Revenue Act of 1978, and the Tax Reform Act of 1986 (Langbert, 1994).
A history of financial regulation in the USA

FIRREA. FIRREA was one of many amendments to HMDA that expanded its scope to more mortgage lenders. FIRREA’s main impact on HMDA was to require lenders to report demographic information such as race, sex, and income, including reports on rejected applications. From FIRREA up through the twenty-first century, HMDA was amended so the data collected could be used to address issues of discrimination. In the early 2000s, HMDA was further amended through changes in regulation rather than through passage of laws. Most significantly, starting in 2004 HMDA required reporting of pricing of loans (Kolar and Jerison, 2005), to support the use of the HMDA loan/application register (LAR) data to assess predatory lending and discriminator pricing.

The Securities Acts Amendments became law on June 4, 1975 (Saunders, 1985). In these Amendments Congress directed the SEC to promote the creation of National Market and National Clearing Systems (Gillis, 1975) encompassing several goals. The National Market System was meant to improve competition, liquidity, efficiency and stability in securities markets (O’Hara, 2004; Werner, 1975). The SEC sought methods to exploit advances in computer technology to combine the several regional exchanges into the Intermarket Trading System (ITS) (Macey and Haddock, 1985; Gillis and Dreher, 1982). To that end, on April 28, 1981 the SEC ordered the ITS and the National Association of Securities Dealers (NASD)’s Computer Assisted Execution System (CAES) be automatically linked (Gillis and Dreher, 1982). Additional SEC-backed projects include the Consolidated Transaction Reporting System to provide real-time transaction reports for NYSE, AMEX, and regional exchanges, and the Composite Quotation System to display quotations and quotation sizes for the Consolidated Transaction System (Gillis and Dreher, 1982). In an effort to end anti-competitive regulations, the SEC ended fixed minimum commission rates by 1975 (Werner, 1975).

Despite its orders from Congress, ten years after the passage of the Securities Acts Amendments, a National Market System had not materialized. Macey and Haddock pointed to off-board trading restrictions as a key way the SEC could act to improve competition, and noted, “[t]he SEC […] was concerned that too much freedom in the marketplace might be detrimental. The Commission was particularly concerned with three phenomena: fragmentation of orders, overreaching, and market surveillance. These considerations are the only policy reasons that the SEC has advanced in defense of its failure to ban off-board trading restrictions” (Macey and Haddock, 1985). By “fragmentation of orders,” Macey and Haddock mean the SEC was concerned with consequences of transactions occurring outside organized exchanges. “Overreaching” refers to internalization of order flows, meaning that a broker-dealer may sell stock to a client at higher than market prices drawing from shares held in inventory by the broker-dealer. “Market surveillance” means SEC market monitoring responsibilities. Macey and Haddock (1985) go on to argue that “fragmentation is an unwarranted
fear,” by applying arbitrage logic, that overreaching is a fallacy, and that the SEC had ample market surveillance facility, concluding that there was no valid reason for the SEC’s failure to enact a National Market System.

10.6 Constructing the modern financial system, 1980 to 1995

During the 1980s and 1990s, the structure of financial regulation in the USA changed dramatically, as summarized in the sixth panel of Figure 10.1. Impetus for change came from three directions. First, free-market thinking increasingly prevailed in policy debates. Second, globalization forced financial institutions in the USA to compete in ever more competitive international markets against institutions operating in more permissive regulatory environments. US institutions incessantly lobbied to loosen regulations and level the playing field. Third, during the 1980s, the S&L industry collapsed. The Fed applied the Depression-era authority to set deposit interest rate ceilings (Regulation Q) to passbook deposits at S&Ls for the first time in 1966 (Gilbert, 1986). As nominal interest rates rose with inflation through the 1970s, deposits gradually fled to uncapped money market funds, a trend exacerbated by the Volcker Fed’s inflation-fighting, which pushed short-term interest rates above 20% in 1981. This put S&L balance sheets under severe stress, because the asset portfolios of long-term mortgages could not adjust in pace with the higher funding costs and outflows in deposit liabilities. Congress responded in March 1980 with the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), which phased out interest-rate ceilings on deposits and more than doubled deposit insurance coverage. Later that year, the Federal Home Loan announced the first of several reductions in capital requirements for the S&Ls. In 1982, Congress enacted the Garn–St. Germain Depository Institutions Act, which fully eliminated interest rate ceilings and broadly expanded S&Ls’ asset powers. These efforts were inadequate to prop up an industry designed to absorb much lower levels of interest-rate risk. Many savings and loans became insolvent. Most teetered on the edge of the abyss. Ultimately the results were disastrous, as bankrupt but fully insured institutions expanded operations into areas of the financial service industry in which they had little or no experience.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) was passed in response to the S&L crisis of the 1980s, mainly to restore confidence to the public. FIRREA amended the Home Owner’s Loan Act of 1933, replacing the Federal Home Loan Bank Board, and creating the Office of Thrift Supervision (OTS), as seen in the sixth panel of Figure 10.1. The OTS was created in the Department of the Treasury. To monitor interest-rate risk, the OTS
implemented the “Net Present Value” (NPV) risk model, which required thrifts to submit aggregated data on the terms and conditions of the full portfolio of assets and liabilities. FIRREA also created the Resolution Trust Corporation to resolve failed S&Ls. This corporation was put under the management of the FDIC. While the FDIC took over the FSLIC’s operations through the Resolution Trust Corporation, the explicit successor to FSLIC in FIRREA was the Savings Associations Insurance Fund (SAIF) (Providenti, 1991).

Changes in regulations in that period tended to reduce restrictions on the operations of financial institutions, allowing them to enter new lines of business. Interstate and intrastate bank branching was heavily restricted up to the 1970s. Intrastate branching was limited, but deregulation began in the 1970s; interstate branching restrictions began to be lifted starting in 1978. The shift to deregulation was slow and gradual, culminating in the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994. This act allowed nationwide branching starting June 1997, but it also had opt-in and opt-out provisions. The opt-in provision allowed states to pass legislation to allow branching earlier than the June 1997 deadline. Only two states, Texas and Montana, passed legislation to opt out of the provisions of the act (Dick, 2006).

Since the Banking Act of 1933, banks were prevented from engaging in universal banking, or banking in both commercial and investment industries. The Gramm–Leach–Bliley (GLB) Act sought to allow increased competition by removing barriers between the banking sectors of commercial, investment, and insurance, repealing limitations set by the Banking Act and Bank Holding Company Act of 1956. It did this by allowing financial institutions to form a “financial holding company” which can engage in all three industries. Anticipating the potential problems associated with the merging of personal financial data in these three industries, GLB included several privacy provisions. These provisions included required annual privacy notices for customers and an opt-out provision for customers to disallow financial institutions from sharing personal information with non-affiliates. GLB also required financial institutions “develop policies to promote data security.” A right of enforcement was assigned to federal agencies including the Federal Trade Commission, the Board of Governors of the Federal Reserve, the office of the Comptroller of the Currency, and the SEC. Despite these efforts, the privacy provisions were universally considered a failure soon after the passage of GLB (Janger and Schwartz, 2002).

The Federal Deposit Insurance Corporation Improvement Act of 1991 reformed rules for bank regulators and aimed to implement principles of prompt corrective action (PCA) and least-cost resolution (LCR). The principle of PCA was a response to banking and savings and loan troubles of the 1970s and 1980s
when regulators delayed taking action. PCA and LCR were designed to realign the incentives of regulators – who may be jockeying for industry jobs – to oversee the industry more conscientiously. To that end, FDICIA mandated more inspections of banks by the FDIC and annual audits of the FDIC by GAO. Subverting this structure, regulators were given discretion, under FDICIA, to set capital/asset thresholds which would trigger additional regulation and restrictions on banks, and immediately set the thresholds low enough for most banks to be considered “adequately capitalized” (Benston and Kaufman, 1997). “The act also addressed such issues as the need for higher capital levels, risk-based deposit insurance, and a strengthening of the regulatory responsibility for early intervention” (Gupta and Misra, 1999). Risk-based deposit insurance was intended to minimize moral hazard distortions on the part of bankers. In this same vein, FDICIA prevented the FDIC from protecting deposits of uninsured depositors – depositors with deposits in excess of $100,000 (Benston and Kaufman, 1997).

FDICIA addressed the doctrine of “too big to fail.” Effective in 1995, the FDIC was prohibited from protecting “uninsured depositors or creditors at a failed bank if it would result in an increased loss to the deposit insurance fund,” with the exception being the case that the institution is considered “too big to fail” (Benston and Kaufman, 1997). “Articulated by the Comptroller of the Currency after the failure of the Continental Illinois in 1984, the too-big-to-fail policy is based on the premise that the failure of a large institution could have a domino effect, starting bank runs that could bring down the financial system” (Gupta and Misra, 1999). FDICIA actually weakens this policy by requiring, “written approval of two-thirds of the Board of Directors of the FDIC and the Board of Governors of the Federal Reserve System [. . .] permission from the Secretary of the Treasury, after the secretary has consulted with the President of the United States. The FDIC is also required to recover any losses incurred from protecting uninsured claimants” (Gupta and Misra, 1999). It was considered that “too big to fail” policy would only rarely, if ever, be used.

10.7 Fine tuning the system: 2000 until today

During the last decade, the regulatory system continued to evolve. Some policymakers intended these changes to loosen restrictions on the behavior of financial institutions. These changes are visible in the seventh and eighth panels of Figure 10.1.

The Commodity Futures Modernization Act of 2000 (December 21, 2000) clarified regulatory jurisdictions between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) over many financial instruments. Title I amends the Commodity Exchange Act, limiting
its scope. Title II amends the Securities Act of 1933, Securities Exchange Act of 1934, Commodity Exchange Act, and Shad–Johnson Jurisdictional Accord, “to provide implementing rules necessary for shared oversight by the SEC and CFTC of single stock futures trading” (Kloner, 2001). “Title III provides additional legal certainty for swap agreements by providing guidelines for SEC regulation of equity based swaps” (Kloner, 2001). Title IV further limits the Commodity Exchange Act by clarifying that it does not apply “to certain swap agreements (including credit and equity swaps), hybrid instruments and other products commonly offered by banks” (Kloner, 2001).

The Public Company Accounting Reform and Investor Protection Act of 2002, more commonly referred to as Sarbanes–Oxley (SOX), passed on July 25, 2002 after several “prominent companies [were] involved in financial scandals and bankruptcies: Enron, Worldcom, Xerox, Sunbeam, Waste Management, Adelphia, Tyco, HealthSouth, Global Crossing, and others” (Coates, 2007). SOX was a direct response to these scandals. SOX contains three main components. First, in an attempt to provide market participants with access to identical information and a level playing field, SOX “forbids preferential disclosures to market analysts,” although this provision may have the unintended consequence of “less total disclosure” (Easterbrook, 2009). Second, in an attempt to create accountability and monitoring within corporations, SOX requires the CEO and CFO of all publicly traded corporations to sign the balance sheets that they submit to the SEC, opening them up to criminal penalties for perjury should the forms prove fraudulent. In addition, SOX requires publicly traded companies have an independent board of directors. Third, SOX mandated “more monitoring by accountants, in addition to monitoring by independent directors” (Easterbrook, 2009). SOX created the Public Company Accounting Oversight Board (PCAOB) to “enlist auditors to enforce existing laws against theft and fraud by corporate officers” (Coates, 2007). The PCAOB is charged with “registering, setting standards for, inspecting, investigating, and disciplining audit firms for public companies” (Coates, 2007). The PCAOB appears in the seventh panel of Figure 10.1.

The Sarbanes–Oxley Act also gave the SEC the task of reviewing the Financial Accounting Standards Board’s (FASB’s) process of creating Generally Accepted Accounting Principles (GAAP). Specifically, it was a commonly held belief that

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9 This provision returned banks to circumstances that prevailed in the past. From the 1860s through the 1920s, the president and chief financial officer of a nationally chartered bank had to sign their bank’s financial statement and faced civil and criminal liability if the financial statement proved to be inaccurate. The McFadden Act of 1927 allowed the president and chief financial officer to delegate this task to a subordinate who then assumed this legal liability.
Enron had avoided detection for so long by adhering to the letter of the rules set down by GAAP. The SEC was asked to determine how long it would take to move from a rules-based system to a principles-based system, the reasoning being that a principles-based system would have exposed Enron earlier than the rules in place under GAAP (Bratton, 2003). After Enron, the FASB was asked, under SOX, to seek an alignment of US GAAP with international standards (Bratton, 2003). Doubts have been raised as to whether convergence is a feasible goal and whether it will ever happen.

The Dodd–Frank Wall Street Reform and Consumer Protection Act, (Pub.L. 111–203, H.R. 4173) (DFA), is a hodgepodge of several unrelated regulations. Passed in July 2010 in response to the financial crisis at the end of the first decade of the twenty-first century, DFA restructured the regulatory system. A few highlights from this act include an overhaul of the bankruptcy code, a re-regulation of most derivatives previously deregulated, and regulations disallowing bailouts in many cases. The act also led to the creation and destruction of many new government agencies. For example, the act led to the creation of the Financial Stability Oversight Council, the elimination of the Office of Thrift Supervision, the creation of the Bureau of Consumer Financial Protection (CFPB), and the creation of the Federal Insurance Office (Davis and Wardwell, 2010). Especially noteworthy from a financial data perspective is the creation of the Office of Financial Research (OFR) under Title I of the Act, with mandates to monitor systemic risk and to standardize and collect positions and transactions data from market participants. One of the OFR’s first major initiatives has been the promotion of a global system of legal entity identifiers (LEIs), to facilitate the management and communication of identifiers for counterparties and other obligors. Many of the final implications of DFA will not be known until regulatory agencies create rules to implement their respective mandates.

“The Volcker Rule” prohibits proprietary trading and certain fund activities by bank holding companies and their affiliates and imposes enhanced capital and other quantitative limits on such activities by systemically important nonbank financial companies, including systemically important hedge funds” (Davis and Wardwell, 2010, emphasis in the original). This effectively repeals Gramm–Leach–Bliley’s deregulation of banking restrictions imposed by the Banking Act of 1933.

As previously mentioned, most derivatives deregulated under the Commodity Futures Modernization Act of 2000 were re-regulated under Dodd–Frank. “Largely following the historical jurisdictional divisions between the CFTC and the SEC, the Act categorizes the derivatives transactions within its scope as either ‘swaps’, which are subject to primary regulation by the CFTC, ‘security-based swaps’, which are subject to primary regulation by the SEC, or ‘mixed swaps’, which are subject to joint regulation by the CFTC and SEC” (Davis and Wardwell, 2010). The
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A requirement for centralized clearing has the side-effect of centralizing information on these transactions, facilitating regulatory data collection.

Nationally recognized statistical rating organizations (NRSROs) have held government-backed significance since the Great Depression. The banking acts of the 1930s required financial institutions to hold high-quality assets, with quality determined by ratings given by commonly used ratings firms. The act did not state the identities of these firms. Over time, this requirement evolved into the notion of NRSRO, and the SEC became the organization that determined which organizations fit into this category. The history of the evolution of this process is opaque, but it seems that the SEC had assumed this role before 1975. An SEC public memo, File No. S7–23–94, from the year 1994, describes the evolution of the commission oversight authority (SEC File No. S7–23–94, available at www.sec.gov/rules/concept/34–34616.pdf).

After Dodd–Frank, Fed investigators are not allowed to use NRSRO ratings at all in their evaluation of the risk of any securities. Additionally, Dodd–Frank “requires each NRSRO [Nationally Recognized Statistical Rating Organization] Board to oversee: policies and procedures for management of conflicts of interest; policies and procedures for determining ratings and the effectiveness of internal controls with respect to such policies and procedures; and policies and procedures for compensation and promotion” (Davis and Wardwell, 2010). NRSROs are now liable for their ratings. “The Act establishes that the enforcement and penalty provisions of the Exchange Act apply to statements made by credit rating agencies in the same manner and to the same extent as they apply to statements made by registered public accounting firms or securities analysts under the securities laws” (Davis and Wardwell, 2010).

Government agencies are now writing the rules that implement the Dodd–Frank legislation. Whether these rules will prevent future financial crises remains to be seen. The authors of this essay are skeptical. Prior to the Great Depression, the US financial system experienced periodic financial panics. Their cause was, in part, the complex and fragmented regulatory system created by the constitutional structure of the US government. During the Great Depression, policymakers prohibited all practices that they believed contributed to financial instability. That regulatory structure prevented financial panics from occurring for fifty years. In the 1990s, our nation dismantled the last of the Depression-era restrictions but took no actions to solve the systemic problems that caused financial instability in the past, and that appears to be causing financial instability in the present. Unless our nation deals with the root cause of the problem – fragmented regulatory authority – we should expect financial panics as regularly in the future as they were before the Great Depression.
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Name of agency (and successor)</th>
<th>Date founded (and date disbanded)</th>
<th>Authorizing legislation and principal reforms</th>
<th>Function</th>
<th>Data collections</th>
</tr>
</thead>
<tbody>
<tr>
<td>BFCU</td>
<td>Bureau of Federal Credit Unions (National Credit Union Administration)</td>
<td>1934 (1970)</td>
<td>Federal Credit Union Act (1934)</td>
<td>Oversight of Federal Credit Unions</td>
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<tr>
<td>FRB</td>
<td>Federal Reserve Board of Governors</td>
<td>1935</td>
<td>Banking Act of 1935</td>
<td>Oversight of Federal Reserve System</td>
<td></td>
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<tr>
<td>CEC</td>
<td>Commodity Exchange Commission</td>
<td>1936</td>
<td>Commodity Exchange Act (1936)</td>
<td>Required commodities futures and options to be traded on organized exchanges to be regulated by the GFA</td>
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<td>Agency/Board</td>
<td>Name</td>
<td>Year(s)</td>
<td>Relevant Acts/Acts</td>
<td>Responsibilities</td>
<td>Website/Source</td>
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<th>Function</th>
<th>Data collections</th>
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<tr>
<td>FSLIC</td>
<td>Federal Savings and Loan Insurance Corporation (Savings and Insurance Fund)</td>
<td>1934–1989</td>
<td>National Housing Act (1934)</td>
<td>Insurance for savings accounts in S&amp;Ls</td>
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<td>Agency/Institution</td>
<td>Description</td>
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<td>GFA</td>
<td>Grain Futures Administration</td>
<td>1922–1974</td>
<td>Grain Futures Act, Board of Trade of City of Chicago v. Olsen, 262 US 1 (1923)</td>
<td>Supervises the trading of commodities futures contracts</td>
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<td>LCR</td>
<td>Least-cost resolution</td>
<td>1991</td>
<td>FDIC Improvement Act of 1991</td>
<td>A rule for bank failure resolution to align regulator actions with proper monitoring</td>
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<td>NCUA</td>
<td>National Credit Union Administration</td>
<td>1970</td>
<td>Federal Credit Union Act (1934)</td>
<td>Facilitates the availability of credit union services</td>
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<td>Name of agency (and successor)</td>
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<td>Function</td>
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<td>PCA</td>
<td>Prompt corrective action</td>
<td>1991</td>
<td>FDIC Improvement Act of 1991</td>
<td>A rule for bank failure resolution to align regulator actions with proper monitoring</td>
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<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
<td>2002</td>
<td>Public Company Accounting Reform and Investor Protection Act of 2002</td>
<td>“[O]versee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports.”[9]</td>
<td>Board public reports: <a href="http://pcaobus.org/Inspections/Pages/PublicReports.aspx">http://pcaobus.org/Inspections/Pages/PublicReports.aspx</a></td>
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<td>RFC</td>
<td>Reconstruction Finance Corporation</td>
<td>1932</td>
<td>Glass–Steagall Act of 1932 (c. 8, 47 Stat. 5)</td>
<td>Authorized to extend loans to all financial institutions in the US</td>
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<td>Wall Street Reform and Consumer Protection Act (2010)</td>
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6. [www.gao.gov/about/history/articles/working-for-good-government/01-introduction.html](http://www.gao.gov/about/history/articles/working-for-good-government/01-introduction.html), 2012.
7. [www.ncua.gov/about/History/Pages/History.aspx](http://www.ncua.gov/about/History/Pages/History.aspx), 2012.
9. [www.pbgc.gov/about/who-we-are.html](http://www.pbgc.gov/about/who-we-are.html), 2012.
10. [http://pcaobus.org/About/Pages/default.aspx](http://pcaobus.org/About/Pages/default.aspx), 2012.
Table 10.2  Non-government organizations with a role in financial standards and oversight

<table>
<thead>
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<th>Abbreviation</th>
<th>Full name</th>
<th>Key dates</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>AcSEC</td>
<td>Accounting Standards Executive Committee</td>
<td>Relevant Data: AICPA reSOURCE</td>
<td>Issues opinions on behalf of AICPA</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
<td>1887</td>
<td>“[S]ets ethical standards for the profession and U. S. auditing standards for audits of private companies, non-profit organizations and federal, state and local governments.”</td>
</tr>
<tr>
<td>AINs</td>
<td>AICPA Accounting Interpretations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ARB</td>
<td>Accounting Research Bulletins</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAES</td>
<td>Computer Assisted Execution System</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAP</td>
<td>Committee on Accounting Procedure</td>
<td>1939–1959</td>
<td>Created to settle accounting problems as they arose</td>
</tr>
<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
<td></td>
<td>Resolves urgent issues before they become widespread</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
<td>1972</td>
<td>Relevant legislation: Public Company Accounting Reform and Investor Protection Act of 2002. “[…] to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports.”</td>
</tr>
</tbody>
</table>

### Table 10.2 (cont.)

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full name</th>
<th>Key dates</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>FINs</td>
<td>FASB Interpretations</td>
<td></td>
<td>“[C]larify or expand upon any accounting pronouncements that have previously been issued, usually addressing very specific topics.”  (^{20})</td>
</tr>
<tr>
<td>FTB</td>
<td>FASB Technical Bulletins</td>
<td></td>
<td>“[I]ntended to clarify or elaborate upon underlying accounting standards.”  (^{21})</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
<td></td>
<td>Relevant legislation: Public Company Accounting Reform and Investor Protection Act of 2002 Accounting standards set by private  (^{22})</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>accounting standards agencies</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
<td>2001</td>
<td>Sets standards for the International Financial Reporting Standards Foundation  (^{22})</td>
</tr>
<tr>
<td>NASD</td>
<td>National Association of Securities Dealers</td>
<td>1938</td>
<td>Relevant legislation: Maloney Act (1938) “Nonprofit organization formed under the joint sponsorship of the investment bankers’  (^{23})</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>conference and the SEC to comply with the Maloney Act, which provides for the regulation of the OTC.</td>
</tr>
<tr>
<td>NRSROs</td>
<td>Nationally Recognized Statistical Ratings  (^{22})</td>
<td></td>
<td>Relevant legislation: Wall Street Reform and Consumer Protection Act (2010) Organizations that give risk ratings to securities  (^{22})</td>
</tr>
<tr>
<td>SFAS</td>
<td>Statements of Financial Accounting Standards</td>
<td></td>
<td>“[P]rimary source of GAAP to the extent that they supersede any previous pronouncements [. . .]”  (^{24})</td>
</tr>
<tr>
<td>SOPs</td>
<td>AICPA Statements of Positions</td>
<td></td>
<td>A set of standards for a particular industry issued by the AcSEC  (^{25})</td>
</tr>
</tbody>
</table>

Table 10.3  Regulatory legislation

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full name</th>
<th>Key dates</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>COBRA</td>
<td>Consolidated Omnibus Budget Reconciliation Act of 1974</td>
<td>1974</td>
<td>Amendment to ERISA</td>
</tr>
<tr>
<td>FDICIA</td>
<td>FDIC Improvement Act of 1991</td>
<td>1991</td>
<td>Reforms rules for bank regulators and implements PCA and LCR</td>
</tr>
<tr>
<td>FIRREA</td>
<td>Financial Institutions Reform, Recovery, and Enforcement Act</td>
<td>1989</td>
<td>Response to the S&amp;L crisis of the 1980s</td>
</tr>
<tr>
<td>GLB</td>
<td>Gramm–Leach–Bliley Act (Financial Services Modernization Act of 1999)</td>
<td>1999</td>
<td>Removed barriers between commercial banking, investment banking, and insurance sectors</td>
</tr>
<tr>
<td>HIPAA</td>
<td>Health Insurance Portability and Accountability Act</td>
<td>1996</td>
<td>Regulatory data standardization(^{26})</td>
</tr>
<tr>
<td>SOX</td>
<td>Sarbanes–Oxley Act (Public Company Accounting Reform and Investor Protection Act of 2002)</td>
<td>2002</td>
<td>Direct response to financial and accounting scandals, including Enron</td>
</tr>
</tbody>
</table>

### A history of financial regulation in the USA

#### Table 10.3 (cont.)

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full name</th>
<th>Key dates</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amendments to Commodity Exchange Act (1974)</td>
<td>1974 Created CFTC, which succeeded the GFA and CEC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banking Act of 1932</td>
<td>1932 Expanded lending powers of the FRS, aligning their powers with those granted to the RFC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banking Act of 1933</td>
<td>1933 Created the FDIC. Split commercial and investment banks. Imposed stricter regulation on financial institutions. Also known as the Glass–Steagall Act.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banking Act of 1935</td>
<td>1935 Increased FDIC coverage. Centralized control of the money supply in the FRS.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budget and Accounting Act of 1921 (42 Stat. 20)</td>
<td>1921 Created GAO</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity Exchange Act (1936)</td>
<td>1936 Required all commodities futures and options be traded on organized exchanges</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity Futures (2000)</td>
<td>2000 Clarified regulatory jurisdictions between the CFTC and SEC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Emergency Banking (1933)</td>
<td>1933 Granted expansive powers to the President. Authorized OCC to seize and operate any US bank. Authorized national banks to issue preferred stock. Expanded powers of FRS.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal (1934)</td>
<td>1934 Established BFCU to regulate credit unions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal of 1950</td>
<td>1950 Required FDIC to collect and maintain call reports from banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Home (1932)</td>
<td>1932 Created FHLBB to oversee the twelve government-backed home loan banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Reserve Act (1913)</td>
<td>1913 Created FRS. Required all national banks to join the FRS, gave permission for state banks to join.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1978 Created FFIEC, which is tasked with creating uniform</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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