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Beyond Finance: Permissible Commercial Activities of U.S. Financial Holding Companies

Saule T. Omarova

This essay explains the legal basis for, and examines public policy implications of, recent expansion of large U.S. financial holding companies' non-financial business activities. Despite its potentially significant impact on economic growth and systemic stability, this phenomenon of financial conglomeration beyond finance remains poorly understood. Yet, any truly comprehensive and effective reform of financial services regulation must address public policy issues that arise when "too-big-to-fail" banks grow even bigger and more systemically significant by combining finance with commerce.

I. The Legal Wall Between Banking Commerce

One of the foundational principles underlying the entire system of U.S. bank regulation is the principle of separating banking from general commerce. Since at least 1863, federally chartered banks have been allowed to engage only in the "business of banking," and therefore prohibited from participating in purely commercial activities.[1] Congress extended the same principle to banks' parent companies and affiliates, when it adopted the Bank Holding Company Act of 1956.[2] The key policy reasons for separating banking from commerce have traditionally included the needs to preserve the safety and soundness of insured depository institutions, to ensure a fair and efficient flow of credit to productive economic enterprise (by, among other things, preventing unfair competition and conflicts of interest), and to prevent excessive concentration of financial and economic power in the financial sector.

In line with these objectives, the Bank Holding Company Act was originally conceived as an anti-monopoly statute, aimed at preventing excessive concentration of economic power in large money center banks.[3] Under the Bank Holding Company Act regime, all companies that own or control U.S. banks—bank holding companies (BHCs)—are generally restricted in their ability to engage, directly or indirectly, in any business activities other than banking, managing banks, and certain financial activities "closely related" to banking.[4]

In the 1980s, under pressure from the banking industry trying to regain competitive ground vis-à-vis securities firms, federal bank regulators began gradually relaxing legal constraints on banks' and BHCs' non-banking activities. Both the Office of the Comptroller of the Currency and the Federal Reserve engaged in aggressively expansive interpretations of the statutory language, to allow commercial banks and BHCs, respectively, to grow their businesses beyond traditional banking. Between the mid-1980s and early 2000s, the Office of the Comptroller of the Currency issued a series of interpretations allowing commercial banks to trade in a wide range of derivative instruments.[5] In a parallel effort, the Federal Reserve's orders allowed BHCs to

underwrite and deal in corporate securities, subject to revenue limitations. Moving beyond pure finance, the Federal Reserve amended its regulations, for example, to permit BHCs to conduct general data processing, storage, and transmission activities, including providing related hardware and other facilities.[6]

II. The Gramm-Leach-Bliley Act of 1999: Three Doors in the Wall[7]

This era of expanding BHC-permissible activities through administrative action culminated in the passage of the Gramm-Leach-Bliley Act of 1999, which partially repealed the Glass-Steagall Act and allowed affiliation between commercial and investment banks under the new financial holding company ("FHC") structure. The Gramm-Leach-Bliley Act amended the Bank Holding Company Act to allow certain qualifying BHCs that elect an FHC status to conduct (through their non-bank subsidiaries) a much wider range of "financial in nature" activities, including unlimited securities dealing and underwriting as well as general insurance business. FHCs were envisioned as "financial supermarkets" serving as a "one-stop-shop" for their customers' financial needs. This structural reform profoundly altered the key dynamics in the U.S. financial sector, unleashing a wave of consolidations and the emergence of large, diversified financial conglomerates such as Citigroup, JPMorgan Chase, and Bank of America.

The Gramm-Leach-Bliley Act also significantly expanded the range of non-financial activities permissible for this new breed of bank-centered financial services conglomerates. By allowing FHCs to enter purely commercial business lines, the Gramm-Leach-Bliley Act quietly dealt a potentially deadly blow to the concept of separating banking from commerce. Even now, more than a decade later, it is difficult to assess fully the implications of this shift in the legal and regulatory regime governing banking institutions. Yet, its importance for understanding the sources and patterns of systemic risk in today's financial sector is becoming increasingly clear.

Three principal provisions of the Bank Holding Company Act, as amended by the Gramm-Leach-Bliley Act, enable FHCs to engage in commercial activities on a much broader scale than before 1999. First, an FHC may make passive private equity investments of any size in any commercial company under the "merchant banking" authority.[8] Second, an FHC may directly engage in any non-financial activities, if the Federal Reserve determines such activities are "complementary" to a financial activity.[9] Finally, the statute contains a grandfather clause to allow entities that become subject to the Bank Holding Company Act after the Gramm-Leach-Bliley enactment to run physical commodity businesses.[10] An FHC may use any one of these statutory authorizations to conduct a particular commercial activity.

Each of these three statutory exemptions from the general ban on banking organizations' non-financial operations—or three "doors" into previously inaccessible sphere of pure commerce—is subject to various conditions and limitations. However, a closer

look at the language, origins, and subsequent implementation of these provisions reveals how weak these formal protections can be in practice.

A. Door No. 1: Merchant Banking

Prior to 1999, a BHC was generally permitted to make passive private equity investments in any commercial company only if such investments did not exceed 5 percent of such company's voting securities.[11] In the 1990s, banks viewed this as a major competitive disadvantage that kept them from making potentially lucrative private equity investments in start-up Internet and high-tech companies. Section 4(k)(4)(H) of the Bank Holding Company Act, added by the Gramm-Leach-Bliley Act, sought to remedy that situation by permitting FHCs to acquire or control, directly or indirectly, up to 100 percent of ownership interest in any commercial entity under the "merchant banking" authority.

The statute does not define the term "merchant banking." In 2001, the Federal Reserve and the Department of Treasury jointly issued the Merchant Banking Rule, which defines merchant banking as a catch-all authorization for FHCs to invest in commercial enterprises, as long as any such investment meets several requirements.[12] Thus, the investment cannot be held through an FHC's bank-subsidiary and must be sold within 10 to 15 years after the acquisition (barring any special circumstances). The investment must be made "as part of a bona fide underwriting or merchant or investment banking activity" (i.e. it must be a financial investment for the purpose of appreciation and ultimate resale). Furthermore, an FHC cannot "routinely manage or operate" any portfolio company in which it made the investment, except as may be necessary in order to obtain a reasonable return on investment upon resale.

These requirements were designed to ensure that FHCs use the merchant banking powers to facilitate their financial intermediation activities, as opposed to getting involved in the commercial businesses of companies in which they invest. Although an FHC is permitted to acquire full ownership of a commercial firm, the principal purpose of its investment must remain purely financial: making a profit upon subsequent resale or disposition of its ownership stake.

The real question is whether, in practice, FHCs comply with the rule's formal requirements while circumventing its intended purpose—that is, to what extent they are able to use merchant banking authority as a means of engaging in impermissible commercial activities. For instance, in general discussions of FHCs' merchant banking activities, the statutory prohibition on "routinely managing" portfolio companies is often understood as a requirement—and an effective assurance—of a purely passive "arm's length" relationship between an FHC and commercial entities it controls under that authority. Yet, this is not necessarily the case. The regulators interpreted the term "routinely managing" narrowly, leaving ample opportunities for FHCs to exercise decisive managerial control over their portfolio companies. Under the Merchant Banking Rule, the indicia of impermissible "routine management" of a portfolio company

include certain kinds of management interlocking and explicit contractual restrictions on the portfolio company's ability to make routine business decisions (e.g., hiring non-executive personnel or entering into transactions in the ordinary course of business).[13] Examples of permissible arrangements that do not constitute "routine management" include contractual agreements restricting the portfolio company's ability to take actions not in the ordinary course of business; providing financial, investment, and management consulting advice to, and underwriting securities of, the portfolio company; and meeting with the company's employees to monitor or advise them in connection with the portfolio company's performance or activities.[14] FHCs can also elect any or all of the directors of any portfolio company, as long as the board does not directly run the company's day-to-day operations.[15]

Thus, unwrapping regulatory interpretation of the statutory language reveals that FHCs enjoy considerable flexibility in directing business affairs of portfolio companies in which they invest pursuant to merchant banking authority. In practice, it is not difficult to structure an FHC's relationship with any particular commercial entity in a way that avoids formal indicia of "routine management" but gives it effective control over important substantive aspects of that entity's business.

B. Door No. 2: Complementary to Finance

The Gramm-Leach-Bliley Act also authorizes FHCs to conduct commercial activities determined by the Federal Reserve to be "complementary" to a financial activity. The Federal Reserve must also determine that any such complementary activity does not "pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[16] Once again, however, the statute does not define what complementary means.

Procedurally, the Federal Reserve makes these determinations on a case-by-case basis. Any FHC seeking to engage in any commercial activity it believes to be complementary to a financial activity must apply for the Federal Reserve's prior approval and provide detailed information about the proposed activity.[17] In making its determination, the Federal Reserve is required to make a specific finding that the proposed activity would produce public benefits that outweigh its potential adverse effects.[18] The statutory list of such public benefits includes "greater convenience, increased competition, or gains in efficiency."[19] The Federal Reserve must balance these benefits against such dangers as "undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the United States banking or financial system."[20] This list of potential dangers directly channels the policy concerns underlying the principle of separation of banking from commerce, which indicates Congress's intention to limit FHCs' potential expansion into the commercial sphere. Yet, the statutory language leaves too many opportunities for interpreting public benefits too broadly and potential risks too narrowly.

The legislative history of this provision shows that the industry deliberately sought the inclusion of the complementary clause as an open-ended source of legal authority for banking organizations to engage in any commercial activities that may become feasible or profitable in the future. Again, banks' real goal was to be able to invest in Internet and high-tech companies. Yet, the industry framed the congressional debate on complementary activities as a debate primarily about low-risk, low-profile activities, such as publishing travel magazines and using back-office over-capacity to offer telephone help lines.[21]

After 1999, the banking industry found other, less innocuous uses for this complementary power, such as physical commodity and energy trading.[22] Beginning in 2003, the Federal Reserve issued several orders allowing Citigroup, JPMorgan, Bank of America, and other FHCs to trade in a wide range of physical commodities as an activity complementary to their commodity derivatives businesses. In making its determinations, the Federal Reserve routinely equated the public benefits of proposed activities with the primarily private benefits to individual FHCs—their enhanced competitiveness and profitability.[23] With respect to potential adverse effects, the orders typically briefly noted the absence of any substantial risks to the safety and soundness of the FHC or the U.S. financial system.

The main safety and soundness limitation the Federal Reserve imposed on these activities was the prohibition on FHC ownership or operation of facilities for the extraction, storage, processing, or transportation of physical commodities.[24] In response, FHCs developed ways to obtain effective operational control of power plants and oil refineries through contractual arrangements. In the wake of the recent crisis, when three large FHCs – Goldman Sachs, Morgan Stanley, and JPMorgan – emerged as major commodity merchants and owners of oil pipelines and metals warehouses, the Federal Reserve's original line drawing began to seem even less relevant in practice.

More generally, this selective expansion of large FHCs into commodities and energy—vitally important and volatile sectors of the economy that are inherently vulnerable to market manipulation and speculative bubbles—raises fundamental questions as to whether the vague regulatory concept of complementarity imposes meaningful limits on banking organizations' commercial activities.

C. Door No. 3: "Grandfathered" Commodity Activities

The third source of authority for FHCs to enter commerce is section 4(o) of the Bank Holding Company Act, which authorizes any company that becomes an FHC after November 12, 1999, to continue "activities related to the trading, sale, or investment in commodities and underlying physical properties," if that company "lawfully was engaged, directly or indirectly, in any of such activities as of September 30, 1997, in the United States."[25]

Thus, section 4(o) seems to allow a qualifying FHC to conduct virtually any kind of commodity trading and any related commercial activities (for example, owning and operating oil terminals and metals warehouses), if it happened to conduct any commodities business—even if on a very limited basis and/or involving different kinds of commodities—prior to the 1997 cut-off date. Potentially, so broadly stated an exemption may open the door for large financial institutions to conduct sizeable commercial activities of a kind typically not allowed for banking organizations.[26]

Grandfathering of pre-existing commodities operations was originally proposed in 1995 by Congressman Jim Leach as part of a broader set of provisions establishing a new charter for "wholesale financial institutions" ("WFIs") that could conduct a wide range of banking activities but could not take federally-insured retail deposits.[27] The proposal sought to create a "two-way street" for investment banks, enabling them to acquire commercial banks and offer wholesale banking services to institutional clients, without becoming subject to the full range of activity restrictions under the Bank Holding Company Act.[28] Because WFIs and their parent-companies—"woofies"—would not have access to federal deposit insurance and, therefore, were not likely to pose any significant potential threat to the deposit insurance fund, the proposal authorized them to engage in a broader set of non-financial activities than regular FHCs backed by FDIC insurance. One of these explicit trade-offs involved the grandfathering of woofies' pre-existing commodities trading.

Initially, several big banks and securities firms strongly pushed for the passage of the woofie charter.[29] Unlike the House bill, the Senate version of the reform legislation did not contain woofie provisions. In April 1999, Senator Phil Gramm introduced an amendment replicating the commodity grandfathering provision for woofies in the House bill, but without any reference to woofies.[30] Ultimately, the entire subtitle of the House bill dealing with the new woofie charter was eliminated from the legislation. The Senate's broader version of the commodity grandfathering clause, however, became the current section 4(o) of the Bank Holding Company Act. Thus, an initially limited concession to financial institutions that were explicitly denied access to federal deposit insurance became an open-ended exemption available to all newly-registered FHCs fully backed by the federal government guarantees.

This commodity grandfathering provision remained largely unnoticed until Morgan Stanley and Goldman Sachs, which became BHCs in September 2008, claimed it as the legal basis for keeping and expanding their vast operations in physical commodities and energy markets. The controversy over this issue brought section 4(o) to the forefront of the public debate on the proper limits of banking institutions' nonfinancial activities and the dangers of failing to police these limits in practice.

III. From Financial Conglomerates to Financial-Industrial Conglomerates? Potential Public Policy Implications

As the preceding discussion shows, the post-Gramm-Leach-Bliley Act regime governing FHCs' commercial activities does not provide effective constraints on such activities. It is not surprising that, since the early 2000s, large U.S. bank-centered financial conglomerates—such as JPMorgan, Goldman Sachs, and Morgan Stanley—have been gradually morphing into financial-industrial conglomerates. This trend is especially visible in physical commodity and energy markets, in which these FHCs conduct significant operations producing, processing, transporting, storing, and marketing oil, gas, electricity, coal, uranium, aluminum, etc. But large U.S. FHCs may also be acquiring stakes in airports, railroads, telecommunications, or defense companies, we simply don't know.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the centerpiece of the U.S. financial regulation reform, does not directly address the question of whether, or to what extent, financial institutions should engage in commercial activities. While the Dodd-Frank Act generally endorses the continuing significance of the foundational principle of separation of banking and commerce, its main focus remains on financial activities and markets. Establishing effective regulatory boundaries for financial firms' non-financial activities and eliminating the current disconnect between legal principles and reality is a task for future reforms.

In the absence of full and reliable information on FHCs' commercial activities and their impact on financial and commercial markets, it is difficult to offer specific policy prescriptions for such reforms. However, as an initial matter, it is helpful to define the range of potential public policy implications of large, systemically important FHCs' large-scale involvement in commercial enterprise and to articulate key policy objectives that should guide our search for solutions.

There are several policy reasons to revisit the existing legal framework for allowing banking entities to conduct non-financial activities. Some of these reasons reflect the heightened relevance of the traditional policies behind the principle of separating banking from commerce in the complex and interconnected world of modern finance. These are concerns about safety and soundness of financial institutions and systemic risk associated with their commercial activities, potential leakage of the public subsidy beyond the banking sector, market integrity and consumer protection, and excessive concentration of economic and political power in the hands of financial conglomerates. In addition, there are serious reasons to doubt the actual capacity of financial institutions and their regulators to monitor and effectively control potential risks posed by such institutions' ever-expanding activities.

These theoretical concerns may be more or less pronounced in the context of a particular commercial activity. It is also worth noting that banks' involvement in certain

non-financial activities may—and often does—produce tangible financial benefits to their clients and, indirectly and perhaps less tangibly, to society as a whole. Yet, after decades of unquestioning acceptance of private firms' self-interested depiction of such benefits, it is critical that policy makers fully address potential social costs of mixing banking and commerce.

A. Safety and Soundness of Financial Institutions and Systemic Risk
It is often asserted that separating banking from commerce undermines banking institutions' safety and soundness by preventing them from diversifying their sources of income. This argument, however, is meaningless if stated in the abstract, as a generally applicable principle. Some forms of diversification may, in fact, produce desired economic benefits for an FHC, while others may have the opposite effects by exposing it to too much risk, often in unfamiliar ways. The task, therefore, is to determine which types of commercial investments and activities are likely to generate significant diversification benefits without, at the same time, undermining the safety and soundness of the individual FHC or the entire financial system.

Large FHCs' involvement in physical commodities and energy markets provides a useful example of how certain commercial activities may raise potentially significant safety and soundness concerns and exacerbate systemic risk. Let us assume that owning or operating oil pipelines and metals warehouses generates profits for an FHC that are both independent from, and significant enough to offset serious downturns in, its core financial-market business. This diversification effort also exposes the FHC to a broader range of risks, many of which are qualitatively different from risks posed by its traditional financial activities. It's easy to imagine, for example, that an accident or explosion on board an oil tanker owned or operated by one of JPMorgan's subsidiaries causes a large oil spill in an environmentally fragile area of the ocean. The news of the disaster may lead JPMorgan's counterparties in the financial markets to worry about the firm's financial strength and creditworthiness. The full extent of JPMorgan's clean up costs and legal liabilities would be difficult to estimate upfront, so it would be reasonable for the firm's counterparties to worry about its financial strength and creditworthiness. This could trigger a run on the firm's assets and bring JPMorgan to the verge of a major liquidity crisis. Without some form of a bailout, its failure is nearly certain to cause a major systemic disturbance in the financial markets.

This hypothetical illustrates how FHC's expansion into physical commodity and energy businesses creates new sources of, and transmission channels for, systemic risk in the financial sector. Systemic vulnerability is likely to increase whenever FHCs enter, on a sufficiently large scale, any commercial business and, as a result, become exposed to financial, operational, and market risks specific to such business. Therefore, any potential benefit from diversifying an FHC's portfolio beyond finance must be weighted against potential costs of increasing the overall level of institutional and systemic risk.

B. Leakage of Public Subsidy

By taking deposits and serving as the main channel for the flow of payments and credit throughout the economy, banks perform a "special" public service. For this reason, the federal government subsidizes banking institutions by guaranteeing their deposit liabilities and providing them with liquidity support through dedicated Federal Reserve facilities. Big, systemically important banks and their affiliates also enjoy implicit subsidy, based on the market expectation that the government would bail out any such entity in order to avoid financial meltdown.[31] As a result of this public support, explicit or implicit, banking organizations have lower cost of funding than ordinary commercial companies, which potentially gives FHCs a crucial advantage over their non-bank competitors in any non-financial market.

Commodities markets, again, provide a classic example. The financial industry often asserts that banks' entry into commercial sectors provides public benefits by increasing competition and by enabling them to provide better, more efficient services to their clients. What these claims leave out, however, is the potential competitive advantage that the federal subsidy of banking institutions gives them when they act in commodity markets. An oil refinery may very well benefit from a lower cost of its crude inventory supplied entirely by Morgan Stanley, but is Morgan Stanley able to offer the lower price because its own cost of funding is partly subsidized by the taxpayer? If it is so, the taxpaying public is indirectly subsidizing the refinery's costs of doing its business—something Congress has never endorsed or even contemplated.

To protect the taxpayers from unknowingly supporting private firms' profit-generating activities, it is critical to impose strict limitations on the ability of banking institutions to leverage their access to federal subsidy. Despite the existence of laws attempting to do just that, in practice, it remains a difficult task.[32] Once banks venture beyond finance, the market-distorting effects of the subsidy leakage become even harder to detect and control.

C. Conflicts of Interest, Market Manipulation and Consumer Protection

One of the key policy reasons for separating banking from commerce is the fear of banks unfairly restricting their commercial-market competitors' access to credit, the lifeblood of the economy. Banks can also use their financial power to influence prices in commercial markets in which their affiliates operate. The relatively recent growth of global derivatives markets, in which large U.S. FHCs are key participants, raises these concerns with potential conflicts of interest and market manipulation to a qualitatively new level. If the same FHC trades derivatives linked to the price of some underlying asset and, at the same time, through its commercial operations, can influence the supply of, or demand for, that asset, that FHC can intentionally move the underlying asset's price to maximize gains from its derivatives positions.

This structural market power from combining derivatives trading with direct participation in related commercial activities creates both incentives and opportunities for

new, more subtle, and harder to detect forms of manipulative conduct across different markets. Furthermore, FHC affiliates acting in various commercial markets in pursuit of their parents' complex trading strategies may fundamentally alter the dynamics within those markets, creating sudden price changes not explained by the traditional supply-and-demand factors. These destabilizing effects of "financialization" of commercial markets often translate into higher consumer prices. Recent revelations about Goldman Sachs' role in artificially inflating aluminum prices, through its metals warehousing operations, provide one example of this troubling trend.

D. Political Economy

Writing almost a century ago, Justice Brandeis famously warned against the dangers of allowing financial institutions to accumulate direct control over industrial enterprises.[33] The recent financial crisis underscored the continuing salience of Brandeis's political-economy concerns. One of the central themes in post-crisis regulatory reform is the prevention of future bailouts of "too big to fail" financial institutions. Yet, if large U.S. financial institutions successfully transform themselves into financial-industrial conglomerates, it would make the reformers' task even less enviable. Not only will these giant firms become even bigger and more complex, they will acquire additional sources of leverage over the economy—and, consequently, the polity—in their new role as providers of vital commercial products and services.

E. Firm Governability and Regulatory Capacity

Significant expansion of FHCs' commercial businesses presents serious challenges for these firms' internal governance and risk management. Large U.S. financial conglomerates are already complex in terms of their corporate structure, risk management, and the breadth and depth of financial services and products they offer. Allowing these firms to run extensive commercial operations that require specialized technical and managerial expertise adds to their internal complexity. Firm-wide coordination and monitoring of operations, finances, risks, and legal and regulatory compliance become all the more difficult in that context.

Furthermore, mixing banking with commerce creates potentially insurmountable challenges from the perspective of regulatory efficiency and capacity. The U.S. system of financial services regulation is already fragmented and ill suited to detect and reduce systemic risk across different financial markets and products. The expansion of FHCs' activities into new areas subject to extensive regulation under very different regulatory schemes—environmental regulation, workplace safety regulation, consumer safety regulation, etc.—lays the foundation for jurisdictional conflicts on an unprecedented scale. In addition to the several federal financial regulators, banking organizations may become subject to direct regulation by the Environmental Protection Agency, the Federal Trade Commission, the Department of Transportation, and numerous other federal and state agencies. Yet, none of these many overseers will see the whole picture, leaving potentially dangerous gaps in the regulation and supervision of these companies.

Non-financial regulatory schemes are not designed to address the unique risks—enterprise-wide and systemic—posed by the activities of systemically important financial institutions. Financial regulators, in turn, lack the necessary expertise and legal authority to exercise meaningful oversight of FHCs' commercial businesses and the risks they generate. This natural limit on regulatory capacity is a critical factor in the discussion of financial institutions' entry into non-financial lines of business.

IV. What Should Be Done? Potential Avenues for Reform

At present, there is surprisingly little public information on the nature and scope of banking organizations' commercial assets and activities. FHCs' public filings do not provide a sufficiently detailed picture, and it is not clear whether the Federal Reserve collects enough data to give it a comprehensive view of their merchant banking and complementary activities. Thus, the first step toward developing a coherent regulatory approach to commercial activities of banking organizations is to demand more specific and targeted public disclosure of all relevant information. Once we have a better idea of how involved our banking institutions are in non-financial businesses, we can decide whether such involvement warrants any particular policy intervention.

As a general matter, intervention could proceed along three lines: (1) strengthening the existing regime by imposing additional regulatory controls on FHC's ability to enter commerce; (2) eliminating specific authorizations of FHCs' commercial activities; and (3) folding this issue into a broader structural reform of financial services regulation.

A. "Policing the Doors"

The least radical policy response would seek to improve practical efficacy of the existing regime by imposing stricter and more meaningful regulatory controls on FHCs' commercial activities.

Size and concentration limits

One possible step in this direction would be to impose additional size and concentration limits on FHCs' permissible merchant banking and complementary activities. The relevant measures and thresholds may vary, and the Federal Reserve should have flexibility to determine whether the size, scope, or relative significance of any individual FHCs' commercial holdings and/or activities—as represented by any single or multiple metrics—reach potentially worrisome levels. In order to be meaningful, these limitations would have to target all of the substantive policy concerns outlined above.

Given the breadth of what constitutes commerce, it may be desirable to identify specific sectors or areas of activity, which are critically important to economic growth and/or potentially vulnerable to speculation-induced instability, and to craft additional limitations and conditions on FHCs' expansion into such areas. For example, additional safeguards could be imposed on FHCs' activities in physical commodities,

real estate, telecommunications, as well as infrastructure and transportation. The list of such "special concern" activities, and activity-specific limitations, may be adjusted by policy makers, if necessary.

Redefining supervisory objectives

The Federal Reserve should be required to (1) collect more granular quantitative and qualitative data on each FHC's merchant banking investments and complementary activities, and (2) monitor compliance with the statutory and regulatory requirements much more closely. The agency's principal supervisory goal should be to understand and evaluate not only each FHC's full commercial-activity profile but also the overall pattern and potential effects (internal and external) of combining its commercial and financial activities.

In evaluating compliance, Federal Reserve examiners must not rely on review of FHCs' corporate documents and formal "policies and procedures." For instance, with respect to merchant banking, examiners should scrutinize the actual relationships between each FHC and its portfolio companies, in order to ensure that the FHC's merchant banking portfolio contains only financial-in-nature investments. The examiners' task would be to monitor the relationship between an FHC and each of its merchant banking portfolio companies for the indicia of de facto operational influence that potentially cross the line between financing commerce and engaging in commerce.

Portfolio-level reporting

To this end, the Federal Reserve could require that each commercial company controlled by an FHC pursuant to merchant banking authority regularly provide quantitative and qualitative information detailing all of its business dealings with the FHC or its clients (e.g., percentage of the company's revenues generated from such dealings, lists of business contracts with the FHC or its clients, specific information on FHC's participation in the management and business decisions of the company). To ease the administrative burden, this portfolio-level reporting requirement may be applied selectively to portfolio companies engaged either in any "special concern" activity (as outlined above) or an activity in which the FHC's investment exceed certain concentration thresholds.

The same type of reporting may be mandated with respect to FHCs' commercial subsidiaries engaged in complementary activities. While the specific purpose of supervisory scrutiny in this context is somewhat different than in the case of FHCs' merchant banking portfolio, the overall goal is fundamentally similar: to ascertain the extent to which an FHC's commercial activities indicate any potentially troubling micro- or macro-trends.

Procedural safeguards

The existing scheme for complementary activities can be further strengthened by imposing additional procedural requirements on the Federal Reserve's decision making.

For example, the Bank Holding Company Act can be amended to require the Federal Reserve to provide a more detailed substantive justification of its determination that the public benefits—which are not to be equated with profitability and competitive gains of FHCs—of allowing a particular FHC to engage in a specific complementary activity outweigh all of the potential adverse effects specified in the statute (and not only those directly related to individual institutions' safety and soundness). Putting these implicit requirements directly into the words of the statute would make it more likely that the Federal Reserve fulfills its responsibilities as the guardian of the public interest.

It is also desirable to mandate periodic regulatory reviews and re-authorizations of each order granting individual FHCs' requests to conduct commercial activities complementary to finance. In effect, this requirement would create an automatic "sunset" period (e.g., every five years) for complementary power grants, which would force the Federal Reserve to reconsider its decisions in light of new information. Again, in issuing re-authorization orders, the Federal Reserve should be required to lay out in full the substantive reasoning behind its decision.

B. "Closing the Doors"

A more radical policy response would be to repeal specific statutory authorizations of FHCs' commercial activities created by the Gramm-Leach-Bliley Act. In contrast to the option outlined above, this option is less complicated and does not create significant compliance and administrative costs.

The easiest case for such outright repeal is section 4(o) of the Bank Holding Company Act. This commodity grandfathering provision has outlived its original purpose and does not serve any real function today.

There is also a potentially strong argument for repealing the statutory authorization of FHCs' merchant banking activities. As discussed above, the banking industry sought the inclusion of this authority in the Gramm-Leach-Bliley Act to enable it to invest in Silicon Valley start-ups. Today, long after the dotcom boom ended, FHCs can use this provision to conduct commercial activities that go far beyond the vague statutory concept of "bona fide merchant banking." Given the practical difficulty of ensuring compliance with the spirit and purpose of this provision, it would make sense to reassess whether the real public benefits of allowing banking organizations to act as private equity funds outweigh potential risks such activities pose from the public policy perspective.

C. "The Wall is the Problem!"

Finally, the most radical approach to resolving the existing tension between the legal principle of separation of banking from commerce, on the one hand, and its inconsistent implementation, on the other, would be to reconsider the principle itself.

This approach could support abandoning the legal fiction of separating banking from commerce and legalizing financial-industrial conglomeration under the rubric of "universal banking." Alternatively, it could support a call for broader structural reforms seeking more effective separation of finance from commerce. The former version of this paradigm shift, while potentially restoring doctrinal consistency, is not likely to address policy concerns discussed above. The latter version, however, might ultimately hold the key to resolving many a regulatory dilemma in modern finance. Developing a coherent system of new regulatory categories that reflect today's market realities better than old-style "walls" and "silos" could enable new solutions tailored more precisely to specific policy problems.

One of the fundamental questions in this respect concerns the social functions and boundaries of financial intermediation. Financial institutions' growing involvement in commercial activities blurs these boundaries, so that it is not clear any more where financial intermediation ends and trade intermediation begins—and what regulatory implications should follow. The recent growth of derivatives markets intensified this conceptual ambiguity by enabling the rise of new, hybrid intermediaries that seamlessly combine financial risk management services with large-scale commercial enterprise, often without being subject to full-blown regulation as financial intermediaries.

Resolving this fundamental ambiguity, however, is a difficult task. Much work needs to be done before we can outline a realistic path toward a new structural paradigm in financial regulation. Understanding where we are today and how we got here is the necessary first step on that path.

Endnotes

1. 12 U.S.C. § 24 (Seventh).
2. 12 U.S.C. §§ 1841 et seq.
3. For a discussion of the origins and subsequent changes in the primary policy focus of the Bank Holding Company Act, see Saule T. Omarova & Margaret E. Tahyar, That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States, 31 Rev. Banking & Fin. L. 113 (2011-12).
4. 12 U.S.C. § 1843. The list of activities "closely related" to banking can be found in the Federal Reserve's Regulation Y, 12 C.F.R. 225.28(b). Many financial activities (securities dealing and underwriting, general insurance underwriting, private equity investing) and commercial activities (real estate brokerage, land development, manufacturing and trading in physical goods) do not qualify as "closely related" to banking and, therefore, are generally impermissible for BHCs.
5. For a full discussion of the history and implications of the OCC's decisions in this area, see Saule T. Omarova, The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking," 63 U. Miami L. Rev. 1041 (2009).
6. 12 C.F.R. 225.28(b)(14).
7. Parts II and III of this essay are based on Saule T. Omarova, The Merchants of Wall Street: Banking, Commerce, and Commodities, 98 Minn. L. Rev. (forthcoming 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647.
8. 12 U.S.C. § 1843(k)(4)(H).
9. 12 U.S.C. § 1843(k)(1)(B).
10. 12 U.S.C. § 1843(o).
11. 12 U.S.C. § 1843(c)(6),(7).
12. 12 C.F.R. § 225.170(a). The Merchant Banking Rule provides the following definition:
 Section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) and this subpart authorize a financial holding company, directly or indirectly and as principal or on behalf of one or more persons, to acquire or control any amount of shares, assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for the financial holding company under section 4 of the Bank Holding Company Act. For purposes of this subpart, shares, assets or ownership interests acquired or controlled under section 4(k)(4)(H) and

this subpart are referred to as "merchant banking investments."

13. 12 C.F.R. § 225.171(b)(1).
14. 12 C.F.R. § 225.171(d)(2),(3).
15. 12 C.F.R. § 225.171(d)(1). This means merely that the portfolio company must employ officers and employees responsible for routinely managing and operating its affairs.
16. 12 U.S.C. § 1843(k)(1).
17. 12 C.F.R. § 225.89(a).
18. 12 C.F.R. § 225.89(b)(3).
19. 12 U.S.C. § 1843(j)(2)(A).
20. Id.
21. H.R. 10—The Financial Services Modernization Act of 1999: Hearings Before the Comm. On Banking and Fin. Servs., 106th Cong. 294-95 (1999) (prepared testimony of Michael E. Patterson, Vice Chairman, J.P. Morgan & Co., Inc., on behalf of the Financial Servs. Council).
22. As of mid-2013, the Federal Reserve approved only one other type of activity – certain disease management and mail-order pharmacy services – as complementary to a financial activity of underwriting and selling health insurance. Wellpoint, Inc., 93 Fed. Res. Bull. C133 (2007).
23. See, e.g., Citigroup, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 89 Fed. Res. Bull. 508 (2003).
24. Id. at 6-7.
25. 12 U.S.C. § 1843(o)(1). In addition, the statute requires that the aggregate consolidated assets of the company attributable to commodities or commodity-related activities, not otherwise permitted to be held by an FHC, not exceed five percent of the company's total consolidated assets (or such higher percentage threshold as the Board may authorize) and prohibits cross-marketing of products and services between any of its subsidiaries engaged in the grandfathered commodities activities and any affiliated U.S. depository institution. 12 U.S.C. § 1843(o)(2),(3).
26. On its face, the statutory 5-percent limit on the FHC's total consolidated assets attributable to grandfathered commodities activities seems to operate as a built-in brake on a new FHC's purely commercial activities in various markets for physical commodities. In absolute terms, however, even such a small fraction of total consolidated assets of a large FHC (with a trillion-dollar balance sheet) may allow for a considerable expansion of its commercial business of owning, producing, transporting, processing, and trading physical commodities.
27. Financial Services Competitiveness Act of 1995,104 H.R. 1062 (Version 1), Sec. 109.
28. This is how an American Bankers Association report described the proposal:

   To allow for two-way affiliations between banks and securities firms, a new type of holding company would be permitted. This would be the investment bank holding company. These companies would have still wider powers than the new bank holding company format would bring, but the separation between banking and commerce would still be retained. These special holding companies could own wholesale financial institutions (WFIs, also known as "woofies") which would be uninsured but also not subject to standard bank holding company firewalls.

   Steve Cocheo, Outlook Brightens for New Banking Laws, ABA Banking Journal, Feb. 27, 1997, at 10.
29. Goldman Sachs lobbied for specific inclusion of the commodity grandfathering clause in the "woofie" provisions of the House bill because of its existing investment in J. Aron, a commodity trading company. The commodity grandfathering provision was "widely viewed as the "Goldman" exception." Martin E. Lybecker, Financial Holding Companies and New Financial Activities Provisions of the Gramm-Leach-Bliley Act, in BACK TO THE FUNDAMENTALS: INSURANCE REGULATION, BROKER-DEALER REGULATION, AND INVESTMENT ADVISER REGULATION (ABA CENTER FOR CLE NAT'L INSTITUTE, NOV. 8-10, 2001), fn. 11.
30. S. Rep. 106-44 (Apr. 28, 1999), at.3.
31. For a recent study attempting to quantify such implicit subsidy of large financial institutions, see Viral Acharya, Deniz Anginer, & A. Joseph Warburton, "The End of Market Discipline? Investor Expectations of Implicit State Guarantees" (2013).
32. Thus, section 23A of the Federal Reserve Act, which imposes quantitative and qualitative limitations on transactions between federally insured depository institutions and their affiliates, should theoretically prevent the leakage of this public subsidy from banks to their commodity-trading non-bank affiliates. 12 U.S.C. § 371c. As the recent crisis demonstrated, however, the practical effectiveness of this statutory firewall is subject to considerable doubt. See Saule T. Omarova, From Gramm-Leach-Bliley to Dodd-Frank: the Unfulfilled Promise of Section 23A of the Federal Reserve Act, 89 N. C. L. Rev.1683 (2011).
33. Louis D. Brandeis, Other People's Money: And How The Bankers Use It (1933), at 3.

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