

Exchequer Club
Capitol Hilton
May 21, 1986

Functional Regulation - The Concept and its Applications
John Shad

I have been asked to discuss the origin and applications of the functional regulation concept. I do not know who originated the concept. It may date back to Plato's Republic, but in my mind, its present incarnation is interwoven with the Glass-Steagall amendments proposed by the Treasury in 1982 and Vice President Bush's Task Group on the Regulation of Financial Services.

The present regulatory structures of the financial service industries were created over half a century ago - on the basis of industry classifications. One group of state and federal agencies was created to regulate:

- o The securities industry;
- o Another the banks;
- o A third, the savings and loan associations;
- o And a fourth group of state agencies, to regulate the insurance industry.

But as a result of new economic opportunities and telecommunication technology, the traditional gaps between these industries have been bridged through major mergers and acquisitions and by new financial products and services - some of which compete on the basis of their regulatory classifications, rather than their economic merits.

Regulatory overlaps, duplications and conflicts have also multiplied. Today, 10 federal and over 100 state agencies regulate various aspects of the securities markets alone. Regulation of the securities registration and reporting requirements of about 400 publicly-owned banks and 300 savings and loan associations are divided among four federal agencies. Over 1,000 bank and S&L holding companies and the 10,000 other publicly-owned corporations file with the SEC.

These regulatory inequities and inefficiencies were identified early in the Reagan Administration. In July 1981, then Secretary of the Treasury Donald Regan, encouraged exploration of the concept of a task force to help simplify and rationalize the regulatory structures of the financial service industries.

Senator Garn, Chairman of the Senate Banking Committee, wisely counselled that "Task forces often delay action on pending legislation. The tendency is to say, 'Let's wait for the task force's report'". So the approach was modified to provide:

- o That legislation not be delayed, pending the task force's report;
- o And that it be a one-year task force of recognized authorities, who were thoroughly familiar with the issues.

The reactions of business and financial groups to speeches that included the idea were neutral to encouraging. And then in early 1982, in a meeting with half a dozen members of the SEC staff - we were preparing testimony for a Senate Banking Committee hearing on the Treasury's proposal to amend the Glass-Steagall Act, to permit banks to underwrite municipal revenue bonds and distribute mutual funds, through separate corporate affiliates, subject to the SEC's jurisdiction.

I thought the banks might oppose SEC regulation of these activities - even though they would be competing with security firms, and should "play by the same rules, with the same umpire". I said, "The sign on the top of the building may say bank, but there are different businesses on every floor. We have monolithic regulation, but it should be according to the activities involved." Russ Stevenson, the SEC Deputy General Counsel said, "You mean regulation by functional activities". I do not know whether Russ thought of it on the spur of the moment, or whether it was an old concept, but that was the idea.

The Commission's testimony supported the Treasury's functional Glass-Steagall amendments, and went on to recite the evolution of the regulatory structures of the financial service industries, and to recommend:

- o Regulation by functional activities, instead of by outmoded industry classifications;
- o Consolidation of overlapping, duplicative and conflicting regulatory activities;
- o And elimination of excessive regulations, within and between agencies.

To implement these concepts, the testimony recommended the creation of a one-year task force of recognized authorities, to help Congress simplify and rationalize the regulatory structures of the financial services industries. Vice President Bush, and his Counsel, Boyden Gray, reacted very favorably to the task force and functional regulation ideas. The Vice President endorsed them in a speech on the same day as the Senate Banking Committee hearing. There were favorable comments on the testimony.

During the next few months, the functional regulation and task force ideas were also discussed with:

- o Senator D'Amato, Chairman of the Senate Securities Subcommittee;
- o Congressman St Germain, Chairman of the House Banking Committee;
- o Congressman Dingell, Chairman of the House Energy and Commerce Committee;

- o Again with Secretary Regan, Senator Garn and members of their staffs;
- o And in meetings with the Fed, the FDIC, the Comptroller of the Currency, the Federal Home Loan Bank Board and the Commodity Futures Trading Commission;
- o And included in testimony before Congressman Wirth's Subcommittee.

In October 1982, the SEC held a two-day major issues conference. Other agencies and senior members of the business and financial communities, and the legal and accounting professions participated. The audience of about 500, included Congressional and agency staff members. The first half day was devoted to the functional regulation and task force ideas. The reaction was very favorable.

Later that week, Secretary Regan recommended to Vice President Bush that such a task force be formed, consisting of the chairmen of the Fed, the SEC and the other financial regulatory agencies, the Attorney General, the Director of OMB and others. It was designated the Vice President's Task Group on the Regulation of Financial Services.

Numerous Task Group meetings of the agency staffs and chairmen were held throughout 1983. Boyden Gray and Richard Breeden, senior members of the Vice President's staff, did an extraordinary job of defining the issues and obtaining the unanimous support of the 13 members of the Task Group for the extensive recommendations, which would not have happened but for the leadership and active participation of the Vice President and Secretary Regan.

The most important recommendations concern reforms of the bank and thrift regulatory structures. While modest by comparison, the securities recommendations are also important. They include:

- o Consolidating within the SEC on a functional basis, the securities registration and reporting requirements of all publicly-owned banks and thrifts, which will result in more uniform disclosure and enforcement practices at lower cost.
- o Exempting from registration conversion of banks and S&Ls into holding companies, if there are no material changes in the securities holders' rights and interests. (Such an exemption should be extended to all corporations).
- o Making NASDAQ stocks that are eligible for inclusion in the national market system automatically marginable.
- o Repealing the Public Utility Holding Company Act, which the SEC administers.
- o Simplifying and improving the investment company, advisers and trust indenture acts.

- o And amending the civil liability provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO) so that they do not apply in routine litigation against banks and brokers.

Some of these recommendations have been implemented. Others are pending before Congress. For example:

- o The Federal Reserve Board, has made NASDAQ national market system stocks automatically marginable.
- o And the Commission has adopted a rule (12d-1), which permits certain investments by investment companies in broker-dealers, investment advisors and their parent companies.

The Commission has also testified in support of:

- o Consolidating the securities registration and reporting requirements of the banks and thrifts within the SEC;
- o Permitting securities firms to engage in certain banking activities, through separate corporate affiliates, subject to regulation by the banking agencies;
- o Permitting banks to expand certain of their securities activities, through separate corporate affiliates, registered with the SEC;
- o Repealing the Public Utility Holding Company Act;
- o And amending the civil liability provisions of RICO.

Also, consistent with the principles of functional regulation, the SEC has adopted a rule (3b-9) which requires banks to conduct certain securities activities through subsidiaries that are registered with the SEC. The Rule has been upheld at the District Court level and is presently on appeal. In the meantime, many banks have already set-up securities affiliates, registered with the Commission, and others are doing so.

Registered broker-dealers are required to disclose to corporations, the identity of their shareholders, who do not object. Under the Shareholder Communications Act, next year banks, S&Ls and other fiduciaries will be required to make similar disclosures.

In conclusion, the lines of demarcation between the financial service industries have eroded. These activities should be regulated, and permitted to compete, according to their functions, rather than outmoded industry classifications.