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FUNCTIONAL REGULATION: OLD AND NEW APPLICATIONS

Aulana L. Peters
Commissioner

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FUNCTIONAL REGULATION: OLD AND NEW APPLICATIONS

I am very honored to have been invited to speak to the Fifth Annual Ray Garrett, Jr. Corporate and Securities Law Institute. One important aspect of gatherings such as this one, which honor the memory of distinguished lawyers and public servants like Ray Garrett, is that they renew our appreciation for our history and traditions.

I never had the pleasure of meeting Ray Garrett. In 1980, the year in which he died, I was hard at work as a securities litigator in Los Angeles. In my day-to-day practice, I did not scrutinize the comings and goings and latest developments at the Commission, like many members of the securities bar. Moreover, the possibility that I would be asked to join the SEC was the farthest thing from my mind. It should not be surprising, therefore, that I came to the SEC with less "institutional knowledge" than perhaps many of you have, especially those of you who are SEC Alumni. In any event, when you invited me to speak today, I decided to get acquainted with the legacy of Ray Garrett so that I could better understand the significance of this annual institute in his honor. So I pulled some dusty volumes off the shelves of the SEC's library and read some of Mr. Garrett's speeches.

Before reading those speeches, I had already decided to speak today on functional regulation, a topic currently of great interest to the Commission and the securities industry. The concept of functional regulation, as you know, is that the activities of

commercial entities performing essentially the same services and selling the same products should be subject to the same regulatory framework. 1/ When I chose this topic, I had no idea that it was one of great interest to Ray Garrett. On several occasions in 1973, Mr. Garrett gave speeches on functional regulation, making many of the same points that I had planned to make today. Fortunately, I have few illusions about how original my thinking is; so whatever bruises my ego suffered were more than offset by the pleasure and wise counsel I received from reading his speeches. I decided that it might be fun and useful to use this forum to weave together portions of Mr. Garrett's speeches on functional regulation with my own thoughts on the subject.

Functional regulation, and its application to expanded bank securities activities, is rather familiar ground. For at least eleven years, the Commission and the securities industry have been highlighting disparities in the current regulatory systems of bank securities activities, on the one hand, and broker-dealer activities on the other. Although this is relatively familiar ground, I would like to discuss it briefly in light of Mr. Garrett's interest in the issue, before going on to other areas in which I think the principle is applicable.

As most of you know, soon after the passage of the federal securities laws, banks began engaging in activities quite similar to traditional businesses of registered broker-dealers and invest-

1/ Letter from Donald T. Regan, Secretary of the Treasury, to John S.R. Shad, Chairman of the SEC (July 12, 1984) (commenting on the SEC's proposed Rule 3b-9).

ment companies. Among other things, banks managed common trust funds and advertised their services as trustees of such funds. Of course, these trust funds look, act and smell like investment companies, but Congress and the SEC said they were not investment companies, in part because bank trust activities are subject to their own comprehensive regulatory system. 2/ In the early 1970's, banks began to offer their customers professional money management services through so-called "mini accounts" and "automatic investment services", which permitted customers to purchase shares in certain designated companies through an automatic charge to their checking account.

In a speech given in October of 1973, 3/ Ray Garrett noted that (and I quote):

"recent attempts by banks ... to attract securities investment dollars have threatened [the Commission's] performance record, since they raise a number of serious policy questions concerning the true meaning of the standards 'public interest' and 'protection of investors' that we are mandated to nurture. In the context of the federal securities laws, where does the public interest of investors lie relative to bank intrusions into areas of the securities business which have heretofore been the preserve of non-bank broker-dealers?"

Summarizing recent bank incursions into the securities business, Mr. Garrett noted that these bank activities "could exacerbate serious structural imbalances in our markets." Banks and their agents are not subject to suitability standards and other regulations applicable to registered broker-dealers and their represen-

2/ 1 T. Frankel, The Regulation of Money Managers V §10.2 (1983).

3/ Address by Ray Garrett, Jr., "Protecting Investors Through Comparable Regulation" (October 19, 1973).

tatives. As a result, he observed, the then present regulatory framework was inequitable and inefficient. One month later, in another speech on many of these same issues, 4/ Mr. Garrett argued that "persons or entities engaged in comparable activities should be subject to comparable regulations [A] legislative approach", he concluded, "may be warranted".

In the eleven and a half years since those remarks, the securities activities of banks and broker-dealers are still subject to the vastly different regulatory schemes that existed in 1973. Indeed, with the passage of time, banks have become even more active in the securities area.

In order to correct the inequities of the current regulatory system, the Commission has proposed for comment rule 3b-9, 5/ which would require banks engaging in certain types of securities activities to register as broker-dealers. This controversial rule has been strongly supported by the securities industry and those truly in favor of functional regulation. Even the bank regulatory agencies, while opposing rule 3b-9, have recently demonstrated some sensitivity to the inequities and inefficiencies of the present regulatory system. The Treasury Department, for example, has proposed legislation that would require banks

4/ Address by Ray Garrett, Jr., "The Challenge of New Investment Services" (November 16, 1973).

5/ SEC Securities Exchange Act Release No. 34-20,357 (Nov. 8, 1983).

conducting certain securities activities, such as underwriting public offerings, to conduct all of their securities activities through affiliated entities as part of a holding company structure. 6/ The affiliate, of course, would be required to register with the SEC as a broker-dealer. The OCC and FDIC have proposed similar rules. 7/ Thus, although much work remains to be done in this area, there is reason to believe that some of the regulatory inefficiencies identified by Ray Garrett over eleven years ago will be eliminated in the near future.

The two areas that I planned originally to discuss in the context of functional regulation, and to which I now would like to turn, are areas not usually associated with that concept. These areas are the SEC's proposed Rule 151, 8/ which would provide a safe harbor for certain variable annuities, and the very recent and very hot issues of whether and how to regulate the government securities market.

Let me tackle Rule 151 first. As I am sure all of you know, in 1933 and 1934, Congress exempted traditional insurance products, such as life insurance policies and traditional annuities, from the federal securities laws. In response to changing market conditions, insurance companies devised products, such as variable

6/ The Financial Institutions Deregulation Act, S. 1609, 98th Cong., 1st Sess. (1983).

7/ 49 Fed. Reg. 15089 (1984) (to be codified at 12 C.F.R. Parts 5 and 12); 19 Fed. Reg. 46709 (1984) (to be codified at 12 C.F.R. Part 337).

8/ SEC Securities Act Release No. 33-6558 (Nov. 21, 1984).

annuities, that were unimagined when the securities laws were enacted. This development raised the issue of whether Congress intended to exempt the variable annuity from the federal securities laws. As all of you know, in SEC v. Variable Annuity Life Insurance Co., ^{9/} the Supreme Court answered that question in the negative, holding that variable annuities are not excluded from the securities laws. In the VALIC case, the Supreme Court emphasized that traditional insurance policies and annuities are exempt under the securities laws because the insurance company, rather than the investor, assumes the investment risk. Variable annuities, on the other hand, place substantial investment risk on the annuitant and therefore are not exempt from the securities laws.

Notwithstanding the Supreme Court's holding in VALIC, and the Commission's endorsement of the concept of functional regulation, the Commission has proposed for comment Rule 151 under the 1933 Act, which would provide a safe harbor for certain annuities within Section 3(a)(8). The proposed safe harbor would exempt from the securities laws even those annuities that impose a substantial investment risk on the purchaser, as long as the corporation offering the annuity is subject to regulation by state insurance officials, the annuity is not marketed primarily as an investment, and several other criteria are met. If the proposed rule were adopted, annuities whose purchase involves a substantial investment risk would be regulated exclusively by the

^{9/} SEC v. Variable Annuity Life Insurance Co., 359 U.S. 65 (1959).

states, while other annuities, whose purchase involves the same investment risk, would be deemed "securities" and thus subject to federal regulation. What justifies these vastly different regulatory schemes for functionally similar products? The SEC's only answers are whether or not the issuer is regulated by a state insurance commissioner, and whether or not the annuity is marketed primarily as an investment. Rule 151, therefore, would result in vastly different regulatory systems for commercial entities selling the same investment products. I question whether this result is consistent with the concept of functional regulation or the Commission's application of that concept to the securities activities of banks.

My last topic concerns the current and controversial issues of whether and how to regulate the government securities market. The SEC recently issued a release seeking public comment on these issues. 10/ All of you are aware of the spectacular and notorious failures of Drysdale, Lombard Wall, Lion Capital, ESM and Bevil Bressler, which gave rise to the current concern with this largely unregulated market.

All of you are also probably aware that one fundamental question in this area is whether the SEC or the Federal Reserve, which oversees the government securities market through its open market operations, should regulate that market. 11/ I think it is helpful to analyze this issue from the perspective of functional

10/ SEC Securities Exchange Act Release No. 21,959 (April 19, 1985);

11/ Assuming, of course, any regulation is necessary.

regulation. That concept, again, is that the commercial entities providing essentially the same services and selling essentially the same products should be subject to the same regulatory framework.

Those who support the Federal Reserve's jurisdiction over the ESM's of the world note important distinctions between the commercial activities of government securities dealers and the commercial activities of other broker-dealers. First, most of the buyers and sellers of government securities are institutions, and, therefore, presumably more sophisticated than the general investing public. Second, the issuer of government securities is the United States government, which might suffer some of the burdens of regulation. From the perspective of functional regulation of broker-dealers, should these distinctions make a difference? I think not.

It is true that the securities laws, and the SEC's regulations under those laws, distinguish between transactions involving different types of investors. The most notable distinctions between transactions involving sophisticated persons and those involving the general public are found in Regulation D. Nevertheless, Section 15's registration requirements for broker-dealers make no distinctions between broker-dealers who do business only with sophisticated investors and those who do business with the general public. The multi-million dollar losses suffered by major banks, thrifts and municipalities as a result of the recent rash of government-securities-dealer failures show that anyone can be defrauded. It would be a novel, and I think unfortunate, approach to the securities laws to determine that a government

securities dealer should not be required to register with the SEC, and consequently, that those with whom it deals do not need the protection of regulation, because sophisticated investors can take care of themselves. The purpose of SEC regulation is not just to protect investors, but to promote the integrity of the securities markets. Regulation of broker-dealers, regardless of the sophistication of their clients, raises the level of trust and confidence of all participants in the securities market. Thus, the alleged sophistication of the players in the government securities market does not obviate the need for SEC regulation.

Should the Federal Reserve, and not the SEC, regulate government securities dealers because the issuer is the United States government? Some have argued that because of the paramount importance of efficient, low-cost financing of the national debt, the Federal Reserve should regulate government securities dealers. Whatever intuitive appeal this argument may have, 12/ it is inconsistent with the concept of functional regulation.

Low-cost financing of ventures in many industries is crucial to their success. Let's look at the defense industry, for example. Major defense contractors, such as Lockheed and United Technologies, must have access to the capital markets in order to finance weapons projects, whose success, many in the administration would have us believe, directly affects our national

12/ With respect to secondary dealers such as ESM, I am not convinced this argument has even an intuitive appeal.

security. But no one would seriously suggest that a securities dealer whose activities are limited to buying and selling stocks and bonds of defense contractors should be regulated by the Defense Department and not the SEC. The point of functional regulation is that if you are engaged in essentially similar commercial activity, in this case buying and selling securities, then you should be subject to the same regulations administered by the same agency. In this case, the SEC is that regulator and those regulations are contained in the federal securities laws and the SEC's regulations thereunder. It is important to note in this context that I am talking about regulating the players, not the market itself. I am not suggesting that the SEC can or should establish fiscal or monetary policy.

Let me now shift my focus from functional regulation to the issue of whether the government securities market should be regulated. I suggested earlier that a healthy government securities market, like any healthy securities market, must inspire a feeling of trust and confidence among dealers and investors. That is hardly a novel idea. In October of 1973, Ray Garrett spoke to the National Security Traders Association. 13/ The speech was given in the shadows of Penn Central, National Student Marketing, Equity Funding and other disasters. Mr. Garrett observed that (and I quote):

"[T]raders should know better than anyone else the importance of maintaining faith in the basic honesty of a system. Your profession knows instinc-

13/ Address by Ray Garrett, Jr., "The Commission and the Traders: A Public Interest Partnership" (October 21, 1973).

tively, and has known for generations, that the whole business rests upon your confidence in the other fellow's integrity.... You do millions of dollars of business by word of mouth -- relying on adherence to professional standards by your counterparts....

As long as you all retain this confidence, the system can survive an occasional bad apple....

But suppose the bad apples became so numerous that your confidence were replaced by suspicion."

I, for one, am anxiously awaiting the responses to our release on whether and how to regulate the government securities market, and I will not make up my mind on what to recommend to Congress until I have reflected on the comments submitted, and deliberated with the other Commissioners. Nonetheless, it seems to me that the recent events in the government securities market suggest that we may be on the verge of a situation in certain sectors of the government securities market where the bad apples may be numerous enough that the crucial ingredient of investor and dealer confidence may be replaced by suspicion. It has been the SEC's mandate for over 50 years to create a market environment in which confidence prevails over suspicion. In my opinion, the SEC has done a generally good job in fulfilling that mandate. There is no reason that I know of to think that the SEC can not inspire trust and confidence in the government securities market. Therefore, it may be that a certain amount of regulation is needed to restore integrity and shore up confidence.

Of course to suggest that the government securities market should be subject to new mandatory regulation, however limited, is to raise the spectre of "change". Mr. Garrett once noted in

a speech given in January of 1975 14/ that human beings, (and I quote) "do not frequently welcome change but they cope remarkably well with it after it has occurred. Once the reality is faced, it is generally neither so monumentally different nor so threatening as it originally appeared." Indeed, he continued, changes are both "necessary and desirable, since changes are the safety valve by which our system is able to operate effectively and within a broad consensus without periodic explosions or revolutions."

It is in the spirit of cautious, but willing, reform that I think we should approach the issue of whether to regulate the government securities market. Regulators should be ever mindful of the burdens they impose on the private sector, and they should impose rules only when they have identified clear public benefits that will result from those rules. Nevertheless, regulators cannot afford to shy away from change just because they are abandoning comfortable old ways, especially when the comfortable old ways result in massive frauds, hundreds of millions of lost dollars, and the widespread hardships we have recently witnessed. Whether we like it or not, our institutions, and our laws, must either evolve or expire. It is in that spirit -- Ray Garrett's spirit -- that I think we should approach the issue of whether to regulate the government securities markets.

Thank you for your attention.

14/ Address by Ray Garrett, Jr., "The Need for Change in Accounting Policies" (January 6, 1975).