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OPEN LETTER TO BUSH TASK GROUP ON REGULATION OF FINANCIAL SERVICES AND WIRTH COMMISSION ON CAPITAL MARKETS

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Open Letter to Bush Task Group
on Regulation of Financial Services
and Wirth Commission on Capital Markets*

Introduction

As you all know, in December of last year, Vice President Bush announced the formation of a Task Group responsible for "reviewing the Federal government's regulatory structure for financial institutions and proposing any desirable legislative changes to the existing system." As the predicate for this undertaking, the Task Group cites differences in the regulation of similar products and services, excessive regulatory controls, overlapping and duplicative regulation, and the difficulty encountered by agencies in the management of shared responsibilities. The Task Group on Regulation of Financial Services -- or the Bush Task Group, as I will call it -- is now at work.

Last August, Congressman Timothy Wirth introduced legislation (H.R. 7014) to establish a Commission to "evaluate Federal and State regulation of financial and investment institutions and other financial intermediaries." As its predicate, the Wirth legislation identifies a number of significant changes in the American capital markets. These include:

(a) the proliferation of new financial services and products;

(b) the emergence of "financial supermarkets" -- single entities offering a wide range of financial services and products;

(c) the evasion or obsolescence of geographic and product limitations on financial intermediaries through technological advances;

(d) the disintegration of distinctions among financial intermediaries and the products and services they offer; and

(e) the internationalization and institutionalization of the capital markets.

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* The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners or the staff.

The Commission on Capital Markets, I will call the "Wirth Commission" -- at some risk to its chance of ever getting off the ground, I fear, given the jealously guarded perogatives of Congress and the number of others who would want their names associated with an effort of this sort. It would have as its mission a "comprehensive and objective review of this Nation's capital needs and the efficiency with which financial intermediaries raise and allocate capital."

The emphasis of the Bush Task Group is on a more simplified regulatory structure. The Wirth Commission would look more at how our capital markets are working with a view to adjusting the regulatory structures to make those markets work better. These endeavors can be made compatible. They could usefully proceed in parallel. I would encourage Congressman Wirth to reintroduce his legislation, sharing as much authorship as necessary to secure its enactment.

The Bush Task Group has solicited public comment on the questions it is addressing. The Chairman of the SEC, John Shad, has submitted his personal views, not on behalf of the SEC, but as a member of the Task Group. I should like to share with you some of my own views, which I here convey in an open letter to the Bush Task Group and -- with a burst of optimism -- to the Wirth Commission.

Gentlemen:

This letter responds to your call for ideas concerning the financial services industry and those who regulate it. I take it that your objective is to prove the philosopher, F. M. Cornford, wrong. Mr. Cornford observed that, "nothing is ever done until everyone is convinced that it ought to be done, and has been convinced for so long that it is now time to do something else."

A. Financial Services Industry Defined

In what follows the term "financial services" will embrace all products and services marketed by financial intermediaries, whether they be of the depository-type, the insurance-type or the investment-type, including securities broker-dealers and futures commission merchants. The financial services industry deals in one way or another with other people's money. Despite this common feature, the industry is subject to a bewildering array of regulation.

Financial regulation has a number of different goals, shared to a greater or lesser extent by the various responsible regulatory agencies. These goals include protecting investors and savers, providing adequate information about investment opportunities, assuring the safety and soundness of financial institutions, maintaining investor confidence in, and the integrity of, the financial markets, fostering competition among the providers of financial products and services, assuring efficiency within the financial markets and promoting capital formation.

These goals are given different emphases by different regulators. And the manner in which the regulators seek to promote these goals also differs. Relatively speaking, for example, the Securities and Exchange Commission has been more concerned about disclosure and investor protection than the bank regulators, whose primary goal has historically been the safety and soundness of banking institutions.

B. The Wisdom of a Comprehensive Approach

The financial marketplace is becoming increasingly homogenized, with mergers and acquisitions crossing traditional boundaries and competing products and services being offered by firms in different segments of the financial industry. There is vast confusion within the complex structure of regulation and law that applies to this industry -- confusion that grows apace as Congress continues to pursue a piecemeal approach to legislation, in response to the crisis of the day (Garn-St. Germain being the latest example), and as different regulators pursue diverse and often conflicting approaches to deal with the institutions they regulate. We need a comprehensive approach to legislative and regulatory reform in this industry.

While the existing regulatory mess may provide a solid reason for comprehensive legislation, that reason alone is unlikely to generate sufficient clout on Capitol Hill to result in useful legislation. Without the underpinning of a careful study and report, such as the Bush Task Force and the Wirth Commission could provide, a comprehensive approach is likely to fail, for much the same reason that comprehensive tax reform has failed over the years. Competition among all the players in the financial services field has never been more vigorous. The dazzling complexity of the regulatory field today offers advantages <u>too</u> important to <u>too</u> many players to lead them to support the creation of a more perfect "playing field," at the risk of losing to others what advantages they now possess.

The problems we face today result from powerful pressures of competition forcing their way over, under, around, and even through outdated regulatory structures -- structures that serve more as obstacles to competition than as channels in which competition by function can flourish. The Task Group and the Commission provide a rare chance to take a fresh look at the whole industry and the many ways in which it is regulated.

While, in my judgment, the prospects for comprehensive legislative reform would remain rather dim, even with the benefits of these two efforts, the comprehensive studies that should result from the Bush Task Group and the Wirth Commission could serve as a useful road map to guide Congress in the piecemeal approach that is more likely to continue into the future.

C. Some Propositions to Consider

Assuming a clean slate on which to write (an assumption I recognize to be highly remote), here are three propositions for your consideration:

1. Like functions should be regulated alike, and by the same agency, regardless of the entity involved.

2. Depository institutions are special and should be so treated, along with entities serving substantially identical functions.

3. We need to design a new safety net to cope with financial crises in the financial services industry.

Now, let me briefly elaborate on these propositions, each in turn.

Proposition 1: Like functions should be regulated alike, and by the same agency, regardless of the entity involved.

This principle sounds impeccable. And it is, although one wouldn't deduce it from examining the diverse theories which underlie the maze of increasingly duplicative regulations.

This principle also sounds simple, but it is deceptively so. The problem lies in the difficulty of defining the function.

To illustrate the functional approach, I want to consider three examples: financial services vendors, pooled funds, generally, and money market mutual funds, in particular.

Financial Services Vendors. First, let's consider the salesman who deals directly with the consumer of financial services -- the "financial services vendor" as I will call him. The financial services vendor will want -- and, indeed, the forces of competition will demand that he have -- as diverse a menu of financial products as possible. But today, he must first master the regulatory thicket, which varies widely depending upon the product involved or the financial institution with which he is affiliated. For example:

-- If our financial services vendor is affiliated with a broker-dealer, he must become a registered representative to sell securities. As such, he is subject to the jurisdiction of the SEC and one or more self-regulatory organizations. To qualify to sell securities he must meet detailed requirements with respect to character and competency; in recommending transactions he is subject to "suitability" standards and generally to the NASD's Rules of Fair Practice. In addition, he is subject to the blue sky laws of the states where his clients reside.

-- If he wants to sell commodity futures or commodity options he can do so only if he is qualified as an associated person of a futures commission merchant and conducts his activities in accordance with the regulatory scheme administered by the Commodity Futures Trading Commission ("CFTC") and the National Futures Association. State laws are expressly preempted.

-- If he wants to sell insurance products he is subject to the jurisdiction of the state insurance regulators. There is no federal regulation applicable to insurance as such. The securities self-regulatory organizations lack the authority to regulate him in this capacity, unless the insurance products he sells are also securities, in which case the securities laws apply.

-- If he wants to provide investment advice with respect to securities (and be compensated for it apart from brokerage commissions), he must register as an investment adviser under the Investment Advisers Act and conform to its requirements. He must also comply with the laws of all applicable states having special provisions for investment advisers.

-- If he is employed by a bank, in addition to being able to offer a full range of banking products, he can offer securities (available through accommodation trades effected by the bank), manage pooled

> investments and render investment advice. Because a bank is not a broker or dealer and is exempted from the Investment Advisers Act, the securities laws do not apply. Instead, a set of different regulations apply, promulgated by bank regulatory authorities, often with different goals in mind.

The application of these multiple regulatory schemes to what is essentially a single function is inefficient, ineffective and, therefore, irrational.

None of the statutes take a synthesizing view of our financial services vendor. All miss the forest by focusing on the trees. Imagine what it would be like if automobile dealers were subject to different laws based upon different theories of what's important and administered by different agencies depending upon such matters as engine design (diesel or gasoline powered), drive (front or rear wheel), or country of manufacture.

It is time to clear out this regulatory thicket in favor of a functional approach. The first step, of course, is to identify the function. For what I am calling our financial services vendor, the function is to offer the consumer as diverse a menu of financial products and services as his affiliations will allow. The second step is to identify what aspects of that function warrant regulation. And the third step is to design an agency to administer the regulation. This speech does not address these questions, which are left to the Bush Task Group and the Wirth Commission. Given the dazzling number of approaches currently in operation, there is plenty of empirical data for them to study.

<u>Pooled Funds Generally</u>. No more dramatic regulatory differences can be found than those that apply to the management of pooled funds. Here the function is management of the customer's money, that is pooled with the money of other customers for ease of management and economies of scale. Yet regulation of the offering and operation of pooled funds varies widely depending on what label is applied to the pool and its sponsor. For example, mutual funds -- pools sponsored by securities or investment management firms for the purpose of investing in securities -- are subject to the extensive regulatory and disclosure requirements of the Investment Company Act of 1940 and the Securities Act of 1933.

If the pooled fund chooses to invest primarily in commodity futures, even if they happen to be of the financial variety, or in real property interests (as do the REITs), it is exempt from the Investment Company Act. Moreover, no comparable regulation exists to burden its activities or protect its customers, depending upon your point of view.

Banks generally may not sponsor mutual funds. Yet banks may organize common and collective trust funds that smell, taste and feel like -- and often compete with -- mutual funds, but are subject to an entirely different set of regulations. These regulations, including Comptroller's Regulation 9 and, in some cases, ERISA, address concerns similar to those of the securities laws, ranging from disclosure and advertising to conflicts of interest. However, there are striking disparities in the respective regulatory systems that raise questions concerning investor protection and competitive equality.

Now, these differences in approach lack coherence. Only the logic of history explains them. Today, on a clean slate one would write differently. How one would write requires an evaluation of the diverse experiences collected over the past 50 years. One would want to ask whether any reason justifies preserving the differences in regulation of pooled funds. One would want to gauge the most appropriate form of investor protection from the various models available. If particular investor protections have proved important in one system, then a persuasive case can probably be made for applying them to all pooled funds. If, on the other hand, their importance is not revealed -- I would say clearly revealed -- then they should be cut back or eliminated from the pooled funds to which they now apply.

Money Market Mutual Funds. These funds raise special, and especially difficult, questions under the functional approach to regulation.

The destiny of these funds, of course, rests in the hands of those with the power to define their function. For example, suppose one were to say that the function of money market mutual funds was to evade the restrictions of Regulation Q. With that restriction gone, logic would suggest that the raison d'etre for the funds was gone too. */ Time will tell whether the public sees it that way. Customer loyalty and the marketing genius of the industry suggest that money market mutual funds will be around for some time to come. So analysis of what they are will continue to plague us.

If money market mutual funds are the equivalent of transaction accounts, in theory they should be regulated in the same way. E. Gerald Corrigan, President of the Federal Reserve Bank of Minneapolis, in a timely and persuasive essay entitled "Are Banks Special?," defines transaction accounts as "accounts that in law, in regulation, or in

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*/ In the first six weeks that banks were permitted to offer money market deposit accounts, they attracted approximately $183 billion in funds. Of this total the Federal Reserve Board estimates that 16 percent, or $29 billion, came from money market mutual funds.

practice are payable on demand at par and are readily transferable to third parties." Those seeking to distinguish the money market mutual funds emphasize the risk, however slight it may be in practice, that the "deposit" may not be paid out at par. Those who see these funds as a competitive threat to depository institutions emphasize functional equivalency and customer indifference to the technical distinctions. The pressure to resolve this question immediately has abated due to Garn-St. Germain and the money market deposit accounts permitted by that legislation. Ultimately, resolution will likely await the answer to Mr. Corrigan's question: Are banks special?

Now let us turn to the idea of having a single agency administer the regulatory scheme designed for particular functions within the financial service industry.

Consolidation of Bank Regulatory Agencies. In the banking industry we find the most prominent example of a multi-agency regulatory apparatus administering very similar regulation for different entities engaged in essentially identical functions. At the federal level there are five agencies for chartering and inspection and three separate insurance funds for deposits. */ In addition, the states have supervisory agencies.

Through legal engineering, depository institutions can choose their regulators and alter that choice if and when it suits their taste. **/ The regulatory response has often

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*/ The federal agencies regulating banking institutions are: (1) the Federal Reserve Board, (2) the Comptroller of the Currency, (3) the Federal Deposit Insurance Corporation, (4) the Federal Home Loan Bank Board, and (5) the National Credit Union Administration Board. Federal deposit insurance is provided by: (1) the Federal Deposit Insurance Corporation, (2) the Federal Saving and Loan Insurance Corporation, and (3) the Nation Credit Union Share Insurance Fund.

**/ Among the more prominent current examples is the interpretation by the Federal Deposit Insurance Corporation that Section 21 of the Glass-Steagall Act does not apply to bona fide subsidiaries of state non-member banks. This has enabled such banks to acquire full service securities firms and to sponsor mutual funds. Concern has been expressed that this difference in the regulation of banks may create an incentive for a bank to leave the Federal Reserve System. This is particularly significant in light of the 1980 Depository Institutions Deregulation and Money Control Act, which extended reserve requirements to non-member banks in order to remove an incentive to leave the Federal Reserve System.

been what Arthur Burns, former Chairman of the Federal Reserve Board, calls a "competition in laxity." Over the past 34 years, at least four federally-sponsored studies, ranging from the Hoover Commission in 1949 to the FINE Study in 1975, have recommended consolidation, in one form or another, of these regulatory and insurance agencies. This problem led Senator Proxmire to introduce legislation in 1975 and again in 1977 and 1978 to unify the three bank regulatory agencies into a single agency, thereby removing the incentive, as he put it, "to regulate all institutions at the lowest common denominator level...."

This "race to the bottom" often produces competition based, not on the price and quality of the products or services offered, but on the different regulatory environments available. Beyond these matters, arguments favoring consolidation include cost savings and other efficiencies for both the regulators and the regulated.

The time for consolidation at the federal level is long past due. So too is a careful analysis of the costs and benefits of having separate systems of regulation at the state level.

Consolidation of the SEC and CFTC. Another matter that should be examined closely is the possible consolidation of the SEC and the CFTC. Partially as the result of recent legislation, jurisdiction between the two agencies is divided along product lines so that there is little direct overlap.

However, because the term "commodity" as defined by the Commodity Exchange Act includes what are also "securities" under the securities laws, certain instruments regulated by the two agencies are functional substitutes. For example, the SEC regulates options on Treasury bills, which compete with futures on Treasury bills and options on Treasury bill futures, both of which are regulated by the CFTC. The CFTC regulates futures on securities indicies and options on securities index futures, which compete with SEC-regulated options on securities indicies.

In addition, many broker-dealers regulated by the SEC are also futures commission merchants subject to CFTC regulation. The persons associated with such firms are increasingly expected by their customers to offer both securities and commodities products. Subjecting firms and their associated persons to a dual regulatory structure (which in many respects is not parallel) increases compliance costs and causes confusion to salesman and customer alike. And most importantly, regulatory differences between the SEC and CFTC become competitive factors weighed by customers in choosing between competing products. As we saw in the case of banking, this situation creates pressure for a competition in laxity between the regulators.

Some progress has already been made in harmonizing the respective regulatory structures by coordinating net capital requirements and reporting forms. More progress is possible. The ultimate solution, however, is consolidation. As a transitory step, one could amend the statutes to permit the President to appoint the same persons to both Commissions as existing terms expire. This would demand more of the Commissioners, but it's possible, in my judgment, through a more efficient division of labor than has been the tradition.

Amendment of Section 12(i). Another area warranting scrutiny is the administration of the Securities Exchange Act with respect to banks. The administration and enforcement of that Act's requirements is the responsibility of the SEC, except with respect to banks and savings and loan associations. Section 12(i) of the Exchange Act makes these classes of public company subject to "substantially similar" regulations issued and enforced by the various federal banking regulators. This splintering of regulatory responsibility has led in some cases to different regulation, not only among banks and between banks and non-banks, but also between banks and bank holding companies (which remain subject to SEC jurisdiction). Centralizing this responsibility in the SEC would provide for more uniform financial disclosure to public shareholders and securities analysts, eliminate delays in conforming regulatory modifications and eliminate the duplication of specific functions by numerous agencies.

Proposition 2: Depository institutions are special and should be so treated, along with entities serving substantially identical functions.

I have always believed that the role of depository institutions in our economy is unique, deserving special privileges and bearing special responsibilities. In a speech given in the fall of 1981, I concluded that many of the concerns underlying the Glass-Steagall Act remain as valid today as they were in 1933. The Glass-Steagall Act reflected a clear Congressional determination that avoidance of the "hazards" and "financial dangers" to banking that arise when commercial banks engage in investment banking, outweighed the advantages of competition, convenience or expertise that might support bank entry into investment banking.

However, increasingly, voices critical of our traditional regulatory system are being heard. Some advocate placing greater, and perhaps even exclusive, reliance on regulation of the reactive, post-failure type. And the apostles of deregulation would substitute disclosure and market discipline for the heavy-handed restrictions that soundness regulation has traditionally imposed.

In addition, the Administration's proposals to remove restrictions against bank sponsorship of mutual funds and underwriting of municipal revenue bonds proceed from the premise that a comprehensive deregulation program is necessary to enable banks to compete with diversified financial services firms.

I know of no immutable principle, or received wisdom, holding that entry into <u>all</u> aspects of the financial services industry must be accorded to every financial intermediary, whether in the name of competition, fairness, efficiency or whatever.

Mr. Corrigan's essay points to three characteristics separating depository institutions from all other classes of institutions, financial and non-financial.

(1) They offer transaction accounts.

(2) They are the back-up source of liquidity for all other institutions.

(3) They are the transmission belt for monetary policy.

He believes the case for segregating essential banking functions into an identifiable class of institutions is as powerful today as it was in the 1930's. "If anything, concerns regarding financial concentration, conflicts of interest and the fiduciary responsibilities associated with lending depositors' money may be more relevant today than they were 50 years ago." The essay concludes that activities outside the essential banking functions, regardless of where housed, "should not entail excessive risk of loss and should not impair the impartiality of the credit decision-making process."

Rather than continue to quote from Mr. Corrigan's essay, I commend it to you for study. Its reasoning I found to be powerfully persuasive.

<u>Proposition 3:</u> <u>We need to design a new safety net to cope with financial crises in the financial services industry.</u>

Financial crises in recent years reflect a growing interdependency among financial institutions. The problems which faced Bache and Paine Webber in 1980, Drysdale and Penn Square in 1982, and the international banks today with respect to their foreign loans demonstrate the interdependency phenomenon. They are examples of how, with increasing frequency, the difficulties of a single financial institution threaten to trigger a chain reaction, extending well beyond the entities immediately involved. And they suggest the need for a government safety net, at the ready and capable of moving swiftly, to supply liquidity and act in other ways necessary to protect the stability of our Nation's financial system.

However, deregulation, today, is much in vogue; pressures are building for greater reliance on disclosure and market discipline to assure soundness. In a time of budgetary restraints and overall disillusionment with government intervention, marketplace forces offer a seductive solution to secure soundness. Yet, the growing <u>interdependence</u> of financial intermediaries should give pause to policymakers tempted by the siren song of Adam Smith.

It is my thesis that:

(1) Market discipline can only assure soundness in an environment where institutions are permitted to fail.

(2) The linkages among financial intermediaries often are too extensive (and growing stronger and more numerous) to prevent one failure from triggering others.

(3) Therefore, the collateral consequences of failures often pose unacceptable costs to our financial system.

(4) Accordingly, to assure soundness, a new system of direct regulation is needed -- a system broad enough to encompass <u>all</u> financial intermediaries and flexible enough to enable the forces of full disclosure and market discipline to do their share of the job.

In fashioning this new system, I urge the closest scrutiny of proposals that seek to protect firms through legal structuring. Whether it be through subsidiary, holding company affiliate or whatever, I have serious reservations as to whether such legalities can adequately immunize the financial intermediary from the risks determined to be incompatable with soundness.

As a point of departure in developing the new system, it would make sense to study the Federal Reserve Act. The Federal Reserve Board continues as the most logical source of regulation and emergency funds. As many critics have observed, however, the Federal Reserve Act is archaic and inflexible. Too much, today, is left to chance and the serendipity of having adequate leadership in place when needed to cope with a crisis. The Act should be studied, and legislation proposed, to turn it into a flexible framework within which the Federal Reserve Board, perhaps with input from the President and Congress, could act to avert or arrest financial crises.