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FUNCTIONAL REGULATION: LOOKING AHEAD*

*Aulana L. Peters**
and David N. Powers****

I. INTRODUCTION

During the last five years, financial institutions have crossed industry lines more and more frequently. As a result, securities firms, commodities merchants, banks, thrifts and insurance companies are offering products that are functionally indistinguishable from one another. Furthermore, through mergers and acquisitions, firms are increasingly offering a full range of financial services that span all these industries. Nevertheless, regulation of these multi-faceted firms is generally determined by what they are called, rather than by the type of commercial activity in which they engage. Consequently, the same type of commercial activity is presently regulated quite differently, depending upon the "type" of firm engaging in that activity. This disparate treatment has been noted by many commentators, who have recommended various solutions.¹ Most recently, the Task Group on Regulation of Financial Services (the Bush Task Force) published its *Blueprint for Reform*² which highlights certain instances of inequitable and inefficient regula-

* The views expressed herein are those of the authors and do not necessarily represent those of the Commission, other Commissioners or the staff of the Commission. The authors express their sincere thanks to Alan Rosenblat, Assistant General Counsel, and Coleen C. Harvey, Deputy Chief Counsel, Division of Market Regulation of the Securities and Exchange Commission, for their insightful comments to drafts of this Article. Ultimate responsibility for the contents of this Article, of course, lies with the authors.

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1. See, e.g., Pitt & Williams, *The Convergence of Commercial and Investment Banking: New Directions in the Financial Services Industry*, 5 J. COMP. BUS. & CAPITAL MARKET L. 137 (1983); Karmel, *Glass-Steagall: Some Critical Reflections*, 98 BANKING L.J. 631 (1980); Note, *Commercial Law—Board of Governors of the Federal Reserve System v. Investment Company Institute: The Continuing Conflict Between Commercial and Investment Banking*, 61 N.C.L. REV. 378 (1982-83); *Homogenization of Financial Institutions: The Legislative and Regulatory Response*, 38 BUS. LAW. 241 (1982); Note, *A Banker's Adventures in Brokerland: Looking Through Glass-Steagall at Discount Brokerage Services*, 81 MICH. L. REV. 1498 (1983) [hereinafter cited as Note, *A Banker's Adventure*].

2. TASK GROUP ON REGULATION OF FINANCIAL SERVICES, *BLUEPRINT FOR REFORM* (July 1984) [hereinafter cited as BLUEPRINT FOR REFORM].

tion of financial services companies, especially with respect to the different treatment of banks and broker-dealers.

The approach that has been adopted by the Bush Task Force and others to simplify and rationalize the existing regulatory framework has been labeled "functional regulation." The concept of "functional regulation," simply put, would require that the activities of commercial entities performing essentially the same services and selling the same products be subject to the same regulatory framework.³ Thus, under the theory of functional regulation, a bank or an insurance company rendering the same services in connection with securities as a broker-dealer should be subject to the same rules and regulations administered by the same agency. The theory of functional regulation is virtually universally supported, especially within the administration.⁴ As a result of this broad support, the Bush Task Force has made several recommendations which, if adopted, would eliminate some of the current disparities in the regulatory framework.⁵ Moreover, federal agencies such as the Department of the Treasury, the Securities and Exchange Commission (SEC or the Commission), the Office of the Comptroller of Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) have proposed legislation or rules that would also eliminate existing disparities. Perhaps most prominent among these is legislation proposed by the Treasury Department that would require banks conducting certain securities activities to do so through affiliates as part of a holding company structure.⁶

Most of the discussion of functional regulation has taken place in the context of expanded bank activities.⁷ An understanding of the concept of functional regulation requires some discussion of the activities of banks and broker-dealers and the regulations applicable to them. Therefore, this Article will trace briefly the development of the current regulatory framework of "industry regulation" and the disparities and inefficiencies that that framework has produced. As the footnotes to this Article indicate, however, tracing the developments of the present regulatory framework and pointing out its disparities is a job that has been

3. 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).

4. See Comment letters to the SEC's proposed Rule 3b-9.

5. The recommendations were unanimously endorsed by the members of the Bush Task Force. See BLUEPRINT FOR REFORM, *supra* note 2, at 2 (report transmittal letter). However, most of the recommendations concerned overlapping regulation of banks and thrifts not overlapping and inefficient securities regulation. This Article will not discuss the recommendations of the Bush Task Force that do not relate to securities regulation.

6. See *infra* notes 68-71 and accompanying text.

7. See, e.g., *supra* note 1.

done quite well by other commentators. The real point of this Article is that through the Treasury Department's proposed holding company requirements for financial services firms, functional regulation can be a "blueprint" for much more than the resolution of a jurisdictional dispute between the banking and securities industries and their regulators. Functional regulation offers a guide for efficient cooperative regulation among federal and state agencies, and among state agencies themselves. For example, the regulation of insurance products, many of which have large investment components⁸ is one area where significant benefits may be gained from functional regulation. Finally, with the possibilities for electronic and telephonic filing of reports just now becoming apparent, the efficiencies to be realized by applying the concept of functional regulation beyond the context of banking and securities regulation may be greater than anyone has realized.

II. THE GROWTH OF INDUSTRY REGULATION

During the 1930's and continuing into the 1970's, Congress established a regulatory system for the financial services industry based on industry lines. Banks were regulated by banking agencies, broker-dealers by state and federal securities agencies, and federal savings and loan associations and federal savings banks (hereinafter referred to as thrifts) by thrift agencies. Regulation of insurance companies was left to the states. This section will briefly review the creation of some of those agencies, and consider the congressional rationale for this regulatory framework.

Prior to 1929, national banks had securities affiliates which were quite influential in the investment banking business. They were regulated by the OCC and, to the extent they were members of the Federal Reserve System, by the Federal Reserve Board (FRB). The stock market crash and the Depression caused the failure of hundreds of banks and securities firms. Congress placed much of the blame for the collapse of the nation's financial system on the securities activities of banks.⁹

8. See *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959); SEC Securities Act Release No. 33-6558 (Nov. 21, 1984) (concerning proposed Rule 151 which would create a "safe harbor" for certain annuity contracts within § 3(a)(8) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(8) (1982)).

9. Pitt and Williams note that:

[H]earings held by Senator Carter Glass revealed a range of activities undertaken by bank securities affiliates which adversely affected the safety and soundness of the parent banks. These abuses included:

[1] borrowing money from parent banks on concessionary terms;

[2] repurchase agreements between banks and affiliates designed to avoid lending limits;

[3] trading upon the public identification between affiliates and parent banks;

One congressional response to this problem was the passage of the Banking Act of 1933,¹⁰ popularly known as the Glass-Steagall Act. Congress intended the Glass-Steagall Act to tighten federal regulation of the banking industry, to restore public confidence in the nation's banks and to prevent another banking crisis. Thus, the Glass-Steagall Act restricted, but did not eliminate, the involvement of national banks¹¹ in securities activities and prohibited securities firms from accepting deposits.¹² The FRB and the OCC were charged with administering the Glass-Steagall Act, including the provisions related to securities activities.¹³

In the aftermath of the Crash, Congress also created a separate regulatory framework for thrifts. Pursuant to the Home Owners' Loan Act of 1933,¹⁴ the Federal Home Loan Bank Board (FHLBB) was estab-

[4] "dumping" of undesirable securities on parent banks by the affiliates;

[5] loans by parent banks to customers for the purpose of purchasing securities offered for sale by affiliates;

[6] unsound shifting of assets between parent banks and the affiliates; and

[7] the assumption of questionable risks by affiliates that were impermissible for the parent banks.

Pitts & Williams, *supra* note 1, at 139 (footnote omitted).

10. Ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). The Banking Act of 1933 also created the Federal Deposit Insurance Corporation. Ch. 89, § 8, 48 Stat. 162, 168 (codified as amended at 12 U.S.C. §§ 1811-1831 (1982)). Pursuant to its delegated authority, the FDIC requires insured banks, which today include virtually all national and state banks, to obtain its prior written consent before changing the general character of their business. It is not clear whether this regulation gives the FDIC veto power over the securities activities of insured banks. For a brief description of the state of the law in this area, see Pitt & Williams, *supra* note 1, at 150 & nn. 80-81.

11. National banks are federally chartered banks, 12 U.S.C. § 21 (1982), whose trust activities are now regulated by the Comptroller of the Currency, 21 U.S.C. § 92(a) (1982). National banks are also required to become members of the Federal Reserve System. 12 U.S.C. § 282 (1982).

12. The three sections of the Act through which this separation was effected were §§ 16, 20, and 21. Section 16 prohibited national banks from dealing in securities except for buying or selling securities and stock "without recourse, solely upon the order, and for the account of, customers." Banking Act of 1933, ch. 89, § 16, 48 Stat. 162, 184. At one time, it was thought that this language required a bank to have a relationship with a customer independent of securities before customer orders could be executed. See 1 BULLETIN OF THE COMPTROLLER OF THE CURRENCY No. 2, at 2 (Oct. 26, 1936). Section 16 also expressly prohibited national banks from underwriting securities or stock, but authorized national banks to purchase certain investment securities for their own accounts, subject to certain limitations. Banking Act of 1933, ch. 89, § 16, 48 Stat. 162, 184-85. Section 20 prohibited the securities affiliate system, *id.* § 20, 48 Stat. at 188, and § 21 prohibited underwriters from accepting deposits, *id.* § 21, 48 Stat. at 189.

13. One widely held opinion is that bank regulators have sought to achieve these goals by "discreet regulation." See Note, *A Banker's Adventure*, *supra* note 1, at 1529 & n.148. The fear of bank runs has led bank regulators to protect depositors by assuring the stability of the banking system and the solvency of the individual bank through behind-the-scenes persuasion and coercion. *Id.* at 1529-30.

14. Ch. 64, 48 Stat. 128 (codified as amended at 12 U.S.C. §§ 1461-1470 (1982)).

lished to provide for the incorporation, organization and chartering of thrifts.¹⁵ The disclosure, reporting and proxy requirements of thrifts under the Securities Exchange Act of 1934¹⁶ (1934 Act) are administered by the FHLBB, not by the SEC. Nevertheless, the SEC has jurisdiction over the disclosure, reporting and proxy requirements of publicly held thrift holding companies, even if the only asset of that holding company is the stock of a thrift.

The Securities Act of 1933¹⁷ (1933 Act), the 1934 Act, the Investment Advisers Act of 1940¹⁸ (Investment Advisors Act) and the Investment Company Act of 1940¹⁹ (Investment Company Act) created a separate system of regulation for the securities industry. Members of that industry, broker-dealers, investment advisers and investment companies,²⁰ as well as issuers, are required to register with the SEC and are subject to complex disclosure, reporting and record-keeping requirements. In addition, industry members are subject to the anti-fraud provisions of the securities laws, which are designed to protect investors and to insure fair and orderly markets.

Notwithstanding their involvement, although limited, in securities activities, banks have been expressly excluded from the definitions of "broker" and "dealer" under the 1934 Act,²¹ thus exempting them from the requirements to register, and be regulated as "broker-dealers." Moreover, securities issued by banks and thrifts are exempt from registration under the 1933 Act,²² and bank common trust funds and tax-qualified pension accounts are excluded from the definition of an investment company. Thus, these securities are exempt from regulation under

15. In 1934, Congress passed the National Housing Act, ch. 847, 48 Stat. 1246 (1934) (codified as amended in scattered sections of 12 U.S.C.), which created the Federal Savings and Loan Insurance Corporation (FSLIC). The FSLIC now insures accounts at not only federal but also state thrifts. Insured thrifts must submit an acceptance business plan to the FSLIC, and the FSLIC may hold hearings and issue cease-and-desist orders if an insured thrift is engaging, has engaged or is about to engage in an unsafe or unsound practice.

16. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)).

17. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1982)).

18. Ch. 686, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1-80b-21 (1982)).

19. Ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1-80a-64 (1982)).

20. The history of securities regulation by the SEC is generally not described as "discreet, cooperative and nonadversarial." See, e.g., R. KARMEL, REGULATION BY PROSECUTION (1982). Instead, the SEC has utilized its access to the courts to curb unethical practices. This difference in style has been to some extent a function of the differing mandates of the securities and bank regulators. While the bank regulators have protected depositors by preserving the stability of the banking system, and thus, in some cases by shielding depositors from bad news, the SEC has sought to protect investors by insisting upon complete and accurate disclosure and by insuring fair and orderly markets through litigious regulation of unethical practices.

21. Sections 3(a)(4) and (5) of the 1934 Act, 15 U.S.C. §§ 78c(a)(4)-(a)(5) (1982).

22. Section 3(a)(5) of the 1933 Act, 15 U.S.C. § 77(c)(a)(5) (1982).

the Investment Company Act.²³

Similarly, the SEC has limited jurisdiction over insurance companies and insurance contracts. Section 3(a)(8) of the 1933 Act exempts from its registration requirements any insurance policy or annuity contract which is subject to the supervision of a state insurance commissioner.²⁴ This exemption has been construed, however, to exempt insurance products from all requirements of the 1933 Act.²⁵ Moreover, the SEC has long taken the position that traditional insurance products are not securities within the meaning of any of the statutes it administers.²⁶ Thus, most insurance products and the sales practices used in connection with them are regulated not by the SEC at all, but by the states.

One may reasonably ask what the congressional intent was in the 1930's when this framework of regulation by industry was established. Of course, there is no legislative history concerning the passage of all these statutes and the formation of the various financial services agencies. Nevertheless, the legislative history that exists suggests that the congressional perception in the 1930's was of a world in which banks, broker-dealers, thrifts and insurance companies would not compete outside their industry. Thus, it made some sense to create separate agencies and separate laws that were specialized for a particular industry. For example, although the legislative history of sections 3(a)(5) and 3(a)(6) of the 1934 Act is not extensive, the legislative history of previous bills includes references to the limited securities activities of banks.²⁷ Similarly, the exclusions in section 3(a)(8) for insurance products seems to have been based on the belief that "traditional" life insurance policies and annuities²⁸ did not compete with traditional investments and thus did not raise the concerns that led to passage of the securities laws.²⁹

Congress' apparent faith in the "regulation by industry" approach

23. Section 3(c)(3) of the Investment Company Act, 15 U.S.C. § 80a-3(c)(3) (1982).

24. 15 U.S.C. § 77(c)(a)(8) (1982).

25. See L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 214 & n.3 (1983).

26. *Id.*

27. See *Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 85-86, 686-87 (1934) (statement of Thomas G. Corcoran, counsel with the Reconstruction Finance Corporation and a principal drafter of the 1934 Act provisions regarding the limited nature of bank securities activities); *Stock Exchange Practices: Hearings Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 6470-71 (1934) (statement of Thomas G. Corcoran).

28. "Traditional" annuities mean annuities in which the insurer guarantees the principal and a fixed rate of return for the life of the contract.

29. See *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65, 77-78 (1959) (Brennan, J., concurring).

continued until as late as 1974, when the Commodity Futures Trading Commission (CFTC) was established.³⁰ The CFTC administers a comprehensive and separate regulatory system for all future contracts, options on futures and options on commodities. Commodities and derivative products on commodities, such as options and futures, are not securities and thus their issuance and sale are not regulated by the SEC. Nevertheless, as will be noted later, the line between commodities and securities in the area of derivative products is anything but bright.

Since the 1930's, firms from different industries within the financial world have competed increasingly across industry lines. The pace of this phenomenon has accelerated dramatically in the last ten years. As a result, the financial services industry is far different in the 1980's than it was in the 1930's. The present regulatory framework, which was designed for the 1930's financial world, is in many respects inefficient and inequitable.

III. BREAKDOWN OF INDUSTRY LINES

Not long after the regulatory framework described in section II was established, industry lines separating banks, thrifts, insurance companies and securities firms began to break down. Banks were the first to expand aggressively their securities activities, but the 1950's arrived to find insurance companies also in the securities business through the marketing of variable annuities. By the late 1970's and early 1980's, all industry lines were faint, if they remained at all, as securities firms engaged in activities that closely resembled banking, and firms from all sectors were being merged into single "full service" corporate entities.

As noted previously, banks were not totally prohibited from engaging in the securities business by the Glass-Steagall Act. In fact, shortly after its passage, banks began to expand their activities to include marketing products and services functionally indistinguishable from those regulated by the SEC. For example, in 1937, the FRB amended Regulation F under the Glass-Steagall Act, which prohibited national banks from commingling trust funds, to allow national banks to establish common trust funds comprised of assets of individual trusts that they administered. In 1940, the FRB authorized national banks to use common trust funds only for the investment of funds held for "true fiduciary pur-

30. Pub. L. No. 93-463, § 101, 88 Stat. 1389 (codified as amended at 7 U.S.C. § 4a (1982)). Indeed, if the first congressional act correcting the disparities caused by industry regulation is the measure for congressional perception of its viability, then perhaps Congress perceived that industry regulation was viable until 1982, when the CFTC/SEC accord was passed. *See infra* note 45.

poses."³¹ The FRB also concluded that although banks could not solicit the public to invest in common trust funds, they could advertise generally the availability of their services.³² Common trust funds, of course, technically are investment companies, as that term is defined in the Investment Company Act, and would have been regulated as such but for the statutory exclusion of common trust funds from the definition of investment company in section 3(c)(3) of the Investment Company Act. Therefore, as early as 1937, banks were engaged in commercial activities functionally indistinguishable from the business of investment companies; nevertheless, these activities were subject to vastly different rules. The advent of common trust funds merely foreshadowed the current state of affairs.

During the 1950's, tax-qualified employee benefit plans came into vogue. The FRB authorized their use by banks in 1955, and the SEC interpreted section 3(c)(13) (now section 3(c)(11))³³ of the Investment Company Act as not requiring registration of collective investment funds as investment companies.³⁴ The theory of these exclusions was that banking regulation obviated the need for SEC regulation,³⁵ even though bank regulation was far different from SEC regulation.

Bank brokerage activities have also expanded since 1934. Banks always have administered dividend reinvestment and employee stock purchase plans and have forwarded customer orders to buy or sell a security to a broker-dealer for execution. The latter was merely an "accommodation service" and thus was not inconsistent with the exclusion of banks from the broker-dealer registration requirements of the 1934 Act. When brokerage commission rates were fixed, the bank typically received a small service charge and the broker received the fixed commission. Today, this service, in the form of "discount brokerage," is aggressively marketed,³⁶ and the bank receives a portion of the commission to

31. 26 Fed. Res. Bull. 393 (1940).

32. 42 Fed. Res. Bull. 228 (1956).

33. 15 U.S.C. § 80a-3(11) (1982).

34. 1 T. FRANKEL, *THE REGULATION OF MONEY MANAGERS* § 10.2 (1983).

35. *Cf.* H.R. REP. NO. 1382, 91st Cong., 2d Sess. 18 (1970) (The committee reasoned that the exemption is intended to grant banks and insurance companies, whose separate accounts are exempt under § 3(b)(5), equal treatment under the federal securities laws. Bank collective trust funds are not exempt if they are used as a vehicle for direct investment by the public.).

36. Examples of banks with internal discount brokerage services that have publicly solicited brokerage customers include: Wachovia Bank & Trust (newspaper advertisement states "When you follow your own advice in buying and selling securities, you can trade through Wachovia and save up to 60% or more on commissions," *Charlotte Observer*, Dec. 26, 1983); and Commerce Banks (newspaper advertisement states: "Trade your Broker for your Banker," *St. Louis Bus. J.*, Nov. 7-13, 1983, at 48).

be paid by the customer. Bank employees involved in discount brokerage increasingly handle customer orders, funds and securities. Finally, although banks still do not provide investment advice or recommendations directly, many are distributing third party advice as part of their service to the investing public.³⁷ Moreover, some are contemplating offering advisory services directly.³⁸ As a result, banks today are competing directly with traditional broker-dealers for the securities business of the public investor.

Banks have not been the only firms that have moved beyond the range of financial service activities Congress envisioned for them in the 1930's. During the period of sustained high inflation of the 1970's and early 1980's, money market mutual funds competed quite successfully with passbook savings accounts, which were limited by law in the interest they could pay. The well documented phenomenon of disintermediation resulted, and certain banks and thrifts, especially small and medium sized institutions, found themselves with loan portfolios at low fixed rates and only very limited sources of funds at passbook rates. As a result, during the 1980's, the "interest rate spread"³⁹ of these financial institutions was often negative, and, needless to say, they were rapidly losing money. In response to this phenomenon, banks and thrifts were given the authority to offer money market type accounts⁴⁰ to compete with money market mutual funds. On the other side of the crumbling fence, securities firms have offered check writing privileges in connection with their money market accounts. Many also offer VISA debit cards. Money market mutual funds with check writing privileges are regulated

37. See American Nat'l Bank of Austin, Texas [1983-1984 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 99,732 (Sept. 23, 1983) (the OCC permitted American National Bank of Austin, Texas, to establish a subsidiary to provide investment advisory services). According to recent articles in the *Wall Street Letter*, banks around the country are relying on the OCC's decision and are beginning to provide what the banks assert is third party investment advice in addition to the discount brokerage which they are presently providing. See *Banks Join Rush to Offer Third Party Investment Advice*, WALL ST. LETTER, Sept. 10, 1984, at 2 ("Banks are distributing advice from *Value Line* in the form of the well-known *Value Line Investment Survey* as well as from *Standard and Poor's*, which sends it advice into computer screens in the banks.").

38. Recent news articles indicate that many banks are contemplating a variety of investment advisory activities. See *First Chicago Prepares to Offer Investment Advice to Retail Customers*, WALL ST. LETTER, Aug. 20, 1984, at 1, 9; *Arkansas Banks Hire Stockbrokers*, WALL ST. LETTER, Aug. 27, 1984, at 1, 10.

39. The principal factor affecting the profitability of a financial institution is its "interest rate spread," which is the difference between yields earned by the financial institution on its loan and investment portfolios and the rates of interest paid by the financial institution for its deposits and borrowings. Obviously, a higher interest rate spread will produce greater profits.

40. Garn-St Germain Depository Institutions Act of 1982, 12 U.S.C. § 3503(c) (1982).

by the SEC. Bank money market accounts are regulated by banking agencies.

Diversification of activities in this area has not been limited to banks and securities firms. Insurance companies also have devised investment products for their customers that were unimagined when the securities laws were enacted. During the 1950's, insurance companies began to market variable annuities as an investment offering the investor protection from inflation.⁴¹ This hybrid instrument of investment and insurance raised the question of whether variable annuities were intended to be excluded from the federal securities laws.

Notwithstanding the Supreme Court's holding in *SEC v. Variable Annuity Life Insurance Co.*,⁴² that variable annuities are not excluded from the reach of the securities laws,⁴³ the SEC has proposed for comment Rule 151 under the 1933 Act,⁴⁴ which would provide a safe harbor for annuities within Section 3(a)(8). The exclusion from the federal securities laws would encompass 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 is adopted, annuities meeting these conditions would not be subject to SEC regulation, but would be regulated exclusively by the states. Ironically, the SEC has proposed a rule that would provide for state regulation of an instrument that is clearly a security since it places substantial investment risk on the purchaser. Thus, the SEC has perhaps reinforced the framework of regulation along industry lines.

Disparate regulation also creates anomalous situations in the commodities area. During the last few years, commodities exchanges regulated by the CFTC have offered for trading futures on stock market indices. More recently, stock and options exchanges regulated by the SEC have offered for trading options on stock market indices. These instruments are functionally indistinguishable but are subject to the sig-

41. For a brief description of the development of the variable annuity and similar instruments, see L. Loss, *supra* note 25, at 215.

42. 359 U.S. 65 (1959).

43. *Id.* at 67-68, 73. The Court emphasized that the issue of whether a variable annuity is exempt from the securities laws is a federal question. In holding that variable annuities are not excluded from the reach of the securities laws, the Supreme Court reasoned that in traditional insurance policies and annuities the insurance company takes the investment risk. Variable annuities, on the other hand, place substantial investment risk on the annuitant and thus are subject to federal securities laws.

44. SEC Securities Act Release No. 33-6558 (Nov. 21, 1984) (Commissioner Peters dissented from the Commission's decision to authorize release of the proposed rule).

nificantly different jurisdictions of the CFTC and the SEC.⁴⁵

In sum, as Chairman Shad of the SEC has observed: [T]he financial world is entirely different from the way it was when the present regulatory structure was created. Today, the securities industry is selling money market funds offering check-writing privileges, banks are selling insurance; insurance companies, credit card companies and a major retailer of consumer goods are acquiring broker-dealers; savings and loan associations are being acquired by steel companies; and the general proliferation of new products and new combinations of formerly distinct financial entities is proceeding at a pace that is unprecedented in our economic history.⁴⁶

IV. DISPARITIES IN THE FINANCIAL SERVICES REGULATORY FRAMEWORK

With so many statutes affecting so many agencies undertaking the regulation of functionally identical business activities, it is no wonder that disparities in regulation exist. These disparities often result in inefficient and inequitable regulation and in some cases have undermined the regulatory scheme. This section will highlight some of the more substantial examples of the problem.

A. Taxes

Existing tax law discriminates between banks and securities firms involved in identical securities activities. As a general rule, interest on any indebtedness incurred to purchase or carry tax-exempt securities, such as municipal bonds, is not deductible.⁴⁷ Thus, day-to-day borrowings by a dealer in tax-exempt securities to finance a position in such securities would not generate deductible expenditures. Nevertheless, banks may deduct the interest paid on short-term borrowings, the proceeds of which are used for the bank's day-to-day operations, which may

45. The SEC and the CFTC waged an intense struggle over which agency would have jurisdiction over these contracts. Pursuant to the SEC-CFTC treaty, the SEC may disapprove a futures contract on a stock market index if it is subject to manipulation. Once the SEC does not disapprove it, however, the CFTC becomes the exclusive federal regulator of trading in that contract. See Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (amending § 2(a) of the Commodity Exchange Act); Act of Oct. 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409 (amending the 1934 Act).

46. *Financial Institutions Restructuring and Services Act of 1981: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. 890-91 (1981) (statement of John S.R. Shad, Chairman, SEC).

47. 26 U.S.C. § 265(2) (1982).

include dealing in tax-exempt securities such as municipal bonds. The Internal Revenue Service (IRS) reasons that such interest expenses constitute part of the ordinary business of a bank.⁴⁸ Therefore, a bank can utilize its traditional source of funds to carry tax-exempt securities, while enjoying an interest deduction that is denied to non-bank dealers in tax-exempt securities. While there is some debate as to just how much of an advantage the tax laws confer on banks and the extent to which non-bank dealers are disadvantaged by the discrimination, there is no doubt that a disparity exists where one should not.

B. Advertising

Another disparity in regulation exists in bank advertising of brokerage services. The advertising activities of broker-dealers are subject to specific regulation by the National Association of Securities Dealers (NASD) and by the SEC.⁴⁹ Although banks are subject to the anti-fraud provisions of the 1933 Act and the 1934 Act, as a practical matter, their advertisements are not regulated because bank regulators do not generally review the advertising activities of banks.⁵⁰

C. Margin

The regulation of the extension of credit for securities purchases is also very inequitable. Regulation T⁵¹ prohibits brokers or dealers from making loans to purchase or carry nonmarginable securities collateralized by those securities. Regulation U,⁵² on the other hand, provides that banks may extend credit on nonmarginable securities. Margin requirements for options and futures also differ. While the margin level required for options on stock market indices is now ten percent of the underlying contract's value plus the current option premium,⁵³ there is no federal margin level required for futures on stock market indices, even though these futures and options contracts are functionally indistinguishable.⁵⁴

48. Rev. Rul. 61-222, 1961-2 C.B. 58.

49. See, e.g., Rule 206(4)-1, 17 C.F.R. § 275.206(4)-1 (1984) (under the Investment Advisers Act); NASD Rules of Fair Practice, § 35 NASD MANUAL (CCH) ¶ 2195. The NASD rule sets forth general standards for communications with the public, such as prohibiting exaggerated, unwarranted or misleading statements or claims, as well as specific standards regarding, among other things, necessary data in advertisements, identification of sources of information, claims and opinions, and offers of free services.

50. Note, *A Banker's Adventure*, *supra* note 1, at 1531.

51. 12 C.F.R. Part 220 (1984).

52. 12 C.F.R. Part 221 (1984).

53. Regulation T, 12 C.F.R. Part 220 (1984).

54. Indeed, absent an emergency, the CFTC is proscribed from even reviewing the futures

D. *Qualification of Personnel and Supervision*

Persons involved in customer securities activities are subject to quite different qualification and supervision requirements, depending on whether they are affiliates of registered broker-dealers or banks. Section 15(b)(7) of the 1934 Act⁵⁵ prohibits registered broker-dealers or persons associated with registered broker-dealers from effecting transactions in securities or inducing the purchase or sale of securities unless they meet the NASD's standards for training, experience and competence. Pursuant to this section, Schedule C of the NASD's bylaws requires all representatives of a broker-dealer who supervise, solicit or conduct a securities business to register with the NASD by passing its Series 7 examination.⁵⁶ The exam tests overall knowledge of the securities markets and the regulatory requirements applicable to broker-dealers.⁵⁷ Thus, section 15(b)(7) and the NASD's Series 7 examination requirement ensure that all representatives of broker-dealers who solicit customers or effect transactions in securities meet minimum qualification standards. Employees of banks who engage in securities activities are not subject to any qualification or testing requirements.

Section 15(b)(4)(E)⁵⁸ of the 1934 Act authorizes the Commission to bring administrative actions against broker-dealers who fail reasonably to supervise with a view to preventing violations of the securities laws. Banks are not subject to similar administrative actions for failing reasonably to supervise the securities activities of their employees.

E. *Insider Trading*

Options and futures on stock market indices are also regulated differently in the area of insider trading. There are no prohibitions on in-

margins established by commodities exchanges. *See* § 8a(7)(C) of the Commodity Exchange Act, 7 U.S.C. § 12a(7)(C) (1982). *But see* letter from Susan Phillips, Chairman, CFTC, to Paul Volker, Chairman, Federal Reserve Board (Nov. 16, 1984) (The CFTC disagreed with a number of the conclusions and suggestions contained in the Board's study. The CFTC objected to the suggestion that there be a federal agency oversight role in reviewing margin levels established by boards of trade for stock index futures. It rejected the "level playing field" concerns voiced by the Board as being empirically unproven. Because of the different functions served by taking positions in futures and the underlying securities, the CFTC found that there is no need for an equivalent margin for stock index future and stocks. Finally, the CFTC disagreed with the suggestion made by the Board that the Board may have authority to set margin requirements for stock index futures.).

55. 15 U.S.C. § 78o(b)(7) (1982).

56. NASD MANUAL (CCH) ¶ 1102A.

57. *Id.*, NATIONAL ASSOC. OF SECURITIES DEALERS, INC., STUDY OUTLINE (1983) (for the SECO/NASD Non-member General Securities Examination).

58. 15 U.S.C. § 78o(b)(4)(E) (1982).

sider trading of futures on stock market indices, but options on stock market indices are subject to the SEC's Rule 10b-5.⁵⁹

F. *Investment Companies*

Banks operating common and collective trusts and investment companies regulated under the Investment Company Act operate under quite different rules with respect to transactions involving potential conflicts of interest. Banks acting as trustees are, of course, subject to the fiduciary duties of trustees under state law. However, registered investment companies are specifically regulated as to the kinds of transactions they may enter into with affiliated entities. Section 10(f)⁶⁰ of the Investment Company Act and rules thereunder restrict the ability of investment companies to purchase securities in underwritten offerings in which their affiliates are participating, and section 17(e)⁶¹ regulates commissions received by broker affiliates in investment company transactions. In addition, section 17(a)⁶² of the Investment Company Act and rules thereunder contain detailed prohibitions on transactions where conflicts of interest may exist. Banks operating collective trusts are not subject to these specific prohibitions.

G. *Administrative Remedies*

In an age of inter-industry competition, the present regulatory framework may undermine the SEC's enforcement program.⁶³ The various securities laws give the SEC the power to revoke the registrations or limit the activities of broker-dealers, investment companies, investment advisors and persons associated with those entities.⁶⁴ The SEC regularly bars or suspends securities laws violators from association with broker-dealers, investment companies and investment advisors. In today's world, however, these sanctions may not have their intended effect—protecting the investing public by keeping such persons out of the securities business. Individuals barred from association with these entities need only become employed by the securities division of a bank or sell variable

59. 17 C.F.R. § 240.10b-5 (1984).

60. 15 U.S.C. § 80a-10(f) (1982).

61. 15 U.S.C. § 80a-17(e) (1982).

62. 15 U.S.C. § 80a-17(a) (1982).

63. The enforcement program of other agencies may be undermined as well. Our comments are limited to the effect of a framework of industry regulation on the SEC's enforcement program only because of our familiarity with that program.

64. Sections 15(b)(4) and 15(b)(6) of the 1934 Act, 15 U.S.C. §§ 78o(b)(4), 78o(b)(6) (1982); § 8(b) of the Investment Company Act, 15 U.S.C. § 80a-8(b) (1982); and §§ 203(e) and 203(f) of the Investment Advisers Act, 15 U.S.C. §§ 80b-3(e)-(f) (1982).

annuities meeting Rule 151 (assuming it is adopted) in order to skirt the SEC's sanctions.⁶⁵ By doing so, they could continue to sell investment instruments to the public. As a result, the SEC's administrative sanctions would neither deter future violations, nor protect the public from persons who have violated the law.

Similarly, the present regulatory scheme obviates the effect of injunctions obtained against further violations of the securities laws. Injunctions do not restrict in any way the activities of persons who are clever enough not to buy, sell or advise others with respect to stocks, bonds, and other investment contracts. Thus, one subject to an order enjoining him from further violations of Rule 10b-5 can act with impunity in buying or selling, for example, futures on stock market indices.⁶⁶

V. PROPOSED SOLUTION

The disparities and inefficiencies highlighted above have led to a number of legislative and administrative proposals for reform. Most recently, the Bush Task Force has recommended legislation that would eliminate some of the disparities in the present regulatory framework. This section will analyze proposed solutions to some of these disparities, including the SEC's proposed Rule 3b-9 under the 1934 Act, which would require banks performing certain securities activities to register with the SEC as broker-dealers.⁶⁷

As a result of the unequal regulation of the securities activities of banks and registered broker-dealers, the Treasury Department has proposed legislation that would require banks conducting certain securities activities, such as underwriting public offerings, to conduct all of their

65. The SEC recently considered an enforcement recommendation against a registered representative of a broker-dealer who had committed serious violations of the antifraud provisions of the securities laws with respect to his customers' accounts. The broker-dealer fired him upon learning of the violative conduct, but he was soon hired as a salesman for an insurance company. Short of criminal sanctions, the SEC has no power to obtain an order that affects his present activities.

66. Persons subject to injunctions against further violations of the antifraud provisions of the federal securities laws are disqualified from registration with the CFTC. 17 C.F.R. § 3.20 (1984). Nevertheless, this disqualification would not effect, for example, someone who merely traded in commodities. Section 1.01 of the Bylaws of the Chicago Mercantile Exchange provides that members of the exchange must be persons of good moral character, reputation and business integrity. This subjective standard does not provide for automatic disqualification of one subject to an injunction against further violations of the antifraud provisions of the federal securities laws, but someone subject to such an injunction may be deemed to be a person not of good moral character, reputation and business integrity. In such a case, the Chicago Mercantile Exchange would have discretionary authority under its bylaws to deny such a person membership on the Exchange.

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

securities activities through affiliated entities as part of a holding company structure.⁶⁸ The Treasury Department has stated that, among other benefits, a mandatory holding company structure would insulate depositories from the risks of securities activities.⁶⁹ Such a requirement would also prevent banks from gaining an unfair competitive advantage by deducting the interest expense of carrying tax-exempt securities.⁷⁰

The SEC has endorsed the Treasury Department's position. In fact, in congressional testimony, the SEC advocated that all banks be required to conduct all their securities activities through affiliates.⁷¹ The Treasury Department's holding company proposal holds the key to the realization of a regulatory framework based on functional regulation. A full-service financial firm operates under the jurisdiction of many state and federal agencies. To prevent duplicative and overlapping regulation, a regulated entity engaged in activities under the jurisdiction of different regulators should conduct its activities through affiliates registered with the appropriate regulatory authority. For example, under such a regulatory framework, the banking or insurance operations of a firm would be subject to regulation only by banking or insurance agencies, respectively, and would not be subject to regulation by both. Moreover, if all affiliates performing those activities were under the jurisdiction of a single agency, functionally similar commercial activities could be subject to the same regulations.

The pivotal role of the holding company concept is also apparent from proposed rules of several agencies designed to further the concept of functional regulation. Virtually all either utilize the holding company concept or implicitly assume that regulated entities will conduct business through a holding company or functionally distinct affiliates. For example, the SEC's proposed Rule 3b-9 would require that certain bank securities activities be performed through broker-dealers registered under the 1934 Act, notwithstanding the fact that "banks," as defined in the 1934 Act, are presently excluded from the definitions of both "broker" and "dealer."⁷² The Commission's authority for this proposal is the preamble to the definitional section of the 1934 Act, which provides that the

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

69. See 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).

70. *Id.*

71. See *Securities Activities of Depository Institutions: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. 28, 28-35 (1982) (statement of John S.R. Shad, Chairman of SEC, regarding the Treasury Department's proposed Bank Holding Company Deregulation Act).

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

stated definitions apply "unless the context otherwise requires."⁷³

Under proposed Rule 3b-9, the activities which banks would be required to conduct through registered broker-dealers are: (1) public solicitation of brokerage business; (2) receipt of transaction-related compensation for providing brokerage services for trusts, managing agencies or other accounts to which the bank provides advice; and (3) dealing in or underwriting, on either a firm commitment or best efforts basis, securities other than exempted or municipal securities.⁷⁴ The SEC proposed this rule in order to ensure adequate investor protection and fair and orderly markets and to subject those engaging in similar commercial activities to the same rules and regulations.

If the proposed rule were adopted, many of the disparities in the present regulatory framework would be eliminated. A bank or bank affiliate registered as a broker-dealer would be subject to the same advertising, margin and supervision rules as other registered broker-dealers. The bank's representatives would be subject to the same qualification requirements and would be obligated to conduct their business in accordance with the same just and equitable principles of trade. In addition, if the bank were required to spin off the securities services business to an affiliate, the tax advantage enjoyed by banks dealing in tax-exempt securities would be eliminated. Finally, SEC administrative orders suspending or barring individuals from association with regulated entities would more closely achieve their goals. Because Rule 3b-9 would require certain securities services of banks to be conducted through an SEC-regulated entity, a person barred or suspended from association with an SEC-regulated entity could not frustrate the purposes of the sanction by entering the securities industry through a bank.

The proposed rule has, however, been widely criticized. Because the rule does not explicitly require banks to conduct securities activities through affiliates, banks and bank regulators have argued that the proposed rule could subject banks to overlapping regulation by both the SEC and bank regulatory agencies. The commentators point out that if banks use subsidiaries or affiliates to conduct their securities activities, they could be subject to SEC inspections of not only their securities activities, but also of their entire banking operations.⁷⁵ Moreover, it has been

73. 15 U.S.C. § 78c(a) (1982). This Article will not discuss the SEC's authority to adopt Rule 3b-9. That subject has been one of great interest to those commenting upon the proposed rule. See, e.g., UNITED STATES DEPT. OF JUSTICE, COMMENTS OF THE UNITED STATES DEPARTMENT OF JUSTICE (Dec. 30, 1983) (regarding Proposed Rule 3b-9).

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

75. Section 17(b) of the 1934 Act, 15 U.S.C. § 78q(b) (1982), authorizes the SEC to con-

noted that certain broker-dealer regulations, such as the net capital rule,⁷⁶ would be virtually impossible for a bank to satisfy.⁷⁷

The SEC has noted expressly that Rule 3b-9 is not designed to regulate the non-securities activities of banks. Those activities would not be subject to SEC review.⁷⁸ In any event, the solution to this problem, if indeed it is a problem, is for banks conducting securities activities that require registration with the SEC to do so through an affiliate or subsidiary and register only the affiliate or subsidiary.⁷⁹ In that case, the proposed rule would not create a system of overlapping regulation, but instead would advance the cause of functional regulation by subjecting similar commercial activity, regardless of who conducts it, to a uniform regulatory scheme.

The FDIC has tacitly joined the SEC and the Treasury Department in moving toward functional regulation through the holding company concept. The FDIC recently approved final regulations that would require certain securities activities of insured non-member banks to be conducted through bonafide subsidiaries or affiliates.⁸⁰ The regulations require subsidiaries to be adequately capitalized and physically separate in their operations, including having a separate entrance. Without passing judgment on the FDIC's regulations as a whole, we applaud the "affiliate or subsidiary" requirement in the rule. It is consistent with the holding company concept underlying both the Treasury Department's proposed legislation and the SEC's proposed Rule 3b-9.

The FDIC regulations also properly impose stricter regulation on subsidiaries than on affiliates. For example, unless a subsidiary is a "qualified underwriter,"⁸¹ it may underwrite only "investment quality

duct inspections of "all records" of registered brokers or dealers. Thus, all records of a bank registered as a broker-dealer would be subject to SEC inspections.

76. Rule 15c3-1 of the 1934 Act, 17 C.F.R. § 240.15c3-1 (1984).

77. Rule 15c3-1, the net capital rule, requires registered broker-dealers to maintain a net capital to liabilities ratio of roughly 1 to 15. *Id.* Banks are generally more highly leveraged than that.

78. SEC Exchange Act Release No. 34-20,357 (Nov. 8, 1983) ("The Commission is not seeking to regulate the non-securities activities of banks.").

79. *Id.* ("While the Commission is not proposing to prescribe any particular structure, it believes the use by banks of separate securities affiliates or subsidiaries would minimize the impact on banks of broker-dealer registration . . .").

80. 49 Fed. Reg. 46709 (1984) (to be codified at 12 C.F.R. Part 337).

81. The regulations define the term "qualified underwriter" as:

- (1) Membership in good standing in the National Association of Securities Dealers ("NASD"),
- (2) continuous operation for the five year period preceding notice to FDIC as required by this part,
- (3) no officer, director, general partner, employee, or 10 percent shareholder of any class of voting securities of the subsidiary has been convicted within five years of the notice required by this part of any felony or misdemeanor in connection with the purchase or sale of any security, involving the making

debt" and "investment quality equity" securities. Among the conditions for becoming a "qualified underwriter" are membership in good standing with the NASD and the absence of judgments against the subsidiary or its officers, directors and major stockholders for violations of the securities laws. A securities subsidiary may be a more immediate threat to the financial stability of its parent bank than a securities affiliate, especially if the bank has a significant amount of its capital invested in the subsidiary. Moreover, it is easier to insulate by regulation an affiliate from the liabilities of its sister companies than it is a parent from the activities of its subsidiaries. Thus, a subsidiary should be subject to stricter regulations in the interest of insuring the safety and soundness of the parent bank.

On April 16, 1984, the OCC proposed a rule⁸² that would allow national banks to conduct certain brokerage activities only through operating subsidiaries registered with the SEC. The proposed rule would require national banks to conduct discount brokerage activities through a subsidiary if: (1) a bank made margin loans to its brokerage customers; (2) a bank held customer securities other than as an introducing broker on a fully-disclosed basis; or (3) a bank provided retail customers with "individualized" investment advice together with brokerage services, for which a separate, transaction-related fee was charged. Although there are some differences between OCC's proposed rule and the SEC's proposed Rule 3b-9 with respect to the activities that would require registration with the SEC,⁸³ the OCC's proposed rule is consistent with the

of a false filing with the Securities and Exchange Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser, (4) neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders of any class of voting securities of the subsidiary is subject to any state or federal administrative order or court order, judgment, or decree entered within five years of the notice required by this part temporarily or preliminarily enjoining or restraining such person or the subsidiary from engaging in, or continuing, any conduct or practice in connection with the purchase or sale of any security involving the making of a false filing with the Securities and Exchange Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser, (5) none of the subsidiary's directors, officers, general partners, employees, or 10 percent shareholders are subject to an order entered within five years of the notice required by this part of the Securities and Exchange Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78, 78o-4) or section 203(c) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(c), (f)), and (6) all officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five years experience in similar activities at NASD member securities firms.

Id. at 46713-14.

82. 49 Fed. Reg. 15089 (1984) (to be codified at 12 C.F.R. Parts 5 and 12).

83. For example, a bank would be required to register as a broker-dealer under proposed Rule 3b-9 if it engaged in order-taking discount brokerage activities. The OCC's proposed rule

holding company concept and thus a major step forward toward functional regulation.

In at least one respect, however, the OCC's proposed rule does not go far enough. The OCC would continue to regulate the securities subsidiary, even though the subsidiary is regulated by the SEC. As a result, the subsidiary would be subject to overlapping regulation. The solution to this problem is a legislative one: to require that banks spin off the securities activities to an affiliate, whose activities by law would be insulated from the bank. Affiliates' securities business would be less likely to threaten the safety and soundness of the banks, and there would be no need for oversight by the OCC to assert its jurisdiction.

The Bush Task Force has recommended that the registration requirements of the 1933 Act be made applicable to publicly offered securities of banks and thrifts and that 1934 Act requirements for bank and thrift securities be transferred to the SEC.⁸⁴ These recommendations would eliminate the obviously irrational disparity that exists today where registration and periodic reporting requirements for banks or thrifts are administered by bank or thrift regulators, but the same requirements for bank holding companies—whose only asset may be the stock of a bank or thrift—are regulated by the SEC. The Bush Task Force should be applauded for these recommendations.

Ironically, though, the Bush Task Force abandons the functional regulation concept in recommending that the FHLBB continue to exercise securities jurisdiction over conversions of savings and loan associations and savings banks from mutual to stock form.⁸⁵ The Bush Task Force suggests that the conversion of a thrift is a matter "involving the safety and soundness of insured institutions."⁸⁶ Although the financial safety of a thrift may theoretically be at risk in a conversion,⁸⁷ it seems to us that the principal public policy concern in a conversion, as in virtually

would allow order taking by a department of a bank as long as the bank introduces and forwards all transactions and accounts on a fully disclosed basis to a broker-dealer for execution.

84. BLUEPRINT FOR REFORM, *supra* note 2, at 91-92.

85. *Id.* at 91.

86. *Id.*

87. The Task Group seems to suggest that the conversion of a thrift is a matter "involving the safety and soundness of insured institutions." BLUEPRINT FOR REFORM, *supra* note 2, at 91. Nevertheless, the Task Group identifies no special regulatory concerns involved in such a conversion. Its report argues only that regulatory concerns exist when a thrift issues mortgage-backed securities, and the mortgages backing the securities are a significant portion of the thrift's assets. *Id.* at 93. Issuance of mortgage-backed securities does, indeed, implicate the safety and soundness of insured institutions, but, in our view, this point is irrelevant to conversions because the newly issued common stock of a thrift would presumably not be a mortgage-backed security.

all public offerings, is full disclosure of material facts to the investors. For this reason, and because SEC jurisdiction over all public offerings is consistent with the concept of functional regulation, the Bush Task Force should have recommended that the SEC have jurisdiction over conversions of thrifts.

The Bush Task Force noted that most of its members felt that the remaining margin responsibilities should be eliminated.⁸⁸ More recently, the FRB has recommended that federal margin regulation be eliminated entirely.⁸⁹ Securities self-regulatory organizations, such as the stock exchanges and the NASD, would then be responsible for setting margin regulations. If the FRB's proposal were enacted into law, the current disparity between margin requirements for options and futures on stock market indices could be eliminated.

The Bush Task Force's recommendations, the Treasury Department's proposed holding company requirement for financial institutions, the SEC's proposed Rule 3b-9, the OCC's proposed rule and the FDIC's regulations are important first steps toward the creation of more efficient and fair regulatory format for financial institutions. In an age where we are all witnessing the breakdown of industry barriers and mergers and acquisitions designed to allow financial conglomerates to provide a full range of financial services, these proposed rules would allow firms to compete fairly against one another and allow regulators to focus their efforts on areas in which they have expertise. The beneficiary on both counts will be the public.

VI. LOOKING AHEAD

The proposals discussed above will help achieve the goals of functional regulation. These proposals will "level the playing field" between banks and securities firms and protect the investing public by requiring all those soliciting securities business from the public to abide by SEC regulations which were designed to protect the public. Nevertheless, the concept of functional regulation has not been discussed as a remedy for regulatory disparities beyond those that exist between banking and securities firms regarding the solicitation of securities.

For example, as noted above, disparities exist in both the regulation of futures and options on stock market indices and in the regulation of dealers in those markets. Nevertheless, futures and options on stock

88. BLUEPRINT FOR REFORM, *supra* note 2, at 93-94.

89. See Murray & McMurray, *Fed Urges Congress to End Its Role in Setting Securities Margin Rule*, Wall St. J., Jan. 15, 1985, at 3, col. 2-3 (western edition).

market indices perform the same economic function. This disparity should be eliminated by requiring that all derivative products on securities be regulated by the SEC. Although there are enormous political obstacles to such a proposal, it is not our intention to reopen recently healed wounds between the SEC and CFTC.⁹⁰ As an abstract proposition, these virtually identical products should be subject to the same regulations.

Although we support the thrust of the OCC's proposed rule requiring banks to conduct certain securities activities through subsidiaries, we would go further. The OCC might consider promulgating, or Congress might consider passing a statute requiring that banks administer collective investment funds of all types through subsidiaries or affiliates. Each collective fund would then be registered under the Investment Company Act, and the subsidiary or affiliate could register with the SEC as an investment adviser. Investment companies and collective funds would then be subject to a uniform regulatory scheme for their functionally similar commercial activity.

Another area where the concept of functional regulation can be utilized profitably is insurance. Hybrid insurance/investment products such as certain variable annuities and their progeny, single premium deferred annuities, should be regulated by the SEC if they place a significant investment risk on the investor. Such instruments appear to be more than just insurance products.⁹¹ The goal of functional regulation will be served if instruments serving the same economic purpose as securities, such as variable annuities and single premium deferred annuities, are subject to the same rules and regulations.

Unfortunately, the SEC's decision to publish for comment proposed Rule 151⁹² is inconsistent with its stated desire to create a framework of

90. See *supra* note 45.

91. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) (Brennan, J., concurring). The Court in *Variable Annuity Life Ins. Co.* stated:

At the core of the 1933 Act are the requirements of a registration statement and prospectus to be used in connection with the issuance of "securities" The emphasis is on disclosure; the philosophy of the Act is that full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved.

The regulation of life insurance and annuities by the States . . . proceeds, on entirely different principles. . . . The system does not depend on disclosure

[The] congressional division of regulatory functions is rational and purposeful in the case of a traditional life insurance or annuity policy, where the obligations of the company were measured in fixed-dollar terms and where the investor could not be said, in any meaningful sense, to be a sharer in the investment experience of the company.

Id. at 76-78.

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

functional regulation. Both the investing public and the goal of efficient regulation may suffer as a result. The proper application of functional regulation would limit the exclusion in section 3(a)(8) of the 1933 Act to securities in which the difference between the guaranteed interest and the discretionary interest is a *de minimis* one. Such a rule would properly distinguish between insurance products, in which the obligations of the insurance company are in fixed-dollar terms, and investment products, in which the investor is to share in profits or losses according to the investment experience of the company.

One final area in which the concept of functional regulation can be profitably pursued is periodic reporting. The SEC's integrated disclosure program has paved the way for EDGAR, presently a pilot program for electronic filing of periodic reports under the 1934 Act.⁹³ With the inauguration of EDGAR, it is not difficult to imagine the day in which all registration statements, periodic reports and proxy statements are transmitted electronically to the SEC and stored by computers. Similarly, it is just as easy to imagine the day when insurance companies, banks and thrifts will file reports electronically with their state and federal regulators. Finally, it is not unlikely that, to the extent these reports are public, one agency will have electronic access to reports filed with other agencies.

Electronic filing of reports presents new opportunities to create an inter-disciplinary regulatory framework based on the function of the product or service offered. The SEC, for example, recently proposed a rule that would require publicly held property and casualty insurance companies to include, with periodic reports filed with the SEC, portions of reports filed with state insurance commissioners.⁹⁴ In addition, the Bush Task Force has recommended that bank holding companies be able to fulfill their periodic reporting requirements to all regulators by filing copies of their Forms 10-K and 10-Q, which are presently filed with the SEC.⁹⁵

These developments foreshadow the utilization of the concept of in-

93. See SEC Securities Act Release No. 33-6540 (June 27, 1984); SEC Securities Act Release No. 33-6539 (June 27, 1984).

94. SEC Securities Act Release No. 33-6559 (Nov. 27, 1984). Currently, § 7(c)(1) of the 1934 Act provides that registered clearing agencies, transfer agents and municipal securities dealers that are regulated by banking regulatory agencies shall file copies of their SEC reports with the appropriate banking regulatory agency. 15 U.S.C. § 78q(c)(1) (1982). In addition, §§ 17(c)(2) and (3) roughly provide for exchanges of information and coordinated action between agencies. 15 U.S.C. §§ 78q(c)(2)-(3) (1982). These statutory provisions also suggest the possibilities for incorporation by reference on an interagency basis.

95. BLUEPRINT FOR REFORM, *supra* note 2, at 91.

corporation by reference on an interagency basis. Once electronic filing of reports is in place, it should be possible to send parts of reports to various agencies that might request them. For example, a publicly held insurance company might file electronically a report with a state insurance commission and also file electronically a portion of that report with the SEC. Moreover, to the extent that agencies can work together and that the Treasury Department's holding company legislation becomes law, it should be possible to tailor periodic reports of financial conglomerates so that the reports of affiliates can be filed separately with agencies having jurisdiction over particular functions and then assemble those reports for filing with the agency or agencies having jurisdiction over the entire holding company.⁹⁶

Take the case of Sears, Roebuck & Co., for example, which owns an insurance company, Allstate, and a broker-dealer, Dean Witter. Each affiliate should be able to file reports separately with the respective insurance or securities agency and then assemble those reports, together with financial statements and narrative discussions of other Sears lines of businesses, when preparing periodic reports to be filed with the SEC. Although this scenario assumes, among other things, major advances toward uniformity in accounting methods for different industries, electronic filing of reports and incorporation by reference of those reports on an interagency basis are worthwhile and practical objectives.

VII. CONCLUSION

Functional regulation is a worthy goal presently being pursued in a narrow context. Disparities in regulation exist which make competition unfair, frustrate administrative sanctions designed to protect the public interest and, in some cases, burden private enterprise unnecessarily. Proposals have been made to remedy some of these disparities, and we endorse these proposals. At their core is the Treasury Department's proposed legislation to require functionally distinct activities to be conducted through affiliated entities as part of a holding company structure. Such proposals move in the right direction toward improving the regulatory framework of the financial services industry. It is time now to step back from the existing debate and consider the broader applicability of functional regulation in the present technological environment.

96. At the SEC at least, the regulations necessary for such a composite reporting system are to some extent in place. The Form 10-K annual report requires registrants to disclose financial information for each of its industry segments. Regulation S-K, Item 101(b) and (c). Of course, these regulations would be amended to allow the incorporation by reference of reports filed with other agencies.