NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

FOR RELEASE: 10:00 A.M. E.S.T. Saturday, November 15, 1980

Remarks to
Public Securities Association

Cerromar Beach Hotel
Puerto Rico
November 15, 1980

"Financial Regulators and Financial Markets: The Tortoise and the Hare"

Stephen J. Friedman, Commissioner

There is a lovely story about the Japanese artist Katsushika Hokusai, who died in 1849. He was wildly prolific, and produced more than 13,000 prints and drawings. As he lay dying at the age of 90, his daughter heard his murmur: "If I could only have just five more years I could become a really great painter."

The same wistful feeling inhabits the souls of financial regulators: "In a year or two the regulatory system will be just right -- if only the financial markets would stand still for a while." Fortunately for our economy, the markets do not stand still. They have responded to the deep running economic and institutional currents of the post-World War II period with imagination and vigor. Change has come in startled bursts like the proverbial hare. And the regulatory tortoise plods along behind.

The regulatory system tends to ratify institutional change in the markets. It does so because there are often no alternatives. For example, in the past decade, there have been wrenching changes as the financial system responds to the pressures of inflation, the institutionalization of savings and dramatic developments in technology. The pressure for market rates of return for small savers made innovation inevitable. The money market fund, which responded to that pressure, has been described as a product of the union of inflation, Regulation Q and the toll-free telephone number.

In general, this process of gradual accommodation by the regulatory system works well. Its very sluggishness preserves the ability of the markets to innovate. Nevertheless, there are times in every society when governmental institutions get so far out of line with events that a fundamental rethinking is required. We are in such a period now in the regulation of our financial markets. It is time to begin to think about the structure of financial regulation in new ways, lest our powers and responsibilities -- or perhaps our whole way of thinking about regulatory problems -- become increasingly irrelevant or counter-productive. Regulation of financial institutions is not an end in itself. It exists to make the financial system work fairly and efficiently; and its major elements should be tested by that objective.

As this discusison proceeds, it will become quickly apparent to you that I have no pat answers. In general, I think we must find new ways to think about the regulatory structure, and to place more emphasis on function and less on the type of institution performing the service. For example, those who participate in the public securities markets should be regulateo with a view to a common set of objectives -- fairness in dealing with customers, and free, efficient and stable markets -- whether they are chartered as banks or securities firms or dealers in interest rate futures. Those who manage the investments of others also should be subject to a common set of regulatory objectives -- as should those who take deposits

and lend money. Yet our current regulatory pattern often places more importance on an institution's label than what it actually does.

Financial Regulation of the 1930's

The present system of financial regulation rests upon an allocation of functions that is assumed to be unchanged since the early 1930's. At that time Congress took a snapshot of the financial markets; it revealed

-- commercial banks employing interest-free demand deposits to fund short-term, self-liquidating loans;

-- newly-authorized savings institutions specializing in long-term fixed-rate mortgage loans to residential borrowers;

-- a securities industry concentrated in the public markets and acting as the principal intermediary for long-term debt and equity investments;

-- investment management services serving primarily individual investors; and

-- a relatively small government securities industry in which individual investors did not play a major role.

The regulatory framework replicated that division of markets. For each market, there was a neat little box (or boxes, in the case of banks) on the government organization chart: the Federal Reserve, Comptroller and FDIC for banks, the Federal Home Loan Bank Board for S&L's and the Securities and Exchange Commission for the securities industry.

This fifty-year-old model has served us well, but is increasingly unrelated to the realities of the current marketplace. Unprecedented pressures and opportunities have blurred -- if not obliterated -- the traditional separation of functions with completely new products. In short, while the real world continued to develop in response to a changing environment, the basic regulatory structure remained the same -- straining to integrate new changes into the old design.

These developments are well illustrated by a brief look at the basic banking and securities industry functions: taking deposits, extending credit, underwriting and trading in securities, and managing investments.

Deposit-Taking

As we all know, banks and other depositary institutions take deposits. But the last 15 years have seen a growing reliance by banks on purchased funds, especially large certificates of deposit, Eurodollar loans and repurchase agreements. In parallel, the market for retail deposits has become highly competitive. And for depositors, many nonbanks have come to be viewed as "deposit-like" alternatives. Examples are legion.

The registration statement that Sears recently withdrew provided for investment notes which were to be nontransferable but redeemable at the holder's option after two years; they were to be sold in minimum denominations of $1,000. From a depositor's standpoint, that is not very different from a small denomination, bank CD.

The Sears offering would have offered consumers market rates without intermediation. The money market funds, many of which are heavily invested in large (unregulated) bank CD's, offer market rates with double intermediation. Even with the added transaction costs, they have been tremendously attractive because of the disparity between passbook interest rates and current market rates. Today the money market funds manage over $77 billion in assets. The money market funds managed by one firm alone have total assets that would place it among the 15 or 20 largest banks in the United States.

The deposit-like activities do not stop there. Merrill Lynch has assembled a variety of services in its Cash Management Account, including investment of free credit balances in a special money market fund. The plan also has associated checking services. In addition, some other brokers are paying interest on customers' free credit balances. Moreover, those cash balances are insurable by SIPC at the same level as FDIC insurance of bank balances.

In spite of these developments, banks are still regulated as banks, money market funds are regulated as mutual funds (albeit with some *ad hoc* rules governing permissible investments) and brokerage firms are regulated as broker-dealers. To be sure, many of these developments are a product of the artificial constraints of Regulation Q, and the regulatory quagmire that is forming may dry up as deposit interest rates are decontrolled and funds are drained out.

Lending

An examination of lending yields similar results. The mortgage credit markets have been transformed by the intervention of the Federal government in the form of Ginnie Mae and Freddie Mac guaranteed securities. A growing portion of the mortgage credit markets no longer depends upon the intermediation of savings institutions, which now account for only 25% of Ginnie Mae securities. This transformation has turned on access to the public securities markets, raising a host of questions that would ordinarily be considered the province of the SEC.

The precipitous rise and fall of interest rates led market participants to hedge in the forward market and through standby commitments. Like futures, those are devices for the transference of risk, and the risk is substantial. The marketing of those risks and the effect of their assumption by dealers is a traditional concern of our Commission. But the Treasury and the Federal Reserve are also deeply interested in the market for securities that carry the credit of the United States. As you know, when the affected government agencies sat down to devise a sensible regulatory scheme, the result was an amalgam of the SEC, Federal Reserve and the Treasury.

Consumer lending has also changed significantly, with traditional banks playing a diminishing role. Credit card issuers and retail companies have occupied an ever larger share of the market. Moreover, to a significant degree, the exten-

sion of credit has become important to the profitability of brokerage firms. An SEC study of nine large, publicly-held securities firms showed that interest income constituted over 32% of their revenues in 1979, almost three times their revenues from principal transactions and four times their revenues from underwriting. The end result of this development is reflected in the Merrill Lynch Cash Management Account, in which margin credit is extended on a convenient and readily accessible basis for any purpose.

Traditional bank lending has also been challenged by the securities industry by development of the commercial paper market as an alternative to bank lending. The similarity between the underwriting of commercial paper and the syndication by banks of short-term loans is so great that it was used by the Federal Reserve as a principal justification for its recent determination that banks may underwrite commercial paper without violating the Glass-Steagall Act.

These developments have obvious implications for monetary control. Gradual attrition in Federal Reserve membership, for example, has resulted in extension of reserve requirements to all depositary institutions that offer transaction services. Moreover, the Credit Control Act grants the Federal Reserve, when authorized by the President, the power to limit the activities of a broad range of financial institutions. That power was in fact exercised to require money market funds to maintain sterile reserves (a requirement that has since expired).

Securities Trading and Underwriting

The regulation of securities activities presents an even more crazy-quilt pattern. Trading in corporate equity and debt securities is the traditional province of broker-dealers and the SEC. Today, trading in municipal and Treasury securities is occupying a larger share of the attention of these firms, and transactions in interest rate futures were an important element of the profitability of some firms in 1979. The fact that these operations are often conducted in separate subsidiaries does not, as a practical matter, insulate them from the operations of the rest of the firm. Similarly, options have come to play a major role in the trading activities of many securities firms. Now, consider the regulatory result:

-- trading in corporate securities and related options is regulated by self-regulatory organizations and the SEC;

-- trading in futures on equities or equity indices would be regulated by the CFTC;

-- trading in U.S. Treasury securities is not regulated by anyone, except for limited rules imposed by the Treasury;

-- futures on Treasury securities are regulated by the CFTC;

-- Ginnie Mae securities are regulated in part by HUD, but only to a limited degree;

-- futures on Ginnie Mae securities are regulated by the CFTC;

-- proposed options on Ginnie Mae securities would be regulated by the SEC; and

-- forward trading in Ginnie Maes could be regulated by a tripartite council.

To an increasing but as yet undetermined extent, public investors are purchasing all of these instruments, securities firms or their affiliates are trading them, and the intermediaries are subject to either bank regulation, SEC regulation, CFTC regulation or no regulation. Without assuming the conclusion of who ought to be doing what, I submit to you that the current system does not make a lot of sense.

Moreover, this is not a matter of quibbling among bureaucrats. Consider the matters of concern to investors in this department store of financial products -- matters which may be slipping through the cracks. As investors seek increased access to government securities and financial futures, gaps in regulatory protection for those investors have appeared. For example, in the Ginnie Mae markets, the SEC has found its traditional approach to suitability not easily transformable in a market where S&L's and commercial banks are the major customers. But the bank regulators, interested in promoting safe and sound banking practices, have not focussed on that problem directly. In the case of financial responsibility, lack of uniform margin and mark-to-market requirements in Ginnie Mae trading were an important cause of losses. But neither the SEC nor the federal bank regulatory agencies have broad authority to impose margin requirements where they are needed. The integrity of the securities markets -- all securities markets -- require investor confidence. Financial regulators should be able to act responsibly to guard against

the dangers of excess leveraging and overspeculation in the markets for new products in order to preserve the health of those markets.

Investment Management

The same pattern emerges in investment management. In the first twenty years of this century, the investment management activities of banks were largely confined to traditional personal trust services. As the financial excesses of the Twenties wore on, the securities affiliates of banks were drawn to the formation of investment companies. But banks were not a major factor in investment company growth. Indeed, the laws adopted in 1940 to regulate investment management assumed that the basic relationship was between market professionals and individuals; and the trust departments of banks were largely exempted in light of extensive bank regulation and common law fiduciary obligations.

Since that time, there has been a revolution in the institutionalization of private savings. Institutional trading on the New York Stock Exchange was recently reported to have reached the 70% level. Between 1960 and 1978 alone, the value of the assets of private noninsured pension funds rose from $6.5 billion to over $200 billion. Life insurance companies managed an additional $120 billion in pension reserves at the end of 1978. In contrast, the assets managed by mutual funds, which were assumed to represent the proto-

typical pattern in 1940, peaked in 1975 at about $55 billion until the explosive growth of money market funds in the late 1970's, which boosted the total to about $95 billion in 1979.

Today, the range of investment advisory services offered by commercial banks and their holding companies is impressive:

-- individual voluntary and automatic investment accounts;

-- individual and pooled fiduciary trust accounts;

-- commingled employee benefit plan trusts;

-- individual agency accounts; and

-- pooled trust accounts funding individual HR-10 and Keogh retirement plans.

As in the case of other financial services, the banks are regulated as banks and the nonbank investment managers as investment advisers. In many cases they have the same clients, yet the Securities Act of 1933, the Investment Company Act and the Investment Advisers Act have little application to bank investment management.

Commodity pools also illustrate the problem in this area. Pooled investments in interest-rate futures which are mass-mechandised are indistinguishable from other investment companies in terms of the needs of investors. There is overlapping jurisdiction between the CFTC and the SEC and our Commission has taken a no-action position. That result may be consistent with the hodge-podge nature of the current regulatory framework, but it is hardly ideal.

* * *

Finally, to add some spice to this stew, the internationalization of the capital markets is proceeding rapidly. That development is seen most starkly in the Eurodollar markets, but it has appeared in investment management and other aspects of the securities market. I fear that we do not have an adequate institutional basis for dealing with the problems that will arise from this development.

The Future

I am not suggesting, as I am sure you suspect, that the Congress could remedy all problems by simply extending SEC jurisdiction to take care of all of them. I am suggesting, however, that the broad issue of the structure of financial regulation should be a continuing occupation of the Congress. In that process, I think we need to pay more attention to function as the touchstone of regulation and less to the kind of institution involved. Moreover, I think that self-regulatory organizations can play a major role as the primary interface between financial institutions and the government. There is no better example of this function than the Municipal Securities Rulemaking Board.

The MSRB, which you have worked so hard to make effective, is the first example of a truly unified regulatory pattern for banks and securities firms conducting the same business. A successful allocation of functions between the SEC and Federal

bank regulators was established. By and large, the system is working well. It leaves to the affected industries the inital task of accommodating the regulatory pattern to their unique differences. And it preserves oversight and ultimate enforcement authority in the Federal regulators.

A similar pattern has been suggested for regulation of mortgage-backed securities. I see no reason why self-regulation also could not be a basis for more unified regulation of investment management, if the Congress should choose to move in that direction.

Self-regulation is only one step in the direction of uniting function and regulation. The task is enormously complex, and it can only be accomplished with the active participation of industry groups. We need your help to assure that the regulatory system evolves in tandem with the markets. Your will remember that in the fable of the tortoise and the hare, the tortoise won. I would be pleased if we cross the finish line together.