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Financial Services Outlook

Thinking Ahead: Treasury Prepares to Lay Down a Marker for the Future (Part 2)

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This is the second of two Financial Services Outlooks *on the Treasury Department's review of the regulatory structure for financial services. In a* Federal Register *notice in October, Treasury requested public comments on a number of questions relating to the regulation of financial services in general, followed by specific questions about the regulation of banks, securities firms, and insurance companies.*[1] *The October* Outlook *addressed regulation and regulatory structure in general;*[2] *this issue addresses Treasury's specific questions about the regulation of banking, securities, and insurance. While it is unlikely that any of Treasury's recommendations will be adopted during the remainder of George W. Bush's term, it is clear that Treasury has a rare opportunity—shorn of the usual issues of political feasibility at a given moment in time—to advance ideas that will influence the direction of regulatory reform for many years to come. For that reason, all financial institutions—especially those with an interest in financial services regulatory policy—should provide Treasury with their considered views.*

Depository Institutions

2.1.1. Are multiple charters for insured depository institutions the optimal way to achieve regulatory objectives? What are the strengths and weaknesses of having charters tied to specific activities or organizational structures? Are these distinctions as valid and important today as when these charters were granted?

Deposit insurance has two purposes: providing the public with an assured savings vehicle and enhancing the stability of institutions that accept deposits withdrawable on demand. Deposit insurance does the first job far better than the second. As noted in the October *Outlook*, there have only been two industries that have suffered serious collapses in modern times in the United States—savings and loans (S&Ls) and banks—and both were either heavily restricted in the geographic scope of their activities, had deposit insurance, or both. The reason for the instability of insured depository institutions is the presence of deposit insurance, which virtually eliminates market discipline and opens opportunities for excessive risk-taking.

Despite its contribution to instability, the effect of deposit insurance in protecting the savings of individuals assures that it will be part of our banking system for the foreseeable future. For that reason, it is good policy to adjust the permissible activities and other regulations applicable to banks so that these do not also contribute to bank instability. Over the past seventy years, it has become clear that restrictions on diversification—whether geographical or functional—will create weak depository institutions. This is because banks and S&Ls confined to small geographic areas or restricted to permissible activities are unable to diversify their risks. S&Ls, initially limited to making housing loans, are a classic example of how restrictions on activities can contribute to weakness and instability when conditions change. The collapse of S&Ls during the high interest-rate environment of the 1980s was a direct result of the short-sighted national policy of restricting their activities solely to the promotion of hous-

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ing. Sound policy, then, would seem to suggest that depository institutions should have a wide scope of activity so that they can diversify their risks. Nevertheless, because banks are chartered, insured, and given access to the Federal Reserve's discount window, they have advantages that other financial intermediaries cannot match. Thus, insured depository institutions should not be allowed to stray beyond their traditional role as deposit-takers and providers of credit. Accordingly, the charters of insured depository institutions should be as broad as possible—so they can diversify their products and the geographic scope of their credit-granting activities—but limited to the traditional credit-granting activities of banks.

There is no reason, however, to have different regulators for depository institutions that have essentially the same powers. The Office of Thrift Supervision should be merged with the Office of the Comptroller of the Currency (OCC) to enable the creation of a single national depository institution charter. At the same time, there is no reason to limit the traditional power of the states to grant bank charters and to regulate the banks they charter in any way they see fit. The trend toward national bank charters strongly suggests that state charters do not offer the same advantages of a national charter, but that is for banks to decide. For regional or local institutions, it may make more sense to be state-chartered.

2.1.2. What are the strengths and weaknesses of the dual banking system?

The strength of the system is that it gives banks a choice among regulators, and the competition between and among the national and state regulators may make regulation more sensitive to the realities of the marketplace. Some contend that it will promote a "race to the bottom," but thus far there is little evidence of this. Banks understand the value of a strong regulatory system and would not like to be caught in a system that does not encourage confidence from depositors and consumers. Competition between state and federal regulators certainly has some value, but it is questionable whether its benefits are significant enough to warrant the costs of duplicate systems. The gradual movement of banks toward national charters—rather than movement back and forth between federal and state charters—suggests that a national charter is superior and that there is no real competition.

The state regulatory system works because the states have adopted a mutual recognition regime that allows state banks chartered in one state to operate in others without host-state safety-and-soundness regulation, and also because there are thousands of small banks that do not do business outside their local communities. The benefits of the system are such that there is no reason to change it, but, as described on pages 3–4, it may be possible to achieve cost savings through a reorganization of the regulatory structure at the federal level.

The main weakness of the dual banking system is that until now it has required a second regulator at the federal level for state banks that have federal deposit insurance. Regulation is essential for banks that have deposit insurance because insurance reduces market discipline, but the proliferation of regulatory agencies raises the costs of regulated institutions, which are passed on to depositors and borrowers. This problem can be surmounted by a consolidated bank regulator at the federal level that would charter and regulate national banks (including the necessary regulation associated with deposit insurance) and regulate state banks that have deposit insurance (just as the Federal Deposit Insurance Corporation [FDIC] does now).

Creating a single regulator at the federal level would require state-chartered banks to pay two fees: one to their state chartering authority and one to the federal regulator. Under current law, state-chartered banks do not pay any fee to the FDIC for the examination associated with their deposit insurance. Because this examination is less comprehensive than the supervision of national banks across the full range of their activities, however, it should be possible to reduce fees paid by state-chartered banks substantially below those paid by national banks. Although this small additional fee could accelerate the trend toward national bank charters, there is no reason to retain a dual system of regulation simply to make sure that both competing groups are equally disadvantaged by a duplicative cost structure.

2.1.3. What is the optimal role for a deposit insurer in depository institution regulation and supervision? For example, should the insurer be the primary regulator for all insured depository institutions, should it have back-up regulatory authority, or should its functions be limited to the pricing of deposit insurance, or other functions?

It is not clear that there is anything about regulation by a deposit insurer that differs sufficiently from regulation by a chartering authority to warrant a separate deposit insurance regulator. For this reason, it would be efficient to have a single regulatory agency at the federal level that charters and regulates national banks and regulates state banks that have deposit insurance. The federal agency

could have two divisions: national bank regulation and insurance regulation for both national banks and state banks. Better still, the national bank regulator, following the structure adopted by Great Britain's Financial Services Authority (FSA), could have divisions dealing with specific functions, such as consumer protection, retail banking, and safety and soundness. The safety-and-soundness division would regulate both state and national banks, while the state chartering authorities would regulate the consumer protection and retail banking activities of the state-chartered banks.

2.1.4. What role should the central bank have in bank regulation and supervision? Is central bank regulatory authority necessary for the development of monetary policy?

Very few central banks in developed countries have any role in bank regulation. The Federal Reserve's usual argument is that it needs authority over bank holding companies to keep in touch with events in the financial system, but this does not seem persuasive. The Fed has many sources of information about the economy available to it when it makes decisions; information about the banking industry is only one of those sources, and it is unlikely to be the most important for the Fed's monetary role. Retaining the Fed's regulatory role in banking thus seems to be a high price to pay for very little real return. Japan, Britain, and Australia are examples of countries that have recently taken bank regulatory authority away from their central banks and given it to a consolidated financial services regulator. These countries did not believe that bank regulatory authority was necessary for the proper functioning of the monetary authority.

Moreover, there is an inherent conflict between the role of the Fed as a source of liquidity and stability for the financial markets and its role as a bank and bank holding company regulator. The Fed's interest in stability may lead it to pull its punches on regulation or supervision in the interest of promoting stability. Forbearance of this kind could allow problems to fester that should be addressed as they are discovered.

In any event, the Federal Reserve now regulates very few of the large banks. Most large banks have moved to national charters and are regulated by the OCC. The Fed's primary role as a bank regulator comes through its authority to regulate bank holding companies, which, as noted in the October *Outlook*,[3] should properly be handled—in a limited fashion—by the regulator of the subsidiary depository institution.

2.1.5. Is the current framework for regulating bank or financial holding companies with depository institution subsidiaries appropriate? Are there other regulatory frameworks that could or should be considered to limit the transfer of the safety net associated with insured depository institutions?

There is no good policy reason for regulating the holding companies of financial institutions such as banks, securities firms, and insurance companies. The sole reason to regulate a parent company is to be sure that its control over the subsidiary financial institution does not enable the parent to weaken the subsidiary's financial condition in pursuit of its own interests. Since any such action would have to involve a transaction between the parent and the subsidiary or a transaction with a third party for the benefit of the parent in which the subsidiary would not otherwise engage, these possibilities can be controlled by the regulator of the subsidiary. Both these transactions, if they disadvantage the subsidiary, would be violations of sections 23A and 23B of the Federal Reserve Act, and it is important to keep in mind that the Federal Deposit Insurance Corporation Improvement Act of 1991 imposes heavy personal penalties on the officers of a bank who authorize a transaction that violates banking laws or regulations. These penalties, up to $1 million per day, should be sufficient when combined with regulatory vigilance to prevent actions that weaken the subsidiary. Thus, there should be no need for special holding company regulation in order to protect the safety net. That can be done through the normal enforcement of banking regulations by the existing supervisors of depository institutions.

Current regulation of holding companies is made necessary, however, by the policy of separating "finance" and "commerce." Since the adoption of the Gramm-Leach-Bliley Act of 1999 (GLBA), which permitted affiliations between banks on the one hand and insurers and securities firms on the other, the idea that banking should be separated from commerce has been converted into a policy of separating commerce and finance. This policy, based on the flawed idea that it is possible to make a principled distinction between financial and nonfinancial (commercial or retail) activities, requires that some agency—currently the Fed—approve the activities in which the parent

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of an insured depository institution is permitted to engage. Not only is it impossible to distinguish finance from commerce (for eight years, the Fed has been unable to determine whether real estate brokerage is finance or commerce), but the policy has had the adverse effect of hindering the development of true financial services conglomerates formed by insurance companies and securities firms. This is because insurance and securities firms do not want to find, after affiliating with a bank, that they have to divest some of their activities or be restricted in the activities in which they can engage in the future.

The understandable post-GLBA reluctance of insurers and securities firms to acquire banks has provided banking organizations with an unfair competitive advantage over other members of the financial services industry. For banking organizations, which had been restricted in their affiliations, the GLBA was liberating, but insurers and securities firms got nothing significant from the act. As a result, of the more than seven hundred financial holding companies formed since the GLBA was enacted, only a few have been formed by securities firms or insurance companies. The rest have been formed by banking organizations. The only way to encourage the creation of consolidated financial services companies—including banks, securities firms, and insurance companies—is to repeal the provisions of the GLBA that attempt to impose a separation between financial and nonfinancial activities. This would then make holding company regulation by the Fed unnecessary.

2.1.6. What are the key consumer protection elements associated with products offered by depository institutions? What is the best regulatory enforcement mechanism for these elements?

We have a single national market in financial services in the United States, in which banks, securities firms, and insurance companies are vigorously competing across industry lines and with one another. As a result, differences in regulation between industries and redundant regulation at both the federal and state levels create unnecessary competitive inequities and increase costs, which are passed on to consumers. Given that there is a national market, there should be a single set of regulations—promulgated by a federal regulator—with which all financial services companies should comply. Although there are major differences among these institutions in terms of their structures—which will require major differences in how they are regulated for safety and soundness—their marketing and sales activities are similar enough to be handled by the consumer protection division of a consolidated regulator.

Insurance

2.2.1. What are the costs and benefits of State-based regulation of the insurance industry?

The only way to answer this question is with another question: compared to what? It seems clear that some insurance regulation at the state level is better than no regulation at all. Insurance is a contractual arrangement, and it is difficult for ordinary consumers to negotiate their own contracts or to understand the terms of a contract furnished by an insurer. Even if the courts are lenient in giving insured parties the benefit of the doubt in contract interpretation, consumer protection at the state level in the form of approving contracts for use in the state is better from the standpoint of consumers than no state regulation.

On the other hand, state regulation of rates probably reduces competition—harming consumers—and multistate regulation of insurance company solvency probably adds more costs than any benefits it might provide. Nevertheless, the state-administered system of guarantees, which relies on insurance companies registered in the state to back the obligations of all other companies offering insurance in the state, seems to be an efficient system that intervenes when necessary but does not place an unnecessary burden on insurers or state taxpayers. This system also provides incentives for insurers to report unsafe and unsound activities by other insurers. So there are some benefits of state-based insurance regulation when compared to no regulation.

For companies that offer insurance in only one or a few states, state approval of contracts and products is certainly better than no regulation and could be more cost-effective than federal regulation, so a state system should certainly be preserved even if a federal chartering and regulatory system were to be adopted, as discussed in the next section.

2.2.2 What are the key Federal interests for establishing a presence or greater involvement in insurance regulation? What regulatory structure would best achieve these goals/interests?

The question of "federal interests" raises the broadest issue and is an appropriate place to start. The federal government should, where possible, encourage competition and innovation in all fields, and an optional federal charter (OFC) for insurance companies would accomplish this. Federal polices of deregulation in many other areas of the economy—air transportation, telecommunications, trucking, securities brokerage, and many others—have consistently resulted in lower prices and better services for the public. It would enhance the ability of life insurance

companies to compete with banks and securities firms. For property and casualty (P&C) companies, it would enhance competition in each state.

In addition, insurance is a major part of the financial economy in the United States. Life insurers compete vigorously with federally regulated banks and securities firms; a vigorous and competitive P&C insurance industry is essential for construction and infrastructure development and recovery from natural disasters; and U.S. trade policy should encourage the sale of insurance abroad by domestic insurers. Since 9/11, the federal government has been deeply involved in terrorism reinsurance. These are only a few of the major ways in which the insurance industry is important to the economy and is affected by and affects national policies. To formulate effective policy in all these areas, the federal government needs the expertise in insurance economics and insurance markets that comes from direct involvement with the insurance business through regulation of insurance companies. In framing federal regulation of the financial services industry, and in crafting the Terrorism Risk Insurance Act, the federal government has found itself short of these resources.

All insurers would have the opportunity to obtain an optional federal charter and thus avoid state rate regulation. This will create benefits for consumers, providing the improved services, greater innovation, and lower costs characteristic of competitive markets.

An OFC for insurance companies would offer a number of significant advantages for consumers by introducing competition at the state level that is impossible under the current state regulatory system. The states could alleviate this problem by adopting a system of mutual recognition, as they have done in regulating banks, so that insurers chartered in one state could freely offer their products in other states. Despite years of effort along these lines, however, this goal does not seem appreciably closer.

The benefits for consumers are different in the case of the two parts of the insurance industry—life and P&C. Life insurance companies compete directly with banks and securities firms in that they offer investment and savings vehicles that are alternatives to banking and securities products. Life companies are hindered in their competitive efforts by the current state regulatory system. New products of life companies must be approved by every state in which the product is offered. This is time-consuming and expensive, placing life insurance companies at a disadvantage in competing with banks and securities firms. In addition, the states often demand changes in products before they can be offered, so that it becomes difficult to roll out a single product nationally.

These are not problems faced by banks and securities firms. Securities products do not have to be approved in advance. The products of state-chartered banks are subject to some degree of prior approval by their principal state supervisor, but once they are accepted, they generally can be offered anywhere in the country because of the mutual recognition system that the banking industry has developed. Of course, nationally chartered banks need only get the approval of the OCC in order to offer a product nationally. An OFC for life insurance companies would address this problem. Life insurance products would still be subject to a review and approval, but only by one regulator, and after the product is approved it could be offered nationally. This would make life insurance companies that operate on a national level much tougher competitors for banks and securities firms, to the benefit of consumers who would get better financial products at lower prices. An OFC would have no effect on small life insurers that operate in only one or two states, but these companies would be required to compete with nationally chartered companies—again to the benefit of consumers.

P&C companies compete only to a limited extent with banks and securities firms, but they compete vigorously with one another. Thus, the burden of state regulation does not come through differential regulation but rather through state regulatory policies that limit the number of companies willing to compete for business in a particular state. Fewer competing companies means higher prices or lower-quality services for consumers, and sometimes both. Among the most pernicious state policies for P&C companies are rate regulations. Assuming that the federal regulator does not impose rate regulation, an OFC will help to alleviate this problem. Rate competition by nationally chartered companies will produce great benefits for consumers, just as rate deregulation has improved prices and services for consumers in other parts of the U.S. economy.

The arguments against an OFC are not persuasive. If we look at the banking industry as the paradigm, there is no indication that consumers are less protected by the OCC than they are by the state bank regulators or other state officials—at least there is no indication that consumers are choosing state-chartered banks over national

banks because they believe they are better protected as customers of state banks. Indeed, the trend among banks is toward national charters—something that banks would not do if it meant any difficulty in attracting depositors.

Nor should concern about a new federal bureaucracy be troubling. It is likely that the federal insurance regulator will be financed—as are the bank regulators—by levies on the companies it charters. Thus, the taxpayers will not be affected by or charged any costs for this new agency. Moreover, it often seems as though the same people who say that a federal agency will not protect consumers are also arguing that the new agency would be a large federal bureaucracy. To protect consumers nationally, an agency might need to be very big indeed. Regardless, such an agency will not add to the size of the federal budget.

2.2.3. Should the States continue to have a role (or the sole role) in insurance regulation? Insurance regulation is already somewhat bifurcated between retail and wholesale companies (e.g., surplus lines carriers). Does the current structure work? How could that structure be improved?

The state structure could be improved substantially by federal legislation under the Commerce Clause, requiring the states to adopt a mutual recognition system. Such a system would allow insurance companies chartered in any state to offer insurance in other states. This would certainly include solvency regulation solely by the home state, but to be of greatest value in promoting competition—the key purpose—mutual recognition should also include the approval of contracts and possibly the export of premium rates. In this way, a state-chartered company with low premium rates could offer insurance in other states.

The states would still be able to exercise authority on behalf of their citizens under this system. The federal legislation should allow host states to review and approve the quality of regulation by the home state of insurers desiring to enter the host states' market. The federal government or the courts would have to supervise this process in some way in order to assure that the states do not use this power in anticompetitive ways. There is a precedent for such a system: the Federal Reserve is required to review and approve the quality of the regulatory structures in foreign countries before permitting banks from those countries to operate in the United States. If this can be done with respect to foreign countries, it should work for U.S. states.

Absent this interstate structure, the states' role should, in effect, be determined by the choices made by companies. Thus, an OFC should be available to all companies that wish to use it. Those companies that operate within only one or a few states may choose to remain state-chartered, while companies that operate in many states may choose the OFC. But insurers chartered at the federal level will be able to compete with state-chartered companies in every state. This will probably mean that state laws that continue rate regulation cannot be sustained, since all insurers—including small and local ones—will have the opportunity to obtain an OFC and thus avoid state rate regulation. This will create benefits for consumers in the form of the improved services, greater innovation, and lower costs characteristic of competitive markets.

2.2.4. States have taken an active role in some aspects of the insurance marketplace (e.g., workers' compensation and residual markets for hard to place risks) for various policy reasons. Are these policy reasons still valid? Are these necessarily met through State (as opposed to federal) regulation?

Workers' compensation systems are different from other insurance systems in that they offer assured, virtually no-fault compensation for injury or death in exchange for a compensation cap. This structure, which is administered by the states, takes workers' compensation out of the free market, and the cap is a matter of state policies. Choices of coverage or premium rates are not made by consumers, and are limited even for employers. Accordingly, it seems appropriate that states continue to control workers' compensation policies, and that the usual reasons for favoring competition not apply.

However, residual markets are a different matter. These are frequently the result of state policies that distort the normal process of linking insurance rates to risks. By holding rates lower than a level that will compensate insurers for risks, state rate regulation (for example) can result in the denial of coverage to customers with adverse loss experience. In order to assure that insurance is available to virtually all their citizens, regardless of loss experience, the states frequently require all companies that write insurance within their borders to contribute to funding residual markets that cover those who would otherwise be uninsurable. This results in a cross-subsidization of customers with adverse experience by those with normal or good experience, and because the costs are hidden in the premiums paid by all insureds with normal or good experience, they are frequently unappreciated by those who must pay them.

The problem can be eliminated by eliminating rate regulation. Almost all customers can be accommodated in a system where rates are not regulated, and the same thing can be accomplished by allowing companies from out of

state, such as those that hold OFCs, to enter the state's insurance market. In that case, many, if not all, insurers in the state will migrate to an OFC. To prevent this, it is likely that the states will eliminate rate regulation. States could still achieve the purposes of residual markets, however, by directly subsidizing insurers who take on risks that would otherwise not be insurable. This will also have the salutary effect of making these subsidies transparent.

Securities and Futures

2.3.1. Is there a continued rationale for distinguishing between securities and futures products and their respective intermediaries?

There are important differences between securities and futures, but it is not clear that the differences are great enough to warrant differential regulation. Both are intangible assets that involve investment risks for which disclosure is the best consumer protection, and both can be traded through established markets or over the counter. Regulation, then, seems to involve virtually identical kinds of issues and competencies. In addition, and perhaps most important, as shown by the long dispute between the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission over their respective jurisdictions, there is no clear dividing line between securities and futures. Although the Commodity Futures Modernization Act of 2000 (CFMA) settled some of these issues, it is likely that disputes will arise again as both markets develop and evolve. If the question is whether the differences between securities and futures justifies the existence of two separate regulators, the answer would appear to be no. A single regulator for both kinds of instruments would seem to be the best policy.

Indeed, if a single financial regulator were established at the federal level, it would be best to adopt a functional regulatory system similar to that used by the FSA. That agency regulates financial services companies through divisions that specialize in particular regulatory functions, such as safety and soundness and retail sales, rather than by the type of product involved.

2.3.2. Is there a continued rationale for having separate regulators for these types of financial products and institutions?

As discussed in the October *Outlook*,[4] the fact that banks, securities firms, and insurance companies are converging into a single financial services industry argues strongly for a single federal regulatory agency. The same approach applies to securities and futures. Although they are not strictly competitive, the instruments themselves are so similar—in some cases simply two sides of the same coin—that having separate regulatory agencies does not make policy sense.

2.3.3. What type of regulation would be optimal for firms that provide financial services related to securities and futures products? Should this regulation be driven by the need to protect customers or by the broader issues of market integrity and financial system stability?

There is no reason to distinguish between the goals of consumer protection and the goals of market integrity and financial system stability. Unlike the question of whether a regulatory agency should have promotional responsibilities for the industry it regulates—a question finally answered in the negative with the demise of the Federal Home Loan Bank Board—there is no inherent incompatibility between protecting consumers and protecting the market and the financial system. Consumers and customers, as a group, have interests in both. In most cases, consumer protection and market integrity—and even financial system stability—serve the same ends: consumer and public protection. To the extent that consumer protection requires actions that might affect system stability, the regulatory agency should be charged with keeping both these goals in balance, but it is seldom that a regulatory step that weakens market integrity or system stability is actually good for consumers as investors.

It is worth noting that in 1996, in the National Securities Market Improvement Act, Congress charged the SEC with responsibility—in addition to protecting investors—for promoting "efficiency, competition, and capital formation" in the securities market. The SEC has largely ignored this mandate, probably because the agency earns more credit for seeming to act as the protector of investors than for pursuing these other, more abstract, obligations. By abandoning its statutory responsibilities, however, the agency has increased the costs of investors and reduced the competitiveness of U.S. securities markets. For example, by paying little attention to "efficiency, competition, and capital formation" in the public markets, the SEC has encouraged the growth of third markets under Rule 144A. Encouraging institutions to trade off the public markets increases the risks of retail investors by eliminating or reducing the contribution of institutional investors to price discovery. One of the objectives of the Treasury recommendations should be to get the SEC to pay the necessary attention to its 1996 congressional mandate.

2.3.4. What is the optimal role for the states in securities and futures regulation?

The securities market is a national market. The interests of investors do not materially differ from state to state. The regulations of the SEC should preempt state laws and regulations intended to apply to securities transactions.

2.3.5. What are the key consumer/investor protection elements associated with products offered by securities and futures firms? Should there be a regulatory distinction among retail, institutional, wholesale, commercial, and hedging customers?

As noted in response to question 2.3.1, there is no reason to distinguish between securities and futures for regulatory purposes, and there are a number of reasons not to do so. But there are real and important distinctions between retail investors, on the one hand, and institutional, wholesale, commercial, and hedging customers on the other. Retail customers generally cannot fend for themselves in their relationships with securities issuers, markets, and brokers. They are unlikely to have the necessary information to understand the risks associated with investing, or the many ways in which they can be mistreated in the securities markets. The same is not true for institutional investors and other professionals and sophisticated investors. But this does not mean that there is a need for a separate regulatory structure for retail investors. Instead, what seems appropriate is a differential application of the laws and regulations that apply to securities and futures, so that retail investors in both securities and futures get more of the enforcement focus, and the regulatory agency structures its regulations so that they distinguish between retail investors and institutional and sophisticated investors. In general, institutional and sophisticated investors do not need the protections of the securities or laws and regulations.

2.3.6. Would it be useful to apply some of the principles of the Commodity Futures Modernization Act of 2000 to the securities regulatory regime? Is a tiered system of regulation appropriate? Is it appropriate to make distinctions based on the relative sophistication of the market participants and/or the integrity of the market?

The key question here is whether the transaction takes place in the primary or secondary market, and whether it involves an instrument that is already traded in the secondary market. As noted above, a tiered system is appropriate for distinguishing between the treatment of retail investors, on the one hand, and institutional and sophisticated investors on the other. The CFMA adopts this approach, treating sophisticated investors in futures differently by, among other things, applying fewer restrictions to their transactions.

The same approach would work well for securities, but in that case a distinction should be made between a primary securities transaction (in which an issuer is selling to the public) and a secondary transaction (in which an investor is buying or selling in an existing market). Because of the presence of institutional and sophisticated investors in the pricing of securities in the secondary market, retail investors run far fewer risks in purchasing "at the market." Accordingly, a tiered system in which there is differential treatment of retail and sophisticated investors—and a further difference in the treatment of transactions by retail investors in the primary and secondary securities markets—would focus the resources of a combined securities and futures regulator in the right place.

Conclusion

In June, when Treasury Secretary Henry M. Paulson announced the second stage of his capital markets competitiveness action plan, he argued that the United States needed a "modern regulatory structure [for financial services] complemented by market leaders embracing best practices." At a speech at AEI in November, Robert Steel, under secretary of the treasury for domestic finance, said that the department would be "bold" in its recommendations. A bold approach to reforming the financial services regulatory structure is certainly necessary if the United States is to maintain its position in the globalizing and competitive world of financial services.

AEI research assistant Karen Dubas and editorial assistant Evan Sparks worked with Mr. Wallison to edit and produce this Financial Services Outlook.

Notes

1. Department of the Treasury, Notice and Request for Comments, "Review by the Treasury Department of the Regulatory Structure Associated With Financial Institutions," *Federal Register* 72, no. 200 (October 17, 2007): 58939–41.

2. Peter J. Wallison, "Thinking Ahead: Treasury Prepares to Lay Down a Marker for the Future (Part 1)," *Financial Services Outlook* (October 2007), available at www.aei.org/publication27029/.

3. Ibid., 3–5.

4. Ibid., 4.