# Proposal for a Lead Federal Financial Services Regulator and State Regulation of Financial Planners

The three main branches of the financial services industry (banking, securities, and insurance) have evolved and been regulated separately for much of their individual histories. However, the recent consolidation of financial institutions and the growth of the financial planning profession present support for a more unified regulatory approach. This paper, after reviewing the historical and current regulatory framework of the financial services industry, proposes and builds a case for a lead financial services regulator whose role is to coordinate certain functions at the national level and oversee other functions at the state level.

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## Introduction

The three main branches of the financial services industry (banking, securities, and insurance) evolved and have remained fairly separate for much of their individual histories. Regulation of financial services has followed a similar approach. However, the growth of financial conglomerates, the fading distinctions among financial institutions, and the emergence of the financial planning profession all support the need for a more unified approach to regulation. This paper addresses the rationale for market intervention, historical and current regulation of the financial services industry, problems with the current regulation, and how it could be improved by creating a federal lead financial services regulator and by regulating financial planners at the state level.

## Rationale for Financial Market Intervention

Dale and Wolfe (2003) identify three purposes of financial regulation: 1) to protect consumers, 2) to encourage prudent behavior of financial institutions, and 3) to maintain confidence and integrity in the financial markets. These objectives provide the justification for market intervention (2003). It is assumed that consumers cannot adequately analyze the financial solvency of a firm, making it difficult to select a safe depository institution. In order to protect consumers from the negative repercussions of this information asymmetry, insurance provisions are established to reimburse any deposits lost from an insolvent firm.

Providing financial firms with depositor insurance gives rise to morale hazard because firms are more likely to make risky decisions, especially if consumers cannot adequately assess the financial situation of a firm. Without oversight, riskier firms would drive financially sound firms out of the market, as is the case in similar situations in other industries (Akerlof, 1970). Regulation is needed to encourage prudent behavior among financial firms, which would reduce potential losses to consumers.

The potential for systemic risk, especially among financial firms, also motivates regulation (Merton, 1995). Dale and Wolfe (2003) describe the potentially devastating effects of a “contagious collapse of otherwise healthy firms” (p.201), which separates the financial industry from any other. Evidence of such a contagious event can be seen in the recent economic events, suggesting inefficiencies in the current policy.

The same purposes for regulation that Dale and Wolfe (2003) outline also apply to the financial planning industry. According to economic theory, markets are efficient and in equilibrium when scarce resources flow to their most productive use. In such a market, consumers choose financial planners who provide the highest quality at a given price, so only the most productive financial planners stay in business. Because financial planning requires specialized knowledge, it is difficult for consumers to assess the quality of a planner, as is the case with credence goods (Nayyar & Templeton, 1994). The uncertainty in the quality of financial planning services is complicated by professionals using similar job titles though they operate under different regulations (Hung, Clancy, Dominitz, Talley, Berrebi, & Suvankulov, 2008). Because consumers cannot adequately identify the quality of a planner, less financial planning is demanded at a given price than otherwise would be with more information (Akerlof, 1970). Lower quality financial planners benefit in this environment and drive higher quality planners to exit the industry.

Regulating financial planners protects consumers from the negative effects of this information asymmetry. According to agency theory (Jensen & Meckling, 1976), financial planners incur bonding costs (e.g. exposure to torts, acceptance of a code of ethics) to provide assurance that they will act in the best interest of the client.

Regulation that decreases the agency costs to consumers (or increases costs to planners for not acting prudently) results in an increase in consumer welfare.

**Current Regulation of the Financial Services Industry**

The most complicated financial regulatory structure is found within the banking industry because of the numerous regulators. The largest and oldest regulator in the banking industry is the Office of the Comptroller of the Currency (OCC), which is responsible for federally chartered banks. Created by the National Currency Act of 1863, the OCC is part of the Treasury Department and now works closely with the FDIC in regulating the majority of the banking industry (Office of the Comptroller of the Currency).

The Federal Reserve System (the Fed) was instituted in 1913 by the Federal Reserve Act. The Fed serves as the central bank for the nation and is responsible for a number of financial institutions, including bank holding companies and private state banks that are members of the Federal Reserve System. The Fed also coordinates international efforts in banking regulation (The Federal Reserve Board).

Another regulatory arm of the banking industry is the Federal Deposit Insurance Corporation (FDIC). The FDIC was established by the Banking Act of 1933 (also referred to as the Glass-Steagall Act) in order to build public confidence in deposit institutions. The FDIC is the main regulator of state-chartered banks that do not become members of the Federal Reserve System and also serves as a secondary regulator of Fed-member banks (Federal Deposit Insurance Corporation).

Other regulators have also been implemented over time, typically in response to disruptions in a section of the financial industry. The National Credit Union Administration (NCUA) has evolved over time from other organizations, and it oversees and charters credit unions at the federal level (National Credit Union Administration). In response to the savings and loan crisis in the late '80s, the Office of Thrift Supervision (OTS) was established in 1989, to regulate the savings and loan, or thrift, industry (Office of Thrift Supervision).

Quite different from the banking industry, the insurance industry is regulated solely on the state level. In 1851, New Hampshire became the first state to regulate insurance, though it was not officially declared a state responsibility until the McCarran-Ferguson Act in 1945, and was reiterated in the Financial Modernization Act of 1999. Though it has no actual regulatory authority, the National Association of Insurance Commissioners (NAIC) was organized in 1871 to serve as a federal aid to state commissioners. As with any regulation, the main goal is to protect consumers; with insurance regulation at the state level, companies (and regulators) can better respond to the individual needs within the state (National Association of Insurance Commissioners).

The securities and investments industry is the most recent branch of the financial services industry to be regulated. Seeing a need for increased investor protection after the crash of 1929, the U.S. Securities and Exchange Commission (SEC) was created by the Securities Act of 1933 and the Securities Exchange Act of 1934. The SEC oversees the creation, sale, and exchange of securities and derivatives. Additional concern for proper investment advice led to the passage of the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, which gave the SEC the added responsibility of investment management companies. Much later, largely due to the Enron collapse, the Sarbanes-Oxley Act of 2002, created the Public Company Accounting Oversight Board (PCAOB), which oversees the auditing of public companies (U.S. Securities and Exchange Commission).

Because of the growth of the securities and investments industry over much of the last century and without a budget increase to meet the demand, the SEC struggled to meet its regulatory obligations (Macey, 2002). As a result, Congress passed the Investment Advisers Supervision Coordination Act as part of the National Securities Markets Improvement Act (NSMIA) of 1996 (Macey). This provided for the division of regulatory responsibilities of investment advisory firms between the federal and state levels. Smaller firms would register with state regulators, and the SEC would continue to monitor larger firms (Macey).

Unlike the three main branches of the financial services industry, financial planners have followed a more functional approach to regulation. They are subject to different regulation, depending on the individual activities performed (Macey, 2002), and the need for additional regulation of financial planners to further protect consumers is the subject of ongoing debate (Gray, 1994; Black, 2005; Hung et al., 2008). The majority of financial planners are regulated as investment advisers, and therefore regulated by the SEC or a state regulator. However, many financial planners are also registered representatives of a broker-dealer, which makes them subject to dual regulation as an investment advisor and as a broker-dealer. Other planners may be registered with their states as insurance agents and are subject to state insurance regulators. Other professionals, such as accountants and attorneys, offer financial planning services and are regulated under their respective state professional bodies as long as any investment advice is "solely incidental" to the practice of their profession. If accountants or attorneys hold themselves out as financial planners, they are also subject to applicable state and federal regulations.

The aforementioned description of the financial regulators is not designed to be all inclusive, though it serves to illustrate the complexity of regulation in the financial services industry. No doubt other regulatory authorities exist, including self-regulatory organizations, with varying degrees of involvement with those listed previously. Similarly, it is assumed additional regulatory bodies exist to enforce other legislative acts, including the Employee Retirement Income Security Act (ERISA) and the Pension Protection Act (PPA).

## Problems with Current Regulation

One of the main problems with the current regulatory approach is that each branch of the financial services industry is regulated separately, and multiple regulators exist within each branch. The fractured regulatory system also complicates the ability to adequately regulate financial planners. Such an environment of similar yet divided regulatory requirements allows multiple options from which firms can choose how they would like to be regulated (White, 2002). If firms can accomplish the same thing under various regulators, then they will likely choose to charter under the least restrictive approach, thereby overburdening the most lax regulator, skirting more restrictive regulators, and thus undermining the very purpose of regulation.

Though it has flaws, the fractured approach may have been adequate, until the passing of the Financial Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act (GLBA). GLBA sets guidelines for financial institutions that cross the traditional barriers among the banking, securities, and insurance industries (Macey, 2002). Such mergers had begun in the U.S. on a large scale prior to GLBA. Perhaps most noteworthy was the merge of Citicorp and Travelers Insurance Group in 1998, which contributed to the final passing of GLBA the following year (Carow & Heron, 2002). As such, the U.S. could better respond to the global "consolidation of the financial services industry" (Berger, Demsetz, & Strahan, 1999, p.135), though it blurred the historical distinctions in the industry (Carow & Heron, 2002; Macey, 2002) and possibly expanded the practice of selecting a preferred regulator.

Not only did passing GLBA open some potentially undesirable options for financial firms, it also created a theoretical shift in regulatory policy, moving towards a more functional regulation approach (Macey, 2002). Regulators are now more responsible for specific actions performed within a firm, rather than for entire firms. In this sense, functional regulation creates a myopic view of a company, allowing for problems to exist outside the scope and view of any one regulator, allowing for problems to go unnoticed and unchecked. A functional approach to regulation does not work well with financial conglomerates (Briault, 1999) and complicates the regulation of financial planners, who cover a wide spectrum of activities (Macey, 2002).

Lacking a single regulatory regime for financial planners also creates confusion for consumers, who typically do not recognize financial planning as a distinct profession (Regulation Task Force, 2006). Further confusion arises because several different groups, including broker-dealers, investment advisers and insurance agents, may hold themselves out as a "financial planner," "financial adviser" or "financial consultant," despite the fact that each group is regulated differently and likely to provide different services, resulting in varying qualities of financial planning (Hung et al., 2008).

Adding to the problems with the current approach to regulation are the constrained budgets of the federal regulators. In many instances, they simply are not able to provide the intended oversight because they lack proper funding (see Gray, 1994; Macey, 2002). Part of the reason for the division of federal and state responsibilities for investment advisers was because the SEC lacked the resources to perform routine inspections (though it left states to find a way to fund their own regulations). Without adequate funding, or at least a more efficient use of funds, the mandated regulation of the financial services industry simply will not take place.

## A Single Federal Financial Services Regulator

The solution to the fractured nature of the federal regulatory environment could rest in the creation of a single national financial services regulator. The United Kingdom took this approach by passing the Financial Services and Markets Act. The process began by changing the name of the Securities and Investments Board to the Financial Services Authority (FSA) in October 1997, and, over time, began merging other regulatory bodies into the newly-formed FSA (Briault, 1999). The rationale was that it is costly and inefficient to have individual regulators, especially as the lines defining the particular components of the industry continue to fade. This new policy allows the FSA the ability to adapt to changes in the market, while still being governed by Parliament (Briault).

Essentially, the reasoning for such a dramatic change is to improve efficiency and to limit regulation to the degree it is purported to be beneficial.

The benefits of having a single national financial services regulator are quite apparent. First, reducing the number of regulators to which large financial conglomerates must answer not only increases the efficiency of those conglomerates, but it arguably provides better oversight (Briault). Coordinating the regulatory efforts of these conglomerates, especially those with banking, securities, and insurance subsidiaries, while also providing a regulator to supervise the entire picture of the financial holding company would seem to greatly improve the regulatory regime (Goodhart, Hartmann, Llewellyn, Rojas-Suarez, & Weisbrod, 1998). Since such financial holding companies are now allowed to cross the traditional barriers, a unified regulatory approach would provide greater oversight.

Not only would coordinated efforts be improved but communication and cooperation would also improve (Briault, 1999). With the current approach, it is difficult to know how much information is actually shared with other regulators. Working with a single regulator would allow for cooperated efforts and quicker, if not enhanced, communication.

Another benefit comes from the need to adapt to the increasingly dynamic environment of the financial services industry. Since the distinctions among the individual sectors of the industry are blurring, it is becoming more difficult to differentiate companies (Briault), and consequently more difficult to decide who should regulate whom and where the responsibility of one regulator stops and another begins. A single regulator would alleviate these problems.

One of the other growing needs of financial regulators is to coordinate regulatory efforts with other nations for international firms (Briault). Growing globalization and technological advances have allowed more firms to have divisions of their companies in other countries. Calomiris & Litan (2000) even suggest that the financial industry is driving globalization. If that is true, a single regulator would allow for easier cross-border cooperation.

Lastly, a single federal financial services regulator would provide a place where financial planners could be regulated. Since comprehensive planners deal with all three branches of the financial services industry, a single regulator seems most appropriate. Providing a means for more adequate financial planning regulation would better protect the public from scrupulous planners because it would then be possible to bar such planners from practicing. In turn, public confidence would grow, thus allowing the financial planning profession to grow as well.

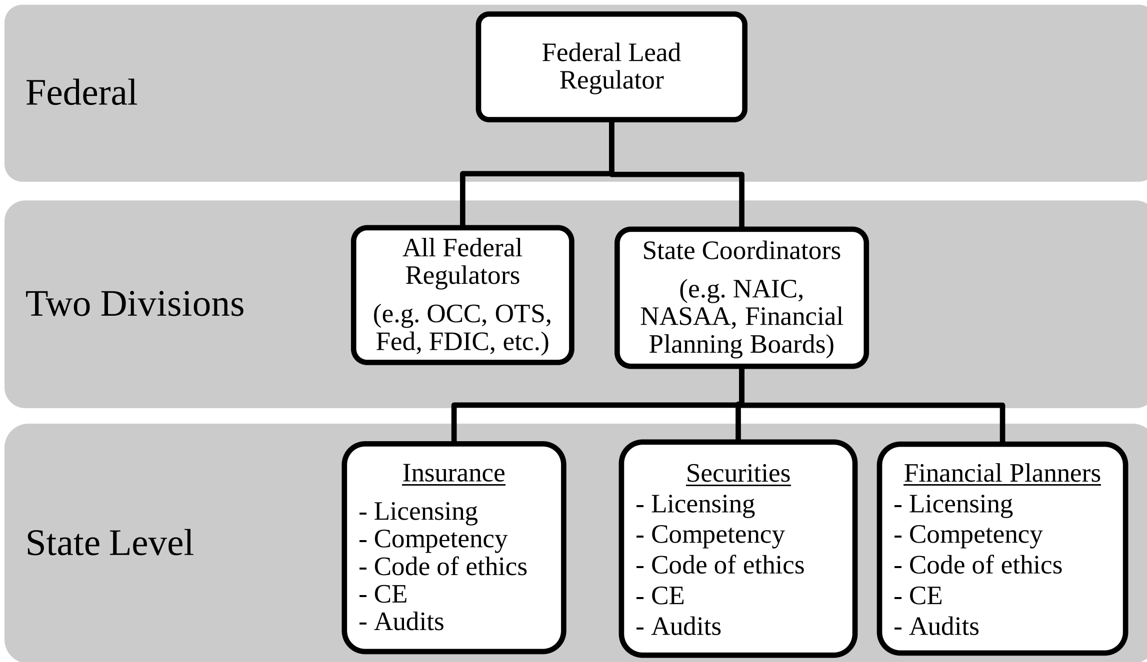
With so many benefits, a single regulator would seem to be the ideal solution to the current problems in the financial industry. However, there are some possible concerns that may arise. Merton (1995) expresses concern that giving all the power to one regulator can be risky. If the regulator inaccurately decides a new innovation is inappropriate, it would be completely blocked from the market. Such would be the case, even when the new product could have been beneficial. At the same time, a fractured regulatory regime can also allow questionable products to be developed and marketed. The underlying argument is whether consolidation or competition in regulation leads to a more desirable outcome (Merton, 1995; White, 2002). Because firms are already moving towards a more integrated and consolidated model, it would naturally follow that subjecting these new financial conglomerates to multiple layers of regulation would likewise inhibit their ability to operate most efficiently.

The idea of optimal efficiency, however, is not always the goal of government, or its regulators, and that may be the main reason why a single national financial services regulator would be nearly impossible to implement in the U.S. While the single financial services regulator may work in the U.K., the U.S. is fundamentally different than the U.K. The U.K. is built on the idea of a strong central power. The U.S. Constitution, however, reserves for the states all powers not explicitly given to the federal government (see Amendment 10). As discussed previously, states are already responsible for insurance and state chartered banks, and most states have also taken responsibility of smaller investment advisory firms. Though a unified, and therefore centralized, regulatory system would be more efficient, a single federal financial services regulator might not be possible in the U.S due to the inherent division of power between the state and federal levels.

## A Lead Federal Financial Services Regulator

Given the political environment of the U.S., perhaps a more appropriate approach would be a federal lead regulator, organized to coordinate the efforts of the underlying regulators. Under such a model, two divisions could exist. The first division would serve to merge all the federal regulators into one organization, which would approximate the single federal regulator described earlier. The second division would serve to merge all the federal level coordinators of state regulators into one organization. This general framework is displayed in Figure 1.

Figure 1. Proposed Federal Lead Regulator Framework




Though some efficiency would be lost, the lead regulator approach seems to be the most fitting solution for the current regulatory system. This would better serve to coordinate the efforts of regulating the industry while benefitting from the economies of scale typically found in private mergers (Briault, 1999). The two divisions would also provide a coordinated effort between the federal and state regulators, while also providing a check of power for each other. Ideally, because the new organization would have the combined financial, capital, and human resources of the underlying organizations, each of the divisions would feel less pressured by budget constraints and would be able to better perform what they were created to do.

It is very possible that the benefits outlined previously will not actually come to fruition. Though improved efficiency is the main goal of such a change, it is possible that a lead regulator would not enhance current regulation, and instead simply creates more administration at the federal level without an added benefit. However, even if resources are not used more efficiently, it is possible that the lead regulator model would prevent future upsets in the financial markets, and thereby reducing welfare loss. Ideally, the lead regulator model would not add additional costs because the fixed costs of the underlying regulators would be shared among the merged divisions.

## State Regulation of Financial Planners

Another great benefit of creating a lead federal financial services regulator is that there would be a place for financial planning regulation, at either the federal or state level. As mentioned previously, this would provide a single regulator of the financial planning profession, which would improve the overall quality of practitioners and better protect the public. While a federal regulator of financial planners may be ideal (as may be the case with the single federal financial services regulator), it may be most feasible and effective if implemented at the state level, for reasons outlined previously. State financial planning regulators could require all who hold themselves out as a financial planner to license within the respective states where they do business, similar to that required by accountants, attorneys and other well regarded professions (Regulation Task Force, 2006). While most states currently regulate financial planners as investment advisers, they do not regulate the financial planning process as a whole. Adopting a state licensing requirement will likely build public confidence and reduce uncertainty about the quality of the services being provided, resulting in an increased demand for financial planning services.

State licensing requirements for personal financial planners could mirror the models used by the accounting and law professions. Every licensed attorney must pass a state bar examination, seek continuing education credits, abide by a strict rule of professional conduct, and most states require attorneys to graduate from an accredited law school and passed a professional responsibility exam (Macey, 2002). State Boards of Accountancy, working with the American Institute of Certified Public Accountants (AICPA) regulate the licensing of certified public accounts (CPA) and those who hold themselves out as practicing accountants in a similar fashion. Likewise, the Regulation Task Force (2006) recommends that state licensing requirements for those who hold themselves out as a financial planner should at least have the following:

- Evidence of competency as manifested by exam, education and experience requirements
- Certified Financial PlannerTM (CFP®) Code of Ethics as a baseline ethics standard
- Continuing education requirements
- Peer review audits

These requirements would increase the costs associated with becoming a licensed financial planner, thereby preventing lower quality planners and those only specializing in one aspect of financial planning from holding themselves out as financial planners. This should help build financial planning as a distinct profession and reduce the uncertainty that consumers face in selecting qualified financial planners. Figure 1 displays the regulatory framework of the state may oversee this process.

A bill built on these ideas was proposed before the Pennsylvania General Assembly in 2005. House Bill 2179 would have required financial planners to be licensed in the state and established a State Board of Financial Planners to regulate the industry (Regulation Task Force, 2006). While the bill did not pass, it provides a framework on which to build to establish financial planning as a distinct profession at the state level, similar to that of accountants and attorneys.

Some limitations do exist to establishing state licensing requirements for financial planners. First, because those holding themselves out as financial planners come from banking, insurance, broker-dealer, investment advisor and other backgrounds, it will be difficult to garner the political capital necessary to see a state licensing bill come to fruition. However, this may be easier to accomplish at the state level than at the federal level. Second, even if states were able to adopt licensing requirements, financial planners would likely self-select to license in states with less stringent requirements. To address this issue, states can require financial planners to license in their state in order to serve clients in that state, similar to the approach used in the accounting profession.

## Conclusion

Because the financial industry in our country evolved separately and over time, we have created a disjointed regulatory system to oversee the previously distinct financial institutions. With a growing number of financial conglomerates and international firms, and an increasing trend towards overlap among the functions of financial firms, there is a greater need for regulatory coordination. In addition, the financial planning profession continues to grow, and there is currently no single regulatory body adequate to regulate the profession. Though a single federal financial services regulator may be desirable, it would be difficult to implement given the division of power between the federal and state levels. Creating a lead federal financial services regulator would serve to coordinate the regulation at the federal and state levels and provide improved oversight of the financial services industry. Lastly, the lead federal financial services regulator model would provide a place to coordinate state efforts to regulate those holding themselves out to be financial planners.

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