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Statement of the Shadow Financial Regulatory Committee on

Federal Preemption for Financial Services Firms

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Since the adoption of the Constitution, the allocation of regulatory authority between the federal government and the states has been a matter of significant controversy. In the area of financial services, there are completely different rules governing whether banks, securities firms and insurance companies are regulated at the federal or state level, or both. In banking, both the national government and the states charter and regulate banks. For national banks, federal law allows the regulator of national banks, the Comptroller of the Currency (OCC), to preempt state law. In insurance, only the states have regulatory authority; and in the case of securities both the federal government and the states have regulatory powers. The courts have recognized that federal policies and regulations, in some circumstances, may preempt inconsistent state laws and regulations, even when Congress has not explicitly authorized preemption.

In the last decade, federal preemption of state regulation has become a significant and controversial issue. This may have been driven by the fact that the market for financial services is national in scope, with banks, securities firms and insurance companies all vying for customers on a national playing field. The Committee believes that, like national banks, insurance and securities firms should have the option to choose a federal regulatory regime that will have the same preemptive authority currently available to the OCC.

Preemption in the Dual Banking System

Since 1863, banks have had the choice of whether to be chartered by the national government or the states. Under the National Bank Act, national banks are chartered and supervised by the OCC, part of the Treasury Department, which has the power to issue regulations that preempt state law, including the power of the states to investigate and bring actions against national banks. Despite the federal regulatory role for national banks, the states have continued to have the power to charter banks that are regulated in part at the state level and subject to all laws of the chartering state and those of other states in which they may do business. State chartered banks are subject to some federal regulation if they are members of the Federal Reserve System or insured by the Federal Deposit Insurance Corporation (FDIC).

Concurrent Federal and State Regulation of Securities Firms

The two principal securities laws, the Securities Act of 1933 and the Securities Exchange Act of 1934, regulate both the participation of securities firms in the offering of securities and the market conduct of securities firms and exchanges. When enacted, neither of these two cornerstone Acts explicitly preempted state law. In recent decades, however, the trend has been toward more federal preemption, as Congress concluded that state regulation was interfering in the functioning of an efficient national capital market.

In 1996, Congress preempted most state authority over SEC registered investment companies, the distribution of stock of publicly listed companies and regulation of broker-dealers with respect to capital, custody, margin, financial responsibility, records, bonding and reporting requirements, although Congress specifically preserved the authority of state officials to investigate and bring enforcement actions with respect to fraud or unlawful conduct by a broker-dealer.

Under this partial preemption regime, state attorneys general have been relatively free to use state civil and criminal anti-fraud statutes to attack allegedly fraudulent business practices of securities firms and to use enforcement actions that have had a significant effect on the regulation and structure of the securities industry.

State Regulation of Insurance Firms

Insurance regulation occurs almost entirely at the state level, with no federal agency having any authority in the area. This system of state regulation has raised a number of problems for insurance carriers, most notably rate regulation, a form of regulation now largely absent from other areas of financial services, and conflicting and overlapping state laws on product introduction and innovation. As a result, legislation has now been introduced in the Senate (S.2509) that would create an optional federal charter for insurance companies, providing a basis for implicit or explicit preemption of state laws and regulations for those insurance companies that seek and are granted a federal charter.

Federal Primacy: A Modern Necessity

In the Committee's view, there are several important reasons why the federal government should have primacy in the regulation of financial services. To be sure, there are strong arguments for retaining state regulatory authority that is intended to protect state residents, especially in cases where the federal government's activities may be deficient.

However, for the following reasons, the Committee believes that the benefits of a single set of federal rules, applicable to all financial services companies, outweigh the costs of preempting state authority: .

- It is important to recognize that a financial services company offering its products or services in a national market can incur substantial costs to comply with 51 different state regulations and legal requirements. These costs are inevitably passed on to the financial services consumer.
- As a practical matter, firms, and particularly insurance companies, are often required to structure their product offerings so as to comply with the rules of the most restrictive state, creating a situation in which the policies of a single state in effect preempt national policies and rules or encroach on the interests and regulatory policies of other states.
- In the case of securities, because the largest nationally active firms all operate in New York, that state's regulatory and enforcement officials have the opportunity to exercise more power than the federal government over the regulatory policies applicable to securities firms operating nationally.
- In some cases, state rules can be inconsistent, making it impossible for a company that operates on a national level to offer the same product or service in every state.
- Although the recent actions by state attorneys general have attracted a great deal of national attention, in the Committee's view the long term record of federal agencies in protecting the interests of consumers has been good. In particular, we cite the work of the federal banking agencies—the Comptroller of the Currency, the FDIC and the Federal Reserve—as examples of effective national regulation of

the banking industry that has been responsive to the needs of consumers of banking services.

- A single set of U.S. rules at the federal level will encourage more activity in the U.S. by foreign firms and thus more competition for U.S, companies, to the benefit of U.S. consumers.

Extension of the National Bank Model to National Financial Firms

The dual regulatory structure that currently prevails in banking provides a useful model for a future system of federal preemption in other areas of financial services. In the banking system, banks can opt for either federal or state regulation. Accordingly, for insurance companies, the Committee endorses the optional federal chartering proposal advanced this year by Senators John Sununu and Tim Johnson as S.2509. At a later time, the Committee will review this legislation in detail.

Our proposal for securities firms is somewhat different. Securities firms are required to register with the SEC, and in doing so they could be given the option to be bound either by state or federal rules governing their business conduct. This would provide companies that intend to operate nationally with a consistent set of federal rules, while those that do not want to operate outside a few states may remain subject to state regulation.

The most forceful reason for the retention of state power is the need for a backup for enforcement when the federal government fails to do its job. If state officials believe there is a lack of enforcement they have a number of options, including invoking media attention, complaining to Congress and the agency involved. Under some circumstances, state authorities may or could be empowered to bring actions on behalf of their residents against a federal agency that has failed to enforce its regulations. The federal government should provide its agencies with sufficient funds vigorously to pursue the enforcement of federal regulations, and consideration should be given to delegating federal authority to state bodies in particular cases.

The Committee has never been an advocate of increasing federal power. We recognize the virtues of federalism. However, we also recognize that state regulation that is inconsistent with federal policy can disrupt and fragment what should be an efficient national market for financial services. When the financial services industry was made up primarily of local banks, insurance companies and securities firms, it made sense that the primary regulation would occur at the state level. Now that the industry operates nationally, it should be regulated under a consistent set of national policies.