The Regulation of Non-Bank Financial Institutions

The United States, the European Union, and Other Countries

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(Continued on the inside back cover)
The Regulation of Non-Bank Financial Institutions

The United States, the European Union, and Other Countries

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Paula Pertunen

The World Bank
Washington, D.C.
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There has been a tremendous growth, worldwide, in the mobilization of financial resources outside traditional banking systems. Much of this channeling of savings is taking place through capital markets. A variety of new, non-bank financial institutions have sprung up to provide the financial services associated with capital markets. Some have investment bank characteristics, such as securities brokers and dealers or universal banks. Others manage the money of clients, such as investment companies, mutual funds, pension funds, and bank trusts. Many hybrid non-bank financial institutions provide a broad range of financial services. Depending on regulatory considerations, individual financial institutions may offer both bank and non-bank financial services.

Such rapid financial diversification is posing new challenges for regulators in many emerging markets. There are different risk factors involved with each of the new financial services, and, from a public policy standpoint, potential for conflicts of interest that must be taken into account in their regulation. This discussion paper describes the regulatory framework adopted in some mature market economies, and also discusses regulatory issues that have arisen in some emerging markets. These issues present options for policy makers in developing economies. At the request of the Non-Bank Financial Institutions Department of the People's Bank of China, the principal regulator of both banks and non-bank financial institutions, the China and Mongolia Department of the World Bank organized a seminar on the regulation of non-bank financial institutions, in Beijing, China in April 1996. The paper draws on material assembled for presentation at the seminar, and has important contributions from the World Bank's Financial Sector Development Department. Another volume based on the seminar, which is being published in parallel, describes some of China's new hybrid non-bank financial institutions, their role in the financial sector, and the regulatory issues they face.

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Director
China and Mongolia Department

Jonathan Fiechter
Director
Financial Sector Development Department
Abstract

This paper first briefly describes the enormous growth of non-bank financial institutions in recent years, the situation of non-banks in the financial systems of different countries and the challenges that such institutions pose for risks in financial systems. Part II then proceeds to a detailed examination of regulation and supervision of non-bank activities and institutions, primarily in the US, but also in many emerging markets. In the US, commercial banks and bank holding companies have been permitted, since the late 1980s, to offer a wider range of financial services, due to more liberal interpretations of the provisions of the Banking Act of 1933 (the Glass-Steagall Act), and the Bank Holding Company Act of 1956. Commercial banks are supervised by Federal and state bank supervisory authorities. Investment funds, as defined by the Investment Company Act of 1940, and securities broker-dealers, who fall under the Securities Exchange Act of 1934, are regulated primarily by the Securities and Exchange Commission (SEC). There are separate regulatory structures for individual and collective trust departments, private pension plans, and insurance company separate accounts.

In Part III, the paper examines European Union regulation of non-bank financial activities and institutions. European Union legislation aims to create a minimum level of uniformity between the legal systems of individual member states in each subject area. Regulations regarding non-bank financial institutions (NBFIs) in European Union legislation are covered in the relevant Banking Directives. Their regulation is thus indirect, consisting mainly of provisions aimed to protect the banking system from undue NBFI influence. The most significant regulations are requirements for a supervisable group structure and supervision on a consolidated basis, including capital adequacy requirements, restrictions on banks' holdings, and restrictions on large exposures.

The European Union legislation represents a minimum common set of regulatory standards for all member countries. Member states however are free to determine their own supervisory structures and institutions and these vary considerably across countries. It must be pointed out, as a consequence, that direct comparisons between the EC model and the US model are thus not appropriate.
Acknowledgments

This report is based largely on material prepared for a seminar on international experience regarding the regulation and supervision of non-bank financial institutions, with special reference to China's Trust and Investment Companies. The seminar was held in Beijing, in April 1996, at the request of the Non-Bank Financial Institutions Department of the People's Bank of China.

The contributors to this report are Terry Chuppe (consultant; principal author of Part II, on legal and regulatory systems for non-bank financial institutions in the US and other countries), Paula Pertunen (World Bank, FSD; principal author of Part III, on legal and regulatory systems for non-bank financial institutions in the European Union), and Anjali Kumar (World Bank, team leader). Natasha Beschorner (World Bank) worked extensively on the editing of all parts of the text. The team would like to acknowledge the support and cooperation of the NBFI department of the People's Bank of China, in particular, Deputy Directors Xie Ping and Pang Zhe Yi. Neither the preparation of the mission nor the final report would have been possible without the excellent support of Adelma Bowrin.

The report benefited from comments received on an earlier draft, reviewed in Washington in October 1996, and from a review held in the Financial Sector Development Department of the World Bank, in January 1997. Detailed comments from Richard Roulier, Vikram Nehru, Constantijn Claessens, Fernando Montes-Negret and Noritaka Akamatsu are acknowledged and reflected, together with comments sent from the World Bank Beijing office. Finally, the report also reflects a further informal discussion meeting with the People's Bank of China, in November 1996, attended by staff from various departments of the People's Bank.
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC</td>
<td>Agricultural Bank of China</td>
</tr>
<tr>
<td>ACM</td>
<td>Alternative Capital Method</td>
</tr>
<tr>
<td>AFP</td>
<td>Administradoras de Fondos de Pensiones (Chile)</td>
</tr>
<tr>
<td>BCCI</td>
<td>Bank of Credit and Commerce International</td>
</tr>
<tr>
<td>BCM</td>
<td>Basic Capital Method</td>
</tr>
<tr>
<td>BITIC</td>
<td>Beijing International Trust and Investment Company</td>
</tr>
<tr>
<td>BOC</td>
<td>Bank of China</td>
</tr>
<tr>
<td>BSP</td>
<td>Banco Sentral ng Pilipinas</td>
</tr>
<tr>
<td>CAD</td>
<td>Capital Adequacy Directive</td>
</tr>
<tr>
<td>CAMEL</td>
<td>Capital-Assets-Management-Equity-Liquidity</td>
</tr>
<tr>
<td>CD</td>
<td>Certificate of Deposit</td>
</tr>
<tr>
<td>CITIC</td>
<td>China International Trust and Investment Company</td>
</tr>
<tr>
<td>CITICED</td>
<td>China Trust and Development Corporation for Economic Development</td>
</tr>
<tr>
<td>CMB</td>
<td>Capital Markets Board (Turkey)</td>
</tr>
<tr>
<td>CNB</td>
<td>Comision Nacional Bancaria (Mexico)</td>
</tr>
<tr>
<td>CNBV</td>
<td>Comision Nacional Bancaria y de Valores (Mexico)</td>
</tr>
<tr>
<td>CNV</td>
<td>Comision Nacional de Valores (Mexico)</td>
</tr>
<tr>
<td>COS</td>
<td>Confirmation of Sale</td>
</tr>
<tr>
<td>CSRC</td>
<td>China Securities Regulatory Commission</td>
</tr>
<tr>
<td>CTFC</td>
<td>Commodities and Futures Trading Commission</td>
</tr>
<tr>
<td>DTC</td>
<td>Deposit Taking Company</td>
</tr>
<tr>
<td>ECU</td>
<td>European Currency Unit</td>
</tr>
<tr>
<td>EEA</td>
<td>European Economic Area</td>
</tr>
<tr>
<td>EEC</td>
<td>European Economic Community</td>
</tr>
<tr>
<td>EFTA</td>
<td>European Free Trade Association</td>
</tr>
<tr>
<td>ERISA</td>
<td>Employee Retirement Income Security Act</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
</tr>
<tr>
<td>FSSO</td>
<td>Federal Securities Supervisory Office (Germany)</td>
</tr>
<tr>
<td>GSA</td>
<td>Government Securities Act</td>
</tr>
<tr>
<td>ICBC</td>
<td>Industrial and Commercial Bank of China</td>
</tr>
<tr>
<td>ICBC TIC</td>
<td>Industrial and Commercial Bank of China Trust and Investment Company</td>
</tr>
<tr>
<td>ISE</td>
<td>Istanbul Stock Exchange</td>
</tr>
<tr>
<td>KSEC</td>
<td>Korean Securities and Exchange Commission</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>NASD</td>
<td>National Association of Securities Dealers</td>
</tr>
<tr>
<td>NBFI</td>
<td>Non-Bank Financial Institution</td>
</tr>
<tr>
<td>NCUA</td>
<td>National Credit Union Administration</td>
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<tr>
<td>NPC</td>
<td>National People’s Congress</td>
</tr>
<tr>
<td>OCC</td>
<td>Office of the Comptroller of the Currency</td>
</tr>
<tr>
<td>OTS</td>
<td>Office of Thrift Supervision</td>
</tr>
<tr>
<td>PBC</td>
<td>People’s Bank of China</td>
</tr>
<tr>
<td>PCBC</td>
<td>People’s Construction Bank of China (now China Construction Bank)</td>
</tr>
<tr>
<td>PCBC TIC</td>
<td>People’s Construction Bank of China Trust and Investment Company</td>
</tr>
</tbody>
</table>
PART I. Non-Bank Financial Institutions in the Financial Sector

An Introduction to Non-Bank Financial Institutions

There are two broad types of non-bank financial institutions (NBFIs). The first include securities broker-dealers, or similar organizations performing investment banking type functions, such as universal banks, merchant banks or trust and investment companies. These are involved in the mobilization of financial resources through the money and capital markets to meet the financing needs of business enterprises and government entities. They are in direct competition with the traditional commercial banking function of taking deposits and providing loans. The second type of non-bank financial institutions acts in the capacity of a fiduciary in managing the money of clients, usually by investing in financial market instruments.

In the first category, the most prominent NBFIs are the securities brokers and dealers who often provide a broad range of investment banking type services to issuers and investors. The second category of NBFIs include investment companies, mutual funds, pension plans, and bank trusts. Sometimes, individual NBFIs offer a broad range of financial services such as securities brokerage, dealing in government securities and corporate securities, and providing money management services on behalf of clients. Depending upon the legal framework, regulatory considerations, and institutional arrangements (i.e., the organization of the financial sector and structure of the financial markets), individual financial institutions may offer both bank and non-bank financial services. From a public policy standpoint, however, it is important to keep in mind that there are different risk factors involved and potential for conflicts of interest that must be taken into consideration in the regulation of such diverse financial entities.

Growth of NBFIs. In the US, NBFIs have played an important role in mobilizing savings and allocating such funds to their most productive uses. NBFIs have experienced rapid growth over the past several decades. From 1960 to 1994, US institutional investors' assets grew from US$118 billion to US$10.3 trillion. Institutional investors have contributed to the growth and maturation of the US capital market, spawning the development of new financial products and services. As a percent of total securities outstanding in the US capital market, institutional assets grew from 20 percent of securities outstanding in 1960 to 67 percent in 1994. Private pension funds have ranked among the fastest growing institutional investors. Since the 1950s, their rate of growth has been almost twice as fast as other types of institutional investors. From 1960 to 1994, pension fund assets grew from US$58 billion to US$4.8 trillion. After pension funds, mutual funds are the next largest US institutional investor group followed by insurance companies and bank trust departments (Table 1 and Table 2).
Part I Table 1. Growth of Institutional Assets, 1950-94 (US$ billions)

<table>
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</thead>
<tbody>
<tr>
<td>Pension Funds</td>
<td>14</td>
<td>58</td>
<td>213</td>
<td>859</td>
<td>3,116</td>
<td>4,750</td>
</tr>
<tr>
<td>Bank Trust</td>
<td>-</td>
<td>-</td>
<td>187</td>
<td>342</td>
<td>759</td>
<td>1,250</td>
</tr>
<tr>
<td>Insurance Com.</td>
<td>74</td>
<td>43</td>
<td>225</td>
<td>519</td>
<td>1,328</td>
<td>1,780</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>3</td>
<td>17</td>
<td>48</td>
<td>135</td>
<td>1,067</td>
<td>2,161</td>
</tr>
<tr>
<td>Closed-End F.</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>5</td>
<td>53</td>
<td>120</td>
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<tr>
<td>Foundations</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>48</td>
<td>143</td>
<td>210</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>91</td>
<td>118</td>
<td>673</td>
<td>1,908</td>
<td>6,466</td>
<td>10,271</td>
</tr>
</tbody>
</table>


Part I Table 2. Securities Outstanding in US Capital Markets, 1950-94 (US$ billions)

<table>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Equities</td>
<td>142.7</td>
<td>425.0</td>
<td>859.8</td>
<td>1,534.7</td>
<td>3,530.2</td>
<td>6,048.8</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>41.4</td>
<td>91.8</td>
<td>204.3</td>
<td>508.4</td>
<td>1,696.0</td>
<td>2,416.9</td>
</tr>
<tr>
<td>Government Sec.</td>
<td>218.4</td>
<td>242.8</td>
<td>341.6</td>
<td>1,008.3</td>
<td>3,911.7</td>
<td>5,641.6</td>
</tr>
<tr>
<td>Municipal Bonds</td>
<td>42.7</td>
<td>71.0</td>
<td>145.5</td>
<td>365.4</td>
<td>1,039.9</td>
<td>1,202.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>445.2</td>
<td>830.6</td>
<td>1,551.2</td>
<td>3,416.8</td>
<td>10,177.8</td>
<td>15,310.0</td>
</tr>
</tbody>
</table>

*MEMO: Asset Backed Debt


The institutionalization of the savings and investment process has been a global phenomenon. In the 1990s, mutual funds based outside have grown as rapidly as those based in the US. In the industrialized nations, private pension plans have also become a significant institutional investor. Pension reform, however, is a more recent event in emerging markets. Thus, countries with emerging market economies have only limited experience in the regulation of private pension plans. Interestingly, even the US did not establish ERISA (Employee Retirement Income Security Act) until 1974 to provide a national regulatory framework for private pension plans.

The tremendous growth in money and capital markets in both developed and emerging financial markets led to the rapid securitization of financial transactions. As a result, NBFIs have come to play a larger role in mobilizing savings through the capital markets. The growth in the non-bank financial services industry in many countries has been more rapid than the deposit/lending activities of commercial banks. As a result, many banking institutions around the world have sought to diversify away from the more traditional commercial banking business that is, taking deposits and making loans, in order to concentrate more heavily on capital market activities such as: investment banking, acting as a broker or dealer in securities, operating a mutual fund, or engaging in money management services. Indeed, in international financial transactions, there has

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1 The assets of US mutual funds expanded by US$1.1 trillion between 1990 and 1994. However, mutual funds based outside the US grew by an almost equal amount (US$1.0 trillion). As a result, it is estimated that the total assets of open-end investment companies around the world increased from US$2.0 trillion in 1990 to US$4.1 trillion in 1994. Many of these funds invest outside their home market.
been a trend toward universal banking whereby investment banking and commercial banking services are offered within the same institution, or through affiliates.

**The Role of NBFIs in the Financial Sector**

The role of NBFIs in the financial sector has important implications for devising a regulatory framework. In this regard, it should be recognized that there are differences in risk between commercial banking and non-bank activities, particularly those involving capital market transactions. Risk will vary depending upon the economic functions performed by NBFIs. Acting as a dealer or underwriter in capital market instruments entails greater risk, for example, than engaging in brokerage, or money management services. This has important implications in establishing regulatory capital and other prudential standards.

A number of NBFIs and market practitioners are essential to the operation of a financial market. These include brokers, dealers, and underwriters of securities, investment advisors, credit rating agencies and institutional investors in the form of investment companies, insurance firms, pension funds, and bank trust departments. The functions of broker, dealer, or underwriter may be performed by specialized securities firms, investment banks, or by diversified financial firms offering a wide array of financial products, such as universal or merchant banks. Some countries permit both securities firms and universal banks to provide financial services. There are different forms of universal banking. In Germany, Switzerland, and Turkey, for example, banks may conduct investment banking operations from within the banking organization. In the UK, Canada, and Mexico, separate legal subsidiaries are the norm. In the US, commercial banks securities business is strictly limited by the provisions of the Banking Act of 1933. Generally today, while US commercial banks may not directly act as an underwriter and dealer in corporate securities, they may offer securities brokerage services, trust services, or act as a dealer in US Government and municipal securities.

In any event, the trend has been toward greater competition in the financial sector which can contribute to market efficiency and foster the development of a wide array of financial instruments for issuers and investors. But, it also creates a serious dilemma for the regulatory authorities in devising appropriate regulatory safeguards for highly complex financial congeneric, or even financial conglomerates. In Asia, some countries restrict the type of entities that can perform investment banking services such as underwriting, or may require different licenses for brokers and dealers in securities even if the same entity is performing such functions. Some countries also require the separation of the function of securities broker and dealer. This arrangement, however, may impede the development of the dealer or market maker function which can contribute to market liquidity.

In most emerging markets, individual investors are unsophisticated and lack investment experience. Yet, small investors often have little to choose from regarding investment management advice. The investment management industry has not had an opportunity to develop in many emerging markets due to the paucity of capital market instruments available for investment, lack of

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2 The recent trend toward diversification by US commercial banks into a wide array of financial services can be traced back to at least the early 1960s. This is not a unique development. During earlier periods (i.e., the 1920s) in the US financial history there have been similar moves toward financial diversification followed by regulatory interventions (i.e., the Banking Act of 1933) that resulted in restriction on the activities of commercial banks. See: Chuppe, Terry M. and Frank Tamagna, 'The Financial Congeneric', Banca Nacional Del Lavero Quarterly Review, Rome, June 1971.
investor awareness of the benefits of mutual funds or private pension plans, and the large amounts of capital that is immobilized in the form of a government sponsored social security and public pension schemes. In addition, the development of mutual funds, private pension schemes, trusts, and other forms of institutional investment has been hindered by the absence of laws and regulations that are necessary to provide clarity with respect to the rights and obligations of the providers and users of such money management services.

In many developed markets and in several emerging markets, the growth of institutional investment has been encouraged by government tax policy and a regulatory environment that has been conducive to the growth of the mutual fund industry and private pension plans. In the US, for example, basic safeguards mandated by the *Investment Company Act of 1940* have provided for a high degree of public confidence in mutual funds. Without a high level of public confidence, it is highly unlikely that the mutual fund industry would have experienced continuous and rapid growth over the past fifty years. Likewise, the enactment of the US *Employment Retirement Income Security Act of 1974 (ERISA)* contributed to the rapid growth of private pension plans by providing basic protection to plan participants. One important benefit to the capital market is that large amounts of funds are mobilized for long-term investment. Yet, the decision making process with respect to the administration of private pension plans are highly decentralized.

The development of private pension plans to supplement Government sponsored social security schemes or public pension plans is now being given a high priority in many emerging markets as well. Chile is most renowned for its efforts to link pension reform with capital market development. By de-centralizing the investment decision making process, this trend should result in greater liquidity and enhanced allocative efficiency in emerging securities markets. Favorable tax policy has contributed to the rapid growth of both private and public pension funds. Tax exempt contributions to the plans provide economic as well as social benefits. The deferment of taxes is essential to support the payment of employee benefits at retirement.

The boundaries separating commercial banking and NBFIs are less clear today than they once were in view of the trend in many countries toward commercial bank diversification into related financial services. In general, commercial banks tend to play a larger role in the money market and Government securities markets while investment banks, merchant banks, and securities firms more often serve as intermediaries in the capital market for private debt and equity securities.

Central banks often have assumed primary regulatory responsibilities for money market instruments. With respect to dealing in government debt securities, both commercial banks and non-bank dealers (i.e., securities firms) commonly play a significant role in the market. In many Asian emerging markets, there has been a tendency for banks to dominate the primary market in government debt with secondary markets normally being inactive. It is noteworthy that with respect to both the government and corporate debt markets, the dealers function is not well developed in most countries with new and emerging securities markets. Likewise, dealers and market-makers do not play a significant role in emerging equity markets.

In emerging markets, the role of banks versus NBFIs in the provision of financial services varies greatly. In Thailand, securities firms play a prominent role in the capital markets while commercial banks tend to specialize in more traditional commercial banking activities. In China, the passage of the *Commercial Banking Law of 1995* appears to require a separation of commercial banking and non-bank financial services. In the Philippines, Mexico, and Turkey, commercial banks have played a more dominant role in the financial sector. They are also providers of capital market services either directly, in the case of the Philippines and Turkey, or through affiliates, in
the case of Mexico. In Turkey, there is a sharing of regulatory responsibilities over bank capital market activities between the Treasury (the bank supervisory authority) and the Capital Markets Board. Bank examinations and the financial responsibility requirements for banks are administered by the Treasury but the central bank also has an important role to play in the capital market through the conduct of monetary policy and in monitoring the financial performance of banks. However, the conduct of on site examinations of banks is the responsibility of the Treasury Department.

In the Philippines, most dealers in Government securities are commercial banks, or universal banks. There are also a few investment banking houses that serve as dealers in Government securities along with the Development Bank of the Philippines which is also very active in the capital market. In addition to the universal banks, broker-dealers (i.e., securities firms) and investment banking houses provide capital market services to private issuers and investors in securities. In the Philippines, the brokers on the stock exchange are relatively small business entities. In addition to serving as brokers, they play a role in the distribution of listed securities as part of the underwriting syndicates. With respect to listed securities, the rules of the Philippine Stock Exchange (PSE) require that at least 50 percent of the public offering of securities be distributed through stock exchange members. There are also financial intermediaries classified as quasi-banks (i.e., finance companies) that are active in the money markets. In most Latin American countries, non-bank financial institutions such as securities broker-dealers and mutual funds are regulated by the securities commission while commercial banks and other deposit taking institutions are regulated by a superintendency of banks.

Securities firms play an important role in the financial markets by performing the functions of broker and dealer. In this capacity, securities broker-dealers facilitate capital mobilization by performing important investment banking functions including the underwriting and distribution of securities to public investors. US securities firms also provide money management services and many are engaged in the underwriting and distribution of mutual fund shares. In their capacity as dealers, or market makers, large inventory positions are held in the full range of capital market instruments. From 1980 to 1994, commercial banks also acted as dealers in US government and municipal securities. In this capacity, they held huge inventories of US Government and municipal securities. Savings and loans, state and local governments, credit unions, and other institutions also make portfolio investments for their own accounts in the money market and through longer-term debt securities, usually Government bonds, Treasury bills, and repurchase agreements.

Financial Market Boundaries

The distinction between money and capital market instruments can have important implications in establishing financial market boundaries in the context of allocating regulatory responsibilities. The legal definition of securities can be very complex. Although the term 'security' normally covers common and preferred stock, notes, and bonds, it can also include other financial liabilities.

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4 In Singapore, all financial instruments are regulated by the Monetary Authority of Singapore. In Malaysia, the issuance of bonds is deemed to be a deposit-taking function with regulation under the domain of the central bank and the securities commission. In Indonesia, however, the regulatory powers of BAPEPAM are limited to financial instruments with maturities exceeding one year. Bank Indonesia, the central bank, is responsible for the regulation of money market instruments. In most countries, however, both the central bank, or Monetary Authority, and the securities commission have regulatory responsibilities with respect to money market instruments.
financial instruments such as short-term commercial paper, options, and financial futures contracts. It is important to carefully define the ‘security’ to avoid the potential creation of gaps in the regulation of NBFIs offering the same or similar types of financial instruments to public investors.

The distinction between money and capital markets is normally determined by the length of maturity of the instrument. Debt instruments with maturities of less than one year are normally defined to be money market instruments. Money market instruments include negotiable certificates of deposit, commercial paper, interbank loans, short-term government paper, and other negotiable debt instruments. While these instruments are normally short-term in nature, some may be issued with maturities of up to five years (i.e., variable rate commercial paper). Marketable debt instruments with maturities longer than one year are usually categorized as notes or bonds depending on the length of maturity. In markets with relatively low rates of inflation, notes and bonds are issued for a specified term at a fixed rate of interest. The price of the bond will vary according to changes in the market rate of interest. Thus, the value of the portfolio will fluctuate with the gains and losses in value of the inventory positions. For a dealer or market maker, price movements on fixed income investments (and also for equity securities and derivatives) will result in trading gains or losses. It is essential that the fluctuation in the value of inventories be taken into account in devising regulatory capital standards for securities broker-dealers, or organizations performing similar functions.

Common and preferred stock are capital market instruments issued in perpetuity but it is noteworthy that stock can be retired and that public companies, on occasion, may even go private (i.e., retire all outstanding shares held by public investors). Common stock holders have the right to choose the board of directors, appoint the management of the corporation, and vote on important matters at the annual shareholders meeting. Dividend payments normally are not fixed but rather are subject to the discretion of the board of directors. The dividend owed to preferred stock holders are guaranteed by the corporation. Consequently, dividends must be paid to preferred shareholders prior to any payment to common shareholders. The development of an equity market can be particularly important because it provides permanent risk capital that can reduce excessive financial leverage which can result from the over reliance on debt financing. This is a key issue in many Latin American countries.

An Overview of Regulatory Models: Developed Markets

The developed markets offer interesting models for countries with new and emerging securities markets to examine. Each country, of course, must develop a regulatory framework that fits its unique needs based upon both legal and institutional considerations particular to that country. In the US, broker-dealers are regulated primarily by the SEC while banks and other types of deposit taking institutions are regulated by Federal or state banking regulatory authorities depending on whether they have a Federal or state charter, or are covered by deposit insurance. In 1934, the US became the first country to establish a national securities regulatory body with the enactment of the Securities and Exchange Act in that year. The US Securities and Exchange Commission (SEC) was established in the aftermath of the stock market crash of 1929 and Great Depression to administer the federal securities laws and provide for the protection of public investors in securities by insuring that markets are fair and honest and that market practitioners
comply with applicable laws and regulations. This followed the enactment of the Banking Act of 1933 that required the separation of investment banking and commercial banking. Since US commercial banks are not included within the definition of ‘broker-dealer’ under the Securities Exchange Act of 1934, the SEC does not have direct regulatory authority over the securities activities of commercial banks.

In general, however, US commercial banks may not directly act as an underwriter and dealer in corporate securities but they may offer securities brokerage services, trust services, or act as a dealer in US Government and municipal securities. In addition, most large US banks have established holding companies which provides greater flexibility in the conduct of non-bank financial services through separate subsidiaries. In this instance, however, the securities broker-dealer of the bank holding company must be registered with the SEC. In any event, the trend has been toward greater competition in the financial sector which can contribute to market efficiency and foster the development of a wide array of financial instruments for issuers and investors. But, it also creates a serious dilemma for the regulatory authorities in devising appropriate regulatory safeguards for highly complex financial conglomerate, or even financial conglomerates. In Asia, some countries restrict the type of entities that can perform investment banking services such as underwriting, or may require different licenses for brokers and dealers in securities even if the same entity is performing such functions. Some countries also require the separation of the function of securities broker and dealer. This arrangement, however, may impede the development of the dealer or market maker function which can contribute to market liquidity.

Commercial banks are supervised by Federal and state bank supervisory authorities. Most large commercial banks have established holding companies. The holding company is regulated by the Federal Reserve Board while the bank and non-bank subsidiaries are regulated by a designated bank supervisory agency (i.e., the Comptroller of the Currency, FDIC, or state banking commissions). The non-bank securities affiliate broker-dealer would be registered with the SEC and an appropriate self-regulatory organization (i.e., the NASD and/or one or more stock exchanges). In the US, all broker-dealers registered with the SEC doing business with investors (i.e., public customers) must become a member of a self-regulatory organization such as the NASD or a stock exchange. The SEC supervises only the securities markets (including options which are defined to be securities under US law) and related infrastructure (i.e., the stock exchanges, clearing organizations, etc.), securities broker dealers, and investment companies. A separate Federal regulatory body, the Commodity Futures Trading Commission (CFTC) is responsible for the supervision of the commodities markets, including futures contracts on stock indices and other financial futures. The separation of the commodities and securities regulatory bodies in the US is

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5 The US SEC is organized as an independent regulatory body headed by a chairman and four other commissioners, each appointed by the President for a five-year term with the advice and consent of the Senate. Each year the term of one of the five commissioners expires so that continuity on the Commission is assured. The US SEC is an independent regulatory body in the sense that each of the five members of the commission is appointed for a fixed five-year term and they cannot be removed except for cause. Also, it is independent of any other government department. The SEC, of course, is subject to substantial congressional oversight by the US Congress and its rules and decisions can be subject to challenges in the courts. The annual budget must be approved by the Office of Management and Budget and the US Congress.

6 The recent trend toward diversification by US commercial banks into a wide array of financial services can be traced back to at least the early 1960s. This is not a unique development. During earlier periods (i.e., the 1920s) in the US financial history there have been similar moves toward financial diversification followed by regulatory interventions (i.e., the Banking Act of 1933) that resulted in restriction on the activities of commercial banks. See: Chuppe, Terry M. and Frank Tamagna, 'The Financial Congeneric', Banca Nacional Del Lavero Quarterly Review, Rome, June 1971.
### Part I Table 3. An Overview of Key Elements of the US Financial System: Banks and Non-Banks

<table>
<thead>
<tr>
<th><strong>Commercial banks</strong></th>
<th>Provide short-term lending to firms, residential real estate loans, agricultural loans and loans to other financial institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Savings and loans and thrifts</strong></td>
<td>Traditionally have provided mortgages and other consumer loans. Many have a mutual structure so depositors are shareholders.</td>
</tr>
<tr>
<td><strong>Stock markets</strong></td>
<td>There are three major exchanges, the NYSE, AMEX and NASDAQ with a total of over 6,500 firms listed. They have traditionally been a significant source of funds from initial public offerings (IPOs).</td>
</tr>
<tr>
<td><strong>Bond markets</strong></td>
<td>These are an important source of funds for the federal, the state and local governments as well as firms</td>
</tr>
<tr>
<td><strong>Derivatives markets</strong></td>
<td>Founded in the early 1970s, these have become very liquid and are widely used</td>
</tr>
<tr>
<td><strong>Firm pension schemes</strong></td>
<td>Firms have a number of options under the Employee Retirement Income Security Act (ERISA) which provides the framework for pensions. Funds are usually invested in the stock and bond markets.</td>
</tr>
</tbody>
</table>


- NBFIs are subject to varying forms of regulation by different regulatory bodies. While investment companies are regulated by the SEC, other types of pooled investments, which in many respects are functionally equivalent to an investment company, are exempt from the definition of investment company and therefore are not required to register with the SEC. This would include

### Part I Table 4. Principal Regulatory Agencies of the US Financial System

<table>
<thead>
<tr>
<th><strong>Regulatory Agency:</strong></th>
<th><strong>Regulatory Areas:</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities and Exchange Commission <strong>SEC</strong></td>
<td>Organized exchanges and financial markets, market participants, mutual funds and investment companies, Section 20 affiliates</td>
</tr>
<tr>
<td>Commodities, Futures Trading Commission <strong>CFTC</strong></td>
<td>Derivatives markets and participants</td>
</tr>
<tr>
<td>Office of Comptroller of the Currency <strong>OCC</strong></td>
<td>Federally chartered commercial banks</td>
</tr>
<tr>
<td>Federal Reserve System</td>
<td>All member banks, bank holding companies, Section 20 affiliates</td>
</tr>
<tr>
<td>Federal Deposit Insurance Corporation <strong>FDIC</strong></td>
<td>State chartered commercial and cooperative banks, insured industrial banks</td>
</tr>
<tr>
<td>National Credit Union Administration <strong>NCUA</strong></td>
<td>Federally chartered credit unions</td>
</tr>
<tr>
<td>Office of Thrift Supervision <strong>OTS</strong></td>
<td>Savings and loan associations, savings banks</td>
</tr>
<tr>
<td>State Banking and Insurance Commissions</td>
<td>State chartered banks (deposit institutions) and insurance companies</td>
</tr>
</tbody>
</table>

individual and collective trust funds administered by commercial bank trust departments, private pension plans, and insurance company separate accounts. Each are regulated by different regulators even though they are functionally similar to investment companies.

Part I Table 5. Profile of US Regulatory System for Selected NBFI's

<table>
<thead>
<tr>
<th>Main Regulator</th>
<th>Investment Companies</th>
<th>Private Pensions</th>
<th>Broker-Dealers</th>
<th>Bank Trusts(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC</td>
<td>Department of Labor</td>
<td>SEC SROs Federal Reserve(^b)</td>
<td>State or Federal Bank Regulators</td>
<td></td>
</tr>
<tr>
<td>NASD</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Securities Act of 1933 Securities and Exchange Act of 1934</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Main Regulatory Tool</td>
<td>Disclosure to Investors Fiduciary Duties</td>
<td>Disclosure Fiduciary Duties</td>
<td>Strong Prudential Standards</td>
<td>Fiduciary Duties</td>
</tr>
</tbody>
</table>

\(^a\) Securities brokerage activities conducted directly by the bank are regulated by the bank supervisory agencies; the NASD does not have authority over the sales practices of banks.

\(^b\) Federal Reserve is involved in the examination of the securities broker dealer affiliates of bank holding companies.

Source: Background paper prepared by Terry M. Chuppe.

In order to understand the regulatory standards applied to investment companies and other entities registered with the SEC, it should be recognized that the cornerstone of the US securities regulatory framework is the disclosure of information to investors and the maintenance of strong prudential standards. The SEC does not engage in merit regulation (i.e., make decisions concerning the quality and quantity of issues brought to the market). It is not permitted to do so under its regulatory mandate. Consequently, investment companies may include in their portfolios more speculative types of investments such as high-yield corporate bonds (so-called junk bonds) provided that this is disclosed to investors at the time the investment company’s shares are registered. Consequently, US investors are expected to make their own informed decisions concerning the relative risks and rewards of a particular investment. It should be noted, however, that the investment objectives of the fund must be clearly disclosed to investors. Moreover, the investment objective cannot be changed without shareholder approval. Also, the SEC assigns certain regulatory responsibilities to the stock exchanges, the NASD, and other self-regulatory organizations. Other US Government agencies and state regulators are involved in the regulation of institutional investors’ money management activities. This includes the US Department of Labor, Federal and state bank regulatory agencies, and state insurance commissions.

In the UK, it was not until the passage of the Financial Services Act in 1986 that the a national securities regulatory body, the Securities and Investments Board (SIB) was established along with an elaborate network of self-regulatory organizations to cover all financial and investment products. Prior to the enactment of the Financial Services Act, the UK’s domestic
securities markets were largely self-regulated by the London Stock Exchange. Under the Act, a Securities Industry Board (SIB) was established to supervise all non-bank financial institutions engaged in the securities and investments business through a network of self-regulatory organizations. The SIB, which is self-funded through fees levied on regulated entities, is overseen by the Department of Trade and Industry. In the UK, anyone conducting a securities or investment business including unit investment trusts and insurance companies must be supervised by a self-regulatory organization, or by the SIB directly. The Bank of England plays an important role with respect to the establishment of prudential standards for financial institutions.

In 1947, the Securities and Exchange Law was enacted in Japan. It was patterned after the US securities laws. In 1948, it was modified to parallel more closely the US securities laws that existed at that time. A Securities Bureau was established within the Ministry of Finance (MOF) to administer the securities law. Also, a Banking Bureau was established under banking law to supervise commercial banks who were generally prohibited from engaging in the securities business. Under the Law, the Securities Bureau within the Ministry of Finance was established to supervise the securities markets and market practitioners such as securities broker dealers and mutual funds. One important difference in the US and Japanese regulatory systems is in the administration of the regulations. In Japan, the regulated entities have traditionally been subject to more direct government management and control by the Ministry of Finance.

An Overview of Regulatory Models: Emerging Markets

With the rapid growth of emerging financial markets, many developing countries have implemented new regulatory frameworks for non-bank financial institutions engaged in the securities and investments business. In Thailand, the enactment of the Securities Exchange Act of 1992 resulted in the establishment of the Thai Securities and Exchange Commission. The responsibilities of the Thai SEC include the supervision of securities firms and mutual funds. Prior to 1992, the securities business was supervised by the Ministry of Finance, the Bank of Thailand, and the Stock Exchange of Thailand. This resulted in some inconsistency and inefficiency in the enforcement of securities regulations.

The Malaysian Securities Commission was authorized with the adaptation of the Securities Commission Act of 1993. In Malaysia, the securities commission also has authority over unit trusts and the responsibility for the administration of the Futures Industry Act of 1993. Bank Negara Malaysia (the central bank) has responsibility for the supervision of banks and non-bank financial institutions such as merchant banks, which also provide investments banking services, and finance companies. In Malaysia, the subscription of bonds is defined to be deposit-taking under the Banking and Financial Institutions Act of 1989. As a result, bond offerings by

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7 In Germany, a national securities regulatory body was not established in the form of the Federal Securities Supervisory Office until January 1, 1995. In addition, to the establishment of the FSSO, amendments to the Stock Exchange Act strengthened the self-regulatory responsibilities of the German stock exchanges. These actions followed several initiatives by the German Federal Government to promote the development of the German capital market in the wake of a more unified European capital market with EC 1992.

8 Securities Markets in Japan, Chapter XIV, Securities Administration, Japan Securities Research Institute, 1992, pp. 248-257.

9 In addition to regulating the securities business, the Thai SEC has a clear mandate to foster the development of the market. As set forth in the Securities and Exchange Act of 1992, the objectives for creating an SEC in Thailand was 'to formulate policies to promote and develop, as well as to supervise' the securities markets, issuers, and related entities.

private issuers must be approved by Bank Negara. The Malaysian Securities Commission is a self-funded statutory body with regulatory, investigative, and enforcement powers. As a result of the Securities Commission Act, there are now two main regulatory agencies in the financial system -- Bank Negara, the Central Bank, and the Securities Commission. Bank Negara continues to supervise and regulate the banking system, including the money markets. In Malaysia, some regulatory responsibilities are within the domain of both the securities commission and central bank. The issuance of private corporate bonds must be approved by both Bank Negara and the Securities Commission.

Mexico offers an interesting case of a financial sector where bank and non-bank financial institutions have been permitted to organize as a financial group. In the aftermath of the financial crisis associated with the peso devaluation in late 1994, banking, securities, and related financial services were placed under a single national regulatory body. On May 1, 1995, the National Banking and Securities Commission Law (the CNBV Law) went into effect which required the merger of the Comision Nacional de Valores (CNV) with the Comision Nacional Bancaria (CNB). As a result, a new Comision Nacional Bancaria y de Valores (CNBV) was established to regulate financial groups, which in Mexico include commercial banks, securities firms, mutual funds, insurance, finance companies and other non-bank financial entities. Under the Credit Institutions Law of 1990, the CNB was established as the supervisory authority for commercial and development banks. The goal of the merger of the CNV and the CNB into the new CNBV was to achieve greater efficiency and coordination in the supervision of the banking and securities industry. For the most part, the CNBV Law did not change the regulatory or administrative functions of the former CNV but resulted in the transfer of its authority over the securities markets and related capital market institutions to the new CNBV.¹¹

In order to understand the current structure of Mexico's financial sector and the regulatory framework for banking and securities, it is necessary to examine the recent history of Mexico's financial sector. In 1982, Mexico's private commercial banks were nationalized while non-bank financial services such as securities brokerage and investment banking were spun-off from the nationalized banks to operate as private firms. In the aftermath of the nationalization of the private commercial banks, the number of banking institutions was reduced through merger and consolidation from 58 in 1982 to only 18 in 1986. While the nationalized banks were granted a monopoly in the provision of banking and credit services, the securities industry, which remained in the private sector was allowed to compete in the provision of capital market services.

The role of the nationalized banks in funding the private sector contracted while their importance in funding the public sector deficit grew. As a result of these constraints, the nationalized banks had become relatively inefficient enterprises by the late 1980s. These events aided the growth of a profitable and competitive securities industry. Although small in size relative to the nationalized commercial banks, the securities industry was in a position to acquire banks when the government introduced financial reforms that led to the re-privatization of the commercial banks. On June 28, 1990, Mexico's constitution was amended to allow for the re-privatization of

¹¹The Board of Governors of the CNBV consists of the President of the CNBV, two vice-presidents from the CNBV, five members designated by the Secretary of Finance and Public Credit, three members designated by the Bank of Mexico, one member from the Comisiones Nacionales de Seguros y Fianzas (the Insurance and Bonding commission) and one member from the Sistema de Ahorro para el Retiro (the Retirement Savings System). The CNBV is accountable to the Board of Governors. The President of the CNBV, who is appointed by the Minister of Finance and Public Credit, serves as Chairman of the Board of Governors. The 1995 CNBV Law also requires the appointment of an alternate for each member.
the commercial banks. The re-privatization of the commercial banks and the issuance of the Financial Groups Law had a dramatic impact on the current configuration of Mexico's financial system. Today, Mexico's financial services industry consists mainly of financial conglomerates organized under the Financial Groups Law of 1990 as holding companies with financial subsidiaries that may include commercial banks, securities brokerage firms, insurance companies, leasing companies, bonding, currency exchange, and mutual funds. Under the Financial Groups Law, industrial companies and other non-financial enterprises may not be part of the group.\textsuperscript{12}

Although it has been substantially amended, the principal law governing the securities markets is the 1975 Capital Markets Law (i.e., the Securities Markets Act) established the Comision Nacional de Valores (CNV) as the regulatory body responsible for the supervision of the capital markets, securities brokerage houses, the stock exchange, and related institutions. The CNV, and its successor organization (CNBV) also have substantial power to conduct inspections and examinations of brokerage houses, the stock exchange, and other market participants, securities market surveillance, and enforce the securities and mutual fund laws. In addition to its regulatory responsibilities, the CNBV was also given responsibility to promote the development of Mexico's capital market. All rules of the Mexican Stock Exchange must be approved by the national securities regulatory body. While contemplated in the Capital Markets Law, self-regulation is not well developed in Mexico but plans are underway to more fully develop the self-regulatory framework.

At the present time, the principal laws governing the operations of bank and non-bank financial institutions are the Capital Markets Law, the Mutual funds Act, and the recently enacted CNBV Law, the 1990 Financial Groups Law and Credit Institutions Law. In 1990, the Financial Groups Law provided the legal basis for the financial conglomerates that prevail in Mexico's financial sector today. In view of the economic condition and structure of the banking industry at the time of privatization, large financial conglomerates were about the only option available to policymakers. Under the Financial Groups Law, commercial banks, securities brokerage firms, and other non-bank financial entities may operate within the same holding company. The 1990 Credit Institutions Law provided the legal and regulatory basis for the regulation and supervision of the re-privatized commercial banks. The law prescribes limitations on the activities of commercial and development banks and provides for their supervision by the CNBV.

Turkey is still another example of an emerging financial market with universal banking. In Turkey, however, the banks may directly engage in capital market activities through a separate division within the bank. This, of course, offers greater possibilities for the transfer of risk between the commercial bank operations, broker dealer activities (including investment banking) and the bank sponsored mutual fund. In 1994, this arrangement contributed to the demise of several securities broker dealers whereby losses incurred by commercial banks in their foreign exchange operations were transferred to the capital markets. The vulnerability of the banking system and weakness of prudential standards was exposed when banks apparently maintained large open

\textsuperscript{12} Mexico's financial services industry and related capital market institutions consists of 34 securities brokerage firms, 34 commercial banks, seven development banks, 309 mutual funds, 44 insurance companies, 60 leasing companies, 45 foreign exchange houses and a number of other non-bank financial enterprises (i.e. warehousing companies, bonding companies, and investment advisors). Also, 16 foreign securities brokerage firms have been authorized to establish affiliates in Mexico. Under liberalizations in the financial services industry associated with the North American Free Trade Agreement (NAFTA), affiliates of foreign financial institutions are granted 'national treatment' in Mexico but may be subject to individual and market share limits.
positions in foreign currency even though prudential regulations called for the matching of asset and liability exposure.

In Turkey, there is a division of regulatory responsibility between the banking regulatory authorities and the capital markets board which supervises non-bank financial intermediaries directly but has only limited authority over the Securities Activities of the banks themselves. On July 28, 1981, the Turkish Capital Market Law established the basis for the regulation and control of the Turkish capital market. The Law, as amended, provides for the protection of investors with the aim of promoting Turkish economic development through investment in securities. The Law established a regulatory framework for the public offering of securities, corporate issuers and auxiliary capital market institutions and authorized the creation of the Capital Markets Board ('CMB or Board') to regulate, supervise, and develop the capital markets of Turkey. Under the Law, the CMB is a self-funded legal entity accountable to the State Ministry of Economic Affairs. The CMB is self-funded by means of a fee obtained from corporate issuers offering securities to the public. If additional funds are needed to cover the expenses of the Board, such funds must be obtained from the budget of the Ministry of Finance. The Ministry of Finance ('MOF') has oversight of the CMB with respect to policy formulation and operations.\(^3\)

The Philippines also operates within a universal banking framework. Universal banks are authorized to act as underwriters of securities while securities brokers play an important role in the distribution of securities. Securities brokers, however, are not licensed to perform the function of underwriter. While the separation of the function of underwriter and broker is apparently intended to promote high prudential standards, it is also anti-competitive. It has led to a securities industry structure which has not been an effective mechanism for capital mobilization. With the passage of the Securities Act of 1936, the Philippines Securities and Exchange Commission was established. The Act (as amended in 1982) along with the Investment Company Act of 1960, provide the framework for the regulation of securities broker-dealers and investment companies. Broker and dealers in securities must be registered with the SEC and meet certain capital and financial responsibility requirements. Registered broker-dealers are required to file periodic financial statements with the SEC. Broker-dealers are monitored by the SEC to insure compliance with the applicable financial responsibility and other regulatory requirements applicable to them.\(^4\)

The central bank, on the other hand, is responsible for the regulation of universal banks and commercial banks dealing in Government securities as well as the activities of primary dealers in such securities. The Securities and Exchange Commissions regulated dealers in Government securities to the extent that they are registered with the SEC as broker-dealers in non-exempt securities.

**Systemic Risk Transfer.** Recent events in both Mexico and Turkey point toward the vulnerability of a highly concentrated financial sector where a few large financial groups control both bank and non-bank financial enterprises under a universal banking arrangement. In both

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\(^3\) The Capital Market Law requires the Ministry of Finance to submit to the Council of Ministers a report accounting for its control over the operations of the CMB along with the annual report of the CMB. In the event that self-funding by the CMB is not adequate to cover operating expenses, the CMB must obtain additional resources through the budget of the Ministry of Finance. The MOF also plays an important role on nominating members of the CMB. As a self-regulatory organization, the Istanbul Stock Exchange (ISE), is responsible for the regulation of members of the stock exchange. ISE rules must be submitted to the CMB for approval. See: Capital Market Board of Turkey, Capital Market Board, Ankara, 1992. Turkey's Capital Market and Istanbul Stock Exchange: Organization Regulation and Operation, Istanbul Stock Exchange, Istanbul, Turkey, March 1992, page 1.

\(^4\) Registered broker-dealers that are members of the Philippines Stock Exchange are subject to regulatory oversight of the stock exchange which, as a self-regulatory organization, has supervisory responsibilities over its members.
instances, an external shock (i.e., currency devaluation) exposed weaknesses in the existing financial structure. Turkey's experience illustrates that systemic risk can quickly be transferred throughout the financial system by financial conglomerates engaging in a wide range of bank and non-bank activities. It also points toward the need to properly segregate risk through prudential standards and to carefully examine the extent to which bank and non-bank activities should be permitted to be combined in a single organization in an emerging market environment. While it is noteworthy that Germany and Switzerland have a long and relatively successful history with universal banking, there are significant differences between mature and emerging financial markets.

In this regard, several points need to be kept in mind. First, the banking system in each country is mature with long histories of applying conservative banking principles. Second, until the late 1980s, cartel arrangements that reduced competition in the issuance of capital market instruments (and thus the risk) were tolerated by government policy. Finally, the securities business (i.e., acting as a broker, dealer, or underwriter of securities) has historically accounted for a relatively small part of the overall business of the universal banks.

**Powers of Regulatory Authorities**

The legal power of the regulatory bodies responsible for the regulation of non-bank financial institutions is an important consideration in establishing a regulatory framework. In countries with new and emerging financial markets, the regulatory bodies often play a role in the development and regulation of the financial markets and related institutions, whereas in developed markets such as the US and the UK, their role is primarily limited to regulation. The discretion, accountability, and governance (or control) of each regulatory body in the financial sector has important implications not only regarding its mission but also in defining relationships among government ministries and private sector entities. Given the distinct types of non-bank financial institutions and their differing economic functions, it is not surprising that in most countries more than one regulatory body is involved in the regulation of non-bank financial institutions such as securities broker-dealers, investment companies, pension funds, and bank trusts.

If permitted under the legal framework, the regulatory bodies responsible for financial regulation should have broad rule making authority. This is important for several reasons. First, it is important to maintain some flexibility since several classes of financial market intermediaries are likely to evolve including banks, brokers, dealers, and diversified financial institutions that will perform the functions of broker, dealer, investment bankers, money management, research, and related functions. At the early stages of financial sector development, it is not always clear which entities are best equipped to efficiently perform each of these functions. Second, since financial markets tend to evolve quite rapidly and often in an unexpected fashion, the regulatory authorities must be in a position to make adjustments to the regulatory requirements as market conditions require.

It is highly desirable to build regulatory checks and balances into the financial system to reduce the potential for fraud and abuse. In addition to capital standards (i.e., a test to assure that intermediaries have sufficient backing to promptly meet the need of customers and other market participants for the delivery of cash and securities) and basic registration requirements, other basic safeguards for the protection of the public would include:
• maintenance of accurate books and records
• financial reporting to the regulatory bodies supervising the various types of non-bank financial institutions with copies to the central bank, or other appropriate government ministry
• efficient systems for the processing, transfer, and safekeeping of financial instruments, preferably by means of a book entry system
• independent audit requirement
• monitoring of financial results by the regulatory authorities
• inspections and examinations
• coordination among government regulatory bodies
• the creation of a competitive environment
• disclosure of meaningful accounts; accurate and timely information

A competitive financial sector should not only lead toward the development of a more efficient financial sector but also allow the users of financial services to choose well-run institutions that are likely to provide for the relative safety of clients financial assets. While the regulatory framework should provide for the delegation of technical details concerning rule-making authority, close coordination among financial regulators is extremely important to avoid regulatory gaps. Financial regulators require a broad mandate to develop capital and other financial responsibility requirements, recordkeeping, audit, inspections, and examinations and related matters to assure that the non-bank financial institutions operate in the public interest and that adequate safeguards are in place for the protection of investors.

In devising a regulatory regime, the enforceability of contracts is an important consideration. The ability to execute financial transactions rests upon the development of a legal and regulatory structure that fosters public confidence in the integrity of the market. The enforceability of contracts is crucial in reducing systemic risk in an emerging market environment. The enforcement of contracts is also important to the operations of an efficient secondary market. The failure to deliver financial instruments or cash within prescribed time frames, for example, could result in losses to the firms engaged in such transactions, or to their customers. This could have an adverse impact on both bank and non-bank financial institutions, clearing organizations, and the financial markets as well.

Enforcement of Regulations. As a general matter, regulations should be designed with enforcement in mind. Regulations should not be enacted which cannot be enforced in the sense that they give the public a false sense of security. This is especially important with respect to NBFIs, which hold substantial amounts of clients monies and securities. While monitoring the operations of financial institutions through regulatory reports, annual audits, and disclosure to customers is useful, additional safeguards to ensure compliance with applicable rules and regulations are needed in the form of inspections and examinations. Also, once violations of the regulatory safeguards are identified, it is important that appropriate enforcement remedies are available to the regulator. The US enforcement mechanism is highly sophisticated. In large part this is due to the legal infrastructure which is absolutely essential to support the regulatory framework and enforcement mechanism that has developed over many decades.

15The US SEC, for example, is authorized to file injunctive actions in federal court as well as to proceed administratively against regulated entities. It is authorized to seek fines and disgorgement of ill-gotten gains and may apply other administrative remedies such as the suspension or revocation of licenses to conduct a securities or investment business. The staff may also provide substantial assistance to criminal authorities (i.e., the Department of Justice) for the criminal prosecution of violations.
In East Asia, Thailand’s enforcement mechanism improved with the establishment of the Thai SEC in 1992. Prior to the adoption of the SEC Act, for example, investigation into unfair practices in the stock market would be conducted by the Stock Exchange of Thailand (SET) but the procedures for enforcement could be long and protracted involving personnel from the SET, Bank of Thailand and Ministry of Finance. Enforcement responsibilities are now clearly within the domain of the Thai SEC. In Malaysia, the SEC also has important investigative and enforcement powers and is the focal point for securities market enforcement with the prosecution of cases referred to the justice Ministry. In the Philippines, the SEC also has direct enforcement powers, and in some instances, it may act as a quasi-judicial agency.

Role of Self-Regulation

In most developed markets, including the US, UK, and Japan, self-regulation has been employed with considerable success in the regulation of non-bank financial institutions, particularly in the regulation of securities brokers and dealers, mutual funds, and insurance companies. Also, much of the day-to-day regulation of the securities markets is conducted by self-regulatory organizations (i.e., stock exchanges, clearing organizations, and others) under the oversight of a government regulatory body. In the US, the stock exchanges were already regulating their members when the SEC was created. Indeed, it is not possible to operate an organized securities market without ‘rules of the game’ and it is in the interest of market practitioners to insure that rules of conduct are obeyed so that securities transactions are conducted in a fair and honest manner. Consequently, with the passage of the Securities and Exchange Act of 1934, much of the responsibility for regulating the US securities markets was left to the stock exchanges and other self-regulatory organizations (SROs), subject to strong oversight by the SEC.

SROs should be required to register with a securities commission or other government regulatory body. For self-regulation to be effective, the SROs must be subject to strong government oversight. Furthermore, SRO rules should be subject to review and approval by the Government regulatory authority. In the US, for example, every broker-dealer that is registered with the SEC to conduct a securities business, must join a self regulatory organization. Also, in the UK, everyone conducting a securities or investment business including securities broker dealers, mutual funds and others must belong to a self-regulatory organization, or be regulated directly by the SIB. Self-regulation is now beginning to take hold in emerging markets as well. In Thailand, for example, the SEC has delegated certain regulatory responsibilities to the Stock Exchange of Thailand. The role of the SEC is to establish overall regulatory policy and to approve the major stock exchange regulations with much of the on-going supervision of the market delegated to the stock exchange. In Malaysia, self-regulation with government oversight by the Securities commission plays an important role in the regulation of the Malaysian Securities Market. Other countries with emerging securities markets (i.e., Mexico, Philippines, and Colombia) are in the process of building the self-regulatory infrastructure.

Self-regulatory organizations can also play an important role in the arbitration and resolution of disputes arising in connection with securities market transactions. It can be an effective mechanism to resolve disputes among market participants in both developed and emerging securities markets. Arbitration, which is a contractual, non-judicial method of resolving disputes, is used extensively in the US by the SROs. Arbitration can be a fair and efficient means of resolving disputes and thereby reduce the cost of litigation. One of the goals is to reduce the cost

16Securities and Exchange Commission of Thailand, op. cit, pp. 2-3.
of securities litigation which is very pervasive in countries with complex legal systems such as the US. The arbitration proceedings in the US are administrated by the SROs and, while the SEC oversees the process, it cannot intervene on behalf of or directly represent individual investors. The SEC cannot vacate or modify an arbitration decision. Furthermore, the grounds for any judicial review of an arbitration decision are quite limited. In emerging securities markets, arbitration offers promise as a vehicle to enhance investor confidence in the market. This would appear to be especially the case in countries where the court system is not well developed, or in those countries where judges may not be well trained in securities law. This is not uncommon in Asia’s emerging financial markets. In most countries in the region, the securities laws are relatively new, or have been substantially modified in recent years.

Role of Credit Rating Agencies

In recent years, policymakers in the developing countries of Asia and Latin America have become increasingly aware of the important role that credit rating agencies can play in the development and regulation of bond markets. A credit rating is an opinion regarding the likelihood of prompt payment of principal and interest. In an exhaustive policy review of factors influencing the development of East Asian bond markets, a 1995 World Bank study concluded that “a key ingredient of bond market development is the establishment of a rating agency.” In an emerging bond market, a credit rating agency can broaden the market for debt instruments by bringing to the market new untapped investor groups, including institutional investors which may require a credit rating as a pre-condition for purchasing the bond. Credit ratings can also be expected to reduce the overall issuance cost by providing economies of scale in performing the functions typically associated with a credit rating agency—information search, analysis, dissemination, and monitoring. In both emerging and developed markets, credit rating agencies increasingly have played an important role in the regulation of the new issues market for debt instruments and in the establishment of prudential standards.

In the emerging markets of Latin America and East Asia, Government policymakers have taken actions to encourage the development of capital market infrastructure support facilities such as credit rating agencies. In Asia, there has been a tendency to have only a single credit rating agency that is locally sponsored, usually with the support of the government and international organizations. While this is the norm, there are exceptions with Korea, India, and China each having more than one credit rating agency. In contrast to Asia, Latin American countries tend to have multiple credit rating agencies. Mexico and Chile, for example, each have four credit rating agencies while Argentina has seven credit rating agencies and Venezuela has nine. In 1989, the first Latin American credit rating agency was established in Mexico. Since then, the number of credit rating agencies has expanded rapidly. In Latin America, there are now more than 25 credit rating agencies. The establishment of Latin American credit rating agencies has been spawned to a considerable extent by mandatory regulatory requirements that the issuers of marketable debt securities obtain a rating prior to a public offering. In a few Latin American countries, credit ratings have also been required for the issuance of common stock. Credit ratings have also been

employed to regulate the investment policies of pension funds and insurance companies. In Asia, credit ratings have also been employed in the regulatory process. In India, Korea, Thailand, and Malaysia, credit ratings are required for the public offering of private debt instruments. In the case of Korea, credit ratings are only mandatory for the issuance of non-guaranteed bonds.\(^{20}\)

In both developed and emerging financial markets, Government regulatory bodies have contributed to the rapid growth in the number of credit rating agencies over the past decade, either by requiring credit ratings with respect to new public offering of debt instruments by private issuers, or by using credit ratings extensively in the establishment of prudential standards for securities firms and commercial banks, or to determine eligibility requirements for the purchase of debt instruments by institutional investors such as pensions, insurance companies and bank trusts. While ratings are not mandatory in the US for the issuance of securities, they are used extensively in the administration of regulatory standards. In this regard, ratings have been used in determining the amount of capital required under the uniform capital net capital standard (i.e., Rule 15c3-3) for securities broker dealers under the *Securities and Exchange Act* of 1934, as amended, and with respect to defining the permissible holding of money markets funds under regulations issued pursuant to the *Investment Company Act* of 1940. Credit ratings are used as criteria for investment eligibility for securities held by fiduciaries (i.e., bank trusts) and state regulated financial institutions such as insurance companies, public retirement funds and state chartered banks.\(^{21}\) In Japan and Europe, credit ratings have been used in the administration of regulatory standards. In both Asia and Latin America, mandatory rating requirements imposed by the national securities regulatory bodies have spawned the development of the credit rating business in both regions. Moreover, it is unlikely that credit rating agencies would be economically viable in most emerging financial markets in the absence of a mandatory credit rating requirement, or other inducement by the securities regulatory bodies.\(^{22}\)

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\(^{20}\) Chuppe, Terry M., Role of Credit Rating Agencies in Emerging Securities Markets, Emerging Markets Institute, Springfield, VA, USA, February 15, 1996.


\(^{22}\) *Ibid*, page 4.1
PART II. Regulation of NBFIs in the USA and Emerging Markets

Regulation of Brokers and Dealers in Securities in the USA

The type of business conducted by a financial institution has a direct impact on the risk assumed. Consequently, the nature of the business conducted by financial firms raises important issues with respect to the protection of clients' monies and securities held by non-bank financial institutions. The customers of securities firms, investment banks, and other market professionals must be protected from fraud, or other misconduct, or in the event of a firm's insolvency. In regulating broker and dealers in securities, it is essential to devise appropriate registration and entry standards, reporting requirements, and financial responsibility standards that take into account the need for liquidity and the risks associated with different lines of business. It is also important to monitor the financial condition of securities broker-dealers and other non-bank financial institutions and for regulatory authorities to inspect such institutions to ensure compliance with capital and other regulatory safeguards.

The US securities industry is comprised of many different types of brokers and dealers. There are many small specialized brokers or dealers offering a single product line as well as large diversified securities firms that provide a broad range of financial services including securities brokerage, margin loans to customers, investment banking services, money management, research, and related services. Some securities broker-dealers are the affiliates or subsidiaries of commercial banks or other business entities. Most securities firms conduct business on behalf of public investors but some limit their business to dealing with other market professionals (i.e., floor brokers, specialists, traders, and market makers). The type of securities business that a broker-dealer conducts has an impact on the financial structure of the firm. The regulatory capital requirements should be carefully devised to reflect the business risk of the firm. In the US, many broker-dealers are diversified and engage in a variety of securities-related business activities. On the other hand, broker-dealers who operate exclusively in the over-the-counter market or through memberships on regional exchanges tend to be more specialized. In the US, there are many small broker-dealers who neither carry nor clear transactions on behalf of public customers. These introducing brokers, which do not hold any customers' funds or securities, or act as underwriters and dealers in securities, have limited risk exposure. As a result, their funding needs and regulatory capital requirements are quite small.

Unlike non-bank financial institutions that primarily engage in money management activities, underwriting and dealing in securities can be highly capital intensive. This is because securities firms often maintain large inventory positions in securities and the price movements of capital market instruments (i.e., equities and long-term bonds) can be highly volatile. The financing needs of securities broker-dealers depend on the day-to-day operations of the firm as well as those imposed by regulatory requirements. Regulatory requirements depend on the nature of the assets that must be financed, which in turn are determined by the type of business conducted. In the US, the customer-related assets of broker-dealers are typically funded by customer-related liabilities.
The funding of dealer positions depends largely upon the types of proprietary securities that are held in inventory and the size and diversity of the firms' dealer operations. Government securities transactions, for example, are normally financed by repurchase agreements but financing equity positions requires larger amounts of retained earnings or other forms of permanent capital. In the US, the amount of capital required to operate the securities business is determined by the interaction of regulatory capital requirements and the business capital needs of the firm.

**Broker-Dealer Qualification Standards.** Under the *Securities and Exchange Act* of 1934, all broker-dealers engaging in interstate securities business in non-exempt securities (i.e., US Government and certain municipal securities are exempt securities) must register with the SEC and join an appropriate self-regulatory organization (SRO) such as the NASD, or one or more stock exchanges. The SEC has broad authority to inspect broker-dealers but it delegates some of its responsibility to self-regulatory organizations. Thus, SROs conduct examinations of their members. Under this system, both the SEC and the SROs conduct examinations. THE SEC conducts examinations of broker-dealers in order to evaluate their financial and operational condition but also to evaluate the quality of the most recent SRO examination. In the event the SEC is alerted to a broker-dealer's potential financial or operational problems, the SEC will conduct a 'cause' examination. Moreover, a broker-dealer must be inspected by the SEC or an appropriate SRO within six months of its initial registration. Also, all securities professionals associated with a broker-dealer, including partners, officers, directors, branch managers, supervisors, and sales persons must register with the NASD (and other SROs) through their firm. Also, securities market professionals, including prospective principles of a securities firm must qualify by examinations administered by the NASD.1

**Bank Securities Activities.** In the US, commercial banks may provide retail brokerage services directly or through a subsidiary or affiliate that is registered with the SEC. Of the 2,400 banks providing securities brokerage services, about 88 percent are provide through a registered broker-dealer subsidiary or through arrangements with non-affiliated registered broker-dealers. Furthermore, the amount of securities business conducted through the remaining 287 banks that provided securities brokerage services directly is relatively small. Because the securities laws exempt banks from SEC registration, the securities activities of the 287 banks that provide securities brokerage services directly are supervised by the bank regulators. In 1994, the bank regulators issued a joint policy statement to banks on the sale of non-deposit financial products such as mutual, funds, stocks, and bonds. In addition, some steps have been taken to ensure greater uniformity in the regulation of bank and non-bank securities brokerage activities.

In 1994, 35 subsidiaries of bank holding companies were operating with Federal Reserve approval to underwrite and deal in certain bank-ineligible securities. The broker-dealer subsidiaries of bank holding companies are registered broker-dealers. Accordingly, they are supervised by the SEC and an appropriate SRO like any other securities-broker dealer. In addition, the Federal Reserve Board examiners are responsible to ensure that appropriate 'firewalls' and internal controls are in place for Section 20 subsidiaries to prevent prohibited intercompany transactions and transfers of assets between the subsidiary broker-dealer and the affiliated insured commercial bank. Thus, both the securities regulators (i.e., the SEC and an SRO) and the Federal Reserve Board examine the Section 20 broker-dealer subsidiaries of the bank holding company but for different

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purposes. Following an exhaustive study of the regulation of bank securities activities, the US General Accounting Office made the following recommendations for improvement:

- The Federal Reserve, FDIC, OCC, SEC, and NASD should work together to develop and implement an approach for regulating bank direct securities activities that provides consistent and effective standards for investor protection, while ensuring bank safety and soundness.
- The Chairman of the Board of Governors of the Federal Reserve System should ensure that either Federal Reserve examiners or internal auditors review and test all applicable firewalls at least once annually and appropriately document the work performed.
- The Chairman of FDIC should establish a program to identify and routinely review the securities activities and the financial condition and performance of bonafide subsidiaries under FDICs jurisdiction to assess the overall risk posed by the activities of federally insured banks and ensure compliance with firewalls. The program should provide FDIC examiners guidance and training on how to examine bank and bank subsidiary securities activities.

**Evolution of Prudential Standards.** The US prudential standards for registered securities broker dealers have evolved over many years. The prudential standards administered by the SEC for registered broker-dealers (including broker-dealer subsidiaries, or affiliates of banks) are comprehensive in their treatment of risk, they are liquidity based, and perhaps most importantly, the standards have withstood the test of time. In fact, capital standards imposed by the stock exchanges for their members existed prior to the establishment of the SEC in 1934. Prior to the enactment of the uniform net capital rule in 1975, exchange members were exempt from the provisions of the SEC’s net capital rule which applied only to over-the-counter broker-dealers that were not members of a stock exchange. With the passage of the Securities Act Amendments of 1975, Congress mandated a uniform capital rule for the entire US securities industry (i.e., broker-dealers that conduct business with public customers). Since banks are excluded from the definition of broker-dealer under the Securities Exchange Act of 1934, commercial bank prudential standards are set by the Federal and state bank regulatory authorities while the securities broker-dealer subsidiaries of bank holding companies are subject to regulation by the SEC and the self-regulatory organizations of with whom they are members. With regard to securities brokers-dealers, individual state securities commissions also regulate securities firms operating within a particular state. As a practical matter, however, the individual states have embraced uniform registration and prudential standards equivalent to those imposed at the national level by the SEC.

Securities broker-dealers often hold large amounts of customers’ funds and securities. Thus, Section 15 (c)(3) of the Securities Exchange Act of 1934 gives the SEC substantial authority to prescribe rules that ‘provide safeguards with respect to the financial responsibility and related practices of brokers and dealers.’ This includes ‘the acceptance of custody and the use of customers’ securities and the carrying and use of customers’ deposits or credit balances.’ It also provides that the SEC ‘shall ... establish minimum financial responsibility requirements for all brokers and dealers.’ Historically, the principal regulatory tool used to insure the financial integrity of broker-dealers has been the requirement that firms maintain an adequate capital base relative to the firms’ aggregate indebtedness. In addition to the net capital requirements, certain financial responsibility rules of the SEC and the self-regulatory organizations regarding the hypothecation

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and segregation of customers’ securities were adopted for the protection of the customers of securities firms.

**Capital Standards.** The SEC’s net capital standard for broker-dealers in securities (Rule 15c3-1) was first implemented in 1944. It was intended to assure that broker-dealers had sufficient liquid assets to promptly meet the demands of customers. The rule describes how to compute net capital (i.e., adjusted net worth) and establishes minimum amounts of net capital that a broker-dealer must maintain. The rule also provides that the aggregate indebtedness of a broker-dealer cannot exceed a certain percentage of net capital (i.e., 1,500 percent). Net capital may be viewed as the adjusted net worth of a broker-dealer. Net worth (assets less liabilities) is adjusted so that certain assets which are not readily convertible into cash are excluded from net capital. Furthermore, proprietary securities positions are valued for net capital determination at less than their fair market value to provide a cushion against market fluctuations. The net capital is essentially the amount by which a securities broker-dealer’s liquid assets (assets readily convertible into cash) exceed its non-subordinated liabilities. Certain prescribed deductions from this amount must be subtracted as a cushion against possible losses stemming from price volatility. The amount of capital required increases as a firm expands its business.

Prior to the adoption of the Uniform Net Capital Rule in 1975, Rule 15c3-1 applied primarily to over-the-counter broker-dealers. Exchange members, including most of the largest firms in the securities industry, were exempt from the rule. In effect, most small broker-dealers (those not having exchange memberships) were subject to the Commission’s net capital rule. Historically, members of the major securities exchanges operated under the exchanges’ capital requirements, which were similar in most respects to the SEC’s net capital rule. The net capital requirements, however, tended to be uneven in their application, and the lines of responsibility for administering the capital rules were not always clear. As is the case in commercial banking, there has been a trend toward greater international coordination in an attempt to harmonize securities broker-dealer prudential standards. Because of the great variety of organizational structures employed and product lines offered by securities firms (i.e., specialized securities firms vs. universal banks, financial conglomerates etc.) as well as the multiplicity of securities regulatory bodies (i.e., securities commissions, central banks, provincial vs. national regulation, etc.) found around the world, it has been possible only to agree on general principles regarding prudential standards.

**Hypothecation and Segregation Requirements.** In 1940, the SEC first developed rules regarding the hypothecation of customers’ securities in the possession of broker-dealers. The hypothecation rules are intended to limit the ability of broker-dealers to pledge customers’ securities as collateral for loans. They have three basic provisions. First, the securities of a customer cannot be commingled under a lien with the securities of other customers without written consent. Second, customers’ securities cannot be commingled with securities carried for the account of a non-customer under a lien for a loan made to the broker-dealer (even with consent).

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7Securities Exchange Act Release No. 2690, Securities and Exchange Commission, Washington, D.C., November 15, 1940. The hypothecation standards are contained in Rule 8c-1 and Rule 15c2-1. The two rules are identical, except that Rule 8c-1 applies to exchange members, while Rule 15c2-1 applies to broker-dealers effecting over-the-counter transactions.
Third, customers' securities cannot be hypothecated to secure a loan which exceeds the total amount that all customers owe to the broker-dealer on securities carried for their accounts.

Prior to January 1973 the Commission had no rules regarding the segregation of customers' securities. The SROs, however, had regulations requiring that customers' fully paid and excess margin securities be kept separate from securities that are permitted to be used for the purpose of meeting margin requirements and from proprietary securities. Customers' securities in excess of 140 percent of the debit balance in a customer's margin account (excess margin securities) were required to be segregated. It was not until the adoption of the Securities Investor Protection Act of 1970 (SIPC Act) that the Commission was authorized to adopt rules regarding the segregation of customers' securities. The SIPC Act was adopted in the wake of the demise of many securities broker-dealers in the aftermath of the paperwork crisis which occurred in 1967-1969 and which was followed by the severe market decline of late 1969 and early 1970.

**Securities Investor Protection Act.** The traditional regulatory tools available to the SEC for the protection of customers did not prove adequate to meet the test of the severe stock market decline of 1969 and early 1970. The insolvency of a large number of broker-dealers resulted in losses to customers of funds and securities that were in the possession of broker-dealers. These events led to the passage of the SIPC Act and major changes in the SEC's financial responsibility rules. The SIPC Act provided for the establishment of the Securities Investor Protection Corporation (SIPC) to protect customer funds and securities within specified limits in the event of a securities broker-dealer's insolvency. In the event of a securities broker-dealer's insolvency, SIPC insures customers' securities and funds held by the broker-dealer up to US$500,000 of which US$100,000 may be in cash. In addition, the SIPC Act amended Section 15(c)(3) of the Exchange Act by broadening and specifying the powers of the SEC on the subjects of reserves for customers' deposits or credit balances and the segregation of customers' securities. The SIPC Act, however, did not specify the manner in which reserves on customers' deposits or credit balances should be determined. Congress left this for the SEC to determine.9

**Reserve Formula Standard.** In 1973, the SEC implemented Section 7 (d) of the SIPC Act by adopting Rule 15c3-3 which provide for reserve and segregation requirements for the protection of customers cash and securities in the possession and control of securities broker-dealers. Rule 15c3-3 established a formula for determining reserve requirements ('Reserve Formula') for customers' cash and monies realized through the use of customer's securities. Also, the rule required and established procedures for the segregation of customers' fully-paid and excess margin securities in the possession or control of broker-dealers.10 Rule 15c3-3 has two major components. First, it provides a 'formula' for the determination of reserves. The Reserve Formula is designed to eliminate the use of customers' funds and securities by broker-dealers in financing firm overhead and such dealer activities as market-making, trading and underwriting. Second, the rule codifies the obligation of broker-dealers to establish procedures for insuring the prompt physical possession or control of all fully-paid and excess margin securities carried for the account of customers.

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10Recommendations for addressing the regulatory policy issues raised by the SIPC Act were first articulated in a capital study prepared by the economics staff. See: Chuppe, Terry M. and Le Manh Tri, *The Financial Condition of Broker- Dealers: A Question of the Adequacy of Capital and Regulatory Safeguards*. US Securities and Exchange Commission (June 1971) ("The Capital Study").
Rule 15c3-3 requires broker-dealers to determine customers’ free credit balances, funds realized by a broker-dealer as a result of the hypothecation or lending of customers’ margin securities, funds derived from the failure to receive securities of customers on settlement date from another broker-dealer, and funds derived from other customer-related sources as specified in the formula. The Reserve Formula enables the broker-dealers to determine whether these customers’ funds had been committed to finance certain permissible areas of brokerage business. Thus, the reserve formula places customers’ cash and funds generated by the broker-dealer from use of customers’ securities on one side of the ledger (i.e., customer-related liabilities). On the other side of the ledger, the broker-dealer is required to calculate customer-related assets in the form of secured margin loans, securities borrowed to facilitate delivery of customers’ securities, certain customer-related fails to deliver. The amount by which customer-related liabilities exceeds customer-related assets must be deposited in a reserve bank account for the exclusive benefit of customers. Rule 15c3-3 also requires that broker-dealers segregate customers’ fully-paid and excess margin securities. This is accomplished by requiring that broker-dealers make daily determinations of the location of fully-paid and excess margin securities. In effect, Rule 15c3-3 prohibits a broker-dealer from using customer funds and securities to finance its on-going business activities (i.e., inventory positions in securities, firm overhead etc.) except for those relatively safe areas of the business related to customer securities transactions.

Uniform Net Capital Standard. A second major innovation in the SEC’s financial responsibility rules came with the adoption of the Uniform Net Capital Rule in 1976. While keeping the basic net capital concept, it provided for an alternative capital method under Rule 15c3-1 which linked, for the first time, the capital requirements of broker-dealers with the Reserve Formula of Rule 15c3-3.¹ The Uniform Net Capital Rule requires all broker-dealers doing business with the public to comply with the SEC’s net capital standard. Prior to its adoption, most of the largest broker-dealers in the industry were exempt from the SEC’s net capital rule because of the exemption from the rule available to members of the stock exchanges. While the capital rules of the stock exchanges were conceptually similar to those contained in Rule 15c3-1, there were important differences in the computation of aggregate indebtedness and net capital.

Under the uniform net capital rule, securities broker-dealers may compute their regulatory capital requirements under one of two methods: (a) the basic capital method (BCM) or (b) alternative capital method (ACM). Under the BCM, a securities broker-dealers ‘aggregate indebtedness’ may not exceed 1,500 percent of ‘net capital.’ Under the BCM, broker-dealers that carry customers accounts must have a minimum net capital of US$25,000. Under the ACM, a broker dealer must maintain a minimum net capital of US$100,000, or two percent of the aggregate debit items contained in the reserve formula calculated pursuant to Rule 15c3-3. The debit balances in the reserve formula are essentially customer-related assets. The reserve formula in effect allows the broker-dealer to use customer-related liabilities to fund customer related assets but not proprietary positions in securities or other assets of the securities firm. The reserve formula contemplates that customer-related assets (i.e., debit balances in customer cash and margin accounts, securities borrowed to effectuate customers’ short sales or to make delivery on customers’ securities failed to deliver) can be liquidated, if necessary, at or near their contract value. Moreover, securities broker-dealers are expected to maintain sufficient liquidity to promptly

meet the demands of their customers for funds or securities left in the possession or control of the firm. While the minimum capital requirements for entry into the securities business are not large, the capital requirements increase rapidly as the business and risk-exposure of the securities firm increases.\textsuperscript{12}

**Financial Reporting, Audits, and Examinations.** US securities broker-dealers are subject to extensive financial reporting, an annual audit, and other on-site and off-site surveillance, including inspections and examinations by the SROs and the SEC. In addition, the annual audit, broker-dealers are required to file a uniform regulatory statement of financial condition (FOCUS Report) prescribed by the SEC each quarter.\textsuperscript{13} In addition to the quarterly FOCUS reports, monthly off-site surveillance reports are also required to be filed with a designated self-regulatory organization in order to monitor the financial condition of broker-dealers and compliance with the financial responsibility standards, including the net capital and other regulatory requirements. The FOCUS report has proven to be a very useful tool in monitoring on-going compliance with the uniform net capital rule, reserve requirements pursuant to Rule 15c3-3 and other regulatory requirements. Copies of the FOCUS reports are filed with the designated examining authority (i.e., an SRO) and with the SEC.

Two copies of annual audited financial statements, which are available to the public for inspection, must be filed with the SEC’s headquarters office in Washington, DC and one copy must be filed with the appropriate regional office of the SEC and with the SRO which is the designated examining authority for the broker-dealer. In the event that a securities broker-dealer does not meet certain financial and operational parameters, more frequent reports (i.e., weekly reports) can be required. Under Rule 17a-5, the audited financial statement of broker dealers must include (a) a statement of financial condition, (b) statement of income or loss, (c) statement of cash flow, (d) a statement of stockholders’ equity, or partners or sole proprietor’s capital and (e) a statement of liabilities subordinated to the claims of general creditors. In addition the audited statement must include supplementary schedules showing compliance with the net capital and other financial responsibility requirements. The annual audit may be on a fiscal or calendar year basis selected by the securities broker-dealer. In subsequent years, however, the audit date may not be changed without prior approval by the SEC.\textsuperscript{14}

**Regulation of Government Securities Dealers in the USA**

Securities issued by the national government and central banks are normally exempt from the registration and disclosure requirement administered by the national securities regulatory bodies. In the US, for example, government securities are not required to be registered with the SEC but transactions in such securities are subject to the antifraud provisions of the securities laws and applicable regulations.\textsuperscript{15} In general issuance procedures are controlled by the central bank, or in some countries, the Ministry of Finance, or National Treasury. In the US, the Federal Reserve Bank of New York is the focal point for the operation of the market while the US Treasury, the

\textsuperscript{12}Levine (1994), op. cit. pp. 5-6.
\textsuperscript{13}On December 17, 1975, the SEC announced the adoption of the FOCUS report as the new reporting system for broker-dealers. This was intended to achieve uniformity in financial reporting for broker-dealers and to reduce the cost burden on the securities industry that resulted from filing financial reports with several SROs that were not uniform but duplicative in nature.
\textsuperscript{14}Audits of Brokers and Dealers in Securities, American Institute of Certified Public accountants. New York, N.Y., 1992.
bank regulatory authorities, and the SEC have regulatory responsibility with respect to certain dealers in government securities.

The US Secretary of the Treasury is authorized to issue treasury securities on behalf of the Federal government and to prescribe terms and conditions for their issuance and sale. The US Treasury, through the 12 Federal Reserve district banks and their respective branches, sell government securities to the public through a competitive auction process. The US government securities market is the largest and most liquid market for debt securities in the world. It consists of the market for US Government securities and the issues of government agencies and corporations. In this market, treasury securities are issued in the form of short-term treasury bills, medium term notes, and bonds with longer maturities. The pricing efficiency of the US government securities market is critical to other financial markets as well. It provides a continuous benchmark. The market in US Government securities is a global market with continuous trading 24 hours a day. This benchmark is used, not only in the US, but world-wide, for pricing US dollar-denominated debt instruments across the maturity spectrum. The Federal Reserve Bank of New York, acting on behalf of the Federal Open Market Committee, uses the day to day purchases and sale of government securities as an instrument of monetary policy. The auction rules are issued by the US Treasury which is also responsible for compliance and enforcement.\(^6\)

The US Treasury, through the 12 Federal Reserve district banks and their branches, sells marketable debt securities to the public through a competitive auction process while the Federal Reserve Bank of New York, acting on behalf of the Federal Open Market Committee, uses the day-to-day purchase and sale of government securities as an instrument for monetary policy. Private participants in the market for government securities include primary dealers and secondary dealers. Primary dealers in government securities are a group of securities dealers and commercial banks that are recognized by the Federal Reserve Bank of New York to perform certain functions. Primary dealers are required to demonstrate market making capacity, credit-worthiness and other factors that demonstrate their ability to participate in the auctions for new government debt.

Primary dealers in US government securities are selected by the Federal Reserve Bank based upon their abilities to perform the function of primary dealer. Dealers in government securities play an important role in providing market liquidity. In the US, the secondary market for government securities is highly open and competitive. Secondary market dealers must meet the prudential and other regulatory standards imposed by the appropriate regulatory authority to whom they are assigned. Dealers in government securities may be subject to different regulatory requirements depending upon their role in the financial sector. The most common approach is for the bank regulatory authority to regulate commercial bank dealers in government securities while either the securities regulatory authority, central bank, or another Government ministry will regulate non-bank dealers in government securities.

While generally recognized as the most efficient securities market in the world, even the US Government securities market has experienced problems that have required corrective measures to be taken in recent years. In the 1980s, the failure of several unregulated government securities dealers resulted in investors’ losses of about US$900 million. In the aftermath of these failures, the

US adapted the *Government Securities Act* of 1986 that brought about significant changes in the regulation of government securities dealers. With the enactment of the *Government Securities Act* of 1986, all brokers and dealers in US government securities became subject to regulation and oversight by an appropriate Federal government regulatory authority. As a result, the US offers an interesting model of regulation applied to both bank and non-bank financial institutions acting as brokers and dealers in government securities.

The current regulatory structure for brokers and dealers in US Government securities is relatively new. A major regulatory gap in the regulation of brokers and dealers in US government securities existed prior to the passage of the GSA in 1986. Although securities broker-dealers and commercial banks were subject to regulation under the securities and banking laws, respectively, there were a large number of dealers in US Government securities, including several primary dealers, that were neither broker-dealers as defined in the Securities Exchange Act of 1934, or banks, as defined under US banking law. Consequently, they were largely unregulated because they were not required to register with any regulatory agency as a result of their activities. The failure of several unregulated government securities dealers between 1975 and 1985 resulted in losses to investors that had engaged in repurchase agreement transactions with the unregulated dealers. In addition to the demise of several savings and loan institutions, a number of other savings and loan institutions, municipalities, and school boards incurred substantial financial losses. It is estimated that between 1982 and 1986, US investors lost about US$900 million due to the failure of unregulated government securities dealers. All of the firms that failed were outside the Federal regulatory structure.

One unregulated government securities dealer, for example, did not reflect in its financial statements for over five years that it had substantial losses from trading government securities. It was able to continue in business by issuing false financial statements and by engaging in repo transactions without adequate collateral. Another unregulated government securities dealers' failure resulted from the provision of financing for a related government securities firm that had incurred large trading losses in government securities. In this instance, the unregulated dealer engaged in repurchase agreement transactions with the customers of its affiliated registered broker-dealer who did not take delivery of the securities underlying the repurchase agreements. It should be noted, however, that repo transactions, when properly conducted, contribute greatly to the efficient functioning of the US Government securities market. Repos are the principal means by which government securities dealers are able to finance their huge inventories in government securities. Repos are the least expensive source of funding for such inventory positions. Without the use of repos, the cost of issuing and transacting in US Government securities would be considerably higher.

Dealers in government securities also engage in reverse repo transactions in which the dealer is the initial purchaser of the securities to obtain securities that are needed for delivery or to

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18 Prior to the passage of the GSA, the lack of regulation resulted from the classification of 'government securities' as exempt securities defined in Section 3(a)(12) of the Securities Exchange Act of 1934. Although the vast majority of government securities dealers were subject to some form of regulation, brokers and dealers that executed transactions exclusively in US government securities were not subject to supervision by any regulatory agency.
engage in other repo transactions. Repos involve credit risk to the extent that the parties to the transaction fail to meet their respective obligations, or to the extent that customers allow dealers to hold custody of securities that have been purchased. Prior to the passage of the GSA, the losses to investors often resulted from hold-in-custody repos by dealers who engaged in practices such as selling the same security under several repurchase agreements and by providing inadequate collateral for the repo transactions. In a hold-in-custody repo, a dealer or broker receives funds from the sale of securities while retaining possession or control of the securities sold. The losses resulted primarily from the failure of dealers to obtain possession and control of government securities on behalf of their customers.

In the aftermath of two rather large failures, many investors and dealers in US government securities would engage in transactions only with primary dealers even though some primary dealers at that time were not subject to federal regulation except that associated with their status as a primary dealer. It was felt that the flight to quality might imperil the viability of some secondary dealers that contributed to the functioning of the market in government securities. In 1986, there were 35 primary dealers of which 14 were banks or bank subsidiaries, 12 were securities broker-dealers subject to oversight by the SEC and nine were unregulated (at the Federal level) government securities dealers. All primary dealers were, however, subject to Federal Reserve Bank of New York oversight in that they were required to submit daily trading or financial data and were subject to Federal Reserve Bank of New York dealer surveillance visits. In addition to the primary dealers, there are a large number of secondary dealers in government securities. Secondary dealers market new issues of government securities to the public and serve as market makers. In 1986, it is estimated that there were about four to five hundred secondary dealers in government securities. The precise number is not known since they were not required to register with any Federal government agency. However, the majority of these dealers were subject to some form of Federal regulation since many of them were commercial banks or securities firms (i.e., broker-dealers) registered with the SEC. It is estimated that about 100 government securities dealers (including seven primary dealers) were unregulated at the Federal level. In this environment, the GSA was passed in 1986.

**Government Securities Act of 1986.** With the enactment of GSA, it was necessary to develop a regulatory framework so that previously unregistered brokers and dealers in government securities would be registered with an appropriate regulatory body. With the enactment of the GSA, the US Treasury was able to issue regulations concerning financial responsibility, protection of investors' securities and funds, recordkeeping, reporting, and auditing of government securities brokers and dealers. The Act also gave Treasury the responsibility for developing regulations over the custody of government securities held by depository institutions. The Act required that the SEC and the Federal Reserve Board establish rules governing the procedure and forms to be used for the registration of all government securities brokers and dealers. In drafting these regulations, Treasury was required by the GSA to consult with the SEC and the Federal Reserve Board. Enforcement authority for these rules rests with the SEC and the self-regulatory organizations or with the appropriate financial institution regulatory agency.\(^{19}\)

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Under the GSA, a government securities broker-dealer is any entity, including a financial institution, which acts as a broker or dealer in government securities. Consequently, previously unregulated brokers and dealers that limit their business to government securities were required to register with the SEC and join a self-regulatory organization. In the US, all broker-dealers registered with the SEC must also become a member of at least one self-regulatory organization (i.e., a stock exchange, or the NASD). In order to assure that all government securities dealers were subject to regulatory oversight, the GSA also required that firms registered as securities brokers and dealers, or as municipal securities brokers or dealers, notify the SEC if they conduct transactions in government securities. Likewise, financial institutions (i.e., banks functioning in the capacity of a broker or dealer in government securities) were required to notify the appropriate financial institutions regulatory agency of their activities in government securities. In the US, there are a number of bank supervisory regulatory agencies that have jurisdiction over financial institutions. Accordingly, such government securities dealers were required to notify the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, or the Office of Thrift Supervision.

In view of the problems that existed prior to the passage of the GSA, regulations were adapted to deal specifically with the protection of customers' securities in the possession or control of government securities related to hold-in-custody repo transactions. The regulations adapted were quite comprehensive in their coverage. Customer protection was enhanced by requiring that (a) information be provided to investors in writing, explaining the specifics of the transaction; (b) disclosures be made concerning the risks associated with granting the broker or dealer the right to substitute securities and that there is an absence of insurance coverage under either the Securities Investor Protection Act of 1970, or the Federal Deposit Insurance Corporation (FDIC); (c) specific securities must be clearly and separately held for, and a description of them disclosed to, the customer; and (d) the securities used to collateralize a repo agreement must be maintained free of any lien.

The GSA gave authority to the Secretary of the Treasury to promulgate rules and regulations concerning (a) financial responsibility, (b) protection of investors securities and funds, (c) recordkeeping, (d) reporting and (e) audit of government securities brokers and dealers. As a result, formerly unregulated government securities dealers were subject to formal capital requirements and other regulatory safeguards for the first time. In developing regulations under the GSA, the Treasury Secretary was required to consult with the SEC and the Board of Governors of the Federal Reserve System. Furthermore, the US Congress directed the Treasury Secretary to use existing regulations whenever possible, thereby avoiding duplicate requirements; avoid imposing overly burdensome rules; and ensure that the rules did not result in unequal treatment of market participants.

With the passage of the GSA, it was contemplated that financial institutions government securities brokers or dealers would be subject to the regulatory oversight of the appropriate Federal financial institutions regulatory agency responsible for the regulation and supervision of banks. The Federal bank supervisory agencies are the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, The Board of Governors of the Federal Reserve System and the

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20 With respect to financial responsibility, broker-dealers registered with the US SEC must comply with its net capital rule for the purpose of complying with the financial responsibility rules pursuant to the GSA requirements. Financial institution government securities dealers must comply with the respective capital requirements of the appropriate financial institutions regulatory agency in order to comply with the GSA regulations.

21 15 U.S.C. 78q-5(b)(2) and (3).
Director of the Office of Thrift Supervision (formerly, Federal Home Loan Bank Board). Unregulated government securities dealers were required to register with the US SEC and join a self-regulatory organization (i.e., the NASD, or stock exchange). With respect to financial institutions, under the GSA, the FED Board was given responsibility to formulate and issue rules regarding the form and content of written notices to be used by financial institutions to give of their status as government securities brokers or dealers. An institution may be exempt from the notice requirement if it engages in specified limited government securities activities. A financial institution, for example, could be exempt from having to give notice if all of its dealer transactions are conducted in a fiduciary capacity or are limited to repurchase transactions.\textsuperscript{2} With respect to non-financial institutions, the US SEC, utilizing existing forms and procedures, developed rules to facilitate the registration and notice for both newly registering firms and for those already registered as brokers or dealers. As part of the registration process, the US SEC required that newly-registered government securities brokers and dealers file statements of financial condition.

On July 24, 1987, the date on which the final regulations were published implementing the GSA, there were 40 primary dealers, eleven of which were previously unregulated. All of the previously unregulated primary dealers became either registered government securities brokers-dealers or registered broker-dealers with the US SEC. Because of the enactment of the GSA and with a more liberal view of the Federal Reserve board of permissible activities (i.e., closely related to banking) under Section 20 of the Glass-Steagall Act, several primary dealers changed their regulatory status. On July 24, 1987, nine primary dealers were financial institutions that conducted their government securities operations within the bank. Since then, several financial institution primary dealers created, or merged existing government securities operations into subsidiaries through which they conduct their securities business, rather than within the bank itself. As a result, by June 1990 only three primary dealers conducted their government securities business as financial institutions.

Perhaps the most far reaching requirement of the GSA regulations pertaining to the protection of customers' securities in the possession or control of a government securities dealers related to hold-in-custody repo transactions. Under the GSA, customer protection was enhanced by requiring that (a) information be provided to investors in writing, explaining the specifics of the transaction; (b) disclosures be made concerning the risks associated with granting the broker or dealer the right to substitute securities and that there is an absence of insurance coverage under either the Securities Investor protection Act of 1970, or the Federal Deposit Insurance Corporation (‘FDIC’); (c) specific securities must be clearly and separately held for, and a description of them disclosed to, the customer; and (d) securities used to collateralize a repo agreement be maintained free of any lien.

**Government Securities Dealers in Emerging Markets**

In Asia's emerging markets, there has been a tendency for banks to dominate the primary market in government debt with secondary markets normally being inactive. In Hong Kong, dealers in government securities include both banks and independent securities dealers. These entities are regulated by the Monetary Authority (banks and deposit taking companies) and the SFC (securities dealers). In Korea, both banks (regulated by the central bank) and securities firms

\textsuperscript{22}The limited exemption from the notice requirement was predicated upon compliance with regulatory requirements for hold-in-custody repurchase transactions (except for foreign branches and agencies dealing exclusively with foreign customers resident offshore) and the provision for custodial holdings of government securities for customers.
(supervised by the KSEC and MOF) participate as brokers and dealers in the government securities market. In Singapore, all financial institutions are regulated by the Monetary Authority.

In the Philippines Government securities are exempt securities; thus, they are not required to be registered with the SEC. This is typical of most countries, including the US, Banco Sentral ng Pilipinas (BSP), the central bank is responsible for the regulation of commercial banks dealing in government securities, including primary dealers. Some Government securities dealers are registered with the Philippines SEC in view of their transactions in non-exempt securities. As a result, commercial banks, accredited dealers, and securities broker dealers (i.e., investment houses) are subject to some form of regulation with respect to their transactions in Government securities. As was the case in the US during the early 1980s, it appears that secondary market dealers not falling into one of the foregoing categories are not subject to regulation under the regulatory scheme. In mid-1994, an unregulated secondary dealer in Government securities failed to deliver to securities owed to investors bringing to light the lack of supervision in a segment of the secondary market for Government securities. The regulatory gap in the Philippines was similar in cause to that which occurred in the US a decade earlier. In the US, the failure of several unregulated US Government securities dealers resulted from the non-delivery of customers securities related to repurchase agreement transactions. In the Philippines, the recent failure of an unregulated dealer in the secondary market for Government securities involved the non-delivery of securities involving a confirmation of sale (COS) transactions whereby securities are expected to be delivered up to one or two months in the future. In both cases, transactions in the secondary market for government securities involving the non-delivery of customers’ securities by unregulated dealers resulted in losses to investors.

There appears to be at least three factors involved in both the US experience in the early 1980s and the recent events in the Philippines that contributed to the problem in both instances. First, there was a lack of regulatory supervision for an important segment of the secondary market in government securities in both instances. Second, there was a lack of adequate safeguards for the protection of customers of government securities held by dealers on behalf of their customers. Finally, there were inadequate checks and balances built into the systems to reduce the potential risk exposure to customers. Both instances point out that imperfections in the regulatory structure can increase risk exposure and erode public confidence.

Regulation of Investment Companies in the USA

Investment companies are a type of non-bank financial institution that obtain monies from a large number of individuals and invest those funds in liquid financial assets in the form of money and capital market instruments. With increased frequency in recent years, institutional investors such as pension plans or bank trust departments have also invested funds under their management in mutual funds.23 With the expansion in the number and diversity of mutual funds, there has also been a dramatic growth in U.S. institutional investors’ demand for mutual funds as an investment vehicle. In the 1940s, few, if any, institutional investors investing their funds through investment companies. By 1970, institutional investors’ investment position in investment companies had grown to eleven percent of investment company assets. Today about half (47.5 percent) of the monies invested in investment companies represents funds supplied by other institutional investors, usually on behalf of managed accounts.


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In the US investment companies are regulated by the SEC under the *Investment Company Act of 1940*. When the Act was enacted in 1940, the dominant form of investment company was the closed-end fund. In 1940, mutual funds (i.e., open-end investment companies) were relatively new. Since then, mutual funds, or open-end funds have grown dramatically. By the 1960s, open-end funds became the most important type of investment company, accounting for more than four-fifths of investment company industry assets. At year-end 1995, open end funds, or mutual funds, accounted for more than 95% of the US$3.2 trillion in investment company assets.

**Establishment and Structure.** Securities laws and regulations provide guidance for the establishment and structure of investment companies. Investment companies may be organized as corporations or as business trusts. In the US, investment companies may take either form. Historically, the corporate form of organization was more prominent in the US because the vast majority of investment companies were closed-end funds. As mutual funds have become the dominant form of investment company, the business trust form of organization has become more common. As a practical matter, however, it should be noted that the regulatory frameworks applied to investments companies in the US and in other countries are quite similar regardless of the type of formal ownership structure.

Under the corporate form of ownership, the board of directors is not only responsible to the shareholders for the operation of the business but also have important regulatory responsibilities. Under the business trust arrangement, the mutual fund is established pursuant to a trust agreement whereby the trust is authorized by the Board of Trustees to issue an unlimited number (i.e., open-end fund) of shares of beneficial interest in the trust. The shareholders in the trust are entitled to vote on matters such as the approval of the investment advisory agreement and on other important matters related to the operation of the trust. As is the case with respect to corporate shareholders, each share issued by the trust has an equal right with respect to earning, dividends, redemption and the net asset value of the mutual fund. In managing the affairs of the mutual fund, the role of the Board of Directors, or the Board of Trustees, is to oversee the operation of the fund in the interest of its shareholders. In this regard, the *Investment Company Act of 1940* imposes strict fiduciary duties on the directors (or trustees) and on the investment advisors with respect to the level of compensation received under the advisory contract. The Act also requires that at least 40 percent of the mutual funds directors be disinterested directors who do not have any relationship with the management or day-to-day operations of the fund (i.e., the performance of investment advisory, management, or underwriting functions).

**Bank Sponsored Mutual Funds.** Prior to the early 1980s, it was generally believed that the restrictions imposed by the *Glass-Steagall Act* prohibited banking institutions from engaging in most aspects of the mutual fund business. Since then, a series of decisions by banking regulators and court rulings has allowed banks and thrifts to engage in a wide variety of mutual fund activities, including selling mutual funds to retail customers and serving as a fund’s investment adviser. Bank sponsored mutual funds are subject to a variety of securities and banking regulations.

Under the *Securities Act* of 1933, all mutual fund shares, including those sponsored by banks must be registered with the SEC. Under the *Investment Company Act of 1940*, the SEC

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25 In most of Europe and Japan the trust arrangement is the norm.
regulates and supervises the operations of all mutual funds the investment advisers to mutual funds are subject to the provisions of the Investment Advisors Act of 1940. Furthermore, the Securities and Exchange Act of 1934 requires that persons who sell shares of mutual funds must be registered with the SEC as broker-dealers and become a member of the NASD which has important regulatory responsibilities with respect to mutual fund advertising and sales practices. However, banks that sell fund shares directly rather than through a broker-dealer subsidiary are exempt from this requirement. Likewise, banks that promise advisory services are exempt from the definition of investment adviser and thus may elect to provide investment advice to a mutual fund with registering with the SEC as investment advisers. The mutual fund activities of banks are also subject to regulation by an appropriate bank regulatory agency: (a) the OCC supervises national banks; (b) the Federal Reserve supervises state-chartered banks that are members of the Federal Reserve System and bank holding companies; and (c) the FDIC supervises state-chartered banks that are not members of the Federal Reserve System. Since thrift institutions are not exempt from the definition of broker-dealer (i.e., the exemption is applicable only to banks), mutual fund sales by thrifts cannot be done directly by the thrift institution. Accordingly, they must be sold through a broker-dealer that is registered with the SEC. In a recent study of the sales practices of bank sponsored mutual funds, the US General Accounting office found inadequate compliance with sales practice guidelines and it recommended that SEC, the Federal Reserve, FDIC, OCC, and OTS (Office of Thrift Supervision) work together to develop and approve a common approach for conducting examinations of banks' mutual fund activities to provide effective investor protection, while ensuring bank safety and soundness.

Types of Investment Companies. There are several distinct types of investment companies. In general, an investment company is essentially an issuer of securities that is primarily engaged in the business of investing in securities. Investment companies perform an important economic function. They offer investors both professional money management and diversification of risk. In the US, there are two basic types of managed investment companies: open-end funds (i.e., mutual funds) and closed-end funds. Mutual funds are called 'open-end' funds because they continually offer new shares to the investing public. Closed-end funds, on the other hand, offer only a fixed number of shares. The number of shares offered by a closed-end fund is determined at the time of the initial public offering. The shares of closed-end funds shares are not redeemable at the option of the investor but rather are sold in the secondary market. In essence, they trade and the market price is determined like that of a typical common stock. Many closed-end funds are listed on the New York and other stock exchanges. Today, this type of investment company accounts for less than five percent of the investment company industry assets whereas in the 1940s the closed-end funds were the dominant form of investment company.

28 ibid., p. 7.
29 As discussed later in this paper, there are several important types of pooled investment funds that are not considered to be investment companies under the Investment Company Act.
30 Unit investment trusts are another distinct form of investment company offered in the US financial market. Unit investment trusts, which were very popular in the US during the early 1900s, are essentially an un-managed portfolio of redeemable units of a fixed portfolio of securities. In the US, unit investment trusts do not have a board of directors. Moreover, the portfolio in the trust is un-managed and remain fixed throughout the life of the trust. Often the trust sole asset is the share of a single open-end investment company in which the trust issues certificates that represent the indirect interest of its investment in the shares of the underlying mutual fund. In other countries (i.e., United Kingdom, Malaysia, and India), it should be noted that the term 'unit investment trust' is often used to refer to what are called commonly referred to as 'mutual funds' in the US.
Mutual Funds. Since the late 1930s, the US investment company industry has experienced rapid and continuous growth. In recent years, the mutual fund has become the dominant form of investment company. It is an important vehicle for the mobilization of the savings of small relatively unsophisticated individual investors. Mutual funds offer a number of important advantages to small investors: professional money management, portfolio diversification, and economies of scale. Mutual fund invests the money of its shareholders in a wide array of liquid financial instruments including equity securities, government and corporate bonds and money market instruments. At least 85% of a mutual funds assets must be invested in liquid securities. Although liquidity is not specifically defined in the regulations, the ability to liquidate a security position in seven business days is normally considered appropriate.

In recent years, there have been many innovations in the investment company industry. At least 18 different specialty fund categories are available to US investors. Because the SEC does not engage in merit regulation, mutual funds may invest in all types of securities including high yield corporate bonds or speculative stocks. The objective of the investment fund, however, must be clearly disclosed to investors. In general, mutual funds may be classified according to the relative safety or stability of capital or current income. Money market funds, for example are a relatively conservative investment. They invest in short-term Government securities, or money market instruments. Many savers would view a money market fund as a deposit substitute since they entail relatively little risk and are highly liquid. Other types of funds invest in more risk investments such as corporate stocks, high yield corporate bonds (junk bond), or specific industries, regions of the world, or specific foreign countries. Many funds invest in a highly diversified portfolio of stocks, bonds, and money market instruments. They are free to alter the composition of their portfolio in response to changing market conditions. Another approach available to investors is to select an indexed fund which does not attempt to out-perform the market but rather simply structure their portfolios to track a particular index such as the Standard and Poor’s 500.

Mutual funds are sold to investors by securities broker-dealers, banks, or directly by the fund own sales force. The later offers an advantage to investors in that this method of distribution does not have a sales charge (so-called no load fund) or a relatively low sales charge. Regardless of the distribution method, mutual funds receive a management fee in return for providing a variety of services to their shareholders. Most funds offer investors the right to buy shares at regular intervals. Under such plans the dividends re-invested automatically. Many sponsors offer a group of funds to investors whereby the individual investors may move their money among funds with a variety of investment objectives. In the 1990s, mutual funds have increasingly been organized into investment company complexes. These are large groups of mutual funds associated with common investment advisers or underwriter which typically offer the investor the privilege of moving monies among the funds.

In the US, any individual or group can establish a mutual fund. Typically, however, a securities firm, investment advisor, or bank will invest the initial capital. In the US, each mutual fund is a separate legal entity organized under state law. A mutual fund may be organized as a corporation or business trust. The mutual fund has a board of directors or trustees that act on behalf of the shareholders that hold equity ownership in a portfolio of securities representing the assets of the corporation or business trust. For an investment company organized as a corporation, the board of directors is responsible for managing the company. For an investment company organized as a

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business trust, the trustees are consider to be directors for the purpose of administering regulations issued under the *Investment Company Act* of 1940.

Typically, the mutual fund contracts with others for the provision of services related to the funds operation including its management and shareholder servicing functions. In establishing the mutual fund, the board of directors, or trustees will enter into a contractual arrangement with an investment advisor, principal underwriter, custodian, transfer agent and external auditor. In this regard, the selection of an investment advisor is very important. It normally is responsible for the day-to-day operation of the fund itself and often has authority for the execution of portfolio transactions in accordance with the funds’ overall performance objectives. The function of the principal underwriter of the mutual fund is the distribution or sale of fund shares to the public. The principal underwriter may perform this function either by purchasing the shares issued by the fund for resale to public investors, or it may act as agent for the fund. It is not uncommon, however, for a mutual fund to act as its own distributor of fund shares without the services of an underwriter. In this instance, the transfer agent, which is responsible for the maintenance of the fund’s shareholder records, will be responsible for the sale or redemption orders.\(^{32}\)

**Regulatory Framework.** In the US, the regulation of investment companies commenced with the passage of the *Investment Company Act* of 1940 and its companion law, the *Investment Advisors Act* of 1940. These laws were enacted following a four year study of investment company practices by the SEC. Under the *Investment Company Act*, two types of management companies are recognized: open-end and closed-end. The *Investment Company Act* operated for 30 years without a significant amendment.\(^{32}\) The *Investment Company Act* of 1940 was finally amended in 1970 to enhance the effectiveness of the board of directors of investment companies by strengthening their independence. Provisions to the Act were also added restricting investment company sales charges and fund expenses. Investment companies are also subject to other laws administered by the SEC in the form of disclosure and reporting requirements covered by the *Securities Act* of 1933 and the *Securities and Exchange Act* of 1934. Under section 31(b) of the *Investment Company Act* and Section 204 of the *Investment Advisors Act*, the SEC has the authority to inspect and examine investment companies and investment advisers.

**Scope of Regulation.** Under the *Investment Company Act* of 1940, all investment companies, including bank-sponsored mutual funds must be registers with the SEC and otherwise meet the requirements of the Act and the rules and regulations issued thereunder. However, private investment companies with not more than 100 shareholders are exempt from the Act. Also, other types of pooled savings managed by financial institutions which in some respect are functionally

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\(^{33}\) In 1958 the US SEC commissioned the Wharton School of Finance and Commerce (University of Pennsylvania) to conduct a study of the mutual fund industry. Following completion of the study in 1962, the U.S. SEC sent its own report to Congress in 1966 that eventually led to the Investment Company Act Amendments of 1970.
similar to investments companies, are also exempt from the Act. Several exemptions are provided in the *Investment Company Act* for institutional investors that are regulated under other systems of regulations such as pension funds, bank common trust funds, and insurance companies. The 1970 amendments to the *Investment Company Act* provided the exemptions from the Act currently available for bank collective trust funds and insurance company retirement accounts holding retirement plan assets. These amendments to the Act in effect codified the then existing position of the SEC with respect to the treatment of collective trust funds and created a level playing field between banks an insurance companies that managed employee benefit plans through pooled investment accounts. The US Congress also amended Section 3(a)(20) of the *Securities Act* of 1933 in order to exempt certain interests in collective trusts funds and insurance company separate accounts for tax-qualified plans from registration under the *Securities Act.*

Investment companies have provided a relatively safe and efficient method for individual investors to participate in the US capital market. Few firms have failed in the 50 plus years following the passage of the *Investment Company Act* of 1940. The investment company industry itself has contributed greatly to this success. It has maintained high standards through self-policing. In the US regulatory scheme for investment companies, the first line of defense is the board of directors of the investment company itself. To understand the US regulatory regime, it is important to keep in mind that the SEC does not determine the quality of securities that an investment company can purchase for its portfolio. Investment companies are free to invest in any type of security provided that they comply with the SEC’s disclosure requirements and invest in the types of securities that are stated in the prospectus at the time of initial registration. In order to change the investment objectives, the board of directors, or trustees of the investment company must first obtain the approval of its shareholders.

Under Section 3(c)(1) of the *Investment Company Act*, private investments companies are specifically exempt from the definition of investment company. Private investment companies are defined under the Act to include ‘any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.’ They are not required to register with the SEC. The private investment company exemption has been used by many small investment clubs. On the other hand, it has also been used by large investment pools with sophisticated investors that rely on the exception to avoid substantive regulation under the Act. The legislative history of the Act suggests that the private investment company exception was intended to serve as an outer limit of an investment base that might be composed of people with personal or family ties. Accordingly, it is available to a personal holding company of a family with substantial wealth that invested its money in marketable securities.

**Regulatory Objectives.** Important protections are provided to investors under the *Investment Company Act*. It has been emulated in a number of countries with new and emerging

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securities markets. The Act’s main objective is to ensure the disclosure of full and accurate information to investors about investment companies and their sponsors. It is also designed to prevent: (a) irresponsible persons from managing the investment company; (b) insiders from managing the companies to the detriment of public investors; (c) the issuance of securities having inequitable or discriminatory provisions; (d) unsound methods of computing earnings and asset values; (e) changing the character of the company without the permission of shareholders and (f) engaging in excessive leverage. In order to accomplish these objectives, the Act requires the safekeeping and proper valuation of fund assets, restricts transactions with affiliates, limits leverage, and perhaps most importantly, imposes governance requirements as a check on fund management.

A basic tenet of the Investment Company Act, is that all investment companies must register with the SEC. After registration, investment companies must comply with reporting requirements designed to provide the SEC, shareholders, and the general public with current information about the company. These requirements include quarterly and annual reports to the SEC and semi-annual reports to shareholders. Full disclosure to investors is essential so that investors may make informed decisions from the wide array of investment funds that are available. The SEC does not issue investment guidelines, or otherwise engage in merit regulation. However, mutual funds may only invest in securities consistent with the investment objectives of the fund. Money market funds, for example, must limit their investments to only high quality securities with short maturities.37

A prospectus must be made available to investors and updated once a year, or more frequently, if a significant event occurs. Moreover, the funds’ investments must be consistent with the objectives of the fund as stated in the prospectus. All financial reporting is done on a marked-to-market basis and all investments must be valued on a daily basis at market value so that mutual funds are able to report net asset values at the end of each day. Registration with the SEC also helps assure stability of the funds’ investment policy. The funds’ objectives must be stated in the prospectus and not changed unless approved by shareholders. While the minimum capitalization for an investment company is only US$100,000, there are many other safeguards. The Board of Directors of the investment companies play an important role in protecting investors. Underwriters, investment bankers, or brokers may not constitute more than a ‘minority’ of the directors and management must be of the highest integrity. Persons convicted of financial fraud are prohibited from involvement in the operation of an investment company. Furthermore, all management contracts must be submitted to shareholders for approval. Also, limitations are placed on the type and affiliations of persons who exercise management functions.

The safety of investment company assets is very important. Assets must be safeguarded and properly valued. Permissible custodians include qualified US and foreign banks and broker-dealers who are members of national securities exchange. Self-custody is permitted but audits are required three times a year. Net asset values of fund shares must be computed correctly and independent checks on management are essential. There is a required annual audit and periodic inspections are conducted by the SEC. There are limits on investment adviser compensation. All compensation must be specified in written contract between the investment company and the investment adviser. Furthermore, the contract must be approved by a majority of voting shares.

37 Under SEC Rule 2a-7, money market funds must have 95 percent of their assets in debt securities rated in the highest category by at least two of the recognized national securities rating agencies.
Compensation must be approved by a majority of non-interested directors. Finally, the investment advisor has a fiduciary duty with respect to fees.

The regulation of investment company sales materials is administered by the National Association of Securities Dealers, a self-regulatory organization with extensive authority delegated to it by the SEC. In the event that sales material is sent to potential investors along with the prospectus, it must not be misleading and may not make any performance claims. Information in the prospectus can be used in advertisements but prospectus must be made available before an investment decision is made.

**Investment Advisors Act.** The Investment Advisors Act of 1940 requires that persons or firms compensated for providing investment advice to the public about securities must register with the SEC.38 Persons may be disqualified from serving as investment advisors if they have been convicted of certain financial crimes or securities law violations. The Act requires investment advisors to disclose the nature of their interest in transactions executed for their clients, maintain adequate books and records, and the books and records must be made available to the SEC for inspection. In general, an investment advisor is defined to be any person or firm that for compensation is engaged in the business of providing advice, making recommendations, issuing reports, or providing advice on securities, either directly, or by means of publications. An investment advisor registers with the SEC by filing an application for registration containing information on the adviser’s background and business practices.39 Unless the SEC has a basis for denial (i.e., the prospective adviser has committed certain prohibited act such as false or misleading statements on the registration for, or securities related convictions, injunctions, or similar offenses), the registration must be approved within 45 days after filing. An annual report must be filed with the SEC to keep the SEC informed that the registrant is still active as an investment adviser and to update certain basic information about the adviser.

**Emerging Markets’ Experience with Investment Companies and Funds**

In Asia India, Korea, Thailand, and Malaysia have achieved considerable success in the development of investment companies and the related regulatory framework. Some of this progress has been relatively recent with the establishment of new securities commissions in Thailand and Malaysia. Prior to 1992, there was only one company authorized to sponsor mutual funds (the Mutual Fund Company) in Thailand. It was partially owned by the government. With the establishment of the Thai Securities and Exchange Commission in 1992, the mutual fund industry was deregulated and new licenses were granted to seven management companies. Malaysia has also made some progress in the development of mutual funds while the Philippines and Indonesia are just beginning to develop the mutual fund industry. With regard to the Philippines, a scandal involving the demise of a mutual fund in the early 1970s resulted in substantial losses to investors.

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39 Under the Advisers Act, an investment adviser may be exempt from registration if it meets one of the following exemptions from registration: (a) all clients are within the same state as the adviser’s principal business office, and the adviser does not provide advice, or issue reports about securities listed on a national securities exchange; (b) the only clients of the adviser are insurance companies; or (c) during the previous 12-month period it had fewer than fifteen clients; it does not hold itself out generally to the public as an investment adviser; and it does not act as an investment adviser to a registered investment company, or business development company.
As a result, no mutual funds were authorized over the next twenty years. In general, the regulatory framework for the mutual fund industry is at a relatively early stage of development in East Asia. Malaysia and the Philippines are actively trying to encourage the development of the investment company industry through legal and regulatory reforms.

Under the Malaysian Securities Commission Act of 1993, a registration statement and prospectus must be filed with the Securities Commission by all unit trusts. The management company must meet certain financial responsibility requirements and appoint a trust company as an independent advisor. In Malaysia, the unit trust industry is still in its infancy. Prior to the establishment of the securities commission, unit investment trusts were regulated by an informal Committee on Unit Trusts that was established by the central bank. One of the goals of the Malaysian Securities Commission is to expand the opportunities for investors to invest in unit trusts by diversifying the range of collective investment structures allowed by law.

In Korea, the securities investment trusts (i.e., unit trusts and open investment trusts) and their management companies are regulated by the Ministry of Finance (MOF). The trust company must obtain a license to operate from the Korean Ministry of Finance. Restrictions are placed upon the management company in terms of the type of investment that is permitted so that the funds’ assets are generally required to be invested in listed securities. In Thailand, the enactment of the Securities and Exchange Act of 1992 established a regulatory framework for the mutual fund industry. In order to establish a mutual fund, a Thai company must first be licensed by the SEC as a securities company and receive approval to manage a mutual fund. Prior to issuing mutual fund shares to the public, a prospectus must be prepared in accordance with the regulations prescribed by the SEC. The management company must appoint a custodian and the funds’ assets must be deposited with a custodian. In Thailand only commercial banks or other qualified financial institution may serve as a custodian. The custodian, commonly referred to as the mutual fund supervisor must meet certain financial responsibility requirements and establish an appropriate system of internal controls which takes into account the relationship between the custodian and the sponsoring securities company. The custodian must also file reports with the Thai SEC.

In Mexico, which has a well developed mutual fund industry, the regulation of mutual funds is governed by the Mutual Fund Law, individuals, corporations, societies and nonprofit organizations may request authorization of the CNBV to organize and operate a mutual fund. Mutual funds are required to prepare a prospectus providing information about the fund to the investing public that must be provided to the CNBV for prior authorization. Under the Mutual Fund Act, the CBNV may approve for registration three types of funds: common stock funds, bond funds and venture capital funds. Mutual funds must be organized as stock companies and may only invest in securities inscribed in the National Registry of Securities and Intermediaries, or securities whose acquisition has been authorized by the CBNV. Under the Act, the CBNV has the power to inspect and examine mutual funds for compliance with the applicable regulations, examine administrative expenses, conduct on site inspections, and supervise compliance with the prospectus requirements. The CNBV also has the power to veto the appointment of directors and members of

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40 The principal distinction between the two type of trusts is that no addition may be made to a unit investment trust after it has been established while additions to principal are allowed over time with respect to open investment trusts. For unit trusts, beneficial certificates must be listed on the Korean Stock Exchange. An investor in an open investment trust is entitled to request repurchase of its certificates at any time based upon the trusts net asset value.

41 In administering the Act, the following objectives are set forth in the Mutual Fund Law: (a) Strengthening and decentralization of the securities market; (b) access to the securities market by small and medium size investors; (c) the democratization of capital; and (d) the contribution to the financing of the productive plant of the country.
the investment committee. In the application of the Mutual Fund Act, the CNBV is required to consider the potential effects on the development of the capital market.

**Regulation of Pension Funds in the USA**

**Role of Pension Funds.** Pension funds are the largest US institutional investor group. Between 1950 and 1994, the assets of pension funds operated by private business entities (private pension plans) and state and local governments (public pension plan) grew from US$17 billion to about US$4.7 trillion. Private pension plans are much larger than public pension plans, amounting to about US$3.5 billion at year-end 1994. In addition, the Federal government has a separate pension plans for its employees and most American workers receive retirement benefit coverage under the social security scheme (Old Age, Survivors, and Disability Insurance Fund) operated by the Federal government, which is funded only to a limited extent. Since non-bank financial institutions are not involved in the management of the Federal government and social security pension schemes, they are not covered in the discussion to follow.

In the US, private pension schemes, which are highly decentralized, are an important vehicle for the mobilization of savings. The Employee Retirement Income Security Act of 1974 (ERISA) provides basic protection to the individual workers for monies invested in private pension schemes. Interestingly, ERISA was enacted 40 years after the Federal securities laws and 34 years later than the Investment Company Act of 1940. In addition to ERISA, state laws governing the responsibility of fiduciaries (i.e., the prudent man rule) provide guidance on conduct which is acceptable for those managing money on behalf of others, including pensions, trust departments of commercial banks, and insurance company separate accounts. Public pension schemes, which are administered by state and local governments, are not regulated by ERISA. Public pension plans are subject to the laws and regulations of the states and local jurisdictions which operate such plans. With respect to their transactions in securities, they would also be subject to the securities laws and regulations.

Under ERISA, two types of private pension plans are recognized: Insured and Trusted plans. Insured pension plans are simply offered through insurance company separate accounts. It does not imply that certain returns are guaranteed to the participants. All other private pension plans must be offered through a trust instrument. Normally, trusted pension plans are offered by bank trust departments but they may be offered through other financial institutions as well. At year-end 1994, trusted private pension plans totaled US$2,610 billion while insured plans amounted to US$907 billion. Private pension plans have also begun to grown rapidly in the other industrialized countries and are expected to become an important part of the financial landscape in the developing countries as well.

In both the industrialized countries and developing countries, favorable tax laws have contributed to the growth of pension funds. Tax exempt contributions to the plans support the payment of employee benefits at retirement. In the US, there are two basic types of pension plans: the defined contribution plan and the defined benefit plans. In a defined contribution plan, the benefits to the employee are limited to the returns from investments chosen by the plan participant. In a defined benefit plan, the benefits to an employee are based upon a payout schedule which must be met by the employer. In the defined contribution plan, the employer sets aside for each

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42In the US, more than fifty million Americans are now covered by private pension plans offered by their employers. In addition, about twenty million Americans are covered by public pension schemes.
employee’s benefit a specified amount is a separate account. Each employee will receive a benefit equal to the amounts contributed to his or her account plus or minus the account’s investment tax deferred gains or loss.\textsuperscript{43} Under this arrangement, it is often the responsibility of the employee to direct the investment of their own individual account. Consequently, the investment judgment is the responsibility of the individual employee rather than the company sponsor. Since the 1950s, there has been a pronounced shift in the composition of pension fund assets toward coverage by the defined contribution plans, especially with respect to the plans offered by small and medium sized companies.

The benefits that must be paid out by a pension plan each year are highly predictable. Consequently, pension plans normally invest in long-term capital market instruments, including corporate stocks, bonds and mortgages. Although investment objectives are long-term and predictable, pension funds normally invest in financial assets rather than real assets (i.e., real estate). In managing fund assets, the plan manager endeavors to hold assets that yield relatively high returns and to reduce risk through portfolio diversification. Over the past several decades, the amount invested in corporate stocks and bonds has grown relative to the amount invested in government securities. As a result, pension plans are now major shareholders of private business enterprises. In the US, they now own about one-fourth of total corporate stock outstanding compared to only about one percent in the early 1950s. In controlling for risk, the pension fund manager must always be aware of its fiduciary obligation to plan participants, which is governed by \textit{ERISA} and the laws of the individual states (i.e., the ‘prudent man’ rule).

In the US, the assets of the private plans are normally managed by employee sponsored pension funds, bank trust departments, and insurance companies. Often the monies are invested through mutual funds, bank collective trust funds, or through insurance company separate accounts. In this regard, the bank trust department or the insurance company may pool the assets of two or more plans to manage the assets more efficiently and to diversify risk.\textsuperscript{44} Although such pooled investment vehicles are functionally similar to investment companies, they are generally exempt from the provisions of the federal securities laws.\textsuperscript{45}

\textbf{Regulatory Framework.} In the US, the private pension plans and their sponsors are regulated at the Federal level under the \textit{ERISA}. Public pension plans (other than those operated by the Federal government for its employees), on the other hand, are regulated by the individual states, an in some instances by the local governments offering such plans. The public pension plans include plans for state government employees, municipal employees, universities, school districts and other government entities. The public pension plans operated by state and local governments are primarily defined benefit plans. These plans are often supplemented with defined contribution schemes similar to 401(k) plans available to the private sector employees. The sponsors of pension plans are subject to a variety of regulations and that have important fiduciary duties regarding the choice of plan investments. Although pooled investment vehicles offered in the form of private pension plans are functionally similar to investment companies, they are specifically exempt from

\textsuperscript{43} \textit{Ibid.}, p. 120.

\textsuperscript{44} The US securities laws which were enacted in the 1930s contain an exception from coverage for certain pooled investment vehicles, including pension funds. At that time, however, the type of pension plans offered were predominately ‘defined benefit plans’ offered by large sophisticated employers.

registration and regulation under the US securities laws.\textsuperscript{36} Instead, employee benefit plans are regulated by the Employee Retirement Income Securities Act of 1974 (ERISA) which is the primary law governing the regulation of pension plans and their sponsors. This Act is administered by the US Department of Labor.

**Scope of ERISA.** Under ERISA, pension plan fiduciaries are responsible to discharge their duties solely in the interest of the participants and beneficiaries. ERISA requires that 'a fiduciary shall discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.'\textsuperscript{47} Consequently, a plan fiduciary must act solely in the interest of the plan participants and such duties must be discharged for the exclusive purpose of providing benefits and with reasonable administrative expenses. Plan investments must be diversified 'so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.'\textsuperscript{48} ERISA does not provide quantity restrictions or engage in merit regulation with respect to a specific investment instrument. This is left to the judgment of plan fiduciaries who, as discussed above, are subject to the requirements of the 'prudent man' rule. Finally, the fiduciary must act in accordance with the documents and instruments governing the plan so long as they are consistent with the requirements of ERISA.

ERISA does not require that pensions be made available to workers upon retirement. In the event that such promises are made to workers, it is ERISA's responsibility to make sure that they are kept. ERISA's assurances are accomplished by applying four basic principals. First, workers must become eligible for benefits after a reasonable period of time. Second, adequate funds must be set aside to provide the benefits promised under the retirement plan. Third, persons managing the plan must meet certain standards of conduct. Finally, sufficient information must be made available to determine if the law's requirements are being met.\textsuperscript{49} In general, ERISA established time frames for unfunded, or partially funded plans to set aside sufficient funds to become fully funded over a period of time. In addition, ERISA applied the prudent man rule to the management of pension plan assets which places limits on the extent to which such plans can hold speculative type investments. Also, ERISA created a Federal pension insurance scheme to guarantee a portion of a vested employees retirement benefits. In this regard, defined benefit plans are insured by the Pension Benefit Guarantee Corporation whereas defined contribution plans are not covered by the Federal pension insurance.

Under ERISA, plan participants are provided a basic disclosure document that describes the plans benefits and investment objectives. Under ERISA, disclosure regulations tend to focus more on the disclosure to participants about the plan itself rather than detailed disclosures about the underlying investments.\textsuperscript{50} There is a requirement that each pension fund submit an annual report to

\textsuperscript{36}Under the Securities Act of 1933, Section 3(a)(2) generally exempts from registration with the SEC the securities issued by collective investment trusts and separate accounts. Under the Securities and Exchange Act of 1934, Section 3(a)(12) exempts securities issued by these vehicles from the registration requirements of the '1934 Act'; and Section 3(c)(11) of the Investment Company Act of 1940 excludes such pooled investment vehicles from regulation under the '1940 Act'.


\textsuperscript{48}Ibid., pp. 1-2.


\textsuperscript{50}Protecting Investors: A Half Century of Investment Company Regulation, op. cit., p. 120.
the US Department of Labor which includes a detailed balance sheet and investments schedule. Pension funds are required to report this information at market value. The information contained in the annual report, which is rather technical in nature, is also available to plan participants. Unlike mutual funds, there is no requirement that fund assets be valued on a daily basis. In this regard, it should be note that pension plans invest for the long-term retirement needs of plan participants. Mutual funds, on the other hand, must be able to meet the short-term liquidity needs of investors. Consequently, mutual funds must also be able to determine the funds’ net asset value at the end of each business day.

**Emerging Markets’ Experience with Pension Fund Regulation**

Pension reform is only beginning to take hold in emerging markets. In the context of an emerging financial market, government policy actions with respect to pension reform can facilitate the widening and deepening of the capital market. Chile is most renowned for its efforts to link pension reform with capital market development. In 1981, Chile took actions to replace its bankrupt pension system and to replace it with a private and decentralized fully-funded pension system. Under the new Chilean pension system, the pension scheme is Government-mandated and regulated but the funds are privately managed by specialized companies known as Administradoras de Fondos de Pensiones (AFPs). As a result of the pension reforms, the private pension plans grew very rapidly, totaling US$22.3 billion or 43 percent of GDP by mid-year 1994. In Chile, pension funds are subject to strict upper limits on investments in particular companies and instruments.

In Chile, the Government is responsible for guaranteeing the funding of a certain level of benefits, establishing regulations for the proper operation of the private pension system, and enforcing the regulations. The regulation of the pension system is the responsibility of the Superintendente de Administradoras de Fondos de Pensiones (SAFP) which reports to the Ministry of Labor and Social Security. The Chief Executive of the SAFP designated by the President of Chile. In administrating the laws and regulations governing the operation of the pension system and the AFPs, the supervisory functions of the SAFP include the following responsibilities:

- Approve the creation of an AFP, its by-laws, and continued existence;
- Supervise the on-going operations of AFPs;
- Ensure AFP compliance with minimum capital and reserve requirements;
- Suggest legal and regulatory reforms to improve the operation of the Chilean pension system;
- Interpret current laws and regulations regarding pensions;
- Provide compulsory general rules applicable to the AFPs;
- Levy fines and, when appropriate, enforce the winding up of the operations of an AFP.\(^5\)

In Chile, credit ratings performed by independent private credit rating agencies play an important role in the administration of the pension regulations. The credit ratings of financial instruments are used to determine the eligibility of a particular instrument for investment by a private pension plan.\(^2\) Thus, only high quality issues are eligible for investment by private pension funds. In 1988, the Chilean Government made it compulsory that all publicly offered securities be

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\(^{51}\) In the event of a cessation of pension payments, or the bankruptcy of an AFP, the Government guarantees certain benefits to every retired person, or beneficiary, or in the case of persons not retired, certain disability and other benefits. See: The Chilean Pension System, Superintendency of Pension Funds Administrator, Santiago, Chile, May 1995.

\(^{52}\) See: China Pension System Reform (discussion draft), World Bank, April 22, 1996.
rated by at least two private rating agencies. In this regard, both debt and equity securities are required to have continuous and uninterrupted ratings. In most countries, however, it should be noted that only debt instruments are rated. In Chile the rating of shares entails an opinion concerning the ‘quality of the stock certificate’ taking into account the expected capacity for equity appreciation as well as other characteristics of the instrument. Each authorized credit rating agency must be registered with the Risk Rating Agencies Register kept by the Superintendencia de Valores y Seguros. They are subject to restrictions intended to insure independence and the professional capacity to conduct the rating business. Today, there are four private credit rating agencies in Chile.

The Government Rating Committee (Comision Clasificadora de Riesgos) plays an important role in the administration of pension regulations by ensuring the adequacy of the rating services provided by the private rating agencies. It has seven members whose task is to determine the eligibility of securities for pension fund investment. The Chilean Government Rating Committee consists of three members appointed by the Government and four members appointed by the private pension funds. Based on ratings provided by the private credit rating agencies operating in Chile, the task of the Committee is to determine eligibility for investment by private pension funds. The Committee cannot change the ratings established by the private credit rating agencies but it has veto power in that it can request to the issuer a third private rating (two are required by law).

Both the US experience with the enactment of ERISA in 1974 and the Chilean experience with pension reform in the early 1980s suggest that properly regulated pension schemes managed by NBFIs can contribute to mobilizing capital on behalf of small savers and contribute to the growth and development of the capital market. In contrast, Asia has had only limited experience with private de-centralized pension schemes. Most pensions are managed by employee provident funds (i.e., Singapore and Malaysia) or Government sponsored social security systems. In recent years, both Singapore and Malaysia have allowed individual workers to invest their provident fund balances in housing and approved securities. In future years, it is expected that individual workers will be allowed more control over their retirement account investments in line with the further maturation of the financial sector infrastructure and related regulatory systems.

Regulation of Bank Trusts

Acting in fiduciary capacity, bank trust departments provide a wide variety of services to clients. On behalf of individual and business enterprises that provide extensive money management services often managing large pools of monies on behalf of clients which are invested in portfolios of corporate stocks and bonds, government, and other securities. Bank trust departments, acting under power of attorney, also manage the affairs of individual clients. In this

53 Under the Securities Act of 1981, as amended, the general rating procedures are determined by the Superintendencia de Valores y Seguros. With regard to debt instruments, the risk rating procedures require the rating of issuers in a range of categories (i.e., A through F). Corporate stocks are required to be rated as first or second class, or without sufficient information. Each rating agency is required to register their rating procedures and criteria with the Superintendency.


55 In Malaysia, for example, the Employee Provident Fund was established in the early 1950s. It is a statutory body under the Ministry of finance with investments managed by an Investment Committee. In the early years, investment by EPF was limited to Government securities but in recent years investments in private money and capital market instruments as well as real estate and infrastructure projects has grown rapidly.
capacity, the trust department may pay bills, effect leases, purchase property and endorse legal documents. Managing the estates of deceased persons is also an important trust function. For business enterprises, bank trusts may manage a private pension plan, maintain a sinking fund for the retirement of a corporation's debt securities, supervise the assets pledged as collateral for a debt security, or otherwise provide important business services such as record keeping or providing for the redemption or retirement of securities.

**Types of Trust Accounts.** US banks pool money from trusts and other fiduciary accounts and invest the money in financial assets. The pool of money may be from the accounts of individuals, or through collective trust funds. Often the money is invested directly in the stock market, money market instrument, or the bond market. There are three basic types of trust accounts: personal trust accounts, agency accounts, and retirement plan accounts. In a personal trust account, the bank holds title to the trust assets for the benefit of its client. In an agency account, the bank trust department holds custody of the assets but the customer retains title to the assets. Concerning the management of the accounts, the bank trust department must follow the instructions of the customer. For an agency account, the customer provides direction with respect to investment decisions for the account within the framework provided by the account agreement. For a trust account, the account sponsor will direct the account as provided in the trust agreement which provides the basis for the operation of the account. A recent trend has been for many institutional investors, including bank trust departments, to invest monies under their management in mutual funds rather than to invest directly in individual stocks and bonds. This is a reflection of the diversity of funds available with a wide range of investment objectives and the high degree of safety (i.e., absence of fraud or fund failures) that is available through mutual fund investments.

For retirement plan accounts, banks compete with other institutional investors for the management of pension fund assets. In the US, all pension plans must be offered through a trust instrument or through an insurance company separate account. In a retirement plan account, a trust department offers through a trust instrument pension plan account services similar to those offered by insurance companies. Such services may be offered to individuals or to corporate plan sponsors through bank collective trust funds. As provided for in the trust instrument, the trust department must follow the instructions of the account sponsor. In recent years, there has been a trend toward self-directed plans such as 401 (k) plans and individual retirement accounts where the individual plan participant is largely responsible for investment decisions.

Commercial banks historically have managed common trust funds, or similar funds maintained by a bank exclusively for the collective investment and reinvestment of monies contributed to the account by the bank in its capacity as trustee, executor, administrator, or guardian. Under regulations administered by the Federal Reserve Board, banks are able to 'invest the assets of pension, profit-sharing, and stock bonus plans collectively, provided that each such plan was exempt from federal income taxes and the collective investment was specifically authorized by the trust instrument underlying the plan.' Because many employee plans are too small to allow for portfolio diversification, an Internal Revenue service ruling has provided that a qualified plan may pool its funds with the funds of other qualified plans in a group trust without losing its 'qualified' status under Section 21 of the Code. The regulations allowing the pooling of funds have greatly facilitated the ability of bank trust to compete with other forms of pooled investments such as mutual funds and insurance company separate accounts.

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Regulatory Framework. In the exercise of trust powers and in providing money management services on behalf of clients, bank trust departments are subject to extensive regulation by a Federal bank regulatory agency, or the individual states, depending upon whether they have a national or a state charter. As institutional money managers, commercial banks provide services through the trust department that are similar in many ways to services provided by other institutional investors that manage pooled investments. Like commercial banks, the trust departments are subject to a dual regulatory system through laws and regulations issued at the Federal and state level. The primary regulatory jurisdiction is determined largely by the type of bank charter (i.e., Federal or state).

Regulatory Authorities. At the Federal level, the main regulators are the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve Board. There is close regulatory coordination among bank regulators and similar procedures are used to ensure proper supervision of both the commercial bank and the trust activities carried out in a fiduciary capacity. The Comptroller of the Currency supervises banks with national charters. Typically, these are the largest commercial banks in the nation which often engage in extensive fiduciary activities through the trust department. The Comptroller of the Currency is responsible for the regulation, supervision, and the conduct of on-site examinations for all national banks, including their trust department. The Federal Reserve, on the other hand, is responsible for the registration and supervision of bank holding companies. In this capacity, the Federal Reserve has extensive power to influence the type of non-bank financial activities that may be undertaken through the holding company arrangement as well as the overseas activities of US banks. It also examines state chartered banks that are members of the Federal Reserve System but are not members of FDIC. The Federal Deposit Insurance Corporation (FDIC) administers the deposit insurance scheme for national banks and for state chartered banks that have become members of the FDIC. For the later group of banks, it performs supervisory functions similar to those performed by the Comptroller of the Currency for national banks. Such examines are usually conducted jointly with state banking commissions to avoid duplication. At the state level, bank and trust laws are enforced by the state banking commissions (or sometimes commissions on banking and insurance).

Trust Powers and Fiduciary Responsibility. In the US, trust powers are governed largely by state law even in the case of national banks which are regulated at the Federal level by the Comptroller of the Currency. Thus, the Comptroller of the Currency has the authority to grant trust powers to national banks which are deemed not in contravention of state and local laws. In nearly all states, the 'prudent man rule' applies to the investments of bank trust departments. Under this concept, a bank trust department would be required to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested. Banks are also subject to a variety of Federal and state regulations related to conflicts of interest. Furthermore, bank managed pension accounts are subject to the requirements of ERISA. As a general matter, bank trust departments must follow the

58 Under 76 Stat. 668, 12 U.S.C., 92a, The Comptroller of the Currency is authorized to 'grant by special permit to national banks applying therefor, when not in contravention of State or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardian of estates, , or in any other fiduciary capacity in which State bank, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the State in which the national bank is located.'

directions of the account sponsors which are contained in the trust agreement or, through instructions from the customer in the case of an agency account.

In recent years, common trust funds, or similar funds maintained by a bank exclusively for the collective investment and reinvestment of monies contributed to the account by the bank in its capacity as trustee, executor, administrator, or guardian have grown in importance. These accounts are exempt from the definition of investment company. ERISA, however, places strict responsibilities on banks as fiduciaries for pension plans whose assets are invested in collective funds. Under ERISA, a plan fiduciary is defined to include ‘any person who exercises discretion with respect to the management of the plan or its assets, renders investment advice to a plan for a fee (direct or indirect), or has discretion with respect to the administration of the plan’.60

**Role of Board of Directors.** The trust department activities of commercial banks are closely supervised by the bank regulatory authorities. Applications for permission to engage in the trust business by national banks, for example, must be approved by the Comptroller of the Currency taking into account the amount of capital and surplus available to the bank relative to the needs of the community to be served and any other facts and circumstances that seem proper for consideration. The authority to exercise trust powers may be revoked in the event that they are exercised in an unlawful or unsound manner. The directors of the bank are expected to be responsible and accountable for the performance of fiduciary responsibilities performed pursuant to trust powers granted to the bank. Thus, the directors are expected to be responsible for the supervision and control over the exercise of the bank’s fiduciary powers. In the administration of the bank’s fiduciary activities, the directors must make sure that the system of organization and administration are prescribed in the banks’ bylaws or in resolutions by the board of directors.

In order to assure the proper exercise of the fiduciary powers, it is necessary for the board of directors to make an annual reassessments of the adequacy of the trust department organization and administrative procedures. In particular, the directors must establish policies and procedures to avoid self-dealing and conflicts of interest by directors, officers and employees of the bank in the administration of trust accounts on behalf of their clients. It is also the responsibility of the board of directors to make sure that a suitable audit is conducted at least once each calendar year to ensure compliance with applicable rules and regulations, including the exercise of fiduciary obligations to the clients of the trust department.61

**Custody and Safekeeping of Trust Assets.** The custody and safekeeping of assets held in trust is a critical element in the regulation of trust activities. Thus, it is important that regulatory safeguards be put in place to ensure the safety of clients assets and that these measure are examined carefully during the course of on-site examinations by the regulatory authorities and at the time of the annual audit. In devising the regulatory scheme for trust activities and others acting in a fiduciary capacity, it is important to note that they are performing as agent and advisor on behalf of clients. Unlike securities broker-dealers and investment banks, they are not taking on the risk of an underwriter or dealer in securities. However, the potential for self-dealing or the possibility of conflicts of interest are high and must be taken into account in the design of the regulatory regime, including the adequacy of internal controls within the trust unit. Clearly, the safeguards in place for

the custody and safekeeping of trust assets are critical to the regulation and supervision of trust activities.

Assets held in a fiduciary capacity by commercial bank trust departments must be kept separate from general assets of the bank. Also, separate books and records must be maintained showing in proper detail all transactions entered into on behalf of clients in a fiduciary capacity. Furthermore, any funds held in ‘trust’ by the bank pending investment must be segregated in a separate account and may not be used by the bank in the conduct of its business unless it shall first set aside in the trust department US Government bonds or other securities approved by the Comptroller of the Currency for that purpose. It is also unlawful to loan funds held in trust to any bank officer, director, or employee. In order to enforce these and other regulatory provisions with respect to trust activities, there is a requirement that national banks be examined each calendar year except that one such examination may be waived in any two year period. In conducting the annual audit and in the inspections and examinations of the trust department, it is important that certain principles are adhered to, including:

- safeguarding fiduciary assets
- accuracy and reliability in accounting data
- timely management and account information
- maintain level of operating efficiency
- compliance with laws, rules, regulations, and bank policies established by the board of directors.

In addition to on-site examinations and audits, bank trust departments are also subject to off-site review. Thus, for example, each national bank exercising fiduciary powers must submit a report on the condition of the trust department annually to the Comptroller of the Currency. The Trust Department Annual Report must be filed in accordance with forms and instructions supplied by the Comptroller of the Currency. While the details of the supervision and review are somewhat different for each category of NBFI acting in a fiduciary capacity, the regulatory principles are quite similar. Clearly, the most fundamental duty of any fiduciary is the undivided loyalty to the beneficiaries or other parties of interest. The enforcement of this principle along with the maintenance of strong prudential and financial responsibility standards should be the guiding principle underlying the design of a regulatory framework for NBFIs acting in a fiduciary capacity.

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62 With regard to the reports of examination of bank trust departments by the Comptroller of the Currency, the State banking authorities may have access to such records of examination. However, state banking authorities do not have the right to examine the books, records and assets of such banks.

Part III. Regulation of Non-Bank Financial Institutions in the European Union

Overview of the European Union Regulatory System

The European Union (EU) attempts to create a uniform internal market with free movement of goods, services, capital and people between the fifteen member states. EU legislation aims to create a minimum level of uniformity between the legal systems of individual member states in each subject area, covered by the EU’s Directives, and in consequence freedom of establishment and mutual recognition of regulation between the member states.

‘European Parliament and Council Directives,’ or ‘Directives,’ are legislative instruments drawn up in cooperation between the European Commission and The Council of Ministers of the European Union, and adopted by the Council of Ministers in which all member countries are represented. Each Directive creates a legal obligation for the member states to adopt new laws or to change their existing legislation to conform with the Directives. The member countries may not impose any rules over and above the minimum level stipulated in the Directive upon entities from other member countries. They may, however, treat their own subjects, both citizens and legal entities, in a stricter manner than the Directive requires. They may also impose stricter requirements to entities from outside EU and the EEA.

The free movement of services in the field of financial services is based on principles of:

- harmonization of minimum requirements imposed on financial institutions
- mutual recognition of established financial institutions in other member states
- recognition of home country control

In practice this means that any financial institution licensed in compliance with relevant EU legislation in any member state can provide its services in any other member state, for example through establishing a branch operation. It would then be supervised by the competent authorities of the original member state of incorporation.

EU Directives are obligatory for the member states, and will override any national legislation not in conformity with the Directives. This provision is enforced by the European Commission and ultimately by the European Court of Justice. According to the original

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1 European Union (EU) and European Economic Area (EEA). The European Union currently comprises fifteen member countries, that is Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the UK. The EU Directives are also in force for the countries that are not members of the EU, but have entered into an agreement on the ‘European Economic Area’ (EEA) with the EU. These countries include Iceland, Norway and Liechtenstein, all former members of European Free Trade Association (EFTA). Consequently, EU Directives are applicable in almost the whole of Western Europe in an area which comprises approximately 370 million people.
European Economic Community Treaty the Court of Justice 'shall ensure that in the interpretation and application of the Treaty the law is observed.'

The level or structure of national legislation that enforces the provisions in the Directives is for each member state to decide at its own discretion. However, these stipulations must be valid under national law and be issued by competent authorities.

The single market in financial services within EU and the EEA is a relatively recent phenomenon. Most of the relevant Directives came into force at the end of the 1980s and the early 1990s. Consequently, less than ten years ago, national legislation in member states on financial sector operations varied significantly or, in some cases, did not exist. Most notably, the UK and Finland first enacted securities market laws in 1986 and 1989, respectively. Some subject areas have yet to be covered by EU law or Directives.

Non-Bank Financial Institutions’ Links to Banks

The most important regulatory issue with regard to financial systems is the relationship between banking and non-bank financial sectors. This issue dominates the whole nature of a financial system, its risk and competitive structures, and its development. Different approaches to this question are discussed below in the sections on Regulatory and Supervisory Issues. The key factors, in order of priority are: (a) structural issues, (b) solvency and capital adequacy requirements, and (c) differences in details of regulation, assuming that the regulation in question meets the minimum acceptable level, based on international standards.

All non-bank financial institution (NBFI) regulations in EU legislation are covered in the relevant Banking Directives. In general these Banking Directives deal with:

- bank licensing
- rules on large credit exposures and loans to shareholders (insider lending)
- rules on banks’ own funds and the capital adequacy requirement
- restrictions on equity holdings by banks
- rules on the suitability of shareholders in banks
- rules on annual accounts of banks
- deposit insurance
- rules on the exercise of bank supervision on a consolidated basis
- rules obliging the external auditor of a bank to provide information to the supervisory authorities
- rules obliging a bank holding company to provide financial information to the banking supervisory authority

Links between banks and non-bank financial institutions are covered in the banking laws, not in the specific laws pertaining to the NBFIs themselves. Thus the regulation is indirect from the point of view of the NBFIs and consists mainly of provisions aimed to protect the banking system from risks assumed by NBFIs. The most significant regulations are requirements for a supervisable group structure, and supervision on a consolidated basis including capital adequacy requirements, restrictions on banks’ holdings, and restrictions on large exposures.
**Requirement for Supervisable Group Structure**

When a bank is part of a group of corporations, the so-called BCCI Directive\(^2\) requires the supervisory authorities to satisfy themselves, as part of the licensing process, that the structure of the group and in particular the relationship between the bank and the other entities in the group enable the bank to be supervised effectively. In practice this means that, in the licensing process itself, the supervisory authorities must ensure that efficient firewalls are in place between a bank and any of its affiliates. It further suggests that, after the BCCI experience, the EU regulations do not favor complicated corporate group structures involving banks, but do allow banks to be part of both upward and downward holding company structures (i.e., as the apex institution or as a member of a holding group).

This stipulation affects the NBFIs only indirectly when they are establishing themselves or when they are part of a corporate group structure involving a bank. The Directive aims to prevent only extreme, complicated and thus unsupervisable corporate group structures. The existence of normal upward or downward holding company structures should not hold up the licensing process.

**Suitability Requirement for Large Shareholders**

The Second Banking Directive\(^3\) stipulates in Article 11 that any natural or legal person who proposes to acquire more than 10 percent in the share capital or of the voting rights in a bank must inform the supervisory authorities prior to the acquisition of the shares or rights. Similar information must also be provided with regard to expanding the holding above 20, 30 or 50 percent. The supervisory authorities then have three months to approve or reject the offer; to either satisfy themselves on the fitness and suitability of the new major shareholder or to object to the intended acquisition on the grounds of unsuitability of the prospective shareholder. In the process, the supervisory authority can, for example, suspend the voting rights of the shareholder. If it suspects imprudence or fears detriment to the management of the bank as a consequence of undue influence from the shareholder it can impose sanctions or injunctions against the bank’s management.

Again, the implications of this Directive for NBFIs are indirect and should rarely cause any problems. The reporting requirements apply to all shareholders regardless of their line of business. Nevertheless, for an NBFI to be deemed an unsuitable shareholder for a bank would be unusual, especially if it is under supervision in some EU member country.

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Restrictions on Large Exposures

The Directive on Large Exposures\(^4\) stipulates the following restrictions on banks' lending:

- any exposure to a single borrower or group of connected borrowers that exceeds 10 percent of banks' own funds is considered large exposure
- all large exposures shall be reported to the supervisory authorities following either of the following two methods:
  (i) reporting all large exposures at least once a year, combined with reporting during the year of all new large exposures and any increases in existing large exposures of at least 20 percent with respect to the previous communication, or
  (ii) reporting all large exposures at least four (4) times a year
- large exposure shall not exceed 25 percent of banks' own funds
- exposures to parent companies or subsidiaries may not exceed 20 percent of banks' own funds
- the total of all large exposures may not exceed 800 percent of banks' own funds

The rules on large exposures apply in principle only to assets that carry a recognizable risk. Thus exemptions are possible, for example, the case of assets directly collateralized by cash deposits placed with the bank, claims on central government or central bank, or claims on central clearing institutions.

As the purpose of large exposure restrictions on banks is to guarantee diversification in a bank's lending portfolio, these restrictions apply to all borrowers regardless of their line of business. Consequently, all NBFIs are treated like any other bank clients in this matter, and, as such, should take this into account when planning their funding in the form of direct borrowing.

The single most disturbing aspect in the restrictions on large exposures is the absence of any discussion or restriction on sector specific exposures. Frequently, both in Europe and in the US, overexposure to an individual sector of the economy has been one of the most significant cause for banking crises. The regulation should at least require the banks to assess and report the sector specific exposure in their portfolio, and also to require prudence in the form of sectoral diversification.

The above are minimum prudential requirements and the member states may apply more restrictive limits to their own nationals. This would be unusual under present circumstances as the member states, after having had a wide variety of different systems before the Directive came into force at the beginning of 1993, are struggling to meet the Directives' requirements by the end of the transitional period allowed for adjustment.

Restrictions on Holdings in Non-Financial Enterprises

According to Article 12 of the Second Banking Directive, a bank's holdings in any non-financial enterprise may not exceed 10 percent of the shares or the voting rights. Also, this should not exceed 15 percent of the bank's own funds. The total amount of holdings in non-

Large Exposures Restrictions Before 1993 - Diversity in Rules

1. Restrictions on individual large exposures for a group of clients as percent of bank own funds:
   - lower than 50: Greece (20%), Luxembourg (30%), Netherlands (25%), Portugal (10%), UK (25%)
   - 50%: Belgium, Denmark, Germany, France
   - over 50%: Italy (100%)
   - Ireland had a system based on a percentage of risk assets (5%)

2. Aggregate ceiling of large exposures as percentage of own funds:
   - 800%: Germany, France
   - no aggregate: Belgium, Denmark, Greece, Luxembourg, Netherlands, Portugal, Spain, UK
   - Ireland limited the ten largest credits to 30% of risk assets, Italy's limit was calculated as 40% of risk assets

3. Reporting requirement to supervisory authorities:
   - 15% or less: Germany (15%), Luxembourg (10%), Netherlands (15%), UK (10%)
   - 20% or more: Spain (20%), Italy (20%), Belgium (20%), France (25%), Denmark (35%)
   - Greece had reporting requirement of approximately ECU 150 000

Financial enterprises may not exceed 60 percent of the bank's own funds. Exceptions are allowed for underwriting share issues in which the bank is acting as an intermediary, and for cases in which the bank acquires shares in a company neglecting its loan repayment.

This stipulation has direct implications for investment companies as they are not deemed financial institutions by the EU legislation. Consequently, all the above-mentioned ownership restrictions apply directly to banks' holdings in investment companies. Other NBFIs are not affected by this restriction on bank holdings as long as they fulfill the EU definition for 'other financial institutions' (see below).

**Holdings in Other Financial Institutions**

There are no restrictions imposed in EU legislation on banks' holdings in other financial institutions. The Second Banking Directive defines 'other financial institutions' as undertakings whose principal activity is to acquire holdings or to carry out one or more of the following activities:

- lending (including inter alia consumer credit, mortgage credit, factoring with or without recourse, financing of commercial transactions including forfeiting)
- financial leasing
- money transmission services
- issuing and administering means of payment (e.g., credit cards, travelers' checks and bankers' drafts)
- guarantees and commitments
- trading for own account or for account of customers in:
  (i) money market instruments (checks, bills, CDs, etc.)
  (ii) foreign exchange
  (iii) financial futures and options
  (iv) exchange and interest rate instruments
  (v) transferable securities
- participation in securities issues and the provision of services related to such issues
- advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating to mergers and acquisitions
- money brokering
portfolio management and advice
safekeeping and administration of securities

In practice this means that banks can engage in almost any type of financial activity either directly or in subsidiary form through their holdings in financial institutions. Although European legislation is based on the principle of universal banking it ultimately leaves the decision on the matter to each member state. Thus a member state may restrict its domestic banks from being directly involved in securities activities, or for that matter in the insurance sector. In principle member states could also restrict their domestic banks’ holdings in financial institutions. With the exception of insurance sector in Italy, this has not been the case.

For international competitive reasons most European countries take a lax approach to the banks’ rights to undertake securities business. Basically, there are two schools of thought: the Germanic universal banking approach and the Anglo-Saxon approach of separation of different businesses into different legal entities. Of the EU and the EEA countries only Spain and Greece, and to a certain extent Italy and Belgium, require a separate subsidiary for a bank to enter securities business. However, both in the UK and in Ireland the banks follow the ‘separation of businesses’ principle voluntarily and usually conduct their securities business through subsidiaries.

**Requirement for Supervision on a Consolidated Basis**

A separate Directive stipulates that supervision on a consolidated basis must be applied to all groups consisting of banking enterprises, including groups of which the parent undertaking is not a bank. In fact the Directive can be considered the European counterpart to the US **Bank Holding Company Act** although it is not as far-reaching and as detailed as the US regulation.

The Directive identifies both financial holding company and mixed-activity holding company structures. In the case of the former, the Directive specifies the precise extent of supervision on a consolidated basis, namely the application to banks and financial holding companies of:

- solvency requirements
- capital requirements for market risks
- limits on large exposures
- limits on the participation of bank parent companies in the non-financial sector

as stipulated in relevant banking Directives.

For mixed-activity holding companies the Directive requires that the holding company and its subsidiaries provide any relevant information requested by the banking supervisory authorities. This introduces the notion of upward consolidation, in which, when assessing the financial position of a bank, the supervisor takes into account not only the financial position of subsidiaries and partially owned companies, but also the financial position of parent companies above the bank and of affiliate or sister companies at the same level with the bank in the group

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structure. In practice, this is particularly relevant for possible financial transactions (e.g., intra-
company loans) between the holding company, its non-bank subsidiaries, and the group’s bank
subsidiary.

NBFIs which form part of a holding company structure involving a bank may have to
report to banking supervisory authorities, but this depends on the type of holding company
structure in question. Financial holding companies are supervised by the banking authorities and
are bound by banking legislation’s restrictions and requirements. If the NBFI is an insurance
company or securities intermediary it may be regulated by a separate body. In mixed-activity
holding companies where the parent undertaking of the group is neither a bank nor a financial
holding company, full consolidation is impossible due to the variety of activities pursued by the
group. Consequently, supervision obligations are limited to the provision of relevant information
requested by the banking supervisory authorities on all undertakings in the group.

**Capital Adequacy Requirement**

As the capital adequacy requirement for banks’ non-banking activities is covered by the
same CAD Directive as for the investment firms the reader is referred to the discussion on
capital adequacy requirements in section on securities market intermediaries.

**Non-Deposit Taking Credit Institutions**

European Union legislation *per se* does not regulate credit institutions which do not fall
under the Second Banking Directive’s definition of banks. As these types of financial institutions
often compete directly with banks and may also be wholly owned subsidiaries of banks, different
member states have taken different measures towards their regulation of non-deposit taking
credit institutions. The European Union’s objective of creating a level playing field for such
financial institutions thus cannot be realized because, when belonging to a financial holding
company group which includes a bank, they still fall into the scope of Banking Directives. In
consequence if only EU Directives are followed, a non-deposit taking credit institution may be
supervised and subject to the Banking Directives stipulations including large exposure
restrictions, solvency requirements and capital adequacy requirements depending on whether or
not it belongs to a financial holding company group which includes a bank.

Different member states have solved the position of non-deposit taking credit institutions
in different ways. France goes the furthest in its approach. In French banking legislation the
definition of a bank arises from only the asset side of the balance sheet, that is, from lending.
Consequently, in France regardless of how credit institutions fund themselves they are
considered banks, and, as such, subject to all banking regulation.

The Nordic countries have, after their banking crises, come out with a two tier legislative
approach in which all provisions in the Second Banking Directive apply to all credit institutions
regardless of type of liabilities. In consequence all credit institutions in Nordic countries,
including banks, are subject to the same requirements on licensing, minimum capital, suitability
of shareholder provision, and standards of management, prudential controls and supervision
requirements. In addition to these regulations, the banking legislation restricts retail deposit
taking to banks and puts forward provisions on permissible forms of incorporation for banks,
stipulations on large exposures, ownership restrictions, own funds and solvency provisions,
provisions on capital adequacy requirements and on supervision on a consolidated basis. The Nordic approach therefore subjects all credit institutions to a minimum level of regulation and supervision and thus creates additional protection for the payment and the banking systems.

The UK and the Netherlands, for example, do not apply any banking regulation to non-deposit taking credit institutions unless they become subject to them through consolidation. Thus these member states apply only the minimum required level of the EU legislation. In these countries the non-deposit taking credit institutions will try to avoid becoming subject to regulation and supervision, which may affect adversely the formation of financial conglomerates and holding company structures. This may have an indirect effect on the ability of financial institutions to compete on the international market.

Hence, there is no common EU market for non-deposit taking credit institutions in the form of freedom of establishment, mutual recognition or freedom to provide services. The financial markets in this aspect are purely domestic in each member state. In effect, there is no level playing field with regard to competition with banks or between different non-deposit taking credit institutions.

Investment Companies

With the exception of a very particular type of investment company stipulated in the UCITS Directive (see section below on Mutual Funds) European legislation does not directly regulate investment companies. The exception is investment companies whose objective is collective investment in transferable securities of capital raised from the public, operating on the principle of risk-spreading, and whose units are redeemed, directly or indirectly, out of the investment company's assets at the request of the unit-holders. The regulation of this type of investment company is discussed further in section on mutual funds.

Other more general types of investment companies escape direct regulation and supervision under the EU law. They are indirectly affected by several Directives on financial services, for example, those which limit their scope of business from deposit-taking, securities intermediation or securities markets advisory services without proper licensing. Moreover, they are indirectly affected by banks' risk control stipulations. Listed investment companies are directly affected by the requirements imposed on listed companies in general and by rules on marketing securities to the general public.

Thus the EU is more lenient in its regulatory approach to investment companies than the US, which stipulates in its Investment Company Act of 1940 that activities of companies engaged primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public, are subject to certain statutory prohibitions and to regulation by the Securities and Exchange Commission (SEC).
The European Union regulates mutual funds and a specific type of investment company in its UCITS Directive. The Directive stipulates:

- the structure, management and authorization of UCITS
- their scope of business
- guidelines and restrictions on investment policies
- information requirements
- provisions on activities
- repurchase requirement of units
- supervision

UCITS are defined as undertakings whose sole objective is collective investment in transferable securities of capital raised from the public; which operate on the principle of risk-spreading; and whose units are repurchased or redeemed, directly or indirectly, from their assets, at the request of the unit-holders. Curiously the Directive interprets the actions taken by UCITS to ensure that the stock exchange value of their units do not significantly vary from their net asset value, as equivalent to such repurchase or redemption.

The Directive allows for UCITS to be constituted according to law, either as common funds managed by management companies, and governed by contract law, as unit trusts under trust laws or as investment companies under special statutes. This does not mean, however, that the member states permit the same forms of incorporation for their own national UCITS. In fact, many member states including the Nordic countries have chosen not to allow their national UCITS to be constituted under statutes, that is, as companies. This is primarily because the withdrawal provisions for UCITS would complicate the interpretation of ‘own capital’ in their respective company laws. The actions taken by an investment company on the stock exchange to ensure that price follows net asset value might be misleading, suggesting possible market manipulation.

It should be noted here that the UCITS Directive does not apply to the following: (a) closed-end funds; (b) UCITS which do not promote the sale of their units to the public, e.g., private placements; and (c) UCITS which may be sold only to the public in non-member countries.

These types of collective investment undertakings are allowed within the EU, should the national legislation of the member state in question permit them. However, there is no mutual recognition of these institutions or harmonization of the regulatory framework. Several member states, including all Nordic countries, for example, do not recognize closed-end funds. In fact the above types of undertakings are more common in countries or locations often considered off-shore tax havens for financial services, such as Luxembourg, Dublin in Ireland and the Channel Islands in the UK.

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The Depository

The EU legislation requires the UCITS to maintain their assets in safekeeping at a depository that is a separate legal entity located in the UCITS home country and separately supervised. Typically, this would be a bank. In addition to safekeeping of the UCITS assets, the depository has a range of other responsibilities, most importantly to: (a) ensure that the sale, issue, repurchase, redemption and cancellation of units effected on behalf of the unit trust or the company or by the management company are carried out in accordance with the law and the fund rules; (b) ensure that the value of units is calculated in accordance with the law and the rules; (c) carry out the instructions of the management company, unless they conflict with the law or the fund rules. The depository thus has a significant legal liability to the management company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them.

Investment Policies

The purpose of UCITS is to give the general public a means for investing with the benefits of whole-sale scale transactions and portfolio diversification. Both these principles are reflected in the investment policy guidelines and restrictions of the Directive. Thus the investments of a UCITS must consist solely of transferable securities with either listing or, in the case of new issues, an intent to list on a stock exchange or other regulated market place, or in the case of debt instruments, liquidity at any time, at an accurately determinable value.

Furthermore, the following restrictions apply:

- no more than 5 percent of a UCITS assets may be invested in securities issued by the same company, with the right for member states to raise the limit to a maximum of 10 percent
- the total value of the securities held in an issuing body may not exceed 40 percent of the value of its assets
- UCITS may not acquire either precious metals nor certificates representing them
- UCITS may invest a maximum of 5 percent of its assets in units of other collective investment undertakings falling under the Directives definition of UCITS
- UCITS may not acquire any shares carrying voting rights which would enable it to exercise significant influence over the management of an issuing body
- UCITS may acquire no more than:
  (i) 10 percent of the non-voting shares of any single issuing body
  (ii) 10 percent of the debt securities of any single issuing body
  (iii) 10 percent of the units of any single collective investment undertaking

Member states are allowed to grant exemptions from the first investment guidelines if the securities in question are issued or guaranteed by any member state, its local authorities, a non-member state or public international body of which one or more member states are members.

The above list of restrictions exists primarily to guarantee a certain level of diversification and risk control in any given UCITS, but seems also to aim to protect the markets, individual issuing bodies and other shareholders from undue anomalies as a result of pooled
investments. Of particular interest is the restriction against UCITS being able to buy shares carrying voting rights with significant influence. This prevents the UCITS from capitalizing on the premium usually placed by markets on such shares. Such a drastic measure suggests that this particular stipulation is a result of a compromise between the member states, as prohibiting the use of the voting rights by the UCITS would have been sufficient to protect the interests of other shareholders. It also suggests that the EU considers UCITS as a form of savings institution for the general public and as such wants to exclude extreme speculative elements from this type of investment.

The Directive leaves the decision whether or not to allow funds which invest solely in debt instruments to each member state. Some member states with a strong banking community have regrettably opted to prohibit money market funds with an obvious objective to protect the banks' deposit base from this significant source of competition.

According to the Directive, individual member states may authorize UCITS to use derivatives on both transferable securities for the purpose of efficient portfolio management, and on foreign exchange to provide protection against exchange risks. The EU leaves the judgment on the extent of use of derivatives to the discretion of each member country. In some countries this has resulted in the authorities giving guidelines which are beyond prudent practice in portfolio management, and can lead to the UCITS circumventing the investment restrictions through the use of derivatives.

**Provisions on Other Activities**

To highlight the purpose of UCITS as a type of savings institutions in form of pooled investment, the Directive restricts the UCITS from borrowing, granting loans or acting as guarantors on behalf of third parties, and from carrying out uncovered sales of transferable securities (short-selling). Thus UCITS clearly are prevented from stepping outside their original core business, which is pooled investment on behalf of general public.

**Information Requirements**

The overriding principle in the UCITS Directive is the protection of unit-holders. Transparency of information serves this purpose with regard to requirement for prospectus for issuance of units and for periodic reports for units outstanding.

A management company or investment company must publish a prospectus, an annual report for each financial year, and a half-yearly report covering the first six months of the financial year for each individual fund it manages.

A prospectus must include information which enables investors to make informed judgment, such as

- name, style, form in law, registered office, management company and possible other funds managed by the company
- fund rules, or where they can be obtained
- brief description of relevant applicable tax rules
- information about managers, auditors and supervisory body
• details on main characteristics of the units (registered/bearer, voting rights, etc.)
• market places where units are listed, if applicable
• procedures and conditions for issue and sale of units, and for redemption or repurchase of units
• description of the fund's investment objectives, including its financial objectives (capital growth/income), investment policy (specialization in industry, type of securities, geographical sectors), any limitations on that policy and policy on use of derivatives
• rules for the valuation of assets
• determination of the issue or sale price and the repurchase or redemption price of the units, including the method and frequency of the calculation, possible fees and the method and place of publication of those prices
• information concerning the depository
• information on possible external advisors

The annual report must include a balance-sheet or a statement of assets and liabilities, a detailed income and expenditure account for the financial year, a report on the activities of the financial year, and any significant information which will enable the investors to make an informed judgment on the development of the UCITS. In addition, it should include the following:

• statement of assets and liabilities, including transferable securities; debt instruments; bank balances, other assets; total assets and liabilities; net asset value
• number of units in circulation
• net asset value per unit
• portfolio, distinguishing between different types of securities
• statement of the developments concerning the assets of the UCITS during the reference period
• a comparative table covering the last three financial years and including, for each financial year, at the end of the year
  (i) the total asset value
  (ii) the net asset value per unit

The information requirements are internationally compatible, although individual member states may have gone further in their national regulations. All publications are to be submitted to the competent authorities, although there are no preapproval requirements.

Supervision

UCITS are subject to supervision, according to the Directive. The member states may assign the supervisory authority at their own discretion. Usually this is the securities market supervisory authority.
Securities Intermediaries

The business of providing securities related services is governed by the Directive on Investment Services in Securities Field\(^7\) and the Capital Adequacy (CAD) Directive.\(^8\) The primary objective of these Directives is to supply the appropriate level of investor protection to various categories of investors while taking into account their level of professional expertise. The Directive also aims to guarantee non-discriminatory treatment of all investment firms authorized in any member state and likewise all financial instruments listed on the member states' regulated markets, i.e., free movement of services.

The Investment Services Directive stipulates the following: (a) scope of business, (b) authorization, (c) suitability requirements for large shareholders, (d) prudential rules and rules of conduct, (e) audit trail requirements, (f) supervision with enforcement authority, (g) access to regulated markets, and (h) price information requirements. The CAD Directive specifies the minimum capital requirements for investment firms and adequate capital requirements for covering market risks, position risks, counterparty or settlement risks and foreign exchange risk incurred by investment firms or banks.

**Scope of Business and Authorization**

In the Directive an investment firm is defined as any legal person whose regular occupation or business is to provide one or several of the following (investment) services to a third party:

- (i) reception and transmission, on behalf of investors, of orders in relation to securities or related instruments
- (ii) execution of such orders other than for own account
- dealing in securities or related instruments
- managing portfolios of investments in accordance with mandates given by investors on a discriminatory, client-by-client basis where such portfolios include securities or related instruments
- underwriting in respect of issues of securities or related instruments and/or the placing of such issues

In this context, securities and related instruments refer to all transferable securities, units in collective investment undertakings, money market instruments, financial futures, forwards and options and interest-rate, currency and equity swaps.

In practice, this means that all securities brokers, dealers, portfolio managers and underwriters fall under this regulation. Nevertheless, the Directive specifically excludes firms providing services only within their own corporate group, firms that administer exclusively employee-participation schemes, commodities professionals and market makers in derivatives. Each investment firm must acquire a business-specific operating license, that is, the authorization must specify in which core business the firm is authorized to operate. The

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authorization may also include non-core businesses. Providing these non-core businesses by themselves does not require authorization according to the Directive. These include:

- safekeeping and administration in relation to securities or related instruments
- safe custody services
- granting credits or loans to an investor to allow him to carry out a transaction in securities or related instruments where the firm granting the loan is involved in the transaction
- advisory services on capital structure, industrial strategy, and merger and acquisitions
- services related to underwriting
- investment advice concerning securities or related instruments
- foreign exchange services where these are connected with the provision of investment services

However, several member states have chosen to include some or all of these services under supervision or at least under registration requirement at the supervisory agency in their national legislation.

The EU member states may choose whether or not to allow banks to provide investment services directly. The Second Banking Directive is based on the principle of universal banking, but individual member states can prohibit provision of investment services in their national banking licenses. In case the national legislation follows the universal banking principle, the provision of all investment services is usually automatically included in the banking license without the need for any additional service-specific licensing.

Before granting an authorization for an investment firm, the authorities must satisfy themselves that the following criteria have been met: (a) sufficient initial capital with regard to the investment service in question; (b) sufficiently reputable and experienced management; (c) suitable major shareholders; and (d) a credible program of operations setting out inter alia the types of business envisaged and the organizational structure of the firm.

**Suitability of Large Shareholders**

As was the case with banks and investment firms, anyone intending to acquire 10 percent or more of the capital or the voting rights in the firm must inform the supervisory authorities prior to the acquisition of the shares. Similar information must also be provided with regard to expanding the holding above 20, 33 or 50 percent. The supervisory authorities then have another three months to either satisfy themselves with regard to the qualification and soundness of the proposed new major shareholder, or to object to the intended acquisition on the grounds of unsuitability. The process is the same as for ownership in banks.

**Prudential Rules**

Every member state is required to draw up prudential rules which investment firms are required to observe. The primary objective of these rules is the protection of clients' property, but also to set the minimum level of care acceptable for a market participant entrusted with client funds. Moreover, they enable the supervisory authority to set the standard and they make it easier for the supervisor to pass judgments on the level of prudence by individual market participants in
comparison to other players on the market. In particular, such rules shall require that an investment firm:

- have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing, and adequate internal control mechanisms including, in particular, rules for personal transactions by its employees
- make adequate arrangements for instruments belonging to investors with a view to safeguarding the latter's ownership rights
- make adequate arrangements for funds belonging to investors with a view to safeguarding the latter's rights and, except in the case of banks, preventing the investment firm’s using investors’ funds for its own account
- arrange for records to be kept of transactions executed, which are sufficient to enable the authorities to monitor compliance with the prudential rules
- be structured and organized in such a way as to minimize the clients’ interests being prejudiced by conflicts of interest between the firm and its clients or the clients

Prudential rules become very important particularly when something goes wrong. Market participants have a tendency to try to cover up mistakes. In the case of individual traders this has often led to a temptation to ‘borrow’ client funds or securities to temporarily cover up a mistake while ‘the problem fixes itself.’ This is also regrettably frequently the case when a whole investment firm runs into financial difficulties. Consequently, the supervisory authorities should consider prudential rules the most sacred of all regulation imposed on investment firms, and treat any violation severely.

EU legislation places a great deal of emphasis on prudential rules. Standards and detailed instructions have been left to each individual member state with regard to their domestic market. Thus prudential rules can partly be considered an exception from the prevailing home country supervision practice, as branches established in other member states must conform with the prudential rules drawn up by the local authorities or host country. This makes sense as the structure of individual market places, their clearing and settlement systems, local book-entry systems and payment systems varies by member state, and therefore only locally adapted rules can be effective. In general the prudential rules imposed by individual member states and their supervision are required to be of international standard.

**Rules of Conduct**

The purpose of rules of conduct is to protect both the clients’ interests and market integrity. The member states are responsible for drawing up rules of conduct for their local investment firms. These require that the firms:

- act honestly and fairly in conducting their business activities in the best interests of clients and the integrity of the market
- act with due skill, care and diligence, in the best interests of clients and the integrity of the market
- have and employ effectively resources and procedures necessary for the proper performance of its business activities
- seek information from clients regarding their financial situation, investment experience and objectives, depending on services requested
- make adequate disclosure of relevant material information in dealings with its clients
- try to avoid conflicts of interest and, when they cannot be avoided, ensure that clients are fairly treated
- comply with all regulatory requirements applicable to the conduct of business activities to promote the best interests of clients and the integrity of the market

Rules of conduct try to enhance the credibility of the market and the market participants. They emphasize integrity and diligence, and the best interest of the client. It is in this context that the proficiency level of the client becomes important. Rules of conduct should put particular weight on the diligence requirement when dealing with the non-professional investors of the general public. In general, as is the case in most regulations regarding investment services, the EU rules of conduct are less detailed and stringent than their US counterparts, but have nevertheless proven quite adequate for the purpose they serve.

**Audit Trail Requirement and Price Information Provision**

To ensure that the supervisory authority responsible has access to information necessary for the performance of its duties, the Directive includes an audit trail requirement. Investment firms have to keep relevant data on transactions relating to the services rendered, including data on transactions for their own account, for at least five years.

Furthermore, the authorities must have access to data on all transactions by the investment firms in securities and related instruments both for the clients' and for their own account at the earliest opportunity. Usually this requirement has been, and can be according to the Directive, satisfied by a direct on-line data-feed from the market places to the authorities complemented by reports for the investment firms with regard to off-market-place trades, if permitted. However, the ultimate responsibility for this reporting lies with the investment firms and the above-mentioned arrangements are usually made for the convenience of the authorities, at their discretion. Most of the competent authorities have an on-line market watch system equipped with 'bells and whistles' for detecting anomalies like sudden large price movements or large blocks trading hands.

In order for the investors to be able to assess at any time the terms of a transaction they are considering and to verify the conditions under which it has been carried out, the Directive empowers the competent authorities to require the publication of price information for each of the regulated markets in a timely manner. This provision is only indirectly connected to the investment firms as it is, in fact, imposed on the market place. It is included in the Investment Services Directive partly because it is indirectly connected to the rules of conduct, and partly so that the Directives on stock exchanges need not be amended.

**Supervision and Enforcement Authority**

The member states can designate supervisory authorities at their own discretion to carry out the duties provided for in the Directive. These must, however, either be public authorities, bodies recognized by national law or bodies recognized by public authorities expressly empowered for that purpose by national law. The legislation further requires that the authorities concerned must have all the powers necessary for the performance of their functions and duties. Thus for the purpose of regulation stipulated in the investment services Directive, mere self-
regulation by the market participants or by their association is not considered sufficient in the European legislation.

The Directive also specifically calls for collaboration between different competent authorities. It obliges the member states to ensure that such collaboration takes place between authorities responsible for the supervision of financial markets, banks and other financial institutions and insurance undertakings, as regards the entities which those authorities supervise.

The Directive also takes a strict and far-reaching approach to enforcement. It stipulates that, without prejudice to the provisions of their criminal law, the member states must provide that their respective competent authorities can adopt or impose measures or penalties aimed specifically at ending any observed breaches of laws, regulations or administrative provisions by investment firms, or by those effectively controlling the business of such firms.

Although the Directive's approach to enforcement is extensive by European judicial standards, it pales in comparison to the US regulators' enforcement authority, particularly that of the Securities and Exchange Commission. A great deal of the investigative and enforcement powers awarded to the US regulators lies in the European case law environment, in fact in the hands of law enforcement authorities, thus requiring far-reaching cooperation between the regulators and the law enforcement agencies, including the police and the prosecutors.

**Minimum Capital and Capital Adequacy Requirement**

The CAD Directive sets forth the rules for minimum capital requirement for investment firms and risk related capital adequacy requirement for covering market risks, position risks, counterpart or settlement risks and foreign exchange risk incurred both by investment firms and banks.

The minimum initial capital requirement for brokers and/or portfolio managers that do not deal in any financial instruments for their own account, and do not underwrite issues of financial instruments on a firm commitment basis, is ECU 125,000. For the purpose of the CAD Directive, the holding of non-trading book positions in financial instruments for the sole purpose of investing the firm's own funds, is not considered dealing. If, in addition to the above, an investment firm is not authorized to hold clients' money or securities the initial capital requirement may be reduced to ECU 50,000. Authorization for dealing on the firm's own account, or underwriting automatically, raises the initial capital requirement to ECU 730,000.

The CAD Directive takes a 'building block' approach to calculating the total capital requirement. Thus the capital should exceed the sum required to cover the requirement for the trading book, the banking book in case of banks, foreign exchange risk for the whole business and other risks. For banks, the CAD effectively divides the banking business for capital measurement purposes into two portions: the trading book governed by CAD, and the banking book governed by the Solvency Directive for banks. The 'trading book' refers to proprietary positions in financial instruments and derivatives that are held for resale, with the intention of benefiting from short term movements in prices and it should be marked to market. The 'banking book' consist of loans and other assets which are normally reported using the accruals method of accounting.
In its building block approach, the CAD starts with general market risk which is defined as risk of change in general market prices regardless of the level or the fluctuations in the creditworthiness of the specific issuer of the asset. Thus the general risk is a function of the size of the portfolio, the degree of diversification, and the price volatility of each asset held. The CAD then adds specific risk requirements, for example on equities held or underwriting committed to, and capital requirements for settlement, delivery and counterparty risks, and foreign exchange risk.

This paper does not include a detailed discussion of risk-adjusted capital adequacy requirements, as the annexes of the Directive are very detailed. Nevertheless, even though the EU work on the CAD Directive has paralleled the work of the Basle Committee on Banking Supervision, the approaches taken are somewhat different. The Basle Committee’s work is more process-oriented and aims to ensure that the banks have adequate internal market risk management systems in place, and it gives the banks some freedom of choice with regard to the type of system used. Under the Basle proposal the focus of the bank supervisory authorities should primarily be on the risk management systems, rather than the presence of categorically defined capital buffers against market risks.

At present, European banks are, or will be, faced with an arduous task of complying with both the CAD Directive and the Basle Committee’s recommendation. The cost of implementation for two different sets of capital adequacy rules simultaneously will be significant. There is some concern over whether the new regulations will put the banks at a competitive disadvantage against their direct and indirect competitors both international and domestic. Consequently, there are calls for some form of reconciliation between the two set of different rules.

The international competitive situation is further complicated by the fact that the US Securities and Exchange Commission has a completely different approach to capital adequacy. It uses the comprehensive approach which is at present 15 percent capital requirement for an ‘all-long book’ with a very limited (25 percent) offset for balanced books. The comprehensive approach takes no account for diversification of the portfolio, and consequently leads into high capital requirement and inefficient use of capital.

### Pension Funds

The various Life Insurance Directives cover all pension products offered by life insurance companies, whether individual pensions, insured group pensions or pension fund management services. Though the Life Insurance Directives cover pension provision through life insurance contracts they completely exclude pension funds not established in corporate form. The EU has proposed a new Directive relating to the freedom of management and investment of funds held by institutions for retirement provision in 1991, however, it is not expected to be adopted by the Council soon.

As the forms of pension fund savings vary greatly within the EU the proposed Directive’s scope was broadly defined to include any separately established retirement benefit arrangement holding identifiable assets. This provision already constituted a problem, as the scope of the proposal clearly included the French pay-as-you-go schemes with reserves, but it failed to include the German book reserve system because book reserves do not represent separate identifiable assets.
The proposed Directive on pensions sought to establish common prudential rules for pension fund investing while still respecting the EU's diversity in the sector. These goals have proven incompatible, given the large volume (over US$1.2 trillion) at end-1995 and politically sensitive nature of these funds. The proposal laid down several investment principles in order to promote free but safe investment across borders. Under the terms of the proposal investment of assets should consider four requirements: security, quality, liquidity and profitability of the institution's portfolio as a whole. Furthermore, the proposal put forward provisions which aimed to prevent discrimination by member states in the form of permissible asset lists, or in the allocation of asset requirements within the member state. This was one of the main problems with the proposal, as several member states still force pension funds to invest in domestic government bonds to fund their budget deficits.

The failure of the EU to agree on a pension fund directive which would establish not only common prudential investment guidelines, minimum funding standards and periodical disclosure (which are all requirements for mutual recognition of pension schemes), but also cross-border portability of pension funds, is a major set-back in terms of hopes for increased cross-border mobility of work force within the EU. Free movement of people within a single European job market remains inconceivable without provision for equally free movement of pension funds.

**Regulatory and Supervisory Issues**

There are basically four principal choices of structures of regulatory regime available as alternatives to solving banks' relations to securities and securitized business. These are (a) the separation model, (b) the firewall model, (c) the universal banking model, and (d) the separate capital requirement model. The international trend today seems to be towards a combination of either the firewall and the separate capital models, or the universal bank and separate capital models. Regional rather than national-level regulation is another option currently under discussion.

Under the separation model or, as it is usually known, the Glass-Steagall model, banks are not permitted to undertake securities business or to own securities firms. Consequently, the banking and the securities industries are separately regulated and supervised in accordance with industry-specific solvency or capital adequacy requirements. This model is based on US experience.

The firewall model originates from the Section 20 amendment to the US Glass-Steagall Act allowing US banks to have subsidiaries with limited powers to undertake securities business. It is a compromise between the separation model and the universal banking model, and it seeks to segregate the risks associated with banking and securities businesses undertaken by financial conglomerates. The mechanism to achieve this is a requirement that the two businesses be conducted through separate legal entities protected by 'firewalls', that is, restrictions on intra-group transactions, the purpose of which is to prevent risk being transmitted from the securities unit to the banking unit.

Under the universal bank model, which was the traditional banking regime in large parts of continental Europe before the introduction of the Capital Adequacy Directive within the EU, securities and banking businesses are freely combined within the banking entity. Thus, the risks involved in the two activities are pooled, and there is a single regulatory authority which applies
a common solvency or capital adequacy requirement to the combined business. This is the traditional universal banking approach, pioneered by Germany. It has also been applied in countries which have adopted the Germanic judicial tradition, most notably all Nordic countries, the Netherlands and Austria. France also adopted the principle of universal banking at the beginning of the 1980s in its banking reform program. This system has had a tendency to lead to a highly concentrated and very strong banking industry, and it may have hindered the development of securities markets to their fullest. However, the universal bank model in its pure form no longer exists in Europe since the introduction of the CAD Directive and Basle Committee Recommendations on capital adequacy.

The separate capital requirement model can be applied either to a bank directly engaged in securities business through its own balance sheet or to a bank with a securities subsidiary. The thinking behind this approach, taken in the EU Capital Adequacy Directive, is to divide up the business into banking and securities, to set a separate risk related solvency or capital adequacy requirement for each part of the business and finally to add up these capital requirements to reach the total capital needed to cover the risks undertaken. In principle the solution is ingenious. However, its applicability and its possible consequences are still under discussion, in light of its apparently favorable treatment of the securities business over the banking business by demanding lower capital requirement. This, according to critics, may lead to the banks trying to transform their traditional lending into securitized lending to achieve a lower capital requirement for de facto the same business. The gravest allegation is that the application of the CAD Directive may upset the regulatory balance, as long as there are no obligatory investor protection schemes available. The banks’ securities business would thus be subsidized by the negative premium awarded to banks’ funding due to deposit guarantee schemes.

The separate capital requirement model is indirectly also the principle behind the Basle Committee’s proposal and as such will be applied quite widely with the implementation of the Basle proposal. In fact, the international trend today seems to be towards a combination of either the firewall and the separate capital models, or the universal bank and separate capital models. To ensure the international competitiveness of their financial industries most countries are following this trend, or at least discussing it, as is the case with the US and Japan.

The arguments for and against of separation of banking and securities industries are old and, to some extent, emotional. The main argument for separation naturally arises from the 1930s case of banks’ misuse of trust funds in their underwriting business. Consequently, its proponents’ claim that there is a potential conflict of interest for commercial banks which engage in underwriting of securities. The argument ignores the fact that both the banking business and the securities business have changed a great deal since the 1930s, that there has been no known similar pattern of incidents in the world of universal banking, and that both the SEC and the banking regulators today possess far greater powers to prevent the kinds of abuses that occurred before the Glass-Steagall Act was passed.

The advocates for allowing banks to engage in securities business argue that, under the present system the banks are placed at a disadvantage, as the securities industries can and have indirectly expanded into the banks’ business through development of money market funds and cash management accounts. They further argue that the Glass-Steagall in effect increases the risk in the banking system through preventing the banks from diversifying their business and prohibiting them from a lucrative fee-based business. They also claim that preventing banks
### An Overview of the German Financial System

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Universal banks</td>
<td>Engage in a full range of activities including taking deposits, loans and mortgages, underwriting security issues and investing directly in securities including equities.</td>
</tr>
<tr>
<td>- Commercial banks</td>
<td>Include the three major banks which are Deutsche Bank, Dresdner Bank and Commerzbank, the regional banks, branches of foreign banks and private banks.</td>
</tr>
<tr>
<td>- Savings bank system</td>
<td>These are not profit maximizing entities but are operated in the public interest. There are three tiers: local savings banks, state savings banks and the central savings bank.</td>
</tr>
<tr>
<td>- Cooperative banks</td>
<td>The depositors are shareholders. As with the savings bank system there is a three-tier structure with local, state and central levels.</td>
</tr>
<tr>
<td>Specialist banks</td>
<td>These concentrate on providing a narrower range of services than universal banks. The include banks which specialize in providing mortgages, agricultural credit, small business credit, etc.</td>
</tr>
<tr>
<td>Stock markets</td>
<td>Seven regional exchanges with that in Frankfurt being the most important. Only 665 companies were listed in 1991. Traditionally stock markets have been a insignificant source of funds for firms.</td>
</tr>
<tr>
<td>Bond markets</td>
<td>Important for the debt of all levels government, their entities, banks and other intermediaries. Industrial firms issue very little debt.</td>
</tr>
<tr>
<td>Derivatives markets</td>
<td>Opened in January 1990. Volume of trade has been unimpressive.</td>
</tr>
<tr>
<td>Firm pension schemes</td>
<td>Firms make provisions for employees by investing directly within the firm (book entry system). Forms a significant source of funds for firms.</td>
</tr>
</tbody>
</table>

from partaking in the securities business hinders competition and as a consequence results in higher cost of intermediation through securities markets.

Historically, the choice of the structural solution adopted has influenced the development of the financial markets significantly as can be concluded from the comparison of the two extremes in their purest forms (i.e., the separation model in the US and the universal banking model in Germany). In the US system the financial markets play a major role while in Germany the system has been, and to a very large extent still is, dominated by intermediaries, that is by banks. To what extent this distortion effect will be true for the development of financial systems in the hybrid environment of the two extremes combined with separate capital requirement model remains to be seen.

The strongest international trend is towards lifting the separation between the banking and the securities businesses. This suggests that regulators are accepting the development that has and is already occurring in the marketplace. In both Japan and the US there have been concrete measures undertaken in recent years to at least partially undertake the separation of banking and securities industries. Japan has historically had a separation model in the form of Article 65, the equivalent of the US Glass-Steagall. In April 1994, Japan introduced the Financial System Reform Act which allows banks and securities companies to enter each others' business through newly-established subsidiaries or acquisition of existing entities. This legislation has led to the opening of new securities subsidiaries by the banks and to new trust banking subsidiaries by both banks and securities companies.
A Comparison of the Effect of Two Extreme Models in Structure of Financial Systems

<table>
<thead>
<tr>
<th>Feature</th>
<th>Germany</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Universal banking</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Number of important banks</td>
<td>Small</td>
<td>Large</td>
</tr>
<tr>
<td>Long term relationship between banks and firms</td>
<td>Extensive</td>
<td>Limited</td>
</tr>
<tr>
<td>Competition between banks and financial markets</td>
<td>Little</td>
<td>Considerable</td>
</tr>
<tr>
<td>Number of publicly listed companies</td>
<td>Small</td>
<td>Large</td>
</tr>
<tr>
<td>Futures and options markets</td>
<td>Illiquid</td>
<td>Liquid</td>
</tr>
<tr>
<td>Information available on publicly listed companies</td>
<td>Limited</td>
<td>Extensive</td>
</tr>
<tr>
<td>Market for corporate control</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

* Historically, before the full implementation of the EU common market for financial services.

**Supervision**

Supervision is a means of enforcing regulations. It includes: (a) authorization of institutions in the regulated business, (b) licensing and approval in the field of regulated business, (c) issuing rules stipulated in law and drafting guidelines for the conduct of regulated business, and (d) performing the actual task of supervision on an ongoing basis. These tasks are by no means separate nor independent of each other; to the contrary, together they form an integrated set of duties to be performed in a consistent, logical and efficient manner preferably by one competent authority per sector of the financial system. It is up to each government to find the right balance keeping in mind their objectives, particularly their protection interests, the culture of the society and the level of sophistication of the financial system in question.

Structurally, supervision can be performed in a number of ways. Competent authorities may be integrated to simultaneously cover several sectors of financial markets. This is often the case with financial systems based on the principle of universal banking. This is particularly true in countries with a Germanic legal tradition, such as Germany, Austria and all the Nordic countries. They may also be separated into different authorities, with each responsible for one individual sector of the financial system, or even responsible for one separate part of an individual sector as in the case of bank supervision in the US. Separation of supervisory functions by sector is in fact more an Anglo-Saxon tradition; the US and the UK are the most notable examples.

Besides horizontal specialization, supervision responsibilities may be divided up vertically with a hierarchical system or even with independent regional authorities responsible for local or regional markets and institutions. Both the US and Germany apply independent regional supervision with regard to local markets and local banks, and savings banks, respectively. Regional or local supervision may in the case of large countries be essential for the success of the task, as local rules or market conditions may vary substantially by region, and as mere physical remoteness tends to complicate and distance the relation between the authority and the supervisory subject. Whether the solution lies in independent local authorities, or whether authorities reporting to a federal central agency are to be adopted should be considered carefully, based on the structure of the financial system and the degree of differences in regional regulation.
Another interesting issue with respect to supervisory structures is the level of independence of the supervisory authority and the role of the central bank in bank supervision. In this regard, the solutions vary greatly from one country to the next, usually for historical reasons. However, the central bank almost always has some kind of role to play in bank supervision. This minimum level of involvement arises from the duties of the central bank as the guarantor of the payment system, and its responsibility as a lender of last resort for the banking system. To be able to perform these essential tasks, the central bank has to be able to monitor the status of individual banks and the banking system as a whole, and, to a certain extent, it has to be able to influence the level of risk-taking by the banks. In many countries, mostly those which follow the Anglo-Saxon tradition, this has led to the central bank being the sole supervisor of the banks. Examples include the Bank of England, and the Federal Reserve in the US.

In this context, Luxembourg provides an interesting example of structural solutions. Given its small size, Luxembourg has not had a central bank of its own but has relied on the National Bank of Belgium to perform certain central banking functions based on the Treaty of the Monetary Union between Belgium and Luxembourg. Besides this interesting arrangement Luxembourg has a unique financial system in which foreign European-owned banks represent by far the largest number of banking establishments. Furthermore, the country is known for being an off-shore tax haven not only for banking but also for securities and mutual funds industries, and it is renowned for its lax regulatory and supervisory environment.

In the Germanic tradition there usually is an independent regulatory authority responsible for the supervision of banks, while the central bank also maintains a supervisory role in relation to its duties. This arises partly from a perception of possible conflict of interest for the central bank in simultaneously being the sole supervisor of the banks and the lender of last resort for the banking system. It is questionable whether the central bank is able to perform these two duties in parallel, as it’s role as the lender of last resort makes it predisposed to protect the banking system and individual banks from extensive scrutiny and ultimately possible failure. As a bank supervisor the central bank’s responsibility may be to have to take punitive initiatives or actions inclined to cause embarrassment for, or even adverse public reactions towards, the bank, and thus inadvertently risk its very existence. Similar concerns over possible conflict of interest have been raised regarding the relation between the central banks’ practical enforcement of its monetary policy through money market interventions and the bank supervisors’ role with regard to banks’ trading on the money market. Consequently, the solution has usually been to grant a significant level of independence to the regulatory authority which, in most cases, reports to the Ministry of Finance. This situation is applicable in Germany, Austria, France, Sweden, Norway and Denmark, while Finland has opted for an independent authority affiliated with the Central Bank.

Whatever the reason for the duplicate supervisory structure for banks, in most countries using this approach, the regulatory authority and the central bank co-operate extensively. Furthermore, they have had a tendency to take slightly different approaches, the regulatory authority emphasizing judicial compliance while the central bank, for obvious reasons, has been more risk-oriented in its approach. However, with the introduction of EU Directives on banks’ large exposures, own funds, solvency and capital adequacy this difference is fading.
The European Union Approach to Regulation and Supervision

The EU's approach to free movement of financial services has for the most part been an admirable balancing act between guaranteeing the minimum internationally acceptable level of regulation while respecting the quite remarkable diversity of its member states. It has achieved this by setting forth a minimum regulatory level for the benefit of the common market for financial services and simultaneously allowing the member states the discretion of being able to set a higher and stricter level of requirements and restrictions for their domestic entities. Thus the EU is guaranteeing only a certain minimum level of protection with regard to financial systems. The EU's interests in terms of protection are aimed primarily at ensuring the stability of the banking and the payment systems, and the credibility of the financial markets and market participants.

The EU regulations stipulate supervision by competent authorities, but do not give direct provisions on the supervisory structure. Each member state can designate the competent authorities at their own discretion to carry out the duties provided for in the relevant Directives as long as these authorities are either public authorities, bodies recognized by national law or bodies recognized by public authorities expressly empowered for a particular purpose in national law. In addition EU law requires that these authorities have all the powers necessary for the performance of their duties.

Although a member state can, for example, require a stock exchange to carry out some particular supervisory task, this does not mean that the EU would consider mere self-regulation without a specific authorization in national law adequate for the purpose of carrying out supervisory duties stipulated in its Directives. In any case the member state is still responsible for ensuring that the authorized body has the powers to carry out the stipulated task.

Different member states have consequently drawn up quite different solutions for the supervisory structure. Some have opted for an integrated structure with one supervisory authority having the task of regulating many different types of financial institutions, which makes sense particularly in the case of universal banking. Sweden and Denmark have gone the farthest in this process, with one independent supervisory authority for the whole financial system, i.e., for credit institutions including banks and mortgage institutions, for securities and derivatives markets, market places and intermediaries including mutual funds, and for insurance companies. Other Nordic countries also have a very high level of integration in their supervisory structure with one supervisor for credit institutions and securities sectors, and a separate supervisor for the insurance sector. Meanwhile, Germany has a separate independent supervisory authority for the insurance sector, with an independent bank and securities market supervisor. At the same time the central bank is very active in bank supervision. Moreover, Germany has also a two-tier supervisory system, which includes separate federal and regional authorities.

Other member states, such as the UK and Ireland, follow a more traditional approach with the central bank solely responsible for bank supervision, and separate independent supervisory authorities for the securities and the insurance sectors.

Regardless of their choice of supervisory structure all EU member states follow the principles of supervision of financial institutions discussed above. This is particularly significant, because of the overriding principles of EU legislation over home country supervision, and mutual recognition within the EU and the EEA. Consequently, within the EU and the EEA, the
quality of supervision is not only under domestic scrutiny, but also under a very thorough observation from the part of the other member states and the European Commission. Hence cross-border cooperation between supervisors of the same sector, and also between supervisors of different sectors, within each member country is very much encouraged in EU legislation.

Finally, EU legislation does not require the licensing authority and the supervisory authority for certain type of financial institution be the same body. However, where licensing and supervisory authorities are separated, the Directives placed utmost importance on formalized cooperation between the two different authorities. This may take the form of requiring the licensing body to request a formal written statement from the supervisory body when considering any licensing issues.
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