



TESTIMONY OF

**RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION**

CONCERNING S. 543 AND S. 713

**BEFORE THE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE**

MAY 7, 1991

**U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549**

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Chairman Riegle and Members of the Committee:

I appreciate this opportunity to appear before this Committee, on behalf of the Securities and Exchange Commission, to discuss plans for reform and modernization of the financial services industry, as set forth in two bills -- S. 543, the "Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991," introduced by Chairman Riegle, Senator Dodd, and Senator Wirth, and S. 713, the "Financial Institutions Safety and Consumer Choice Act of 1991," introduced by Chairman Riegle and Senator Garn at the request of the Department of the Treasury. I would like to thank you, Mr. Chairman, for calling this timely hearing on this important issue, and for inviting the Commission to present its views.

I. S. 543: Enhancing the Stability of the Banking System

S. 543 contains a number of very useful suggestions for reforming federal deposit insurance and strengthening supervision. Indeed, introduction of S. 3103, the

predecessor of S. 543, undoubtedly helped in the formulation of other reform proposals. Mr. Chairman, you deserve compliments for your leadership on these issues.

Many provisions of S. 543 would make very significant improvements to the current system. First, S. 543 would reinforce the role of real capital in enhancing the solvency of our banking system. Section 3 of the bill would direct the Commission, in consultation with the Federal banking agencies, to facilitate the development of accounting principles for insured depository institutions that accurately reflect their economic condition.

As part of this legislation, the Commission would be specifically directed to facilitate the development of accounting principles that reflect market values to the extent feasible. This provision reflects the fact that capital is only effective in reducing risk and providing a cushion before taxpayer exposure if it is accurately and realistically measured. Items such as good will or unrealized losses on securities do not provide any buffer for absorbing losses, and hence are not of value in the computation of required minimum capital levels for embarking on new or risky types of activities. Requiring the Commission to develop market value accounting principles for liquid assets with ascertainable values would help to ensure uniformity and reliability that would not only facilitate effective supervision, but would also benefit investors. "Gains trading" is an example of one type of abuse of current historic cost accounting practices that results in exaggeration of an institution's operating results and financial condition.

Second, Section 4 of S. 543 would require bank regulators to examine annually each insured depository institution. This provision, again, would improve the accurate measurement (and consequently the real value) of capital. This seems like a simple step, yet we have seen too many cases where rapid deterioration between on-site examinations was not detected by remote monitoring.

Third, S. 543 recognizes that some form of prompt corrective action is necessary to avoid significant losses to the deposit insurer. The bill ties enhanced regulatory powers to capital -- and provides for the effective exercise of those powers by requiring meaningful, market-based accounting, as described above. Early intervention has been effectively used by the Commission to ensure that firms that reach a critically low level of capital are closed or recapitalized before capital is exhausted, so as to prevent losses to customers or the Securities Investor Protection Corporation ("SIPC"). S. 543's proposed capital-based assessment system underscores the importance of capital for insured depository institutions.

S. 543 also contains other provisions that would serve to limit the scope of deposit insurance coverage, a necessary step in controlling unnecessary taxpayer exposure. The provisions would limit insurance coverage on multiple accounts at any one institution, limit certain pass-through insurance coverage, and limit the acceptance and insurance of brokered deposits. These steps seek to curtail the unnecessary expansion of taxpayer exposure through the deposit insurance system without reducing

the average customer's protections. In this manner the core insurance program, which is extremely important to depositors across the country, could be strengthened.

S. 543 would also authorize the FDIC to restrict any state bank activity that poses a risk to the insurance fund. This mirrors comparable authority given to the FDIC with respect to savings and loans in FIRREA, and it represents a very sound protection of the system. Indeed, the large percentage of savings and loan losses that came from state-chartered savings and loans in a handful of states makes this reform extremely sensible. The bill would also limit actual FDIC expenses by requiring the FDIC to resolve troubled banks at the least possible long-term cost, and it would prohibit the FDIC after 1994 from protecting any uninsured depositors or creditors.

All of these provisions are positive steps that merit serious consideration to enhance the overall safety of the banking system. In the aggregate, these types of reforms would reduce the level of taxpayer exposure and subsidy through the federal safety net and inject more market discipline into our financial system. By utilizing both strong supervision and market forces, risk-taking by insured institutions would be more effectively controlled than it is under the current system.

II. Promoting Competition

For many decades, the financial system of the United States has been increasingly affected by the existence of legal barriers to competition within the banking industry, and between the banking industry and other types of financial services firms such as those in securities and insurance. Often these barriers have been justified on the basis

of legitimate public policy interests such as avoiding conflicts of interest, preventing excessive risks for taxpayer insured firms, or protecting against excessive concentrations of market power.

Though the issues of competitive barriers are usually controversial due to their impact on protected groups, many of these legal restraints on competition are plainly much broader than necessary to achieve their specific objectives. In the aggregate, our complex legal and regulatory system restrains competition and its benefits for market efficiency to an unhealthy degree.

Three of the principal barriers to competition in financial services are (1) geographic restraints that limit the ability of banks to compete with each other; (2) the Glass-Steagall Act, which limits the ability of banks to compete in the securities business; and (3) the Bank Holding Company Act ("BHCA"), which shields banks from potential acquisition by securities firms and other types of organizations. This latter statute has had the effect of isolating the banking system from the capital, technology and managerial resources available to other types of financial firms, as well as precluding bank participation in most types of insurance activities.

The Commission's position with respect to each of these specific areas has one consistent theme -- promoting competition. In each of these three areas, revisions to federal statutory restrictions against competition can and should be made. Laws should be targeted to prohibit specific potential abuses, such as inadequate capitalization,

inappropriate cross-subsidization, misleading sales practices or violations of fiduciary principles rather than serving as general barriers against all competition.

The Glass-Steagall Act is an example of legislation for which reform is long overdue. Indeed, the erosion of Glass-Steagall in recent years shows the benefits that can flow from elimination of unnecessary competitive barriers. To date, the Federal Reserve has authorized more than 30 bank holding companies to operate securities affiliates engaged in underwriting limited types of corporate debt securities, all corporate debt securities, or corporate debt and equity securities. Two domestic firms, Bankers Trust New York Corporation and J. P. Morgan & Co. Incorporated, have, along with two leading Canadian banking organizations, received approval to engage in underwriting of both corporate debt and equity issues.

On March 26, 1991, a milestone in the process of financial reform was reached when the Commission declared effective a registration statement covering 5,850,000 shares of common stock offered by Amsco International, Inc. J.P. Morgan Securities underwrote 422,500 shares of the total offering as co-manager, representing the first time in almost 60 years that a commercial bank affiliate has underwritten a public offering of equity securities in the United States. According to published reports, J.P. Morgan Securities Asia is currently serving as lead manager of the international portion of an initial public offering by Ayala Land Inc., a Philippines real estate company.

Of course, numerous other securities affiliates of U.S. and foreign banks are active in various areas of the securities business. More than 30 member firms of the

New York Stock Exchange are directly or indirectly controlled by, or under common control with, a domestic or foreign bank. Almost half of these firms are affiliated with U.S. banks, including many of the largest money center banks. Five NYSE member firms are affiliated with banks from each of Switzerland and Germany, four are affiliated with banks from Canada, two are affiliated with banks from France, and one member firm is affiliated with a bank from each of Great Britain, Italy and Japan. Numerous other banks engage in securities activities, including the U.S. government bond business, without becoming a member firm of the NYSE.

In the aggregate, the "Section 20" affiliates of bank holding companies have over \$83 billion in assets and have invested approximately \$2.7 billion in capital. This represents roughly 7% of the aggregate capital of all member firms of the NYSE, which in turn account for the largest share of total capital engaged in traditional securities activities in the United States. Bank affiliates have become important competitors in several specific product areas, especially the commercial paper market. On the whole, bank affiliates have brought both capital and competition to their securities activities, to the overall benefit of customers and market efficiency.

Intermingling banking and securities activities within a federally insured bank would raise a number of serious concerns with respect to risk to the public safety net for banks, as well as the ability to adequately supervise very different types of risks and certain potential conflicts of interest. Indeed, the absence of "universal banking" in the United States may be one reason for the growth of commercial paper, securitization of

receivables and the extraordinary creativity of U.S. securities markets in providing financing products at lower cost than traditional intermediated loans.

To date, however, bank entry into securities activities has occurred in many cases through separately capitalized affiliates of bank holding companies. This has enabled true "functional regulation" to be applied, with the "Section 20" affiliates being regulated in the same manner as all other securities firms. Thus, competitive harm to securities firms, undue expansion of the public safety net for banks and a variety of supervisory problems have been avoided by applying a system of "equal regulation for equal activities."

The evolution that has occurred to date has been tailored to fit within the confines of the Glass-Steagall Act. While this has resulted in some limitations, such as maximum percentage limits on business in "ineligible" securities, the increased competition seems to have been positive for the overall market. These results also appear to have been achieved without creating any unusual risks to the securities market or to the banking system.

Legislation could and should be enacted to expand the benefits of this competition both to banking organizations and to the users of the securities markets by removing unnecessary limitations on the size and activities of bank securities affiliates, while ensuring that the principles of functional regulation and appropriate firewalls to protect the banking system and to limit expansion of the use of federally insured funds are maintained. At the same time, such legislation would ideally permit equal freedom

for securities firms to own banking affiliates without a radical change in their overall pattern of regulation. Thus, the bank owned by a broker-dealer holding company should unquestionably be subject to a bank regulator, but where the bank subsidiary represents a small percentage of the overall organization it would seem unnecessary to subject the entire firm to the requirements of the BHCA.

Similarly, legislation addressing the fundamental operating characteristics of the banking system should remove remaining geographic barriers to competition. These barriers do not prevent banking organizations from conducting business within virtually any state, but they do have an impact on the cost and flexibility of those banks that seek to operate on a multi-state basis. These costs reduce the health of the banks involved without contributing to the stability of the overall system, or otherwise achieving a public benefit. Here too, competition should be allowed to help achieve an efficient and stable banking system.

III. S. 713: The Treasury Proposal

Like S. 543, S. 713 contains many very important and sensible proposals for limiting the scope of deposit insurance, enhancing the role of capital in bank supervision and responding more quickly to failing institutions. However, S. 713 also contains provisions designed to improve the competitiveness of the overall financial system. These provisions include streamlining holding company regulation, permitting interstate banking and branching, repealing the Glass-Steagall Act, and substantially eliminating the BHCA separation of banking and commerce. All of these are important steps toward improving the profitability and competitiveness of our financial services industry.

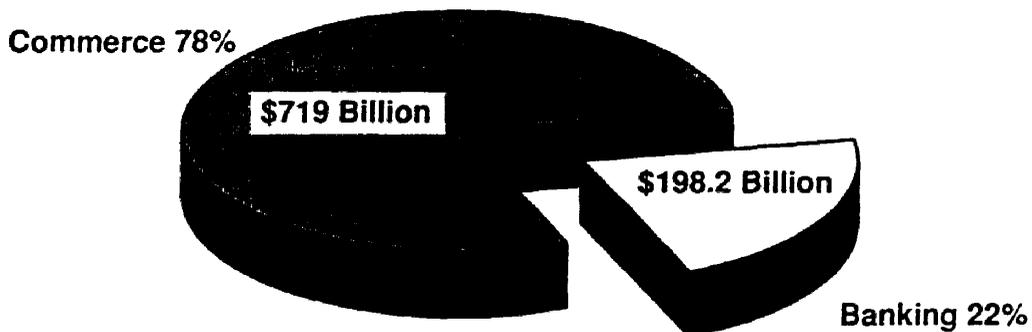
While S. 713 contains many useful changes in financial services regulation, the Commission has a number of specific concerns regarding the drafting of various sections of the bill. These include provisions relating to the regulation of bank securities activities, securities disclosure, and bank-sponsored pooled investment products, the examination and reporting authority of the Commission and the bank regulatory agencies, and consolidated capital requirements for financial services holding companies. Overall, our comments are directed toward greater utilization of the core principle of functional regulation where broader bank powers are authorized.

A. Barriers to Competition -- Banking and Commerce

One of the most important provisions of S. 713 would remove the restrictions on most U.S. companies' ability to invest in U.S. banks. One must emphasize the restriction on "U.S." companies, because current law has allowed much intermingling of banking and commerce. Sadly, the only mix permitted is U.S. banking owned by foreign commerce.

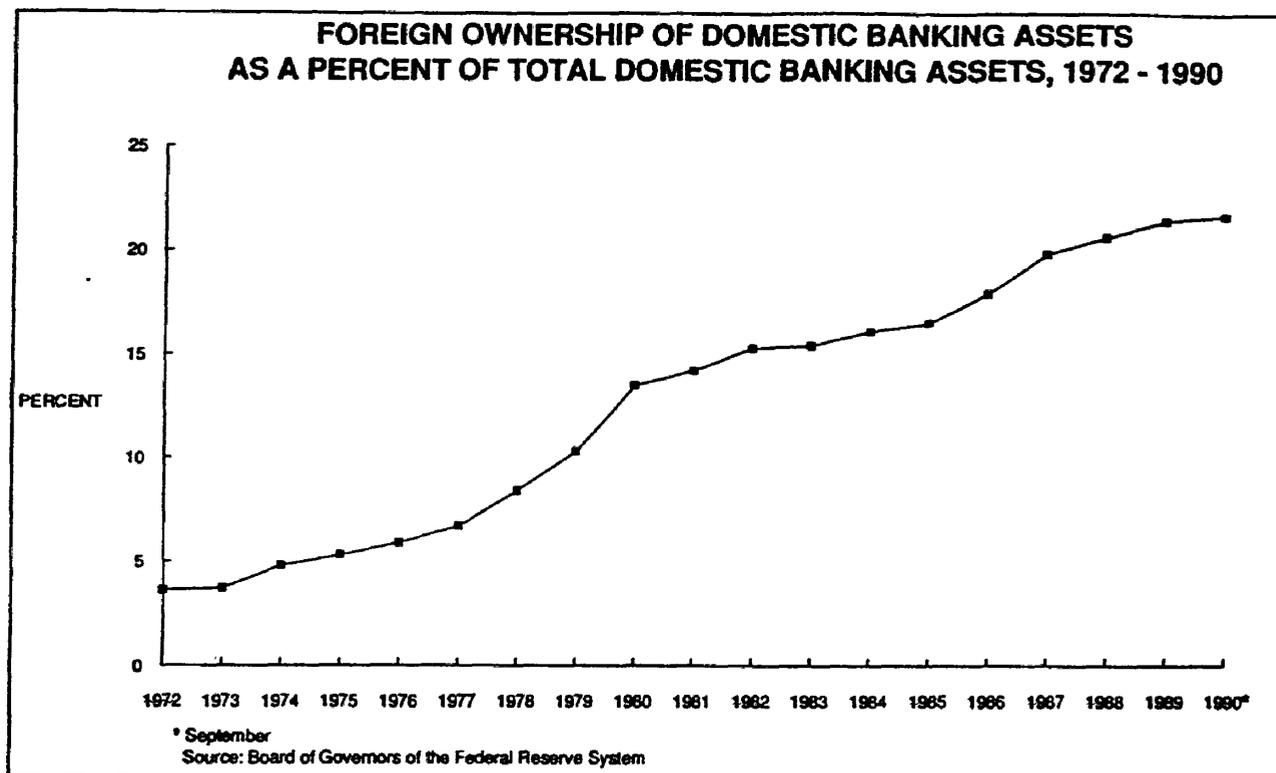
As the following chart shows, the Fortune 500 companies have over 3-1/2 times as much equity capital as do all U.S. commercial banks combined. However, under the BHCA this capital generally may not be utilized to acquire failed U.S. banks, although the recent investment participation of the firm of Kohlberg Kravis Roberts & Co. in the acquisition of the Bank of New England is an example of one apparently successful effort to evade this barrier against private capital investment in a failed bank.

EQUITY CAPITAL OF BANKS AND FORTUNE 500 FIRMS 1989



Source: Board of Governors of the Federal Reserve System and Fortune

By preventing bank access to the largest source of U.S. corporate capital -- but permitting the indirect combination of U.S. banking and foreign commerce -- the BHCA encourages U.S. banks to turn to foreign capital. In fact, as the following graph shows, foreign ownership of U.S. banking assets has increased by more than 500 percent during the past two decades. There is no reason to permit foreign banks with commercial affiliates to acquire U.S. banks while preventing U.S. commercial firms with demonstrated success in lending and other activities similar to banking from investing capital or management expertise in U.S. banks.



Historically, the asserted justification for this rigid barrier between banking and commerce has been the need to prevent overconcentration of economic assets, conflicts of interest, and unfair competition. If these problems ever warranted the radical approach taken by the BHCA, experience demonstrates that such is no longer the case.

Several of the largest U.S. securities firms are owned by, or affiliated with, major commercial enterprises or firms that include non-financial activities.¹ Commercial

¹ For example, a Salomon Brothers affiliate operates an oil refinery; Dean Witter is a subsidiary of Sears Roebuck; Kidder Peabody is a subsidiary of General Electric Company; Shearson Lehman is a subsidiary of American Express; and Van Kampen
(continued...)

affiliations in the securities markets certainly do not appear to have resulted in the supposed abuses targeted by the BHCA. Specialized investment banking organizations have not disappeared because of their lack of commercial affiliations. Rather, they continue to operate profitably and to compete effectively with firms that have commercial parent companies. Moreover, the larger commercial conglomerates do not appear to have abused their affiliate relationships by offering unfair discounts or tie-ins.

During 1990, parent holding companies from outside the securities business bolstered their broker-dealer subsidiaries' capital position by \$3 billion, either by direct capital infusions or by purchasing risky or illiquid assets from the broker-dealer.² Judging from this experience, there is every reason to expect that allowing similar affiliations, if accompanied by appropriate regulation and firewalls, would provide access to critical capital reserves for hard-pressed U.S. banks. For many of these institutions, the only other alternatives are closure or sale to a foreign company.

¹(...continued)

Merritt is a subsidiary of Xerox Corporation. Kemper Financial, Prudential Securities, Oppenheimer Management, Massachusetts Financial, and The Equitable Life Assurance Society, among others, all combine securities activities with insurance operations.

² For example, American Express contributed \$450 million in new capital to Shearson Lehman Hutton, and \$300 million more to Shearson's immediate holding company, an American Express subsidiary. General Electric purchased \$750 million of high-yield bonds and bridge loans from Kidder Peabody. Credit Suisse contributed \$300 million in capital to, and purchased a \$250 million bridge loan from, First Boston's immediate parent, which in turn reduced its bridge loan exposure by over \$700 million by, among other things, transferring three bridge loans to a new entity that it owns jointly with Credit Suisse. Prudential Insurance Company provided \$200 million in capital to Prudential Securities' immediate parent and bought \$600 million in bridge loans from a Prudential Securities affiliate.

In addition to restricting the sources of capital available to banks, the BHCA creates significant regulatory costs for banking organizations due to the need to determine whether particular activities are "closely related to banking and a proper incident thereto." Interpreting whether specific activities are permissible under this statutory standard consumes 13 pages of printed regulations, and has resulted in more than 900 administrative proceedings, and 47 reported court decisions since 1975.

Changing current law to separate "finance" and "commerce" would perpetuate the cumbersome and expensive regulatory system for determining permissible activities. Specific transactions such as the acquisition of a block of equity securities from an unsuccessful underwriting or financing of an LBO could trigger a finding that a parent organization of a broker-dealer suddenly included unlawful "commercial" interests. Litigation and administrative proceedings would still be necessary to determine whether particular activities like travel services or data processing constitute "finance." These proceedings would impose substantial costs that could be avoided by allowing affiliations freely as proposed by S. 713, perhaps subject to augmented antitrust standards designed to prevent excessive concentrations of market size or power. Since the existing limitations of the BHCA have proven extremely costly and valueless in promoting safety and soundness, allowing U.S. commercial firms to invest in broad-based financial firms, including banks, would appear to represent a desirable step to improve overall competitiveness.

B. Barriers to Competition -- the Glass-Steagall Act

As described above, the Glass-Steagall Act is another significant barrier to competition in the financial services industry. While banking organizations already participate significantly in the securities industry, the Act still restricts unduly the ability of bank affiliates and bank holding companies from full participation in the securities industry. Moreover, to the extent that banking firms may engage in the securities business under current law, they must first secure the approval of the OCC or the Federal Reserve -- another barrier to entry -- and any such approval comes with quantitative limitations on the amount of securities business an affiliated securities firm can do.

Changing Glass-Steagall to allow banking organizations to conduct securities activities through separate affiliates will potentially allow the overall organizations to diversify their businesses and risks, and to meet better the needs of customers. The traditional products of banks and securities firms were once quite distinct, but now are largely indistinguishable in many cases. Product innovation and lower regulatory costs would also be encouraged by appropriate legislation to remove barriers against affiliations between separately-capitalized securities firms and well-capitalized banks.

The Commission believes that it is important to require that banking organizations entering into the securities business be well-capitalized. Last year New York Stock Exchange members doing a public business suffered combined losses of some \$160 million. On average, in any given quarter of 1990, 43% of these firms lost money. To the extent that bank affiliates were to enter the securities industry for the

first time in large numbers, without an existing market share or established operating staff, their performance could be considerably worse than average during early years. Thus, the net result of bank entry into the securities industry in 1990 would have most likely been significant losses, rather than profits. For this reason, wider bank entry into direct securities activities should be seen as an avenue for well-capitalized institutions to seek long-term profits -- not as a means for ailing institutions to shore up their earnings with short-term profits.

When considered in the context of Glass-Steagall reform, the case for eliminating the BHCA's separation of banking and commerce becomes still more urgent. Unless Congress eliminates the rigid barrier against affiliations between commercial firms and banking organizations, many of the largest securities firms would be barred from having similar separate bank affiliates because of their affiliations with commercial companies or insurance firms, even where such affiliations represent less than the predominant part of the overall company. This would not be a fair or a balanced reform of our system. Recognizing this fact, S. 713 would repeal both Glass Steagall and the BHCA's restrictions on affiliations. This would allow fair and equal competitive opportunities for both banks and securities firms.

C. Barriers to Competition -- Interstate Banking and Branching

Perhaps the single biggest step to reduce unnecessary costs contained in S. 713 is the elimination of the restrictions on geographic expansion imposed by the McFadden Act and the Douglas Amendment. As this Committee well knows, under the terms of the McFadden Act, banks have been largely prohibited from establishing interstate

branches. In addition, the Douglas Amendment to the BHCA generally leaves to the states the decision on the extent to which bank holding companies can create nationwide interstate networks through holding company acquisitions.

The inability of banks to operate freely across state lines creates inefficiencies and increases costs significantly. It may also encourage overcapacity, and it prevents banks from diversifying regional risks. The McFadden Act's prohibition against interstate branching creates significant and unnecessary costs for banks with operations in multiple states.

While a multiple bank holding company system may result in interstate banking, the cost of doing so through separate banks for every state is far greater than it would be for operating through branches in each state. For each separate bank (but not for branches), there must be separate top management, a separate board of directors, and legal formalities regarding inter-bank funding of loans. As a result, substantial overhead costs are incurred, largely to preserve a fiction that interstate banking does not already exist. Every extra dollar in costs through mandated legal complexity is a dollar of earnings that could attract capital or provide stability for the FDIC.

Of course, independent banks have created many benefits for communities across the United States. They provide institutions that are flexible and know the financial needs of their communities. If interstate branching would hurt well-run independent banks, or make them uncompetitive, it would be a different issue. However, this does not appear to have been the result where states have moved from unit banking to state-

wide branching, and there is no evidence that this would result from repeal of the McFadden Act.

IV. Enhance Regulatory Effectiveness

Both bills under consideration today contain provisions for enhancing effective regulation as part of the program to reform our financial services industry. The Commission supports the goal of enhancing regulatory effectiveness. However, we would recommend several modifications that would serve to improve the bills.

A. Functional Regulation

In 1984, the Bush Task Group on Regulation of Financial Services recommended regulatory restructuring along functional lines. The Commission has long endorsed the principle of functional regulation articulated in the Bush Task Group report. The Commission believes that functional regulation would provide enormous benefits by reducing duplication of efforts among different government agencies, preventing conflicting regulation by different regulators of the same activity, and promoting equal regulation of competing activities by different types of financial firms. Functional regulation should thus reduce regulatory costs and ensure that competition among firms is based on market performance rather than arbitrary differences in regulation.

1. Securities disclosure

S. 713 would amend Sections 3(a)(2) and 3(a)(5) of the Securities Act of 1933 and would repeal Section 12(i) of the Securities Exchange Act of 1934, thereby transferring to the Commission responsibility for regulating the issuance of securities and

periodic reporting by banks and thrifts. In this respect, S. 713 follows the recommendations made by the Bush Task Group in 1984 -- recommendations that were unanimously endorsed by all thirteen members of the Task Group, including the Federal Reserve, the FDIC, and the OCC. It also follows S. 2496, introduced by Senator Wirth in the last Congress, as well as H.R. 797. The Commission strongly supports the repeal of these outdated and counterproductive exemptions from the federal securities laws.

Under this approach, the Commission would oversee the full and accurate disclosure of financial information by depository institutions to the investing public. Needless gaps in investor protections would be avoided, and the agency with the greatest expertise and no conflicting objectives would assure that bank investors received the same protections enjoyed by investors in telecommunications, computers, chemicals, energy, transportation and every other type of business. Without such protections, investments in banks will continue to be more risky for investors -- and capital more costly for banks.

In addition, consolidation of securities disclosure regulation in the Commission would eliminate inconsistent disclosure policies among regulators. Currently, the Commission reviews the disclosures made by over 11,000 public companies, including roughly 1,400 bank and thrift holding companies. Four federal banking agencies regulate securities disclosures made by some 700 publicly-held banks and thrifts. Inevitably, with five regulators, there are inconsistencies in the interpretation and

application of disclosure policies. These inconsistencies make it difficult for investors to obtain accurate and fully comparable information about all financial institutions.³

Bank and thrift deposits would continue to be exempt from Securities Act registration under S. 713. While the Commission fully supports this exemption, it has concerns regarding the definition of deposit. The definition would include any instrument subject to Federal Reserve requirements or regulated by any bank regulator as a deposit. Because the purposes for which the Federal Reserve determines to subject an instrument to reserve requirements or a bank regulator determines to regulate it as a deposit may not relate to the purposes of an exemption from Securities Act registration, we believe that these parts of the definition should be deleted. S. 2496, introduced by Senator Wirth last year, includes a better definition of deposit.

2. Broker-dealer activities

S. 713 would move toward functional regulation of securities activities by requiring that new bank securities activities be conducted in a broker-dealer separate from the bank, and by partially removing the exclusion of banks from the definitions of broker and dealer contained in the federal securities laws. This bank exclusion is a historical vestige from an era when banks were largely precluded from the securities business.

³ Although S. 543 would not transfer authority for securities disclosure to the Commission, it would improve bank disclosure by directing the Commission to adopt, to the extent feasible, market value accounting for bank financial statements. The Commission believes that this provision would benefit investors and facilitate effective supervision.

We strongly support removal of the bank exclusion from the broker and dealer definitions. However, S. 713 includes numerous new exceptions for bank activities that are not necessary, desirable or workable. These complex new exceptions would permit banks to engage in many securities-related activities without being subject to securities regulation.⁴

While the Commission does not necessarily object to the specific aims of some of S. 713's exclusions,⁵ the creation of special statutory exclusions for banks will split the regulation of functionally equivalent brokerage activities between the Commission and the bank regulators. This would conflict with the principle of functional regulation and would possibly impede the Commission's administration of the broker-dealer regulatory scheme with respect to banks.

⁴ S. 713's nine "mini-exclusions" from the definition of "broker" cover seven pages of the bill. Exclusions are provided for banks that engage in brokerage activities in connection with "networking arrangements," certain trust activities, transactions in exempted and similar securities, transactions in municipal securities, transactions in connection with employee benefit plans, "sweep" transactions, affiliate transactions, private placements, and a de minimis number of transactions. The bill also provides three exclusions from the definition of "dealer" for banks that engage in transactions involving exempted and similar securities, municipal securities, and bank and trust department transactions for investment purposes.

⁵ For example, the networking exclusion is consistent with existing Commission policies -- although incorporation of this exclusion into legislation would deprive the Commission of flexibility it would otherwise have to modify the exclusion in response to changing circumstances. On the other hand, the exclusion for bank private placement activities exempts from functional regulation a traditional, and increasingly significant, broker-dealer activity. Similarly, the exclusion for banks that limit their brokerage activities to fewer than 1,000 transactions per year (and that do not have separate broker-dealer affiliates) sets a limit that is simply too high for a statutory de minimis exclusion, particularly since it appears that this exclusion would apply over and above any transactions that fall within another exclusion.

We believe that it would be preferable to give the Commission exemptive authority, rather than devising multiple (and complex) statutory exclusions for banks. Congress would make a serious mistake if it were to replace existing law with convoluted exceptions that will be the source of ambiguity and litigation. Banks that sell securities should be under the same rules as everybody else -- no better and no worse. S. 713 falls short of this goal, although the relevant provisions could easily be adjusted to eliminate these problems.

S. 713 would take other steps toward effectuating the principles of functional regulation by amending the securities laws to require that banks conduct their broker and dealer activities in an entity separate from the bank, except where these activities are excluded from the definition of broker or dealer.⁶ This separation would permit the application of appropriate safeguards between banking and broker-dealer activities.

In requiring banks to conduct their securities activities in separate entities, S. 713 would allow these activities to be conducted in either a bank subsidiary or a holding

⁶ Certain portions of the amendments to the Banking Act of 1933 proposed by S. 713 would contribute to functional regulation by directly prohibiting national banks from underwriting or distributing securities backed by assets originated or purchased by the bank, and from sponsoring, organizing or controlling a registered investment company. As a result, these activities must be conducted outside of the bank, in an entity subject to broker-dealer regulation. The amendments to the Banking Act of 1933, however, would allow a national bank without a securities affiliate to distribute the shares of unaffiliated registered investment companies. We believe that this activity also should be conducted through a registered broker-dealer, and note that, notwithstanding this provision, S. 713's amendments to the securities laws would generally require that these activities be conducted outside the bank, unless conducted pursuant to an exemption or exclusion.

company affiliate. Although use of either entity is far preferable to directly conducting securities activities in a bank, the holding company affiliate structure would offer a greater separation and create sharper distinctions between the bank and the broker-dealer entity.⁷

S. 713 would further distinguish between banking and securities activities by generally prohibiting the sale of securities of a bank or bank affiliate on premises of the bank that are "commonly accessible to the public for the purpose of accepting deposits." This provision seeks to implement the Commission's recommendation that "lobby sales" of a bank's own securities, or those of its parent, should be prohibited. S. 713 also would require disclosure to customers regarding the uninsured status of securities sold by banks and bank securities affiliates and through joint marketing arrangements with insured depository institutions. Although in our experience this type of disclosure will not completely prevent customer confusion, it can help reduce customer misunderstanding of the nature of the instrument being sold and the entity with which it is dealing.

However, the three provisions of S. 713 mandating these disclosures would variously authorize the Commission and the appropriate federal banking agency to adopt the regulations specifying the disclosures required. S. 713 should not, in our judgment, fragment disclosure authority. Multiple sets of disclosure requirements would be complex, cumbersome to administer, and probably ineffective. Since customers, not

⁷ For example, Congress could permit small banks to use a subsidiary rather than an affiliate for some securities activities.

issuers, are the intended beneficiaries of disclosure of this type, uniform customer protections provided in the form of required disclosures should be the primary responsibility of the Commission. Of course, the Commission should consider the views of the banking regulators in the course of its rulemaking process.

3. Securities affiliates: examination and reporting

Under S. 713, the bank regulators would have direct regulatory authority over a financial services holding company ("FSHC"). In addition, they would also have broad authority to collect "risk assessment" information directly from a FSHC's affiliates. Thus, a broker-dealer owned by a FSHC that also owned a bank would file FOCUS and other reports with self-regulatory organizations and with the Commission, but the relevant federal banking agency could also require different reports from the broker-dealer. It is not clear how this system of duplicate reporting would improve bank supervision, although providing copies of existing broker-dealer reports would not be objectionable.

Under S. 713, any commercial or diversified parent controlling a FSHC could also be subject to direct reporting to the bank regulator regarding the full range of its business and other activities at any time. This reporting does not require any showing that either the bank or the holding company is experiencing a financial risk of unusual dimensions, but rather simply a determination by the banking regulator that the activities or financial condition of the holding company could have an impact on an affiliated bank. In the case of large diversified parents, this standard would almost always apply, resulting in huge volumes of information and extensive regulatory oversight for perfectly healthy companies.

Under the Market Reform Act of 1990,⁸ the Commission has the authority to require broker-dealers to file regular, summary reports regarding any material risks to the broker-dealer from the "financial and securities" activities of its holding company and other affiliates. These summary reports are designed to provide the Commission with a "snapshot" overview on a periodic basis of any material risks to the broker-dealer posed by its affiliates. In addition, the Commission may obtain immediate and more detailed information if it reasonably concludes that it has concerns regarding a broker-dealer's financial or operational condition. The Commission believes it would be more appropriate to define bank regulators' authority with respect to holding companies and other affiliates of banks according to standards similar to those used in the Market Reform Act.⁹

In addition, S. 713 would not go as far as the Market Reform Act to reduce burdensome duplicative reporting requirements.¹⁰ The Commission believes that S. 713's reporting provisions should give explicit deference to the reporting requirements

⁸ Pub. L. No. 101-432, 104 Stat. 978.

⁹ The Market Reform Act represents a carefully crafted balancing of the Commission's need for information and the need to provide for flexible, non-intrusive regulation of broker-dealer holding companies -- including banks and bank holding companies. S. 713's provisions, however, would subject broker-dealer holding companies (with bank affiliates) to potentially significant regulatory reporting and examination provisions imposed by banking regulators. We are now actively working to implement regulations and to acquire necessary data processing systems. Congress should not rewrite the examination and reporting provisions of the Market Reform Act less than one year after its passage.

¹⁰ S. 713 would require consultation with other regulators and use of their reports only "to the extent possible."

of other regulators, in the same manner as bank reporting requirements are treated in the Market Reform Act. Under that Act, the bank affiliate of a broker-dealer will provide the Commission with its normal report to bank regulators, rather than a new report designed by the Commission.¹¹ We think the converse should also be true -- a bank regulator should be required to use the existing reports broker-dealers provide to the Commission. Requiring this same approach for bank regulators seeking information from broker-dealers would ensure that reporting requirements applicable to holding companies are not unnecessarily burdensome and would preserve the functional regulator's primary responsibility for the entity it regulates.

Similar deference to the primary functional regulator should be given in the area of examination authority. S. 713 would give the appropriate banking regulator authority to examine a broker-dealer affiliate of a bank whenever (*inter alia*) the agency reasonably believes that the affiliate or its holding company is engaged in a particular transaction or course of conduct that directly or indirectly could constitute a material risk to an insured depository institution. The Commission has serious reservations about this provision, which is capable of very broad application. We do not believe that bank regulators should have broad authority to examine broker-dealers, which they are not trained to do, rather than requesting a special examination by the Commission. Extending bank examination and supervision of risky securities activities is not the best

¹¹ See Section 17(h)(3) of the Exchange Act (as amended by the Market Reform Act). Under this provision, the Commission regularly will use bank regulatory reports for most risk assessment information and may only ask for supplemental information if it makes a finding that it explicitly needs the additional information and only after it has first asked the banking regulators to expand their reporting requirements to include such information.

means of controlling risk to the affiliated bank. This should come from insulation of such activities in a holding company affiliate and adequate capital levels in the bank to allow it to remain solvent notwithstanding the failure of any related securities affiliate. To the extent necessary, regulatory cooperation, not duplicate examinations, should be mandated, with an exception for instances in which the functional regulator is unable or unwilling to perform an examination.

4. Pooled investment activities

S. 713 takes an important step toward recognizing that banks' involvement with collective investment vehicles should be regulated under the securities laws, particularly the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The bill would remove the exclusion from the Advisers Act for banks and bank holding companies that advise registered investment companies. Further, it would make them subject to Commission regulation under the Advisers Act, like any other advisers to registered investment companies. These are positive steps. However, further improvements in these provisions should be made.

a. Conflicts of interest

S. 713 rightly recognizes that conflicts of interest will arise if banks are permitted to sponsor investment companies or to distribute investment company shares. The bill would allow the Commission to adopt appropriate restrictions "regarding loans, purchases or sales of assets, and other transactions involving a bank, an affiliated person, and an affiliated registered investment company." However, S. 713 would not address three situations that are particularly prone to conflicts of interest. Specifically, in the

absence of a Commission rule, the bill would not restrict an investment company from (1) borrowing money from an affiliated bank; (2) purchasing securities in an underwriting, the proceeds of which will be used to retire any part of an indebtedness owed by the issuer to a bank affiliated with the investment company; or (3) being advised by a bank which also, as trustee for trust clients, owns a controlling interest in the investment company.

These are classic and direct conflicts of interest that could cause significant harm to investors. By leaving these conflicts permissible unless restricted by rule, S. 713 would encourage a system in which unscrupulous or failing banks might take advantage of affiliated mutual funds. Second, the bill would fail to reach conduct that may involve debtors of the bank who are not affiliates, as in the second example above. Third, a bank's unique access to trust assets requires recognition of the conflicts that exist when the bank serves both as adviser to the fund and as trustee to shareholders of the fund. Aside from serious potential losses to investors in the bank's mutual funds, problems such as inducing the purchase of worthless securities from bank borrowers could discredit the public confidence in all investment companies, which now have more than \$1.2 trillion in assets. We believe that the bill should prohibit the activities that give rise to these three conflicts, except as permitted by Commission rule or order.

b. Affiliated bank custodians

S. 713 also correctly identifies the need for the Commission to have rulemaking authority to oversee the use of affiliated bank custodians by investment companies. In the absence of appropriate limitations, a bank could cause its affiliated investment

company to select the bank as the fund custodian, thereby depriving the fund of an independent custodian and creating the potential for abuse and self-dealing. However, as with the provision addressing conflicts of interest, this provision of S. 713 would have no effect in the absence of a Commission rule. We believe that the bill should prohibit the use of affiliated custodians, except as permitted by Commission rule or order.

c. Notification and consultation

As noted above, S. 713 would take the important step of making banks that act as advisers to mutual funds subject to the Advisers Act. However, the bill would require the Commission to notify and to consult in writing with the appropriate banking agency before examining, entering an order of investigation, or commencing disciplinary or enforcement proceedings against any FSHC, bank, or department or division of a bank registered as an investment adviser, unless the protection of investors requires immediate action and prior notice or consultation is not practical. Such a requirement will inevitably cause delays and permit frauds to continue undetected.

The Commission endorses the concept of cooperation and coordination between regulatory agencies. Accordingly, the Commission would support a requirement that the Commission notify, where practicable, the appropriate bank regulator when the Commission begins an examination or enforcement action, so long as the requirement of written consultation is deleted. Of course, bank regulators should also be required to notify the Commission when they begin examinations or enforcement actions against banks or FSHCs that are registered as investment advisers.

d. Common trust funds

S. 713 acknowledges the need to clarify the laws affecting common trust funds and to restrict banks' use of common trust funds to situations where the bank is acting in a fiduciary capacity for bank customers. It would modify the common trust fund exclusion from the Investment Company Act, and the companion provisions in the Securities Act and the Exchange Act, to restrict the exclusion's applicability to a common trust fund meeting three conditions. First, the common trust fund must be employed solely as an administrative convenience for the managing of accounts created and maintained for fiduciary purposes. Second, interests in the fund may not be advertised or offered for sale to the public, except in connection with generic advertising of the bank's overall fiduciary services. Third, the common trust fund may not be charged any fees or expenses, which, when added to any other fee charged to a participant account, would exceed the total compensation which would have been charged if no assets of the participating account had been invested in the common trust fund, except for "reasonable and necessary expenses related to the prudent operation of the fund," as determined by the new Office of Depository Institutions Supervision.

The first two of these conditions codify long-held Commission positions. The third condition, however, departs from the status quo and is excessively broad. Under current law, a bank may not charge a participant in a common trust fund more than the participant would pay for a separately managed trust account. We cannot see a justification for permitting a bank to form a common trust fund for its own convenience and then to impose additional charges on participants.

B. Facilitating Prompt Corrective Action

Both of the bills under consideration today view enhanced bank supervision and regulation as an integral part of deposit insurance reform legislation. Both propose a detailed framework for "prompt corrective action." S. 713 and S. 543 would each classify banks according to the institutions' capital levels and enumerate mandatory and discretionary regulatory actions to be taken with respect to banks in each of the categories.

The Commission supports the concept of prompt corrective action, which has worked effectively in the securities industry. Certainly, regulators must have the authority and the means to intervene with an undercapitalized institution at a point before the capital of that institution is depleted and insurance fund losses are unavoidable. However, the Commission believes that special attention should be paid to the appropriateness of some of the specific requirements that would be imposed by S. 713 and S. 543.

As a threshold matter, it is hard to see how "prompt" corrective action can work when the foundation for taking such action is capital calculated on the basis of outdated historic cost data. The true potential of prompt corrective action proposals will not be realized unless mark-to-market accounting is used in the calculation of bank capital, at least as to the valuation of assets -- such as investment securities -- for which there is a liquid trading market and reliable public quotation of current prices. Accordingly, the Commission believes that Section 3 of S. 543, which would direct the Commission to facilitate the development of accounting principles that accurately reflect the economic

condition of depository institutions, including principles based on market values to the extent feasible, would be a useful adjunct to the principle of "prompt corrective action." In implementing any such program, it is important to recognize that many illiquid bank assets such as loans do not have a readily-calculable market value. Continuation of current accounting principles in this area may be perfectly appropriate.

C. Source of Strength

The "source of strength" provisions contained in both bills are problematic. Under S. 713, FSHCs with undercapitalized banking subsidiaries would have to maintain consolidated capital at identified levels. In addition, a FSHC that does not requalify as a Zone 1 institution after undertaking an authorized expansion or acquisition would be required to post a bond in the amount that would be necessary to return the capital of its subsidiary bank to Zone 1 levels.

S. 543 takes a different approach. Bank affiliates would be liable to the FDIC for any loss incurred or anticipated by the FDIC in connection with the bank's default or any assistance provided by the FDIC to the bank. Liability would be capped at a level equal to 5% of the bank's assets at the time of default.

The Commission is concerned that the "source of strength" provisions in both bills could have undesirable effects on the capital markets. First, source of strength provisions would almost certainly discourage investments in depository institutions. In this manner, the consolidated capital requirements of S. 713 could reduce the intended

benefits to the banking system of increasing access to outside capital and management and of authorizing FSHCs to offer broader financial services.

More particularly, we are concerned about the implications of S. 713's "source of strength" requirements for a broker-dealer within a holding company. By requiring a holding company to inject capital, without giving the holding company the option of selling or divesting the undercapitalized bank, a bank regulator could force the holding company to withdraw capital from an affiliated broker-dealer in order to transfer such funds to its affiliated bank. This could impair the solvency of the broker-dealer, putting its customers and counter-parties directly at risk of loss. Transferring the insolvency of a bank over to its uninsured and otherwise solvent broker-dealer could have significant ripple effects on the securities markets generally.

Thus, the Commission strongly believes that any such "source-of-strength" policy should not override the Commission's requirements concerning broker-dealer capital. If a FSHC needs the value of its investment in a broker-dealer to support a money-losing bank, the proper step would be to sell the broker-dealer, not to drain its capital so as to bring the broker-dealer to the brink of insolvency.

The cross-guarantee provisions of S. 543 raise similar concerns. By making broker-dealers potentially liable for losses of affiliated banks, S. 543 would seriously undermine the confidence of those who do business with broker-dealers affiliated with depository institutions. Enforcement of such cross-guarantees against broker-dealer affiliates would, among other things, preempt the Commission's authority to regulate

broker-dealer net capital in favor of the regulatory scheme for banks. This would significantly affect the strength and liquidity of the securities markets and undermine the SIPC. It could also have particular impact on the markets for government and municipal securities, in which banks are already substantial participants.

The Commission believes that cross-guarantees and consolidated capital requirements are unnecessary to protect banks from the risks presented by their nonbank affiliates. Consistent with principles of functional regulation, banking regulators can and should directly regulate the capital of insured depository institutions. If the capital of a particular institution declines, the bank regulator could appropriately require the holding company to choose between injecting additional capital, or divesting itself of affiliates or the bank itself.

V. Narrowing The Scope Of Deposit Insurance

While improving the capital and overall strength of our financial services industry through the measures discussed above would be important, certain additional steps are required in order to protect the deposit insurance fund and U.S. taxpayers. Both of the bills under consideration by the Committee introduce various provisions aimed at reducing the overextended scope of the deposit insurance system through direct limitations on the federal safety net.

S. 713, in addressing the issue of the "too big to fail" policy, would authorize the protection of uninsured depositors only when the Federal Reserve and the Treasury jointly determine that a least cost resolution would "caus[e] a severe adverse impact

upon the financial system." While this standard appears to represent a significant improvement over the existing policy, additional measures could help ensure that the Federal Reserve and the Treasury exercise restraint in making systemic risk determinations under the authority provided in S. 713. For example, Congress could require the Federal Reserve and Treasury to report immediately to Congress regarding each instance in which the FDIC was directed to protect uninsured depositors.

In addition, depositor discipline would be enhanced and the exposure of the deposit insurance fund would be reduced if uninsured depositors were limited to some percentage (e.g., 90%) of the value of their deposits recovered in federally assisted transactions. Such a requirement was unanimously recommended by the Bush Task Group in 1984, and more recently by the American Bankers Association.

VI. Conclusion

The pressing need for banking reform should be addressed immediately. Provisions for interstate banking and branching, prompt corrective action, deposit insurance reform, and the adoption of functional regulation can and should be made now. Glass-Steagall reform, together with the repeal of the BHCA's separation of banking and commerce, is also warranted to improve our overall financial system.

Any reform package that Congress adopts must be effective to govern the movement of trillions of dollars in funds. Enacting a poorly crafted reform proposal could be far worse than enacting no reforms at all. Changes in the system must make it stronger, with more soundly financed firms. Reforms must provide realistic and effective

protection against instability, excessive risk-taking, and loss to the taxpayers or to the public customers of these firms.

We certainly need to try to reduce risk to the American taxpayers. Firms handling insured funds should be soundly capitalized and carefully supervised. Market incentives for strong balance sheets and prudent operations should be encouraged, not undercut by regulatory policy. Full disclosure and effective functional regulation need to be hallmarks of the system. And, of course, careful limits must be maintained on the handling of insured funds.

The Commission looks forward to continuing to work with the Committee on S. 543 and S. 713 toward these important goals and the creation of a modern regulatory structure that will meet the needs of the 1990s and beyond.