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# NEWS

## SECURITIES AND EXCHANGE COMMISSION

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BANK SECURITIES ACTIVITIES  
ECONOMIC EVOLUTION OR GOVERNMENTAL RESOLUTION

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It has been one year since we last met here in San Francisco at a similar Practising Law Institute meeting on Banks and the Securities Laws. At that time, we discussed the various securities activities of banks, the application of the federal securities and banking laws to such activities, and how and by whom they should be regulated. For those who are impatient, it may seem that little, if anything, has been accomplished during the past year to resolve the issues we discussed then. While it is true that final answers as to the appropriate regulation of bank securities activities and a determination of those activities in which banks should be allowed to engage are not available, bank agencies have affirmed earlier rulings, securities industry representatives have filed legal actions, action has been taken on legislation dealing with bank securities activities, and other processes leading to rational resolution of such complex relationships have been initiated.

I believe that the contesting banking and securities industries, seeking on the one hand to expand into new activities and on the other trying to avoid competition which

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is considered unfair, have discovered that there will be no easy victory. There is too much at stake for either side, each cloaking its own position with the mantle of public interest, to retreat from respective positions without a major struggle. This being true, both sides are marshaling support for their points of view and have begun to analyze critically the intent and scope of existing laws, regulatory structures, and the nature and fairness of present and possible future competition.

To a certain extent the Securities and Exchange Commission became a catalyst in this process when it issued a release in April of this year inviting all interested parties to comment on certain policy and legal questions associated with securities investment services currently being offered to the public by banks. Such an informational gathering and analyzing process, though time-consuming, serves several important purposes. First, it is a means of communication to facilitate a better understanding of the similarities and differences between bank and non-bank securities activities from different viewpoints, and this process should assist participants to understand the regulatory standards that must be met by competitors. Second,

the regulatory agencies, who are not immune to the danger of seeing relationships through the eyes of the industry with which they are most closely associated, may obtain new insights as to possible methods under which the public should be and can be adequately protected with a minimal burden on those who are regulated. This information may also aid regulatory agencies in establishing reasonable positions regarding competition between these two industries and appropriate regulation of the areas in which they compete. Third, these agency positions as well as the industry submissions should be beneficial to Congress in its ultimate law making responsibilities.

This process is necessary because Congress determined in the Glass-Steagall Act of 1933 that the public would be served best if the parameters within which commercial banking and investment banking would be allowed to develop were established by law and not by the marketplace. Although segments of that Act have been interpreted by bank regulators and the courts, there are still conflicting views and open questions regarding the application of certain provisions to present bank securities activities.

Since Congress believed it appropriate in 1933 to limit competition between commercial and investment banking

by statute, federal agency officials and elected members of Congress have a responsibility to review and reevaluate that determination periodically and decide anew whether, in an economy that is substantially different from that which existed in 1933, it is appropriate to retain, extend, restrict even further or remove Glass-Steagall limitations. Such an in-depth review, in my opinion, is overdue.

While the primary purpose of this program is to discuss the application of various securities and banking laws and regulations to banks when acting as an issuer of securities, a participant in certain types of securities transactions and as a broker or adviser, I believe it may be worthwhile to focus on some of the fundamental factors which may determine the degree to which the banking industry will be involved in future securities activities.

In the absence of changes in present conditions, it is possible that economic forces alone will resolve this issue. However, it can be argued that there is no assurance that the result would be in the public interest. Banks and bank holding companies, over the past decade through their aggressive and expansive activities which one member of the Federal Reserve Board of Governors recently called "revolutionary," have

become perhaps the most powerful, single non-government economic institutions in this country, with assets exceeding \$850 billion and capital of more than \$60 billion. The growth has been so rapid, particularly through bank holding company structures, that federal bank regulators themselves are becoming concerned about the health of the banking system and the adequacy of its capital.

In contrast, the securities industry is struggling to survive. Economic forces, such as international monetary instability, food shortages, an energy shortage, inflation, record interest rates, increasing unemployment and political instability in our own country as well as throughout the world, have created an atmosphere of uncertainty and apprehension which, in turn, has caused a serious crisis in the securities industry. Quite naturally, many individuals and institutions have attempted to preserve their assets and minimize their risk exposure through a reduction of equity securities holdings and a flight into fixed income investments.

This flight has precipitated a drastic decrease in securities trading volume and, as the prices of equity securities have declined, brokerage firms have experienced significant losses on their own portfolios. In addition,

underwriting revenue has dwindled as many corporations have chosen to obtain needed capital for expansion and modernization through bank loans, rather than long term debt securities which would lock in present high interest rates, or equity capital which would dilute existing shareholders equity because of current low stock prices.

In short, while the banking industry has been expanding into new activities with deposits increasing by as much as 40 percent over last year in some large money market banks and business loans from large banks expanding at about a 25 percent annual rate, the securities industry has been experiencing major losses and contraction during 1973 and 1974. Partially in search of less risky havens with better returns, and partially as the result of asset losses, capital in the securities industry has declined during that period by \$700 million, or about 16 percent, to \$3.4 billion.

To the extent that funds which have been available for capital through equity markets are shifted to deposits in commercial banking institutions, the continuation of inflation, tight money, high interest rates and uncertainty in our economy will virtually force more business firms to satisfy their needs for external capital from banks, will

exacerbate the contraction of the securities industry and will weaken its ability to perform its equity capital raising function. If basic national economic policies are not adopted to bring about reasonable price stability and interest rates more in line with investors' view of business enterprise ability to earn future profits, we may very well witness a restructuring of the entire capital raising mechanism of this country--a restructuring brought about by economic pressures in which ownership of American business would become more concentrated and in which a relatively few large institutions could dominate our capital markets and thus exercise a substantial degree of control over the development of our economy.

I wish I could predict that the problems which have brought about the securities industry crises will be resolved quickly. Unfortunately, I cannot. There is no easy way to bring about such a result. Even if the present economic summit discussions lead to proper fiscal action, a victory against persistent inflationary pressures will not be easily won. Assuming, however, as we must, that these basic economic problems eventually will be resolved, Congress will have an opportunity to decide the extent to which competition between commercial and investment banking should be allowed.

A new look at the banking and securities industries should not be limited to an interpretation of Congressional intent in 1933 when it enacted the Glass-Steagall Act and the issue as to whether or not specific bank securities activities such as automatic investment services, mini-accounts, and investment advisory services to investment companies are consistent with that Act. From a public policy viewpoint, the basic determination to be made is whether the possible benefits from increased bank and bank holding company competition in securities activities would outweigh the possible adverse effects of such competition. Such an overall determination must be based on answers to a number of interrelated underlying questions.

One such question is whether a viable non-bank securities industry can continue to exist if commercial banks and their holding company affiliates are allowed to engage increasingly in securities activities while being protected from investment bank competition in commercial bank activities through the bank chartering system, which restricts entry, and through the Glass-Steagall Act, which forbids investment bank competition "to any extent whatever" in such fundamental banking activities as "receiving deposits subject

to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt or upon request of the depositor . . . ." Securities industry spokesmen have suggested that banks have an inherent competitive advantage because of their banking powers, and that, with this advantage, if banks are not limited in their securities activities a separate securities industry cannot survive.

If a separate securities industry cannot continue to remain viable and meet projected demands for equity and long term debt capital without a clear separation and legal protection from commercial bank competition, in the absence of such protection, the present functions of the securities industry in raising debt and equity capital would have to be met increasingly, and, eventually, perhaps completely, through commercial banks and their affiliates, and this possible concentration of power must be weighed carefully by policy makers in reaching their decisions. Furthermore, the potential for the types of abuses that occurred in the late 1920's and early 1930's as a result of combined investment and commercial banking must be reconsidered.

Despite the apparent dangers, however, policy makers must be willing to contemplate the possibility that

the cyclical nature of the securities industry, in an era which requires the industry to become more automated and computerized and thus more capital intensive, may mandate a combination with an industry which is counter cyclical or is at least more stable, such as the commercial banking industry. Otherwise, it may be necessary for government to become much more involved in security industry operations and perhaps even provide subsidies to the industry during prolonged slack periods.

It is very likely that a thorough Glass-Steagall review will include the possibility of separating the trust departments from commercial banks because of certain conflicts of interest. A similar concern has been expressed with respect to the combination of brokerage and money management functions. While some believe that a so-called "Chinese Wall" may be a sufficient protection against conflicts of interest, a Glass-Steagall review could lead to a complete separation of these activities. No doubt there are other alternatives for restructuring which I have not mentioned, but I believe those that have been mentioned indicate clearly that future bank securities activities could be altered significantly, either through natural economic forces or through government action or both.

Regardless of the ultimate determination concerning appropriate bank securities activities, it is essential that such activities be properly regulated. To the extent banks are permitted to expand their securities activities, proper regulation becomes even more important. Securities regulation has several interrelated purposes within an overall objective of protecting the public interest. This objective includes a mandate to protect investors through fair disclosure and the prevention of fraud as well as to ensure equitable and fair market practices and thus promote and maintain an efficient mechanism through which equity and long term debt capital can be obtained.

An important aspect of equitable regulation is that those engaged in similar activities be similarly regulated. This means that the overall objective for which regulation exists be equally achieved and not just that the burden of regulation be equivalent or comparable.

The submissions we have received relating to bank-sponsored investment services provide interesting positions on this point. Securities industry participants generally claim that there is unequal regulation because securities firms and non-bank investment advisers are subject to the

pervasive regulatory provisions of the Securities Act, the Securities Exchange Act, the Investment Company Act, and the Investment Advisers Act, while banks appear to be generally exempted from most provisions of these statutes other than the antifraud sections. On the other hand, bank submissions have stressed the fact that banking laws along with fiduciary-obligation standards and applicable provisions of securities laws impose more substantial costs and burdens on banks than the securities laws do on non-bank firms and that protection afforded to investors by banks are at least as responsive to investor needs as those provided through non-bank firms. Both of these positions need to be evaluated and analyzed carefully.

On prior occasions I have stated that in order to have fair competition it is necessary for all participants to operate under comparable rules with equal enforcement of appropriate standards. I have also expressed my opinion that the differences in regulatory philosophy between the Commission and bank regulatory agencies make it unlikely, if not impossible, to obtain evenhanded regulation under a divided jurisdiction.

In response to our request for views on this issue, it has been suggested that current bank regulation is not

directed simply to depositors' interests but affords protection to all types of customers and investors. Therefore, it is argued that differences in regulatory philosophy do not suggest that it would be appropriate to divide regulatory jurisdiction on a functional basis, thus allowing the SEC to have regulatory jurisdiction over bank securities activities.

It has also been suggested that equal regulation does not always mean the same or identical regulation, and it is argued that this is consistent with the SEC position that dealers in the third market need not necessarily be subject to the identical regulatory pattern for members of securities exchanges. I don't have any problem in agreeing that there are areas of operation, such as financial responsibility, wherein it may be appropriate to have standards established on a different basis and administered by separate regulators because of fundamental differences in the operations and structures of the banking and securities industries, but it should be equally as clear that there are other practices which should be and can be regulated best by a single agency to assure continuity and evenhandedness. It should also be evident that there is a great deal of difference between an agency such as the SEC tailoring regulatory requirements to

differently situated competitors under its jurisdiction, such as third market dealers and exchange members, and the situation that would exist as the result of dividing regulatory jurisdiction between two separate agencies subject to different statutes and with differing regulatory philosophies.

As you might expect, I believe that the Commission should have clear jurisdiction with the ultimate decision making responsibility in all securities activities. It is worthy of comment that during the past year Congress has been faced with the problem of equal regulation in proposed securities legislation involving both banks and non-bank firms. One such bill, S. 2474, recently passed the Senate and is presently pending before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce. This legislation deals with the regulation of municipal bond trading activities by banks and non-bank firms and may serve as a pattern for the future in its attempt to accommodate the concerns of bank and securities regulators. In this legislation the SEC is granted primary governmental rulemaking responsibility that, among other things, authorizes the Commission to establish standards of conduct and practices for municipal securities activities of banks as well as non-bank firms.

Another bill, H.R. 5050, has been approved by the same House Subcommittee and is presently being considered by the Committee on Interstate and Foreign Commerce. Title IV of this bill deals with the regulation of all securities depositories and transfer agents whether or not they are organized as banks. Again, the SEC is granted primary regulatory authority. While a comparable bill passed by the Senate, S. 2058, does not go quite as far as Title IV of H.R. 5050, the same trend is apparent.

Congressional attention has also been focused on proposals to require disclosure by all money management institutions, including banks, of their significant securities holdings and transactions. Although the Comptroller recently adopted disclosure regulations for the trust departments of national banks, which, pending the enactment of legislation is beneficial, I am confident that Congress in this instance will also enact legislation in which the Commission will have the ultimate authority and the responsibility to administer institutional disclosure requirements. Obviously, and correctly, the Commission is required in all of these bills to coordinate its activities with the bank regulatory agencies and to consider the impact that proposed regulations might have on banks subject to such regulation.

Through evolution, banks with the concurrence of their regulatory agencies, are expanding their securities activities. Whether this is consistent with existing federal law is being argued in various court actions. In recent legislative actions, Congress has indicated a tendency to grant the Commission regulatory jurisdiction over bank securities activities. In my opinion, there must also be a Congressional resolution as to whether the present evolution of bank securities activities is in the public interest. Absent such a resolution, it is quite possible, in fact, most probable, that economic forces themselves will decide this issue. Thus, inaction is a decision in this instance, and in view of the possible ramifications of present market developments, governmental resolution of this growing confrontation between the banking and securities industries is imperative.