NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

Remarks to
American Bar Association
Annual Meeting
Atlanta, Georgia
July 31, 1983

PANEL DISCUSSION ON THE PROSPECTS FOR THE REORDERING OR RESTRUCTURING OF THE REGULATION OF FINANCIAL SERVICES

Bevis Longstreth
Commissioner

PANEL DISCUSSION ON THE PROSPECTS FOR THE REORDERING OR RESTRUCTURING OF THE REGULATION OF FINANCIAL SERVICES

I propose to speak briefly on three topics:

1. The Federal Deposit Insurance Corporation's proposed rule-making to permit bona fide subsidiaries of insured non-member banks to engage in securities activities, subject to limitations.

2. S.1609, the Treasury's bill to enact the Financial Institutions Deregulation Act of 1983.

3. Some regulatory implications of the trend toward institutionalization of money management.

1. The FDIC Rule-Making. The Federal Deposit Insurance Corporation ("FDIC") has proposed a rule to permit bona fide subsidiaries of insured non-member banks to engage in all manner of securities activities, including the underwriting of corporate securities and dealer functions such as market making.

This step is a fascinating attempt to exploit the statutory weakness of Glass-Steagall on behalf of non-member banks -- that is, the some 8,500 banks assigned by the federal regulatory scheme to the FDIC for regulation. This proceeding is not rendered academic by recent legislative initiatives, such as S.1609 and the moratorium proposals, because none of them are assured of passage. In its carefully crafted release, the FDIC takes the following approach:

1. Bank involvement in securities activities is not, *per se*, unsafe or unsound. In this judgment, the FDIC puts itself squarely at odds with the Congressional judgment underlying Glass-Steagall -- namely, that certain securities activities were to be off-limits to banks and their affiliates because they were, *per se*, unsafe and unsound.

2. While insufficiently dangerous to call for a *per se* rule, the hazards associated with bank involvement

---

The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners or the staff.

> in securities activities (See Investment Company Institute v. Camp) do exist, in varying degrees, but can be eliminated or lessened adequately by rules designed to protect the safety and soundness of the bank against harm due to (a) faulty judgments resulting from conflicts of interest or (b) financial difficulties of the securities affiliate.

I do not believe the approach taken by the FDIC is necessarily wrong. However, Glass-Steagall represents a different policy judgment on the part of Congress. It would be far better for Congress to decide whether the concerns that supported that judgment are no longer valid or can be handled in less rigid ways. In the absence of Congressional action, however, it is understandable, given today's competitive ferment, that a statutory ambiguity would be tested in this way. Nor is it unfortunate, for perhaps the FDIC proposal will prompt Congress, at last, to declare itself on the broad question. There is some urgency, now, because if these activities are to be permitted for FDIC-regulated banks, there is no valid reason why they should not also be permitted for other banks. Indeed, if Congress doesn't act, one outcome of the FDIC approach may be the conversion of nationally chartered banks to state charter and a major surrender by member banks of their membership in the Federal Reserve System. This incentive to forum shop could possibly lead to a dangerous competition in laxity among regulators. And it would undermine our Federal Reserve System.

Time does not permit me to comment in detail on the specific rules. As a general matter, the rules aimed at conflicts of interest are well conceived, although they do not go far enough. The limitation on size of investment that a bank can make in its securities subsidiary may be helpful, although one could question the high level -- 20% of capital -- at which it would be set. One could raise further questions about the extent to which loans and other extensions of credit such as guarantees, letters of credit and the like would be permitted.

What doesn't make sense, however, are the notions of limiting equity and other than top-rated debt underwritings by the subsidiary to "best efforts" and of prohibiting the subsidiary from being "identified with" the bank. Perhaps these ideas are intended to allay fears about safety and soundness, in order to let the proverbial camel get his nose under the tent. As a practical matter they do not comport with the realities of business, and accordingly, would not last long once the camel made his way inside. The bank-affiliated securities firm could not effectively compete if limited to "best efforts." It would, therefore, find practical ways around this limitation and, in so doing, no doubt expose the bank to as much risk as would a firm commitment underwriting. It is important to note that there are no restrictions on making markets in securities. The subsidiary can be a dealer in any securities. The risks of this activity far exceed those associated with underwriting.

Finally, in trying to hide from public awareness a bank's ownership and control of its securities subsidiary, the FDIC defies common sense and turns good business practice on its head.

In short, if concern over safety and soundness warrant restrictions of these kinds, the hazards would appear to me to be too great to allow the activity at all.

2. The Financial Institutions Deregulation Act of 1983 ("FIDA"). The dominant purpose of bank holding company regulation should be to assure the safety and soundness of the depository institutions included within the holding company complex. FIDA seeks the further deregulation of depository institutions, in the interests of enhanced competition, without compromising safety and soundness.

The major problem with a bank holding company structure is the potential for abuse of the bank subsidiary for the benefit of other interests in the holding company enterprise. This is a problem whether we permit unlimited types of affiliation with the bank or limit the affiliation to certain types of financial activity, as FIDA does. There are two aspects to this problem:

First, the safety and soundness of the bank may be impaired, for example, by the payment of excessive dividends, the making of unwise loans to affiliates or the payment of excessive fees to affiliates.

Second, unfair advantages may be accorded to the affiliates, enabling them unfairly to compete with others.

I'm not convinced that the Treasury Bill goes far enough in seeking to deal with this problem. It would add a new Section 23B to the Federal Reserve Act, which would prohibit certain activities altogether and subject others to a "fairness" test: that the terms and conditions of the transaction be substantially the same as, or at least as favorable to the bank as, those prevailing for comparable transactions with unaffiliated companies.

This standard is very easy to meet, even though the transaction may accord real advantages to the affiliate and subject the bank to serious risks. Put the other way, unfairness is very hard to detect. If the point of this regulation is to protect safety and soundness, why not flatly prohibit affiliated transactions, other than the payment of dividends (subject to limits) and downstream contributions? What would be lost? Perhaps some economies of scale, but much regulatory complexity would be avoided, and so too would the risks of self-dealing.

Alternatively, one could permit some affiliated transactions, if they met a "fairness plus" test -- demonstrably returning to the bank not just what could be obtained at arm's length, but something more, in fair payment for the added risk to the bank of the self-dealing transaction. This added return would presumably occur when the transaction had some kind of synergistic benefit to the enterprise. */

In addition to questioning whether the Treasury Bill has gone far enough in coping with self-dealing problems, I question whether it has gone far enough in the scope of business permitted to bank affiliates. It essentially leaves the core of Glass-Steagall -- i.e., the absolute separation of commercial banking from investment banking for, and market making in the securities of, private enterprise -- untouched. The important question is why? Is it because of safety and soundness concerns? Why, then, permit such highly speculative activities as real estate development? Indeed, why permit, as FIDA would, any other activities determined by the Federal Reserve Board to be of a "financial nature?" To be sure, the Federal Reserve Board has authority, using four criteria, **/ to disapprove a proposed business expansion. For reasons of fairness and competition, however, I

---

*/ For a general development of this concept, see, Clark, The Regulation of Financial Holding Companies, 92 Harvard Law Review 789 (1979).

**/ (1) the managerial resources of the companies involved;

(2) the adequacy of their financial resources;

(3) any practice or arrangement that may adversely affect the independence or impartiality of an affiliated bank in the provision of credit or other services;

(4) any material adverse effect on the safety and soundness or financial condition of an affiliated bank.

doubt that this power to disapprove will often be exercised. Like a suitor in pursuit of matrimony, the applicant will put its best foot forward in making a submission to the Federal Reserve Board. The problems are likely to develop later on, when the temptation to self-deal has grown irresistible. I would favor a bill with less restriction on businesses in which bank affiliates could engage, but more (yet simpler) restrictions on transactions among affiliates. This shift of emphasis, I believe, would achieve more in the way of needed protection for banks with far less regulatory effort and intrusion into the private ordering of financial enterprises.

3. Some Regulatory Implications of the Trend Toward Institutionalization of Money Management. The post-World War II trend toward institutionalization of investment funds has been well recognized. Today, at least 70% of the trades on the New York Stock Exchange and 50% of those in the over-the-counter market are by institutions. Developments such as the increased availability of IRA's and increases in the limits for Keogh contributions will tend to place more capital, and thus a greater portion of the securities markets, in the hands of institutions and their professional money managers. This trend means relatively fewer trades by individuals trading for their own accounts. It is a trend that will continue apace.

The increased substitution of institutional money managers as intermediaries between the ultimate investor and the marketplace may alter to some extent the nature of the protection that the Commission should afford these professional managers and their clients. Money managers, acting for others and charged with the duties of a fiduciary, need opportunities to shop for and develop innovative services and new investment techniques more than they need protection in dealing with market makers, brokers, issuers and investment bankers. Generally speaking, these fiduciaries ought to be able to fend for themselves. This conclusion, if correct, would have profound consequences for future regulation. It invites the question of whether the high level of regulation directed at issuers, market makers and brokers, for example, needs to be sustained in the coming years. As the shift to professional money management continues, the Commission's focus should itself shift to the relationship between the manager and its client.

New businesses are springing up to help the client. Selection advisers, for example, specialize in picking managers for clients lacking the expertise to choose intelligently. They boast the ability to track a manager's performance and compare it with that of the competition.

This type of firm is growing in numbers and may be expected to continue to do so as the institutionalizing process proceeds. Also growing in numbers are the so-called "financial planners," who seek to provide comprehensive advice on the financial needs and opportunities of their clients. Regulation is not now developed adequately to assure that the client is not misused by these new financial service vendors. Suppose, for example, that a client uses a financial planner to establish an investment strategy and implement it through the use of a variety of mutual funds selected by the planners. The protections of the Investment Company Act of 1940 do not touch the relationship between the planner and his client, even though the critical investment decisions will be made by the planner in both the formulation of investment strategy and the selection of mutual funds to carry it out.

To keep pace with these developments the Commission must be willing to shift its focus, and apply its scarce resources, to new products and services where the investors' needs for protection are greatest. To do this, the Commission must be willing to disenthrall itself from past successes. It will have to challenge the continuing utility of the various securities laws in their present forms. It may have to abandon certain types of regulation previously viewed as essential. For example, in areas dominated by professionals on all sides of a transaction, the antifraud rules (backed up by rigorous law enforcement) may suffice. In other areas where the public investor is becoming newly exposed, the Commission may have to evolve new regulations, and even sponsor new laws, to replace those no longer needed. This task will pose one of the greatest challenges for the Commission in the future.