U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

CONFLICTS OF INTEREST -- A REGULATOR'S VIEW

Remarks to

The Wall Street Planning Group

The Mayflower Hotel
Washington, D. C.

February 6, 1986

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The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff.

1. INTRODUCTION

We are witnessing a pattern of explosive expansion in the functioning of financial institutions. I expect that most of you would agree that the singular nature of the large financial entity is a thing of the past. Today's successful financial firm is multifaceted; however, distinct financial services blending together may warrant concern. Because today's financial institutions perform a myriad of functions, the potential for conflicts of interest has increased and the complexity of those conflicts should be closely scrutinized.

The April, 1983 issue of Dun's Business Week featured an article on the growth of six leading financial firms that enjoy major positions in a number of critical financial services businesses. The information presented in the Dun's article was later incorporated, by a Congressional subcommittee, into two charts contrasting traditional businesses with their current status as financial conglomerates. 1/ The first chart linked major firms with their traditional business functions: American Express, was listed as a multiproduct financial firm; Bank America and Citicorp, as banking; Merrill Lynch, as securities; Prudential, as insurance; and Sears for its retailing functions. The second chart dramatically showed that each firm has shifted away from the limitations of its single traditional business function. As you all know, each now plays its hand, however artfully, in securities and insurance and real estate and banking and savings activities.

Whether you call them financial conglomerates, supercompanies or supermarkets, they all have one thing in common; they are expanding into new businesses and creating new products as fast as the new technologies and the legal loopholes will allow. We are here today because of the popular belief that this expansion has produced, if not actual conflicts, certainly the potential for conflicts of interest within the diversified financial services firm itself and the financial services industry generally.

II. THE SEARS EVOLUTION

The entity that provides diverse financial services and products into the marketplace has typically followed an evolutionary path. Hindsight teaches us that the existence of today's financial supercompanies, with all their complexities, should come as no surprise. A closer look at the Sears Roebuck chronicle, makes clear that natural progression has brought the company to a point where its wide range of interests may pose potential problems.

1/ Financial Restructuring Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, 99th Cong., 1st Sess. April 2, 1985.

Let's take a journey back in time. Transport yourself to the year 1935. It's early Saturday morning and you are waking up with your first cup of Chock Full O'Nuts coffee while flipping through the latest Sears Roebuck Modern Home catalog. You recall that just last week your next door neighbor went to the local railroad depot to pick up his new home. In fact, you can hear the sounds of construction in the background. Right now he is beginning the task of following the 76 page instruction manual and blueprints provided by Sears that will help him assemble the prefitted parts of his soon to be new home.

As you thumb through the pages of your catalog, reviewing the different home models and the wealth of options from which to choose, your eyes become transfixed on one particular house. Under the black and white photograph it reads: "The Strathmore -- six rooms, bath and lavatory. No. 3306 already cut and fitted $1,584.00." I wonder if they offered The Strathmore without the lavatory at a discount. The price is right and with monthly payments as low as $10.00 it seems to be within your budget. The choice is made.

Over the course of the mail order home program, Sears would not only deliver more than 100,000 homes but it would grant mortgages to the purchasers of the homes and, in some instances, advance cash to pay construction labor costs. Needless to say, Sears would provide a complete line of fixtures and home furnishings to compliment the interior of the house as well. The American mail-order dream was fulfilled. 2/

Sears, either through its catalog, its retail stores or its financial supermarket is as much a part of the American family's consumer needs and financial planning today as ever. In fact, for many American families, Sears is in some way involved from birth to death; that is, by selling bassinets and offering life insurance. Mrs. Cardiss Collins, Congresswoman from Illinois, of the House Committee on Energy and Commerce, summed up the impact that Sears has on the American economy when she said:

> Well, Sears seems to be doing all right. You have the Coldwell Banker group which sells you the house and the Sears bank takes a mortgage on it, and if somebody goes to buy a car, you offer insurance on it, you have a credit card to use to furnish the house, and you have insurance on the folks that live in the house. Sears is getting over like a fat rat. 3/

In response to Mrs. Collins' remarks, I would like to share a 16th century English proverb with you. Simply put, "A fair

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2/ Schwartz, "When home sweet home was just a mailbox away," Smithsonian, Nov., 1985.

3/ Financial Restructuring Hearings, supra note 1 at 190.

exchange is no robbery." 4/ What Sears represents is a company that has realized the all-American business success story. The question then is not one of the evils of diversification, but of whether any economic, competitive or other market advantage that is gained through such diversification translates into a benefit or a harm to the consuming and investing public.

III. DIVERSIFICATION AND CONFLICTS OF INTEREST

Why is it that diversification of financial firms raises such concern about conflicts of interest? What exactly do we mean by a conflict of interest? To me, it seems that the problem arises as financial firms take on added functions, e.g., as banks enter the securities industry or as securities firms enter the insurance industry. When two or more legitimate interests are present, the profit incentive may conflict with fiduciary obligations. For example, a bank may attempt to require an issuer of securities to use its underwriting services as a condition to obtaining commercial loans; or a bank offering discount brokerage services may provide margin loans to its customers through a finance company affiliate; or a real estate affiliate of a bank may tie the availability of a mortgage to the purchase of the real estate.

As financial firms integrate, either vertically or horizontally, the added function may present conflicts of interest. There are three separate ways of dealing with these conflicts of interest: (1) internal policy of a firm; (2) economic forces in the marketplace; and (3) regulatory constraints.

Numerous internal conflicts of interest problems are faced by diversified financial firms everyday. Such problems include: (1) the use of confidential nonpublic information between the investment banking side and the retail side of a broker-dealer business; (2) the conflicts of pricing a new issue so as to give the issuer the highest possible price while at the same time obtaining the lowest possible price for its investor client; or (3) the conflict of interest concerns associated with allowing specialists on an exchange to become affiliated with other non-specialist member organizations. Other restrictions, such as those specified in Schedule E of the National Association of Securities Dealers' rules, which regulate the broker-dealer participating in the distribution of a public offering of securities issued by one of its affiliates, present serious concerns for the inter-company transactions of diversified companies. I will not discuss these kinds of internal conflicts and the policies that firms have developed to deal with them. I will leave that to the panelists who know considerably more about firm policies than I do. Although I suspect that these kinds of potential internal conflicts were

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4/ Simon James, A Dictionary of Economic Quotations (1981), at 82.

once concerns raised by diversification of financial services firms. I will offer some comments on economic forces and on regulatory constraints in the context of current diversification of financial firms.

IV. TYING AND OTHER ARRANGEMENTS

The conflict presented by tying whether it's tying loans and underwriting services or real estate and financing, is usefully addressed by some first principles of economics. I have examined the antitrust problems of tie-in-sales on several occasions, and while I recognize that fine distinctions exist between the application of anti-tie-in arrangements under federal and state antitrust laws generally, and the types of tying arrangements that may be prohibited under Chapter 22 of the Bank Holding Company Act, I believe that the interstices allow for a useful analogy.

The typical tying arrangement occurs when the sale of one product (the tying product) is conditioned on the purchase of a separate sometimes unwanted product (the tied product). Given the tendency for financial functions to overlap and the general requirement that the two products or services must be distinct, it is sometimes difficult to conclude that a tie-in arrangement exists. Using a common textbook example, that of the left and right shoe, it is easy to see why the individual shoes would not be considered separate and distinct products for antitrust purposes. It is more difficult, however, to conceptualize the tie-in arrangement where new and sophisticated financial products enter the equation. Clearly the potential for abuse, if not the public perception of the potential for abuse is evident if, for example, a precondition to obtaining a loan from Bank America were to purchase securities through Schwabb Discount Brokerage.

The question still remains of whether a problem exists. While conditioning the sale of one product on the purchase of another is often regarded as subverting competition in the market, a close examination reveals that it may or may not be harmful to the individual purchaser.

Sometimes tie-in arrangements are merely a form of packaging and are mutually beneficial to the buyer and the seller. The type of tie-in arrangement that would be of concern is where the buyer is forced to purchase the tied product when he otherwise would not do so. The seller can impose such a tie-in arrangement only where he has monopoly power in the market for the tying product. If there were no monopoly power, the buyer would simply deal with other sellers and the seller would have no ability to impose a tie-in. It is important to note that the problem is monopoly power in the market for the tying good. Simply prohibiting the tie-in does nothing to alter the monopoly power that would manifest itself in a different form. The point is that the buyer is harmed, because of the monopoly power, however it manifests itself.

Suppose, for example, that Sears attempted to require its customers to buy Allstate car insurance in order to purchase, say, a bicycle. No buyer in his right mind would consider that a real threat because it is impossible to force a condition on consumers in a competitive market where substitutes are readily available. In the same sense, financing through a real estate developer, where the rates of financing are competitive, would probably be mutually beneficial to the buyer and seller. In this instance, the home buyer is spared the inconvenience of securing separate financing. Using another textbook example, it stands to reason that when given a choice, most new car buyers choose the tires that come with the car, or upgrade them through the car dealer, rather than bear the inconvenience of purchasing the tires separately. 5/

My point is that where the potential for tying abuses is perceived, the fundamental solution is to promote competition in the market for the tying product, not to prohibit the seller from selling the tied product.

V. REGULATORY RESPONSES TO CONFLICTS OF INTEREST

In the wake of the stock market crash of 1929, it was generally perceived that the banking industry was to blame. Specifically, it has been argued that the banking failures of the 1930's were attributable, in large part, to the role of banks in the securities business and their use of customer funds to help boost securities transactions. It was in this atmosphere that Congress passed the Glass Steagall Act as an attempt to remedy the inherent conflicts of interest between commercial and investment banking functions.

I disavow the theory that the bank failures of the 1930's were brought on by the role of banks in the securities business. Consequently, I think, there is a strong argument that the separation of banking and investment banking is unnecessary and unnatural, and that any potential abuses can be adequately handled through less severe legislative and administrative means. Some researchers, who have studied foreign countries where barriers between banking and securities markets do not exist, contend that the systems do not seem to suffer any significant limitations. 6/

5/ See generally 1 V. Kalinowski, Antitrust Laws and Trade Regulations, § 4.02(2) (1985). See also 12 U.S.C. § 1972 (1976 ed.).

6/ See generally H. E. Buschgen, "The Universal Banking System in the Federal Republic of Germany," 2 Journal of Comparative Corporate Law and Securities Regulation 1-27 (1979) and I. Walker, Deregulating Wall Street Commercial Bank Penetration

(Footnote Continued)

In recent years, the Glass Steagall line of demarcation between banking and securities businesses has become increasingly more difficult to draw. This is so, in part, because the legal barrier that was imposed on the marketplace by Senator Glass and Representative Steagall was simply not strong enough to withstand the force of the economic incentive for commercial and investment banking to merge. Over time, these forces have given rise to the evolving process we confront today; that of immense financial diversification.

Fifty years later some argue that we have receded into a climate where similar conflicts of interest to those that inspired Glass Steagall are allowed to fester. While there are no systematic studies available to support or refute my suspicions, I am mainly of the opinion that many of these problems are exaggerated. While it is easy to defend the wisdom of Congress when it enacted Glass Steagall, I cannot help but conclude that much of the support behind the move to strengthen the legal barrier is intended to thwart competition. While its purpose may have been to help eliminate serious conflict of interest concerns, Glass Steagall actually serves as a barrier to entry that keeps commercial banks out of the securities market and vice versa. If we have learned nothing else from experience, we know that the changing economic conditions and technological progress cry out first for honesty and then for a reexamination of our existing legal framework.

Strong economic incentives to combining functions of investment and commercial banking have given rise to the creation of nonbank banking entities and several variations of discount brokerage services performed by banks and bank subsidiaries. From the standpoint of the firms, the question of regulation of intra-company relationships and transactions involving diversified financial holding companies, for example, is a very crucial matter. In the overall scheme however, the amount of legal and regulatory effort that has been devoted to blocking or expanding nonbank banking activities and discount versus full service brokerage seems a waste. The question should be asked: is the amount of resources devoted to erecting and surmounting legal barriers as socially productive as the resources devoted to producing banking and securities services?

As a Commissioner at the Securities and Exchange Commission, I have noticed again and again that under current regulatory conditions, the regulated entities find it necessary to devote considerable resources to influencing competition through regulation rather than competing through their products or services.

(Footnote Continued)

6/ of the Corporate Securities Market, 255 et seq. (1985). See also Gill, "Banks and Securities Markets: Some Thoughts on Evaluating Financial System Depth and Efficiency and Implications of Alternative Financial Systems for Securities Market Development."

VI. FUNCTIONAL REGULATION

One approach to resolving the breakdown of Glass Steagall and other legal barriers, which has been advanced by the Commission, is to accomplish a system of functional regulation; that is regulation by functionally related activity rather than by industry classification. The banking exemption can no longer be interpreted to exclude banks when they walk, talk, and effect transactions in securities just like registered securities firms.

A. Adoption of Rule 3b-9

In response to the recent expansion in bank securities activities and to assure investor protection, the Commission has recently adopted Rule 3b-9 under the Securities Exchange Act of 1934. 7/ Rule 3b-9 provides that the term "bank," which is expressly excluded from the definitions of "broker" and "dealer" in the Exchange Act, not include entities that engage in certain securities activities. In particular, the rule requires that banks conducting the following activities do so only through a registered broker-dealer:

(1) public solicitation of brokerage business for transaction-based compensation;

(2) receipt of transaction-based compensation for providing brokerage services for trust, managing agency or other accounts to which the bank provides advice; or

(3) dealing in or underwriting securities.

Despite attempts by the American Bankers Association to stay the effective date of Rule 3b-9, it became effective on January 1, 1986. To date, at least forty-two banks have registered with the Commission. In addition, the Division of Market Regulation has granted approximately 150 temporary exemptions. The vast majority of these interim exemptions were made pursuant to pending broker-dealer applications for bank subsidiaries. The remaining few were granted pending the completion of permissible networking arrangements.

The adoption of Rule 3b-9 represents a giant step towards attaining the goals of functional regulation in connection with banking and securities activities in that it affords public investors the protection of the securities laws regardless of with whom the investor makes his securities transaction. Still, it is merely an example of functional regulation. While the

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7/ *See* Securities Exchange Act Release No. 22205, 50 Fed. Reg. 28385 (July 12, 1985).

Commission is primarily concerned with investor protection and maintaining a fair and orderly market, it recognizes that comparable functions should be subject to comparable regulation, regardless of where it exists and regardless of the entity that performs the function.

B. The Nonbank Bank

Another area where functional regulation may be appropriate involves the proliferation of the so-called nonbank bank and the separation of banking and commerce functions. These nonbank banks, which are established or acquired by banks, securities firms, and retail, finance and insurance companies, have avoided the definition of bank under the Bank Holding Company Act of 1956 by either accepting demand deposits or making commercial loans, but not both. On January 22, 1986, the Supreme Court decided that the Federal Reserve Board's attempt to close the nonbank bank loophole by amending its Regulations to redefine the term "bank" was "inconsistent with the language of the statute." 8/

While the Supreme Court decided against the Federal Reserve System, it acknowledged that "[w]ithout doubt there is much to be said for regulating financial institutions that are the functional equivalent of banks." 9/ The opinion implies that any resolution to the nonbank bank loophole can only be corrected by Congress.

The decision leaves unresolved the advantage that nonbank banks have over regulated banks as well as possible conflicts of interest that are created by the erosion of the separation of banking and commercial enterprises. Nonbank banks enjoy such privileges as federal deposit insurance, the ability to clear their transactions through accounts at the Federal Reserve and to transfer funds through Fed wire. On the other hand, by falling outside of the carefully construed definition of a bank, such entities are not subject to the same restraints as traditional banks. 10/ One such restraint involves restrictions on certain tie-in sale arrangements.

The anti-tie-in restrictions are imposed on bank holding companies subject to the Bank Holding Company Act, but not on the nonbank bank entity. The nonbank bank entity is afforded different treatment simply because it falls outside of the historical definition of a "bank." For banks subject to the Act, the restriction creates an absolute prohibition against tie-in sales

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8/ Board of Governors of the Federal Reserve System v. Dimension Financial Corp., et al., Slip op. No. 84-1274, January 22, 1986.

9/ Id at 12.

10/ See "The Demise of the Bank/Nonbank Distinction: An Argument for Deregulating the Activities of Bank Holding Companies," 98 Harvard Law Review 650 (1985).

among separate components of the bank holding company while allowing similar types of arrangements to flourish between a nonbank bank and its affiliates. In sum, while functional regulation does not, in and of itself, solve the problem, it does allow a regulatory framework that conforms to the realities of the marketplace.

Another principle of functional regulation that the Commission advocates is an end to fragmented regulation of essentially similar activities. In this regard, the Bush Task Group has recommended, and the Commission has endorsed, the repeal of Section 12(i) of the Securities Exchange Act of 1934. By its terms, Section 12(i) designates the federal bank and thrift regulators as the appropriate authorities to administer and enforce bank and thrift disclosure. Under the current system, each of the four bank and thrift regulatory agencies maintains a separate securities division to handle disclosure requirements for securities issued by banks and thrifts. Disclosure requirements for all other public companies, including bank and thrift holding companies, is handled by the Securities and Exchange Commission. A repeal of this provision would consolidate securities disclosure responsibility for all publicly-held banks irrespective of whether they are part of a bank holding company structure. At the same time, it would reduce duplication of agency staff resources for administering and enforcing the comparable disclosure requirements. It is estimated that at least 1,000 publicly-held banks and thrifts would come under the Commission's reporting requirements, resulting in more uniform regulation at a lower cost.

I am told that there are a number of congressional staff members in the audience. Clearly, the next step, both on the issue of fragmented regulation and the nonbank bank loophole, must be taken by Congress. I am sure that everyone here today and indeed the entire financial community will be watching closely for your decision.

VII. CONCLUSION

In closing, I would like to reiterate my concern over the amount of attention that has been given to attacking so called conflict of interest problems. As an economist and a regulator, I fear that some proponents of the legal barrier theory are perpetuating a sham. Certain special interest groups gain much when government affixes a seal of approval on what would otherwise be identified as barriers to entry in the marketplace.

I am suspicious that neither the creation nor the continuation of legal separation is the way to solve conflict of interest problems. Where we conclude that no legitimate conflict of interest problems exist, government regulation should not stand in the way of competition. Where there are legitimate conflict of interest concerns, however, carefully tailored regulatory responses are appropriate.