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News Release

"Functional Regulation -- New SEC Powers and Regulatory Trends"

Remarks to

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It is, of course, a common-place proposition that the lines of demarcation between the components of the financial services industry are rapidly blurring. If nothing else, the fact that all of you chose to put aside your ordinary activities to attend this conference attests to that fact. In short, not long ago, an entity which looked like a bank and acted like a bank, was probably a bank -- and was regulated as a bank. Today, it may well be Sears -- or Merrill Lynch.

Whether this breaching of the Maginot Line which has separated banking from the securities industry for 50 years is good or bad is widely debated -- with the speaker's perspective often depending upon whether he sees himself (or his constituents and contributors) as winning or losing in the competitive race between formerly protected businesses. Similarly, whether and how the laws regulating the financial services industry should change to reflect the new competitive realities is unsettled.

Today, I would like to offer a securities regulation perspective on this issue. The Commission does not aspire to become a bank regulator. The Commission's more modest goal is simply to continue to do what Congress created the agency for in 1934 -- to regulate the securities markets. In my view, that goal requires functional regulation. Functional regulation means that, as new

types of entities enter or become more prominent in securities activities which the Commission is charged with regulating, they must be subject to the same rules as are the traditional players in the securities markets. Otherwise, competition will be skewed for nonbusiness, regulatory reasons. And, the investor protection objectives which Congress has charged the Commission with implementing will not be effective -- they will apply to some competitors and not to others, depending on the label above the entity's door.

My views today are solely my own and do not necessarily reflect those of the Commission or other members of the staff. Nonetheless, I want to trace the concept of functional regulation through a number of recent Commission actions and decisions -- and explain where I believe functional regulation is likely to lead in the future.

I. Introduction - Functional Regulation

Before I begin, a little background on the changing nature of financial services may be useful. Until a short time ago, functional regulation and regulation based on industry category amounted to the same thing. It was clear that Citicorp and Bank America were banks, that Merrill Lynch was a securities firm, that Sears was in the retailing business, and that Prudential was an insurance company. The premise underlying the regulation

of the financial services industry, embodied in the Glass-Steagall Act, was that banking and securities were separate and mutually exclusive businesses.

Today, that is obviously no longer true. Imaginative and aggressive lawyers have found crevices in the supposedly impenetrable Glass-Steagall barrier. Changing economic conditions, major mergers and acquisitions, and technological advances have engendered new financial products and services that make it increasingly difficult to distinguish between the many types of financial services activities. As a result, financial services companies no longer fall within neat industry categories. Sears, for example, markets securities, insurance, real estate, and savings accounts right along with garden rakes and thermal underwear. More than a thousand banks now engage in discount securities brokerage. 1/ Chemical New York Corporation has announced that it plans to set up a stock trading unit specializing in takeover speculation and equity arbitrage, 2/ and J.P. Morgan has become involved in arranging major mergers and acquisitions. 3/ Bankers Trust has announced that it is reorganizing to merge its lending, corporate finance and money market operations into a single

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1/ Applicability of Broker-Dealer Registration to Banks, 50 Fed. Reg. 28,385, 28,386 (July 12, 1986).

2/ Chemical New York Said to Plan Unit Specializing in Takeover Specialization, Wall St. J., Feb. 14, 1986, at 3.

3/ See J.P. Morgan Is Expected to Reorganize, Reflecting Investment Banking Growth, Wall St. J., Feb. 12, 1986, at 2.

financial services group. 4/ Citicorp is seeking to form a subsidiary to engage -- although not to engage principally -- in underwriting securities. 5/

It is clear that this rapid evolution of the financial services industry has overwhelmed the traditional legal framework. Fifty years ago, in the wake of the collapse of both the stock market and the banking system, Congress undertook to restore confidence and stability by separating commercial and investment banking and by establishing separate regulatory schemes for each industry. Two distinct regulatory philosophies emerged. Commercial banks were to be regulated in a way that would promote their safety and soundness. As a result, the federal deposit insurance system was instituted; 6/ interstate branching was limited; 7/ banks were prohibited from engaging in what were perceived to be risky securities activities; 8/ and, disclosure concerning the financial condition of banks was, to a degree, tempered by the spectre of that scourge of the 1930s -- the bank run.

4/ Bankers Trust Merges 3 Divisions into Single Group, Wall St. J., Apr. 23, 1986, at 12.

5/ Fed to Consider Citicorp's Request to Take Step into Securities Business, American Banker, Dec. 4, 1985, at 1.

6/ Federal Deposit Insurance Corp. Act, 48 Stat. 162 (codified as amended at 12 U.S.C. 462a-1, 1811-13).

7/ McFadden Act, 44 Stat. 1224 (codified in scattered sections of 12 U.S.C.); see also Section 3(d) of the Bank Holding Company Act, 70 Stat. 135 (codified as amended at 12 U.S.C. 1842(d)).

8/ Glass-Steagall Act, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

By contrast, the fundamental premise underlying the regulation of the securities industry is the protection of investors. Companies issuing securities are required to make full disclosure so that investors are aware of the potential risks. 9/ Investors are protected through regulation of the securities markets, 10/ of the brokers through whom they deal, 11/ and of the people who advise them. 12/ Comprehensive antifraud provisions serve as a back-stop for abuses which the regulatory scheme fails to prevent. 13/

Fifty years ago, these separate regulatory structures may have made sense. But today, as the lines between the industries blur, regulation by industry classification leads to competitive disparities, inconsistency and confusion in the regulatory system. The Commission has responded to these changes by urging the need for functional regulation.

9/ Securities Act of 1933, 48 Stat. 74 (codified as amended at 15 U.S.C. 77a et seq.).

10/ Securities Exchange Act of 1934, 48 Stat. 881 (codified as amended at 15 U.S.C. 78a et seq.).

11/ Id.

12/ Investment Advisers Act of 1940, 54 Stat. 847 (codified as amended at 15 U.S.C. 80b-1 et seq.).

13/ See, e.g., Securities Act of 1933, Section 17, 15 U.S.C. 77q; Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. 78j(b); Investment Advisers Act of 1940, Section 206, 15 U.S.C. 80b-6.

A. Shareholder Communications Act

One simple example of functional regulation is the recently-enacted Shareholder Communications Act. 14/ Proposed by the Commission, the Act deals with an area in which banks and broker-dealers perform the same functions under different regulatory schemes --the holding in street name of customer securities.

Currently, Commission Rule 14b-1 requires broker-dealers to disseminate proxy and other materials to beneficial owners of street-name securities. The rule also requires broker-dealers to provide issuers, upon request and assurance of reimbursement of reasonable expenses, the addresses and securities positions of beneficial owners who do not object to disclosure. But broker-dealers hold only a small percentage of the securities registered in nominee name. Banking institutions hold 70% of these securities, 15/ and accordingly, the Commission's lack of authority over this facet of bank securities activity causes a serious regulatory gap. That gap has prevented corporations from communicating fully with their investors and has denied beneficial owners of securities held by entities other than broker-dealers the benefits of mandatory, timely delivery of information.

14/ Pub. L. No. 99-222, 99th Cong., 1st Sess. (Dec. 28, 1985).

15/ H. Rep. No. 181, 99th Cong., 1st Sess. 2 (1985).

The Shareholder Communications Act closes that gap and, in essence, permits the Commission to regulate the function of holding securities in street name. The new Act authorizes the Commission to adopt rules that require bank, savings and loan, and other nominees that exercise fiduciary powers to perform the same functions as registered broker-dealers with respect to proxy voting and distribution of shareholder communications. The Act will be effective on December 29, 1986.

B. Bank Financial Reporting -- Section 12(i)

If functional regulation makes sense in a narrow area like street name securities communication, shouldn't the same principles apply in other facets of financial services regulation? A much broader area in need of legislative reform is the regulation of bank securities issuance and financial reporting.

Under present law, publicly-held banks are outside the Commission's disclosure orbit. The Securities Act of 1933 generally requires that securities offered for public sale be registered with the Commission. The Securities Exchange Act of 1934 requires publicly-owned companies to make periodic disclosure of financial information and to comply with certain other requirements, including rules governing proxy solicitations. Although Commission authority in these areas covers holding companies that own banks and savings and loans, securities issued directly by depository institutions are generally exempt from the Securities Act registration requirements and from the Commission's Exchange Act disclosure authority.

Instead, Congress has provided in Section 12(i) of the Exchange Act for the administration of the depository institutions' financial disclosure system by the federal banking agencies.

Retaining these bank exceptions no longer makes sense. To achieve uniformity and eliminate the inefficiencies and anomalies in the current system, Vice President Bush's Task Group on Regulation of Financial Services has recommended consolidation within the Commission of the securities reporting requirements of all publicly-owned banks and thrifts. 16/ Specifically, the Bush Group has made two important recommendations:

- First, public offerings of securities (but not deposit instruments) by banks and thrifts should be subject to the registration requirements of the Securities Act.

- Second, administration and enforcement of disclosure requirements under the Exchange Act should be transferred exclusively to the Commission, by repealing Section 12(i).

The Task Group recommendations would result in more uniform regulation and financial disclosure to investors and securities analysts, at lower cost. First, uniform accounting standards and disclosure requirements facilitate comparative analyses of investment alternatives among industries such as banks, savings and loan associations, finance companies, and securities firms.

16/ Blueprint from Reform: The Report of the Task Group on Regulation of Financial Services (July 1984).

Under the current system, the bank regulators, not the Commission, specify the accounting principles and other requirements that must be followed in preparing the Exchange Act disclosure documents of federally-insured, publicly-held, depository institutions. As a result, there may be differences in the type of disclosure required from banks, depending on whether they are owned by holding companies or directly held by the public.

Second, the Bush proposals would eliminate delays by the various agencies in conforming their regulations governing depository institution filings with those adopted by the Commission. While, in theory, the bank regulators and the Commission are supposed to apply the same rules, in practice this is not always the case.

Third, the Bush proposals would reduce duplication of the various agencies' staffs for the establishment, interpretation, processing, and enforcement of securities disclosure requirements. Under the current system, each of the bank regulators and the Federal Home Loan Bank Board maintains a separate securities division to perform the same responsibilities handled by the Commission for all other publicly-owned companies.

Finally, enactment of this proposal would provide for equivalent access to information concerning banks and other publicly-held companies. The Commission is on the verge of creating an electronic

system -- Edgar -- through which public filings will be instantaneously available nation-wide. Absent repeal of Section 12(i), banks will be the only major category of public company outside of the Edgar electronic disclosure system.

C. Bank Securities Activities -- Rule 3b-9

The Shareholder Communications Act applies functional regulation to the process by which companies communicate, through intermediaries, with their shareholders; the Bush Task Group's recommendations seek to apply to same concept to public company disclosures. The third element of functional regulation -- and the most controversial -- is broker-dealer regulation. Commission Rule 3b-9 17/ reflects equality of regulation in that realm. Rule 3b-9, in effect, requires banks to conduct certain securities activities through a broker-dealer registered under the Securities Exchange Act.

A bit of a background may be useful. The Exchange Act requires all brokers and dealers to register with the Commission, unless an exemption is available. However, the Act defines the terms "broker" and "dealer" to exclude a "bank". Indeed, because of Glass-Steagall Act restrictions, banks traditionally have engaged in limited brokerage activities. These activities have been conducted primarily as part of bank fiduciary duties for

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17/ Applicability of Broker-Dealer Registration to Banks, 50 Fed. Reg. 28,385 (July 12, 1986).

trust accounts or as an accommodation for customers and on a cost basis.

But the nature of bank brokerage activities has recently changed dramatically. The American Bankers Association has estimated that over 1,000 banks publicly solicit brokerage business. Banks now heavily advertise their brokerage services to the general public and compete directly with traditional securities firms. Moreover, banks no longer offer these services at cost; rather, these new activities are designed as profit centers. One estimate indicates that this year banks will handle 16% of the volume in securities brokerage transactions and that their market share will reach 21% by 1990. 18/

Rule 3b-9 seeks to conform the scope of Commission broker-dealer regulation to these realities. The rule defines activities that the Commission believes place an entity outside the bank exclusion. In essence, Rule 3b-9 says that a bank which engages in certain kinds of securities business with the public is not a "bank," as Congress used that term in defining "broker" and "dealer".

As I am sure most of you know, the American Bankers Association has brought suit questioning the Commission's authority to

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18/ Arthur Andersen & Co. and the Bank Administration Institute, New Dimensions in Banking: Managing the Strategic Position 19 (1983).

adopt Rule 3b-9. In October, 1985, the District Court for the District of Columbia upheld the Commission's authority; that decision is currently on appeal, with oral argument likely to occur next Fall. It is not my purpose here today to explain in detail the Commission's view of its authority to adopt Rule 3b-9. Briefly, all of the Exchange Act definitions are preceded by the phrase "unless the context otherwise requires." The Act also gives the Commission the authority to define terms and general authority to adopt rules necessary or appropriate to make the Act work. Thus, the Commission believes that it is authorized, in exercising its authority to define the word "bank," to examine the context of current bank securities activities in relation to the activities they conducted when the Act was adopted in 1934. And, because of the dramatic changes in the nature of bank securities activities, the Commission has concluded that there are sound reasons to believe that Congress never intended to exclude these brokers-in-banks'-clothing from regulation.

However, Rule 3b-9 leaves traditional bank accommodation services untouched. Instead, it focuses narrowly on three types of bank securities activities that are functionally indistinguishable from the securities business. Rule 3b-9 applies the broker-dealer registration requirements of the Exchange Act to any bank that (1) publicly solicits brokerage business for transaction-related compensation, (2) receives transaction-related compensation for providing brokerage services for trust, managing agency, or

other accounts to which the bank provides advice, or (3) deals in or underwrites securities.

The rule contains numerous exemptions to accommodate traditional arrangements and services where regulation is not necessary. Also, there is an exemption for so-called networking arrangements under which the bank merely refers customers to a broker-dealer that is registered and fully subject to the securities laws. Moreover, the staff has authority to exempt banks from the operation of the rule on a case-by-case basis, if their activities are not within the intended meaning and purpose of the rule.

The underwriting prong of Rule 3b-9 warrants special attention. It is perhaps generally assumed that, if it retains any vitality at all, the Glass-Steagall Act forbids banks from underwriting securities. From that proposition, it might be concluded that underwriting is not a topic with which Rule 3b-9 need deal. Few things are, however, as they seem in the world of banking law today, and, in Securities Industry Association v. Federal Reserve Board 19/ -- which I will call the Bankers Trust case to distinguish it from a dozen or so other cases with the same name -- Bankers Trust has argued that the placement of commercial paper is not underwriting for Glass-Steagall purposes.

19/ A.G. Becker, Inc. v. Board of Governors, 519 F. Supp. 602 (D.D.C. 1981), rev'd, 693 F.2d 136 (D.C. Cir. 1982), rev'd and remanded sub nom Securities Industry Ass'n v. Board of Governors, 104 S.Ct. 2979 (1984), No. 80-2730 (D.D.C. Feb. 4, 1986), appeal pending, No. 86-5089 (D.C. Cir. filed 1986).

"Underwriting" is not defined in the Glass-Steagall Act, but "underwriter" is defined in the Securities Act to include "distribution." Bankers Trust and the Federal Reserve Board have argued that the term "distribution," and hence "underwriting," is limited to public offerings. But, the Commission has stated that the scope of some private offerings may be so broad that, even though the offerings are exempted from registration, they should be considered distributions under the Securities Act. In holding that Bankers Trust engaged in impermissible underwriting under the Glass-Steagall Act, the district court cited the Commission's view that a private offering can be a distribution. Moreover, the court stated, Congress was well aware of the distinction between public and private offerings in 1933, and its failure to draw that distinction in the Glass-Steagall Act indicates that it did not deem the distinction relevant to the Act's purposes.

Commercial paper is an exempt security under the Exchange Act and, therefore, Bankers Trust will not have to register as a broker-dealer, even if it wins its fight with the SIA and is able to continue to place its customers' paper. However, the reasoning on which Bankers Trust relies is not limited to commercial paper. It could be extended to permit banks to place long-term corporate debt, preferred stock -- even common stock. Rule 3b-9 makes clear that, if that occurs, the Commission will have ample authority to decide whether participating banks are engaged in private placements as the Commission construes that term in the

broker-dealer context or whether such banks are engaged in underwriting and required to register as broker-dealers.

In summary, the Commission is not, of course, a bank regulator and does not seek, through Rule 3b-9, to become one. Indeed, no banks have registered with the Commission under the rule -- only affiliates of bank holding companies have registered. The adoption of Rule 3b-9 will, however, further the goal of functional regulation by affording public investors the protection of the securities laws, regardless of through whom the investor places his securities transactions. I believe that the courts will continue to uphold the validity of the rule. If they do not, however, it is, I think, obvious that Congress will have to legislate the same result, if it wishes to continue its 50 year old commitment to effective broker-dealer regulation.

D. Uniform Regulation of Pooled Investment Vehicles

At the outset, I promised a prediction about the future. I believe that there is a final area of Commission responsibility in which the principle of functional regulation will eventually be applied. That area is the regulation of pooled investment vehicles. Here, too, banks and securities firms offer functionally similar products -- bank-sponsored collective investment funds, on the one hand, and mutual funds on the other -- under radically different regulatory schemes. I am not, however, making a plea

for the further extension of Commission authority. Harmonization need not be accomplished by subjecting the bank funds to investment company regulation -- although that is one possible approach.

In order to eliminate the regulatory anomalies that arise under the existing structure of investment management regulation, two possibilities exist. First, banks might be authorized, through affiliates, to sponsor and manage investment companies, and then required to transfer at least certain of their collective investment funds to these affiliates. The Treasury's legislative proposal, incorporated in the Garn Bill that passed the Senate in 1984, 20/ provides a first step in that direction. That proposal would authorize banks to sponsor and underwrite mutual funds, provided that these expanded bank securities activities are performed by means of bank holding company affiliates regulated under the federal securities laws. The Commission advocated extending that approach to require that the management of all collective investment vehicles -- including common trust funds and pooled employee benefit plans -- be conducted within a separate corporate affiliate. The investment management activities of this affiliate would be subject to a regulatory scheme designed to be coordinated closely with the regulatory scheme applicable to investment companies not affiliated with banks.

20/ S. 2851, 98th Cong., 2d Sess. (1984).

Perhaps, however, a different approach should be considered -- one which jettisons much of the Investment Company Act 21/ regulatory scheme. Under this approach, it would be necessary to create a new regulatory scheme that would subject all collective investment vehicles -- common trust funds, pooled employment benefit plans, and investment companies -- to comparable regulation. The scheme should not necessarily mirror the existing provisions of the Investment Company Act. For example, legitimate questions can be raised about the continuing need for shareholder voting, statutorily structured boards of directors, and a statutory fiduciary duty standard regarding advisory fees. The importance of many of these protections seems especially problematic in the case of funds sold on the basis of yield -- for example, money market funds.

The Commission recognized the possibilities of this type of streamlining in a 1982 concept release which requested comments on whether the Commission should propose rules or recommend legislation to enable investment companies to be organized and operated without shareholder voting and without boards of directors. 22/ This new type of mutual fund would be called a unitary investment fund. The legal relationship between the fund manager

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21/ 15 U.S.C. 80a-1 et seq.

22/ Investment Company Act Release No. 12,388 (Dec. 10, 1982), 47 Fed. Reg. 56,509 (1982).

and investors would be established in a contract. That contract would specify investment objectives, management fees, and charges to shareholder accounts. The unitary investment fund would look much more like existing bank collective funds, than do mutual funds today.

In any event, whether investment company regulation or the unitary investment trust concept would work best, the important point is that differences in the regulatory structure between functionally similar bank and investment company products are hard to justify. Yet, complete identity of regulation would be impracticable, given the current differences in legal structure between investment companies -- which are normally in corporate form with a board of directors and shareholders -- and bank-managed collective investment vehicles -- which are generally in the form of trusts organized under state trust law. It should nevertheless be possible to conform the regulation of the various types of collective investment vehicles to provide more equal regulation. I would predict that this will be the next item on the functional regulation agenda.

III. Conclusion

In conclusion, the Commission's primary interest is in the protection of investors and in maintaining fair and orderly securities markets. The Commission's jurisdiction and regulatory activities are generally not concerned with the proper scope of

depository institution activities or the regulatory framework necessary to protect bank depositors. Increasingly, however, the lines of demarcation between the banking and securities industries are eroding. Future regulatory and legislative action in the financial services area should implement the concept of functional regulation -- that is, comparable functions should be subject to comparable regulation, regardless of the entity that performs the function. The Shareholder Communications Act, the Bush Task Group Recommendations, and Rule 3b-9 all illustrate that philosophy.

In short, banks are welcome to become full participants in the securities markets. They should, however, play by the same rules as the teams already on the field.

Thank you.