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Reflections on the Changes Occurring in Our Securities Markets

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First let me say what a pleasure it is to appear at the President's Dinner of the Law and Compliance Division of the Securities Industry Association. I thank your President, and my good friend, Bill Harmon for this invitation. I think the work you do as individuals within your own companies and the work you do collectively is crucial to the well functioning of our securities markets. I have a deep respect for the "self-regulatory" compliance with the securities laws that takes place in your companies each and every business day.

One of the great strengths of our economic system is the good faith compliance by the securities industry with the laws enacted by the Congress and administered by the SEC to allow the marketplace for securities to work unfettered by fraud and manipulation. This reflects I think the fact that both the SEC and the private sector share the goals of a free marketplace for securities transactions and the reality that both the SEC and the private sector must necessarily work together if the interest of the laws regulating securities transactions are to be carried out. The importance of our joint mission in this regard should not be underestimated. We have what is generally recognized to be the most efficient capital raising mechanism anywhere in the world. The number of investors in the market is due at the core to their confidence that the market is an honest one and that securities prices reflect real market value.

It was not always so. Fifty years ago our capital markets had collapsed, the world had sunk into a deep depression, investor and consumer confidence had hit rock bottom, our economy was stalled and the very nature of our free market system was called into question by events taking place in one country after another around the world. Congress responded with the enactment of a number of laws that I believe are basic to the maintenance of a free market economy. Together with other laws established around the turn of the century, these statutes represent a charter of economic freedom central to the maintenance of a functioning democracy. I refer to the antitrust laws which seek to maintain an economy free from monopolistic practices, the establishment of a central banking system to maintain a stable currency, the establishment of a deposit insurance system to maintain confidence in our banking system and the passage of the securities laws designed to give the investor all of the data necessary to make informed investment decisions and to prevent fraud, deceit and manipulation in capital markets.

The past fifty years have seen the development of a vast free market capital raising mechanism, based upon investor confidence. Our domestic capital market operates at the heart of a developing worldwide market that reflects the open international trading system established at the end of World War II to prevent a recurrence of the beggar thy neighbor policies of the 1930s. Central, I think, to the maintenance of our efficient capital markets, so important to the establishment of new enterprises and technologies, is the work of the S.E.C. Investors, the public, and the public's representatives have come to expect markets free from fraud, manipulation and deceit ensured by a vigorous enforcement program by the S.E.C.

In our society, every law enforcement scheme depends for its effectiveness primarily on voluntary compliance. The securities laws are no different. Voluntary compliance rests on two foundations. One is the assurance that the S.E.C. applies the laws in a rational manner and brings cases that reflect good judgment. The other is that offenders will be caught and that the remedy applied will be appropriate to the violation.

The S.E.C. recently observed its 50th Anniversary. During this time regulatory agencies have hit high tides and low tides. The S.E.C. stands out among them as one agency that has consistently maintained its high standing. Perhaps the reason is the nature of the S.E.C.'s mandate. Its mandate is to assist the market to function in an optimum fashion by disclosure and not to regulate the market in accordance with any preconceived philosophy. To fulfill its mandate of full disclosure the S.E.C. has a wide array of enforcement tools: injunctions, including provisions for equitable relief such as restitution or disgorgement; administrative proceedings; criminal sanctions and contempt citations. I can tell you as a former prosecutor, and based upon my experience at the S.E.C., to date, that the Commission undertakes enforcement actions only after the most careful deliberation. Each of these enforcement remedies is important to the functioning of an efficient free market in securities. Criminal sanctions for the more serious cases is sometimes appropriate. This year Congress will increase the applicable fines for criminal violations from $10,000 to $100,000, reflecting its view that criminal sanction is a necessary one.

Currently Congress is in the final stages of enacting legislation which will provide the Commission with authority to seek civil penalties tantamount to reble damages in insider trading cases. In addition, a serious attempt will be made in the tender offer area to alter the 10 day window and to curtail greenmail and golden parachute abuses. My own view is that each of these changes is desirable. The risk needs to be increased for insider trading and we need to continually remind ourselves in the takeover area that the law is intended to assist shareholders not bidders or targets.

It is apparent to me that markets do change and that the Commission needs to exercise its jurisdiction and make recommendations with good judgment.

Change is reflected in the increasing internationalization of the world's capital markets. Foreign secrecy laws and blocking statutes often enable violators of U.S. securities laws to hide both their identity and activity. The Commission is grappling with a so-called "waiver by conduct" concept designed to curb these abuses.

Waiver by conduct shows us the dilemma we face. The United States derives great benefit from being at the center of the world's financial and capital markets. The integrity of our market demands that traders not abuse our markets from foreign sanctuaries. Yet, we are not an island. We live in a fast-moving, technological, world-wide marketplace. Procedural toughness can result in international doubts that may move markets overseas. Unless we are to shoot ourselves in the foot, we need to work in concert with other nations, not as the Lone Ranger, in developing international sanctions to international problems.

Change is also reflected in the increased competition between securities firms and banking firms for customer services. Here I think the public interest demands equal regulation. For example, I personally believe that new requirements for broker-dealers respecting issuer communica tions with their shareholders whose shares are held in street name raise a substantial issue until commercial banks, which hold the majority of shares in nominee name are put under identical requirements. The question of equal regulation is at the center of the current debate over the future course of the financial services system.

The question is being asked if the Glass-Steagall separation between banking and securities continue to make economic sense? My own view is that it does.

Underwriting of corporate securities is fundamentally at odds with the goals that the public demands for bank regulation to provide including safety of depositors funds and allocation of credit based upon objective criteria. But what about a whole host of other securities activities such as the following where clearly banks have the capacity to provide the product and there is consumer demand for them:

(a) Mortgage backed securities. Chairman Shad testified that mortgage backed securities represent the very type of securities that the Glass-Steagall Act was designed to prohibit banks from underwriting: that is to say, privately issued and privately assessed securities not guaranteed by any government agency, potentially risky securities, jeopardizing the safety and soundness of banks.

(b) Municipal revenue bonds. Like mortgaged backed securities, municipal bonds do not carry a government guarantee. Moreover, the legislative history of the Glass-Steagall Act reveals that each time Congress authorized banks to underwrite particular bonds, such as housing bonds, there was a demonstrable public need in developing a market. No such exception would appear applicable respecting municipal revenue bonds. The current market in municipal revenue bonds is already highly competitive.

(c) Mutual funds. The Supreme Court in the ICI case pointed to a whole host of incompatibilities and stated as follows: "Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system." Is the Congress ready to overrule this history?

(d) Discount brokerage and possibly investment advice. The purchase of securities is a risky endeavor. Congress originally limited the securities brokerage activities of banks accommodating the needs of customers. Some say that brokerage is not a risky business because it is merely order taking for a fee. Experience of the past 15 years of failures and consolidation in the brokerage industry is experience to the contrary. Moreover, there are potential liabilities associated with securities brokerage. Further during period of low volume discount brokers, because they are not diversified, face greater risks of earnings declines than full service brokers.

Nevertheless it should be clear that banks engage in activities that upon objective analysis are somewhat related to securities activities. Banks do underwrite general obligation bonds and certainly can handle municipal revenue bonds and mortgage backed securities. Banks offer pooled trust funds which look like mutual funds. Banks have accommodated customers by acting as brokers and they surely can act as discount brokers. And customers do want these services.

As close as these questions are it seems to me that public policy should use utmost care breaking down Glass-Steagall. Bank regulation and securities regulation proceed from fundamentally divergent premises. Bank regulation proceeds primarily on the basis of guaranteeing the safety of depositors funds and confidence in the banking system and in banks. Bank failures are to be avoided at the expense of the discipline of the free market. Securities regulation is premised on the proposition that the investor is entitled to full disclosure. Central to securities regulation is the concept that the market works best when all material information is disclosed, even and especially when the information may be damaging, and result in the failure of the enterprise.

Because of their special place in the life of our economy, as impartial allocators of credit, banks have been given special treatment under Federal law to foster the objective of public confidence in their viability and of maintaining their continued operation. There is a special statutory structure underpinning the insured financial system that is in reality a safety net for the system. The safety net consists of a federal deposit insurance program which can be called upon to ensure against bank failure and assure a deposit base for the institution; an ability of the Federal Reserve to advance funds to banks in distress without limit, to undergird the solvency of the financial system (an ability I might add in passing this is not statutorially limited to bank assistance but which the Federal Reserve would not exercise for any other corporate enterprise); and an international lending agency which is authorized make loans for the purpose of stabilizing the international financial structure.

The safety net is of primary benefit to large banking institutions. In the market, large banking institutions derive substantial competitive advantages from the operation of the safety net. When Arthur Burns was Chairman of the Federal Reserve about 10 years ago and made a very comforting statement about not letting large banks fail there developed a two tier price structure for bank borrowings which favored money center banks over regional banks. FDIC and Federal Reserve assistance to large banks in distress substantially cushions, if not avoids altogether, market discipline that might otherwise impact on bank mangement and shareholders. IMF assistance makes it possible for third world countries to pay their obligations as they come due which otherwise would not be the case in order to maintain a world trading system.

The safety net for insured large banks is a reality and meets desirable public policy objectives but raises a further question concerning whether it is in the public interest to permit those banks which benefit by the safety net to engage in securities activities. The separation of the banking and securities industries up until the last several years has served to protect the bankers market from nonbank competition and to foster an independent and viable securities industry. I need not catalogue to you more recently all of the various ways that banks and securities firms have sought to offer products to consumers that traditionally have been regarded as out of bounds. So much so that the question whether there should be anything left to Glass-Steagall may be asked legitimately.

I would argue that the maintenance of an independent and viable securities industry is important enough to the capital markets alone to give caution to the enactment of public policies that lead us down the road to combining these two industries. If, however, public policy goes in the direction of combining the industries then, at a minimum, bank entry into the securities industry should be accompanied by abandonment of the safety net for large banks; and polices that lead to effective market discipline on banking institutions through full disclosure should be adopted.

Commissioner Treadway has stated that the structural issues of the permissible range of nonbank activities by banks, and the issue of disclosure and market discipline for banks are two sides of the same coin. He says that "If market discipline is to become a truly effective regulator of banks, three factors must necessarily exist. First, banks must be required to make prompt, full disclosure of all material information, positive and negative, even at the risk of damage to or collapse of the enterprise. Second, banks must be allowed to fail just like other enterprises. Third, both stockholders and large depositors must be left to bear their losses. Only then will banks be truly subject to market discipline."

Even Commissioner Treadway's arguments might not be compelling if there were some overriding public benefits to be derived from bank entry into the securities field. Governor Wallich in a recent speech makes a powerful case to the contrary, however. He says in a recent article published in London: "The experience of American banks with nonbanking activities has not always been a happy one. Their record of performance seems to be rather worse than that of the industry generally. This raises a question, at least, about the ability of commercial banks to perform better in real estate, insurance, and securities activities than those already active there." End of quotation.

The existing situation is untenable. Commercial bank entry into the securities business has begun to take place outside the purview of the securities laws which have played such a crucial role in establishing investor confidence which is the cornerstone of our capital markets. Direct bank discount brokerage takes place without the protection of securities requirements and regulation, national banks are established for the purpose of marketing collective investment vehicles for employee benefit plans outside the securities laws, bank investor advisors need not register under the Investment Advisors Act. At a minimum when banks enter any phase of the securities business they should abide by the same standards and enforcement mechanisms that apply to securities firms under the securities laws.

Should it be determined that bank entry into the securities business is desirable, it should follow that the deregulation should be equal. There would be no good argument then for keeping securities firms out of the banking business. Piecemeal solutions would only serve to deprive regional securities firms of the earnings they need so badly to maintain their position as full service securities firms which enable them to play such a big role in the formation of capital for regional companies. Consistency also necessitates that if banks are to be prohibited from entering the securities business that securities firms be prohibited from entering the banking business.

Having said all of the above let me conclude with the thought that Glass-Steagall has served the nation well and there is no compelling public necessity requiring its alteration. On the other hand, if it is to be rewritten, public policy would be best served by requiring all securities activities to be regulated by the SEC. If banks are to become substantial factors in nonbanking enterprises they should be subject to the same market disciplines that apply to nonbank firms. And finally, if Glass-Steagall is to be eroded, securities firms should be given the reciprocal right to enter the banking business.