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CURRENT ISSUES FACING THE SECURITIES INDUSTRY AND THE SEC

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Introduction

"The Times They Are A-Changin", as Bob Dylan's song tells us. Commodities include securities, but securities do not include certain options on securities and those options are to be treated like futures for regulatory purposes, says the Seventh Circuit. Amidst the turmoil and ferment of today's financial markets, it is amusing to recall the prosaic objects and purposes of your distinguished organization:

> "To enable the securities industry better to serve corporations and federal, state and local Governments by the underwriting and distribution of securities to raise capital for financing and expanding private and public facilities and activities; and to enable the securities industry better to serve investors by maintaining vigorous securities markets and providing investment advice."

Your theme is capital formation and service to investors. But the action today is in futures, and with hedgers and speculators.

Or, consider the name of the agency I serve: "Securities and Exchange Commission." How simple! How quaint! There was a time, not too long ago, when we knew what the words "securities" and "exchange" meant. Today, I could devote the entire morning to an elaboration of the myriad uncertainties which now surround these terms. Instead, I'm going to speak about two specific issues facing the securities industry and the Commission. These are the Administration's proposal to amend the Glass-Steagall Act and the SEC-CFTC jurisdictional accord.

Although these subjects may seem unrelated, there is a common thread: in each, the players and the regulators compete in markets stretching beyond the commercial and regulatory boundaries originally set for them; in each, the SEC's jurisdiction is threatened; and in each, solutions require legislative action.

Recent events illustrate the common thread.

On March 24, 1982, a deeply divided panel of the Seventh Circuit, in a decision of awesome breadth and imagination, declared first, that the CFTC has exclusive jurisdiction over GNMA options and, by a parity of reasoning, any exchange

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formed option on securities that have become the subject of futures trading; and second, that the SEC, even apart from the Commodity Exchange Act, lacks any authority to authorize trading in options on exempt securities. Failing reversal on en banc review, which the SEC is now seeking with widespread support, or reversal by the Supreme Court, only Congress can restore the major loss of regulatory authority inflicted by the Seventh Circuit. The SEC-CFTC accord, if implemented by Congress, would accomplish the restoration.

In recent weeks efforts to outflank Glass-Steagall, which I like to think of as the Maginot Line of finance, have grown apace.

BankAmerica Corporation has applied to the Federal Reserve Board to permit it to acquire The Charles Schwab Corporation, a discount securities broker, and thereby to engage through a subsidiary in the activity of securities brokerage. The subsidiary would remain subject to the Securities Exchange Act.

Union Planters National Bank of Memphis is proposing to acquire the assets of Brenner Steed & Associates, another discount securities broker, and to offer securities brokerage through its branch offices and affiliated banks, using the Brenner Steed tradename. Unlike the BankAmerica-Schwab proposal, the Union Planters' approach would deftly remove the Brenner Steed operation from the jurisdiction of the SEC and the regulatory structure of the Securities Exchange Act. There is nothing unique about the Union Planters proposal. If it works there it can work everywhere.

I mention these developments because they illustrate the tempo and ferment of the times, because they link somewhat the two subjects I am going to address this morning, and because they powerfully concern us, as regulators seeking to carry out our longstanding mandate.

Glass-Steagall Legislation

The Securities and Exchange Commission has endorsed the Treasury Department's proposal to amend the Glass-Steagall Act. This proposal would permit bank holding companies to establish securities subsidiaries to underwrite and deal in municipal revenue bonds and to organize, sponsor, and advise investment companies and distribute their shares. Under the Treasury bill, any bank that creates a securities affiliate to engage in those new activities would be required to transfer to it much of the bank's other securities activities as well.

In considering the Treasury proposal and S.1720 (the Garn alternative), the Commission looked at four concerns. From its perspective, any change in Glass-Steagall should:

- foster investor protection;
- avoid regulatory handicapping;
- avoid impairing capital formation; and
- avoid undercutting bank safety and soundness.

Investor Protection

The protection of investors continues to be a prime concern of the Commission, whether those investors are dealing with a bank, a securities firm, or a dry goods store turned "financial supermarket." Both the Treasury proposal and S. 1720 would subject bank sponsored investment companies to regulation under the Investment Company Act of 1940, which currently provides a comprehensive system of regulation. The Treasury proposal is preferable, however, because it would also subject bank affiliates to the Investment Advisers Act of 1940 and to broker-dealer regulation under the Securities Exchange Act of 1934. In so doing, the Treasury proposal would provide a means to:

(a) regulate management fees;
(b) require salespeople to meet professional qualification standards; and
(c) regulate advertising, suitability and other sales practices.

In its testimony on the Treasury proposal, the Commission also recommended that a nonpartisan task force be created to study remaining Glass-Steagall issues. In particular, the Commission testified that it would be premature at this point to remove existing Glass-Steagall restrictions against bank underwriting of corporate securities without further study. If implemented, the task force would also consider a related issue -- whether all securities-related services now provided by banks should be made subject to regulation under the federal securities laws, under the affiliate structure or otherwise.

The Treasury proposal's approach, by establishing a general framework for limited additional securities activities by banks, will provide a useful basis for implementing the regulatory solutions to these and other issues. That is its fundamental strength and its most desirable feature.

Regulatory Handicapping

New competitors in the securities industry should not be exempt from applicable regulation, not only for reasons of investor protection but also for reasons of fairness to others competing in that industry. Currently there are major exemptions in the federal securities laws for banks. For example, Glass-Steagall issues aside, banks may enter the brokerage business without being subject to broker-dealer regulation. Banks may also sell their own securities without SEC supervision. And retail repurchase agreements, if offered by broker-dealers or any other nonbank competitor, would carry much more disclosure than that now required of banks.

These exemptions were built on the Glass-Steagall foundation, which assumed banks would be severely limited in their securities activities. If that assumption is no longer valid, the resulting exemptions will need to be re-examined. A task force study or Congress should consider whether additional bank securities-related activities, such as the administration of common trust funds and collective trust funds for pensions, should be regulated under the federal securities laws. The exemption now in place for such activities was rooted in the notion that they were incidental to the traditional trustee function and would not compete with investment companies seeking public money to invest. Recently, because of changes in the regulation of advertising by banks, there has been an increase in the public marketing of these bank products, bringing banks into direct competition with investment companies. One can now seriously question whether the nature of these bank activities has not carried them beyond the limits of the theory on which they were originally exempted from regulation under the securities laws.

Capital Formation

Some commentators have suggested that the removal of any part of the Glass-Steagall barrier will lead to undue concentration within the securities industry. One consequence of this concentration, they believe, will be that small businesses will not be able to find underwriters for their securities. It is argued that economies of scale will make it unprofitable for the large banks and broker-dealers to handle underwritings for small issuers and, because of anticipated concentration in the industry, there would be few, if any, small, regional broker-dealers to perform that function. Even if there were some small broker-dealers to perform the underwriting function, the cost to the issuer would allegedly be greater because of an absence of competition. These commentators worry that small business would be particularly vulnerable in times of tight money when funds are available only for the best customers.

In our view, the enactment of the Treasury proposal would not necessarily lead to a highly concentrated industry. As a practical matter, the barriers to entry into the business of underwriting small issues are relatively low today. The history of the deregulation of brokerage commissions suggests that there will be competitors to serve the needs of issuers of all sizes. In any event, Congress has tools more than ample to deal with problems like this one, should they arise.

Protection of Bank Safety and Soundness

The combination of the business of banking with the securities business has long been seen as a threat to the banks themselves because of the temptation to speculate. This concern was at the heart of Glass-Steagall, and it is a concern that remains valid today. However, Glass-Steagall was an inflexible approach to the problem of assuring bank safety and soundness. Given the changing character of our financial markets and the competitive conditions in which they operate, bank holding company regulation should have as its objective the preservation of bank soundness in the least restrictive way possible. In this regard, I believe that regulation of bank holding companies need not embody a specialized antitrust policy designed to prevent bank holding companies from achieving competitive advantages or amassing undue concentrations of power. In other words, aside from safety and soundness concerns, bank holding companies should not be bound by regulations more stringent than those applicable to non-bank competitors. Of course, the antitrust laws should be vigorously enforced against illegal tie-ins and other proscribed behavior.

The Treasury proposal's protections for bank soundness and safety consist of (1) providing for Federal Reserve Board regulation under the Bank Holding Company Act, (2) requiring arms' length dealing between the bank and its securities subsidiaries, and (3) prohibiting a bank and its securities affiliates from suggesting that the bank's credit would be available to meet the obligations of the securities affiliate. However, the REIT experience of the 1970's indicates that a more affirmative approach in this area should be explored. For example, consideration should be given to prohibiting the use of names by securities affiliates which are substantially similar to those of the bank or the bank holding company.

The Treasury proposal's conflict of interest provisions may, in addition, not go far enough to assure adequate protection of bank safety and soundness. It is useful to recall that over the decades most bank failures have been caused by conflicts of interest and fraud. Transactions

between a bank and its related corporations should be subject to adequate restrictions to deter and detect conflicts of interest and fraud. Additionally, the bank regulators' concern about the ability to inspect the securities subsidiaries should be respected.

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In summary, then, the Treasury proposal represents a workable and effective approach to lowering the rigid and outmoded Glass-Steagall barriers -- a goal whose time has come. It will permit enhanced competition and innovation at an acceptable level of risk. Broader questions of the structure of the financial markets have also been raised by the current unprecedented economic conditions and competitive pressures. To respond adequately to these new pressures, Congress will have to proceed with dispatch, lest it be left irretrievably behind. Then, too, it must proceed with care and far-sightedness. This poses a challenge of great moment and consequence to us all.

The SEC-CFTC Accord

Congress is also challenged by the Seventh Circuit's mistreatment of the SEC. Here, the fix is legislation to implement the SEC-CFTC accord, a subject to which I would now like to turn.

In 1974, Congress amended the Commodity Exchange Act to create the CFTC as an independent agency with exclusive jurisdiction over futures trading in commodities, and vastly to expand the definition of commodity to include virtually anything (except onions) which became the subject of futures trading on an exchange. From that date to 1981 there has been a continuing turf battle between the SEC and the CFTC, accompanied by an eruption of new financial products.

The turf battle abruptly ended with the appointment by President Reagan of new chairmen at the SEC and CFTC. Intensive negotiations, effectively led and staffed, yielded an accord on jurisdictional issues which was publicly announced after approval by the two Commissions and briefings of the leadership of Congressional oversight committees. This accord marks an unprecedented effort by two agencies to rationalize their overlapping jurisdictions in the interest of efficiency, accommodation and simply "getting on with the job."

As you all know, legislation to implement the accord is now under consideration in the halls of Congress. Despite some rumblings from John Dingell, swift progress has been achieved in both the Senate and the House. Daring to grasp at the more optimistic possibilities, I will assume that this progress will continue to fruition. On that basis I will speak briefly about the terms of the accord, evaluate it and then look ahead somewhat into the future.

Terms of the Accord

Here are the principal points of the accord. The SEC will regulate trading in options on all securities, including exempt securities, and on certificates of deposit and groups or indices of securities or CD's. The CFTC will retain its authority to approve futures trading on exempt securities, other than municipal securities, and on CD's, as well as options on such futures. And the CFTC will be permitted to authorize futures trading on broad-based groups or indices of securities, as well as options on such futures, subject to conditions designed to protect against manipulation.

Each agency will be empowered to approve trading of options on foreign currencies -- the SEC for such trading on national securities exchanges and the CFTC with respect to boards of trade.

Two other aspects of the accord merit mention. Neither agency will be permitted to authorize trading in futures contracts on individual corporate or municipal securities or options on such futures. And the SEC will continue to regulate the capital-raising and corporate functions of commodity pools and their operators pursuant to the securities laws, including, if applicable, the Investment Company and Investment Advisers Acts.

Evaluation of the Accord

Now, turning to an evaluation of the accord, it is helpful to remember that the parties were not writing on a clean slate. There were the relevant statutes, with all their ambiguities. And there were the markets, which were proceeding to develop apace without regard to the jurisdictional quarrel.

The agencies recognized that the accord ought not disrupt these markets. While a logician might have been tempted to concentrate in one agency jurisdiction over all forms of trading in securities and their derivatives, as Holmes put it: "Upon this point a page of history is worth a volume of logic." In 1978, at the CFTC reauthorization hearings, the

SEC had made precisely this point to Congress and lost. Congress continued to favor the logic of concentrating in one agency regulation of futures trading in all forms of commodity, including securities.

Thus, the accord is pragmatic; it is a product of the situation at hand. Each agency gave up something, as is appropriate -- indeed necessary -- in a successful negotiation. Each agency abandoned some of its claims to regulate the new products.

Beyond this give and take, the accord has opened lines of communication between the agencies. It has heightened their awareness of the growing interdependence of the nation's securities and futures markets. It has bred, not co-option, but cooperation.

Of course, the accord did not resolve all issues of concern to the agencies. The question of whether, and how, futures on individual nonexempt securities should be approved for trading was deferred for future study. And the regulatory differences under the agencies' statutory schemes were left untouched.

The agencies deferred the question of futures on individual corporate and municipal securities because they were unable to agree on the appropriate regulatory scheme to be employed. The "hands off" policy toward the differences in regulation was simply a necessary condition to reaching the accord. It was, as we say, a "deal breaker." Whether this "hands off" policy will prove to be a cost or benefit of the accord depends on how the future unfolds.

The Future

Looking, then, to the future, the most significant aspect of the accord is that it opens the way for competition among financial instruments across jurisdictional lines.

The recent growth in trading of financial futures has been dazzling. In 1977, under one million futures contracts were traded on financial instruments and foreign currencies. By 1981, the total was well over 25 million contracts. With many new products in the pipeline, one can safely assume that, once the accord has been implemented, the growth in financial futures and options will continue apace.

The profile of those using these markets is changing. Ten years ago, traders in the futures markets consisted almost entirely of commercial groups engaged in business-related hedging and a small number of professional speculators.

Today, increasing numbers of nonprofessional hedgers and speculators are being attracted to the financial futures markets.

Competition is expected to develop among several types of products approved by the two agencies. Options on foreign currencies are a prime candidate for competition, since under the accord exactly the same products may be traded on the exchange markets regulated by the two agencies.

In addition, options on exempt securities, approved by the SEC, are expected to compete with futures contracts on those securities, as well as options on those futures contracts, approved by the CFTC. And options on broad-based stock groups and indices approved by the SEC will compete with futures contracts on such groups and indices approved by the CFTC.

The anticipated competition among financial instruments across jurisdictional lines will inevitably highlight the regulatory differences between the two agencies. Indeed, there is something of a paradox here. By clarifying and accommodating the jurisdictions of the SEC and the CFTC along pragmatic rather than logically functional lines, the accord will increasingly accentuate the differences in regulatory approaches pursued by the two agencies. More importantly, since competing products will be subject to differing regulatory schemes, those differences will be counted among the competitive factors influencing the customer's choice. Thus, in relaxing one set of tensions, the accord has planted the seeds for another.

The inter-agency tension emerges from the potential conflict between each agency's natural tendency to want to see its exchange markets flourish in competition with others, and that agency's statutory mandate to protect the investing public.

Now, this tension could turn out to be a productive one. With lines of communication open, the agencies may benefit importantly from the opportunity to observe the effects of different regulatory approaches. One would hope that, through shared experience, the agencies would tend to adjust their regulatory schemes to adopt the most effective and least costly means of protecting the public investor and otherwise serving the public interest.

Of critical importance to this outcome, however, will be both an awareness of the inherent dangers of inter-agency competition and a dedicated effort to avoid falling prey to them. Examples of these dangers are easy to find. The multiagency regulatory apparatus for banks is believed to foster what Arthur Burns, former Chairman of the Federal

Reserve Board, has called "competition in laxity." As Chairman Burns put it to the American Bankers Association in 1974:

> "[T]he present system is conducive to subtle competition among regulatory authorities, sometimes to relax constraints, sometimes to delay corrective measures. I need not explain to bankers the well-understood fact that regulatory agencies are sometimes played off against one another."

This problem led Senator Proxmire to introduce legislation in 1975 and again in 1977 and 1978 to unify the three existing bank regulatory agencies into a single agency, thereby removing the incentive, as he put it, "to regulate all institutions at the lowest common denominator level. . . ."

In the field of state corporate law, Professor William Cary, a former Chairman of the SEC, has documented what he saw as a "race to the bottom", with Delaware the apparent winner.

What may be a concrete example of this tendency among bank regulators emerged just last month. The FRB has been considering whether to approve J. P. Morgan & Co.'s application for permission to act as a futures commission merchant through a subsidiary. The FRB instituted a rulemaking proceeding to determine whether this would be a permissible activity for a bank holding company under the Bank Holding Company Act.

Concurrently, the Comptroller of the Currency was apparently concluding that, under the National Banking Act, a bank could engage in commodity futures brokerage. On April 7, it gave preliminary approval to a proposal by the North Carolina National Bank of Charlotte to establish a futures subsidiary.

If the FRB were inclined to hold that commodity futures brokerage is not a proper incident of banking, it would be taking a more restrictive view than the OCC. And, of course, the effect of such a ruling would be to bar bank holding companies from conducting potentially lucrative activities _not_ forbidden to national banks.

Regardless of the underlying validity of the OCC decision, it puts pressure on the FRB to reach a similar decision with respect to the Morgan proposal. This pressure would not exist if a single agency were charged with making these determinations.

Returning to the SEC-CFTC relationship, it is interesting to note that sensitivity is already being shown to the danger that regulatory differences may become competitive factors. In its recent release proposing rulemaking to establish margin requirements for stock index futures contracts, the FRB noted that such contracts can compete with, and be an economic substitute for, stock options, on which margin requirements are currently imposed. This led the FRB to conclude that margin requirements on stock index futures may be appropriate not only to limit the use of speculative credit, but also to assure competitive equality among functionally similar instruments.

While recognizing these dangers of inter-agency competition, my own hunch is that the SEC and the CFTC will gradually evolve substantially similar regulatory approaches to address their common concerns in cost effective ways. Regulatory differences will be eroded where not justified by product or customer distinctions, but not at the expense of the investing public.

I hold to this essentially optimistic view for two reasons. First, significant competitive advantages derived from regulatory differences cannot last. They will prove intolerable. Second, my experience with these agencies suggests that each, motivated by the public interest and a congruent instinct for survival, will stand by its public trust, despite the temptation to resolve the differences through a "competition in laxity."