REMARKS OF

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As many of you know, I started practicing as a CPA on Long Island about the time the area's economy started booming. Sixteen years have passed since then. During this time I have observed first hand the important role played by banks in making possible the tremendous growth of the Long Island business community. I don't have to tell you that this industrial growth owes its origin principally to the formation of a great number of small companies. These companies were completely dependent on their local banker for capital. This meant that much of the money loaned to these companies was, in every sense of the word, "seed" money.

Let's not forget that in making these loans the banking community took considerable risk, but if it had not, many of the young companies would have failed and the economy of the Island would not have prospered. But this isn't the case and all of us are the beneficiaries. I congratulate you bankers on the important role you have played, and continue to play, in fostering the growth of the economy of this area.

Long Island isn't an isolated example. Banks traditionally are one of the major suppliers of funds to business. But when economic conditions make credit difficult to obtain, business must look to other means of obtaining needed financing. An increasingly popular method is to "go public." During the past few years thousands of companies have "gone public" for the first time -- not all of them seasoned companies. And the trend will undoubtedly continue when market conditions improve.

The tendency for companies to go public carries with it more significance for bankers than some of you may realize. For one thing, it means that you and your associates throughout the country will find that your customers in the 1970's will, for the most part, be publicly-owned. And because these customers will be subject to the various acts administered by the Securities and Exchange Commission, you, as well as they, must be familiar with the securities laws. If you are not, you will not be aware of your new area of public responsibility -- to say nothing of the civil and criminal liabilities to which you will be exposed.

Because of the importance of the subject, I'd like to discuss certain aspects of banking operations and how they are affected by securities laws.

First, a few references to Regulation U promulgated by the Federal Reserve Board in accordance with the power delegated to it under the securities acts. Regulation U stipulates the amount of credit that can be loaned under certain circumstances for the purchase of listed securities. Regulation U may become operative in "takeover bids." Let me give you an example. Assume that a larger company is the target of a smaller company that doesn't have the funds to even justify thinking about taking over the larger company. What can it do about the situation? With careful planning and the generous assistance of a banking institution it can obtain the funds to acquire securities of the target company.

In one instance which has recently come to the attention of our staff, the acquiring firm went to its bankers not once but on two separate occasions to obtain loans with which to acquire the securities of a target company.

Now, in itself, there is nothing illegal about borrowing money to buy stock. But where loans fall within the category of purpose loans, they are subject to Regulation U. The bank appeared to disregard this possibility. In each instance it loaned an amount equal to the purchase price of the securities of the target company and in excess of the margin limitations set forth by Regulation U.

To make things even more complicated, the total amount of the loan exceeded the bank's legal maximum lending capacity, and other banks were requested to participate. Finally, the loan was recorded on the books of the bank as an unsecured loan, despite the fact that the securities purchased with it were on deposit in the lending bank's corporate trust department. Purportedly these securities were there merely for safekeeping and were not collateralizing the loan.

There are many reasons why a bank might engage in this kind of questionable transaction. First, it might not want to refuse a large customer for fear of losing his account. Second, the loan, at an attractive rate of interest, might seem to be a riskless transaction. Third, by cooperating with a borrower a bank may hope to be the beneficiary of all the banking business of the combined firms. In other words, banks may not always be thinking of the public interest and may not be aware of the applicability of the federal securities laws to "takeover bids."

I'll give you another illustration of a bank being unmindful of responsibilities other than to its own shareholders. Again a so-called "riskless" transaction is involved.

It started when a bank customer wanted to dress up his year-end financial statement. It ended when the Commission filed an injunctive action against the bank accusing it of aiding and abetting a violation of the federal securities laws.

In this case the customer went to his local banker -- he didn't have to go far because the lending officer was also a director of the company -- and borrowed the necessary funds. Next, the company immediately purchased a certificate of deposit and pledged the certificate as collateral for the loan. Then the company issued its year-end financial statement and showed the certificate of deposit as a current asset, but failed to show that it was used to collateralize the bank loan. On the other hand, the bank debt was shown as a long-term liability because the maturity date was 14 months after the date of the loan.

It turned out that the loan was outstanding for only a short time. And since the bank received a copy of the financial statement, it was aware of how the loan was recorded.

If this had occurred only once the matter might not have been viewed so seriously. But it occurred the following year in identical fashion, leaving little doubt in the mind of the Commission that grounds existed for injunctive action.

You might also be interested to know that the transactions were not concluded by a junior lending officer or even by one senior lending officer acting alone. They were approved by a lending committee of the bank. The moral is obvious. A banker who is offered an opportunity to participate in "riskless" transactions should first ask himself some very probing questions.

Still other types of difficulties and conflicts of interest can arise when a bank officer is represented on the board of directors of one of its borrowers, or when a bank performs other services for one of its borrowers, such as acting as transfer agent, custodian of employee pension funds or as a shareholder through its trust department. Any one of these relationships can present substantial problems for both the bank and the borrower. One of the most serious is the danger of acting on inside information.

This can happen when the bank's trust department holds shares of the borrower's stock and also possesses confidential information gathered through the commercial department of the bank. Can the bank act on that information and claim as a defense that it had a positive responsibility to act because of its fiduciary capacity? The staff of the Commission believes the bank cannot because a fiduciary is not charged with the responsibility to commit a federal crime. The bank has a positive responsibility to determine whether the information it possesses is in the public domain. If it is not, then the safest course of action for that bank is no action.

On the other hand, if the bank as a creditor and as a shareholder receives information also available to the investing public, and it is the analysis of this information by the bank, rather than the use of non-public information which guides the bank's action, then no anti-fraud problem exists.

Let's look at another danger area -- this one involving stock holdings. As a matter of prudence, a bank should periodically survey its holdings to determine whether its equity position and other business relationships in any one company classifies it as a control person under the federal securities laws. This is important because if a bank

is so classified it cannot sell its shares of that particular stock in the absence of a specific exemption without first registering the shares under the Securities Act of 1933.

As many of you know, another current point of contact between the Commission and the banking industry is the Institutional Investor Study. This Study was created by act of Congress during the summer of 1968, gotten under way early in 1969 and is scheduled for completion this year. The Study's mandate, most simply stated, is to study the impact of institutional investors of all types, including bank trust departments, on the nation's securities markets, corporate issuers and the general economy.

Banks, of course, are the largest of all institutional investors, administering approximately $280 billion in trust department assets. Their relative importance in the equity markets is even greater; stocks held by bank trust departments far exceed the combined holdings of mutual funds, life insurance companies, property and casualty insurance companies, foundations and educational endowments.

The Study has focused its attention primarily on the 50 largest bank trust departments. Together, these banks manage approximately 70 percent of the industry's assets. Through questionnaires and interviews the Study has addressed itself to a wide range of areas regarding the manner in which banks administer particular classes of accounts, the manner in which trades are executed in particular types of securities, the manner in which securities markets and broker-dealers are selected and the extent to which banks do or do not vote their shares, do or do not acquire new issues or private placements, or otherwise affect portfolio companies. All these analyses parallel comparable studies of other important institutional investors.

All together this is a most interesting and ambitious -- and perhaps history-making -- undertaking. I am sure it will contribute significantly to our understanding of this rapidly developing and increasingly important segment of our securities markets.

Now a brief comment on the interest of the Commission in certain non-banking services offered by banks. As you may know, these non-banking activities have been the topic of much Congressional discussion during the past year or so. I will leave to the Congress the decision as to whether or not these services are appropriate for banks to perform. However, I will comment on one of the services banks now perform for mutual funds -- an industry which the Commission does regulate. Banks act as custodians of fund securities and they also often maintain fund shareholder records. It does not appear that the departments rendering these services receive the same attention from auditors as that given the commercial loan department.

It seems to me that business prudence alone requires they should. I know of one particular instance when an outside review probably would have saved two banks hundreds of thousands of dollars expended to untangle the chaos resulting from their apparent failure to maintain the shareholder records of a large mutual fund.

I believe that if banks are going to perform non-banking services -- and I do not pass judgment on whether they should or should not -- they must achieve a level of performance consistent with their achievement in banking activities. Part of the answer lies in automation, but do not confuse increased efficiency with increased protection. Only strong internal controls over data centers, backed up by outside system audits, will assure against improper access and use. This is particularly true when the same computer and data centers are used for both demand deposit accounting and the performance of non-banking services.

You must also be concerned with the matter of stolen securities, a problem that resulted from the back-office log jam produced by the high volume of securities transactions in 1968. The Attorney General of the United States reported that $65 million of stolen securities are unrecovered. This is an alarming statistic. The banking industry, of all industries, should be particularly concerned.

To attack the problem, the Board of Governors of the New York Stock Exchange urges banks and securities firms to subscribe to a service which permits almost immediate identification of stolen securities. Since such securities are frequently used to obtain bank loans, universal use by banks of the system would discourage security thefts.

Some banks have resisted on the ground that if they participate, they will no longer be able to claim they are bona fide purchasers for value. Legally, a bank is in a delicate position when a loan turns sour and the collateral is identified as stolen. However, if security thefts can be eliminated, bankers will not have any reason to be concerned whether or not they are bona fide purchasers. The banking industry has every reason to support the position of the New York Stock Exchange.

On the plus side, the securities industry is making vast strides in an area which will benefit the banking industry directly. This is the development of a national quotation system for securities traded over-the-counter. It will enable every broker-dealer in the country to obtain an instant quotation from marketmakers on thousands of securities. Undoubtedly, the ready access of price information will stimulate trading in over-the-counter securities. How will the banks benefit from the development of this system? Simply because they will quickly and easily be able to find out if a security being pledged as collateral is marketable, and at what price.

Another new development already in existence is the establishment of a universal identification system for securities of all types. By providing the banking and securities industries with a common language for identifying securities, it will speed up transactions, reduce errors and lower costs. Initiated by the American Bankers Association, and known as the CUSIP System, it has been endorsed by both national exchanges and the leaders of the securities industry. Starting in January, all newly-issued stock certificates will bear a CUSIP number.

If I have seemed to point with alarm tonight at too many activities involving both banks and securities, it is because of my concern for your well-being and our mutual responsibility to the public interest. I began by reviewing the immeasurable contribution banks have made, and continue to make to our country's economy. I'm going to conclude by saying that no one believes more firmly than I that bankers will play a key role in determining the economy of the future. That's why I intend to continue to the limit of my capability to support you, to help you, and to provide such guidance as I am in a position to give you.

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