FINANCIAL SUPERMARKETS

Address by

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Our affluent society has produced an unprecedented number of investors with ever increasing amounts of savings available for investment. Just as honey attracts bees, money attracts salesmen. The great increase in the amount of money available for investment has accelerated the tendency for financial institutions to add to their traditional wares securities or other investment media generally associated with other types of institutions.

To list a few examples: commercial banks establish savings accounts. They sell certificates of deposit (as well as lottery and football tickets), and establish commingled agency accounts to invest in equity securities; life insurance companies sell variable annuities, a means of investment in equity securities; savings banks sell life insurance and distribute mutual fund shares; mutual fund distributors sell life insurance; and department stores and other basically commercial enterprises sell a wide variety of financial services.

The markets for financial services have always been marked by a high degree of economic regulation. Unrestrained price competition has never really been allowed to prevail in this area, and for a very good reason. A customer can shop for the lowest price for an automobile or appliance with relative unconcern about whether the manufacturer or dealer can operate at a profit while selling at that price. However, in the case of some but not all financial institutions, the entire investment may be at risk because of the lack of business acumen or efficiency of the managers of those institutions. For example, if a bank offers a higher rate of interest than it can profitably maintain, and makes speculative investments to meet its interest requirements, it may wind up being unable not only to pay the interest but to return the principal amount invested. While not precisely parallel, if a mutual fund offers its shares below the net asset value of the underlying portfolio, the bargain for the incoming purchaser is achieved at the expense of diluting the interests of those who had previously invested in the fund.

Where a separate charge is made for management services to an investment vehicle such as a commingled account or a mutual fund, there is, theoretically, some room for price competition in that end of the business, at least when the investment vehicle is not under the practical control of the manager. But the amount of the management charges is generally small when viewed solely in relation to the benefits which a particular investor in the fund or the account hopes to realize. Of course, this is the reason for the creation or acquisition of the investment vehicle -- that is, the pooling of many interests should make available economies of size and institutionalized management. Nevertheless, there really is no effective competition for the favor of ultimate consumer, the investor. The reason is obvious. These management charges may not seem large to the individual participant in the fund or account. However, the sum of the charges leveled on the fund or account to all the participants can become very large in the aggregate unless the expected economies, which led to creation of the investment vehicle to begin with, are in fact, shared equitably with the fund. But unless competition is in fact available, this result is not always achieved. Consequently, in a situation where the normal controls cannot operate effectively, there is a special burden on the regulatory agencies to see to it that the prices charged for financial services to the investment vehicle are not excessive.

No industry is homogeneous, and the regulatory agency charged with responsibility to prevent, or to mitigate the effects of, overreaching must be extremely careful, within the limitations and the legislative decisions and purposes contained in the charter from which it draws its authority and responsibility, to avoid favoring one legitimate and productive segment of industry as against another in the same or a competing industry. This problem is of course greatly complicated by the growing tendency of certain institutions to venture into areas traditionally served by other types of institutions regulated by other agencies. Put simply, in"regulating" its "constituents" an agency cannot ignore entirely what their competitors are doing. Questions would undoubtedly arise if an agency regulated its "constituents" without consideration of the possibilities that they might be subjected to an unfair competitive disadvantage; on the other hand, the agency cannot permit the standards of the industry for which it is responsible to fall to the level of the worst or the least regulated of its competitors.

A related question is the extent to which a regulatory agency should seek to extend its jurisdiction over activities which are functionally similar to those of the industry for which it has principal responsibility, but which are conducted by different people and in a manner which does not fit precisely the agency's traditional methods of regulation. In the recent past, the Commission has asserted jurisdiction over such diverse "securities" as interests in beavers, variable annuities issued by life insurance companies or special accounts specially created for this purpose, "scholarship funds", and bank commingled agency accounts. These "securities" have given us many headaches. They have required a good deal of our attention to accommodate them to the statutory requirements and the need of investors for relevant information at a time when our regular function of maintaining public confidence in what are commonly recognized as the securities markets is complicated by what many feel are dangerous new trends. Yet, I think this activity, even if burdensome, is essential to our basic function and to the maintenance of that indispensable public confidence. If we did not take prompt action on these off-beat types of securities, we would find that a substantial portion of the talents and efforts of those engaged in traditional securities business was being lured away--either to unregulated activities which offer the prospect (albeit often unreal, or at least greatly overstated) of greater immediate return precisely because they are unregulated, or to activities governed by different sets of rules which constitute a form of unfair competition and which are injurious to the public interest.

While the competition within a regulated industry may be relatively docile and non-price-oriented, competition between industries is often vigorous. Not all of it, however, is aimed at the consumer. Much of it is directed to the salesman by offering him ever greater rewards, frequently without reference to the efficiency of these efforts or their proper place in the overall system for the allocation of the nation's savings or the best long term interests of the individual investor and the national interest in proper allocation of available savings. A portion of the effort of the competing industries, although not so identified, at least publicly, is directed at legislatures, the courts and regulatory agencies in an effort to establish rules which will favor the activities of one group and hamper the activities of another, or to prevent such discriminatory treatment. The recent lawsuit by the Investment Company Institute to prevent the banks from competing with the mutual funds for investors' dollars by providing essentially similar services at less cost is a striking example. And, a part of the effort is devoted to resisting the efforts of lawmakers, the courts, and others having a responsibility, in their efforts to secure or redress the interests of investors who are viewed simply as a source of funds in this struggle which manifests itself in offering ever greater rewards to the salesman and those who assist him in that effort.

A regulatory agency has a responsibility to those engaged in the business which it regulates as well as to the members of the public with whom they deal. But the scope of that responsibility is frequently a matter of debate. On the one hand, it is urged that the agency should not be a lobbyist for the industry; on the other, that it should stand ready to inform the legislators and others of the contributions and problems of the industry as well as its shortcomings.

In the area of financial services, securities firms, commercial banks, savings banks, savings and loan associations and insurance companies are regulated to a greater or lesser extent and in widely differing ways by federal, state and local agencies with varying jurisdiction. Each of these agencies has the authority--and consequent responsibility--to apply the governing statutes, which differ widely in purpose and provision, and its implementing rules to anyone providing the kind of financial service which those rules were designed to regulate.

There is a good deal of overlap in this regulatory pattern. I suppose that regulatory agencies at every level sometimes compete with one another as do the industries which they regulate. I do not see anything wrong with this; in fact, it may be one of the most constructive modern applications of the idea of federal government. Recent suggestions for some sort of deposit insurance for securities firms, and guidelines for the regulation of bank advertising and other practices comparable to that imposed on securities firms, are but two relatively noncontroversial illustrations of areas in which cross-fertilization may be productive.

It is clear that none of the regulatory agencies has a complete answer to all of the economic and other problems of our capital markets--not even the SEC--but out of the competition of different regulatory techniques, developed in different contexts and at different times, approaches and solutions have emerged which serve the public interest. This is and must be a continuing development in which the regulated industries can and should undertake an important role, to assure a sensible development and the avoidance of unnecessary burdens.

I should like to conclude my remarks with a brief reference to an accelerating facet of this development which has not received adequate attention from the business and academic communities.

One consequence of the increasing competition of different types of financial institutions for the savings of investors has been the process which is described as the "institutionalization" of the markets for equity securities. This is a process by which a constantly increasing percentage of national savings is being invested in equity securities indirectly, through the medium of financial institutions, rather than directly by public investors. This development has very important effects on and future implications for the markets in equity securities, the securities business and, in the view of many, it has the potential for important effects on the issuers of securities.

It is interesting to note that in the markets for debt securities, which have long been dominated by institutions, patterns of trading are entirely different than those in the organized stock markets. For example, bonds are generally not traded on exchanges even when they are listed. The stock exchanges have not materially restricted this situation. Convertible bonds, hybrid securities, which have received extraordinary attention in recent years, are also hybrid in their market aspects, with substantial amounts of listed convertibles traded on and off the exchanges on which they are listed.

On the other hand, in the case of common stocks listed on the New York Stock Exchange, which constitute by far the largest portions of institutional stock portfolios, stock exchange member firms are prohibited by Exchange rules, except in certain limited circumstances, from dealing in them off the various exchanges on which they enjoy listing privileges. By way of an aside, I should mention that some years ago the New York Stock Exchange attempted to limit, to its <u>own</u> floor, member trading for their own account or for others in securities listed on that exchange. Had not the Commission insisted on abrogation of that rule, it is probable that many of the Regional Stock Exchanges, which now represent a "second" market in these securities, would have long since disappeared from the national scene.

This system has come under additional competitive pressure as a result of the desires of some institutions and others to obtain better execution at lower cost for purchases and sales of large blocks of stock than they are able to obtain on any exchange. This has resulted in some shift of business to the so-called "third market" in listed securities, maintained by nonmembers of the New York Stock Exchange. This is another kind of competition--

not between different types of financial institutions, but between different segments of the securities industry for the trade of these institutions. It is a current concern of the Commission to prevent a stifling of this form of competition under circumstances which will not damage unfairly the health and viability of the "first" and "second" markets so that the public interest can be served best.

There is a growing recognition of the potentials implicit in this development as well as a consensus that a fuller understanding of the dramatic changes now taking place will make it possible to avoid adverse consequences and to channel some of the potential to the public good.

I would close on the note that there is an increasing interest in the genuine institutionalization of our securities markets and a developing concern as to the current and potential effects of this growth on the financial and other sectors of our economy.