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BEFORE THE

COMMITTEE ON COMMODITIES REGULATION

ABA SECTION OF CORPORATION, BANKING & BUSINESS LAW

CERROMAR BEACH, PUERTO RICO

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I am delighted to be the last speaker at this gathering. By now, all the experts have solved all the problems, so I have the luxury of being philosophical. That is a great luxury.

When I was kindly invited to speak, I was told that my topic could be anything in the commodities - securities area, but that my thoughts about a possible SEC-CFTC merger or consolidation would be particularly of interest. That's quite a bit of latitude, so if I wander some today, you'll know I've only taken the invitation at face value.

BROKERAGE AND BANK EXPANSION INTO NON-TRADITIONAL AREAS

More seriously, however, I would like to talk about the consolidation of the financial services industry and reflect upon some of its causes and consequences. I then would like to share with you some thoughts about the increasing significance of disclosure and the possibility that disclosure may be an appropriate substitute for other, perhaps more paternalistic, forms of regulation.

To begin my philosophizing, I note that 1983 is the fiftieth anniversary of the Glass-Steagall Act. To answer your question, no, I didn't bring the wrong speech. Although this program has focused upon commodities - securities regulation, I mention Glass-Steagall as a backdrop. I believe that Glass-Steagall has created an historical mind-set, which is as much consequence as the technical barriers and distinctions embodied in that Act and its interpretations. Banks should be banks, and brokers should be brokers. And the commodities business was yet something so different and remote from banking and securities that it was little noticed at the time. Presumably there was no particular concern in 1933 about separating the commodities industry from the banking or securities industries. Perhaps no one thought they ever would be under one roof.

The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners, or the staff.

A rapidly changing economy, however, has changed the structure of the financial services industries, sometimes dramatically. That, of course, has tested the ability of our regulatory system to respond to such changes without becoming excessively burdensome. Particularly with the proliferation of the many new financial products and services, investors, industry and regulators alike have questioned the viability of the traditional assumptions underlying the statutory, regulatory and historical separation of the various elements of the financial services industry.

This has been accompanied by a significant movement toward concentration within the financial services industry. Financial institutions can no longer be identified merely by reference to a name or title. Major investment banking and brokerage firms such as Bache, Shearson, and Dean Witter have merged with larger corporations which offer other financial services. BankAmerica Corporation, the holding company for BankAmerica, has sought and obtained the approval of the Federal Reserve Board to acquire Charles Schwab & Co., the nation's largest discount brokerage firm. Discount brokerage services are increasingly offerred to bank customers in a variety of forms. Indeed, it is unusual to pick up a copy of the Wall Street Journal without reading about some new linkage between a bank and a money market fund. They may be called "Sweeps," "Super Now - Accounts" or "Daily Money Fund Accounts," or many other similiar and sometimes confusing names.

The securities industry has not sat idly by while the banks invaded their traditional territory. Securities industry expansion into the traditional banking arena has been highlighted with the acquisition last month by Dreyfus Corp., a major mutual fund manager, of Lincoln State Bank of New Jersey. The Federal Deposit Insurance Corporation, which has primary jurisdiction, has issued a "letter of non-objection" with respect to the acquisition, based upon Dreyfus' plan to sell the bank's commercial loan portfolio, which would remove Lincoln Bank from the definitional test of a "bank." The FRB, however, notified Dreyfus that it will review the acquisition because it believes Lincoln may still be a bank, notwithstanding the disposition of the commercial loan portfolio. In turn, the FDIC has charged that the FRB is overstepping its authority. Before all of this, we all thought we knew what a security was, our notions about commodities may have been slighten vaguer, but we all thought we knew what a bank was. That appears to be no longer true.

Further crossings of traditional industry lines have occurred as depository institutions have moved to expand into the commodities business by organizing Futures Commission Merchants. Indeed, it appears legally possible that any entity I have identified above can become a Futures Commission Merchant, or at least own one.

Of course, the examples I have referred to above are only a few cases of blurring of lines that immediately come to mind. There are many others, and the list grows daily.

NEW PRESSURES FROM NON-TRADITIONAL PRODUCTS

It is the explosion of new products and services -- most or many related to an instrument historically or presently offered by a financial institution -- which, I believe, creates the most public and investor interest, the most pressure on the regulatory system, and the most pressure for industry consolidation. As depository and other financial service institutions react to the homogenization of financial services, the rise of the financial service conglomerate, and the advent of innovative financial products, "Glass-Steagall" has changed from an obscure legal reference to a much-bandied about and frequently misunderstood catchword. After all, only a few years ago the traditional view was that Glass-Steagall precluded discount brokerage by bank, sweeps, and many other such activities.

To focus briefly more specifically on Glass-Steagall, let's look at several developments.

BankAmerica Corporation, the holding company for Bank of America, recently obtained approval to acquire control of Charles Schwab & Company, Inc. The Adminstrative Law Judge determined that Schwab's discount brokerage business was functionally similar to traditional bank participation in stock brokerage activities, that is, customer transaction services, dividend reinvestment plans, employee stock option plans, the marketing of government obligations, and brokerage activities on behalf of bank trust accounts.

Washington Mutual Savings Bank, a large state-chartered thrift institution in the Pacific Northwest has acquired Murphey Favre, Inc., a full service broker-dealer, which provides customers with investment advice and may engage in underwriting, selling or distributing securities. Its activities exceed the range contemplated by the BankAmerica - Schwab consolidation.

Security Pacific National Bank has established an "introducing broker" relationship with Fidelity Brokerage Services, Inc. Furthermore, the Comptroller of the Currency has also approved the application of Security Pacific National Bank to offer discount brokerage services, on an agency basis, through a new subsidiary, Security Pacific Discount Brokerage Services, Inc. Finally, the Comptroller this month granted Security Pacific's application to purchase Kahn & Company, a discount brokerage firm with offices in the South and in Texas, which will give Security Pacific 30,000 additional retail accounts.

Union Planters National Bank of Memphis has obtained approval from the Comptroller to acquire the stock of Brenner Steed & Associates, Inc., a discount broker.

The Federal Home Loan Bank Board has approved the plan of a group of S&L's to form a jointly-owned registered broker-dealer subsidiary, Savings Association Investment Securities, Inc. ("SAIS"), to act in a agency capacity as an "introducing broker."

Recent bank activity in the area of investment managment includes the creation of new bank-sponsored investment companies.

Citicorp's proposed new collective fund for IRA's has been found legal by the Comptroller, as has been underwriting commercial paper.

THE SIGNIFICANCE OF DISCLOSURE

I have spent the past few minutes focusing on these general developments because I believe them all to be interrelated and to be relevant to any meaningful discussion of securities - commodities regulation. I emphasize that I am not debating the accuracy of any of the various decisions, but rather acknowledging that they exist. As the traditional distinctions between and among banking, commodities, securities and insurance blur, however, I believe that disclosures issues and the significance of disclosure will become more important. The failure of Penn Square Bank, the Drysdale debacle, the well-publicized problems of other financial institutions, and the emergence of the many new financial instrument-based products have caused many to question whether the existing disclosures required for participants in the financial services field are sufficient.

Banks perhaps present the most striking example to consider. The basic premise underlying post-depression regulation of depository institutions was that confidentiality, and therefore non-disclosure of problems or potential problems, breed confidence. That secretive approach was accompanied by a philosophy that banks simply ought not to fail. Likewise, no depositor should suffer loss. Weaknesses uncovered during examinations of banks historically have been closely guarded to avoid runs on troubled institutions. That traditional secrecy is breaking down, however, as evidenced the recent case of SEC v. Youmans, dealing with the confidentiality of adverse information contained in bank examination reports.

Of course, the general principles of disclosure under the securities law are familiar and quite different. The objective is not to protect the enterprise or issuer, but the investing public. The tension between the "banking" approach and the "securities" approach remains strong, but I believe it is eroding. For example, in July, 1982, the Commission concluded that Fidelity Financial Corp. and Fidelity Savings and Loan Association had violated the anti-fraud provisions of the securities laws in connection with the sale of retail repurchase agreements because the Association had not disclosed adequately the risks involved, including the uncertain status of secured interests in the underlying securities forming the collateral and the Association's greatly deteriorating financial condition which affected its capacity to meet its obligations on the repos. The report emphasizes that, merely because the issuer of securities is a depository institution, there is no immunity from the securities laws. My impression is that bank regulators recently have demonstrated a greater liking -- perhaps more correctly a lesser dislike of -- SEC type disclosure. The attitude, which is quite new for the banking world, seems to be premised on the theory that more disclosure may subject the depository institutions to a form of market discipline. For example, the Federal Deposit Insurance Corporation and the Comptroller of the Currency are considering a series of proposals, which include announcing disciplinary actions and disclosing certain weaknesses uncovered by examination. This would be a major shift in historical attitude.

Of course, in the commodities area, any historical basis for "non-disclosure" seems to lack the rationale which has supported the secretive approach historically present in our banking system. Nonetheless, there are historical differences between securities and commodities regulation and the securities and commodities business. While those differences have narrowed, they still exist. I believe, however, that those differences will narrow further.

OVERLAPS BETWEEN SECURITIES & COMMODITIES

In the past few years the securities and commodities industries have developed many new trading products. These new products have contributed substantially to increased trading volume, and therefore to high levels of profitability, in each industry. Particularly noteworthy, of course, is the parallel trading in options, futures, and options on futures based upon financial instruments. Under the SEC-CFTC Accord, the securities exchanges, subject to SEC regulation, trade, or are authorized to trade, options on:

1) GNMA Certificates;
2) Certificates of Deposit;
3) Treasury Notes, Bills, and Bonds;
4) Foreign Currencies; and
5) Stock Indices.

The trading markets which are subject to CFTC regulation, trade, or are statutorily authorized to trade, futures on:

1) GNMA Certificates;
2) Certificates of Deposit;
3) Treasury Notes, Bills, and Bonds;
4) Foreign Currencies;
5) Stock Indices; and
6) Eurodollars.

In addition, the commodities industry is now developing programs to trade options on most of the same futures contracts listed above. Thus, the securities and commodities firms will be trading very similar products, all based on the same underlying financial instruments. Yet, the products are regulated by different agencies and are subject to different margin requirements, tax treatment, risk disclosure requirements, and sales practice regulations, such as a suitability rule. Many of the broker-dealers regulated by the SEC are also Futures Commission Merchants regulated by the CFTC. Thus, one firm may offer similar instruments to a customer, whose investment decision may be determined largely by the regulatory scheme in effect for the instrument, rather than by its intrinsic characteristics. I submit that such a result simply cannot be viewed as logical.

In addition, there are other dramatic examples of a recent coalescence of the securities and commodities markets. In October 1981, Phibro Corp., the largest independent commodities trader in the world, acquired Salomon Brothers for $550 million. Previously, Phibro had been evolving from a trading company into a merchant bank. Phibro had established a Swiss bank to handle loans and letters of credit and was routinely arranging debt financing for mining projects and other production facilities in return for the right to market the output -- an activity which might look like underwriting. Before the Salomon acquisition, Phibro had begun to trade financial futures.

If the Phibro - Salomon amalgamation proves fruitful, and I have no reason whatsoever to believe it will not, the two companies will be able to share information, contacts and clients; Phibro's international operations may help Salomon expand its international banking activities; Salomon may help

Phibro develop its merchant banking capabilities; and the two may work together to originate and trade novel instruments.

The same factors presumably were behind two acquisitions by securities firms of commodities concerns: Donaldson, Lufkin & Jenrette acquired ACLI International, paying over $100,000,000, and Goldman, Sachs acquired J. Aron. These major consolidations in the securities - commodities area strongly suggest, if not prove, that traditional industry classifications present no real obstacle to an innovative restructuring of the financial services industry.

New entrants into the commodities field are not confined to brokerage firms. Several banks or bank holding companies have recently received approval to establish Futures Commission Merchants as subsidiaries. The Federal Reserve Board has approved applications from J.P. Morgan, Bankers Trust, and Citicorp, not insignificant entrants. An application from Bank of America is pending. The Comptroller recently approved a similar application from North Carolina National Bank. Such activities do not raise questions under Glass-Steagall, the major historical barrier to inter-industry consolidation, because that Act restricts securities activities, not commodities activities. Thus, the regulatory impediments which historically have principally inhibited consolidation in the securities - banking field are not present to the same extent in the commodities field, although there may be other legal barriers to consider. If the consolidation that has occurred in the banking - securities industry has occurred notwithstanding the historically strong Glass-Steagall separation of industries, I think we must ask what that portends for the commodities industry?

No discussion of recent developments indications of a coalesence of the commodities and securities field would be adequate without some reference to the Silver Crisis. For six days in March 1980, a potential default by one family on its obligations in the silver market threatened to seriously disrupt the entire U.S. financial system. Various broker-dealers carrying commodities and other accounts of the Hunt family, including some of the largest brokerage firms, faced the possibility of crippling losses if these customers failed to satisfy their obligations. The failure of even one of these firms threatened a chain reaction that would have jeopardized commodity clearinghouses and their members, other broker-dealers and their customers', banks, and public companies and their stockholders. That catastrophe fortunately was averted.

The interest both of the CFTC and SEC in the Silver Crisis was obvious and direct. The cash price of silver was plummetting, creating enormous selling pressure on the market. Maintenance margin calls were forcing futures contract holders to dump additional silver on the market to obtain sufficient cash to meet those calls. Market conditions were chaotic, and several Futures Commission Merchants were under severe financial pressure. Because many of those FCMs were also broker-dealers, the SEC was concerned about the protection of their public securities customers. Of greatest concern, of course, was Bache. During the Crisis, the Hunt's silver futures contracts in accounts at Bache, computed at the spot price, had unrealized losses of $429 million. In addition, many of Bache's bank loans were collateralized by silver warehouse receipts.

As the situation worsened, the value of the loans began to exceed the value of the collateral. When Bache was unable to supply additional warehouse receipts, the banks threatened to call loans and sell silver to satisfy the loans. Furthermore, unmet margin calls in the Hunt family accounts were being charged against Bache's capital, threatening to put the firm in net capital violation and possibly cause SIPC intervention. And I might emphasize out that once SIPC steps in, it has no authority except to liquidate a firm. There is no middle ground.

These problems were not restricted to the securities and commodities markets and securities and commodities dealers. Because of the extensive bank credit involved, the viability of several banks became questionable. The Treasury and the Federal Reserve Board closely monitored the situation, working with the SEC and the CFTC. Fearing a possible chain reaction, the Federal Reserve Board eventually stood by and raised no objections to a $1.1 billion syndicated bank loan to a Hunt family company, which finally defused the Silver Crisis.

The Silver Crisis vividly demonstrates -- even without regulatory or industry consolidation -- the interdependence of our financial markets and the "players" in those markets. I also believe it points up the risk of regulating different elements as isolated industries, which they are not. Even without the inter-industry consolidations, discussed earlier, it is apparent that the federal regulatory structure needs to reflect this interrelationship. Recent developments that weave together banking, securities, commodities, and insurance dramatically heighten that interdependence, for those developments may concentrate all the elements of the next Silver Crisis in a single, major financial services firm.

CONCLUSION: WHAT DOES ALL OF THIS MEAN?

I have spent much time talking about other than pure commodities and securities issues. But I have done so intentionally and believe that to be the correct focus. Let me try to bring my thoughts together.

1. It is, I believe, no longer practical, and certainly not wise, to speak of the problems or prospects of any one distinct segment of the financial services industry, whether it carries a historical label of commodities, securities, insurance, or banking. To be sure, there are historical differences, and there are operational differences. Furthermore, there are distinct "personality" differences: commercial bankers are different from investment bankers, who are different from institutional traders, who are different from the the historical participants in the commodities industry. To complete the circle, the various regulators historically have a different perspective.

2. The flood of new financial services and products, and therefore flood of potential regulatory conflicts and problems, has dramatically raised the question whether it is time for regulatory reform. The Administration has formed a special "Task Force" to consider possible ways to reorganize federal agencies which regulate financial institutions. The Task Force, led by Vice President Bush, and composed of heads of federal financial regulatory agencies, will address the difficult and sensitive question of regulatory structure, including possible consolidation of financial regulatory agencies. The formation of the Task Force is strongly endorsed by our agency, as many of you know.

Last August, Congressman Timothy Wirth introduced a bill, co-sponsored by sixty legislators, to create a one-year Commission on Capital Markets. The proposed Commission would have a combined membership of representatives from the Congress, industry, and the regulatory agencies and would examine the role of financial intermediaries in the accumulation and allocation of capital within the United States economy. While the focus of this Committee would differ from that of the Task Force, it nonetheless evidences a broad concern about our financial markets and their future.

3. But, in advance of any statutory or legislative changes, there have been numerous significant administrative developments which have permitted or hastened consolidation. I have mentioned some of those earlier. Recent actions of various banking authorities, the SEC, and other agencies have permitted market and economic forces to determine whether certain consolidations would occur. So, even without legislation, the administrative developments have been very significant, and will continue to be so.

4. With all of this in mind, we must ask: "What is the driving force?" Why does Dreyfus buy Lincoln Bank, why does DLJ buy ACLI, and why does Sears buy Dean Witter? To turn it around, why are Lincoln Bank, ACLI, and Dean Witter willing to be acquired by firms historically foreign to their fields of enterprise. Profits for those with equity ownership cannot be dismissed -- it is a strong personal motive. The

typical partner at Salomon received $7 million in the Phibro transaction, no insignificant amount. But the more powerful force is, I believe, the need for a larger, stronger, permanent capital base for market participants. The proliferation of the many new products, the competitive need to offer them to hold as well as gain customers, and the ability to take risks -- some quite substantial -- all require that capital. That is true both as a practical business and as a regulatory matter. I do not see the need for larger, permanent capital bases diminishing. Indeed, the opposite prediction seems more in order.

5. All of this prompts me to reach at least one conclusion. The significance of disclosure will increase, particularly for those segments of the financial services industries where SEC - type disclosure has not been the norm. As I stated earlier, depository institutions, since the 1930's, have operated under federal insurance and a widely-held assumption that no depositor would be hurt by bank failures. That has been accurate, at least until Penn Square. But now, with the elimination of Regulation Q and the resulting new freedom to compete for deposits, banks in effect are more "free to fail." Thus, additional disclosures to all who invest funds in such institutions, whether they be equity investor or depositor, will and must assume greater importance.

Historically, the commodities arena has been largely confined to professionals: market professional vs. market professional, agri-business vs. agri-business. That has affected the traditional commodities approach to disclosure. But that has changed, and will continue to change, whether prompted directly and intentionally by pure commodities firms or by competitors offering virtually a parallel product. With the many new products and participants, as well as new and less sophisticated investors in those products, the commodities field has changed. Given that change, I believe that increased disclosure is an alternative to internal, extensive, substantive regulation, and I would commend it to those in the commodities field.

Of course, I recognize that as an SEC Commissioner and ex-securities lawyer, I can be accused of a pro-disclosure bias. I have spent my entire professional career dealing with the concept. Yet, it seems to me that there are two philosophical approaches to regulation during times of economic ferment. One is to attempt, from a regulatory position, to understand all the long and short-term implications of a particular product or development, make policy, political, economic, philosophical and regulatory decisions about its merits, and regulate the product, service, or dealer accordingly. An alternative to such an elaborate, and perhaps paternalistic, procedure is full, meaningful, and open disclosure, so that participants, would-be participants, and their advisers can make reasoned judgments and take calculated risks. In some areas, such as the commodities and banking fields, this will mean more disclosure -- perhaps substantially more -- than has been customary. The precise disclosures will differ and will change from time to time. Furthermore, the development of appropriate disclosures will require the thoughts and refined judgments of many skilled and experienced persons. And, finally, if the securities field provides any precedent, perfection in the art of disclosure is a long time coming, if ever.

6. The issue I was specifically asked to address today was the prospect of a CFTC-SEC merger or consolidation. If I have been successful, I have not answered that question -- although I emphasize that I still support full disclosure. But I do have some underlying logic for avoiding a direct response to that question. The relationship of the SEC and CFTC is but one part of a larger mosaic. Indeed, some might characterize it is as a relatively small part compared to other issues. My speculations about an SEC-CFTC amalgamation would focus on too narrow a topic, and I suggest we all await the report of the Task Force and any other similar groups looking at the broader issues.

I have enjoyed the opportunity to appear before you. Thank you for your attention.