SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

For Immediate Release: June 27, 1973

THE NEED FOR COOPERATION

BETWEEN THE BANKING AND SECURITIES INDUSTRIES

Address by

John R. Evans
Commissioner
Securities and Exchange Commission
Washington, D.C.

Utah Bankers Association
Sun Valley, Idaho
June 27, 1973

Ladies and Gentlemen, I am pleased to have this opportunity to speak to you concerning the relationship of banking and securities activities. As a staff member on the Senate Committee on Banking, Housing, and Urban Affairs for about 8½ years, I was intimately involved with legislation dealing with both banking and securities. My present position has provided me an opportunity to become even more familiar with issues and problems which frequently create conflicts between the philosophies and regulatory responsibilities of the federal banking agencies and those of the Securities and Exchange Commission.

In dealing with these kinds of problems, and in trying to find solutions, it has become apparent to me that a comprehensive approach similar to that recommended by the President's Commission on Financial Structure and Regulation (popularly known as the Hunt Commission) must be undertaken if our banking and securities institutions are to fulfill their proper function of providing capital to meet the demands of industry while protecting investors and depositors who supply the funds. As you know, the Hunt Commission dealt primarily with the structure and regulation of financial intermediaries with significant deposit and thrift functions and did not specifically address itself to the responsibilities of the Securities and Exchange Commission.

After studying these financial institutions, the Hunt Commission attempted to develop a regulatory philosophy and framework which would provide fewer restrictions on competition and require "all institutions competing in the same market to do so on an equal basis." In its proposed reorganization of the federal regulatory agencies, the Hunt Commission developed several criteria among which were "...uniform application of laws and regulations on all competing institutions," "efficiency in examination and supervision," and "regulatory specialization to accompany the specialization of depository institutions...." In addition, the Hunt Commission recommended that "each of the responsible regulatory agencies take due regard for compliance of institutions under its jurisdiction with regulations applicable to them which are promulgated by other agencies," and that "each of the responsible regulatory agencies, as its interests appear, have the right to examine institutions under the jurisdiction of the other agencies and, as a last resort, issue cease and desist orders."

After considering these recommendations, it seems clear that the proposed structure would provide for regulation of various activities of a single institution by several federal agencies. Communication, coordination and cooperation

between the different regulatory agencies under such a system would be an absolute necessity to provide proper regulation yet avoid overlapping and duplication and keep regulation to an absolute minimum.

If these recommendations of the Hunt Commission are valid, and I believe they are, I suggest that because banks are presently engaged in and are increasing their activities involving securities matters, there is need for greater understanding, consultation and cooperation between the Securities and Exchange Commission, the bank regulatory agencies, and the securities and banking industries. In view of this need, I hope that my remarks this morning will contribute to a better understanding of the complex issues confronting us in the future structure of our banking and securities markets and that together we may bring about a resolution of these issues. You should be aware, of course, that my comments do not necessarily reflect the views of the Commission nor any of the other Commissioners.

Before becoming a member of the Securities and Exchange Commission, I frequently heard the observation that the SEC regulates and enforces through public exposure while bank regulators usually avoid such exposure. Generally, I believe this observation is accurate, but it must be pointed out that there are legitimate reasons for these differences in the regulatory approaches.

A major thrust of the securities laws is full and adequate disclosure of all material information relating to the operations and management of publicly-held corporations which may affect investment decisions. In this regard, investors, as well as the SEC, are provided statutory remedies in order to ensure that such disclosure is made for the benefit of the investing public. On the other hand, bank regulatory agencies are concerned with the strength and stability of our commercial banking system, and thus focus primarily upon money supply, interest rates, loans, and, of course, the safety of depositors' funds. Banking regulations discourage public exposure of enforcement or regulatory action because such exposure could cause a run on a bank or banks and jeopardize the stability and confidence that bank regulators are trying to promote. These differences in regulatory approaches are thus, to some extent, attributable to the different public interests and policies inherent in the banking and securities industries themselves, and they are reflected in the statutory structure of the securities laws.

For example, the Securities Act of 1933 exempts any security issued by or representing an interest in or the direct obligation of a bank from registration under the Act although the securities of public bank holding companies must

be registered. In addition, the Securities Exchange Act of 1934 provides that banks are not within the definition of a broker or a dealer. However, when the Exchange Act was amended in 1964, banks became subject to certain reporting and disclosure requirements with the enforcement of these provisions vested in the bank regulatory agencies. Completing this statutory structure, it should also be noted that banks are generally exempted from the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

I do not mean to leave the impression that the SEC has no authority over bank securities and investment activities. The fraud provisions of the securities laws do _not_ contain any exemptions and thus the Commission has authority to investigate any person in connection with a fraudulent or manipulative scheme involving securities and may seek appropriate judicial and administrative remedies. You may have noted recently that the First National Bank of Boston consented, without admitting or denying the allegations, to a censure by the SEC on charges that it had aided and abetted securities laws violations by extensions of credit and custodial and compensating balance arrangements with certain investment companies. Also, in appropriate circumstances, the SEC may suspend trading in the securities of a publicly-held bank.

Notwithstanding the statutory structure, banks are engaged in a variety of securities and investment activities which frequently place them in direct competition with non-banking firms. I, for one, favor this competition so long as there are safeguards against conflicts of interest and so long as the competition is based on economic factors. However, when enforcement and regulation of these two industries differ, fair and equal competition between the various segments of both industries cannot be assured. Let me illustrate this thought by discussing several areas where, in view of exemptions for banks under the securities laws, the Commission has recently encountered some difficult problems which require careful consideration.

Through subsidiaries of bank holding companies, formed under the 1970 Amendments to the Bank Holding Company Act, banks are now aggressively offering investment advice to open and closed-end investment companies and to the general public. This situation raises the question as to whether these activities should be exempt from the securities laws. The Commission's staff has taken the position that bank holding company investment advisory subsidiaries should register under the Advisers Act. However, a number of banks are able to offer the same services through existing in-house

bank facilities without forming any subsidiaries and thus avoid registration as investment advisers. It seems quite anomalous to me to have the Advisers Act apply haphazardly to banks simply on the basis of whether bank management, in the exercise of business judgment, decides to create an investment advisory subsidiary instead of offering the service through a department in the bank. In this context, our staff has raised the question whether Congress, in excluding a bank from the definition of an investment adviser in 1940, meant to exempt all bank-related advisory activities that might be permitted in the future or only those customarily conducted by a bank in 1940.

In another area, the Commission is considering a similar question with regard to the Securities Exchange Act's applicability to bank activities. Several banks contemplate offering a service which permits depositors to automatically accumulate money toward the purchase of specific securities selected from a list compiled by the bank. This type of service doesn't appear to be significantly different from a typical Monthly Investment Plan operated by a New York Stock Exchange member firm and raises the question as to whether a bank or its employees who administer the service should be registered with the SEC.

The so-called "mini-accounts" represent another problem area. These accounts purport to provide individualized portfolio management to investors with accounts as low as $10,000. Entry by banks into this area represents a significant departure from their traditional practice of limiting similar managing agency accounts to a minimum of as much as $200,000 or more.

The Commission has been concerned for some time about the regulatory implications of these services. The basic question has been whether a discretionary investment management arrangement, which is mass merchandized to small investors and provides substantially overlapping investment advice to clients, is the functional equivalent of an investment company and, if so, whether it should be registered under the Investment Company Act and the discretionary accounts registered as securities under the Securities Act.

Last year, the Commission decided to reevaluate its position and develop clearer policies and guidelines in this area and, as a first step, appointed an Advisory Committee to focus on the very difficult legal issues involved. The Advisory Committee found that 71 firms were already providing mini-account services with assets under management of just

under $1 billion. About 70 percent of the 24,000 accounts were in the $5,000 to $50,000 range. None of those arrangements was registered under the Investment Company Act or the Securities Act. The threshold issue for the Advisory Committee was whether a mini-account service involves a public offering of a security.

The Advisory Committee recommended that discretionary mini-account services not be deemed to be a public offering of a security if they afford clients individualized treatment. In the absence of Securities Act registration, the Committee recommended that the Commission require firms which offer discretionary or non-discretionary mini-account services to furnish prospective clients with a simple disclosure document containing basic information such as the range of services offered by the firm, the qualifications of its personnel, and any conflicts of interest.

Closely related to the Securities Act problem is the question of the application of the Investment Company Act to discretionary mini-account services. In the past, the Commission and the staff, concerned with the need for Investment Company Act type protection, have tended to construe such arrangements as investment companies, even in

the absence of pooling in the conventional sense, so long as substantial overlap of investments among clients existed. The Advisory Committee urged, however, that investor protection problems in the mini-account field be handled by remedial rules developed under the Advisers Act, rather than attempting to impose the unwieldy pattern of the Investment Company Act.

Thus, the Advisory Committee's report calls for a broad re-thinking of our approach to discretionary account management arrangements. In formulating our views, we must consider the fact that one major difficulty with the Investment Advisers Act approach is that most banks might not be subject to any rules adopted under the Advisers Act because of the exemption afforded them by that Act.

Of course, it is easy for reasonable men to differ on these very close and difficult questions of policy particularly since there is little precedent to which one can look for guidance. This lack of precedent is a reflection of the fact that the offering of mini-account services is a relatively novel development, made possible at least in part by computer technology, which permits an investment adviser to efficiently maintain separate records for clients and provide continuous account supervision for a large number

of individual portfolios. The Commission and its staff are now grappling with these complex issues to find a prudent resolution and we would certainly welcome any suggestions or comments you may have.

Bank advisory services to the general public, monthly investment plans, and mini-accounts are only now emerging as significant bank activities in the securities business. We are also concerned with several other more traditional areas of bank competition including underwriting of municipal securities, the investment management activity of bank trust departments, and custodial functions for securities.

Under the Glass-Steagall Act, banks are allowed to underwrite state and municipal general obligation bonds. Such securities are exempted from the registration requirements of the Securities Act, whether the underwriter is a bank or not, but a non-bank underwriter of both exempt and non-exempt securities is required to register with the Commission. Also, in view of the Hunt Commission's recommendation that banks be authorized to underwrite revenue bonds which have accounted for approximately one-third of the total of tax exempt bonds in the past few years, it is possible that banks may eventually increase their activities in this area. Legislation for this purpose was originally introduced

in 1967, but was passed only by the Senate. Again this year, Senator Proxmire has introduced similar legislation.

The Securities and Exchange Commission's concern with respect to bank activity in the municipal bond area arises in another context as well. As you are aware, most underwriting and trading activities in general obligation securities are unregulated. Last year our enforcement program disclosed numerous abusive sales practices of municipal bond dealers, including outlandish misrepresentations and excessive markups. These abuses demonstrate the need for comprehensive regulation of municipal bond underwriters and dealers and the Commission is contemplating legislation to meet this need. A threshold question in developing such legislation is the extent to which it should be applicable to banks.

Apart from the bank underwriting activities permitted under the Glass-Steagall Act, the buying and selling of securities by bank trust departments has expanded to the point where trust departments are the largest of the institutional investors aggregating $340 billion according to latest available figures (December 1971), which is more than all other institutional investors combined. Naturally, with this kind of buying power, trust departments have a very significant impact on the structure and character of the

securities markets. In particular, the rapid growth of bank-administered pension funds and the increasing commitment of these funds to equity securities, along with the expansion of bank-advised mutual funds, have made bank securities activities one of the most important forces in today's securities markets. As a matter of fact, banks have been accused of being the principal cause of the present "two-tiered" market in which the securities of some large blue-chip growth companies are selling at very high price-earnings ratios while securities of many smaller companies with good earnings are selling at unusually low price-earnings ratios and in many cases below book value.

Irrespective of where responsibility for these developments may lie, the activities of trust departments have contributed to the institutionalization of the securities markets. Institutional trading patterns have impacted on the securities markets to the point where major institutions find that they are sometimes unable to buy or sell large blocks of securities without adverse influence on the price. Under present conditions, the allocation of capital has also been sharply affected. Many smaller companies with good prospects find equity financing very difficult or simply impossible and are thus hampered in the expansion and modernization of facilities needed to meet competion.

In view of these problems, some responsible parties are recommending substantial restrictions on institutional trading and holdings. At present, I am opposed to the imposition of any artificial impediments of this type to the free marketplace. Instead, I would suggest that we need an in-depth, statistical profile of market activities based on continual disclosure to really understand what institutions are doing in the marketplace. The Commission, therefore, directed its staff to submit to it proposed legislation which would request authority from Congress to require all institutions to report their holdings and block transactions for accounts over which they have management discretion. Without such information, I do not see how the Commission can meet its responsibility to help structure our securities markets to ensure liquidity for all investors, and I hope the Commission can reach a decision on this issue within the next few weeks. This authority, which has been referred to as an Institutional Disclosure Act, would reach beyond the few bank advisory subsidiaries presently registered under the Investment Advisers Act to all discretionary trust and advisory accounts. Banks, insurance companies, pension funds, broker-dealers and all other money managers would be required to report their holdings and trading in securities. I should

quickly note, however, that our goal must be to balance the recognized need for institutional reporting with the potential burdens such reporting may impose upon the respondent institutions.

I believe that one very important benefit which will flow from increased reporting by institutional investors is that any person, including the Commission, will be able to examine data reflecting institutional holdings and trading activity in particular securities. This should dispel the feeling, whether right or wrong, that institutional investors engage in their securities activities behind a veil of secrecy.

The processing of securities and related custodial functions is another area where banks have a significant role. There is no doubt that banks handle most of the transfer agent work and are important participants in securities depositories. Traditionally, the Commission has exercised authority over depositories and clearing agencies because they have been affiliated with one of the self-regulatory bodies under the Commission's jurisdiction. Some of these depositories have recently been reorganized as trust companies in order to satisfy bank fiduciary requirements with respect to the safe-keeping of securities under their control.

In view of our expectation that physical movement of stock certificates will be virtually eliminated, clearing corporations and depositories will have a critically important role in our future securities markets. For this reason, the Commission believes strongly that it should establish the rules and regulations relating to clearing and depository functions in order to assure appropriate access and standards of performance and to implement an interface with existing and future organizations throughout the nation.

Last year the Commission also recommended legislation to retain its authority to inspect, require reports, and enforce compliance with its rules and regulations by clearing agencies and depositories whether bank related or not.

In the transfer agent area, the Commission should have full responsibility for setting standards and ensuring compliance by non-bank transfer agents. In the case of banks which act as transfer agents, the Commission has recommended that it have the authority to set minimum standards while federal bank regulatory authorities would conduct inspections and monitor compliance with those standards.

Last year both Houses of Congress considered and passed different securities processing bills. Both bills granted the SEC authority to establish performance standards

for all depositories, clearing agencies and transfer agents. The House bill, in addition, granted inspection and enforcement authority for all such entities to the Securities and Exchange Commission. The Senate bill, on the other hand, provided that examination and enforcement of standards for bank transfer agents, clearing agencies and depositories organized as banks would be by the appropriate bank regulatory agency. Unfortunately, Congress was unable to resolve the differences between the two bills before the end of the session.

This year, Congress is again directing its attention to these subjects. Section IV of an omnibus bill, H.R. 5050 dealing with the securities industry, contains the essence of the bill passed last year by the House and S. 2058, introduced in the Senate last week, contains the essence of the bill passed by the Senate.

There is no question that the development of a unified nationwide securities processing system is essential and that the primary responsibility for rulemaking over all entities involved in securities processing, including banks, should be with the Securities and Exchange Commission. The Commission should also have inspection and enforcement authority over all non-bank participants.

While it would be simpler and perhaps more efficient from a regulatory point of view for the Commission to be responsible for inspection and enforcement of all entities, including banks, in my opinion--and I want to stress that this does not necessarily represent the view of any other Commissioner--the most appropriate approach at this time considering all factors, is to delegate responsibility for the inspection and enforcement of rules concerning those entities which are banks to the proper bank regulatory agency with requirements for cooperation and coordination with the SEC. This would minimize duplication of inspection and examination of banks and should increase support at this critical point for a unified nationwide securities processing system and for State laws which will permit such a system to include all securities and all possible participants.

If we find that the split jurisdiction creates problems of uneven regulation and enforcement which cannot be solved through cooperation by the federal regulatory agencies, there will be a good case to present to the Congress that the Commission, which has delegated authority from Congress to prevent unfair and inequitable practices in securities transactions, also be authorized to enforce rules relating to these activities by banks.

As you can see, there are a number of issues that require the attention of both the banking and securities communities. I have discussed some of them which I consider most important. I believe that resolution of these issues requires a closer, more cooperative effort by the banking and securities industries. I would also like to see a continuing liaison and dialogue between federal agencies responsible for the regulation of banking and securities firms. Such a development, I think, would enable each agency to understand better the objectives, regulatory philosophies and approaches to these problems. Without our combined input and prudent consideration, I do not believe these important issues can be properly analyzed and resolved. With the necessary cooperation, I am sure we will work out solutions which will protect investors and depositors and assist banking and securities institutions to fulfill their proper function of providing capital efficiently with a minimum of governmental regulation.