NEWS

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FAIR COMPETITION REQUIRES EQUAL REGULATION

Remarks by

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I believe I might feel much like Daniel of the Old Testament going into the lion's den by coming to discuss with you the subject of banking and securities activities if it weren't for the fact that I have had the opportunity to work with many of you on banking legislation. Having had that experience, however, and knowing of your combined expertise in banking and related subjects, I hope that my comments may stimulate a discussion that will focus on some regulatory and competitive problems resulting from bank competition with the securities industry which I believe to be important and which will no doubt receive more attention with the passing of time.

I intend to raise some issues on which there are strong differences of opinion. Although I may express some opinions, I do not intend to provide final answers. Hopefully, however, our discussion after my remarks will be helpful in bringing about resolutions. I am sure all of you are aware that my comments do not necessarily represent the views of the Commission nor of any of the other Commissioners.

As many of you know, I start with a bias in favor of competition and minimum government regulation. I believe this bias was very evident in my approach to legislation

considered by the Senate Committee on Banking, Housing and Urban Affairs such as Truth in Lending, Consumer Credit Reporting, Bank Credit Card legislation, and Bank Holding Company legislation. You will recall that a major issue in the 1970 Amendments to the Bank Holding Company Act was whether commercial banks should be prohibited by law from engaging in certain activities generally referred to as a "laundry list."

With respect to this issue, I strongly supported the position that the business of banking should not be defined narrowly as was the desire of several industries which did not want to have banks competing with them. I mention this because I believe it has a bearing on our discussion this evening. Although there are different interpretations of what should be included in a definition of banking, there is no doubt in my mind that Congress intended the business of banking to be evolutionary and dynamic within certain guidelines.

One of the most basic guidelines is the Glass-Steagall Act which Congress approved in 1933 after a decade of problems resulting at least in part from the combination of commercial banking with investment banking and other

securities activities. While the main purpose of the Act may have been to divorce those activities, the divorce was not a complete one, and banks were permitted to engage in certain activities which were not too clearly defined. For example, the Glass-Steagall Act permits banks to perform brokerage functions in securities to the extent of purchasing and selling them without recourse, solely upon the order and for the account of customers. In addition, while national banks are forbidden to underwrite any offering of an equity security, they are permitted to purchase for their own account bonds, debentures or other similar notes pursuant to restrictions prescribed by the Comptroller of the Currency.

Along with the legal restrictions on bank securities activities, the Congress provided exemptions from certain provisions of the federal 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, perhaps because of the separation of activities intended by the Glass-Steagall Act, the Securities Exchange Act of 1934 excludes banks from the definition of a broker

or dealer. Completing this picture, banks are generally exempted from the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

In view of this background, I believe bank competition with other industries could probably have been predicted when commercial banks began to break out of their traditionally conservative or even stodgy mold and began to broaden their operations into new activities with the intent of becoming one-stop, full service, financial centers. This expansion is desirable, in my opinion, if it is legal, does not represent unfair competition, does not lead to anti-trust problems, conflicts of interest, jeopardize safety of deposits and solvency of banking institutions or if it does not result in sacrificing investor protection and safeguards which other institutions which are competing for the same investment dollars are required to provide. Although present bank securities activities are being questioned on all of these counts, I would like to focus primarily on fair competition, equal regulation, and investor protection.

In order to have fair competition, it is necessary that all competitors operate under the same rules with equal enforcement of appropriate standards. Nearly everyone agrees

with this in theory, but problems are inevitable if some of the competitors are exempt from statutes which govern the activities of others, as is true in the case of banks under the federal securities laws, and if the competitors are under the jurisdiction of different regulatory agencies which have different approaches to enforcement.

The regulatory agencies with which we are concerned this evening are the Federal Reserve Board, the FDIC, and the Comptroller of the Currency which regulate the banking industry and the Securities and Exchange Commission which regulates the securities industry. 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. As indicated by the Comptroller of the Currency, James Smith, in recent testimony, bank shareholder or prospective shareholder interests are not a very high priority item in bank regulation. Banking laws and regulations strongly discourage public disclosure of enforcement or regulatory action primarily because of the concern that such exposure could cause a run on a bank or banks and jeopardize the stability and confidence that bank regulators are trying to promote.

On the other hand, the 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. Any withholding of such material information or any disclosure made only to a select few, may well result in a violation of the anti-fraud provisions of the securities laws and exposure to lawsuits both by the Commission and private parties.

Although we know it isn't true, let's assume that banks and non-bank competitors in securities activities were subject to exactly the same rules and regulations and that the only difference in the regulation of banks and their competitors in securities activities is the difference in enforcement. When it is discovered upon examination or investigation that an institution under the jurisdiction of the SEC does not meet appropriate standards of practice, the Commission takes enforcement action which is disclosed to the public so that both present and prospective investors may have a basis on which to make investment decisions. If

the exact same violation were to take place in a bank, the enforcement would not be made public and investors would not be aware of adverse information.

Let's take a case in point. From what the Comptroller testified on Tuesday, apparently in September of last year, a Regional Office of the Comptroller referred to the Justice Department matters relating to the activities of United States National Bank including 25 separate transactions which may have violated criminal statutes. Later, on May 24 of this year, the Comptroller issued a private cease and desist order against the bank. As is the usual practice, this was not made public so the public shareholders of the bank did not know that their investment might be jeopardized by the bank's activities. Even worse, from the Commission's point of view, any prospective purchaser of U. S. National Bank stock did not have access to information which from all appearances would have been material to his investment decision.

After an investigation by our staff of Westgate-California, a large conglomerate complex controlled by the same individual who was also the chief executive officer and the major shareholder of the U. S. National Bank, we filed a fraud suit asking the court to remove this individual and close associates from their management positions in Westgate-

California and any other public companies unless it could be demonstrated that procedures had been implemented which would prevent a reoccurrence of activities similar to those alleged in our complaint. We worked closely with the Comptroller's office on what to do with the bank itself, which was deeply involved, and we were considering naming it in the proceeding. The Comptroller's office and the FDIC recommended strongly against naming the bank and the Commission agreed not to name the bank so long as the Comptroller obtained all relief which the Commission believed necessary prior to the filing of our action. In addition, we were contemplating a suspension of public trading in the bank's securities on the basis that there was not sufficient information in the marketplace to continue trading unless the Comptroller agreed to make the cease and desist order public. Upon agreement, the order was made public at the same time we filed our action against Westgate-California.

This example shows that even with cooperation between the SEC and the banking agencies, the differences in Congressional mandates and enforcement approaches result in conflicts which may not be subject to completely satisfactory resolution.

Now let's consider the effect which such enforcement differences may have on the ability of the bank and non-bank institutions to compete for similar securities business.

The reason bank proceedings are not public is based on the premise that if the public knew, it could result in a loss of public confidence in the bank and to some extent this would extend somewhat to the whole banking system.

It's interesting that there is the same reaction to public notification when dealing with industrial firms or securities firms. Now if you are an investor and you are aware of these actions against securities firms but you haven't heard or read of any against banking firms and if they both offer comparable services, which one do you suppose you would patronize? There is only one obvious answer--the bank. Thus we see that even with identical standards, banks would have an unfair public confidence advantage and public confidence is probably one of the most important assets, if not the most important asset, the banking industry has.

With this background, I would like to discuss areas of direct bank competition with securities firms. Banks have authority to underwrite municipal general obligation bonds and have been trying for years to expand that authority to permit them to deal in revenue bonds. Presently, this type municipal security is distributed and traded by non-bank firms

which are subject to the Commission's jurisdiction because they also deal in non-exempt securities and by non-bank firms exempt from Commission jurisdiction because they deal solely in exempt securities. The Commission is very concerned with the absence of equal regulation of municipal bond underwriting and after market trading by both banks and non-bank dealers which are not under our jurisdiction except for the anti-fraud provisions.

Legislation, S. 2474, has been introduced establishing the Commission as the federal agency with full regulatory and enforcement jurisdiction over both bank and non-bank municipal bond activities. As you know, banks do not want the Commission to have such jurisdiction and the bill is very controversial. It seems to me that the bill would provide a satisfactory means of assuring equal regulation of municipal bond underwriting without affecting other banking activities although the Commission may not agree with all of its provisions.

Bank trust departments represent another area of competition with non-bank money managers who are under Commission jurisdiction and must comply with the Investment Company Act and the Investment Advisers Act. Assets of bank

trust departments significantly in excess of $400 billion exceed those of all other institutional investors combined and the manner in which these funds are invested may have a major impact on competing money managers and on our securities markets, the allocation of capital and the possibility and cost of equity financing by business firms. If the SEC is to influence the evolution of our markets and has some responsibility to see that they provide a means of equity financing and a vehicle for sound equity investments, we must have information on institutional holdings and trading.

We have requested legislation which would provide us with needed information on holdings and transactions and I don't have any doubt that we will get such legislation.

In a related development, the Commission has embarked upon an effort to improve and restructure our securities markets into an efficient nationwide, integrated system with automated securities handling and the virtual elimination of physical handling of stock certificates. An important part of this system is the securities depository which can change ownership through book entry. The Commission has requested and supported legislation which would grant it regulatory authority over the entire system

and its components including securities depositories, clearing agencies and transfer agents regardless of their corporate structure or bank affiliation. The Commission has requested enforcement authority over all segments of the processing system except bank transfer agents but has stated that enforcement by bank agencies of activities of entities organized as banks would be acceptable. This legislation has been stalled in Congress for more than a year because of regulatory jurisdiction differences which have not yet been resolved.

There are other rather recent developments in bank competition which also raise questions which need answers. In 1968, the First National City Bank of New York began to offer an innovative dividend reinvestment service to corporations. This service permitted shareholders to have the option of reinvesting their cash dividend checks automatically in the corporation's stock. Soon banks were also allowing shareholders to contribute additional cash to be invested in the securities of the issuer along with the cash dividend. Shareholders were then authorized to deposit securities of a different class issued by the same corporation, and the dividends from these securities were also reinvested in the common stock of the issuer.

The Commission has not generally required registration of securities acquired pursuant to such plans under the Securities Act when the bank is not affiliated with the corporate issuer, and when the securities acquired pursuant to the plan are not acquired from the corporation or its affiliates. However, these investment programs raise questions as to the need for the investor protections afforded by registration under the Securities Act, and the operation of these plans may also raise questions as to the applicability of the Investment Company Act.

In line with the commercial bank one-stop, full financial service concept, the next step was a broader investment service in equity securities. That service, first introduced last May by the Security Pacific National Bank, is now well known as the automatic stock investment plan being offered by banks not only to present customers but also to the general public through national advertising and personal contact.

The typical plan allows an individual to select stocks from a list of 25 securities and arrange for payments of $20 to $500 to be deducted automatically each month from his savings or checking account. The orders for shares of

each company from all participating customers are pooled prior to purchase to obtain volume discount commission rates. In February of this year, the then Comptroller of the Currency, William B. Camp, concluded that because the service would only involve purchases for the account of customers and not for the bank's own account and would not involve the issuing, underwriting, selling or distributing of securities, it was consistent with applicable banking law (12 U.S.C. §§24, 378).

Counsel for Security Pacific National Bank and counsel for Investment Data Corporation, a data processing company, submitted requests for "no action" to our staff on whether the automatic stock purchase plan was an investment company. On that narrow issue, the staff replied that it would not recommend any action to the Commission if the plan was not registered under the Investment Company Act. However, the bank was warned by the staff that certain actions by the bank in connection with its plan might create fiduciary relationships and thus require the bank to assure that investments were suitable for each customer. Although the staff granted a no-action letter with respect to the Investment Company Act issue, you are all aware that the

Commission is not bound by these staff advisory letters nor are such letters a bar to civil suit by other parties. Moreover, the staff did not express an opinion as to the status of the bank or the data processor with respect to the Securities Act, the Securities Exchange Act, or the Investment Advisers Act. The Commission has not yet taken a position on these issues.

Perhaps more important than the question of whether these plans are in compliance with law is the question of whether investor protection standards generally required of those who operate under the Commission's jurisdiction should be applicable to the bank or the data processor. Because these plans are being actively "merchandised" to encourage individual investors to purchase listed securities, there is a legitimate concern that the transactions are not subject to appropriate customer safeguards under the securities laws, such as suitability, receipt of a confirmation, and insurance protection. These programs are similar in many respects to the monthly investment programs offered by many brokerage firms, and there is a good argument that persons offering a similar service ought to be subject to the same regulations in order that they fairly compete with each other.

The New York Stock Exchange, the Investment Company Institute, and the Securities Industry Association, have requested the present Comptroller of the Currency to reconsider the ruling of his predecessor that automatic stock purchase plans are appropriate and legal activities by national banks. Briefs have also been submitted by the other side in this controversy, and I understand the Comptroller's office is reconsidering the ruling. If the ruling of the Comptroller is not rescinded, it is likely that these bank plans will be the subject of either litigation or legislation, or possibly both.

The so-called "mini-account" service is another relatively new area of bank activity. This service is designed to provide individualized portfolio management to investors with accounts as low as $10,000. Entry by banks into this area is in direct competition with brokers and investment advisers.

The Commission has been concerned for some time about the regulatory implication of these services. The basic question has been whether a discretionary investment management arrangement, which is mass merchandised 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 mini-accounts registered as securities under the Securities Act. Concerned with the need for Investment Company Act type protection, in the past the Commission has tended to construe such arrangements as investment companies, even in the absence of pooling in the conventional sense so long as substantial overlap of investment among clients existed.

Whenever commercial banks and other financial institutions are active in our securities markets, the Commission has both an obvious interest and an obligation to fulfill the mandates imposed upon us by Congress. We are anxious to prevent deterioration in our system of investor protection which could result from entry into the securities business by institutions not regulated by the Securities and Exchange Commission. As I have indicated, we are also concerned with the potential impact of this entry on the structure of our securities markets. This is not to say that the Commission believes that the securities industry as it now exists should be protected from competition by commercial banks, insurance companies and others, although the industry criticizes us for not taking that position.

We do feel a responsibility, however, to maintain strong, viable capital markets to assure that business firms have an efficient mechanism through which to obtain equity capital and that investors have an opportunity to invest in American enterprise knowing that financial institutions dealing in the securities markets are equally and adequately regulated, that there will be full and fair disclosure, and that they, as investors, will be protected from unfair and manipulative market practices.

If a securities firm decides to expand into the insurance business, that segment of its operations would be regulated by the appropriate state insurance regulator. If an insurance company wants to expand into banking, its banking activities would come under the jurisdiction of a bank regulatory agency. This assures that the bank activities will conform to certain industry standards thus protecting the public and assuring equal regulation of competitors. No one seems to take issue with this concept. It is equally compelling to advocate that the securities activities of all who offer them, regardless of their corporate structure, should be regulated by the Securities and Exchange Commission.

While some may view such a suggestion as an attempt by the Commission to become involved in bank regulation, I can assure you that we have no interest in regulating non-securities activities. We do, however, have a responsibility to assure that investor interests are protected.