NEWS

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Remarks to

D.C. Bankers' Association Convention
The Homestead

Hot Springs, Virginia

June 7, 1984

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The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

Outline of Remarks
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I. An Initial Observation

A. The reason we have so much confusion in the bank-securities activity area is that we have never resolved a basic conflict between the underlying philosophy of the banking laws and the securities laws. Until we do so, the confusion will continue.

B. The underlying theme of the banking laws is to promote public confidence among those who have investible funds by protecting depositors against the loss of funds. This is done so by, in the first instance, protecting the enterprise at virtually all costs. This is a "protectionist" approach, sometimes called safety and soundness.

C. The underlying theme of the securities laws is to promote public confidence among those who have investible funds by compelling full disclosure, even if it damages the enterprise. The would-be investor thus theoretically has all information, good and bad, necessary to make an investment decision, but is subject to market risk, etc. This is a "market discipline" approach.

D. With that distinction in mind, how do I view banks, the securities industry and the recent changes? It's essentially a two-level, two-part analysis.

1. The general conflict between the protectionism and disclosure philosophies.

2. The relationship of disclosure to the expanding scope of activity.

II. The Activity Side -- Glass-Steagall

A. Banks are now in the "securities business," whatever that means.

B. The securities industry is now in the "banking business," whatever that means.

C. Bank of America - Schwab & Bankers Trust cases

1. Predict Bankers Trust will find distribution of third party commercial paper to violate Glass-Steagall.

2. Predict Schwab will find discount brokerage not to violate Glass-Steagall.

3. If my predictions are correct, we have a 1-1 tie and continuing controversy.

III. Where is the Glass-Steagall Line? Why Do We Have Glass-Steagall?

A. From 1913 (the date of the Federal Reserve Act) to 1933, 15,502 U.S. banks failed. That's more banks than exist today.

B. From 1929 to 1933 alone, more than 9,000 banks failed. 4,004 failed from 1932-1933. The year after the FDIC was created, only 62 failed.

C. The Banking Act of 1933 was explicitly designed to promote the safety and soundness of banks. First, deposit insurance was created. But banks also were simply barred from activities perceived to be potentially troublesome. With certain minor exceptions, they were forbidden to underwrite or deal in securities and were permitted to engage only in those activities "necessary to carry on the business of banking." Interest was prohibited on demand deposits, interest rates on time deposits were regulated, and bank examiners were given additional powers. The result was a partnership between the federal government and the banks it regulated, with the government as a senior partner.

D. The overall effect was to encourage people with available capital to deposit it and leave it in banks, with the assurance that nothing adverse would happen to the institution and, in the unlikely event it did, they were nevertheless insured. Such a "protectionist" system makes disclosure largely irrelevant.

E. The Securities Act of 1933 was adopted at the same time as the Banking Act of 1933, is essentially a companion piece of legislation, and even emanated from the same Senate Committee. In fact, the bills emerged from the same Committee only ten days apart. But the Securities Act seeks to promote public confidence on the part of investors in a totally contrary manner. It mandates full disclosure, even of adverse information, and even at the risk of damage to the enterprise.

F. In a larger sense, both acts regulate the investment process -- the process by which people entrust their investible capital to another -- and both proclaim that they are designed to promote public confidence. But is difficult to imagine two approaches more legislation seem irreconcilably in conflict.

IV. Proposed Rule 3b-9 -- One Regulatory Response To the Expanding Activity Issue

A. Sections 3(a)(4) and (5) of the Securities Exchange Act provide that the terms "broker" and "dealer" do not include a "bank."

B. Under proposed Rule 3b-9, a bank could not rely on this exclusion if it (1) publicly solicits brokerage business; (2) receives transaction-related compensation for providing brokerage services for trust, managing agency, or other accounts to which the bank provides advice; or (3) deals in or underwrites securities other than exempted or municipal securities.

C. Proposed November 8, 1983 (comment period expired February 15, 1984, but letters are still being received); approximately 250 letters have been received to date.

D. Other Developments

1. American Bar Association told us we lack the authority to adopt Rule 3b-9.

2. Comptroller of the Currency published an alternative proposal requiring SEC registration of certain bank brokerage acitivity.

3. Possible judicial clarification soon from the Supreme Court on the scope of SEC authority.

a. Bankers Trust - commercial paper

b. BankAmerica/Schwab acquisition

E. Not sure Rule 3b-9 is that important, compared to all the other issues.

V. Can A Full Disclosure = Market Discipline Approach Be Applied to Banks?

A. In recent times, we have heard of an emerging preference, at least on the part of some banking regulators, for more regulation by "market discipline." Some argue that market discipline will promote long-term safety and soundness.

B. Others argue that such an approach is inimical to promoting safety and soundness.

C. Regardless of which argument you support, a preference for market discipline has potentially significant consequences. If market discipline is to become a truly effective regulator of banks, three factors must necessarily exist. Only then will banks truly be subject to market discipline.

1. Banks must be required to make prompt, full disclosure of all material information, positive and negative, even at the risk of damage to or collapse of the enterprise.

2. Banks must be allowed to fail just like other enterprises.

3. Both stockholders and large depositors must be left to bear their losses.

D. The ultimate question is whether our society is willing to allow banks to engage in a wider range of progressively riskier activities, to subject banks to the spotlight of disclosure, particularly as they diversify, and to subject banks to the ultimate market discipline I have suggested.

E. Disclosure Implications of Risk-Related Insurance

1. Bush Task Force may recommend that FDIC and FSLIC may be permitted to institute systems of risk-related deposit insurance.

2. FDIC has talked about this approach in favorable terms.

3. S.2699 (Garn introduced May 22, 1984) provides that "assessment credit" (the premium rebate) provided by FDIC to banks shall be set on the basis of the risks presented by the bank's capital level, quality of assets, exposure to changes in interest rates, etc.

4. If it comes to pass, risk-related depoist insurance is highly significant from a disclosure perspective. After all, what could be more material than the fact of an adverse rating and the factors which caused that rating?

F. The Erosion of the Confidentiality of Examination Reports - Youmans.

G. The Lingering Conflict Between Protectionism and Disclosure.

1. The more banks go beyond "traditional" banking, the more disclosure becomes important.

2. Otherwise, activities traditionally subject to disclosure become insulated from disclosure.

VI. Continental Illinois -- A Case Study

A. "What Continental Illinois shows us, if nothing else, is that our economy is not a free market economy, it's a political economy, and that our society is not prepared to practice Social Darwinism on certain elements of our economy -- big banks, automobile manufacturers, and large municipalities." George Will.

B. "Deregulation sounded so good to us conservatives -- more competition, good for the consumers. But look what it did to the airlines. We can't allow that to happen to banks. Maybe those of us who have favored deregulation so strongly have to have some second thoughts." James J. Kilpatrick.

C. Less than full coverage for $100,000+ deposits recently announced (or reiterated) as FDIC policy.

1. Big bank v. small bank issue.

2. Independent Bankers' Association criticizes FDIC as favoring big banks.

3. Are banks special? Apparently big banks are, in light of Continental Illinois.

D. Additional Powers Issue and The Future of Deregulation.

1. St Germain bill would draw a very strict Glass-Steagall law.

2. But expanded powers didn't cause Continental Illinois problems -- banking did.

3. The political climate.

E. If the government is the ultimate backstop, does market discipline, SEC-style disclosure, or whatever you choose to label it, work? Or is it irrelevant?

VII. Recent SEC Enforcement Actions Involving Banks

A. SEC v. IntraWest Financial Corporation, et al., filed February 28, 1984. Injunctive action against IntraWest and two officers. The Complaint alleges violations of Section 17(a)(2) of the Securities Act of 1933 and Section 13(a) of the Securities Exchange Act and Rules 12b-20, 13a-1 and 13a-3 in connection with the overstatement of earnings for the first three quarters of the company's fiscal 1982 year and the reporting of other material corporate developments. Simultaneously with the filing of the Complaint, the Court entered Final Orders against IntraWest and the two officers enjoining them from further violations of the above provisions. The defendants consented to the entry of the Final Orders without admitting or denying the Commission's allegations.

B. In the Matter of Utica Bankshares Corporation, administrative proceeding instituted February 29, 1984. The proceedings were based upon alleged material overstatement of earnings resulting from an understatement of Utica's allowance for possible loan losses for its third quarter, ended September 30, 1982. The misstatements were found by the Commission to have caused two of Utica's periodic filings to fail to comply with the periodic corporate reporting provisions. In its order, the Commission noted the need for "careful periodic review" by financial institutions of their loan portfolios on at least a quarterly basis to insure that accurate financial information is available to the investing public.

C. Cases demonstrate less reluctance than in the past to bring actions against banks.

VIII. Bush Task Force

A. Final recommendations due soon.

B. Section 12(i) requires bank regulators (OCC, Fed, FDIC, and FHLBB) to issue within 60 days regulations "substantially similar" to those issued by the SEC under Sections 12, 13, 14, and 16 of the Securities Exchange Act (the disclosure, reporting, and proxy provisions) unless the bank regulators specifically find that such regulations would not be "necessary or appropriate in the public interest or for the protection of investors."

C. Problems created by this approach: fragmented system, delay in adopting "substantially similar" regulations, and dissimilar requirements.

D. Possible Solutions

1. Repeal of Section 12(i);

2. Provide for automatic incorporation by reference of SEC rules by bank regulators; or

3. Automatic incorporation by reference unless specifically waived by the bank regulator.

E. Possible revocation of §3(a)(2) exemption for registration of stock of banks and S&L's.

IX. Confidence v. Disclosure -- The John Law Story

Our difficulties in striking a balance between the conflicting regulatory schemes, however, are not unprecedented. Others have found the task equally difficult. Back in 1716, France was in appalling financial condition. Expenditures were twice receipts, causing cash flow problems. The Royal Treasury was chronically empty.

But John Law, an enterprising Scotsman, then arrived on the scene. Through high-born acquaintances, Law obtained the right to establish a bank with capital of about 250,000 English pounds. The bank was authorized to issue notes, and it did. The French Crown used the notes issued by Law's Bank to pay off its creditors and declared the notes legal tender. That's called money. The Bank notes floating through the the system stimulated the economy. Louis encouraged everyone by dying, and that furthered a substantial economic revival.

At this point, let me tell you why John Law was in France, where he was rapidly becoming that nation's central banker. He was fleeing a murder charge in England. He had been singularly successful in a duel. In addition, he had gambled his way through a considerable inherited fortune in his home country.

But back to the French banking system. All these events had such a beneficial effect that Royal Regent proposed that Law's Bank should issue additional notes. Law agreed, but even he was becoming concerned that the growing volume of notes in circulation -- now a form of paper currency -- was not backed by a sufficient reserve of hard currency -- gold coins in those days. Law didn't call it public confidence, but that was his concern.

Even in 1719 banks apparently were restricted in what they could do -- their own version of McFadden and Glass-Steagall -- so Law had to look to ventures outside banking to generate profits to support the bank. So Law established the Mississippi Company, later called the "Company of the Indies." It was to explore for gold in Louisiana. I suppose this could be called the first separate corporate affiliate. The gold was to be minted into gold coins, which would back the notes or the soft currency issued by Law's Bank. The Company of the Indies also received an exclusive trading monopoly in India, China, and the South Seas, a monopoly on tobacco, and the right to coin money.

John Law also understood the hot issues market. His next step was to take this burgeoning financial services conglomerate public. It was truly a hot issue. The value of the initial shares rose by several thousand percent. Throughout 1719 more and more shares were issued, ostensibly to be used to find gold in the Louisiana wilderness to make the gold coins to back Law's Bank's notes.

But that was not the case -- in those days there were no full disclosure documents discussing the use of proceeds, nor any SEC to police disclosure. Instead, the funds raised were loaned to the Crown. Only interest paid on those loans by the Crown was available to the Company for its operations. One historian described it as follows:

> "Law was lending notes of the [bank] to the government which then passed them on to people in payment of government debts or expenses. These notes were then used by the recipients to buy stock in the Mississippi Company, the proceeds from which went to the government to pay expenses and to pay off creditors who then used the notes to buy more stock, the proceeds from which were used to meet more government expenditures and pay off more public creditors. And so it continued, each cycle being larger than the one before."

But there were problems -- something called public confidence and the harsh consequences of disclosure. In 1720, a minor royal prince sent a batch of notes to the Bank to be redeemed in hard currency. This was the

first suggestion of a lack of public confidence. Others then began to redeem their notes for the little gold which existed, which they spirited out of France. As word spread that the gold might not be there -- effective disclosure -- the trickle of redemptions became a torrent. Finally, one fine Summer day in 1720, the mob in the Bank was so dense that 15 people were crushed to death. Law's legacy to France was broken fortunes, ruined businesses and an enduring suspicion of banks.

This historical incident -- true by the way -- demonstrates that public confidence in banking is a fragile thing and that progressively greater risk-taking can affect the bank itself, even if done indirectly and not by by the bank itself, and for the best of motives. The harsh impact of disclosure is also eloquently demonstrated. Full disclosure of the use of the proceeds of Law's offering may well have stopped the scheme before it got out of hand. On the other hand, such disclosure would have undermined public confidence in the Bank, the Bank would not have gotten off the ground, and the French economy would not have been rejuvenated, albeit briefly. Indeed, it was disclosure which shook public confidence and brought the Bank down.

Whatever anyone declares to be the appropriate activities of banks, the appropriate level of risk to which they should be subjected, and the role and value of disclosure, we should at least acknowledge that an abiding conflict between safety and soundness regulation and full disclosure, and the question of the proper range of bank activities, have been with us at least 250 years, thanks to John Law. And I suggest that Continental Illinois proves it.

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