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THE SEC, THE BANKS

AND THE CAPITAL MARKETS

Remarks by

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CARTER GOLEMBE ASSOCIATES EXECUTIVE SEMINAR

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Alan F. Blanchard*

I was interested to note that mine is the only talk on your program with no title. That probably is appropriate. The overall Conference topic is "regulation," and my mere presence is probably as eloquent a statement on the regulation of banks as anything I can say. If an economic Rip Van Winkle were to come upon this scene, I think he would be very surprised to see a Securities and Exchange Commission official addressing a bankers conference. He would probably conclude that "something" had changed, and that that "something" had to do with regulation. Finally, he probably would decide that it does not mean that there is less of it.

I think that our Commission today looks quite different to its historical clients, the brokers and investment advisers, than it does to the banks. To its historical clients, and to government in general, the Commission is in something of a deregulation mode. The unfixing of commission rates on securities transactions was an historic and phenomenal event in terms of voluntary deregulation by a governmental agency. Other less dramatic steps have also helped make the Commission, at least to the government, one of the deregulatory "good guys." From your perspective, however, I suspect that the Commission is like a very large camel who is suddenly in your tent up to its second hump.

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Given all that is going on, there is quite a lot that I could talk about today. I would like to touch very briefly on the recent actions the Commission has taken affecting banks and then spend the rest of my time on some of the basic conceptual and philosophical questions that I think the Commission will be wrestling with in the years ahead.

In summary, I am going to try to support three basic points. The first is that the major actions the Commission has taken over the last year or two affecting banks follow logically from its traditional regulatory purposes: for example, municipal bond regulation, and transfer agent and depository regulation can be viewed as facilitating fair and orderly markets. The Commission's increased involvement in bank holding company disclosure requirements is natural given its responsibility for full disclosure and particularly important given increased investor interest in bank stocks.

My second point relates to what I think is going to be one of the major issues in the future: the concept of "making the capital markets work." We all know that major changes have occurred in the functioning of the securities market over the recent years. I think that a review of the major market changes indicates an increase in the importance of the banks to the effective working of the securities markets. This change is another cause of our increased involvement.

My final point relates to what I have given the tongue twisting title of "increased inter-financial intermediary competition." Competition among financial intermediaries is increasing, and I believe that this makes the question of the strengths and weaknesses and relative competitive position of each group far more important. Since the financial intermediaries are all highly regulated, the attitudes of their regulators is a particularly important aspect of their competitive position.

Let me try to develop each of these thoughts.

BANKS AND THE COMMISSION'S REGULATORY PURPOSES

I think that the best way to develop a frame of reference for looking at the Commission and the banks is to examine recent events in the context of the Commission's basic regulatory purposes. Most students of government would agree that the Commission has two, or perhaps three, regulatory purposes, such as the ones I have listed on Exhibit 1 (following this page). The first is helping to facilitate fair and orderly capital markets; the second, insuring full disclosure to investors. I think that the Commission's mandate in these two areas is relatively uncontroversial. However, I have put a question mark by what I listed as a third purpose - to facilitate effective capital markets. As I will later indicate, what that means and what the Commission's role should be is widely contested.

From your point of view, the important fact is that, under each of these purposes, there have been a number of Commission activities over the last year or so which very much involve the banks. I have summarized them on the right-hand side of the exhibit. In the "fair and orderly capital markets" area, there have been municipal bond regulation and

RECENT SEC REGULATORY EFFORTS AFFECTING BANKS

REGULATORY PURPOSE	SEC ACTION / DISCUSSION
Fair and Orderly Capital Markets	Municipal Bond Regulation
	Transfer Agent and Depository Regulation
Full Disclosure to Investors	Bank Holding Company Disclosure
Effective Capital Markets (?)	The Bank Study
	The New Agency Debate

transfer agent and depository regulation; in full disclosure, bank holding disclosure. Against effective capital markets, there has been the bank study and something I will explain further which I have called the new agency debate.

FACILITATING FAIR AND ORDERLY MARKETS

I think I can deal quite quickly with the fair and orderly markets issues. While each of them is a major expansion of Commission responsibilities and operationally very important to you, their content is relatively straightforward.

Transfer Agent Regulation

With regard to transfer agent regulation, all I want to do is to point out that the context in which authority over bank transfer agents was granted was that of the overriding objective the Congress has laid down of streamlining the securities transactions process. This is evident if you look at the "findings" section of the 1975 Act Amendments which gave the Commission this authority. The Congress found that:

> the prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and safeguarding of securities and fund related hereto are necessary for the protection of investors...
>
> (B) Inefficient procedures ... impose unnecessary costs;
>
> (C) New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures...

(D) The linking of clearance and settlement facilities development upon standards ... will reduce unnecessary costs, ...

(2) The Commission is directed, therefore, having due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and the maintenance of fair competition among brokers and dealers, clearing agencies and transfer agencies, to use its authority under this title to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities.

The way this relates to you, of course, is that the transfer agent is the one guy in this process over whom the Commission has had no real authority, until this legislation. Initial Commission responsibilities here are to work out a system of registration for transfer agents with the bank regulators and then to try to establish some rules which are helpful but not burdensome, a process which is just beginning. If you want to know more about it, I recommend a recent speech by Commissioner John Evans, entitled "Transfer Agents Meet the SEC."

Municipal Bond Regulation

Municipal bond regulation is a major new responsibility. Again, however, I suspect that you are sufficiently familiar with it that I need not say much about its substance. What has happened here is that the basic Commission authority has been extended to a whole new marketplace; one which is very close to you. You are, I am sure, familiar with the abuses that resulted in the Commission's being given this authority.

I think that from your point of view, the greatest hope for sensible regulation is for the new Municipal Securities Rule Making Board to get involved deeply enough so that the private sector does relatively more in this area and the Commission relatively less.

As you know there are five bankers on the Rule Making Board. They are:

Richard F. Kezer, Senior Vice President
First National City Bank

Bert C. Madden, Senior Vice President
Trust Company Bank of Atlanta

Frank K. Spinner, Senior Vice President
First National Bank, St. Louis

David G. Taylor, Executive Vice President
Continental Illinois National Bank and Trust Company

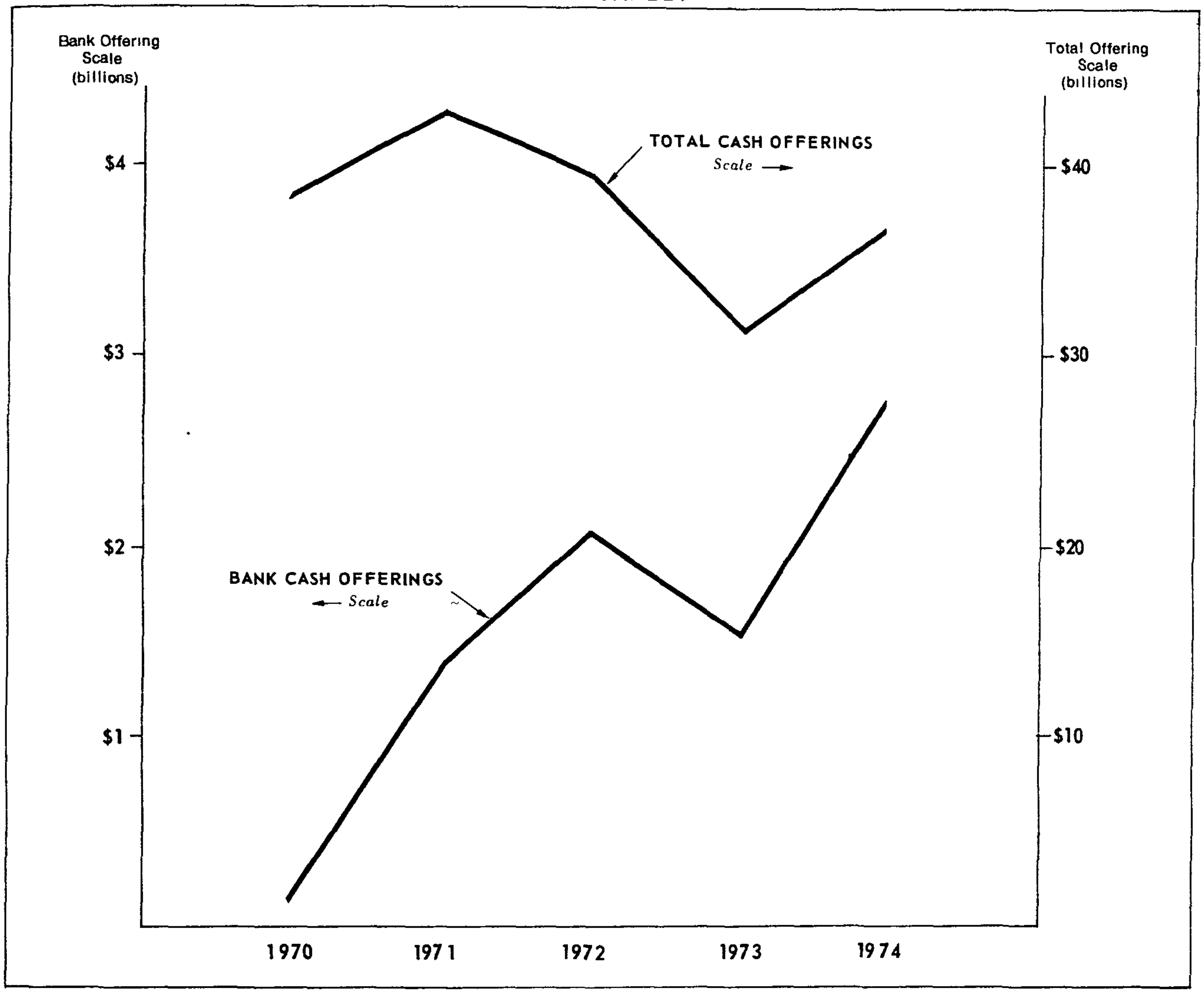
John R. Valla, Vice President
Investment Banking Group, Bank of America, San Francisco

The Commission is impressed and encouraged by the professionalism of the first steps taken by this group. The Commission's initial efforts will be working on the registration of municipal dealers and resolving the questions of when a bank itself must register and when it can be said that the bank has a separately identifiable municipal department.

ACHIEVING FULL DISCLOSURE

Bank holding company disclosure is the current Commission activity in which I suspect you have the greatest interest, since it vitally affects those of

CASH OFFERINGS BY BANKS HAVE INCREASED SUBSTANTIALLY



you who; one, are holding companies subject to Commission jurisdiction; and two, are thinking about going to the capital markets for funds. And, I should point out that the number of you who have these two characteristics has risen substantially over the last five years. Exhibit 2 compares the cash offerings of bank holding companies with the total cash offerings in the market, for each of the past five years. You will see that bank holding company offerings have gone from $132 million (a total of 26 offerings) in 1970 to $2.86 billion (a total of 130 offerings) in 1974. During the same period, total cash offerings oscillated around the $38 billion level. This means that the banks have gone from less than one half percent of capital raised to over 7 percent; their market share, therefore, has increased 14 fold.

The History of Commission Involvement

The Commission's recent involvement in this area began when a number of the accounting firms that audited banks expressed some concerns about the adequacy of disclosure, particularly disclosure of risk loan portfolios. The result was a great deal of study and discussion with the bank regulators and the recently released proposed guide for disclosure by bank holding companies.

The Commission staff worked quite closely with the bank regulators in an effort to make the disclosure called for in most of the areas similar to the figures reported to the bank regulators. For this reason, I think that much of the information asked for will not be troublesome. However, major questions remain in two areas as highlighted in the release.

Loan Portfolio Issues

The guide discusses three alternative approaches to disclosing information in two important loan areas: "non-performing loans" and "additional high-risk loans." For "non-performing loans," each alternative requires some disclosure of loans which, "are contractually past due 60 days or more as to interest and principal payments," or, "the terms of which have been renegotiated to provide a reduction or deferral of interest or principal." While all the alternatives require disclosure of the interest income lost, two require disclosure of the aggregate amount of loans in the category as well. The release asks that you comment on these two options.

For "additional high risk loans," two alternatives establish a category called "loans involving reasonable probability of non collectivity." These are defined as loans which, "in management's opinion, involve a reasonable probability that principal and interest, in whole or in part, may not be collectable." One alternative again requires disclosing both interest payments lost on these loans and their aggregate amount; the second requires disclosing only the aggregate amount.

The third alternative defines these additional risky loans more narrowly. This alternative creates a category called "loans involving expected losses" which are, "those outstanding loans which management has taken specific account of in computing its provision for loan loss reserves because of expected loss in whole or in part." In this case, both the aggregate amount of the loans and the interest lost must be disclosed.

Foreign Banking Operations

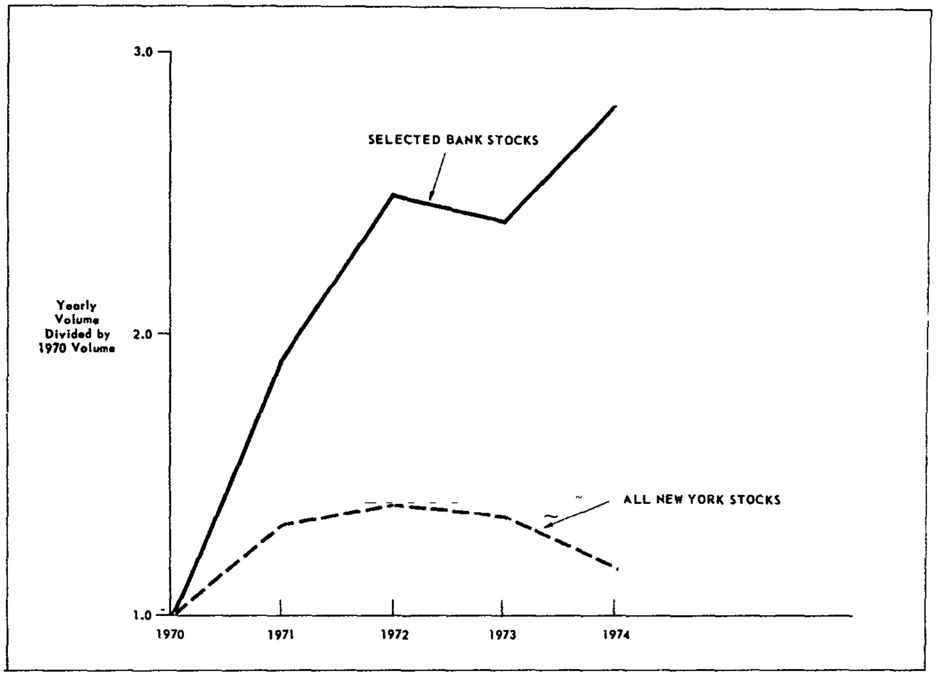
The guide also calls for a certain amount of disclosure of foreign banking operations, and comments are specifically requested on how foreign banking operations should be defined. Should they be "business transacted through foreign branches" or "business with foreign obligors or depositors whether through foreign branches or not" or something fundamentally different?

In both of these areas, I think that your comments would be very helpful. Comments are also requested on the cost of compliance; if you have strong points of view on this topic, please make them known as well.

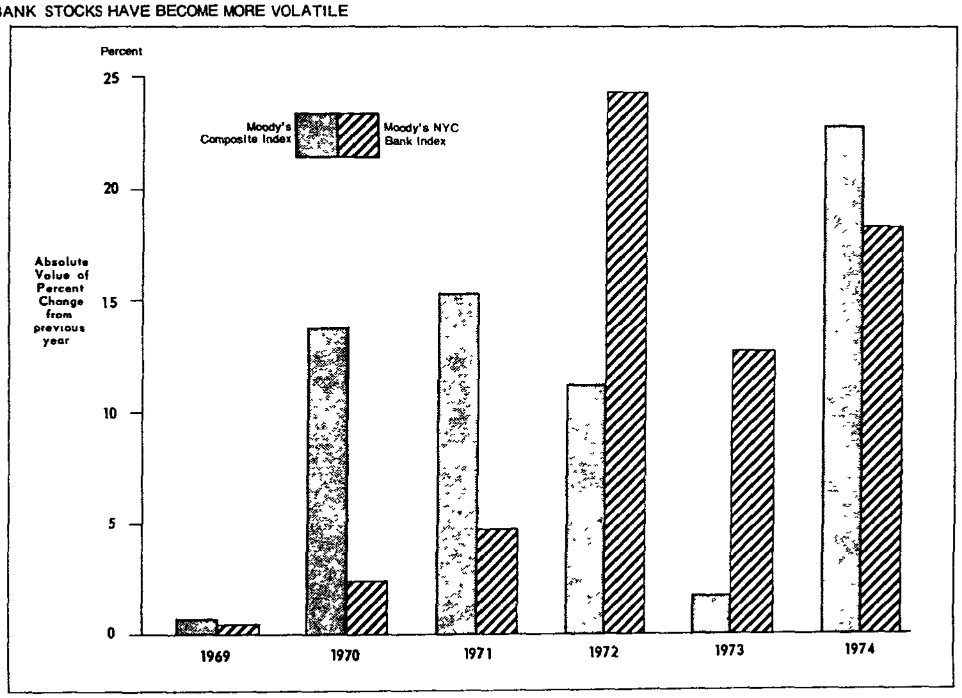
Increased Bank Stock Activity

If you are like most of the people with whom I have discussed this topic, I suspect you have a somewhat ambivalent reaction at this point. You are not really against "full disclosure" or "fair and orderly markets"; in fact, you are for them. And, however reluctantly, you probably will concede that the Commission has contributed to the historically outstanding success of the United States capital markets. At the same time, all of this new regulation probably sounds like an incredible administrative burden.

THE VOLUME OF BANK STOCK TRADING IS UP SUBSTANTIALLY



BANK STOCKS HAVE BECOME MORE VOLATILE



I don't really propose to try to talk you out of that feeling, because I think your arguments regarding the burden and practicality of the things the Commission does are valid. If you have such concerns, you should make them known in the most forceful way possible.

I do want to make one additional observation, which may further help explain why this topic has become such a hot one. That is, bank stocks have become a lot more important to investors over the last five years. Let me show you this in a couple of ways.

First, the trading in at least some bank stocks has increased substantially. Exhibit 3 compares the trading in five major New York banks with all New York Stock Exchange stocks. Trading in New York bank stocks has increased about three-fold, from 12.7 million shares to 35.9 million shares over a five-year period. Over the same period, overall New York Stock Exchange trading has gone up only 18 percent (from 3.2 to 3.8 billion shares) so that the banks' percentage of trading has gone from 0.4 percent to 0.9 percent.

Secondly, the bank stocks appear to become considerably more volatile. This is evident by comparing the Moody's Composite Index and the Moody's Bank Stock Index, both of which measure percentage change in value from one to the next year, as shown on Exhibit 4.

This chart shows the absolute value of percentage changes in stocks so, unfortunately, it does not indicate that there has been only positive stock movement over the past years. But you can see by comparing the shaded bars (the banks) with the solid bars (the stock composite) that from 1969 to 1971 the movement of bank stocks was very small compared with the movement of the market overall. In 1970, for example, when the market was down 14 percent, bank stocks were down only 2.4 percent. In 1971, the market recovered and rose 15 percent, while bank stocks rose only 4.8 percent. But in 1972 and 1973, the movement of bank stocks was far greater than the movement of the market. The market was up 11 percent in '72 and the banks up 24 percent. In 1973, the market was down 2 percent and the banks were up 13 percent. In 1974, when the market dropped a little over 20 percent, the banks almost matched the drop.

What these two factors - more new issues and increased price volatility - mean is that investors have a great deal more at stake in bank stocks than they did before. I think this adds to the sense of urgency of disclosing bank economics accurately to investors.

So much for the Commission's major activities involving banks and the reasons for them. I would like to move now into a much less precise area - those activities which seem to derive from what I contended was the Commission's third role.

FACILITATING EFFECTIVE CAPITAL MARKETS

Facilitating effective capital markets is a much more controversial purpose for the Commission; in fact, many Commission staff members argue vehemently that the Commission has no role at all in this area. But it is an indisputable fact that the agency is devoting a lot more attention to the question of capital market function; this appears consistent with the increased government-wide and country-wide concern with economics. finance, and the capital markets.

I suggested that the Commission has been involved in two specific activities relating to this objective which relate to the banks: the bank study and the new agency debate. Let me consider the first briefly and then introduce the second by talking briefly of some fundamental changes in the marketplace.

THE BANK STUDY

The Commission's bank study is one of two such studies which are currently being conducted. The other is planned by the Senate Banking Committee; you may have seen their 42-page outline. The Commission has set up a task force to work on what its study is going to encompass but it is still too early to say precisely what the study will look at or what might be concluded. So what I would like to consider is the question of why all this activity is going on. Why is there suddenly all this interest in the banks and the capital markets?

TRENDS CONCERNING BROKERS	IMPORTANCE OF BANKS
1. Institutionalization of the market	• Banks control more business
2. Unfixing of commission rates	• Banks market power unleashed
3. The capital shortage	• Banks are going to demand capital • Banks are more important to corporations
4. Increased inter-intermediary competitions	• Banks are huge • Economic environment is more favorable • Bank regulators are more supportive

One of the simplest reasons, I think, is that in most discussions, as soon as you start talking about capital markets, some one says, "You better look at the banks." If it is a broker talking, he goes on to say, "The banks are going to put us out of business, and that is bad." And I think exploring why brokers say this might yield some insights on the kinds of questions that will arise in the various bank studies and on the kind of things I think you will want to think about as you participate in this debate.

THE MAJOR MARKET CHANGES

It seems to me that what is really happening is that a lot of changes are occurring in the capital markets. Like almost all changes, these make participants in the process uncomfortable. More specifically, I think that a number of them do happen to involve the banks, and a lot of them do appear to increase the power of the banks. I have listed on Exhibit 5 the four major trends which seem to be of greatest concern to the brokerage industry. They are: the institutionalization of the market, the unfixing of commission rates, the capital shortage, and increased inter-intermediary competition.

I will discuss what I mean by each of these in a moment. The key point for today's discussion, I think, is that one of the effects of each change, at least superficially, can be argued as increasing the influence of the banks in the capital markets. I have listed the aspects of each trend which appear to increase bank power on the right-

STOCK HOLDINGS UNDER BANK INFLUENCE HAVE INCREASED SUBSTANTIALLY

	COMMON STOCK HOLDINGS ($ BILLIONS) 1967	1973	% CHANGE
Bank Influenced Investors	$ 157.9	$ 239.2	+ 51%
Other Institutional Investors	$ 69.9	$ 87.8	+ 26%
Individuals	$ 567.9	$ 550.6	- 3%

hand side of Exhibit 5. I will discuss each of them as we look very briefly at the trend itself.

Market Institutionalization

Institutionalization of the market, my first major trend, is so widely discussed that we do not have to spend much time defining it. As you know, commission brokerage fees make up 52 to 65 percent of New York Stock Exchange member firm revenues each year. What market institutionalization has meant to the brokers is that the identity of the customer that generates that revenue has shifted dramatically. New York Stock Exchange trading has flipped-flopped from 35 percent institutional, and 65 percent individual to exactly the opposite over the last ten years.

This is primarily because the holdings of institutions have increased substantially. I have rearranged some Commission data on equity holding to break out what it seems to me you can call "bank influenced" investors versus other institutional investors and individuals. As shown on Exhibit 6, I calculate that the holdings of bank influenced investors have grown from $157 billion in 1967 to $239 billion in 1973. (I have included non-insured pensions, personal trusts, state and local retirement funds, foundation endowments and educational endowment funds in this group. Obviously, banks do not control every penny of this money, but the magnitude of these numbers appears consistent with ABA estimates that bank trust fund assets have gone from $275 billion to $400 billion from 1968 to 1975).

The other institutions, primarily mutual funds and insurance companies, are quite small in comparison and their growth has been no where near as rapid. Individuals, the largest single group, have decreased in size; and, as you know, the trading rate of individuals is considerably lower than that of the other groups.

All of this means that banks have become far more powerful as consumers of brokerage business. Combined with the statistics looked at so far, it is fair to say that banks are a large and growing component of market activity and that they have considerably more influnce than they did ten years ago.

The Unfixing of Rates

The second major change, which is closely related to the first, is the unfixing of commission rates. As you know, the government has forced a very dramatic change on the brokerage industry through the unfixing of rates. The pricing decision is one of the most difficult decisions to be made in any business, and for 190 years the brokers did not have to make it. Over that period, the brokers whole method of operation has been based on assuming prices are fixed and adjusting services, merchandising and other elements of their business to provide effective non-price competition.

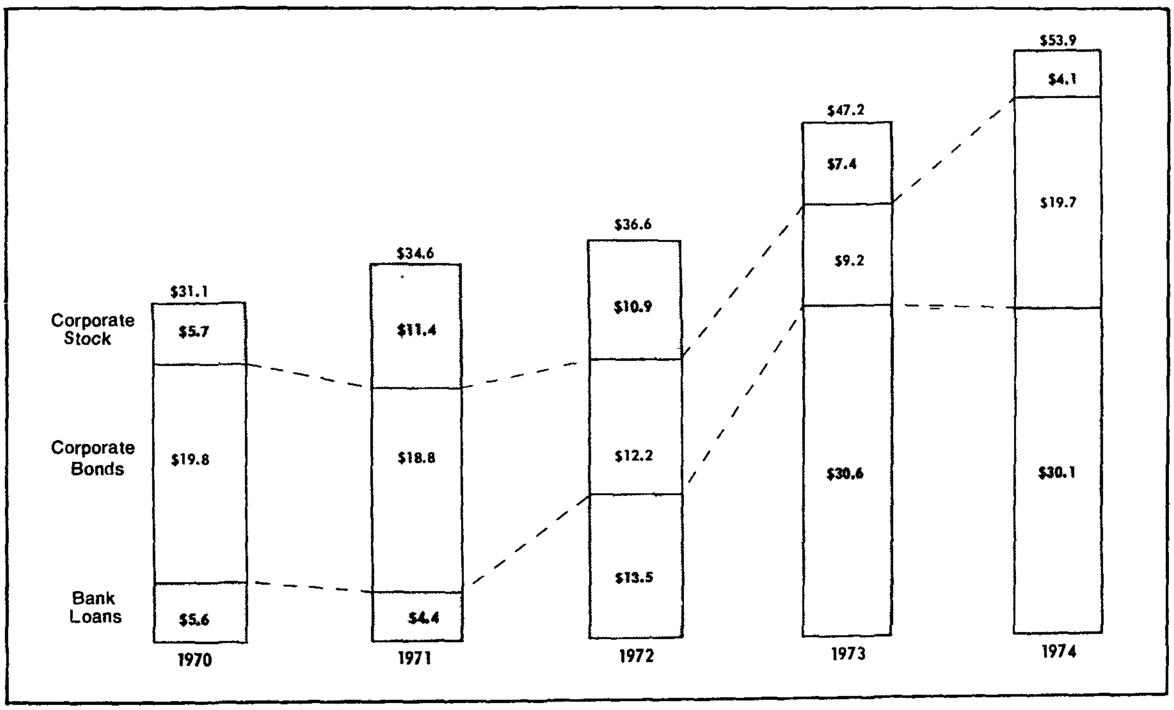
In terms of today's topic, the unfixing of rates mean that given their size and great importance as customers, the banks are now in a position to do some very tough negotiating regarding what they pay for the service they receive. The potential market power that comes from the size and growth rates already discussed are unleashed. Before, with no latitude to negotiate about price, the relative size of the seller of the service (the broker) and the purchaser of the service (the bank) had far less importance. The ability to negotiate does seem to make a difference, since institutional rates have gone down about 30 percent. This may not just be because of bank "power," but you will have trouble convincing the brokers of that.

The Capital Shortage

The third major trend, I think, is the capital shortage. There is no disagreement between banks and brokers as to the existence of a capital shortage. The New York Stock Exchange has suggested that there will be a $600 billion shortfall over the next 10 years. Chase Bank has been running ads with titles like "A Time to Cry Wolf." The big question this raises with the brokers, I think, is what the future capital markets will look like, and who will play what role in the underwriting activity of the future. This is a very important question to the brokerage community, since the broker's major source of income after commission revenues is underwriting, which makes up 10 - 15 percent of total income each year.

The relative importance of brokers and banks as suppliers of funds to corporations already has changed significantly, over the past

BANKS HAVE SURPASSED BROKERS IN PROVIDING CORPORATE FUNDS



five years. Exhibit 7 shows the size for each of five years of the three major external sources of funds: bank loans, corporate bonds, and corporate stocks. You see that bank loans have grown significantly; absolutely, they have gone from $5 billion to $30 billion: as a percentage of the total, they have grown from about 15 percent to over 50 percent.

If a capital shortage of anything like the dimensions being discussed develops, the problem of the securities firms' role as underwriters will almost certainly become far worse. The equity markets may very well dry up for a large number of companies, and bank credit will become even more important. This means that those companies which are looking for types of financing which either the banks or the brokers can provide for them, for example private placements, may well feel they have to go to the banks, because of the importance of retaining their good will. This could result in the situation which I think was very accurately described by Otto Eckstein, former Chairman of the Council of Economic Advisors, in a statement prepared for the Economic Summit Conference in the fall of 1974. He said:

> More fundamentally, a healthy capital market promotes the competitiveness of the American economy. If the current stock market situation were to persist, there would be increased concentration of the economy. The largest companies tend to be the most credit worthy and have the ability to stand at the head of the line at the lending windows of the large commercial banks. The banks would become as powerful as they are in Europe and Japan.

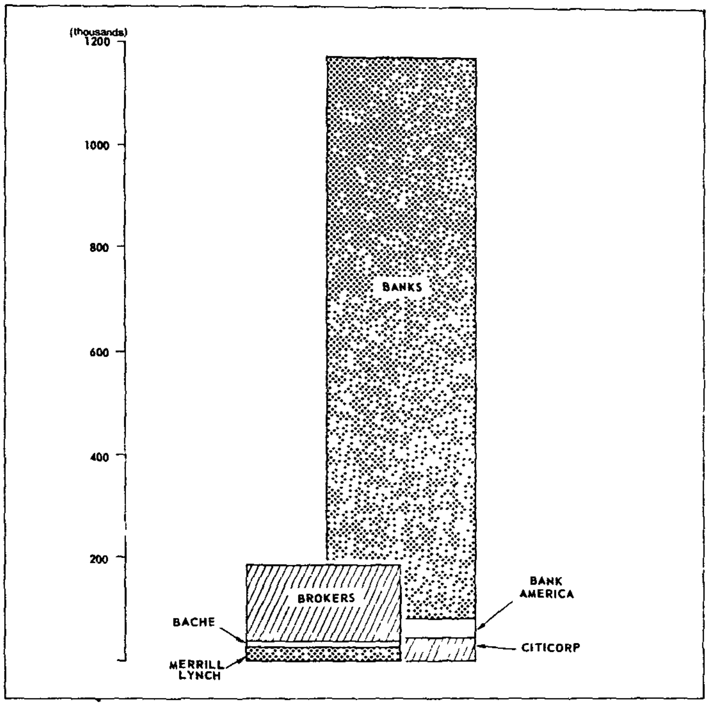
A NEW AGENCY TO MAKE INCREASED COMPETITION FAIR

I have very briefly reviewed three of the trends which I think have made the brokers increasingly nervous about the banks: institutionalization, unfixed rates and the capital shortage. The final trend I showed on my slide was increased "inter-intermediary competition"; I would like to spend a minute on this one for two reasons. First, I think that, in a way, this is the one that makes all the others so scary. Second, I think that this is the trend which has led to the "new agency" debate which I initially suggested as the final Commission activity affecting the banks.

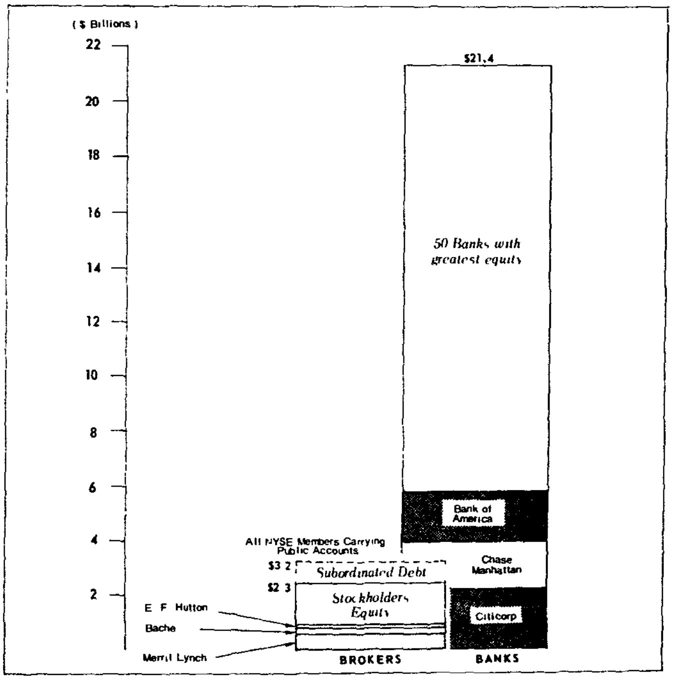
We are all aware that the traditional lines between the various classes of financial intermediaries have blurred substantially over the past years. Restrictions on services offered have lessened, and many aggressive financial service firms are constantly searching for ways to take business from the other guy.

I think that the brokers feel particularly vulnerable relative to banks in the newer, more open, competition. The trends discussed above are part of the reason for this. Let me quickly cite three other elements which I think concern the brokers: first, the banks are huge; second, their economic environment is more favorable; and third, the brokers view their regulators as more supportive. Reviewing these concerns will lead logically to my final topic, the new agency debate.

AND IN EMPLOYEES



BANK HOLDING COMPANIES DWARF THE BROKERAGE INDUSTRY IN STOCKHOLDERS EQUITY



THE SIZE OF THE BANKS

One could argue that any simple comparison of the size of brokers and banks is not really fair, because of the tremendous differences in the service mix of the two industries. But I think that the "David and Goliath" phenomenon is a little scary to the David, even if not all the resources of the big guy are devoted to fighting him. Obviously there are a lot more banks than there are brokers; roughly 14,000 versus 4,000. Accordingly, it is not surprising that the brokers people resources are considerably smaller than the banks. The left hand side of Exhibit 8 depicts Merrill Lynch with about 20,000 employees and Bache with 5,000. The 25,000 employees of those two largest brokers are considerably smaller than Citibank's 41,000 employees. And the total staff of the two brokers is only a third the number of employees of Citibank and Bank of America combined, which is 75,000. The disparity continues to apply when you look at the industries overall; the brokerage industry has about 180,000 employees, while the banks have over a million.

In the current environment, the availability of capital resources may be even more important than the availability of people; and comparison of the equity resources of the two industries is even more dramatic than the people resources. The left-hand side of Exhibit 9 shows the broker capital: Merrill Lynch has about $500 million of equity (these are 1974 figures); Bache and E.F. Hutton raise the total for the largest three to about $670 million. The rest of the New York Stock Exchange member firms carrying public accounts, which are by far the largest firms in the industry, raise

FAILURES ARE FEWER

	1970	1971	1972	1973	1974
BANKS					
Total FDIC Banks	14,199	14,294	14,436	14,676	14,968
Number closed for financial reasons	8	6	3	6	4
BROKERS					
Total SIPC Brokers	*	3,994	3,756	3,974	4,238
Number closed for financial reasons	*	24	40	30	15

* *Data not available*

the total to $2.3 billion in equity. Adding their "subordinated debt," an unusual form of capital, raises the industry figure to $3.2 billion.

In contrast, Citicorp's $2.2 billion is almost as large as the equity of the New York Stock Exchange member firms overall. Citicorp and Chase, with a total of $4 billion in equity, are considerably larger than the equity and subordinated debt of all New York Stock Exchange firms. And if you look at the 50 largest banks, you get an equity figure seven times that of the brokerage community. Based on this, it is not hard to understand why competition looks a little rough.

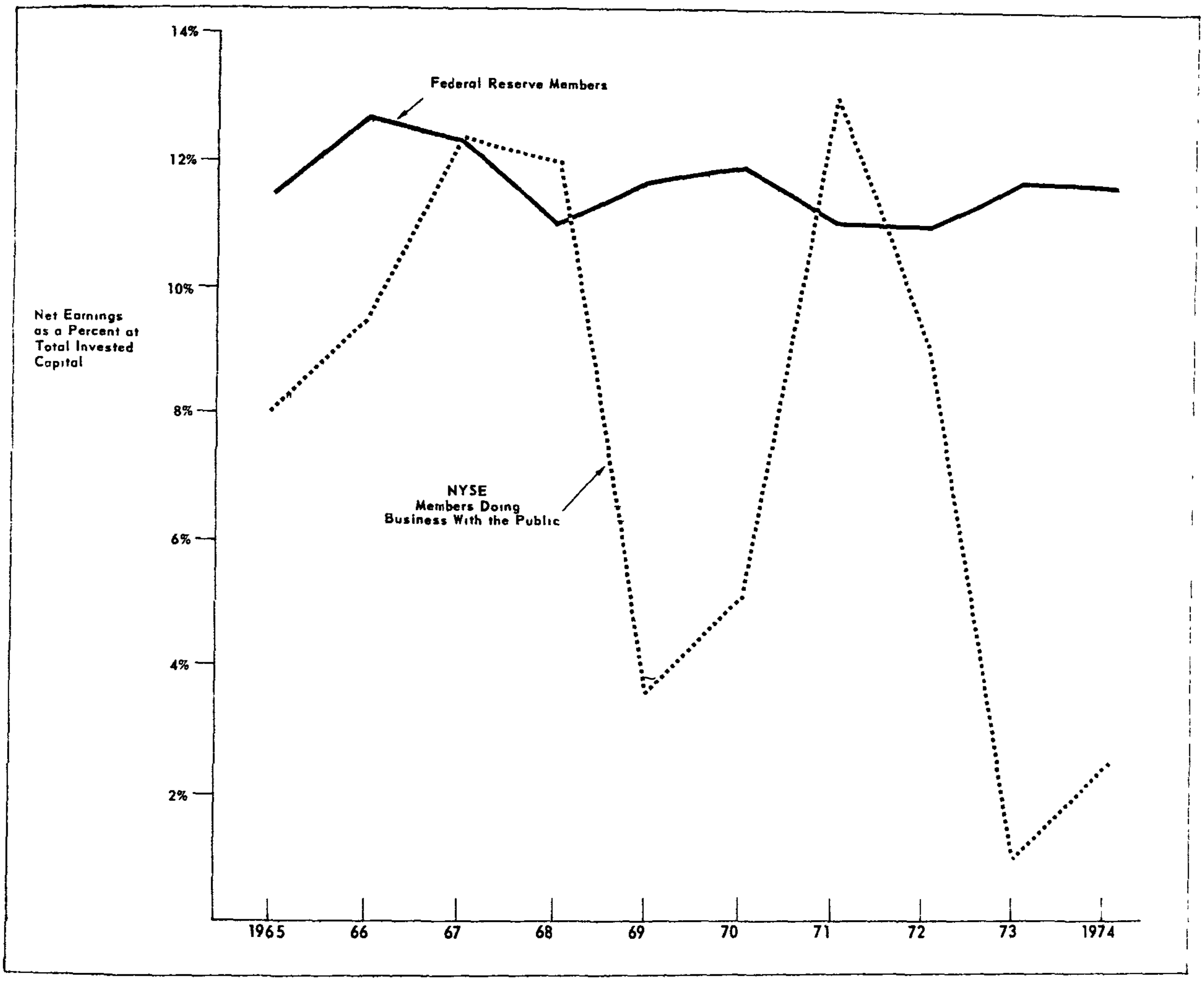
BANKS EASIER ENVIRONMENT

There is a second argument which we hear from the brokers so frequently that it gets a bit repetitious. This argument is that the banks operate in a far easier economic environment than the brokers. To some extent this belief may just be based on a "grass is greener" outlook; but if you look at the numbers, it does appear there is some basis for this statement. Let me present three interesting facts; the failure rate of banks is far lower than that of brokers, second, their income appears to be far less volatile and, third, tax rates appear to be more favorable.

The Rate of Failure

Exhibit 10 compares Federal Deposit Insurance Corporation statistics on the number of banks closed for financial reasons with

BANK EARNINGS ALSO ARE LESS VOLATILE



Securities Investor Protection Corporation statistics on brokers closed for the same reasons. Over the last five years, the FDIC has had an annual average of 14,516 banks registered with it each year. The annual number of failures has averaged 5.4 and aggregated 27 over the five years. The aggregate number of failures, therefore, is less than two-tenths of 1 percent. SIPC, which is the brokerage equivalent of the FDIC, has had an average of 3,990 brokers registered with it in each of the 4 years since its creation. It has had an average of 27 failures a year, or an aggregate of 109. In other words, the aggregate percentage of brokers failed for financial reasons is 2.7 percent over the 4 year period. This is a failure rate 14 times as high as that of the banks.

Stability of Earnings

It seems almost certain that one of the reasons for this difference in the rate of failure of banks and brokers is the terrific difference in the volatility of earnings experienced by the two communities. I have attempted to illustrate these differences on Exhibit 11. This exhibit should be viewed as showing patterns of change rather than absolute levels, since developing the brokerage firm numbers require several heroic assumptions. However, the pattern shown of the brokers is essentially correct. The bank figures are fine; they come directly from the Standard and Poor's survey.

The exhibit shows that the banks have an average annual after tax return on total invested capital of 10.5 to 13 percent over a five-year period. Over the same period, the brokers ranged from a high of 15 to a low of 1 1/2. And the difference in the volatility is incredible. The average annual percent change in after tax earnings for the banks was 5.7 percent; for the brokers it is really striking 67.4 percent.

This kind of economic uncertainty, makes the brokers planning - and competing - very difficult.

Differing Tax Rates

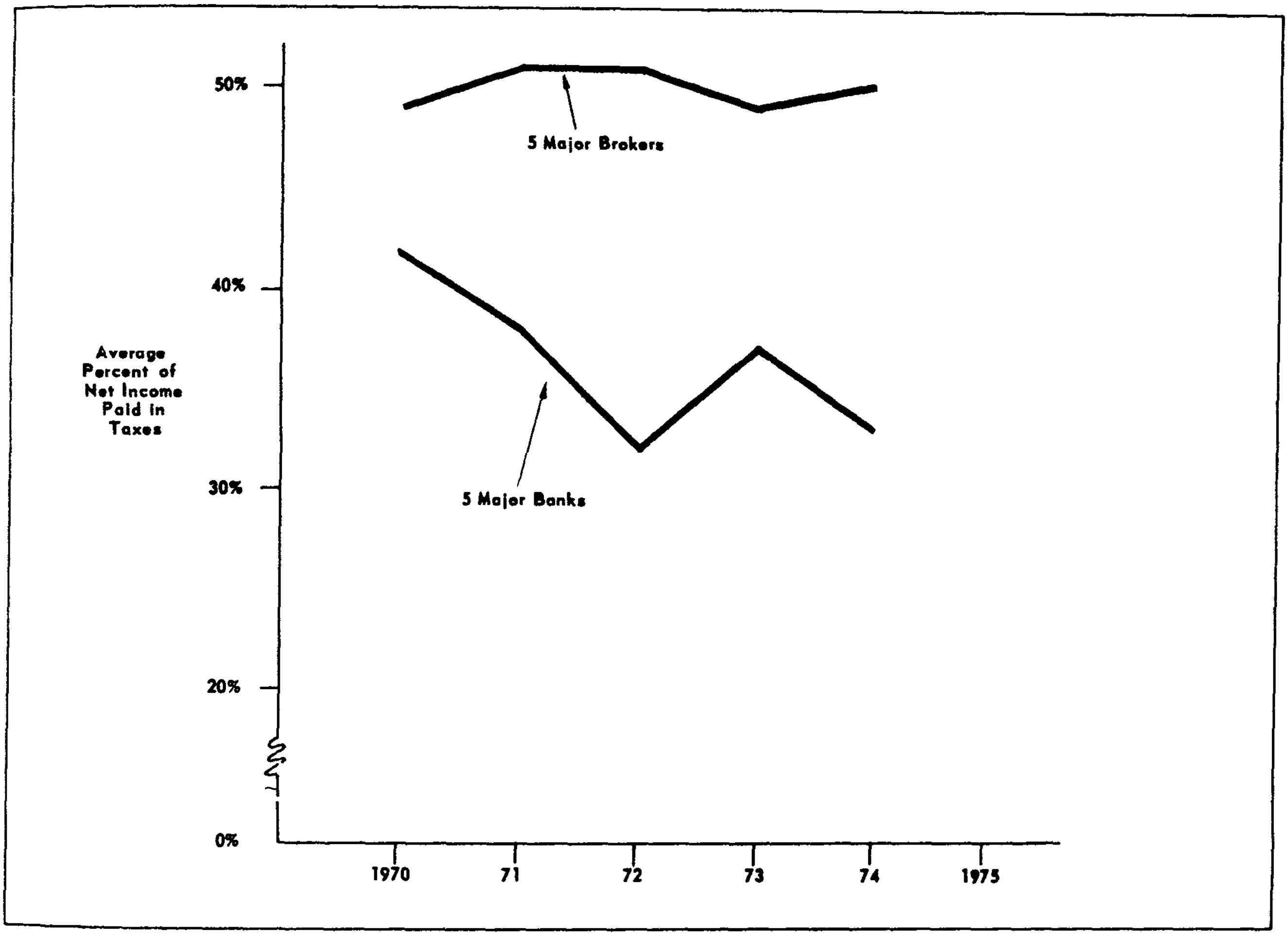
The final point is the tax rate, and again, this is one about which the brokers feel very strongly. Let me quickly suggest the basis for the concern by showing some figures developed from the annual reports on five major brokers and five major banks (Exhibit 12). It appears that the effective tax rate, as a percentage of net income, has been considerably lower over the last five years for banks than for brokers.

There are a series of reasons for this difference. The major of these is the significant municipal. state, and local debt instruments held by banks. But, once again, to the broker it looks a bit unfair.

DIFFERENT REGULATORY PHILOSOPHY

We could argue for weeks about the accuracy and implications of each of these comparisons. But I think most objective observers would agree that, in aggregate, they do suggest that "something is

EFFECTIVE TAX RATE IS LOWER ON BANKS THAN BROKERS



different" when you look at the numbers on the two communities. Historically, it might have been explained simply by the fact that the businesses were different. Banks were less risky, more conservative - less businessmen than trustees of savings and assets. Brokers are more high fliers, and riskier - entrepreneurs with earnings patterns more consistent with a boom-and-bust approach to business.

But if the emerging public policy is to minimize the differences between the two, take off the wraps and allow more competition, this historical explanation is no longer sufficient. And in this context, the final point I want to make is that many securities industry people feel that one important reason for the historically easier economic environment of the banks is the difference in the regulatory attitude which the government takes toward banks and brokers. Some brokers believe that your regulators are more sympathetic towards your economic conditions, and some also believe that this constitutes unequal unfair regulation.

It is this perceived difference which led two years ago to the suggestions for a new regulatory agency; and this is what I meant when I referred on my first slide to the "new agency debate."

This debate really is not alive today partially because it never generated much interest at the Commission. But I think some of the points made in it are interesting and helpful, in thinking about the appropriate focus of regulation in an environment of expanded competition.

I can highlight the major points of the debate by quoting some of the comments made by the industry over its course.

As noted, the argument begins with the feeling that somehow the Commission is fundamentally antagonistic towards brokers and, by extension, towards the capital markets. One particularly articulate senior industry official said:

> The SEC because of the nature of its orgin and its legislative mandate, feels quite properly that it must assume the role of an adversary rather than an agency dedicated principally to the improvement of the nation's capital markets.

Now, obviously, the commentator thought that this was the wrong focus, and that the Commission should be more supportive. The proper focus was suggested by the statement that:

> The SEC should start with the premise that as a matter of national policy the capital markets of the United States must continue to be developed and improve; that broad public ownership of equity securities should be fostered; that the economic function of the securities industry must be preserved and enhanced; that the securities industry should consist of soundly capitalized independent underwriters, marketmakers and brokers, whose primary obligation is to act as professionals serving the public interest; and that all securities markets should be subject to comparable disclosure and regulation.

The brokers feel that other regulated industries have been dealt with in a more supportive manner. The statement was made that:

> Other industries imbued with similar essential public interest characteristics operate under statutes designed to develop and improve the functioning of those industries. The commercial banking system for example, having been determined by Congress to be affected with a public interest, looks to Government agencies to foster their growth and development. The Federal Reserve Board and the Comptroller of the Currency seek to insure the solvency of the banks. Banks do not look upon their regulators as adversaries.

At another point in the debate, one individual was, in fact, rude enough to make specific reference to the differences.

> In the area of preventing fraud, I can't help but compare the SEC's normal response to a Weis Securities or a duPont-Walston situation, in which the Commission is prone to charge out like gangbusters, whistles blowing shrilly, with the Federal Reserve Board's measured reassuring comments and actions in the recent Franklin National Bank situation.

Now having reached this conclusion, some of the commentators were led to question whether or not the Commission can change its spots. As one said:

> Let me hasten to say that I can see no way for the SEC to play a constructuve role in the solutions of the problems that I have described until it visualizes its principal role to be that of improving the nation's capital markets, rather than as a constant adversary and critic of our corporate issuers and of our securities industry.

This is the logic which leads to the suggestion that there is a need for a new equity market regulatory agency. The same commentator then said that:

> To meet this problem, I would propose the creation of a new Federal agency or public corporation to be called the Federal Capital Markets Board, whose five governors would be full time public members appointed by the President of the United States with the approval of the Congress for 10 year terms, similar to those of the Federal Reserve Board, and which Board would report regularly to Congress.

My own private sector experience with commerical banks leads me to believe you will be a little amused to find that others see your regulators as such great benefactors. Again, it may be that all that this argument is based on is the standard "grass is greener on the other side of the fence" belief. But it may also be that there are differences in the objectives and focus of regulation which should be explored. It seems to me that this debate raises fascinating questions as to whether fundamental changes are needed in regulation if the battlefield of competition is to be fair.

SUMMARY

Now what to conclude from all of this? Again I apologize for my length. My problem is that I find the topic so fascinating. I think three conclusions are evident:

(1) The Commission has picked up responsibility for some involvement with day-to-day activity of banks through its traditional full-disclosure and fair-and-orderly markets functions and that banks and the Commission will have to work together to try to make that involvement as effective and unburdensome as possible. I think the Commission is sensitive to the danger of being overburdensome.

(2) I think that when you look at the broader question of how the capital market works it is evident that the bank's role is increasingly important and at least some people feel there are fundamental differences in its objectives and execution of regulation which should be standard as relative roles of various financial intermediaries and the new capital markets emerge.

(3) All of this, I suspect, means that a lot of attention will be given to these topics by all of us over the years ahead.

Thank you very much. I hope we can continue the dialogue.