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BANK PARTICIPATION IN SECURITIES ACTIVITIES

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I appreciate the opportunity to participate with you in this Practising Law Institute program. The topic--"Banks and the Securities Laws"--is particularly timely considering the amount of attention presently being given by Congress and federal regulatory agencies to bank activities, the securities markets, and the scope of the securities laws.

I have noticed the suggestion that banks be subject to federal securities laws and SEC regulation tends to arouse particularly strong feelings. This is a natural reaction. Nobody desires additional regulation, and banks are already heavily regulated by governmental agencies. I had a somewhat similar reaction when I awoke at 3:00 a.m. this morning (6:00 a.m. Washington time) and could not sleep. I was regulated by California time last night in retiring and by Washington time in awaking. Before the day is over, I am sure I will feel quite unhappy about this overlapping, dual regulation.

The analogy is not a perfect one, but it seems obvious to me that if I were to continue activities in this area, I would be required to adjust to the rules, regulations, and standards existing here. I believe the same is true of bank

participation in securities activities because the Securities and Exchange Commission has a major responsibility with respect to bank activities under the securities laws. Before going further, I should point out that my comments here today do not necessarily reflect the views of the Commission nor any of the other Commissioners.

During the 8½ years that I served as a staff member of the Senate Committee on Banking, Housing and Urban Affairs before coming to the Commission in March of this year, I devoted a considerable amount of time to banking and securities issues. One of the most important matters that came before the Committee during that time was the 1970 legislation amending the Bank Holding Company Act of 1956. As you may recall, a major issue in that legislation, which was finally resolved only after a protracted and difficult conference between the Senate and House Banking Committees, was whether commercial banks should be prohibited from engaging in certain activities referred to as a "laundry list". There were a number of persons who advocated this strait jacket approach to banking. Travel agents, courier and

armored car services, insurance agents, data processors, accountants, and leasing companies, to name a few, attempted to influence the legislation so that it would prohibit banks from offering competing services. It is interesting to note that, at the same time, municipalities were lobbying to obtain legislation which would allow banks to underwrite revenue bonds. This attempt was, of course, strenuously opposed by investment bankers.

The legislation enacted by Congress did not specifically define appropriate banking activities but instead reflected the continuation of a policy, which has existed since before the enactment of the National Bank Act of 1864, permitting banking to be evolutionary and dynamic within certain guidelines. As a staff member of the Senate Committee, I worked with those who obtained that result, and I continue to support that position.

Absent a strict prescription of permissible activities, it is only natural that banks would seek to expand their services in areas where management feels they can profitably offer a wider range of financial services to customers or

where such services may attract new customers and thereby increase profits. This competition with other financial institutions, in my opinion, is desirable, as long as it does not lead to anti-trust problems, involve unacceptable conflicts of interest or jeopardize bank safety and solvency and, perhaps most important from the vantage point of the Commission's regulatory perspective, as long as this bank competition is not fostered at the unnecessarily high cost of sacrificing needed investor protections and safeguards applicable to competitors vying for the same investment dollars.

Against the background of a decade of problems with bank solvency and certain conflicts of interest, Congress enacted the Glass-Steagall Act of 1933 to draw a line between commercial banking and investment banking activities. That Act prohibits banks from underwriting and dealing in securities except for U. S. government or agency guaranteed issues and municipal obligations which are guaranteed under the full faith and credit of the issuing municipality. On the other hand, the Act allows banks to effect other securities transactions solely to accommodate orders of customers. Apparently, because banks were prohibited from engaging in the securities business, with some exceptions,

Congress exempted them from various regulatory provisions of the Securities Exchange Act of 1934. Banks are also generally exempted from the registration provisions of the Securities Act of 1933, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

Notwithstanding these statutory prohibitions and exemptions, commercial banks are presently engaged in a variety of securities and investment activities in direct competition with members of the investment banking and securities industries. There have been serious questions as to whether the line drawn by Congress between commercial and investment banking permits these activities or whether the line has become so eroded that it is completely illegible. In any event, the split jurisdiction between the bank regulatory agencies and the Commission over persons offering similar or competing services may result in unequal regulation and thus unfair competition. Competition in some activities specifically authorized by the Glass-Steagall Act has existed for many years, but other forms of competition are emerging because of a more aggressive attitude on the part of commercial banks to offer one-stop, full, financial services.

In the more traditional areas of competition, the Commission is concerned with (1) the underwriting of municipal bonds; (2) the investment management activities of bank trust departments; and (3) the custodial services for securities such as those provided by transfer agents and depositories.

The Commission's interest in the municipal bond area arises in two different contexts. We are concerned with the absence of appropriate regulation in connection with the underwriting of and after-market trading in municipal bonds by both bank and nonbank dealers. As you all know, municipal bonds are presently exempt from registration under the securities laws and firms which deal solely in such securities are exempt from registration as broker-dealers. We also have an interest in the proposal that banks be allowed to underwrite revenue bonds in addition to their present authority to underwrite general obligation bonds of municipalities.

During 1971 and 1972, the Commission discovered through its investigations that there were numerous abusive sales practices, including outlandish misrepresentations, excessive markups, and boiler room tactics being utilized to sell municipal bonds to the public. In October of 1972,

the Commission filed its first enforcement case against a municipal bond dealer in Memphis, Tennessee and made the term "Memphis Dealer" into one of the better known phrases of last year. The extent of these practices clearly demonstrates the need for comprehensive regulation of municipal bond underwriters and dealers.

The Commission has approached this problem in two ways. We have continued our vigorous enforcement program leading to additional allegations of fraud against dealers in municipal securities. Two of our more notable actions involving First U. S. Corporation and Paragon Securities Co. are currently before U. S. district courts. In addition to our enforcement activities, the Commission directed a thorough examination of the policy implications of undertaking appropriate regulatory measures in this area.

As part of this examination, the staff has been in continuous contact with leaders of the securities industry and with a broad cross section of dealer bank officials in order to better understand the municipal bond industry and to determine what form regulation in this area should take. The staff, as well as members of the Commission, have met with individuals representing the different segments of the

municipal bond industry. At the request of Senator Williams of New Jersey, the Commission's staff drafted legislative language last month to establish a regulatory framework over municipal bond activities.

Although no definite date has been set, hearings are expected by the Senate Committee on Banking, Housing and Urban Affairs later this month on legislative proposals providing for regulation of those dealing in municipal securities as well as authorizing banks to underwrite revenue bonds. The subjects of these hearings will be S. 1933, introduced by Senator Proxmire, which amends the Glass-Steagall Act of 1933 to permit commercial banks to underwrite revenue bonds, and S. 2474 introduced a week ago by Senator Williams. The most controversial provision of the Williams bill is an amendment to the Securities Exchange Act of 1934 establishing the Commission as the federal agency with full regulatory and enforcement jurisdiction over bank municipal bond activities. The bill also provides for, but does not require, the creation of a new self-regulatory body for municipal securities dealers under the Commission's jurisdiction. All bank and nonbank dealers in municipal securities would be required to be members of a self-regulatory association or

be subject to comparable rules promulgated by the SEC. In my opinion, this approach provides the Commission with adequate authority to assure equal regulation of bank and nonbank dealers in municipal bonds without affecting other banking activities. There is some concern at the Commission, however, over the possible development of a multiplicity of self-regulatory organizations.

The second area of traditional competition with which the Commission is concerned is the investment management activity of bank trust departments. Bank trust departments are the largest of institutional investors with assets in excess of all other institutional investors combined. I understand that a joint report of the Federal Reserve Board, the F.D.I.C., and the Comptroller of the Currency, entitled Trust Assets of Insured Banks-1972, which is to be released in a few days, will indicate that total trust assets of insured banks were nearly $404 billion at the end of 1972. The impact of this purchasing power in the market, in addition to that of other institutions, directly affects 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 equity markets. Justly or unjustly, banks have been widely 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 some cases, below book value.

There is no doubt that the activities of trust departments have contributed to the institutionalization of the securities markets. Institutional trading patterns have impacted on the liquidity of the securities markets so that major institutions are sometimes unable to buy or sell large blocks of securities without an adverse influence on the price. The allocation of capital has also been sharply affected. Many smaller companies with good prospects find equity financing very difficult, if not impossible, to arrange

and are thus hampered in expanding and modernizing their facilities to meet competition.

Before the Commission can help resolve these problems, we need a greater understanding of institutional trading. Last July, Senator Williams requested the Commission to submit legislation which would require disclosure of institutional holdings and trading in securities. The Commission responded by submitting a draft bill with the caveat that it did not reflect the Commission's final position and indicated that further consideration of certain issues was needed. On July 23, Senator Williams introduced S. 2234, entitled the Institutional Investor Full Disclosure Act, which embodied some of the provisions contained in our draft. S. 2234, however, also contained some significant changes which, in my opinion, may impose a reporting burden which is not commensurate with the public interest to be served. The Commission is now formulating its own proposal to resolve this issue and will soon produce a bill reflecting our best thinking.

As you know, some responsible parties are recommending that restrictions be placed on institutional trading and holdings. I am opposed to the imposition of any arbitrary

or artificial restrictions at this time, and I am sure the Commission will not recommend or support legislation for that purpose.

I do believe, however, that we should have legislation requiring all institutional investors (banks, insurance companies, pension funds, broker-dealers and all other money managers) with investment discretion over assets of $100 million or more to report their holdings and each equity securities transaction exceeding a specified dollar amount. Furthermore, the Commission should be granted flexibility to adjust these levels up or down through rule-making with proper notice and opportunity for expression of views as we gain experience. In this way, the need for institutional reporting may be properly balanced against the potential burdens upon respondent institutions.

As another area of concern, the Commission has always had reason to be interested in the securities custodial functions performed by banks. Banks handle most of the transfer agent work and are important participants in securities depositories. Traditionally, the Commission has exercised authority over depositories because they have been affiliated with self-regulatory bodies under the

Commission's jurisdiction. Recently, however, some depositories have been reorganized as trust companies in order to satisfy bank fiduciary requirements with respect to the safekeeping of securities under their control.

In view of our expectation that physical movement of stock certificates between securities processors will be virtually eliminated in the future, depositories will have a critically important role in our future markets. It is essential, therefore, to assure that these entities have appropriate standards of access and performance and that a workable interface between all securities processing organizations is implemented throughout the nation. For these reasons, the Commission believes strongly that it should establish the rules and regulations relating to both bank and nonbank transfer agents and depositories.

A bill to regulate transfer agents and depositories, S. 2058, has been passed by the Senate. That bill, as well as a House bill, H.R. 5050, is presently under consideration by the House Committee on Interstate and Foreign Commerce. The major point of controversy between these two bills is the proper division of regulatory responsibility between the SEC and the bank regulatory agencies. The Commission,

in testimony before the Congress, has recommended a middle ground providing for primary regulation by the Commission with cooperation and coordination between the Commission and the banking agencies. I believe the final Congressional decision will reflect the Commission's position.

In addition to these traditional areas of competition which I have discussed, I would like to comment briefly on other more recent bank activities on which the Commission is presently focusing its attention.

In 1968, the First National City Bank of New York began to offer an innovative dividend reinvestment service to corporations permitting shareholders to have the option of reinvesting their cash dividend checks automatically in the corporation's stock. Soon banks were also permitting shareholders to contribute to the bank additional cash which would be invested in the securities of the issuer along with the cash dividend. Another development was to permit shareholders to deposit securities of a different class issued by the same corporation, and the dividends from these securities would also be reinvested in the common stock of the issuer.

Up to the present time, the Commission and the staff have 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, the offering of these investment programs may raise questions as to the need for the 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.

Following the development of the dividend reinvestment service, in line with the one-stop financial service concept being promoted by commercial banks, it was perhaps natural that the next step would be a broader investment service in equity securities. That service, which was first introduced last May by the Security Pacific National Bank, is now well known as the automatic stock purchase plan being offered by banks to checking account customers and to the general public.

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 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 since the service only involves purchases for the account of customers and not for the bank's own account and does not involve the issuing, underwriting, selling or distributing of securities, it was consistent with the 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 indicated it would not recommend any action to the Commission if the plan was not registered under the Investment Company Act. However, the staff also warned the bank 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 informal advisory letters of the staff 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.

Perhaps equally important, if not more important than the question of strict legality of these plans, 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 should be 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 and the Investment Company Institute have requested the present Comptroller of the Currency, James E. Smith, to reconsider the ruling of his predecessor that automatic stock purchase plans are appropriate and legal activities by national banks. A few days ago, in hearings before the House Banking and Currency Committee, it was again suggested that a "laundry list" of activities in which banks may not engage be established. It now appears that if the ruling of the Comptroller is not rescinded, these bank plans will be the subject of either litigation or legislation, or possibly both. To understand the strong feelings of the securities industry, it might be well to recall the reaction of the banking community to the negotiable orders of withdrawal (NOW Accounts) offered by savings banks in Massachusetts and New Hampshire in competition with commercial bank checking accoun

The so-called "mini-account" service is another 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. 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 investment among clients existed.

The Commission's Advisory Committee on Investment Management Services for Individual Investors recommended that the Commission reconsider its approach to discretionary account management arrangements. There seems to be little question that further consideration is necessary.

I have commented briefly on some banking activities involving securities. The balance of this program will provide an opportunity to further discuss these and other issues. Such issues are important to the Commission because it has been delegated responsibility by Congress to administer

the securities laws and to prescribe rules and regulations for the protection of investors, to provide full and fair disclosure in the interstate sale of securities, and to insure the maintenance of fair and honest securities markets. We have no interest in expanding this Congressional mandate into banking or any other area of activity not involving securities. We do, however, have an obligation to fulfill completely our statutory responsibility, and we feel that persons competing in the securities markets should be subject to equal rules, regulations, and enforcement standards.