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COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, DC 20515

August 4, 1986

Hon. John S.R. Shad
Chairman
Securities and Exchange Commission
Washington, D.C. 20549

Dear Mr. Chairman:

We were very pleased to receive your testimony on Glass-Steagall issues at our July 23 hearing, and I want to thank you again for the extensive background data your staff prepared for us. As I indicated at the hearing, I have a number of further questions, which are presented below. I am sorry we did not have time to cover these in the hearing, but we shall include your written responses in the hearing record.

UNDERWRITING RISK

1. Commercial Paper Risk: Your testimony generally emphasized the riskiness of corporate securities underwriting and market making. Do you consider commercial paper underwriting and market making to entail as much risk as underwriting and making markets in registered corporate debt securities? On what factors do you base your conclusion?

2. Diversification of Risks: In your testimony you emphasized the riskiness of securities underwriting and securities brokerage and questioned whether it would be wise to permit banking organizations to engage in such a risky line of business. Advocates of extending broad underwriting powers to banks argue, however, that bank expansion into underwriting and brokerage activity, which may be risky when considered in isolation, will not necessarily increase the overall risk for a banking organization as a whole. This argument relies on the diversification principle, that expansion into risky activities that are not closely correlated with the other risks undertaken by the corporation need not increase overall corporate risk and may even reduce it. Do you disagree with this position on the role of diversification? What significance do you attach to the role of diversification of risks in judging the extent to which broad underwriting authority would increase the risks to banking organizations?

3. Insulation of Bank: If underwriting activities are not permitted within banks but are strictly confined to separately capitalized subsidiaries of bank holding companies, then the riskiness of the underwriting activities need not be of concern if the bank is effectively insulated

from its securities affiliates. Is it your position that such insulation would not be effective, and that the risks could not be confined just to the securities subsidiary and the holding company parent but would also affect the bank?

4. Risk of Insolvency and the Role of Capital: Public policy concern regarding risk in banking extends primarily only to the risk of bank or holding company insolvency, I believe, and not to earnings volatility per se. Increased volatility of earnings, such as might arise from expanded underwriting activities, could affect the risk of holding company failure, of course, but this effect could also be offset, presumably, by an appropriate increase in holding company capital. What is your position on the feasibility of compensating for the riskiness of expanded underwriting activities in banking organizations through some form of enhanced capital requirement?

COMPETITIVE ISSUES

5. Concentration of Power: One of the principal justifications for the Glass-Steagall Act originally was to prevent excessive concentrations of power in the hands of a few banking institutions, who might otherwise have had almost a stranglehold over the financial affairs of major corporations. Do you see that as an issue today, or have financial markets developed to such an extent that concentration of power is no longer a significant concern?

6. Product Tie-ins: From a corporate marketing point of view, an important advantage of being permitted to conduct a wider range of financial services within a single corporate organization is the potential for joint marketing or "packaging" of several products. Such "packaging" can also lead, however, to abusive tying practices, where customers are pressured or compelled to purchase some unwanted product or service, or a product or service for which they wish to shop independently, in order to obtain another product or service they need.

a. How serious a problem are abusive tying practices currently in the securities industry, and how does the SEC address such abuses? (Please cite concrete examples where relevant.)

b. To what extent does recent experience in the securities industry suggest a significant danger of such problems arising in banking firms if broadly expanded securities powers are granted to the banking industry?

7. Conflicts of Interest: In diversified financial firms there is always the potential for abusive practices, either through the improper exchange of privileged customer information or the improper use of customer funds, where the interests of certain customers conflict with the interests of other customers, the firm itself, or its employees. Such abusive practices arising from conflicts of interest, if not effectively controlled, can seriously impair the fairness and efficiency of competitive markets and may potentially threaten the safety of individual firms.

a. In the securities industry, how are such conflict-of-interest abuses currently controlled, and what are the respective roles of SEC enforcement, actions of the self-regulatory organizations, and competitive market forces in controlling such abuses?

b. Do you see any fundamental problems with relying upon this same combination of regulatory enforcement and private sector controls to limit the conflict-of-interest abuses that could potentially arise in diversified financial firms if the securities underwriting and other investment banking powers of commercial banking firms are substantially expanded? In other words, would substantial relaxation of the Glass-Steagall restraints on banking firms' securities activities create any serious potential for intractable conflict-of-interest abuses that could not be effectively controlled by appropriate application of the same combination of regulatory enforcement and private sector controls that is currently employed in the securities industry?

8. Ease of Entry: During the hearing you stated, in response to my questions about the probable competitive effects of permitting banks to underwrite corporate debt securities, that corporate debt underwriting is a market with great ease-of-entry.

a. Does this characterization apply, in your opinion, to entry into the top ranks of underwriters, with a capacity to act as lead or managing underwriter of large corporate offerings, and thereby to compete directly with the 5 or 7 largest current underwriting firms?

b. What are the main requirements for entry into the business of managing large corporate security offerings?

c. Does the ease of entry to which you referred imply that large commercial banking firms, which are currently excluded from this market by Glass-Steagall, do not appear to possess any inherent advantages - as compared with numerous other possible entrants - in terms of the financial and human resources they could draw upon as a base for entering this business?

FUNCTIONAL REGULATION ISSUES

9. Dividing Line Between Banking and Securities Functions - General Rule: The concept of functional regulation, which you have consistently supported, can not be applied comprehensively to banking firms engaged in various forms of securities activities unless there exists a clear natural division - or unless a workable arbitrary division can be established - between banking functions and securities functions. If the present Glass-Steagall restrictions are substantially relaxed in the future, by what general rule or principle do you believe the specific activities of diversified financial firms should be classified as either banking functions or securities functions for regulatory purposes?

10. Dividing Line - Specific Activities: How do you believe each of the following activities should be classified, in terms of whether they should be treated under functional regulation as banking functions, subject to banking agency oversight, or securities functions, subject to SEC oversight:

a. Brokers' handling of customers' cash balances which, although generally structured as money market mutual fund investments, in essence represent a form of deposit balance;

b. Banks' and brokers' extensions of margin credit to customers for the purchase of securities;

c. Commercial paper underwriting;

d. The packaging and placement or underwriting of securitized bank loan assets, such as automobile loans;

e. The conduct of short-term investment activities for the account of the firm, for purposes of arbitrage or other speculative objectives;

f. Service activities, such as arranging interest-rate swaps or currency swaps; and

g. Investment management activities, including those conducted by bank trust departments, whether in a fiduciary or other capacity.

11. Dividing Line - Tripartite Division: Given the probable controversy about how to classify several of the activities identified above, would it be reasonable to establish a tripartite division of activities, according to which certain activities would be considered to be neither exclusively banking nor exclusively securities in nature - and would be regulated by the principal regulator of the corporate entity conducting the activity, without regard to notions of functional regulation? If you would find this acceptable, which activities would you suggest would be candidates for this treatment?

12. Shared Oversight if Same Entity Has Both Banking and Securities Functions: Under functional regulation how should the presence of both banking and securities functions within the same business entity be treated? In particular:

a. Is it essential, in order for functional regulation to be implemented effectively, that banking and securities functions be strictly segregated from each other, so that no single business entity engaged in banking conducts any securities functions internally and no single entity engaged in the securities business conducts any banking functions internally?

b. If absolute segregation is not essential, then how should regulatory responsibility be assigned in the case of any securities activity conducted within a bank that may affect the safety and soundness of the bank?

c. For example, how would a system of functional regulation apply, hypothetically, to the government securities options trading activity that has been proposed by Security Pacific Bank - as discussed in the hearing dialogue between Congressman Craig and Mr. Ketchum - if that activity were located in the bank? In that case, would it be consistent with the principle of functional regulation for the Comptroller of the Currency also to exercise regulatory oversight, concurrently with the SEC, to the extent necessary to fulfill its obligations regarding the safety and soundness of the bank?

13. Shared Oversight - Federal Reserve Position: When Federal Reserve Chairman Volcker testified before us on June 11, he expressed his support for the concept of functional regulation, but he also added a qualification. He stated:

> If they are going to be part of a bank holding company, I think they also have to be subject to some oversight by the banking regulators to see that the business is conducted in a way that is consistent with the kind of standards that we have for safety and stability, which may not be within the SEC's charter or function.

It has long been a concern of the Federal Reserve that, if trouble develops somewhere in a bank holding company, the insulation that is supposed to protect the bank from the financial troubles of the other subsidiaries may break down. I believe Chairman Volcker is arguing from this that they need to have access, in some supervisory sense, to the entire holding company in order to fulfill their responsibilities to protect the bank. How do you feel about this? If bank holding companies were permitted to have major securities subsidiaries, under the direct regulation of the SEC, do you see any problem with sharing regulatory responsibility for the securities subsidiary with the Federal Reserve, at least to the degree necessary to protect the bank?

14. Model of the Municipal Securities Dealers: Under the Securities Acts Amendments of 1975, regulatory responsibility for the activities of municipal securities dealers that are banks is in effect shared between the SEC and the bank regulators. The principle of functional regulation has thus not been applied to municipal securities dealers.

a. Have there been any problems that have arisen in the municipal securities area because of the law's present requirement that the SEC share regulatory authority with the bank regulators?

b. Could this model of shared regulatory responsibility be applied more generally, as an alternative to functional regulation, if and when banks are allowed to expand their securities activities? If not, why not?

15. "Chinese Wall" Regulation: The "Chinese wall" that is intended to prevent improper exchanges of information between the underwriting, investment management, and brokerage departments of a securities firm also has a counterpart in banks, of course, because the trust and commercial lending divisions of banks are not permitted to talk to each other about certain things. Can functional regulation be relied upon for effective control of abusive violations of the "Chinese wall", if and when bank holding companies receive expanded securities powers, given that one side of the "Chinese wall" will be in a bank - supervised by one of the banking agencies - while the other side will be in a securities subsidiary under SEC jurisdiction? Might this division of responsibility create serious problems of interagency coordination, especially if the SEC's methods and philosophy of dealing with "Chinese wall" violations are substantively different from those of the banking agencies?

Sincerely,

Doug Barnard, Jr.
Chairman

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