MEMORANDUM

November 5, 1986

To: Chairman Shad

From: Daniel L. Goelzer, General Counsel

Re: Questions posed by Chairman Barnard concerning hearing of July 23, 1986

In his letter dated August 4, 1986, Doug Barnard, Jr., Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations, posed a number of questions in connection with the Subcommittee's July 23, 1986 hearing concerning the regulation of financial services. Chairman Barnard's questions are set forth below, together with responses prepared by the Office of the General Counsel, the Division of Market Regulation, and the Division of Investment Management.

UNDERWRITING RISK

QUESTION 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?

ANSWER: Underwriting and market making in commercial paper that is exempt from registration under the Securities Act of 1933 presents more risk than many of the traditional banking activities to which it is frequently compared, but it generally presents less risk than underwriting and market making in registered corporate debt securities. Because exempted commercial paper is a short-term obligation, it is less sensitive to interest rate fluctuations than long-term corporate debt. In addition to this smaller market risk, high-quality commercial paper usually presents a smaller credit risk. The credit condition of a financially sound issuer is

unlikely to deteriorate within a short period, and, in practice, almost all commercial paper issuers, in order to be judged creditworthy by the rating agencies, are required to have backup lines of credit to ensure that they will be able to redeem the paper.[1] Consequently, commercial paper underwriting and market making today usually involves less risk than the underwriting and market making of long-term corporate debt.

The commercial paper market is not without risks, however. As Chairman Shad noted in his oral testimony before the Subcommittee,[2] market making activity presents different risks from traditional loan activities because a market maker must be prepared to carry inventories marked to market and cannot protect its position through the kinds of protective covenants that are used in loan agreements. The market has experienced major issuer defaults in the past, with substantial collateral effects on the banking system and the market in general.[3] In addition, the

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[1] Banks are Ready and Eager to Deal in Commercial Paper, The Bond Buyer, Jun. 11, 1984, at 22.

[2] Oral testimony of John Shad before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations (July 23, 1986).

[3] For example, in 1970, when the Penn Central Transportation Co. went into bankruptcy, it defaulted on $82 million in commercial paper that had been placed by Goldman, Sachs, & Co. As dealer of the paper, Goldman, Sachs was held liable in several lawsuits stemming from its failure to disclose and fully investigate facts which cast doubt on the safety of the paper. See, e.g., SEC v. Goldman, Sachs & Co., [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,556 (S.D.N.Y. 1974). The default also had collateral effects on the market in general and the banking system that are instructive in analyzing the potential effects of permitting bank affiliates to underwrite and extend their involvement in the commercial paper market. Penn Central's default precipitated a crisis in confidence that resulted in the inability of other, sound borrowers to roll over their notes. The Federal Reserve Board responded by opening its discount window, encouraging banks to lend additional funds to these companies. The Board also exempted certificates of deposit from interest rate ceilings, encouraging investors unwilling to buy commercial paper to supply more funds to the banks to enlarge their lending capacity and ability to deal with the crisis. A greater crisis was averted, but at a cost of $2 billion in bank money that went to aid corporations in paying off their maturing commercial paper. See Staff Report of the SEC, The Financial Collapse of the Penn Central Company, Special Subcommittee on Investigations of the House Committee on Interstate and Foreign Commerce 272 (Aug. 1972).

involvement of banks, their holding companies and affiliates in the commercial paper market presents special concerns in light of their unique position as potential underwriter, lender and issuer of commercial paper.[4]

The banking regulators have recognized some of these risks in connection with the regulation of banks' current activities in the commercial paper market. For example, the Federal Reserve Board and other banking agencies have proposed guidelines for banks' minimum capital reserves that would take into account the riskiness of investments, including off-balance sheet items such as backup letters of credit. Moreover, the Federal Reserve has taken the position that a bank which engages in commercial paper placement services must keep its extensions of credit separate and independent from those services.[5] The Board has also stated that banks selling third-party commercial paper should, among other things, sell only prime quality commercial paper, sell to only financially sophisticated customers, maintain a complete credit analysis of the issuer, exercise due diligence in investigating the issuer's financial affairs, adopt internal limits for the amount of paper that will be sold for any single issuer, and furnish all purchasers a written statement that states that the paper is not an obligation of the bank and that the bank has no obligation to repurchase the paper.[6]

Some of these conditions have been incorporated in legislative proposals that would

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[4] Banks currently provide letter of credit support for commercial paper issuers and perform private placement services for commercial paper issuers, and bank holding companies and their affiliates act as competing issuers themselves in the commercial paper market. The legality of banks' private placement services under the Glass-Steagall Act is currently in litigation. See infra at n.5.

[5] Federal Reserve System, Statement Concerning Applicability of the Glass-Steagall Act to the Commercial Paper Placement Activities of Bankers Trust Company 39-41, Concurring Statement of Chairman Volcker at 1-2 (June 4, 1985), rev'd on other grounds, Securities Industry Assoc. v. Board of Governors, No. 80-2730 (D.D.C. Feb. 4, 1986), appeal pending, No. 86-5089 (D.C. Cir.).

[6] Federal Reserve Board, Policy Statement on Sale of Third-Party Commercial Paper by State Member Banks, 67 Fed. Res. Bull. 494 (June 1981).

permit bank affiliates to underwrite commercial paper.[7] Others are similar to the conditions enumerated in the Commission's interpretation of the commercial paper exemption in the Securities Act. Under that interpretation, commercial paper qualifies for an exemption from registration if (1) the proceeds are used for current transactions, (2) the notes have a maturity not exceeding nine months, (3) the notes are of prime quality, and (4) they are sold only to institutions and highly sophisticated individuals, and not to the general public.[8] If Congress intends to limit banks to activities less risky than underwriting and market making in corporate debt securities, it may be advisable to expressly incorporate similar conditions in legislation granting banks the power to underwrite commercial paper.

The Commission has, however, taken no position with respect to whether banks should be permitted to underwrite commercial paper. The Commission's statutory mandate is primarily concerned with investor protection and the integrity of the securities markets, not with bank safety and soundness. Ultimately, the question of how much risk in the banking system is advisable or appropriate is a question for Congress and the banking regulators. The Commission has endorsed permitting bank affiliates to underwrite municipal revenue bonds and mutual funds because it has extensive experience in these areas and, based on that experience, it appears that the risks to investor protection and the securities markets would not be excessive, if the activities are subject to Commission regulation. Entities that deal solely in commercial paper and other exempt securities are not subject to Commission regulation, however, and the Commission accordingly has taken no position on whether the Glass-Steagall Act should be amended to permit this activity.

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7 See, e.g., Section 605(a) of S. 2592, 99th Cong., 2d Sess. (1986).

8 Securities Act Release No. 4412, 26 Fed. Reg. 9158 (Sept. 28, 1961).

QUESTION 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?

ANSWER: The Commission takes no position on how much risk to the banking system is advisable or appropriate, but in order for diversification to result in lower overall risk, the component activities of a diversified holding company must be negatively correlated -- that is, the returns on each activity must run counter to each other. Although several studies have examined the correlation of certain nonbanking activity returns with banking returns, additional study would be useful to more completely evaluate the effects of bank holding company diversification into the particular securities activities under discussion in Congress today.[9]

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[9] Some writers have postulated a weak positive or a negative covariance between underwriting revenues and banking revenues based on the assumption that underwriting revenues depend on interest rates and the amount of capital in the market, and almost immediately diminish when sources of capital begin to dry up, whereas loan losses do not instantly result from tight capital market conditions. Restrictions on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation, 97 Harv. L. Rev. 720, 729 (1984), citing Securities Indus. Ass'n, Bank Securities Activities: Memorandum for Study and Discussion, 14 San Diego L. Rev. 751, 794 n.128 (1977) (graph depicting net return on equity of Federal Reserve members and New York Stock Exchange members doing business with the public from 1965 to 1974). A negative covariance was also found between banking returns and the returns of holding and investment companies (including trust companies and bank holding companies) in Heggestad, Riskiness of Investment in Nonbank Activities by Bank Holding Companies, 27 J. of Econ. and Bus. 219, 222 (1975) and Johnson & Meinster, Bank Holding Companies: Diversification Opportunities in Nonbank Activities, Eastern Eco. J. 316, 320 Oct. 1974). But see Wall & Eisenbeis, Bank Holding Company Non-Banking Activities and Risk, Paper presented to Conference on Bank Structure and Compilation, Federal Reserve Bank of Chicago (1984), cited in Deregulating Wall Street 177 (I. Walter, ed. 1985) (finding positive covariance). Another study found that an efficient holding company activity portfolio resulted from diversification of banking with investment banking and other nonbanking activities. Eisemann, Diversification and the Congeneric Bank Holding

Further, consideration should be given to the effects of today's changing economic conditions. As consolidation of financial functions and markets increases, variations in earnings within a diversified financial conglomerate may be less likely to be negatively correlated.[10]

In addition, for the full benefits of diversification to be realized, capital should be permitted to move among affiliates and between affiliates and their holding companies. But bank holding companies and their banking affiliates are subject to capital restrictions and restrictions on asset transfers. These restrictions, although advisable for reasons relating to potential conflicts of interest and the safety and soundness of the banking system, may partially offset the gains that might otherwise result from diversification.[11]

Other firm-specific considerations also are important. In any particular concern, the potential benefits from diversification may depend upon the holding company's managerial and financial resources, market and location factors, and the types and extent of diversification in

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Company, J. of Bank Research 68, 75 (Spr. 1976). See also Wall & Eisenbeis, supra (finding negative correlation between bank and security broker-dealer earnings and bank holding company and security broker-dealer earnings); Litan, Assessing the Risks of Financial Product Deregulation, Paper presented to the American Economics Association Annual Meeting (1985) (noting that earnings data for securities activities do not distinguish between brokerage and underwriting, but positing generally negative correlation for securities underwriting based on substitute data, such as the real value of the New York Stock Exchange index).

None of these studies, however, comprehensively examines the particular effects of permitting bank holding company affiliates to engage in underwriting commercial paper, mortgage-backed securities, municipal revenue bonds, investment companies, and corporate debt or equity securities. Since reducing overall risk through diversification requires either a wide variety of uncorrelated activities or a few nearly perfectly negatively correlated ones, a meaningful study would examine these activities both in isolation and in conjunction with other nonbanking activities currently permitted or proposed.

[10] Restructuring Financial Markets: The Major Policy Issues, A Report from the Chairman of the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce 178 n.27 (July 1986).

[11] See Johnson & Meinster, Bank Holding Companies: Diversification Opportunities in Nonbank Activities, Eastern Eco. J. 316, 321-22 (Oct. 1974).

which the holding company is already engaged.[12] Accordingly, legislative proposals have authorized the Federal Reserve Board to weigh potential gains in efficiency among the relevant factors it should consider in approving applications for nonbanking activities within a holding company structure.[13]

QUESTION 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?

ANSWER: The Commission has advocated permitting banks to engage in expanded securities activities only through separate corporate affiliates within a holding company structure. The holding company structure, however, is neither a substitute for prudent management nor a fail-safe device for containing risk.

As was apparent with bank-sponsored real estate investment trusts in the mid-1970s, banks have great incentives to prevent their affiliates from failing, even when those affiliates are legally separate from the banking organization.[14] In some cases, insulation of the bank from risk

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[12] Id. at 693. Indeed, studies demonstrate that the actual effectiveness of risk reduction through diversification has varied significantly for bank holding companies as a group over the past 15 years. See Litan, Evaluating and Controlling the Risks of Financial Product Regulation, 3 Yale J. on Regulation 1, 22-23 (1985).

[13] See, e.g., Section 604(d) of S. 2592, 99th Cong., 2d Sess. (1986).

[14] See Schotland, Bank Holding Companies and Public Policy Today, reprinted in Compendium of Papers Prepared for the FINE Study, House Committee on Banking, Currency and Housing 211, 270-77 (1976). In general, courts will ignore the separate corporate form of nonbanking affiliates within a holding company structure only when the facts of a case satisfy some version of the so-called Lowendahl test, which holds that one corporation will be liable for the act of another only when it controls the subservient corporation and uses its control to cause harm through fraud or wrong. See Lowendahl v. Baltimore & O.R.R., 247 A.D. 144, 287 N.Y.S. 62, aff'd, 272 N.Y. 360, 6 N.E.2d 56 (1936). Because a bank held by a holding company is an affiliate, not the parent, of other nonbanking affiliates, it is less likely to be in a position to control other affiliates, although

may be accomplished through restrictions in the banking laws designed to prevent conflicts of interest, for example, by limiting the amount of the bank's capital that may be involved in transactions with affiliates or by prohibiting advertising that suggests that the bank will be liable for the obligations of its affiliates. In other cases, reliance can be placed on the supervisory process, examinations, disclosure, and general prohibitions against unsafe and unsound banking practices.

QUESTION 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?

ANSWER: Banking institutions are subject to capital requirements designed to help ensure their safety and soundness. Similarly, securities brokers and dealers are subject to various financial responsibility rules, including the Commission's net capital rule,[15] which requires the maintenance of capital at a level designed to reduce the risk of insolvency.

Although the Commission's financial responsibility rules cannot provide complete assurance of continuing liquidity, these capital requirements have proven to be effective in limiting the risk of broker-dealer insolvency. The effectiveness of these rules is due in large part to the fact that they are specifically designed to account for and protect against the specific

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representations by a bank that it guarantees the affiliate's debts could weaken the legal insulation of the bank. See The Demise of the Bank/NonBank Distinction: An Argument for Deregulating the Activities of Bank Holding Companies, 98 Harv. L. Rev. 650 (1985). Nevertheless, the legal separation of a bank and its nonbanking affiliates does not answer the question whether, as a practical matter, banks will be subject to pressures if their nonbanking affiliates experience financial difficulties.

[15] Securities Exchange Act Rule 15c3-1, 17 C.F.R. 240.15c3-1.

functional, operational, and market risks inherent in the securities business. Accordingly, if banks and bank holding companies are to be allowed to engage in expanded securities underwriting, which the Commission has to a limited extent endorsed, the most effective way to ensure their solvency is for such activities to be conducted in separate corporate affiliates within a bank holding company structure. Such separate securities entities would be registered with the Commission and subject to the same financial responsibility rules as all other broker-dealers. While in theory these capital requirements could be applied to the bank itself, this would be impractical given the illiquidity of banks' loan portfolios that would more than offset any increased capital requirement that was reasonably related to a bank or bank holding company's securities business.

A separate broker-dealer affiliate could also affect the financial health of the parent by causing the public to lose confidence in the parent or by draining capital from the parent because of the unwillingness of the parent to let an affiliate fail.

COMPETITIVE ISSUES

QUESTION 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?

ANSWER: The multiple relationships and activities of banks as short-term lenders, federally insured depositories, transfer agents, registrars, trustees, foreign exchange agents and guarantors, would facilitate concentrations of power if their activities were expanded to include corporate underwriting and market making activities. Restrictions designed to prevent tie-ins and conflicts of interest may have some impact on these relationships and activities, as discussed more fully in the responses to questions 6 and 7.

QUESTION 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.)

ANSWER: Although product tie-ins may be useful to financial institutions as marketing tools, the Commission has witnessed abuse of tie-ins, particularly in the area of "hot issues",[16] and has taken action against such abuses. Tie-ins in the hot issues market have generally involved underwriters requiring investors receiving part of a hot issue to commit to purchase additional shares in that issue or shares in a subsequent issue. As early as 1961, the Commission indicated that tie-ins in the hot issues market involved violations of the anti-manipulative provisions of the federal securities laws.[17]

In 1982, the Commission brought administrative and injunctive actions against Cayman Islands Reinsurance Corporation, Ltd. ("Cayman"), various persons associated with Cayman, and individuals associated with John Muir & Co. ("Muir"), a then registered broker-dealer now in Securities Investor Protection Corporation ("SIPC") liquidation, for an underwriting of Cayman securities in which Cayman did not disclose that, as a condition to Muir underwriting

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[16] A hot issue is an initial public offering in which the price of a security in the after market quickly rises to a substantial premium over the initial offering price.

[17] See Securities Exchange Act Release No. 6536 (Apr. 24, 1961), in which the Commission discussed its view that distributions of new issues linking allotments to customers only if such customers agreed to make comparable purchases in the open market after the initial offering generally involved a violation of the anti-manipulative provisions of the Securities Exchange Act, particularly Rule 10b-6, and might involve other violations. The Commission then expressed its intention to take action if evidence of such practices by individual firms was developed.

the offering, Cayman was to reinvest substantial portions of the proceeds from the offering in other Muir underwritings.[18] However, such cases are rare and the Commission does not believe abusive tying practices are common in the securities industry.

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?

ANSWER: Tie-in abuses may be magnified if banks with a broader range of related financial products are allowed to market securities in addition to their existing financial products. With a view to limiting abusive tie-ins between banks and their securities affiliates, the Commission's staff has advocated amendment of Section 106(b) of the Bank Holding Company Act.[19] As currently written, Section 106(b) prohibits banks from conditioning loans or other services upon a requirement that additional services be obtained from or provided to the bank, a bank holding company of the bank, or a subsidiary of the bank holding company of the bank, or a subsidiary of the bank holding company. However, the Section as currently written would not guard adequately against tie-in abuses with respect to securities subsidiaries or affiliates.

First, Section 106(b) prescribes only conduct by banks. The Section should be amended to also prohibit bank affiliates from conditioning their services upon a requirement that the client obtain additional services from, or provide them to, the bank.

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[18] See SEC v. Cayman Islands Reinsurance Corporation, Ltd., 551 F. Supp. 1056 (S.D.N.Y. 1982); see also [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,717 (S.D.N.Y. June 17, 1982), SEC Litigation Release No. 9830 (Dec. 7, 1982), SEC Litigation Release No. 9746 (Sept. 2, 1982) and SEC Litigation Release No. 9827 (Nov. 30, 1982).

[19] 12 U.S.C. 1972. See Memorandum to Chairman Shad from Office of the General Counsel (Aug. 8, 1983), reprinted in Hearings before the Committee on Banking, Housing, and Urban Affairs, 98th Cong. 1st Sess. 384 389-91 (1983). See also Statement of Daniel L. Goelzer before the House Committee on Government Operations 23 (July 20, 1983).

Second, the Section should be amended to prohibit banks from tying loans to a customer's purchase of trust services, especially the management of pension funds.[20] Such tying may not be in the best interest of the employees whose pensions are managed by their employers' banks. The employers may be impelled, albeit subconsciously, to subordinate the quality of management of their pension funds to the need to maintain a favorable credit relationship with the bank.

Finally, if bank subsidiaries are permitted to engage in expanded securities activities, Section 106(b) should be amended to prohibit a bank that is not part of a holding company structure from conditioning a loan upon a requirement that the borrower use the bank's subsidiary as the underwriter for an offering of securities, and to prohibit tying arrangements engaged in by the bank's subsidiary. However, the Commission does not recommend that the subsidiaries of banks be permitted to engage in expanded securities activities. Instead, as noted in the Commission's written testimony before the Subcommittee,[21] the Commission believes that securities activities should be placed in separate corporate affiliates within a holding company structure.

QUESTION 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 interest 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

[20] See 12 U.S.C. 1972(1)(A).

[21] Statement of John Shad before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations 2 (July 23, 1986).

abuses?

ANSWER: As discussed in written testimony before the Subcommittee,[22] conflicts of interest are currently addressed in the securities industry by both self-imposed and regulatory mechanisms designed to protect investors from potential conflicts between research, investment banking, and market making activities and obligations to investor clients and to issuers of securities. Four basic tools are utilized to protect customers of securities firms from conflicts of interest -- disclosure, "Chinese Walls," restricted lists, and self-regulatory organization rules. In addition, in the investment management area, both statutory and common law provisions exist to address conflicts of interest arising between investment advisers and their customers.

The securities laws and the rules promulgated by the Commission thereunder require extensive disclosure of actual and apparent conflicts of interest. These include requirements that registration statements for new issues contain extensive disclosure relative to the new issue, the registrant, the registrant's affiliates, and its personnel. Pursuant to Regulation S-K under the Securities Act of 1933, disclosure is required regarding: (1) the nature of any material relationship between the underwriter and the registrant,[23] (2) underwriters' compensation,[24] (3) any arrangement whereby the underwriter has the right to designate or nominate members of the registrant's board of directors,[25] (4) indemnification of underwriters[26] and (5) compensation received in any form in connection with the sale of securities.[27]

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22 Appendix to Statement of John Shad before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations 26-36 (July 23, 1986).

23 17 C.F.R. 229.508(a).

24 17 C.F.R. 229.508(e).

25 17 C.F.R. 229.508(f).

26 17 C.F.R. 229.508(g).

27 17 C.F.R. 229.508(h).

Statutes and regulations require additional disclosure when an investment banker assists in effecting a tender offer or a going private transaction. For instance, when a tender offer occurs, disclosure of participants, sources of funds, bidders' plans and all persons retained to make solicitations or recommendations and the terms of such arrangement, among other things, must be disclosed.[28] Also, when a going private transaction occurs, plans of the issuer or its affiliates, sources of finance, any fairness opinions, reports, or appraisals received from outside parties, and any prior relationships between participants and the investment banker rendering such opinion must be disclosed.[29]

The Commission is responsible for reviewing disclosure filings in order to determine whether issuers and parties to transactions have complied with the applicable statutory and regulatory provisions. When an apparent failure to comply is discovered, the Commission may bring an enforcement action for violations of the disclosure provisions of the federal securities laws, and, when appropriate, for violations of the antifraud provisions of the securities laws.

Additional disclosure requirements imposed on a registered broker-dealer acting in a principal capacity include: (1) the amount of any markup or other remuneration received in connection with transactions in certain securities,[30] (2) whether the broker-dealer is a market maker in the security,[31] (3) the date and time of a transaction,[32] (4) the type, amount and price of

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[28] See Schedule 14D-1 under the Securities Exchange Act of 1934.

[29] See Schedule 13E-3 under the Exchange Act.

[30] 17 C.F.R. 240.10b-10(a) (8) (i).

[31] 17 C.F.R. 240.10b-10(a) (8) (ii).

[32] 17 C.F.R. 240.10b-10(a) (1).

the securities purchased,[33] (5) disclosure of a control relationship with an issuer,[34] and (6) disclosure of an interest in a distribution.[35] These rules are enforced, in the first instance, by the self-regulatory organizations under the Commission's oversight. The SROs are charged with responsibility for examining for compliance with, and enforcement of, the Securities Exchange Act and the rules and regulations thereunder. The Commission also enforces these rules directly.

"Chinese Walls" are self-imposed by broker-dealers to create an intrafirm separation of personnel and services, thereby reducing the possibility that employees will trade while in possession of inside information and involve the firm in violations of the federal securities laws.[36] Generally, "Chinese Walls" separate the physical locations of, and ban exchanges of information between, investment banking and trading departments and investment banking and investment adviser departments. Restricted information generally includes information regarding financing, and merger and acquisition activities.

As used by investment banking firms, "restricted lists" are lists of companies that a firm may be advising in a financial transaction, or for which a firm may be underwriting an offering of securities or negotiating a possible business relationship. These lists circulate on a regular basis. If a company's name appears on an investment bank's restricted list, the investment bank's employees are generally prohibited from purchasing the company's securities for the firm or themselves and, also, are prohibited from offering any unsolicited recommendations regarding the named company and its securities to any customer. Many firms employ restricted lists and "Chinese Walls" together to reduce the likelihood of conflicts of interest.

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[33] 17 C.F.R. 240.10b-10(a) (2).

[34] 17 C.F.R. 240.15c1-5.

[35] 17 C.F.R. 240.15c1-6.

[36] <u>See</u> 17 C.F.R. 240.14e-3.

Additional safeguards in the securities industry include a statutory prohibition on any exchange member effecting transactions on an exchange to which it belongs for its own accounts or certain accounts over which the member has control before it effects orders for customers, except in accordance with Commission rules.[37] Also, the self-regulatory organizations impose certain restrictions on their members that issue their own securities. The National Association of Securities Dealers, for instance, requires that a member firm underwriting its own securities obtain independent pricing[38] and imposes more stringent suitability and disclosure requirements for sales of those securities.[39] In addition, the New York Stock Exchange requires that any member issuing its own securities refrain from effecting solicited trades or recommending purchases of its own securities, or securities of any corporation controlling, controlled by, or under common control with the member, in the secondary market.[40] The self-regulatory organizations also require broker-dealers to refrain from recommending unsuitable investments to customers.[41]

Provisions of the Investment Company Act of 1940 protect investment companies from conflicts of interest on the part of affiliated persons. For example, Section 17(a) of the Investment Company Act prohibits an affiliated person, promoter or principal underwriter from buying or selling property or securities from or to an investment company unless the Commission approves the transaction.[42] Also, Section 17(d) generally prohibits joint

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[37] See Section 11(a) of the Securities Exchange Act.

[38] See NASD By-Laws Schedule E, Section 3 NASD Manual (CCH) ¶ 1755 (1985).

[39] NASD By-Laws Schedule E, Sections 8, 11 NASD Manual (CCH) ¶ 1755 (1985).

[40] NYSE Rules of Board Rule 312(g), NYSE Guide (CCH) ¶2312 (1983).

[41] See, e.g., NASD Rules of Fair Practice, Article III, Section 2, NASD Manual (CCH) ¶ 2152 (1985), NYSE Rules of Board, Rule 405, NYSE Guide (CCH) ¶ 2405 (1983).

[42] Rules 17a-1 through 17a-8 grant exemptive relief for certain transactions under Section

transactions between an investment company and its affiliates unless the Commission approves the transaction. In addition, Section 10(a) provides that no more than 60% of the board of directors of an investment company may be interested persons of the investment company; Section 10(f) limits the extent to which an investment company may purchase securities when an affiliated person is a principal underwriter of the offering (Rule 10f-3 provides a limited safe harbor from this prohibition), and Sections 36(a) and (b) authorize the Commission to bring an action against various persons associated with an investment company in the case of a breach of fiduciary duty.

In addition, the Investment Advisers Act of 1940 imposes a general fiduciary obligations on advisers intended to, among other things, mitigate potential conflicts of interest between a firm's investment management and advisory obligations, and underwriting and market making obligations. These include a requirement that an adviser must act in a client's best interest. Honesty and good faith alone are insufficient. Rather, an adviser must disclose all relevant information and avoid any conflict of interest that cannot be cured through disclosure and client consent. Also, fiduciary obligations include best execution, suitability, and exclusive loyalty to a client.

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?

ANSWER: The same combination of regulatory, enforcement and private sector controls

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17(a).

presently in place in the securities industry to limit potential conflict of interest abuses should be implemented if the investment banking powers of commercial banking firms are expanded; however, additional safeguards may also be necessary. While these controls have worked adequately in the securities industry and could be expected to prove useful in regulating expanded commercial bank affiliated securities entities, the potential for conflicts of interest in combined banking and investment banking is greater than in investment banking alone. In any event, although many of the federal securities provisions regarding fraudulent and manipulative activities would apply if commercial banking firms function as both commercial lenders and investment bankers to individual issuers, additional prohibition or disclosure of overlapping relationships would be necessary.[43] Examples include the need to reduce or eliminate problems that could arise if proceeds of an underwriting are to be used to repay an issuer's loans from the commercial bank or if a commercial banking firm's investment banking arm is engaged in a troubled underwriting and finds itself pressured to lend the issuer funds to rescue the offering.

A first step toward eliminating or reducing such conflicts of interest would be to require that securities activities are carried out in bank holding company affiliates registered with the Commission.

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[43] For example, a recent incident in London in which senior employees of Chase Manhattan Securities, a British subsidiary of Chase Manhattan Corporation, purchased the securities of an issue Chase Manhattan Securities was underwriting and then resold the securities to the public several days later illustrates one form of conflict of interest that may occur in a broker-dealer, whether or not affiliated with a bank. The federal securities laws do not reach the wholly foreign activities of foreign affiliates of U.S. institutions; however, the future regulatory body for British securities activities, the Securities and Investment Board, observed that compliance with formal regulatory safeguards pertaining to areas such as conflicts of interest is about to become a requirement in London. London Views Mishap at Chase Broker; Stagging by Employees Ill-timed Before Big Bang, American Banker, Aug. 11, 1986, at 2.

In addition to the protections afforded by the federal securities laws, the Commission has supported additional amendments to the banking laws designed to address potential conflicts of interest in relationships among depository institutions and their non-depository affiliates.[44] Senator Garn's bill in the 99th Congress[45] provides a model for addressing such concerns through the addition of a new Section 23B of the Federal Reserve Act.

As proposed by Senator Garn, Section 23B would require that certain transactions involving a bank and its securities affiliates be on substantially the same terms as those for comparable transactions involving nonaffiliated companies, or at least as favorable to the bank as comparable transactions. In addition, the proposed Section would, among other things, prohibit a bank from purchasing as a fiduciary any securities or other assets from the affiliate unless such practices are authorized by the trust instrument, by court order, or by the jurisdiction where the trust is administered. However, it would be too permissive to allow the purchase of securities or assets from the affiliate by the depository as fiduciary simply because the trust agreement permits such transactions. Boilerplate language in trust agreements could facilitate possible overreaching by banks with regard to trust beneficiaries, and accordingly, the reference in proposed Section 23B to trust instruments should be deleted.

In addition, proposed Section 23B of the Federal Reserve Act would provide that a member bank and its subsidiary, "whether acting as principal or fiduciary, shall not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any

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[44] Statement of John S.R. Shad before the Senate Committee on Banking, Housing, and Urban Affairs 13-14 (Mar. 21, 1984). Additional amendments to the banking laws may be needed because, for example, while the Investment Company Act would prohibit a bank acting as an investment adviser to an affiliated mutual fund from causing the fund to purchase its own certificates of deposit, that Act does not apply to bank common trust and collective funds, which commonly purchase CDs of their managing banks, thus providing a ready source of funds for the bank.

[45] S. 2592, 99th Cong., 2d Sess. (1986).

security a principal underwriter of which is an affiliate of such bank. ***." The term "principal underwriter" is defined as any underwriter who, "in connection with a primary distribution of securities," is in privity of contract with the issuer, initiates the formation of an underwriting syndicate, or is allowed a commission greater that that allowed another underwriter participating in the distribution. The term "distribution" is not defined, but new Section 23(B)(e) would give the Federal Reserve Board the authority to further define terms used in the Section.

We believe that this proposed Section should be amended to make clear that the prohibition in Section 23B applies to private placement activities as well as public offerings. In Securities Industry Association v. Board of Governors,[46] it was argued that the term "distribution" does not refer to private placements of securities. The District Court for the District of Columbia has rejected this interpretation for the purposes of the Glass-Steagall Act. That case is on appeal, however, and the issue is likely to be the subject of further litigation. We believe the Section should be modified to preclude potential ambiguity on this point. Private placement activities are equally susceptible to conflicts of interest as public issuances of securities. Moreover, limiting the prohibition to "primary" distributions is undesirable because conflicts of interest in secondary distributions may be as substantial as those in primary distributions. The word "primary" should be deleted.

QUESTION 8. Ease of Entry: During the hearing you stated, in response to my question 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?

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[46] No. 80-2730 (D.D.C. Feb. 4, 1986), appeal pending, No. 86-5089 (D.C. Cir.).

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

ANSWER: Entry into the top ranks of underwriters is premised on the existence of three factors -- capital; qualified, experienced personnel; and reputation. If banks are permitted to engage in expanded underwriting activities and commit sufficient capital, attract and retain qualified personnel, corporate and investment clients, and develop good track records as managing underwriters, they can compete in the top ranks of the underwriting business. The recent gains of Japanese firms in the Eurobond market provides an example of the ability of new, well-capitalized firms to compete in investment banking. A number of banks are in the top ranks of underwriters of municipal general obligation bonds.

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?

ANSWER: Commercial banks have advantages over other entrants into investment banking, including their access to low-cost federally insured deposits as a source of capital and their extensive contacts with corporations arising from their lending and other activities. Therefore, their investment banking activities should be conducted through separate corporate affiliates, without access to the federally insured funds and subject to the Commission's regulatory jurisdiction. Also, noted in the Commission's testimony before the Subcommittee,[47] if commercial banks are permitted to enter into investment banking, subject to appropriate

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[47] See Statement of John Shad before the Subcommittee on Commerce Consumer and Monetary Affairs of the House Committee on Government Operations 2 (July 23, 1986). The concept of a separate securities subsidiary was prominent in S. 2851, the Financial Services Competitive Equity Act, that Senator Garn sponsored and that the Senate passed in 1984.

regulation by the Commission, then amendments to the Glass-Steagall Act or other banking statutes should allow broker-dealers to engage in commercial banking activities subject to the authority of appropriate banking regulators.

FUNCTIONAL REGULATION ISSUES

QUESTION 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?

ANSWER: Financial services should be regulated by functional activities, rather than by outmoded industry classifications. These services should compete on the basis of their economic merits, rather than their regulatory classifications.

In most cases, the appropriate regulatory structure can be determined by current law, if the provisions that grant different regulatory treatment to different types of entities are removed. Thus, if a bank engages in activities, such as offering, selling or underwriting investment instruments, that are within the scope of the federal securities laws, it should do so through a separate securities affiliate, subject to the same rules and regulations, administered by the same regulatory agency, as all others that engage in such securities activities. Similarly, if a securities firm engages in activities, such as taking deposits or making commercial loans, that are within the scope of the banking laws, it should do so through a separate banking affiliate, subject to the same rules and regulations, administered by the same regulatory agency, as all others that engage in such banking activities.

As discussed more fully below in the responses to questions 10-15, some activities may implicate concerns within the respective jurisdictions of both the Commission and the banking regulators. The concept of functional regulation does not require that these activities be exclusively categorized as either banking functions or securities functions. Rather, the concept simply requires that activities that fall within the Commission's mandate under the federal securities laws to protect investors and maintain fair and orderly securities markets be regulated by the Commission. Separate concerns may be raised by the banking regulators' mandates in banking laws to protect the safety and soundness of banks and the banking system; functional regulation of bank securities activities by the Commission does not seek to limit the authority of bank regulators to deal with those concerns.

QUESTION 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;

ANSWER: Money market mutual fund investments used by brokers to handle customer cash balances should remain subject to Commission oversight as securities functions. Even if used by brokers as a functional equivalent to commercial bank deposits, money market mutual funds are investment companies under Section 3(a) of the Investment Company Act of 1940 ("1940 Act"), and the interests in such funds are regulated by the Commission as securities, and should remain regulated as such. A customer who treats money market investments through a broker-dealer as the equivalent of a bank deposit should be aware of the functional differences between a deposit held by a bank and an investment in the shares of a money market mutual

fund. Money market funds are not insured by the FDIC or by SIPC. Further, if a broker-dealer holds monies not intended for investment for a customer directly, those monies are not insured by SIPC.

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

ANSWER: Banks' extensions of margin credit to customers purchasing securities in transactions in which the bank is an active participant, such as providing the brokerage aspect of the transaction, should be regulated as securities functions, subject to SEC oversight, in the same manner that broker-dealers extending margin credit on the purchase of securities are regulated. However, where a bank provides a loan for the purchase of securities in a transaction in which the bank is only lending the purchase funds, that transaction should remain within the oversight of the banking agencies, and the lending activity should be regulated as a banking function.

Broker-dealer margin lending is incidental to the brokerage business, and therefore is appropriately regulated by the securities laws. The distinction between lending incidental to the purchase of securities and non-securities may break down, however, when margin lending is used not to finance securities purchases, but rather to finance purchases of consumer goods. However, financing the purchase of consumer goods is not solely a banking function. Today a wide variety of institutions not regulated as banks, including retail stores and finance companies, provide consumer goods financing. Thus, it would not appear to be necessary for broker-dealers that engage in that function to be regulated as banks.

c. Commercial paper underwriting;

ANSWER: Although commercial paper is a security for purposes of the Securities Act of 1933, it is exempted from the requirement that it be registered with the Commission prior to its

offer or sale to the public. In addition, although underwriting and dealing in commercial paper is functionally the same process as underwriting and dealing in debt securities,[48] entities that only underwrite commercial paper or limit their underwriting to securities exempted under the Securities Exchange Act of 1934 are not required to register with the Commission as broker-dealers and are not subject to the reporting, disclosure, recordkeeping, and capitalization requirements of the Securities Exchange Act.

The antifraud provisions of the Securities Act do apply to transactions involving commercial paper because commercial paper is a security under the Act, albeit exempt from registration. However, the antifraud provisions of the Securities Exchange Act may not apply because notes which have a maturity not exceeding nine months are excluded from the definition of a security in that Act. Therefore, although it is clearly a security under the Securities Act, the status of commercial paper, generally, under the Securities Exchange Act is not as clear.[49]

Recent legislative proposals have provided that banks should be permitted to underwrite commercial paper only in a separate affiliate within a bank holding company structure.[50]

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[48] Section 3(a)(3) of the Securities Act defines as an exempted security:

> Any note, draft, bill of exchange or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

[49] In a recent Supreme Court case, Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137 (1984), the Supreme Court concluded that commercial paper being placed by Bankers Trust Company of New York also is a security for purposes of the Glass-Steagall Act. On remand, the Federal District Court for the District of Columbia, reviewing a conclusion of the Board of Governors of the Federal Reserve System, determined that Bankers Trust's commercial paper activities involved underwriting and therefore Bankers Trust Company had violated the Glass-Steagall Act prohibition regarding securities underwriting. See No. 80-2730 (D.D.C. Feb. 4, 1986), appeal pending, No. 86-5089 (D.C. Cir.).

[50] See, e.g., 2592, 99th Cong., 2d Sess. (1986).

Consequently, such activities would be subject to the same degree of regulation by the Commission as any broker-dealer engaging in commercial paper activities. In addition, the Federal Reserve Board would have the authority to approve the formation of the affiliate and perform other functions for the purposes of fulfilling its responsibilities to insure bank holding company safety and soundness under the Bank Holding Company Act. As discussed below in the answer to Question 13, such a system is consistent with the principle of functional regulation.

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

ANSWER: The packaging and private placement of loans, such as automobile loans or credit card balances, is the function of an issuer, whether a bank, finance or other company. The underwriting of a public offering of such securitized loans, making markets or executing brokerage transactions in them is a securities activity that should be regulated by the Commission. When bank loan assets are pooled and then undivided interests are sold in the pool, or interests in individual large loan assets are publicly distributed, a security backed by the loan asset is created. The public distribution of this security should be registered with the Commission pursuant to the requirements of the Securities Act of 1933, unless it is exempt from such registration, and those individuals or entities selling or placing the securities should be appropriately registered and licensed to sell securities pursuant to the Securities Exchange Act of 1934.

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

ANSWER: To the extent that short-term investment activities, whether for a commercial or investment banking firm, are investment activities solely for the account of the firm, involving the firm's investment portfolio and not involving customers, they should remain within the

institution, overseen by the appropriate agency, whether a self-regulatory organization in the case of an investment bank, or a banking regulator, in the case of a commercial bank. The Commission recognized the legitimacy of bank involvement in these securities activities in Rule 3b-9, which was adopted on July 1, 1985.[51] The Rule exempts from its scope transactions effected by a bank for the investment portfolio of affiliated companies, also implicitly excepting transactions effected by a bank for its own investment portfolio. However, a bank engaging in such activities for public customers' accounts performs the functions of a "dealer,"[52] and should be subject to the federal securities laws. Once such activities involve public customers, whether conducted in a commercial bank or an investment bank, securities regulations should apply, because the activities are those that the securities laws are designed to regulate.

The Commission is not a bank regulator and does not wish to become involved in the regulation of internal banking activities. Therefore, it has recommended that banks form separate securities affiliates to conduct their securities activities. Hundreds of banks have done so and others are in the process of doing so.

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

ANSWER: Financial institutions intermediate or arrange interest rate swaps and currency swaps often in conjunction with the underwriting of corporate debt or commercial loans. Presently, interest rate swaps are provided by commercial banks, of which Citibank and Bankers

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[51] See Applicability of Broker-Dealer Registration of Banks, 50 Fed. Reg. 28385 at 28392 (July 12, 1985). On November 4, 1986, the United States Court of Appeals for the District of Columbia Circuit ruled that Rule 3b-9 is invalid. American Bankers Association v. Securities and Exchange Commission, D.C. Cir. No. 85-6055 (Nov. 4, 1986). The Commission is currently determining what further steps it may wish to take in this case, including whether to seek review of the decision.

[52] See Section 3(a)(5) of the Securities Exchange Act.

Trust Company have the greatest volume, and investment banks.[53] The question remains open as to whether these activities are securities activities and therefore are more appropriately placed within the Commission's jurisdiction or should remain outside the system of securities regulation. However, there is no question that the swap activities of publicly-owned companies registered with the Commission, if material, must be disclosed. The Commission views disclosure concerning currency and interest rate swap activities as necessary, in the context of registration statements and annual reports, if a publicly-owned company's swap activities are so substantial as to be material.

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

ANSWER: Investment management activities, other than those of investment companies, could legitimately be regulated by either securities or bank regulators, as long as these activities are conducted in a manner that does not involve receipt of brokerage fees. The Commission determined in Rule 3b-9 that investment management services that include brokerage execution involving the receipt of brokerage fees in addition to management fees are traditional securities activities and should be regulated by the Commission under the securities laws.[54]

Functional regulation should be applied to certain products offered by bank trust departments that are in many respects indistinguishable from similar products offered by securities firms. Investment vehicles such as pooled employee benefit plans that are actively promoted or advertised and managed by bank trust departments are currently subject only to state

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53 Weiner, Banks Outstrip Wall Street in Swap Market, American Banker, July 15, 1986, at 1.

54 See 50 Fed. Reg. 28390-28391. Rule 3b-9 deems a bank that receives transaction related compensation for providing brokerage services for trust managing agency or other accounts to which the bank provides advice to be a broker unless certain limited conditions are met. Id.

and federal banking regulation, in reliance on Section 3(c)(3) of the 1940 Act, which exempts banks and certain funds maintained by banks from the coverage of the Act. Securities firms offering similar pooled products are generally subject to disclosure, reporting and regulation under the federal securities laws, and are subject to state securities regulation as well. This results in competitive inequality and a significant lack of regulatory uniformity.

Securities firms have attempted to compete by forming limited purpose trust companies subject to state banking regulation. These trust companies manage employee benefit plan assets and other large accounts on a pooled basis free of federal and state securities laws.

The Commission's view is that pooled investment vehicles offered by banks that are widely advertised or promoted to the public should be transferred to bank securities affiliates, subject to the same regulation as securities firms offering the same products. In the case of pooled investment vehicles targeted to large institutional accounts and employee benefit plans, an appropriate regulatory scheme might be one that is based on the 1940 Act, but with the elimination of some of the more detailed requirements, such as those relating to corporate governance, shareholder voting, and daily pricing. This system of regulation could be similar to that suggested by the Commission in a 1983 release requesting comments on whether certain investment companies should be allowed to operate as unitary investment trusts subject to relaxed 1940 Act requirements.[55]

QUESTION 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 find this acceptable, which activities would you suggest would be candidates for this treatment?

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[55] Investment Company Act Release No. 12888 (Dec. 10, 1982).

ANSWER: As discussed above, the fact that some activities may implicate the separate concerns of both the banking and securities regulators does not preclude the application of the principle of functional regulation. The real task of effecting functional regulation is not to segregate particular activities into either banking or securities categories, but to determine which aspects of those activities should be regulated under which laws. In some cases, this will result in a particular activity being entirely regulated by one or another regulator; in other cases, regulatory jurisdiction may be concurrent under different laws with different purposes. For example, under current law, a bank holding company that establishes a discount brokerage affiliate must both obtain the approval of the Federal Reserve Board to form the affiliate under the Bank Holding Company Act and register the affiliate with the SEC as a broker-dealer under the Securities Exchange Act. This system accommodates the separate regulatory concerns of both agencies and also implements the principle of functional regulation by ensuring that public investors are protected by the securities laws regardless of the entity with which those investors choose to deal with respect to their securities transactions.

We do not recommend, however, that the banking regulators and the Commission be given concurrent jurisdiction to administer the same provisions of the same laws. Under current law, certain securities activities under the Securities Exchange Act are enforced by five separate agencies pursuant to Section 12(i) of that Act. The Commission has recommended the repeal of Section 12(i), because it believes that administration and enforcement of the provisions regulating these activities can be carried out at lower cost by a single agency.[56]

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[56] See also Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services 91 (July 1984).

QUESTION 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 and no single entity engaged in the securities business conducts any banking functions internally?

ANSWER: If banks are granted expanded securities powers, the Commission has recommended that these new activities be conducted only through separate affiliates within a holding company structure. Moreover, the Commission recommends that if a bank holding company establishes such a securities affiliate, existing securities activities that banks are currently permitted to conduct under Section 16 of the Glass-Steagall Act should be transferred to that affiliate as well.

The purposes of such a separation are threefold. First, segregation of traditional banking functions from securities functions is designed to reduce the potential for conflicts of interest and risks to the safety and soundness of the bank. Second, the separation of securities and banking functions within separate corporate affiliates simplifies the coordination of regulatory jurisdiction between the SEC and the banking agencies, by insuring SEC supervision over activities that are functionally equivalent to those engaged in by entities now subject to the securities laws. Banking functions would be supervised by the banking agencies, without regard to SEC regulation. Finally, separation of functions reduces the competitive inequality that arises from the ability of banks to utilize tax advantages and insured deposits in their securities business.

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?

ANSWER: As discussed above, the most desirable legislative approach is to segregate banking and securities functions into separate corporate affiliates. If securities functions were conducted within a bank, the Commission could still regulate those activities concurrently with the bank regulators, but such a system would be more difficult to administer.

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?

ANSWER: Options trading activity carried out through a proprietary computer system operated by a bank provides an example of functional regulation. Security Pacific National Bank ("Bank") has received no-action letters from the staff of the Division of Market Regulation[57] pursuant to which the Security Pacific Corporation, the Bank's holding company, will operate, through subsidiaries of SPC Securities Services Corporation,[58] a computer trading system that will enable primary dealers, other dealers in U.S. Government securities, and institutional investors (collectively "participants") to trade put and call options on U.S. Treasury securities, without registering this system as a securities exchange. As a condition to the staff's position, the Bank has agreed to provide the Commission with extensive information about Security Pacific Options Trading Corporation ("SPOTC") on a quarterly basis. The information to be provided includes rules and regulations developed for the system and participants, trading information such as volume of transactions, positions that are closed out, exercised and allowed

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[57] Letter to Eric Roiter from Richard T. Chase (July 19, 1985); Letter to Eric Roiter from Richard G. Ketchum (August 8, 1986).

[58] The subsidiaries are Security Pacific Options Services Corporation and its subsidiary, Security Pacific Options Trading Corporation.

to expire, the number of defaults, the extent to which the Bank satisfies such defaults, and the number of defaults participants satisfy. This information is generally the type of information that exchanges are required by statute and regulation to disclose to the Commission. The Bank and its proposed system are functionally regulated in that the system's operations will be overseen by the Commission and the banking functions of the Bank will remain within the domain of the appropriate banking regulator, in this case, the Comptroller of the Currency.

As the Subcommittee suggests, to the extent that the system's operations might affect the safety and soundness of the Bank, the Comptroller of the Currency must maintain some oversight, without such oversight necessarily being direct and concurrent with the Commission's. However, in order to reduce the potential adverse effects of the system on the Bank, the preferable way to organize the system, under functional regulation, is to insure that SPOTC, as a separate subsidiary of the Bank, is financially and operationally isolated from the Bank's depository and other commercial banking activities. The Comptroller of the Currency largely accomplished this goal through requiring a revision of the system whereby General Electric Credit Corporation, rather than Security Pacific, will provide the clearing guarantee for performance of the contracts. Under this approach, the potential safety and soundness concerns raised by SPOTC would be minimized.

QUESTION 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 standard 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?

ANSWER: The Commission has no objection to concurrent regulation over bank holding company securities affiliates by the Commission and the Federal Reserve Board, with the division of responsibility described above. In recent legislative proposals,[59] for example, the Commission would have jurisdiction over the securities activities of such affiliates, just as it does now over most entities subject to the Securities Exchange Act. However, the Federal Reserve Board would maintain jurisdiction under the Bank Holding Company Act to approve the formation of bank holding company securities affiliates, examine such affiliates, and perform other functions for the purposes of fulfilling its responsibilities under the Act. Of course, some regulatory coordination is necessary under such a proposed structure. To that end, the recent bills provide that the Board shall generally accept in fulfillment of the securities affiliate's reporting obligations reports containing the same information required to be submitted to the SEC under the Securities Exchange Act. The Commission supports this provision, which is consistent with the Bush Task Group recommendations.[60]

QUESTION 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 principal of functional regulation has thus not been applied to municipal securities dealers.

ANSWER: Functional regulation is a fundamental aspect of municipal securities dealer

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[59] See, e.g., H.R. 5220, 99th Cong., 2d Sess. (1986); S. 2592, 99th Cong., 2d Sess. (1986).

[60] Blueprint for Reform at 76; Statement of John S.R. Shad before the Senate Committee on Banking, Housing and Urban Affairs (Mar. 21, 1984). See Section 105(h) of H.R. 5220, 99th Cong., 2d Sess. (1986); Section 603(g) of S. 2592, 99th Cong., 2d Sess. (1986).

regulation. Each municipal securities dealer whether a bank department or a broker-dealer, must register with the Commission. These dealers are subject to the regulations promulgated by the Municipal Securities Rulemaking Board ("MSRB"), the activities of which are, in turn, subject to the oversight authority of the Commission, including rulemaking activity. It is only with respect to examination and enforcement activities that functional regulation has been modified. Banking regulators oversee the effects of the day-to-day operations of bank municipal securities dealers on the overall soundness of the bank, and inspect and bring enforcement actions for violations of MSRB regulations, performing substantially the same function as the securities self-regulatory organizations. However, the Commission is statutorily empowered to limit activities, revoke registrations, and censure municipal securities dealers, and in consultation with the appropriate regulatory agency for any municipal securities dealer, to investigate and commence proceedings against any municipal securities dealer or its associated persons, in violation of any relevant statute or regulation.[61] Therefore, enforcement of these regulations lies simultaneously with the Commission, in its role as the primary enforcer of the federal securities laws, and with the bank regulators.

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?

ANSWER: Shared responsibility for regulation of municipal securities dealers is structured to insure that the appropriate regulator, whether of banking or securities activities, is authorized to bring any necessary actions to ensure the integrity of the municipal securities markets and the soundness of banks. The shared regulatory authority of the banking regulators

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61 See Section 15B(c) of the Exchange Act. The appropriate regulatory agencies are also empowered to investigate and proceed against any municipal securities dealer or associated person for violation of relevant provisions. Section 15B(c)(6)(B).

and the Commission is problematic only if interpretive and enforcement efforts are not coordinated. Significant coordination problems have not developed in the regulation of municipal securities dealers, in part because of the informal coordination activities of the MSRB. Moreover, coordination difficulties are limited by the SEC'S overriding authority to enforce the MSRB's rules against any municipal securities dealer, whether a bank or a broker-dealer.

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?

ANSWER: The model of shared responsibility for examinations and enforcement resulted from Congress' decision not to require banks to set up separate affiliates to carry out municipal securities activities. It would have been burdensome and unwieldy for banks for the Commission to perform examinations of the banks' municipal securities activities that generally constitute only a small portion of a commercial bank's business. Banking regulators have responsibility for routine oversight of banks involved in municipal securities activities because the regulators' primary responsibilities require their presence in those institutions on a regular basis.

If banks are allowed to expand their general securities activities, shared responsibility for regulation would become quite unwieldy. Unlike the regulatory system applied to approximately 320 bank municipal securities dealers, which, by and large, consist of small departments within much larger banks subject to "tailor-made" regulations, shared regulation of general securities activities would be difficult to administer, particularly if the American Bankers Association's estimate of at least 1000 banks involved in, or interested in engaging in, securities activities is accurate.[62]

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[62] See Letter from Robert L. Bevan, Senior Government Relations Counsel to George A. Fitzsimmons (Dec. 19, 1983) (commenting on proposed Rule 3b-9).

One reason shared regulation would be difficult is that concurrent oversight of an area as diverse and extensive as the general securities business could lead to substantial inconsistencies in interpretation and application of regulations. The discrete and limited nature of municipal securities regulation and the existence of a single rulemaking body allows sufficient coordination among enforcement bodies to avoid divergent interpretations in this area. In contrast, front-line securities regulation is the province of the NASD and the ten national securities exchanges, each which has both regulatory and enforcement authority for the operation of its market place, and the Commission performs both oversight and front-line regulation as well.

Another problem with shared regulation is that it would be inefficient. A substantial amount of time and money is required to insure that the Commission staff is aware of new developments in the present, ever evolving securities industry. Requiring a number of agencies to devote themselves to securities regulation is far less efficient than requiring all institutions or entities engaged in securities activities to be under the regulatory auspices of a single regulatory agency.

Finally, a single regulator should be responsible for oversight and regulation of all securities activities, as well as enforcement, in order to ensure that violations of the securities laws are identified rapidly, and violators are apprehended and regulatory responses are developed. Divided oversight authority could undermine any attempt to develop a cohesive enforcement program because of the time difficulties usually involved in sharing information among agencies, adopting a uniform enforcement approach, and coordinating law enforcement actions. For these reasons, separate affiliates are recommended in order to substantially reduce the need for coordinated enforcement.

QUESTION 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?

ANSWER: As discussed in Question 7, the "Chinese Wall" is a viable concept for a bank holding company engaged in commercial banking through one subsidiary and investment banking through another subsidiary, provided that a "Chinese Wall" is not only placed between the affiliates, but also exists within each entity. A securities subsidiary of a bank holding company, like any other investment banking firm that uses a "Chinese Wall", should be able to prevent any outflow of material information, both to other areas of the firm, and to affiliates.[63] A

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[63] The Commission has recognized this since at least 1968 when, in In the Matter of Merrill Lynch, Pierce, Fenner and Smith, Inc., Securities Exchange Act Release No. 8459 (Nov. 25, 1968), [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,629 at 83,347, it accepted an offer of settlement in which Merrill Lynch, Pierce, Fenner & Smith, Inc. issued a statement of policy prohibiting members of its underwriting department from disclosing any material information obtained from a corporation in connection with negotiation of a public or private offering to members of the firm's research department, or members of the buying departments of prospective co-underwriters. These restrictions also applied to any and all employees obtaining such information. The firm undertook to adopt, implement and ensure compliance with the procedures to provide more effective protection against disclosure of confidential information. Id. at 83,350. In this case, Merrill Lynch, Pierce, Fenner & Smith's underwriting department provided confidential information to members of the firm's research department about a client's decrease in profits. The information was obtained during the course of arranging an underwriting for the client. The research department then provided the information to large institutional and individual clients who, on the basis of the information, were able to avoid losses, and, in certain cases, profit, through short sellings of the corporation's securities.

The Commission recently approved amendments to New York Stock Exchange Rule 98 and American Stock Exchange Rule 193, relaxing exchange rules that prohibit an entity affiliated with a specialist from trading in specialty stocks, except in performance of specialist functions. The amendments effectively will allow a specialist affiliate, such as a retail broker-dealer, to trade in specialty securities free from restriction, provided that the specialist

securities subsidiary of a bank holding company would basically be required to extend the range of the intrafirm prohibitions on transfer of material, non-public information to include any commercial banking affiliate that might stand to profit from early knowledge of such information.

If a "Chinese Wall" is breached and, by the breach, a violation of the federal securities laws occurs, investigation and prosecution of that violation would not be substantially hindered by a division of responsibility for bank activities between the Commission and bank regulators. The Commission is authorized to investigate violations of the federal securities laws, wherever they occur. After the Commission formally begins an investigation, the Commission can use its subpoena authority to obtain information relating to possible securities law violations from any entity, including banks. Coordination with bank regulators would be important, however, in the stages of inquiry preliminary to a formal investigation, in which the Commission often obtains information voluntarily from broker-dealers as a result of its regulatory relationship with these firms. In dealing with breaches of a "Chinese Wall" between a bank's securities and lending functions, the Commission might need to rely on bank regulators' influence with the bank to obtain the preliminary information necessary to initiate a formal investigation.

Apart from such cooperation, functional oversight of the use by banks of "Chinese Walls" would raise few difficulties. The Commission could continue to enforce the securities laws where a breach of a "Chinese Wall" results in a violation of these provisions. At the same

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and its affiliate adhere to written procedures designed to prevent either party from receiving knowledge of the other party's trading activity, or from the affiliate receiving information concerning the specialist book. The written procedures would require, among other things, the creation of an Exchange-approved "Chinese Wall" isolating the flow of material, non-public corporate and market information, as well as require that specialists receiving market-sensitive information disclose receipt of that information, and in most cases give up their specialist book in the specialty stock until the information is no longer market sensitive. See Securities Exchange Act Release No. 23768 (Nov. 3, 1986).

time, a banking regulator could take action if a breach of a "Chinese Wall" results in a violation of banking regulations or fiduciary requirements. Of course, if substantial legislative changes are effected and the statutory structure of financial institution regulation changes, the relevant agencies, be they banking regulators or the Commission, will have to modify their regulations to ensure that regulatory and enforcement efforts are carried out in keeping with the principles of functional regulation.