Y4.B22/1:100-40/pt 2

REFORM OF THE NATION'S BANKING AND FINANCIAL SYSTEMS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

ONE-HUNDREDTH CONGRESS

FIRST SESSION

PART 2

NOVEMBER 18; DECEMBER 2, 3, 9, AND 10, 1987

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 100-40

U.S. GOV'T DEPOSITORY

MAR 30 1988

NORTHWESTERN UNIVERSITY
LAW SCHOOL LIBRARY
CHICAGO, IL 60611

I look forward to the presentation of your testimony this morning, Chairman Ruder.

Mr. RUDER. Thank you.

Chairman ST GERMAIN. Chairman Ruder, I really feel honored and privileged to welcome you this morning, and looking at the background, your achievements, your accomplishments, particularly—not particularly, but at Northwestern, I think it is a very enviable record that you have established. With all due deference to your predecessors, I think we would have to go back a long time to find anyone with the credentials and the demonstrated ability that the present Chairman of the SEC brings to the job, and certainly, you came at the right time.

I might incidentally mention to the committee, Mr. Ruder and the SEC's general counsel, Daniel Gelzer, are graduates of the University of Wisconsin Law School, but then we on the committee are proud of the fact that also our staff director, Lee Peckarsky, is a graduate of that same law school.

So we are really and truly fortunate, as I say, in having you here today in the post that you now occupy.

We will put your entire statement in the record, and you may proceed.

STATEMENT OF HON. DAVID RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. RUDER. It is a pleasure for me to be here on my first appearance before you. The Securities and Exchange Commission appreciates this opportunity to present its views concerning the reform of the Nation's banking and financial system. I am pleased that you have put my written statement in the record. Because of the short time period between your invitation and this hearing, not all of the specific questions in your letter of invitation are addressed in my written statement.

I will be pleased to answer questions with regard to those matters today and pleased to supplement a supplemental response addressing those questions at a later time.

As the Federal agency primarily responsible for regulation of the securities markets, the Commission has a fundamental interest in the protection of investors. Our primary concern is that our capital markets be regulated in a manner providing protection for those investors. A major component of the regulatory structure established by Congress is the regulation of brokers and dealers, defined as those entities engaged in the business of affecting transactions and securities either for their own account or for the account of others.

When the Securities Act was passed, banks were not heavily engaged in broker-dealer activities and were exempted from regulation as brokers or dealers. In recent years, however, banks have expanded dramatically their securities activities, but have nevertheless remained outside the broker-dealer regulatory scheme. If the Glass-Steagall Act is repealed, bank securities activities in the broker-dealer and other areas will increase and will exacerbate the present regulatory disparities. I use the word "disparities," because

the regulation of bank securities activities under banking law is not an adequate substitute for Commission regulation.

The primary purposes of banking laws are the protection of depositors and the preservation of the safety and soundness of the banking system.

In contrast, securities laws are directed to the protection of investors and the maintenance of fair and orderly markets.

Accordingly, the Commission at this time is unable to support repeal of the Glass-Steagall Act. It is unable to do so, unless it is given the power to regulate bank securities activities. It is the Commission that is directly charged with protecting investors. It is the Commission that should be able to apply its regulation to all market participants, in order to ensure investor protection. Banks must be required to conduct both their existing securities activities and any new activity authorized by Congress in separate securities affiliates, subject to Commission regulation.

The Commission recognizes some practical limitations, however, and does not propose that banks be required to place Government securities or commercial paper activities in securities affiliates regarding structure. Although we believe a holding company structure will be best suited to separating bank and securities activities, we also believe it may be appropriate to permit small banks to conduct some securities activities through bank subsidiaries rather than through a bank holding company or affiliate.

Bank securities activities other than broker-dealer activities also should be regulated, if banks are permitted to underrate and distribute investment company securities, the Investment Company Act and the Investment Advisers Act must be amended.

Concerns that must be addressed include advertising, bank custody of assets of affiliate investment companies, affiliated transactions and investment company borrowing from affiliated banks.

We also believe that Congress should implement the recommendations of Vice President Bush' Task Group on Regulation of Financial Services to consolidate within the Commission the securities registration and reporting requirements for all publicly owned banks and thrifts.

The views that I am expressing today are not new. The Commission has long been on record in favor of functional regulation of securities activities, with that regulation conducted by the Securities and Exchange Commission, the agency that has a special mandate and special expertise in the area of investor protection.

Thank you.

[The prepared statement of Mr. David Ruder can be found in the appendix.]

Chairman St Germain. Chairman Ruder, Senator Proxmire's proposal would allow banks to affiliate with securities funds that deal in all manner of instruments. That includes options, futures and strict securities. Some of these volatile instruments are currently not regulated by the SEC. Given the fact that such affiliations could endanger the affiliated bank, if not—if the wall isn't as impenetrable as we hope it will be, what reforms do you think should be made in the regulation of the instruments I referred to above, to wit: options, futures and strict securities?

Mr. RUDER. In 1982, an accord was reached between the Commodities Futures Trading Commission and the Securities and Exchange Commission with regard to regulatory authority over futures products and option products, and that accord essentially said that the Securities and Exchange Commission would regulate all options, all options products, and the CFTC would regulate all futures products.

Since 1982, futures products have been developed in what are called derivative indexes and derivative index products. That means there have been futures tradings on the stock market indices. That trading is governed by CFTC regulations, whereas options on these derivative index products are regulated by us, and they are traded on the Chicago Board Options Exchange.

In the course of our study of the securities market activities in the October market break, we will be looking at the question of whether or not there should be some regulatory reform with regard to the way in which these products are regulated, and currently, we have not reached a conclusion, other than to say that we think that in current times we should develop more coordination and contact with the CFTC, in order to have a greater amount of joint regulation.

Now if banks engage in the very risky—in their securities affiliates in the very risky futures trading and options trading area in these derivative products, they will, as the securities firms are now, be subject to risks.

We would expect if these activities were conducted in securities affiliates, that we would regulate—through our net capital requirements would regulate the securities affiliates of a bank holding company, in a way which we think would be protected against these risks. These risks exist now in the securities industry, and we believe that we are able to regulate them adequately.

I may say that that is another area of interest in our postmarket crash investigation.

Chairman ST GERMAIN. In February this year, general counsel Harvey Pitt testified before the Senate Banking Committee and stated, "There can be little doubt that the Commission lacks both resources and remedies necessary if the agency is to deter securities laws violations in a most efficacious manner. Saddled by budgetary constraints, a 6-year policy of enforced silence about those constraints, the Commission is in danger of falling behind the effort to police our securities markets."

Then he said, "The Commission's budgetary constraint should be alleviated by permitting the agency to fund its operation from the private sector. Findings and other fees should be utilized to fund the Commission's operations."

We look at recent budget data, it appears that Chairman Shad, that SEC was a whipping boy of the administration's reduction efforts. Every year since 1979, OMB has cut SEC's budget requests, only to have Congress turn around and restore budgetary resources to the level requested by SEC, and still SEC's budget has shown insufficient growth with the tremendous increase of the stock market taken into account.

Regarding the concept of functional regulation, the SEC will be given an increased role as a regulator of our financial system, and

therefore, can the SEC count on receiving additional resources over the next 5 years, let's say, to carry out the proposed new responsibilities under functional regulation?

Is it realistic to assume that SEC will continue to receive the type of budget increase like the 50 percent increase received in 1988, and should SEC, in fact, be funded by fees, filings, and so forth, and be exempt from the administration's budget review process?

What is the present level of SEC fees and would they be sufficient to fund the operation of SEC in the future?

Mr. RUDER. There are several questions there, Mr. Chairman. Let me take the last one first.

Our revenues for 1987, the SEC-related revenues, were something in the range of $250 million. Our budget for 1987 was approximately $114 million. So during the fiscal year 1987 the amount of revenue generated by the SEC, various statutory fees and filing fees, was more than double our budget. Indeed, our—the budget which has been tentatively approved by both the House and Senate, and we don't know what is happening in the current legislation for 1988, is roughly $142 million, and that figure again is far exceeded by the amount of revenue which the Commission generates.

We have been asked by the Senate Banking Committee, the Securities Subcommittee of the Senate Banking Committee, to receive our revenues and expenses and to give them a report as to the possibility that we might become self-financed. We are in the process of doing that, but we have not yet come forward with a report.

The really crucial question contained in your question is whether we will have adequate resources to do the job.

During the period which ended, I think, approximately a year ago the Commission had a rule 3(b)(9), in which it attempted to regulate bank broker-dealers, and we had registered under that 3(b)(9) rule, approximately 170 broker-dealers from the banking community. We were—that rule 3(b)(9) was later declared invalid by the District—by the Circuit Court for the District of Columbia and that regulation is no longer in place, but we found that we were able, within our resources, to regulate the bank broker-dealers who registered with us, and I think we would have been able—we will be able fulfill our regulatory responsibilities, should we be asked to regulate the banks in their securities activities.

I would make two caveats to that—three, perhaps. One is that much of our regulation takes place through the self-regulatory organizations. We have regulatory oversight responsibility with regard to the stock exchanges and the National Association of Securities Dealers. These entities are self-regulators. They do very much—a great deal of the inspection work. So we would expect that the largest burden of increased regulation, should we be given responsibility over bank securities activities, would be in the self-regulatory agencies.

Nevertheless, we would have increased responsibilities, and that would be particularly true, if we were given power to regulate bank disclosures directly, as we have suggested. In that case, we would need to have some additional resources, and I guess the third caveat is that I have, as a matter of record, differed from my

predecessor and urged that the Commission be allocated additional resources on the theory that we need to have more resources in order to adequately perform our regulatory function, more resources in order to do the kind of planning activities and long-range activities that are necessary.

So my answer, in summary, is twofold. I think we can do the job with our present resources, but we really need more resources, in order to meet new challenges.

Chairman ST GERMAIN. Thank you, Mr. Ruder.

Mr. Wylie?

Mr. WYLIE. Thank you, Mr. Chairman. I would be pleased to recognize the presence of a former constituent and the son of a very good friend of mine—except on the golf course—Mr. David Mahaffey, who is Associate General Counsel for Mr. Ruder now.

Welcome, David. Good to see you here. Pass on my regards to your father.

I would like to follow up on a question that Chairman St. Germain has asked here. Would not expanding the powers of the banks necessarily require and assume a greatly enhanced level of supervision by the bank regulators. Many of them have expressed reservations about the capability of bank regulators providing the necessary degree of supervision. You have testified that if you are given these expanded securities powers or banks are given these securities powers, that you would probably need some additional help.

Have you done any specific looking into that? You said that right now you don't need any additional help, but if the banks were allowed to compete in the securities business. You have also said that you favor that, as I understand it, although your statement here right now reflects the statement in the "Wall Street Journal" is not quite as strong.

Mr. RUDER. The statement in the "Wall Street Journal" was taken out of context of a speech I gave in Florida, and the statement, particularly the headline was not accurate. Our statement is that we cannot support repeal of Glass-Steagall unless we have power to regulate bank securities activities. We have not taken a position as to whether we favor Glass-Steagall repeal, if that event should occur.

Mr. WYLIE. I am glad I got into that, so we could have that modification, because the first paragraph was pretty strong. It simply said that "David Ruder, Chairman of the Securities and Exchange Commission, said banks should be allowed to compete the securities business."

Mr. RUDER. I would be pleased to read the entire paragraph to you.

Mr. WYLIE. Maybe we could place that in the record.

Mr. RUDER. All right.

Chairman ST GERMAIN. Is there objection?

[No response.]

The Chair hears none.

[The information referred to can be found in the appendix.]

Mr. WYLIE. Have you been looking into what additional staff you might need, if banks were allowed in the securities business? I'm

referring to the line of your thinking, that they should be regulated by SEC, as to how much additional staff you might need?

Mr. RUDER. No, sir, we have not made a specific examination as to how much staff should be needed. I may say that I have, in my 1988 budget, 1989 budget submission, asked—already asked for significant new staff to increase the number of people in the Division of Market Regulation, which is, essentially, the division which regulates in the broker-dealer field, and if that—if that request is granted by Congress, we will be in a much better situation to regulate in this area.

Mr. WYLIE. I'm sorry I do not know as much about the SEC as I do about the FDIC and the Federal Home Loan Bank Board, but do you get your funding from fees like the FDIC and the Federal Home Loan Bank Board does? Fees within the industry?

Mr. RUDER. No. We receive appropriations, although there are statutorily generate fees which go into the general revenues. There is a fee which is imposed on securities trading on the stock exchanges, and there are filing fees which are imposed by us. And the bulk of our—the bulk of the revenues which the Commission produces, come from the stock exchange fees and the filing fees relating to public offerings of securities.

We must then negotiate with the President through OMB and with Congress as to our appropriation each year.

Mr. WYLIE. Then my follow-up question is not quite as appropriate. I was going to ask if you felt that you should be taken off budget like FDIC and the Federal Home Loan Bank Board suggested that they be taken off budget, but I don't think it would be quite as appropriate in your case.

Mr. RUDER. We are looking at that question. The fact that we may be self-sufficient in terms of revenue as against expenses is one, of course, which is of great interest to us, because we might possibly have an opportunity to become more self-sufficient. We do not, however, seek relief from oversight by the various committees.

Mr. WYLIE. My time has expired. I do have a couple more questions.

Chairman ST GERMAIN. Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman. Mr. Ruder, you have said that you favor allowing banks in the securities business, but only if this activity is supervised by the Securities and Exchange Commission. I do not favor allowing banks into the securities business, but if that is what Congress decides, then I do want the SEC to supervise the banks, because I do not think that bank regulators—and the record proves itself—would supervise the banks, but rather will merely continue to be cheer leaders. The recent case of Continental Illinois violating regulations with regard to lending to its affiliate First Option, shows me that bank regulators cannot do a good job.

My question is simply this. If your agency had the responsibility to enforce the laws and regulations concerning bank securities activities, what would you have done in the Continental Illinois First Option situation? I need to know if you are going to be tough on the banks or wave a powder puff?

Mr. RUDER. Mr. Congressman, the Securities and Exchange Commission, I think, has never had a powder puff reputation.

Mr. ANNUNZIO. There's always a first time!

Mr. RUDER. We have the reputation—the reputation we like is the tough cop regulation. Indeed, we frequently are castigated, mildly, by the securities industry for failure, apparent failure to be as great cheer leaders as the industry might want.

Our attitude regarding supervision of broker-dealers is that we have a responsibility to protect the customers and the securities markets. I would certainly say that we would treat a bank securities affiliate with the same tough copy attitude that we would with regard to any securities operation.

Additionally, in our prepared testimony, we have suggested that there must be some special regulations adopted with regard to the interaction between securities affiliates and bank affiliates of the—in a bank holding company structure, so we would be concerned with that.

Mr. ANNUNZIO. Mr. Ruder, I am trying to get an answer. I have watched these bank regulators. I have been to all of these hearings. I have seen all of the violations. It is the integrity of human beings. It is a frailty that is responsible for most of these—practically all of the failures.

What would you have done in this case? Would you have fined Continental? I would like to know, specifically, what kind of punishment would you mete out?

Mr. RUDER. Sir, we do not have——

Mr. ANNUNZIO. When these banks are shut down it is because they made poor loans and used poor judgment. Stealing the public's money is what the bankers have done. You see, the only punishment they get is a slap on the wrist. In fact, they get a little better than a slap on the wrist. Wherever they shut down, the FDIC is ready with billions of dollars to save the bank, because they are going to save the community. They reward them for being crooks. They give them more money. They put more money into their banks instead of shutting them down.

That is what I want to know. What would you be doing?

Mr. RUDER. There are several areas of regulation which we would have with regard to bank securities affiliates. We would not—the bank holding company securities affiliates would not have direct regulation over the banks, as such.

Indeed, we have no power with regard to the—with the First Option Continental situation.

In general, however, I can tell you that we do have a very, very vigorous enforcement program at the Securities & Exchange Commission. I participate on a weekly basis in Commission meetings, in which we authorize our own enforcement division to either initiate proceedings, and those proceedings can be either administrative proceedings against the broker-dealers or injunction actions against the broker-dealers or injunction actions against anyone who has violated the securities law. And we may be relatively unique, that sense, that we do have such a vigorous enforcement arm within the Securities and Exchange Commission, both at the Commission and at the regional office level.

So we do look at all of the indicia of human greed, which, believe me, is out there in the securities industry, just as it is in every area

of life, I am afraid to say. But we step forward as strongly as we can, when we find something wrong.

Mr. ANNUNZIO. We have more regulation up here watching the Congressmen than the banks have over the banks.

The CHAIRMAN. The gentleman from Georgia?

Mr. BARNARD. Thank you, Mr. Chairman.

Let me also express my welcome, Mr. Ruder, to this committee, and our thanks for the contribution you will make in the deliberations we will be taking up.

Mr. Ruder, as I have read your testimony and posture, it is that if Glass-Steagall is repealed, we should be concerned about safeguards. I don't think that any of this committee would disagree with that.

Mr. RUDER. I am glad to hear that, sir.

Mr. BARNARD. I think very definitely we are looking to maintain the safety and soundness of the banking industry as well as the securities business and that we are trying to maintain the public confidence in both institutions.

I think, generally speaking, most of the legislation that I have seen to some degree—maybe not as much as your testimony discusses it, but more than most of the legislation introduced both in the House and in the Senate—has included many of the safeguards. Have you found that not to be the case?

Mr. RUDER. I have not examined the House legislation, but the three bills in the Senate did not go nearly far enough with regard to our giving us power to regulate banks' securities activities, and we are in the process of working with the staff of the Senate committee to see if we can't work out the legislation.

Attached to our written submission today is the Bank Broker Dealer Act, which was introduced both in the House and in the Senate in prior times. So, there is particularly one issue which the bills have in common, it seems, is that they have indicated that they only wish to have new activities of banks put in securities affiliates. Our Bank Broker Dealer Bill and our 3(b)(9) rule, which was declared invalid, sought to have current bank activities regulated.

Mr. BARNARD. I don't say that the market bill is not timely. I think it is timely, but I think it should be considered in the total context as we move toward, you know, further deregulation, of further change, you might say, in the financial structure. But I think as we move in that direction, I think that the market bill should very well be considered.

Time, as Mr. Annunzio said, is very limited up here, so we have to run from one point to another.

I noticed that you endorse the Vice President's task force recommendation on financial reform. That sort of surprises me because nothing has ever happened to that bill. It has been 18 months in developing the bill, and to my knowledge, Mr. Chairman, it was never even introduced by anybody. Of course, it was changed. It was changed significantly in the last 3 weeks before the thing was ever reported. I don't know how well you followed that in your previous role, but it confused all of us because they studied it for 18 months and came up with a proposal and then 3 weeks before it

came out, it was all changed. I don't know how much credibility we can put into that report or not.

But let me get back to the other aspects. Somehow you singled out in your testimony this morning commercial paper. Would you reiterate that? I didn't follow that.

Mr. RUDER. The banks are currently engaged in commercial paper activities. We do not currently regulate them, and we do not propose to regulate those activities under new regulatory environments. It would be possible for us to see that, since there are some risks associated with commercial paper.

Mr. BARNARD. What the Bankers Trust is doing, is that really underwriting commercial paper, the activity of the commercial paper operation, is that really underwriting commercial paper?

Mr. RUDER. They are certainly dealing in commercial paper. Whether they are regulating it, I would have to ask: Are they underwriting? As we use the term underwriting, they are doing it in a best-effort situation. They are agreeing that they will be the principal promoter of commercial paper.

Mr. BARNARD. Let me ask you this. In the underwriting of commercial paper today by securities firms, what is the activity of the SEC in regulating that? The reason I make that point is because in your testimony you said that you were concerned about the bank use of underwriting to dispose of poor loans. So, I guess what I am trying to say is what do you do today to guarantee that the commercial paper offering of securities houses are not poor loans and how do you address the "junk bonds," the quality of junk bonds and the underwriting of them?

Mr. RUDER. There are two questions. But with regard to the commercial paper offerings, commercial paper, we are talking about exempt commercial paper that is short-term—usually 3 months. It is sold to a highly sophisticated group of buyers, and to that extent we do not regulate it.

Mr. BARNARD. That is like the general public. You know, sometimes we forget that public and the problem is that in forgetting that public we are concerned about public policy too.

Mr. RUDER. We do regulate it indirectly. We have antifraud regulations applicable to the commercial paper market, so that if there are misrepresentations or half-truths, we would have regulatory power to do that.

In the discount bond market we follow our traditional regulatory approach, and that is that we insist upon full disclosure as we do with regard to all underwritten securities, but we do not have what is called merit regulation. We do not take positions as to whether something is something that should be or should not be purchased. We insist that the disclosure documents reveal risk. That is as far as we go with it.

Chairman ST GERMAIN. Mr. Parris?

Mr. PARRIS. Thank you, Mr. Chairman.

Just to follow up on my friend from Georgia's question, Mr. Ruder, in your testimony you suggest that the underwriting of municipal revenue bonds should take place in the securities affiliate rather than the bank itself. Banks under existing law have the authority to underwrite general obligation bonds directly, and I would assume from your position that you would terminate that

right under the new legislation fold it into this affiliate, securities affiliate. Is that correct?

Mr. RUDER. Our position on that is that if they continue to underwrite general obligation bonds, we would not disturb that, but if they chose to have a securities affiliate and underwrite municipal revenue bonds, then we would suggest that their general obligation underwriting activities go into the affiliate.

Mr. PARRIS. That is exactly my question, Mr. Ruder. It would seem to me that if you terminate, if you will, the current right under existing law to underwrite general obligation bonds, if there is the securities affiliate, then in fact there would appear to be—and I am sure that we will hear the argument from the financial industry that it will be—the diminution of existing powers rather than expanded powers.

My simple question to you is: Is there any evidence to suggest that municipal revenue bonds are any more risky than general obligation bonds? If the underwriting of either one of the two is mutually exclusive, what is the difference between the two?

Mr. RUDER. A municipal revenue bond is different from a general obligation bond in the sense——

Mr. PARRIS. If I might, time is very—I think I understand the difference between the two securities. What I am saying is, in terms of the risk of the safety and soundness of the bank, what is the difference between general obligation bonds and municipal revenue?

Mr. RUDER. I am not talking—our opinion does not go to safety and soundness of the bank, it goes to protection of investors. When a municipal revenue bond is sold, the municipal revenue bond depends on the stream of revenue from the particular activity, and that is a riskier investment than if you have the full faith and credit of the municipality behind the bond. So, we think the broker-dealer part of this should be regulated. We are not at this point talking about the general obligation underwriting function being regulated.

Mr. PARRIS. The only quarrel I have with your statement, Mr. Ruder, is that this committee's responsibility goes to the safety and soundness of the industry and to the individual investor and depositor. Talking about investors, very quickly, it is a widely held view that since the events of October, Black Monday, and so forth, a couple of the recent insider trading scandals that we hear about has adversely impacted on the public perception of the securities industry to the small investor and the safety, if you will, of the small investors' investment in securities themselves.

My question, Mr. Ruder, is: In the speech—and I suppose we all are dealing with the Wall Street article of last week—in the Securities Industries Association talk that you gave last week, you suggested that the securities firms must pay more attention to individual investors. Have the firms themselves, has the industry, come forth with any specific suggestions as to how that might be accomplished? Has the SEC put any guidelines or recommendations out in regard to the individual investors' protection, if you will, of the sanctity of that investment? Where are we on that situation?

Mr. RUDER. We have two initiatives underway. One has been to urge the self-regulatory organizations, the stock exchanges, to be more critical of the broker-dealers themselves with regard to the

broker-dealer regulation of customer sales practices. We, in turn, are asking the broker-dealers directly to be more concerned with supervision of the registered representatives.

My speech to the Securities Industry Association was a bit of chairman jaw-boning intended to alert the industry to my view that customer sales practice were a serious matter as far as we are concerned, that we will be looking at the brokerage firms to see that they are engaged in the supervisory practices which we think are mandated by our rules and by the rules of the self-regulatory organizations.

Mr. PARRIS. I congratulate you on that point, Mr. Ruder. But my only question is: Isn't that mildly like putting a different fox in charge of the chicken coop?

Mr. RUDER. The self-regulatory organizations, particularly the New York Stock Exchange, have recently increased their compliance personnel at our urging, and the New York Stock Exchange particularly has initiated procedures to try to alert the industry to the need for greater supervision. We are and will be deregulating the broker-dealers in the same way, urging them to pay as much attention to supervision of customer sales practices as they do to profits.

Mr. PARRIS. I hope that applies to computer trading programs.

My time has expired. Thank you, Mr. Chairman.

Ms. OAKAR. Chairman Ruder, I am trying to get to the bottom line of your feeling. You mentioned you were quoted out of context in the Wall Street Journal. As to Glass-Steagall, is your only objection relative to the repeal of Glass-Steagall that you want to have parallel power in terms of overseeing the activities of banks that, frankly, you don't have now, do you?

Mr. RUDER. That's correct. We do not have as much power as we would like.

Ms. OAKAR. The repeal of Glass-Steagall in terms of your support would be that you would have this contingent power relative to the repeal, giving banks more opportunities in the securities area?

Mr. RUDER. I will read the sentence, if I may, that expresses our opinion—

Ms. OAKAR. I read it. I think it is on page 1 where you say——

Mr. RUDER. In the——

Ms. OAKAR. It just says——

Mr. RUDER. Prepared statement: "The Commission is unable to support repeal of the Glass-Steagall Act unless the investor protection concerns arising from bank entry into securities activities are simultaneously addressed."

Ms. OAKAR. The fact is that you are not satisfied with the oversight you have in the regulatory area now?

Mr. RUDER. That's right.

Ms. OAKAR. You would not be satisfied if it were repealed unless you had current power that you don't have and additional powers; correct?

Mr. RUDER. We would vigorously oppose repeal of Glass-Steagall if the banks could enter into securities activities in circumstances that we could not regulate them.

Ms. OAKAR. You are not able to regulate them now?

Mr. RUDER. That's right. But we would make a bad problem worse, as far as we are concerned.

Ms. OAKAR. So, you want the power that you don't have now, plus the additional powers relative to the repeal?

Mr. RUDER. Congressman Markey has already introduced on our behalf——

Ms. OAKAR. Yes or no. I just want to get to the bottom line of what you are looking for.

Mr. RUDER. Yes, we would like increased bank power over bank securities activities now, even if Glass-Steagall is not repealed, and we would want them, if Glass-Steagall were repealed as well, more vigorously.

Ms. OAKAR. Now, in your testimony this morning you mentioned that the Commission supports the theme of securities activities through affiliates under a bank holding structure, and you specifically propose that smaller banks be able to engage in limited securities activities.

What specifically do you mean by limited securities activities, and how would you define a small bank?

Mr. RUDER. We don't have a number on small banks. What we are concerned with is this, that a bank holding company with an affiliate structure would give a greater separation between the banking activities and the securities activities and be better suited to preventing what we would conceive of as activities which might injure either the bank or the securities firm.

We would permit, however, in certain—in the smaller banks, it may be difficult for them——

Ms. OAKAR. I guess what I am trying to figure out is whether you were talking about the banks in Cleveland that are moderately large, and we have independent banks, or are you talking about——

Mr. RUDER. There are banks for which it would be—there are some banks for which it would be a significant burden for them to have to establish a separate affiliate with a separate board of directors, and what we would expect is that there could be a subsidiary of a smaller bank in which the smaller bank would be subject to the control of the bank board of directors. The smaller bank's securities activities would be subject to control of the bank board of directors.

Ms. OAKAR. The larger the umbrella then you are talking about?

Mr. RUDER. Yes.

Ms. OAKAR. Lastly, with the recent crisis in the stock market, are you concerned that if we have more institutions involved in these activities it would possibly lead to more difficulties?

Mr. RUDER. Initially, in preparation——

Ms. OAKAR. Does competition help the situation or hurt the situation, do you think?

Mr. RUDER. I cannot speak with a commission position. But my general view is that increased competition may well provide greater liquidity for the securities industry, and that would be positive.

Ms. OAKAR. That would be positive?

Mr. RUDER. Yes.

Ms. OAKAR. Provided you have the control over what the regulation——

Mr. RUDER. You must understand that we regulate the broker-dealer activities with a primary view to investor protection. We do not regulate their risk activities other than through the net capital requirements, which we require them to have a net capital sufficient to bear certain risks of the business. But we do that in order to have essentially broker-dealer solvency.

Now, the question of broker-dealer liquidity and capital is one that we are looking at very carefully in our market study, and we intend, I hope, to come forward with some suggestions which might meet the problem of how the industry in general is going to deal with the kind of events that occurred in October.

Ms. OAKAR. Turf battles, which in a sense is one of the points that you have made—and which is also common to this committee because we feel sometimes that we have jurisdiction in areas that we don't get the jurisdiction.

Thank you, Mr. Chairman.

Chairman ST GERMAIN. Very frankly, I could see a lot of turf battles developing as I read the testimony last night.

Mr. Vento?

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Ruder, one of the concerns that has come up is the issue of, if the new powers are granted, that there would be—there has been a lot of discussion, incidentally, about the concentration of activities in a handful of brokerage companies today, and you might want to talk about that. But as in Canada, there has been a number of mergers that has occurred between banks, large banks and the brokerage units.

Do you feel that the existing antitrust laws are adequate to deal with that, or do you think that the further guidance is necessary that has been placed in some of the Senate and House legislation on that matter?

Mr. RUDER. Essentially, I think the antitrust laws are sufficient to deal with concentration problems.

I am additionally—I have in mind another problem, and that is that when you mention Canada, we have to deal with the fact that in the overseas markets the banks and securities firms are not separate and that as we go through and have a greater globalization, internationalization of the securities industry, we are going to find our own industry to be, I think, at increasing competitive disadvantage.

Mr. VENTO. Most of the legislative measures I saw with regard to the S&L's and State-chartered institutions granting them different types of powers, securities powers, which really present a problem.

I notice your solution, your solution in that instance, is in fact to expand the regulatory role of the Securities and Exchange Commission to those activities; is that correct?

Mr. RUDER. I don't like to use the word expand. We believe that we should regulate all securities activities in order to prevent fraud, in order to protect investors. It is not a change in function at all, it is simply an effort to regulate the people who are engaged in those activities. We think it is not a correct analysis to say that because the person engaged in the activity is a banker or a thrift, that investor protection is not a proper goal.

We frankly don't think that the bank regulators have enough experience or perhaps enough will-power to regulate in the investor protection area. That is what our point is.

Mr. VENTO. You indicate a number of changes, of course, changes in terms of bank powers you think should be—irrespective if there are changes, you feel that there ought to be these extensions of regulation into these other activities, but especially, I guess, if there is expansion of powers in securities areas. You suggest that there be the extension of the regulatory role on the part of the SEC in these holding companies or subsidiaries, the activities that now are securities activities that would provide a clarity in terms of functions.

In other words, you see in this, you point out in your executive summary, investment company protections, and you list a whole list of them: independent directors, use of the bank's name, affiliated transactions, investment company borrowing from affiliated banks—and we might get back to that one—and then you go to protections against conflict of interest.

In other words, do you feel that these types of protections ought to be articulated in the law that passes so that you have direction with regard to those, or do you think that they just ought to be left to rule and regulation? Mr. Ruder: Some should be articulated specifically, and others should probably be left to rule and regulation.

We have had a lot of discussion in the committee in the opening hearings with regard to the First Options. Can you give us a response as to your feelings about the concerns about Continental Illinois and First Options?

Mr. RUDER. We did not approach the First Options situation as a bank regulator. We approached First Options as a securities regulator. First Options was the clearing corporation for many of the member firms of the Chicago Board Options Exchange.

Indeed, a very substantial segment of that floor was a clearing through First Options. That means that First Options was the financially responsible organization with regard to settlement of trade on the floor at that time.

Had First Options been forced to cease business the effects on the securities markets would have been very, very bad because essentially all of the members who were clearing through First Options, whether or not they were in particular trouble, would no longer have had a clearing member. That would have caused a dramatic decrease in the liquidity of that market, and might have had resulting overflows and difficulties in our other markets.

So, from a securities point of view, the fact that First Options finally received enough capital was positive. It did so, as I finally understand it, by having substantial infusions of capital from the holding company after the regulatory problem was solved, and indeed as we understand it, First Options has had lines of credit and borrowings with a great many other banks besides Continental. There was a substantial amount of liquidity afforded to First Options from elsewhere. So, from a securities point of view, the fact that First Options remained active and able to conduct its business was very positive.

Mr. VENTO. Thank you.

My time has expired.

Mr. ROTH. Mr. Ruder, with the bank entry into securities, would you include concentration limitations; in other words, the biggest banks merging with the biggest securities firms?

Mr. RUDER. We do not have a commission position on that. As I have indicated earlier, I think that the antitrust laws, my own personal position would be that the antitrust laws would be adequate to deal with concentration questions. So, we would not have a provision of that kind. At least I would not.

Mr. ROTH. You mentioned this issue of powers and regulating people involved in this activity. We have had some instances in this past year of insider trading and so on. What has SEC done to bolster that action so that the public can have confidence that this is not going to happen or a continuation will not happen of this sort of activity?

Mr. RUDER. We have a very vigorous enforcement program in the insider trading area, and we have recently sent to the Senate securities committee our proposed insider-trading legislation which would codify and somewhat increase the commission's enforcement powers over insider trading.

In addition, we are publicly making it clear that we will enforce the insider trading laws against anyone, and that includes industry members, corporate people, and friends and relatives, if you will. We get into so-called tipping chains, which I find to be a very great indication of greed and very negative.

Mr. ROTH. Thank you, Mr. Chairman.

Mr. SCHUMER. Mr. Ruder, I noticed in your testimony you talk about existing securities powers which banks can do, should be put into a separate sub. As we know, overseas banks are doing many of the powers that you feel should be in that separate sub.

Now, what would be your view of legislation that would take the present situation and simply put the existing bank securities powers in a separate sub and see how that would work, before granting any new powers?

Mr. RUDER. That would be a good step forward, sir.

Mr. SCHUMER. I appreciate that, and we should all be mindful of that comment. So, just to rephrase it, if Congress were not to take any action in changing Glass-Steagall, it would still be a step forward to take bank existing securities powers, put them in a sub, and then let the SEC regulate?

Mr. RUDER. Yes.

Mr. SCHUMER. Very good. Thank you very much.

Second question: Did the SEC encounter any instances in the wake of October 19 which suggested certain banks were reluctant to make loans available to securities firms? And if Glass-Steagall were eliminated, would we find that kind of problem exacerbated because banks would not want to make loans to competitors of their own existing securities subs?

Mr. RUDER. With regard to the first question, we have had information that I don't know whether it is reliable that there was one bank in New York which was not anxious to, which did not extend credit to securities firms.

On the other hand, the Federal Reserve Board made it clear to other banks that lending to securities firms would be favored.

During the October 19 break, there was a dramatic amount of liquidity made to the banking industry.

Mr. SCHUMER. That was with Glass-Steagall without the direct interests of the banks having competitors. And it still happens. Wouldn't it be more likely to happen in the next crash again?

Mr. RUDER. I had that concern when we began to examine Glass-Steagall. I was concerned first of all that a bank might not be willing to loan money to another securities firm because it had its own securities affiliate, and I was concerned as well that if a bank securities affiliate was in trouble, that bank might not want to make additional borrowing to other securities affiliates.

I tested both of those propositions with bank regulators and with members of the banking industry. And those concerns were alleviated substantially.

Mr. SCHUMER. Were you asking the foxes whether they were going to eat the chickens?

Mr. RUDER. They responded as bankers sometimes do, that it would be the economics of the loan that would determine whether the loan should be made.

Mr. SCHUMER. We know one person's economics could be another person's good loan or bad loan, don't we?

Let me move on to another question. I see you do share some of the concerns.

Mr. RUDER. I took out of my testimony in an earlier draft some concerns of that kind because I felt that my concerns had been substantially met by the assurances I received.

Mr. SCHUMER. We are all concerned about the safety and soundness of the banking system. We all know that one of the things some of the other regulators have told us is that you could not pierce the corporate veil.

In other words, if the securities affiliate went under and creditors were after it, that they couldn't reach the bank because of the corporate veil.

But you point out there are a number of other legal theories. You mentioned equitable distribution, equitable subordination, pension fund and tax liability, controlling personal liability could shift that liability to another subsidiary within the holding company structure.

I would first appreciate a description of those theories. But, with the Chair's permission, I think if you could submit those in writing, I think that would be helpful to the committee.

Mr. RUDER. I would be willing to do that.

Mr. SCHUMER. Would the SEC support efforts to pierce the corporate veil based on those theories, given his obligation to represent shareholders and get their money back?

Mr. RUDER. That would be highly unlikely. We have two areas of investor protection. One, our so-called net capital rules in which the primary aim is to provide customer protection for broker dealer customers.

In addition to that, we have the so-called SIPC Fund, which is available to provide protection for customers of brokerage firms if they become insolvent.

So, SIPC has a fund of some $380 million plus a bank line of $500 million, plus the possibility of going to the Fed for a billion dollars.

So there is a substantial amount of credit available there.

Mr. SCHUMER. Thank you, Mr. Chairman. My time is expired. I have one little observation.

It seems—and I think the testimony we've had here, your ideas are well-taken. But, every regulator that comes before us seems to have a plan that expands their own power.

Corrigan's plan expands the Fed's power. Greenspan's plan expands the Fed power. Seedman and Clark want something that expands their power. You want something that expands your power.

I think, just in terms of the committee, we have to sort of take some of these regulated positions with some of that in mind, that everyone is out to expand their own turf and we have a lot of turf work going on among the regulators.

Mr. RUDER. I hope you won't consider that we are in a turf war here because——

Mr. SCHUMER. I consider you less in a turf war than some of the other regulators.

Mr. RUDER. The SIPC billion dollar line of credit comes from the U.S. Treasury, not from the Fed.

Mr. SCHUMER. Thank you.

Chairman ST GERMAIN You obviously saw——

Mr. RUDER. I saw your head wagging in distress and I looked at my notes.

Chairman ST GERMAIN. Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman. I, too, want to compliment Mr. Ruder. I think his prepared text, which we had available to us for study, is clear. His positions have been stated very forthrightly with respect to the matter at hand.

However, there is just one thing that came up in the course of your testimony and that was the Senate direction of trying to make the SEC self-sustaining. I just wanted to make my own personal view that I hope it doesn't happen because we have had the longtime experience with the Comptroller of the Currency, where there are no appropriated funds available.

I have been here at times when the Comptroller has come before us and has as much as thumbed his nose at the Congress and declared his independence and said it was none of our business.

I hope it doesn't happen here because I think it will be the very thing that will destroy the effectiveness as a police watchman or a cop on the corner, that is necessary.

The other thing was just a question that I have had since before the October 19 crisis. That is, to what extent do you have any power over this stock loan activity that preceded the October 19 break in which you have this high accelerated borrowing on stock or stock loans as a means of—that, in my book of evading the regulatory enactments of the thirties with respect to marginal provisions.

Mr. RUDER. We have regulatory power over broker/dealers. So, to the extent that they are engaged in stock loan activities, we can deal with the relative risk. Under our net capital requirements, we do not have power, for instance, with a thrift engaged in stock loan activities.

We have been given additional regulatory power with regard to Government securities through the legislation adopted with regard

to the—giving us some oversight responsibility with regard to Government bonds.

But, essentially, we have not been into a vigorous policy with regard to that. We do not have—the margin, the regulation of margins is in the Federal Reserve Board, so we do not have that power either.

Mr. GONZALEZ. Did you note any connection between the occurrences on October 19 and the heightened activity in the stock loans or lending in the immediate year preceding October 19?

Mr. RUDER. We have not yet identified any connection between stock loan practices and the market volatility problems of that week.

We can—we have a very full plate with regard to our investigation and we certainly would report if we did find any indications that that was a problem.

Mr. GONZALEZ. I would be very much interested because my understanding was that when the sudden corporate liquidity came on some of these borrowings, you had quite a crisis, or an emergency.

But I would be most interested if, in the course of your investigation, you find that there was some contributing factor.

Mr. RUDER. There may be a settlement and clearing problem but, again, we can look at that, sir.

Mr. GONZALEZ. I appreciate that.

Thank you very much.

Thank you, Mr. Chairman.

Chairman ST GERMAIN Mrs. Roukema.

Ms. ROUKEMA. Chairman Ruder, I greatly appreciate your testimony today and I do want to follow up on two questions that were previously asked.

One was Mr. Schumer's and his questions regarding the lines of credit from the banks, or withholding the lines of credits from the banks.

I wasn't quite sure about your response to that. And so I would like you to clarify.

You stated something to the effect that your concerns had been satisfied, but I didn't quite understand how your concerns had been satisfied and whether or not you do not believe that with some further deregulation there is not need for a legislative protection with respect to the relationship and lines of credit to the bank, from the banks to the investment banks.

Mr. RUDER. There really are two lines of thought here. One is the question of how to prevent the bank subsidiary from loaning money to the securities subsidiary in order to protect the bank against the undue riskiness of the loans when it is the securities subsidiary of its own holding company.

In that instance, I think that we would support a legislative prohibition against that kind of activity.

The other question is whether the Bank Holding Company would take steps to prevent the bank or itself from loaning money to other securities industry participants because of its selfishness with regard to its own subsidiary, or fear that—the result of its own subsidiary should lose money, that it might lose money with regard to other securities industry participants.

In that regard, my concerns have been alleviated, I think would be a better word, rather than satisfied. But I think that one needs to be concerned about those matters.

But I have to say that if both the bank regulators and banking industry members tell me that the question of whether to make a loan to a securities industry participant in the first place is a matter of banking, economic policy, and the question of whether to make additional loans to a bank, to a securities industry participant in times of stress, is also governed by those same questions, then I am not so concerned with structure.

Ms. ROUKEMA. You're still not so concerned with structure despite the fact that there seems to be general agreement that we came dangerously close to a melt-down on the Tuesday after October 19 because of the threat of withdrawal of lines of credit?

Mr. RUDER. I am very concerned about the liquidity questions in the securities industry in times of stress. One part of our study will be—and recommendations, I hope—will be a discussion of means of having a greater assurance of liquidity.

The problem, of course, in any—at any time in which there is stress in a borrower, at least my experience is that the banks are not so anxious to lend to an entity which is in negative circumstances.

That will always create problems. It may be that in times of economic downturn, volatility problems and the securities markets, then it is going to be the Federal Reserve Board, or some other perhaps private source, which will make the kinds of liquidity available which is necessary.

Ms. ROUKEMA. You're going to submit a specific report on that subject?

Mr. RUDER. It is part of our study that we're going to deal with. I regard that question as probably the most—I personally regard that as probably the most important question to come out of the market decline.

Ms. ROUKEMA. Thank you very much. I appreciate that answer, and we look forward to your study.

Second, and this really follows up on Mr. Vento's—one of the problems with being so late in the questioning, it gets to be repetition.

But I do want to go to the issue of protection against conflict of interest to which you referred in your statement. I think, in response to Mr. Vento's questions, you said there might be a legislative remedy or a rule and regulatory remedy.

Is there any way that you can amplify on that?

Mr. Greenspan has said that the Chinese Wall is sufficient. Is there a way that we write the Chinise Wall into legislation?

Mr. RUDER. In our prepared testimony, we have several areas in which we think that a Chinese Wall should be legislated. I think we would believe that the bank affiliate ought not to be allowed to loan money to the securities affiliate.

We ought to be concerned about taking money from the bank and putting it into securities affiliate, or vice-versa. So that we can—so that one of the affiliates in terms of—either one of the affiliates.

Now, the question of how exactly those should be drafted is one which we are going to be working with the Senate committees, at least, in terms of those—the drafting.

Mr. ROUKEMA. You would suggest you are going beyond the recommendations of Chairman Greenspan?

Mr. RUDER. Yes. There is some consideration in our draft, in our testimony, which I think goes beyond that.

I'm not exactly sure where he is, but I can't respond identically and specifically to that.

Mr. VENTO. The point on the first option, if there is other credit available, why didn't they use it instead of going to the affiliate, they didn't. They chose to go to the First Options.

That is really the question that raises the conflict of interest in all of the other concerns. Not that they didn't need liquidity and it wasn't a good thing.

Thank you.

Ms. ROUKEMA. Thank you, Chairman Ruder.

Your testimony has been very helpful.

Chairman ST GERMAIN. Chairman Ruder, did I just understand you to say that the SEC is working with the FDIC, FSLIC, the Fed and Senator Proxmire's staff?

Mr. RUDER. We have been asked by Senator Proxmire's staff to work with, particularly with the FDIC and the Comptroller to help to draft legislation.

Chairman ST GERMAIN. Is the Senate Banking staff participating in that?

Mr. RUDER. Yes. Or will be.

Chairman ST GERMAIN If that is the case, don't you think it would be delightful if the staff of this committee were involved?

We do have equal votes and equal voice, believe it or not.

Mr. RUDER. We would be quite willing to work with you. In fact, we would be pleased to work with you.

Chairman ST GERMAIN. I would be pleased to have an invitation to have our staff assigned to participate in that endeavor.

Mr. RUDER. I cannot commit Senator Proxmire's staff in any way. I can certainly tell you that we would be——

Chairman ST GERMAIN. We will ask you to do the same darned thing with our staff. You can do it twice instead of once.

Mr. RUDER. We would be delighted to assist you in drafting legislation if you desire us to do that. We think we can contribute.

Chairman ST GERMAIN. We're looking to safeguards.

Mr. NEAL. A summit with the Senate.

Chairman ST GERMAIN. There is a report you're going to submit to Ed Markey's subcommittee on Glass-Steagall. There is also a report or a study going on with respect to October 19, what led to it or what the consequences were.

In answer to Mrs. Roukema's question, I think you said that liquidity question is being addressed. It is being addressed in the second study.

Mr. NEAL. In the market study. The October market crash. Not "marquee". [Laughter.]

Chairman ST GERMAIN. When do you anticipate that? Do you have a target date for that study?

Mr. RUDER. We are putting our staff through Christmas crisis and hoping that they will be able to finish eight reports sometime in mid-January.

Chairman ST GERMAIN. That will be available. And that will be available to us?

Mr. Morrison?

Mr. MORRISON. Thank you, Mr. Chairman.

I thank you, Mr. Ruder, for being with us this morning. I have a lot of questions. I hope we will get another round.

In your answer to Ms. Roukema's questions, did I understand you to say that you didn't think that the banking affiliate ought to be able to loan money to the securities affiliate?

Is that what you said?

Mr. RUDER. I think that's what our prepared testimony says.

Mr. MORRISON. So, in other words, it is zero? Zero lending from the banking affiliate to the securities affiliate?

Mr. RUDER. Yes.

Mr. MORRISON. Did I also hear you say that you did not think that funds should flow from the securities affiliate to the banking affiliate?

Mr. RUDER. Yes, sir.

Mr. MORRISON. As I understood the testimony we had from the various industry representatives at the last hearing, the whole reason for their support for the repeal of Glass-Steagall and the creation of various kinds of financial services holding companies, was that they wanted resources to flow out of the securities affiliate and other affiliates that they might create and into the banking affiliate in order to make the banks in some fashion more profitable or more liquid or more something.

Have I missed a step in this whole process?

Mr. RUDER. Yes, you missed the bank holding company step, the fact that the bank holding company, as I understand it, would be the recipient of profits from both the bank and the securities industry.

Mr. MORRISON. They were talking about so-called downstreaming the benefits of this extra profit to the holding company.

Mr. RUDER. I presume it would be possible for the securities affiliate to pay dividends to the banking affiliate—to the holding company. And for the holding company then to contribute to capital to the securities—to the banking affiliate, or vice-versa.

It is the direct interchange of funds to which we objected.

Mr. MORRISON. Now, do I understand that your testimony is that you are not taking a position on whether we should repeal Glass-Steagall, but you are saying what we must do if we repeal Glass-Steagall?

Mr. RUDER. That is correct.

Let me indicate to you that I come to you with a Securities and Exchange Commission position with regard to the regulation of securities activities. And that we as a Commission have not yet dealt with the question of what our position would be if we got whatever—if all of our wishes were granted.

Mr. MORRISON. We should not hear you to be supporting the repeal of Glass-Steagall.

Mr. RUDER. Not at this point.

Mr. MORRISON. You are saying that, in the absence of certain kinds of regulatory protections, we definitely should not repeal Glass-Steagall.

Mr. RUDER. That is our opinion.

Mr. MORRISON. Now, is there really any reason that you either personally or on behalf of the Commission, to whatever extent you can speak in either of those roles, that you can give us in support of repealing Glass-Steagall?

What benefits, if any, are we looking to in that kind of an action?

Mr. RUDER. I may seem unduly reticent to you, but this is such an important area. The chairman of the Securities and Exchange Commission is so often thought to be speaking for the Commission when he or she speaks that I would rather have the opportunity of having full discussion and authority from the other Commissioners with regard to an answer concerning Glass-Steagall repeal with our other objectives.

If I try to answer to you now——

Mr. MORRISON. I understand why you take that position. We have been told by others who are here asking us to repeal Glass-Steagall that we need to enhance the competitive position of the banks by enhancing their return on equity in one fashion or another.

One of the attractive businesses that they might go into in order to improve their return on equity is securities. Therefore, we should do this.

Now, as I understand it, the New York Fed has done a calculation, which is somewhat instructive on that point. I wonder if you have any comments on it. That is, if the top 17 U.S. commercial banks were to acquire the top 10 investment banking firms, that the banks' return on equity would increase from what was then reported to be 12 percent to 13.2 percent.

In other words, a 10 percent increase. Even though the rate of return for the investment banks is substantially higher, the combined rate of return would not rise significantly because the capitalization of the banks is so much higher than that of the securities firms.

This seems to me a rather small or marginal gain to justify making the very significant change in policy involved in repeal of the 50-year tradition of Glass-Steagall separation.

Do you have any comments on that study, or those numbers?

Mr. RUDER. I don't think I can comment directly on that, but I would make an observation. I think, in analyzing what is going on here, one ought to distinguish between the large banking—the large banks and the competitive position of the large banks and the small banks and the competitive positions of the small banks.

I think there are substantial differences in what you are looking at when you are looking at the effects of repeal of Glass-Steagall with regard to the small banks and with regard to the large banks.

In the large banking area, I do note that we are—and from the Commission's point of view, I can say this—we are looking at a world explosion in the securities markets. We are looking at an incredibly complicated environment, which is arising throughout the world.

We have automation, which is just revolutionizing our markets. We have at the same time bank and securities firms combined in overseas markets. And the same entities competing in both Euro-dollars, futures and securities products with our entities here.

I think that whatever legislation appears, I think it is important that substantial attention be given to the question of the competitive environment for our financial capital markets as such as they compete, as they will be competing in the world to come.

It is not an easy question.

Mr. MORRISON. I understand. You are saying that there are a lot of complex facts. It seems to me, with respect to those facts, one could resolve the question in either directions. Moreover, it is not at all clear that because these facts exist that we should move away from the separateness rather than move toward extending the effectiveness of the separation with respect to other institutions that are operating in our markets.

My time is expired, and I hope to have a chance to pursue that further.

Chairman ST GERMAIN. Indeed, you shall.

Mr. Ridge. Wait a minute. Mr. Price. I'm sorry.

Mr. PRICE. Thank you, Mr. Chairman.

Mr. Ruder, as you know, in considering bank regulatory reform, we are dealing on this committee with two broad approaches that have been proposed, the first being a Glass-Steagall repeal of sections 20 and 32, which would open up broad new powers for banks and would also, in most versions, locate securities activities in a separately-capitalized and separately-regulated affiliate.

Second, a granting of specific powers which would open up a more limited range of powers but, in many proposals, leave those powers within the bank itself.

Am I correct in concluding from your testimony this morning that, in general, you would prefer that first approach?

Mr. RUDER. That is correct.

Mr. PRICE. Although you would go further than many of those proposals in the wall of separation which you would require?

Mr. RUDER. I think that is correct, although probably not to an enormous degree.

Mr. PRICE. The requirements that you laid out on pages 13 through 21 of your testimony would seem to be a rather stringent set of——

Mr. RUDER. If you characterize it that way, I would accept it.

Mr. PRICE. I wonder, looking at the limited powers approach, how far you might be willing to go in that direction.

You indicate that Government securities, and commercial paper would not have to be located in a securities affiliate under your proposal.

But, when we get into municipal bonds, you would want to move general obligation bonds as well as this new revenue bond activity into an affiliate.

Mr. RUDER. Only if a securities affiliate were established for other reasons.

Mr. PRICE. Yes. Well, could you elaborate a bit on that? What is the criterion that you are applying in separating the permitted from the nonpermitted bank activities?

Mr. RUDER. The U.S. Government securities and the commercial paper markets have not been regulated by us in the past. Both of those markets involve quite sophisticated purchasers.

What we are talking about with regard to municipal revenue bonds and general obligation bonds is a difference in, probably in the purchasing public.

Here we are talking about regulating the broker-dealer part of this rather than talking about the underwriting part of it.

We are not talking about asking municipalities to register their municipal revenue bonds or their general obligation bonds with us in the same way that a corporation would.

What we are talking about is regulating the broker-dealer activities of the banks when they are selling these instruments to the public.

There, we think that our rulemaking powers and our net capital powers are regulatory, provide regulatory avenues for us to provide greater public protection.

Mr. PRICE. Now, exactly what is your position with respect to municipal revenue bonds?

Are you opposed to proposals that would permit banks as presently constituted to engage in this activity?

Mr. RUDER. The underwriting of revenue bonds is something upon which we have not taken a position. We believe that if they are engaged in—when they are engaged in dealing trading in those bonds, they should be regulated by us as broker-dealers.

Mr. PRICE. That implies separate——

Mr. RUDER. A separate subsidiary, that's right.

Mr. PRICE. And you are saying that once such a subsidiary is required that general obligation bonds——

Mr. RUDER. Then it would make sense to regulate—the regulatory burden would not be substantially greater. We think then that it would make sense to regulate the other activity in the broker-dealer sub.

The problem of trying to regulate an activity inside the bank as though it is a broker-dealer activity is that you get dual regulation, two agencies coming in and attempting to regulate the same organization.

You get at that point questions of bank requirements as to capital and our net capital requirements perhaps conflicting with each other.

You may have—you have insolvency questions, whether FDIC or SIPC is the right regulator to deal with insolvency questions.

So there are regulatory problems which can be solved by putting the activities into a sub and letting us regulate them.

Mr. PRICE. My time has expired. I would hope that, in later questions, we could explore the logic of the exception, the limited exception, you are apparently willing to grant for smaller banks.

But my time has expired for now.

Thank you very much.

Chairman ST GERMAIN. Mr. Ridge.

Mr. RIDGE. I would like you to assume a financial market where the bank's affiliates offer security products. I would like you to assume the investor can avail himself or herself, or their institution, of this service in the bank itself.

What kind of disclosure should be made by that securities affiliate operating under the same roof of a bank to that potential investor, if any.

Should there be any disclosure?

Mr. RUDER. Regarding the affiliation with the bank?

Mr. RIDGE. Yes.

Mr. RUDER. I would rather go the other direction myself. I think that the securities affiliate should probably have a different name, and the securities affiliate should not be in the position of being able to advertise itself as though it were a bank.

There are safety and soundness, there are customer protection features, as you well know, in a bank which don't exist in a securities affiliate.

Indeed, one of the regulatory problems we have is that there doesn't seem now to be an adequate separation of what are really securities activities with a greater deal of risk associated with them than there are in bank activities which don't have—which are historically not such risky activities.

Mr. RIDGE. Assuming the financial marketplace did not take your suggestion, or did not follow your lead in this regard, and permitted activities, securities services to be provided within the bank, permitted cross-marketing, did not require separate affiliates, separate buildings, different names—assume that.

Should there be a disclosure requirement? What should the requirement contain?

Mr. RUDER. Of course there should be no circumstances. I would expect that there should be both disclosure of the affiliation and disclosure of the various risks that are involved, and particularly disclosure of the fact that they are not regulated by the Securities and Exchange Commission if that should be the case.

Mr. RIDGE. Thank you very much. That is helpful.

Mr. Chairman, it is my understanding that five dealers place about 90 percent of all dealer-placed commercial paper. The five largest underwriters of domestic corporate debt account for almost 70 percent of the market.

The five largest underwriters of public stock issues account for almost ½ of the market.

So, clearly, in the securities industry, you have a much higher concentration than you do in the banking community. I am thinking in terms of the smaller, independent banks of Pennsylvania. And in a very parochial way, the smaller, independent banks of northwestern Pennsylvania.

I have enjoyed the exchange you have had with some of my colleagues about the ability for banks to offer municipal revenue bonds, the broker-dealer situation that you mentioned, the ability to underwrite.

I have in the process of drafting some legislation that would permit banks of $500 million or less to be agents of municipal funds and to offer and underwrite municipal revenue bonds.

Would you care to comment?

Mr. RUDER. Yes, sir. Particularly at the local level, we frequently encounter sales practices and advertising practices which are bad. We find that it is at the local level that individuals may do things that are not acceptable in terms of public protection.

What we are concerned with is that the banking industry does not have the same kinds of registration, educational and supervisory activities with regard to sales practices that occur in the securities industries.

This is particularly true in the offering and selling of mutual fund products.

Mr. RIDGE. I want to focus in a little bit on the municipal revenue bond side of it, if I might, for a moment.

The concerns that you have based upon the experiences you have observed, do you feel that they can be addressed to legislation or regulation? Or will you insist on this being, these kinds of activities, being under-taken by a qualified securities affiliate rather than the bank itself?

Mr. RUDER. That is our current position.

Mr. RIDGE. Thank you, Mr. Chairman. My time is expired. I have a couple of additional questions that I would ask permission to submit in writing.

Chairman ST GERMAIN. Without objection.

Mr. RIDGE. Thank you.

[The questions and answers referred to can be found in the appendix.]

Chairman ST GERMAIN. Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman. It is nice to see you again, Mr. Ruder.

Mr. RUDER. It's good to see you.

Mr. KENNEDY. Sir, I wonder, your testimony, I think, is very encouraging in the sense that you are the first regulator that I think has come before this committee and really detailed some of the potential abuses that could take place, given the possibility of expanding bank powers.

One of the things that comes to my mind is the fact that, as a regulator, you come in regulating an industry that has a great many transactions.

Yet, in comparison to the overall banking industry, it is obviously much smaller in the total size of the assets.

It just seems to me that one major question would be whether or not you should be reporting to the existing committee that you report to, or whether or not you ought not to be reporting to this committee on a permanent basis if, in fact, new bank powers are provided.

Mr. RUDER. Well, I greatly respect this committee and its oversight responsibilities. I think that there is merit, however, to separating the regulation—of the regulators—just as there is merit in the regulators having regulation over separate activities.

What we are talking about is our ability to regulate the securities activities banks, not the banking activities of banks. If the structure we would propose is followed through, what we would be dealing with primarily would be a new securities—a new entrant into the securities business.

In that sense, we would not be regulating a bank, we would be regulating a securities industry participant.

Mr. KENNEDY. Certainly, the activities from bank to bank would have to be regulated in order for you to stay on top of the potential abuses that you list on your table of contents.

Mr. RUDER. One of the suggestions put forth in the Senate bills, I believe it is Senator D'Amato's bill, is that there be an informal, or perhaps formal group of regulators who meet for purposes of dealing with inter-industry problems.

I think that has merit. So that we can—we could as a group of regulators deal with the problems which arise which may involve some potential for conflict between regulators.

Mr. KENNEDY. I hear you with regard to the problems regulator to regulator. But, it does seem to me that, fundamentally, you see the differentials between these committees going back to Glass-Steagall, and what you've got now is the elimination of Glass-Steagall, or a part of that.

Therefore, you are coming back to where we were back in the 1920's and that seems to me that you don't want you on one hand reporting to one committee that doesn't, in fact, have the jurisdiction that oversees the banks themselves.

If you've got inter-bank relationships, it seems to me that you are just opening the door for the kinds of greedy abuses that you alluded to earlier.

I just don't see how it works unless you, in fact, have direct lines of communication between one committee and the regulators, so that they oversee this new entity.

Mr. RUDER. We are subject to oversight by your committee at present, as I understand it. Certainly, investigatory oversight. And we would clearly be willing to cooperate in providing information and to listen to suggestions.

I may, without appearing to be more independent than I am, say that we are an independent regulatory agency. And we are—we are charged by Congress to maintain our independence.

Mr. KENNEDY. I just want to make sure that you do, sir.

Mr. RUDER. I find it interesting to be dealing with you and your grandfather was the first chairman of the agency that I represent, an event I regard as of historic importance.

Mr. KENNEDY. I appreciate that very much, sir, and I'm sure that grandpa is looking down on us right now making sure I'm doing my job and you're doing yours. [Laughter.]

Just a final observation. I think you did lay out a lot of the concerns at least that I have had with regard to this whole set of transactions and potential abuses.

But, if I could just read to you your opening line—for instance, just as an example of misuse of confidential information, you say, quote:

"Congress should consider whether and to what extent the sharing of nonpublic information between banks and their securities affiliates should be prohibited."

You go on for another few paragraphs about that. The conclusion then is these new combinations of activities present opportunities for use of client information for the benefit of the bank board or securities affiliates that Congress may wish to prohibit. Quote:

"If we are focusing on new bank powers and legislation, then we have got to have much more specific recommendations out of regulators such as yourself and the SEC in general in order to provide the kind of detailed answers to questions like Bruce Vento's and Mrs. Roukema's as to whether these are rules or not."

Mr. RUDER. We are happy to work in that direction. We have indeed a project underway to try to put our concerns into legislative language.

Mr. KENNEDY. Thank you very much, Mr. Ruder.

Mr. RUDER. You're welcome.

Chairman ST GERMAIN. Mr. Neal.

Mr. NEAL. Thank's, Mr. Chairman.

Chairman Ruder, have you had a chance to look at Senator Proxmire's bill yet in terms of how adequately it addresses questions of safety, soundness?

Mr. RUDER. I have looked at Senator Proxmire's bill, but my focus has been on questions of investor protections. I have examined the bill. I could respond to some extent, if you wish.

Mr. NEAL. Please do respond.

Mr. RUDER. The bill does have safety and soundness features in it. It is somewhat limited in the amount of new competition that it would permit, since with its 80 percent requirement, it would not permit—it would not permit a securities industry participant who had real estate or insurance or commercial interests of any substantial size to own a bank.

So, in that sense, the bill is more limited and I think arguably is—because it is more limited, it is closely directed to soundness, safety and soundness.

But I do not speak as a bank regulator nor with a really great comprehension of what that phrase means. So I don't want to move too far in that direction.

Mr. NEAL. But that is an essential part of your job, isn't it?

Mr. RUDER. Safety and soundness of banks?

Mr. NEAL. No. The system. Consumers. Market participants, and so on.

Mr. RUDER. My job consists of carrying out the regulatory policy of the securities acts. The primary focus in those securities acts is on investor protection and the preservation of fair and orderly markets.

In the market part of my responsibility, I do think that I have an obligation to look in a broader way with regard to where the financial markets are operating.

I responded to Congressman Morrison earlier that I am somewhat hesitant to take—I'm very hesitant to take positions regarding the overall policies involved in Glass-Steagall reform without having had a Securities and Exchange Commission position developed.

We have not yet developed that position. I learned in my experience as chairman that sometimes the things that I say are thought of as being positions of the Commission.

In this case, I don't want to be too broad.

Mr. NEAL. I understand. Are you all working on that?

Mr. RUDER. Yes, we are.

Mr. NEAL. Maybe you answered this earlier, but have you set some sort of deadline? Is this the deadline you set for mid-January?

Mr. RUDER. No, it is not. We do not presently have a deadline for consideration of our ultimate Glass-Steagall position.

Mr. NEAL. May I ask you to, please, give that consideration soon? The reason I'm asking, there is a moratorium that will end on

March 1. This committee is committed to some kind of mark-up before that time.

Your advice would be useful to us.

Mr. RUDER. Yes.

Mr. NEAL. I understand you to say——

Mr. RUDER. We are looking at the question. We would like the assurance that our investor protection concerns would be met with those, and then we could go a long direction toward reaching a conclusion regarding the rest of it.

In the absence of that, I think we are going to be stymied on it, on coming to a conclusion about what the rest of Glass-Steagall should be.

Chairman ST GERMAIN. Has the SEC ever propounded or come forth to say that we would like to see Glass-Steagall repealed?

Mr. RUDER. The farthest it has gone is to say that it favors functional regulation, but it has not taken a position on Glass-Steagall, to my knowledge.

Mr. NEAL. Another subject if I can. I know that this is not your specific responsibility. But you have some experience in the area.

I am just curious what you think about the adequacy of current margin requirements for commodities and futures and other financial instruments.

Mr. RUDER. The question of margin requirements is one that we're looking at in our October market break study. We are concerned with the question of whether margin requirements on derivative index products futures are adequate as compared to margin requirements on stocks.

That is something that I think we will have a recommendation about when we finish our study.

Mr. NEAL. When do you think that will be?

Mr. RUDER. Our study is currently targeted for mid-January, staff report to the Commission. The Commission itself will then be looking at that report as well as other reports which are going to be completed, including a Brady Task Force Report and others, with the hopes of reaching conclusions as to what should be done.

Mr. NEAL. Let us have them, please.

This Domestic Monetary Policy subcommittee of this committee has some responsibility in the area of margin requirements because the Federal Reserve has that responsibility and will be very interested——

Mr. RUDER. One of the things we are concerned with is whether or not the margin requirement should be consolidated in one agency or organization. That is a matter of concern to us.

Mr. NEAL. What is your opinion?

Mr. RUDER. Again, we are not at the resolution stage.

Mr. LEACH. First, let me welcome Mr. Ruder.

In reference to the gentleman from Massachusetts, Mr. Kennedy, I would say, sir, that your grandfather might have been the first chairman, but the father of my grandson, or my God-son, is the current chairman.

David, you make the suggestion that, in your testimony, that the securities and reporting requirements of the banking and thrift industry ought to come under the jurisdiction of the SEC.

You suggest that this would enable investors to receive the same disclosure protection that other publicly-held companies provide.

By that request, are you implying that, today, the disclosure is inadequate or improper?

If you are, how big a problem is it?

Mr. RUDER. The problem is one of providing comparative information for investors with regard to bank activities. As you know, when a bank holding company structure is involved, then the bank holding company is—will be providing information to the Securities and Exchange Commission, which, in turn, is available for investors.

It is only when the bank is not in a bank holding company structure that the disclosure obligations are not the same.

We do think that the comparative—that it would be beneficial if we were able to have comparative information available to investors.

I don't think that our—I don't think that our testimony is intended to say that things are terrible, only that we think they could be better.

Mr. LEACH. Let me define that somewhat.

There is some concern, for example, that the thrift industry is in some difficulty today.

Are you implying that the people at the SEC have done studies that indicate that new kinds of disclosure should be made that are not being made? Or that this is just a uniformity of jurisdiction issue?

Or is it a problem issue?

Mr. RUDER. It is much closer to the latter, Jim. Uniformity of jurisdiction. The conclusion comes out of a Commission-endorsed position in the Bush task group study, which was endorsed on the theory—it was really one that says that uniformity of disclosure is of great advantage.

We have not done a detailed study on whether a thrift industry disclosure is adequate, nor have we done a detailed study on whether bank disclosures are adequate.

Mr. LEACH. One follow-up question, a follow-up on the gentleman from North Carolina's query.

On the margin requirement issue, there is a question of where the authority for setting margin requirements should reside.

One argument is that financial instruments should be under the jurisdiction of the Federal Reserve Board.

Does that strike you as appropriate or inappropriate?

Mr. RUDER. Again, we are looking as a Commission and in the staff as well at the question of margin requirements and where they should be set.

I think—and I just cannot respond to you at this point except to say that I do have concerns over the uniformity, over having the correct regulators, the same regulator, setting margins which may give a chance to have a more uniform, or at least——

Mr. LEACH. The regulator should be the SEC or the Federal Reserve Board?

Mr. RUDER. As you know, the CFTC has some authority over margin regulations for futures. We have some authority over, indirect authority, over some of the margin regulations in the options,

in the derivative product options market; and the Fed has authority with regard to options—with regard to stock markets.

It may very well be that, somehow or other, there should be a look at the margin situations in some unified way.

Perhaps it is not necessary to have the same regulator setting them, but there should be coordination and a uniformity of viewpoint regarding this.

Mr. LEACH. I agree with you on that concern. I am just not clear where the institutional bias should be. But there does seem to be some implicit conflict of interest to having the same people that control the exchanges set its requirements.

Mr. RUDER. The stock margin requirements were set—came in the 1934 act regulation and basically dealt with credit environment, the credit environment of the country in terms of national markets; whereas, the so-called margin in the futures industry is essentially described by the participants as a deposit intended to make sure that the participants would be able to pay up.

So it is not a credit-oriented margin requirement. In that sense, I think that one needs to look at all of the margin requirements and see if they are instigated for the same reason.

Mr. LEACH. Thank you.

Chairman ST GERMAIN. Looking at the SEC figure as of August 1987, the number of firms listed is 9,328.

Mr. RUDER. Broker dealers.

Chairman ST GERMAIN. There are 500 New York Stock Exchange firms that do about 80 percent of the wholesale business; is that correct?

Mr. RUDER. I do not have that figure in mind. That would sound correct.

Chairman ST GERMAIN. Do you have some of your pundits with you today?

Mr. RUDER. My pundits say yes, it sounds right.

Chairman ST GERMAIN. We have the monks in the monestery so we will give pundits to the SEC, very brilliant people.

Mr. RUDER. We have a brilliant staff at the SEC.

Chairman ST GERMAIN. I mean that.

Now, to the best of my knowledge, I don't recall at any point in time the SEC saying we need to repeal Glass-Steagall so that we can have more broker dealers in the field.

Is that accurate?

Mr. RUDER. I think that's accurate.

Chairman ST GERMAIN. Now, do you feel, in view of the 9,328 firms as of August 1987, that there is a shortage of broker dealer firms out there?

Mr. RUDER. No.

Chairman ST GERMAIN. All right. And then, as I said, you have 500 New York Stock Exchange firms doing 80 percent of the business. That's a pretty substantial amount of firms, isn't it?

Mr. RUDER. Yes.

Chairman ST GERMAIN. Of the wholesale business?

Mr. RUDER. I would guess that the number would be smaller than that actually doing a very substantial amount of business.

Chairman ST GERMAIN. Oh, there are larger firms that do a good part of it. But I am saying that 500 members, the 500 members of

the New York Stock Exchange do 80 percent of the wholesale business.

Which business is more profitable? Wholesale or retail?

Mr. RUDER. I don't have an answer to that question. I think it may depend upon the firm's structure. Some of these firms have different kinds of structures.

Merrill-Lynch, for instance——

Chairman ST GERMAIN. Does both?

Mr. RUDER. Solomon Brothers does not have——

Chairman ST GERMAIN. Isn't the wholesale business more profitable than the retail business?

Mr. RUDER. In recent years, it has been my understanding, and I don't know how accurate this is, but it's been my understanding that the profits from the large firms have come through their arbitrage activity through I think activities you would describe was wholesale rather than dealing with retail customers.

Chairman ST GERMAIN. Now, if financial institutions, banks, were allowed to go into the retail brokerage business around the country—there are 14,000 I think commercial banks—they would be competing with 9,328 broker dealers out there already. Correct?

Mr. RUDER. That is right. They already are in many ways.

Chairman ST GERMAIN. In some ways, yes.

Is there that much business out there to add another 14,000 firms?

Mr. RUDER. I cannot really answer that question. I will tell you that I come from an environment in which competition is a word that I like. So we will find out. If it happens, we will find out whether there is that much business for them to survive.

Chairman ST GERMAIN. In the competition, about the only thing they compete in would be the fee they charge to the customer. Correct?

Mr. RUDER. There are services. There is the matter of giving investment advice. There is the execution capability of the broker dealer firm. There are other kinds of——

Chairman ST GERMAIN. Are you telling me that the firms out there are not providing efficient service in those areas?

Mr. RUDER. There are firms offering different kinds of services. You have discount brokerage——

Chairman ST GERMAIN. It does not give you all of the—all they do is execute the transaction.

Mr. RUDER. There are different kinds of services provided by different entities.

Chairman ST GERMAIN. As a matter of fact, sir, if there were to be a repeal of Glass-Steagall, what would be more attractive to the large money center banks? The wholesale or the retail? Their broker dealer business?

Mr. RUDER. I would expect that——

Chairman ST GERMAIN. Or would they have both?

Mr. RUDER. I would expect, and this is pure conjecture, that the money center banks would want to be in the wholesale business. If you include in that in the equity underwriting business, they would want to be in that.

The smaller banks might want to be in the underwriting of mutual funds sales business on a local level.

Chairman ST GERMAIN. In order to do that, those large money center banks, it would take a while to be able to compete with the Solomon Brothers or Goldman-Sachs or Morgan-Stanley if they were to go into it de novo, wouldn't it?

Mr. RUDER. I don't know if that's true. When the Big Bang took place in London, it did not take too long for both the brokerage firms and the banks to get over to London with subsidiaries which were very well capitalized and very well staffed, and engaging in competition over there.

Chairman ST GERMAIN. Where did they get the staff?

Mr. RUDER. They took it from the United States in most cases.

Chairman ST GERMAIN. From firms here.

Mr. RUDER. Yes.

Mr. VENTO. What types of firms? Do you mean investment?

Chairman ST GERMAIN. Investment banking firms.

Mr. RUDER. Yes. Well, they were banks with securities affiliaties overseas and investment banking firms with securities affiliates overseas, in London.

Chairman ST GERMAIN. They were already doing it there.

Mr. RUDER. Some were and some weren't.

Chairman ST GERMAIN. My point is what would happen here in the United States if legislation were enacted to repeal Glass-Steagall? I'm trying to figure out how these large banks could set themselves up to compete with Goldman-Sachs, Morgan-Stanley, the new E.F. Hutton, Merrill-Lynch, American Express, Shearson.

Mr. RUDER. On the wholesale level, I would be very surprised if they were not able to compete quite quickly. Whether they would be able to set up a large retail, so-called warehouse operations, is another thing. That requires a much more extensive network and different kinds of organizational structure.

Chairman ST GERMAIN. Let's go back one step and then I can yield to somebody else on the wholesale business.

What has prevented more firms from getting as big as Goldman-Sachs, Morgan-Stanley, Merrill-Lynch, and so forth? We're looking at about eight big firms, right?

Mr. RUDER. Right.

Chairman ST GERMAIN. Why are there only eight instead of 15 or 30? Is it the same reason that you have got 10 big super banks in the country? A lot of regional banks that are small?

Mr. RUDER. I don't know how well you can compare them, but the consolidation of the broker dealer industry took place after May Day, 1975, May 1, 1975, in which the Commission rates, the fixed Commission rate structure was abolished. You had substantial increase in competition. You had a decrease in subsidization for some of the firms that were able to survive with the fixed Commission rates.

That was followed by a substantial amount of consolidation of brokerage firms. And you have seen that since; you are witnessing it still, that the need for large capitalized brokerage firms is driving the firms to combine so that they can have the efficiencies of operation which are available through large capitalizations.

Chairman ST GERMAIN. Do you feel that there is a shortage of large firms right now?

Mr. RUDER. I don't have a judgment on that.

Chairman St Germain. By the way, you can speak for yourself when you're here. You don't have to—as in your answer to Mr. Morrison, just as with the Federal Reserve Board. We don't anticipate the Fed chairman to tell us what is going to happen with the discount rate. He usually circumvents that, although he's asked every time, or which way interest rates are going to go.

However, he does, and members of the Fed—whether it be the Chairman or other members—are asked for their own personal opinions as opposed to Federal Reserve Board opinions.

We get that on a regular basis. You are entitled. Don't make yourself a second class citizen because you are a chairman. You have a lot of ability and knowledge and we want to draw upon it.

Mr. Ruder. I am quite willing to use my authority and position as chairman on almost every issue. But, Glass-Steagall is one on which I feel reticent. So I can answer most of your questions.

Chairman St Germain. If you want to answer on your own as an individual as opposed to answering for the Commission, that is proper.

I have to go to Mr. Wylie because my time is expired, and we will get back again.

Mr. Wylie. Thank you, Mr. Chairman, and I hope that you won't feel reticent about answering this. But I think that there may still be some confusion on the part of some Members—maybe on my part—as to the SEC's position on expanded powers for banks.

I want to give you another opportunity to explain your position.

As I understand it, the SEC is not taking a position on whether or not new powers should be given to banks. Rather, the SEC is saying that banks are already engaging in a number of securities activities and that these activities, as well as any new activities, should be placed in a separate affiliated and regulated by the SEC.

Mr. Ruder. That is correct.

Mr. Wylie. I know you don't speak as a bank regulator. You said that. But, we got into this a little bit on the first round and it is a fascinating concept, it seems to me, as to bank regulation by the Securities Exchange Commission.

We, on the banking committee, are very familiar with the regulatory structure of the banking industry. Could you summarize for the committee the structure used to regulate the securities industry?

As I understand it, the SEC regulates the broker dealer, but it does not regulate the parent holding company.

You also rely heavily on the industry self-regulation, so-called SROs, self-regulatory organizations.

So this is an approach that is not used in the banking industry; examination of banks is the primary tool of bank supervision.

Does the SEC examine securities firms? I think a better understanding of the regulatory structure would be helpful. Would you write the rules by which banks are governed if given expanded securities powers? Do you think banks would agree to that?

I am giving you quite a few——

Mr. Ruder. The answer to that last question is no. We would not attempt to have any interest in regulating the banking industry and their banking activities.

Related to that is that the Securities and Exchange Commission does not regulate the parent in a holding company owning a securities affiliate as the Fed regulates the bank holding company in a bank holding company situation.

So there is a significant difference there as to the way in which we regulate.

Our regulation is directed solely at the registered broker dealer. The way we get at that is to require that any person or entity engaged in the buying or selling of securities as a business, either as principal or agent, is required to register with us as a broker dealer.

Once that person is registered with us, then the broker dealer has responsibilities. The broker dealer has responsibilities to report to us regarding a whole range of matters, including their capital position and financial structure.

Then, typically, that broker dealer will also become a member of a self-regulatory agency organization. That is, it will become a member of a stock exchange which regulates the trading of securities and it becomes a member of the National Association of Securities Dealers, which regulates the over-the-counter market.

Those two—the stock exchanges and the NESD have broker dealer inspection responsibilities. They do the regular inspections of the brokerage industry with very large compliance staffs. And they supplement our activities.

We do not undertake to supervise, to do inspections on a regular basis of the broker dealer firms. We let the self-regulatory agencies do that and then we supervise the self-regulatory agencies.

We do do two kinds of inspections. We do follow-up inspections. We follow the inspections of the self-regulatory agencies to see whether they have done their inspections correctly on some occasions; and we sometimes do what we call cause inspections, in which we will go in and make an inspection of a broker dealer, which we think has violated the law in some respect.

But, essentially, we have a layered kind of broker dealer supervisory activity with the self-regulatory agencies regulating the broker dealers.

We, on the other hand, can write rules for the broker dealer community. We review all—for the self-regulatory agencies, we review all of the self-regulatory organizations, rule proposals and we conduct surveillance inspections of those organizations ourselves.

We periodically send letters to them saying we have looked at the way you are regulating the broker dealer community and we think your regulations and your activities need to be increased in certain ways.

We talked a little earlier about telling or encouraging the New York Stock Exchange to increase their surveillance activities.

Mr. WYLIE. My time has expired. If you want to expand on that for the record, that will be helpful.

Mr. RUDER. We are preparing a written statement.

Mr. WYLIE. Also, if you would speculate as to how the banks would accept a rule regulating them.

Chairman ST GERMAIN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Ruder, I think that you kind of glossed over the holding company issue, but there are two different types of holding companies we are talking about here, aren't there? And that seems to have escaped me.

In other words, bank holding companies and other holding companies. We have no experience with bank holding companies other than the 5 percent rule that they are invested in, some 578, 20 different financial nonbanking activities, according to the study I have.

Mr. RUDER. Bank holding or non-bank holding?

Mr. VENTO. Being distinct and different.

So my point is: What are the rules with regard to the fact that the holding company or a bank holding company becomes—has to be liquidated?

We don't know because we haven't had, you know, bank holding companies with affiliates.

Is that correct? That had to be liquidated in the same way?

Mr. RUDER. You do have bank holding companies with affiliates. And some of them in the brokerage business, as you may know. The question of what you will do in liquidation is one apparently you have not had.

Mr. VENTO. That's what I'm talking about. We have not had the fire wall. If the fire wall doesn't work, I might point out, if it doesn't work, it adds fuel to the fire.

Mr. RUDER. We have extensive experience in the public utility holding company area, and we have substantial regulatory responsibility there. We also have bankruptcy jurisdiction which allows us to enter into the bankruptcy of any——

Mr. VENTO. How would this work? If there is a bankruptcy proceeding and a holding company that is affiliated under the Bank Holding Company Act, A,B,C, how will it work? Where do you stand in line? What type of resources do you get? Who gets paid off? Who doesn't get paid off?

I think these are the types of questions that we're going to have to answer. If we set up some sort of a subsidiary or whether we set it up under the existing holding, I think that we are mixing basically oranges and apples here, is what is going on consistently during these hearings, not just——

It is not a criticism of you or anyone else, it is just that I think if we're going to get to those questions, they're going to have to be answered. And there are no answers right now.

Mr. RUDER. It is important to recognize that the Bank Holding Company Act has set up a system so that the Federal Reserve Board will directly regulate the Bank Holding Company Act.

Mr. VENTO. You have a special interest. We have a whole different ballgame. We are not just talking 5 percent limitations any more, are we?

Mr. RUDER. If a securities affiliate is owned, let's say for example, by American Express, we don't regulate American Express. We regulate the subsidiary.

Mr. VENTO. Is that the bank holding company? Or that's the other holding company?

Mr. RUDER. It is a non-bank holding company.

Mr. VENTO. I know. I am just suggesting that the rules are not necessarily the same.

Mr. RUDER. Of course they're not.

Mr. VENTO. Let me ask you about anti-trust because my time is limited and other Members want to shout here, too.

I want to lay these questions out. In Hutton-Shearson-Layman merger, do you have any roll in terms of anti-trust there? Are you going to be reviewing that or what?

Mr. RUDER. No, sir.

Mr. VENTO. In a merger between a large bank holding company and investment banker, which would obviously occur—that is the way that they're going to go. They're not going to go de novo. We heard that. In other words, they're not going to start from anew—there are going to be all sorts of mergers, as occurred in Canada. And you would have no role in that particular instance.

Mr. RUDER. Other than the regulation of the disclosures.

Mr. VENTO. You are saying that the anti-trust laws the way they are are fine if the largest brokerage merges with the largest bank, that the existing anti-trust laws are all the protection we need.

Mr. RUDER. We do not have jurisdiction to examine.

Mr. VENTO. I know you don't. I'm talking about the ideal world. I'm talking about what you want, what you need.

Mr. RUDER. I think the anti-trust laws are a satisfactory means of dealing with mergers.

Mr. VENTO. I think you should look at what this administration has done. They have not come into the 19th century as far as I'm concerned.

One of the criticisms and one of the concerns has been the profitability, the return on equity of banks. It has been pointed out that—we had some great charts that pointed out that they dropped from 12 percent to 8 percent.

I think, largely due to price deregulation. I think that would be—they claim it is due because they are not in investment banking. That is the total basis.

Their portfolio of commercial loans, while being reduced in percentage, has grown in aggregate to over $300 billion. It has grown consistently.

Now, tell me about investment banking today. What is the profitability in it? What is the hope for the future?

In other words, if we expand this power, is this going to be a cornucopia of profits for the banks in terms of risks? Are we going to attract all sorts of new capital, or redistribute the existing capital in terms of investment in the near future?

Mr. RUDER. I don't have a crystal ball here, sir, but I should note for you that the major Wall Street banking brokerage houses are in the process of cutting back, because they see their profitability declining. And I simply—my guess is that if Glass-Steagall were repealed, we would not see an addition of 15,000 to 9,000 to create 24,000 competing institutions. We would see some mergers.

Mr. VENTO. The question is, if we see these types of mergers, do we lose a certain degree of stability in terms of the marketplace that we now have today?

That's the $64,000 question. Do we lose a certain element of stability by combining these all into one big snowball in terms of what is going on?

That is where we're moving. Do you gain or lose stability by increasing the size of these and tying these markets together.

So, if the stock market has a problem, the financial institutions are going to have a problem on the other side. And they're going to be backed up by the national government.

In other words, do we want a free economy over here, or do we want the whole thing covered by Federal insurance?

This is an instance where I think we want to fight for free enterprise and fight for the national government not being involved in all of this, and let free enterprise work, which involves risk and it involves loss and it involves profit.

Chairman ST GERMAIN. Mr. Morrison.

Mr. MORRISON. Thank you, Mr. Chairman.

Let me take you to a completely different place for a minute.

Mr. RUDER. All right.

Mr. MORRISON. I believe that your regulatory role is not in the area of safety and soundness except that you have minimum capital requirements and you have the SIPIC protection.

But, beyond those protections, and those are really investor protections, too, you are basically regulating the market and the information in that market for the protection of the investors.

Mr. RUDER. We are against fraud.

Mr. MORRISON. You are for open markets. Fair markets. Fully informed markets. And let the losses and gains fall where they will.

Mr. RUDER. We do not engage in merit regulation.

Mr. MORRISON. Among the things that you don't make safety judgments about are commercial paper and similar investments. You have no safety or soundness role with respect to that.

Mr. RUDER. Correct.

Mr. MORRISON. You have somewhat less of a role—in fact, you are at the base fraud level in the regulation of short-term commercial paper.

Mr. RUDER. To the extent that we regulate the dealers, we do have regulatory responsibility. And to the extent that there is fraud in that market, we have anti-fraud enforcement powers.

Mr. MORRISON. One of the phenomena of the late seventies and the eighties has been the creation of deposit-like accounts by firms like Merrill-Lynch, which, in fact, are invested in commercial paper and short-term Government securities.

Mr. RUDER. The money market funds are quite strongly invested in commercial paper.

Mr. MORRISON. As I understand it, their share of financial assets has gone up from 2 percent in 1976 to something like 8.3 percent in 1986, a fairly dramatic increase.

Now, one of the things that banks complain about is the competitive disadvantage that these kinds of accounts create for them—in comparison to the depository accounts of banks which are loaded with two costs that are not involved with respect to these accounts.

One of them is the FDIC premium—and a second is the requirement to maintain reserves.

Mr. RUDER. As I understand it, the money market funds ma contractual arrangements with banks, and that when you write check in connection with a money market called Cash Manag ment Fund account, if you look and see what is happening, th check is being written on a bank.

Mr. MORRISON. But the funds are not held in the bank. The fun are held in a mutual fund.

Mr. RUDER. That's right.

Mr. MORRISON. As such, those funds—they are not deposits as matter of law.

Mr. RUDER. They are more like a comingled trust account.

Mr. MORRISON. But they are like deposits and they are used b the customers in many ways in the fashion of deposits because yo can write a check on them.

In other words, they function much like demand deposits, eve though, as a legal matter, they are not demand deposits.

Mr. RUDER. That's right. You do not have the right to get th money back in the same sense——

Mr. MORRISON. You have a market risk.

Mr. RUDER. You do not have the right to say: Give me my mone tomorrow.

Mr. MORRISON. However, they are marketed as similar t demand deposits. One of the advantages one gets by opening a cas management account with Merrill-Lynch is that they tell you:

"Hey, pay your bills. You can write these checks, just like a ban account."

Mr. RUDER. In fact, you do write them on a bank account.

Mr. MORRISON. That is correct, but the money is not a deposit Legally, it is not regulated in the same way.

In a minute, you will understand where I'm going with my question, but there is a point.

The equivalent demand deposit in a bank is, number one, insured by the Federal Government, which these accounts are not. Number two, they are backed by reserves which are part of that insurance system that do not pay interest for the bank. For some kinds of deposits, I believe it can be as high as 16 percent.

Both of those things raise the cost of funds for the bank.

Mr. RUDER. Some of the insurance costs are paid by the U.S. Government.

Mr. MORRISON. It is a self-insurance. The taxpayer has not yet been asked to pony up money on the FDIC.

Let me get to my point and maybe I can get an answer. The point is this:

If you compare these two accounts, these two kinds of ways of holding money, what we have is in the one case in the demand deposit in the banks. The cost of funds includes the cost of insuring those funds against loss. We have securities firms that are marketing to the public demand deposit-like accounts, the CMA type accounts, which do not bear those costs and, in fact, do not have that safety.

They are really at risk. Do you have any concern about the dramatic growth of those accounts, the creation of a kind of loophole for what are pretty much the same kinds of accounts for which deposit insurance was needed in the first place.

...e deposit insurance, it seems to me, for two reasons. First, ...t the individual depositor against the loss of his or her ...Second, to protect the system against runs on those funds ...of perceived lack of safety.

...reate deposit insurance. And now we have 8 percent of fi... assets in the uninsured funds compared to 31 percent in in... commercial banks.

...ht we not to be worried about those same concerns that led ...create the FIDC when we have people who essentially have ...they think are checking accounts that are neither insured for ...enefit of the individual investor nor insured to protect the ...m against runs? And on top of that, have the competitive ad...ge that they do not cost the security firms the safety premi... if you will, that is paid by the banks?

...ught we not to be concerned about that? Are we sure that the ...ple who are putting their money in these accounts think that ...have demand deposits and will never make a run on these ac...ts in the same way as people did with banks in the thirties? ...realize it is a complicated question. I took all of my 5 minutes ...ask it, and I apologize to the chairman.

Mr. RUDER. The mutual fund industry that you are talking about, the money market mutual fund industry, is one which re...quires a prospectus to go to the purchaser, so the purchaser knows through the prospectus that there is risk involved.

Second, I think that there is a distinction to be made between the type of investor that is in a Merrill-Lynch money market fund and the kind of investor that is putting money in the bank.

Mr. MORRISON. Do you have data that demonstrates that?

Mr. RUDER. We have data that indicates that—no, I don't have statistical data.

Mr. MORRISON. Then you are speculating about that. We should be careful about speculating if we don't know. You might be right, but I don't think we could make policy based on that.

Mr. RUDER. I will give you a piece of information I do have, and that is that the number of securities holders, stockholders, in the United States of any kind is far, far smaller than the number of people who are depositors.

That statistic is one which I can put to you without fear of contradiction.

Let me go on. The mutual fund, if you deal with a broker dealer who holds your securities, as is the case with the Money Market mutual fund, I believe, if the—if Merrill-Lynch is holding that for you, there are insurance features which are involved in that.

We have our SIPIC fund. If Merrill-Lynch is holding your money market mutual funds securities, and Merill-Lynch itself, whatever——

Mr. MORRISON. That is protection against the insolvency of Merrill-Lynch. It is not protection against the loss of principal value of the securities.

Mr. RUDER. It is not a protection against loss of risk.

Mr. MORRISON. It is fundamentally different from the FDIC insurance, which is an insurance of the principal.

Chairman ST GERMAIN. I'm sorry. Mr. Barlett.

Mr. BARTLETT. Thank you, Mr. Chairman. I want to go back and follow up to a lot of questioning that Chairman St Germain began and began with the admonition that you be ruder and speak for yourself, and we prepared you that you are not prepared to speak for the Commission, since they do not have a position on Glass-Steagall.

In your judgment, can a legislative and/or a regulatory framework be developed that would, in essence, repeal Glass-Steagall or permit banking affiliates to be associated with owned or either owned by banking securities affiliates that would protect investors and that would meet the other concerns that you presented in your testimony?

Mr. RUDER. Yes, I believe that can be done.

Mr. BARTLETT. Do you believe that the pursuit of this committee and Congress as a whole is a worthy pursuit, do you think that we should then pursue this matter?

Mr. RUDER. Personally, I think that it is time for the Congress to look at the question of Glass-Steagall repeal, to look at the question of competition between the securities industry and the banking industry.

We have seen, as you know, a fairly large amount of banking industry activities performed in terms of our last colloquy by securities industry participants, and we are seeing securities industry activities performed by banks.

The moratorium that is set for March 1 is a quite good point to look at because it really is there because of this increasing competition.

I think that the effort to look at this problem is not only—is essentially, important. I may say that I do feel a responsibility as a regulator to enter the fray and present my own opinions; if I cannot get the Commission within the next 2 months to have a position on this, you will hear from me individually.

Mr. BARTLETT. You have examined the—we all do appreciate your candor on that, and that is very helpful to this committee.

As you have examined the Proxmire-Garn Bill, introduced in the Senate, taking a special note of the investor and other protection concerns that you raise, do you believe that legislation then is generally in the right direction?

Or, put another way, do you believe that they have satisfied half of your concerns, or more than half? Or do you have a percentage?

Mr. RUDER. In terms of investment protection, I can say only some of the concerns. There is a great deal to be done before any of that legislation would be acceptable to us. But, that is not to say that it can't be done with appropriate drafting.

Mr. BARTLETT. Does the structure itself satisfy you, in your judgment, many of the concerns are not yet addressed?

Mr. RUDER. I don't mean to express an opinion, but I think one has to look very carefully at the very minimal types of competition which the Proxmire-Garn Bill seems to permit to the securities industry participants.

Essentially, if a securities industry participant wants to enter—wants to own a bank, it has to be regulated by the Federal Reserve Board.

That may be an unacceptable condition for many of them. In addition, they would have to get rid of many of their commercial activities, another probably unacceptable condition.

Mr. BARTLETT. It sounds like you would tend to expand the Proxmire Bill, at least in that regard, to permit additional activity.

Mr. RUDER. I don't want to go any further than that.

Mr. BARTLETT. That goes a long way, so I will let you off the hook with that. Let me then pursue some of the specific concerns that you did raise and ask you the general question as to if you were in our shoes how you would, in general terms, address these concerns, either by—and it seems to me there are essentially three mechanisms for addressing the concerns that you have testified to, or there may be others you could prohibit these types of transactions.

You could require full disclosure to all parties of the transactions, or you could require an arm's length transaction, or a Chinese Wall or some combination.

Let me tell you specifically the kinds of transactions I am inquiring about:

Transactions of the securities affiliate being the underwriter and the bank being the lender, or using underwriting to pay off a bridge loan is one specific example you used with that in general; or providing the bank affiliate, providing credit to the purchasers of securities and the securities affiliate. Or the securities affiliate selling stock to the bank customers, or the placement of underwriting in controlled accounts, or other kinds of conflicts.

My general question is, as you would have us address those, would you prohibit those transactions? Would you require fuller disclosure of the transactions? Or would you simply require the transactions be made at an arm's length kind of basis or something different? Something else?

Mr. RUDER. For the most part, I would prohibit the activities. In some regards, I might be willing to allow disclosure. In certain regards, I might be willing to get to what would be an arm's length approach.

One of them has to do with the pricing of certain offerings. The NESD right now is concerned about the pricing of offerings which are used essentially to pay off debt of a holding company, and they are trying to be sure that there is an independent pricer—independent person who comes in—to look to see whether the offering prices are appropriately priced.

There may be kinds of regulatory initiatives that way, which would meet some of the objections that we have.

Mr. BARTLETT. A quick follow-up.

What I'm hearing you say is that you would begin in your own mind with a prohibition.

Mr. RUDER. I would.

Mr. BARTLETT. Unless you could demonstrate to yourself that a disclosure or an arm's length would be more appropriate.

Mr. RUDER. I think that is a fair characterization of where I would be.

Mr. BARTLETT. Thank you, Mr. Chairman.

Chairman ST GERMAIN. In other words, when you say that the Proxmire-Garn Bill needs a lot of working over before the Commission could support it, what you're saying is that, in the area that

would come within your jurisdiction, investor protection, there is a good deal of work to be done.

Mr. RUDER. That's right.

Chairman ST GERMAIN. I think there is no secret some of that legislation was designed in such a manner as to avoid you.

Mr. RUDER. If that is true, then I have to make a vigorous stand.

Chairman ST GERMAIN. Because they want to avoid the committee across the hall, you know, named Energy and Commerce. You've heard of that committee?

Mr. RUDER. I certainly have.

Chairman ST GERMAIN. They tried to avoid jurisdiction there. So perhaps that is why the legislation as drafted leaves a bit to be desired as far as the SEC is concerned.

Mr. RUDER. I would say this very strongly. If the banking industry wants to be engaged in securities activities, they must submit themselves to our jurisdiction. And we will with all the power we can muster make that point in every form that we can.

Chairman ST GERMAIN. They are complaining about the Fed. They come and complain to me privately about the Federal Reserve Board. They say they're tough. Just wait till they get you, huh?

Mr. RUDER. I gave a speech in Florida warning or telling the broker dealer community that we were going to be looking at their supervisory practice and their customer sales practices matters very vigorously.

After I made that speech, I said:

Before I switch to Glass-Steagall discussions, perhaps if the members of the banking industry had heard this speech, they might not be so interested in entering the securities industry.

Chairman ST GERMAIN. Let me ask you this, Chairman Ruder.

Would the repeal of Glass-Steagall and the addition of X-number—we don't know how many—broker dealers around the country, would that satisfy a need that is out there?

Is there a need out there? John Q and Jane Q citizen, have they been calling the SEC and saying, Yes, we are short of brokerage firms out here, do something about it?

Mr. RUDER. No. But what you do have is that, at the local level, considerable confusion I think between bank activities and small bank activities and small broker dealer activities.

That confusion—the elimination of that confusion would probably be in the public interest.

Chairman ST GERMAIN. Wouldn't you still have small brokerage firms functioning in those small communities?

Mr. RUDER. You would have the banks acquired brokerage firms or the broker firms acquiring the bank and would eliminate the competition.

Chairman ST GERMAIN. Eliminate the competition so all you have is a new owner and a new name.

Mr. RUDER. It might be. But better regulation if we're in the picture.

Chairman ST GERMAIN. Are you regulating well now?

Mr. RUDER. Not in bank activities. We are regulating wonderfully with regard to broker dealers.

Chairman ST GERMAIN. So, isn't the answer to give you the jurisdiction over those activities now being performed by banks that are being properly regulated?

Mr. RUDER. If you could undertake to have our bank broker dealer act passed now before Glass-Steagall, that would be an advance as far as we are concerned.

Chairman ST GERMAIN. Would that increase or decrease the passion from the SEC for repeal of Glass-Steagall?

Mr. RUDER. It would require us to say now that we have jurisdiction over existing bank activities, don't now take away what you have just given us and create new bank activities which aren't subject to our regulation.

We would still want to look at Glass-Steagall reform to see what was going to be suggested with regard to new bank activities.

Chairman ST GERMAIN. But, in reality, do you feel there is a big need for the repeal of Glass-Steagall? You, Mr. Ruder, not chairman of the SEC, but just——?

Mr. RUDER. I am reluctantly going to have to tell you that I wouldn't want to answer that question until I had spoken with my fellow commissioners.

Chairman ST GERMAIN. Mr. Vento, do you have further questions?

Mr. VENTO. Following up, I think the small bank thing is especially perplexing. The suggestion here seems to somehow say that small banks are going to go into the primary agents in terms of broker, I think that most of them are really looking for the opportunity to compete for the dollars through mutual funds and other types of instruments.

So it might be through a banker's bank or some other vehicle.

Mr. RUDER. The mutual fund aspect is one of great concern to us currently on the local level.

Mr. VENTO. I understand that it is. I would not suggest that you should not have a voice in that. I think it hardly the type of concern—one of the industry figures I have in front of me says:

"Such extension of powers would leave less than ¼ of the Nation's dollar volume of financing restricted to traditional stock and bond dealers only."

It would absorb a tremendous amount of the dollars, that would then be in the financial institution kind of holding company, or in the banks.

That would be of concern, I expect, that you would have this tremendous shift, especially if it was done without the types of credit-worthiness and objective credit-worthiness tests weighing in?

Mr. RUDER. If I understand what you are saying, you are dealing with banking concerns. We would of course want the broker dealer operations to be subject to our net capital rules, so we would want full disclosure of activities. We would want to deal with sales practices.

Mr. VENTO. Are we by virtue of this reorganization—I think the question is a rhetorical by virtue of this type of extension of power—going to expand the total capital, equity capital base, in terms of money ready for investment to stocks and bonds, or other types of equity?

Are we redistributing it among the various agents that are going to be in the marketplace?

Mr. RUDER. I don't know the answer to that. If I did, I could probably——

Mr. VENTO. I don't know why it would expand it myself. If you have 9,000 dealers and 14,000 banks and, all of a sudden, you combine them, you do not necessarily increase it.

Mr. RUDER. I do not know what will happen to total dollars. You may have some efficiencies coming from these——

Mr. VENTO. The only choice would be this type of financial configuration would be so advantageous that we would have global bases, people running here to dump the money in.

Mr. RUDER. Perhaps.

Mr. VENTO. The chairman says, and I hear it, what about the saving rate? What happens to the savings rate?

Chairman ST GERMAIN. If the gentleman would yield, in this morning's paper, Mr. Greenspan says the big problem is savings. We're not saving enough. The problem is that the savings we do have are overseas. They come from overseas.

Well, would repeal of Glass-Steagall encourage more savings deposits in financial institutions, do you think?

Mr. VENTO. I think the question is, if it is not—the point is, in the ideal world, obviously, if this could occur, you would have a completely objective and there would be market forces. Stock and securities activities would be as free-flowing as today and with proper regulation by the SEC and others that are involved.

But I think it points out that if we end up with less than the present configuration of regulation, or a different configuration of regulation, it might impede or reflect the flow of that capital in the free enterprise system in the marketplace that has produced, I guess, sort of the connective tissue that holds the whole economy together.

Mr. RUDER. An argument can be made for the fact that we have two industries, neither of which is very happy with their current situations. And that by coming the two industries, you may have a more efficient and more competitive environment in the financial services area.

That is an argument that can be made. The argument can also be made that by repealing Glass-Steagall, you are going to create inefficiencies.

Mr. VENTO. I'm looking for facts to support the arguments one way or the other. If you can provide the committee with any, I would be most interested in reviewing them.

I think we ought not to go through this just because we want to juggle balls in the air, but because it's going to have a positive effect. If that answer were to come down that we don't know, I think then maybe we'd better wait until we do know before we take action, because, obviously, the economy and the circumstances of our economic circumstance are not such that we ought to just say: Well, let's try this.

This isn't exactly a time for another River Boat Gamble with regards to financial institutions, with regard to investment banking.

Do you regulate today, Mr. Ruder, the function of the security or investment banking activities of banks, United States banks overseas?

Mr. RUDER. No, we do not.

Mr. VENTO. I notice the Federal Reserve Board has the role in that case. And you did not address that in terms of bringing that under any type of regulatory role, or disclosure role in your statement.

Is that just not addressed? Or is it something that you think you would like to address further, after some contemplation?

Mr. RUDER. If a broker dealer chooses to participate in an overseas market using a subsidiary, we could regulate through the broker dealer.

If the broker dealer is owned by—in a holding company situation, and the holding company creates a different sub overseas, we do not have jurisdiction. Indeed, there are enormous problems in terms of our attempting to assert jurisdiction over entities in foreign countries in which we have no other contact.

Mr. VENTO. They are treated the same as investment bankers would be that are regulated in the United States and have affiliates overseas as well.

Mr. RUDER. We do not—as I say, the only people we regulate are the broker dealer firms themselves who have activities overseas. If it is a bank, or if a bank has a securities affiliate overseas or a securities affiliate has a sister company overseas, we do not have regulatory jurisdiction.

Mr. VENTO. The Federal Reserve Board does exercise some surveillance on that.

Thank you, Mr. Chairman.

Mr. MORRISON. Thank you, Mr. Chairman.

I will not try to return to our discussion except to ask you if you would please respond to whatever degree you feel capable of doing in writing to the point that I have raised about these demand-like accounts that are held by securities, that are administered by securities firms.

Mr. RUDER. We would be glad to. We will describe and respond.

Mr. MORRISON. I would like you to just think about and respond to my concerns about the extent to which their attractiveness to the depositor, if I can call them that, includes the higher rate of return that is in part available because of the lack of what I will call the safety premium that the bank has to pay in order to ensure deposits.

The extent to which you are comfortable that neither the individual security that insured deposits give nor the system's security against a run that insured deposits give are not concerns with respect to these types of accounts.

I know that given the point of view of the SEC and what you have already said, that your instinct would be to say that if there is a prospectus in that, people are on notice.

But, before you give me an answer, I would like you to at least look at what happened in Maryland and Ohio, where people went and put their money in nonfederally-insured accounts, largely because they paid better rates of return and then, lo and behold,

when the moment came that it was clear that those insurance funds did not in fact adequately——

Mr. RUDER. Weren't those S&Ls?

Mr. MORRISON. That's not the point. I'm just pointing out to you that when you gave me—the first answer you started to give me on this subject was that there is a prospectus. Those people have notice.

But, before you glibly say the same thing in response to my concern, I want you just to look at Ohio and Maryland and remember that those were inadequately insured accounts where people put their money. The depositors knew that these accounts were not federally insured, but they were willing to overlook that fact.

They were attracted to the higher rate of return. In fact, those types of institutions competed for their money on the basis of those higher rates of return.

Mr. RUDER. You may call it glib, but I can give you an answer right now. When people put their money with a broker, they know that they are putting their money in a riskier situation than they do when they're putting their money with a bank.

Chairman ST GERMAIN. Mr. Ruder, let me make an observation. A few years back, the State insuring fund in Maryland failed, when I first got to Washington.

Lo and behold, 20 some odd years later, the same scenario. And a lot of people, believe it or not, Rhode Islanders had their money in these institutions in Maryland because of an extra ¼ of a point or ½ a point.

They knew that it was a State-insured fund. A lot of them—I don't know how many—remembered the fact that that State-insuring fund had failed once before and a lot of people lost a lot of money.

With all due respect to you, sir, the fact that a prospectus goes out, there are a lot of little people out there who put their money in these accounts. And they——

Mr. RUDER. In mutual money market funds?

Chairman ST GERMAIN. Who put their money in these savings and loans here, because they saw the high rate of return and they put their money in the money market funds the same way. All that they really care about is that they are getting a higher rate of return.

Frankly, if you were to do a study on how many read the prospectus, I think it would be shattering to find out that very, very few read the prospectus. That's the way it is.

Mr. RUDER. I must say I will speak for Ruder right now. I find that the analogy between the savings and loans and the securities money market funds is simply one that I cannot follow.

Mr. MORRISON. Let me try to help you follow it.

Mr. RUDER. I will reassert, although you will ask me for statistics, I will reassert to you that the people who are engaged with broker dealer accounts, by and large, are not those trusting individuals that are taking their life savings with safety and soundness objectives and putting them into these accounts.

Mr. MORRISON. Let me first tell you that if you're right, if in fact we shouldn't worry about this, fine. I'm not raising this because I

something new to worry about. But I am raising it because, at first blush, I think it hasn't been looked at that carefully.

There are two real issues with these accounts. You could be correct that if somebody is foolish enough not to read the prospectus and understand the risk they are taking with their money, and they lose it, well, we really can't protect them. That it is not our job to protect them from their own lack of care.

But it may be of concern to protect a system against runs that are caused by a systematic failure to understand what is involved. You might call it a paternalistic responsibility of Government. There are some things that we protect people from because we find that information alone just does not work.

We bar certain kinds of things from being sold in the marketplace which some people could buy safely, because we just don't think information is enough.

The second thing that I hope you will look at when you examine this analogy between the savings and loans and the money market funds is the shift of funds that occurred when savings and loans were given new opportunities to create money market deposit instruments. After the huge flow of money out of the savings and loan industry into the money market funds during the seventies, a lot of money actually picked up and came back over to insured institutions.

So I think that is a bit of evidence that, to some degree, these people are the same, that they were shopping between those two institutions.

Now, maybe those people were all the safety-oriented people. And as soon as they got a safe haven for a good return, they went back. But I don't think that our analogy is completely without some historical evidence, and that maybe we can come up with data which will tell us where the line is.

But you were just a little bit quick to tell me that I'm just off in left field when I think that I am at least in center field.

Mr. RUDER. The chairman asked me to say what I wanted.

Mr. MORRISON. I have one more set of questions.

Chairman ST GERMAIN. Set? [Laughter.]

Mr. RUDER. You asked that complicated question. But I want to make sure I understand it. You have asked really two questions. You have asked a safety protection principle, which is akin to a bank deposit, insured bank deposit. And you have asked a risk of capital safety question, which has to do with whether or not there is a market, a market risk for the person that puts his money into these accounts.

With regard to the first one—that is, the safety of capital—we do have an insurance feature in the securities area through the SIPC organization.

We do have another customers securities feature through our net capital requirements. Both of these requirements are intended to protect the customer against risk loss.

So that if you are asking whether there is a comparison with regard to the safety of the, "deposit", if you want to use that word, there is an equivalent level of safety in the securities situation when the securities broker dealer holds these money market accounts.

The difference is that there is a risk of loss of capital which comes from the nature of the investment. That is, that it is in a commercial paper or money market kind of risk. And that is the risk that I think is meant by the use of a prospectus.

I can go one further point for you, that in the broker dealer regulatory area, we require our broker dealers to inform their customers when they engage in their investing activities.

So that if our system is working right, the registered representative will tell the investor in the money market fund that there is risk in addition to sending the prospectus.

Mr. MORRISON. I asked you to give me something in writing. Before you do that, I will send you a piece of paper that says exactly what I would like you to respond to.

With the chairman's indulgence, I will be very brief on this last point. I will try to be. I realize I wasn't at all brief in the last one.

Earlier in your testimony, you indicated that you had initially had concerns about the conflict of interest problem of lending by banks if those banks also had affiliated securities businesses.

In other words, there were two kinds of concerns. One was a favoratism toward one's own securities affiliate. And a disfavoring of competing securities dealers.

That those were two concerns. Your concerns had been allayed to a significant extent by information that you got from industry people and regulators who said that it was not a problem that you needed to worry about.

Mr. RUDER. Not a problem to which I felt—a problem that I did not need to address particular attention to at this time.

Mr. MORRISON. Leaving aside the kind of breaches that do exist in Glass-Steagall for the moment, because there are obviously some, in the overseas activities and the rest, but focusing on the separation that currently exists, it seems to me that we are currently relying on market forces to give us the protection against favoritism so that we will have an arm's length credit judgment being made by the bank when it was making a decision as to whether or not to loan money to a securities dealer.

That is what we really want, I take it. We want the bank to maximize its rate of return, to be thinking only of how good a proposed loan is.

Mr. RUDER. That's what I understand the banking people do.

Mr. MORRISON. The regulators told you they're going to do that anyhow.

Mr. RUDER. That it is likely that a bank in the holding company affiliate situation with a securities affiliate will make its credit judgments without regard to the fact that there is a sister securities affiliate there.

Mr. MORRISON. Wouldn't you agree that what you are making is a statement of faith? Or is it a statement that credit decisions will be adequately controlled by regulatory oversight or one of the other?

Mr. RUDER. The former.

Mr. MORRISON. Statement of faith. So you're not relying on regulation?

Mr. RUDER. No.

Mr. MORRISON. As between those two concerns, wouldn't we be better just to leave in place in the market discipline that currently exists rather than take a promise that people, even though they have a structure that inherently has a conflict built into it, will behave in accordance with the market principles that exist today? Why should we breach that when we have the protection already existing from the market incentives?

Mr. RUDER. I guess one has eventually some definition of what the market is. I don't believe, if I hear what is happening, the judgment is that, even if we change the structure, the market will continue to operate.

Mr. MORRISON. You have really changed the allegiance because if you think about this in structural terms, now we have bank stockholders to whom I, as the bank lender, owe allegiance.

In the new structure, my allegiance is to the holding company stockholders, who have a interest in profitability and viability of the securities affiliate as well as the bank.

Now the market forces or the fiduciary forces, or whatever you want to call them, that are on me as a bank lender are inherently in conflict.

Mr. RUDER. The holding company is not a bank lender.

Mr. MORRISON. The holding company stockholders are the only stockholders around. There are no other stockholders. They are the only people.

Mr. RUDER. The question I was dealing with was the question that they might not lend.

Mr. MORRISON. That's the same kind of behavior. In order to favor your——

Mr. RUDER. What the concern was was that the lender might not lend money to competitors. That's the concern that was alleviated by my discussion with people who are bankers, who make these decisions more frequently than I do.

They said, look, that is not the way we work. That is not the way we would operate.

Mr. MORRISON. You have told us that you want to outlaw lending between the affiliates. So, if we go down your road, we don't have to worry about the lending.

I think I have made my point, and perhaps you just don't agree with it. It does seem to me that when you have a structure that, by its structural characteristic, prevents a conflict of interest, you have to have very good reasons to create a new structure that has the conflict built in and then take assurances about how people will behave as an adequate substitute for the structural protections we currently have.

That's my point.

My time is expired.

Mr. RUDER. My aides tell me that banks lend to banks. Maybe that's the answer to the question.

Chairman ST GERMAIN. Chairman Ruder, as to the cooperation among the regulators with the SEC, concerning US&B of San Diego, had not the regulators and the Comptroller listened to the SEC, that situation could have been brought to a halt at least a year ahead of time.

Mr. RUDER. That was before my time at the SEC.

Chairman ST GERMAIN. I will have my staff send you a few excerpts to make it very easy for you.

Then you go to Penn Square and Oklahoma City, where the regional offices of the Comptroller's office were not talking to each other.

Now, the regional office in Dallas had called in the board of directors, and so forth, and never told the regional office in Chicago and New York. As a result thereof, this little hayseed bank with a fellow who wore Walt Disney hats, Nazi helments, drank beer out of his boots, he took the big city bankers for a big ride, because the Comptroller's office was not talking to itself.

Now I just mention that because if the SEC is going to place faith and confidence in colloquy and communications, we can give you innumerable instances where it doesn't happen.

The same thing on money laundering. When we had the witnesses out here from the Comptroller's office and Justice, and so forth, again, people in the same office were not talking to each other. They seemed to have a problem communicating.

Franklin, FDIC, the Fed put $3 billion in there before FDIC knew that there was a problem there. We want you to know that there is a big problem with communications.

For that reason—do your best.

Mr. RUDER. I am at this point concerned with communication at the global level that I think we need. I mean, at the top regulatory level.

But, I think, as well, we need to increase communication at the enforcement level. Our current interaction is with the CFTC and we also have interaction with NASA, the Association of State Securities Regulators, in which we need to exchange enforcement regulation, enforcement information. And, we have even a communication problem sometimes within our own agency between our Washington office and our regional offices.

We are constantly trying to get that improved.

Chairman ST GERMAIN. Let me ask on NASD, if Glass-Steagall were repealed and the small banks would have their little broker dealer firms, would they be regulated by NASD? Or watched over by the State associations?

Mr. RUDER. It would be subject to State regulation as well.

Chairman ST GERMAIN. Do you defer to them in great part?

Mr. RUDER. Not with regard to broker dealer regulation.

Chairman ST GERMAIN. How about enforcement?

Mr. RUDER. We cooperate with them.

Chairman ST GERMAIN. They have their rules and their enforcement capability, and you have yours?

Mr. RUDER. Right.

Chairman ST GERMAIN. There have been experiments by the FDIC where they allowed in a few States to let the State banking superintendants do the exams and everything.

Mr. RUDER. We conduct our own examinations through our self-regulatory organizations. We do cooperate and it is important that we cooperate.

Chairman ST GERMAIN. You went way beyond the prepared testimony that we got ahead of time. You have been a very refreshing, helpful witness. I am so happy that you were able to come before

us today, and we want to continue working with you and your staff in this very critical area.

But, by God almighty, you really do the SEC proud as a witness before this committee, I can tell you. So we are very, very grateful to you.

I am sorry we kept you so long, but let's face it. You are interesting, and you are in an area that is very crucial to the subject matter before us.

Mr. RUDER. Thank you very much.

Chairman ST GERMAIN. This Chair would like to announce—by the way, there will be written questions, and without objection, from other Members who could not be here, as well as some of the Members who are here.

Mr. RUDER. We will be glad to receive them and respond.

[The questions and answers referred to can be found in the appendix.]

Chairman ST GERMAIN. Tomorrow, our witnesses will be Mr. S. Parker Gilbert, who will be accompanied by Robert Girard from the firm of Morgan-Stanley. I would like to point out, make it clear for the record that I have attempted—and done a great deal in attempting to have some of the large international banking organizations before us this week.

But I guess they are all tied up with their Christmas shopping because they all had calendar problems. I could say more, but I won't.

I just wanted to make it clear that the opportunity for them to testify prior to the Christmas recess was afforded them. We made every effort, myself and our staff.

The subcommittee will be in recess until tomorrow morning.

[Whereupon, at 1:22 p.m., the subcommittee adjourned.]

REFORM OF THE NATION'S BANKING AND FINANCIAL SYSTEM

THURSDAY, DECEMBER 10, 1987

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS, SUPERVISION,
REGULATION AND INSURANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met pursuant to call at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain [chairman of the subcommittee] presiding.

Present: Chairman St Germain, Representatives Annunzio, Barnard, Vento, Schumer, Lehman, Kanjorski, Gonzalez, Neal, Morrison, Erdreich, Carper, Patterson, Price, Kennedy, Wylie, Shumway, Parris, Roukema, Roth, McCandless, McMillan, Saxton, Swindall.

Chairman ST GERMAIN. The subcommittee will come to order. Today we continue our discussion of the need to repeal or substantially modify Glass-Steagall. The subcommittee has endeavored to secure counsel and advice from all segments of our economy. Certainly, large international financial organizations are in a special position for the evaluation of globalization issues, including international regulatory concepts related to technological developments with immense safety and soundness ramifications for the world's financial market systems.

We are privileged this morning to have the counsel of S. Parker Gilbert, chairman of Morgan Stanley which is one of the world's foremost investment banking firms and as such, has been a major contributor to the development of our securities marketing system justifiably recognized as the world's most efficient distribution system.

Mr. Gilbert will be accompanied by Robert A. Gerard, who is managing director of Morgan Stanley and Company. I believe that Mr. Gerard continues to serve as chairman of the Municipal Finance Committee of the SIA, a clear indication of the respect that he enjoys from his peers in that industry.

I might at this point ask unanimous consent to put my entire opening statement in the record in view of the fact I have abbreviated it this morning. Is there objection? The chair hears none.

[The opening statement of Chairman Fernand J. St Germain can be found in the appendix.]

Chairman ST GERMAIN. Mr. Wylie.

Mr. WYLIE. I want to join you, Mr. Chairman, in welcoming our distinguished witnesses today. Nice to see you again, Mr. Gilbert and Mr. Gerard.

In the past, the banking industry has been divided on most of the major issues, powers and interstate banking and may I say that it seems we are getting mixed signals from the securities industry as well now. Some are arguing for the status quo and for extending the moratorium and others seem to be hinting that they would accept a limited laundry list of powers and strengthening the so-called fire wall and now still others are arguing that the whole system should be dismanteled, the Financial Services Council or Mayflower Group approach.

I am particularly pleased that we have Mr. Gilbert and Mr. Gerard with us this morning. Both are very distinguished in their field and I know that they will be forthcoming with some very interesting and helpful testimony. Thank you, Mr. Chairman.

Chairman ST GERMAIN. We are being summoned to the floor for a vote on the journal, I imagine, but I must—it is my duty to state that the Chair is very disappointed with the situation this morning. The rules of the committee are very clear. We require copies of testimonies to be delivered 24 hours ahead of time.

The reason for that is so that the Members might have an opportunity to review the testimony and not have to stay into the wee hours of the night. The testimony of these witnesses before us this morning did not arrive until 6 o'clock or thereafter last night. We don't think it is a great deal to ask and we are very disappointed.

As a matter of fact, if anyone wanted to, they could just object to the testimony this morning and we won't be able to hear you. Hopefully that will not occur.

The subcommittee will be in recess for about 5 minutes in order to vote on the approval of the journal, at which time we will return and resume our sitting.

[Recess]

Chairman ST GERMAIN. Mr. Gilbert, we will put your entire testimony in the record, and you may proceed.

STATEMENT OF S. PARKER GILBERT, CHAIRMAN, MORGAN STANLEY AND CO., ACCOMPANIED BY ROBERT A. GERARD, MANAGING DIRECTOR, MUNICIPAL FINANCE DEPARTMENT, MORGAN STANLEY AND CO.

Mr. GILBERT. Thank you very much, Mr. Chairman. It is indeed a privilege for me and Bob Gerard to be with you and your committee today to express our views on what we believe is a critical issue and to respond to your questions. If I might be permitted to just give a very brief description of Morgan Stanley, to put in context our views on this matter, I would say that from the standpoint of services, Morgan Stanley views its principal function to raise capital around the world through primary markets for our corporate, Government and agency clients.

A related and equally important function is our activity in the secondary markets. We have found over a long period of time that it is necessary and desirable to distribute and trade securities in

secondary market and that is an important function which compliments our primary marketing activities.

Our reach is throughout the major capital markets of the world. We have approximately 6,500 people in our organization. Of that number, approximately 1,000 are located in London. Over 500 are located in Tokyo, and we have other smaller offices in Switzerland, Germany, Canada and several offices in the United States.

Our capital is approximately $1.6 billion. We are a public firm. We sold securities in the public market in March 1986. The employees of the firm own approximately 80 percent of our stock at this point in time and the public owns approximately 20 percent.

As a public firm we report our results on a quarterly basis and the firm in 1986 achieved a level of profitability of approximately $200 million. For the first 9 months of this year, we are at about that level of profitability. We think the matters that you are reviewing are critical because the real issue is what type of a financial system serves and will serve our national interest in the best way.

I think as a starting point we would all believe a banking system that is safe and sound is at the heart of any financial system. We have a system in place and has been in place for some time that is designed to accomplish these objectives. Our testimony outlines a number of privileges given to banks so that they can carry out the role of the safe receiver of deposits and an independent provider of credit and liquidity to the system.

These privileges include Federal deposit insurance, access to the discount window and the payment system, sources of funding at rates that are unavailable to other financial institutions and accounting treatment which permits assets to be carried at cost rather than current market value to cushion the bank's financial statements against significant market fluctuations.

The Banking Act of 1933 did recognize there were distinct differences between the needs and requirements of the banking system and the securities industry and provided a sensible separation of powers. The basic concepts embodied in Glass-Steagall have served us well. I think there is little doubt that the United States over a long period of time and today has the finest capital markets in the world.

The largest capital market, if you simply value the market value of outstanding equities, is Japan but the two capital markets are roughly the same size on that value standard. It is interesting to note that in Japan they have a financial system that is very comparable to the system that we have in place in this country.

I think it is clear that the securities industry does not operate under a Federal safety net. Availability of credit is critical to a securities industry and the banks are major providers of credit and liquidity to our industry. We are important customers of the banks.

We have to be able to succeed in volatile markets. Our financial statements are marked to the market every day. We live with the market risk that volatility of the markets produces and the success or failure of Morgan Stanley or any other firm in our business is dependent upon our ability to assess correctly market risk.

So while we are all part of a financial system, it is my sense that we occupy different places in that system and for that reason we

are treated differently. Mr. Chairman, I would suggest that the right starting point in your deliberations is to test what is in place and to come to some conclusions as to whether it has served the country well and as to whether it should in the future.

My own judgment is that it is a sound system. I do not believe it is sensible to merge these financial functions. The Federal safety net does not need to be cast in ever broader circles. I think the inherent privileges that banks are accorded requires that they maintain the greatest possible degree of independence and a clear understanding of what their powers are.

If as you go through this debate Congress believes it is important to consider expansion of bank powers, we think you should do it in a way which promotes the safety and soundness of the system and is fair. Our judgment is that this requires the establishment of a separate securities affiliate which should be set up under a bank holding company.

We think that the right and necessary first step is that the securities activities of banks be placed in that securities subsidiary. When I say that I mean the existing securities activities. I think that you all who are charged with the responsibility of designing the best system should see what the impact of placing power in an existing subsidiary actually is.

The testimony that we have provided describes what we believe are minimum requirements to insulate securities activities from banking. We believe that this framework should be tested and observed and dealt with to your satisfaction before new powers are granted. I think this is an important point because today, as we look both in the United States and around the world, there is no question that banks do have considerable securities activities and we really don't know very much about how they work and whether it is possible to set up a fire wall that accomplishes the kind of insulation we feel is appropriate.

So, Mr. Chairman, those are the principal points that I would like to make at this time. Bob Gerard and I would be happy to respond to your questions.

[The prepared statement of Mr. Gilbert can be found in the appendix.]

Chairman ST GERMAIN. Thank you, Mr. Gilbert. I am sure that it has been brought to your attention that many witnesses have testified before this committee as to the heavy concentration that predominates in the securities industry today.

Chairman Greenspan of the Fed stated to us just recently, and I quote, "The five largest underwriters of commercial paper account for over 90 percent of the market. The five largest underwriters of all domestic corporate departments account for 70 percent of the market, and the five largest firms account for over 75 percent of mortgage bank securities and the largest five underwriters of public stock issues account for almost half of the market."

Would repeal of Glass-Steagall reduce the level of concentration in the securities industry, number one, and second, if Glass-Steagall were repealed, what would really occur, in your opinion? Would the banks merge with securities firms already in existence in order to enter the securities business with a running stock or would the trend be to establish securities operations de novo?

Mr. GILBERT. Mr. Chairman, on the concentration issue certainly the statistics are clear that in some parts of our industry, major participants have a very large market share. I think there are a lot of reasons for this. In many cases, it requires enormous distribution systems and analytics and a significant infrastructure to put in place the skills to deal with some of these financial instruments. From our standpoint, I think one of the most valid tests on concentration is the profit margins in the business. These products to which you have referred are not the most profitable businesses in which we perform, and in some cases the profit margins are razor thin. I think that has been borne out recently from some of the exits from businesses such as the commercial paper business.

It is clear that any institution that is not a federally chartered bank is able to enter the securities markets and there are many competitors that we have that are part of large insurance or industrial companies so that we have never felt that our business is characterized by lack of concentration.

It is a hard business. Now, what would happen if Glass-Steagall is repealed, I think you obviously understand it is a purely speculative question. But our view, we have been in the securities business now for 52 years, having been founded in 1935, is that the business as a whole is a very difficult business to build. However, one of the interesting facts about our industry is that it is extraordinarily diverse.

There are great numbers of firms who are not necessarily full service and engaged in various parts of the business and each of them has an opportunity and an option to expand their reach if they see fit. But I would think that there would be significant pressures for further concentration if Glass-Steagall were repealed.

One can look to Canada as a possible indication of this. They went through a process late last year and early this year, of in effect, doing just that and the major Canadian securities firms are in the process of either being controlled or being acquired by banks. Most of them are the large Canadian banks, but there are several—at least one U.S. bank that has announced a significant interest in one of those firms.

I think there is a very distinct possibility that should Glass-Steagall be repealed entirely, one would see a combination or a series of combinations. It certainly is not out of the question at all that the large money center banks would wish to join forces with the large global securities firms. That would be the most powerful combination that one could envision.

Mr. GERARD. Mr. Chairman, could I add one observation on the concentration?

Chairman ST GERMAIN. If it is brief, because my time has expired.

Mr. GERARD. Simply, concentration, per se, is not the issue. You have to look at the impact of——

Chairman ST GERMAIN. You may not think it is the issue, but a lot of the Members of the committee and a lot of witnesses have zeroed in on the concentration aspect of it, so it is an issue.

Mr. GERARD. I understand, and I am saying per se it is not the issue. Concentration is bad if it has an adverse impact on the pricing structure, and there is no evidence in the 3 years you cited, as

are treated differently. Mr. Chairman, I would suggest that the right starting point in your deliberations is to test what is in place and to come to some conclusions as to whether it has served the country well and as to whether it should in the future.

My own judgment is that it is a sound system. I do not believe it is sensible to merge these financial functions. The Federal safety net does not need to be cast in ever broader circles. I think the inherent privileges that banks are accorded requires that they maintain the greatest possible degree of independence and a clear understanding of what their powers are.

If as you go through this debate Congress believes it is important to consider expansion of bank powers, we think you should do it in a way which promotes the safety and soundness of the system and is fair. Our judgment is that this requires the establishment of a separate securities affiliate which should be set up under a bank holding company.

We think that the right and necessary first step is that the securities activities of banks be placed in that securities subsidiary. When I say that I mean the existing securities activities. I think that you all who are charged with the responsibility of designing the best system should see what the impact of placing power in an existing subsidiary actually is.

The testimony that we have provided describes what we believe are minimum requirements to insulate securities activities from banking. We believe that this framework should be tested and observed and dealt with to your satisfaction before new powers are granted. I think this is an important point because today, as we look both in the United States and around the world, there is no question that banks do have considerable securities activities and we really don't know very much about how they work and whether it is possible to set up a fire wall that accomplishes the kind of insulation we feel is appropriate.

So, Mr. Chairman, those are the principal points that I would like to make at this time. Bob Gerard and I would be happy to respond to your questions.

[The prepared statement of Mr. Gilbert can be found in the appendix.]

Chairman St Germain. Thank you, Mr. Gilbert. I am sure that it has been brought to your attention that many witnesses have testified before this committee as to the heavy concentration that predominates in the securities industry today.

Chairman Greenspan of the Fed stated to us just recently, and I quote, "The five largest underwriters of commercial paper account for over 90 percent of the market. The five largest underwriters of all domestic corporate departments account for 70 percent of the market, and the five largest firms account for over 75 percent of mortgage bank securities and the largest five underwriters of public stock issues account for almost half of the market."

Would repeal of Glass-Steagall reduce the level of concentration in the securities industry, number one, and second, if Glass-Steagall were repealed, what would really occur, in your opinion? Would the banks merge with securities firms already in existence in order to enter the securities business with a running stock or would the trend be to establish securities operations de novo?

Mr. GILBERT. Mr. Chairman, on the concentration issue certainly the statistics are clear that in some parts of our industry, major participants have a very large market share. I think there are a lot of reasons for this. In many cases, it requires enormous distribution systems and analytics and a significant infrastructure to put in place the skills to deal with some of these financial instruments.

From our standpoint, I think one of the most valid tests on concentration is the profit margins in the business. These products to which you have referred are not the most profitable businesses in which we perform, and in some cases the profit margins are razor thin. I think that has been borne out recently from some of the exits from businesses such as the commercial paper business.

It is clear that any institution that is not a federally chartered bank is able to enter the securities markets and there are many competitors that we have that are part of large insurance or industrial companies so that we have never felt that our business is characterized by lack of concentration.

It is a hard business. Now, what would happen if Glass-Steagall is repealed, I think you obviously understand it is a purely speculative question. But our view, we have been in the securities business now for 52 years, having been founded in 1935, is that the business as a whole is a very difficult business to build. However, one of the interesting facts about our industry is that it is extraordinarily diverse.

There are great numbers of firms who are not necessarily full service and engaged in various parts of the business and each of them has an opportunity and an option to expand their reach if they see fit. But I would think that there would be significant pressures for further concentration if Glass-Steagall were repealed.

One can look to Canada as a possible indication of this. They went through a process late last year and early this year, of in effect, doing just that and the major Canadian securities firms are in the process of either being controlled or being acquired by banks. Most of them are the large Canadian banks, but there are several—at least one U.S. bank that has announced a significant interest in one of those firms.

I think there is a very distinct possibility that should Glass-Steagall be repealed entirely, one would see a combination or a series of combinations. It certainly is not out of the question at all that the large money center banks would wish to join forces with the large global securities firms. That would be the most powerful combination that one could envision.

Mr. GERARD. Mr. Chairman, could I add one observation on the concentration?

Chairman ST GERMAIN. If it is brief, because my time has expired.

Mr. GERARD. Simply, concentration, per se, is not the issue. You have to look at the impact of——

Chairman ST GERMAIN. You may not think it is the issue, but a lot of the Members of the committee and a lot of witnesses have zeroed in on the concentration aspect of it, so it is an issue.

Mr. GERARD. I understand, and I am saying per se it is not the issue. Concentration is bad if it has an adverse impact on the pricing structure, and there is no evidence in the 3 years you cited, as

Mr. Gilbert mentioned—and certainly in one of the areas there is strong evidence to the contrary—that there is anything like oligopolistic pricing in any of these marketplaces. And that is a function, among other things, of alternatives.

You wouldn't, if it so happened coincidentally that one automobile company made 85 percent of the blue cars in the country, you wouldn't say it had a monopoly on blue cars because people could buy other sorts of products. For example, there are worldwide alternatives to financing through commercial paper. That is why the commercial paper market, even though five firms may control 90 percent of it, is a market where you can't charge even break even prices, much less monopolistic prices.

Chairman ST GERMAIN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

I mentioned in my opening statement that we seem to be getting mixed signals now from the security industry. Some are in favor of maintaining status quo and some are suggesting maybe it would be time to accept the limited laundry list of powers and strengthening the so-called fire wall with a separate affiliate. Others are suggesting maybe it is time to merge the investment banking with other banking interests.

I want to make sure I understand your position, because I do respect your judgment. You have shown you have good judgment throughout trying times of the stock market here. But you are in favor of maintaining the status quo, as I understand it, but if Congress decides to act, you favor an incremental approach.

First, transfer all currently permissible bank securities activities to a separate affiliate that would be funded independently, and I would assume that would be foreign operations as well?

Mr. GILBERT. Yes.

Mr. WYLIE. Second, functional regulation would be required.

Third, after all of the above has been done and objectively tested, Congress should consider extending a limited number of new powers to banks. These might include commercial paper, revenue bonds and mortgage backed securities. Is that an accurate summation of your material?

Mr. GILBERT. Yes.

Mr. WYLIE. Why didn't you include mutual fund authority?

Mr. GILBERT. We certainly recognize right from the outset that you all have the tough call if you get to that point of deciding what is appropriate and why. I think the why is a very important question. The list that we suggested is not meant to be definitive, because we recognize that is not our province.

Mr. WYLIE. Are you representing the SIA position, or is that the position of just Morgan Stanley, Mr. Gilbert?

Mr. GILBERT. No. I am here for Morgan Stanley.

Mr. WYLIE. Many proponents of expanding banking powers have argued that the globalization of financial markets might require change in our domestic structure imperative if U.S. firms remain competitive. You seem to turn that around—that the increasing globalization, the high velocity international financial environment in which we live argues against further deregulation or expanding powers for banks.

Is it possible over the long run, to stand against market driven forces, and don't we run a real risk by not modernizing or updating our own statutory framework? We may be permanently relegating this country to the status of a second class financial citizen? I ask that question advisedly because it is one on which I need some help to answer.

Mr. GILBERT. I think you have to start, Congressman, with the real question as to whether our major financial institutions are not indeed world class competitive. My view is that the U.S. institutions that have elected to participate in a major way in global markets are indeed world class competitive under the system that operates today, and in fact, most of their major competitors and the ones that are most often cited as ones the firms are to be concerned with are the Japanese that as, I said earlier, are operating under virtually the same set of ground rules.

So I think if you have the opportunity to take a survey around the world of competitive institutions, that you would find a lot of U.S. institutions both on the banking side and on the securities side that would fall into that very competitive category.

I don't think it is an issue of second class, becoming a second class institution, and I think the most important issue sitting here in the United States is what is right for this country. Because it is likely what is right for this country is likely to produce a set of competitive dynamics that works around the world.

Mr. WYLIE. Well, Japan is mentioned frequently as a nation which is our primary competitor in this area of delivery of financial services on an international scale. On page 5, you state in your testimony that the Japanese have their own version of the Glass-Steagall. You just mentioned Japan again. Is it possible you could tell us some similarities and differences in the Japanese version of Glass-Steagall and ourselves?

Mr. GILBERT. Yes. I think that is a very fair question and perhaps deserves a response that is more detailed and complete than I am capable of giving now. It is one of those areas I think on which we should provide the committee with some information. But essentially, as they started to develop after the war their own financial system, it, not surprisingly, was modeled very closely on the system that we have today, and had in the United States at that time.

Now, when you get into an area like banking, they didn't have some of the constraints on interstate banking that we have had in the United States, but there is a very clear separation between what securities firms are allowed to do and what banks are allowed to do. The powers are clearly and carefully separated.

Now, what has happened in the banking system? If you measure competitive capability by just plain sheer size the Japanese banks do run larger balance sheets than the large American banks. The large Japanese securities firms are also significantly larger than the major securities firms.

The markets change and all of that, but I can tell you that at one point not too long ago, the market value of the equity of the largest Japanese securities firm was over $40 billion. That market valuation in fact is larger than the market valuation of all the securities firms and the money center banks put together.

But we have found that while they are very significant competitors that we can compete with them and I think the American banks can compete very successfully against the large Japanese banks.

Mr. WYLIE. My time has expired, and I am sure the chairman will permit you to expand on that for the record.

Chairman ST GERMAIN. Without objection, you may submit a more detailed reply for the record, to be inserted in the record at this point.

[The information referred to can be found in the appendix.]

Chairman ST GERMAIN. The Chair now recognizes Mr. Annunzio for questioning. After your questioning, we will go to vote and return immediately.

Mr. ANNUNZIO. I was tremendously pleased to read your statement. It is an outstanding statement. I have underlined what I consider to be some very, very important information which the committee will have. I was one of the conferees, and the only conferee back in 1981 that voted against deregulation. I am no fan of deregulation. I have never changed my mind. But in your statement, deregulation has brought a blurring of the lines between bank and security activities and insurance.

During the past several years we have had increases in pressure with some banks and regulators for authority to expand banking activities beyond the traditional role of depositing and lending. They are asking for these new powers at a time when last year we had 148 bank failures. There will probably be more failures this year. I don't have the record before me of the number of S&Ls that have gone under, the billions and billions of dollars that have been lost, and we are afraid to say, you know, on the record that deregulation was the cause.

I won't make a flat statement that deregulation is the cause, but it sure didn't help it any, because when they got the bank powers, these bankers didn't know what the hell to do with it. The only reason they want banking powers is to make more money, and you know the purposes of banks is to receive deposits, to make loans, to play a vital and important role in communities, in our economic system.

I am Chairman of the Consumer Affairs and Coinage Subcommittee of this particular committee. Naturally, I have a deep interest in the consumer views on expanding bank powers, as well as my own views that have been created by experience after 22 years on this committee. I think I have seen a lot of legislation. Witnesses that come before us speaking of what is going to happen. All I have seen over the years is our financial institutions get deeper and deeper into trouble.

Sometimes I think we shouldn't worry if we didn't legislate since 1981. If we don't legislate for 10 or 20 more years, people would be better off. I am, of course, interested in the consumer views on expanding bank powers. Surveys have shown that consumers don't want the banks in the new businesses, and last week the major consumer groups testified against any new powers.

Is there, in your opinion, a ground swell of support for new bank powers among your own customers?

Mr. GILBERT. Well, I have to preface that comment, Congressman, by saying that one of the reasons I wanted to tell you a little bit about Morgan Stanley at the outset is that our firm, with very limited exceptions, deals predominantly in the institutional marketplace, and with corporations and governments.

Having made that comment, I can tell you that I am not aware that we have gotten a whole lot of pressure from the people with whom we deal to support repeal or major extension of powers.

Mr. ANNUNZIO. Say that again. You have gotten a lot of——

Mr. GILBERT. We are not feeling pressured from our constituents. I am not aware of pressure.

Mr. ANNUNZIO. To expand the banks?

Mr. GILBERT. To expand the banks.

Mr. ANNUNZIO. All right. I thank you.

Now, the committee will stand in adjournment until after the vote.

Chairman ST GERMAIN. The gentleman from Georgia.

Mr. BARNARD. Thank you, Mr. Chairman. Mr. Gilbert, welcome to the panel this morning.

Certainly all of us recognize Morgan Stanley is one of the old, reputable well-recognized investment houses in the country. We appreciate your being here this morning. I understand you are speaking only for Morgan Stanley this morning and not the Security Industries Association as a whole. Would you say your testimony was representative of the major investment houses of the country?

Mr. GILBERT. I have not had the opportunity to check nor have I received any comments, Congressman.

Mr. BARNARD. Do you attend SIA meetings?

Mr. GILBERT. No, sir, I do not.

Mr. BARNARD. You don't go to any of the SIA meetings?

Mr. GILBERT. No.

Mr. BARNARD. Are you a member of the SIA?

Mr. GILBERT. Morgan Stanley is a member.

Mr. BARNARD. Does your organization participate as a member in the conventions and so forth?

Mr. GILBERT. We have extensive participation.

Mr. BARNARD. Wouldn't you, though, know whether or not your view points fairly represent the opinions of the major investment houses without having to check with them individually?

Mr. GILBERT. My surmise would be that major investment houses would not disagree in a significant way with what I have said and the major retail firms could see things differently.

Mr. BARNARD. How do you differentiate retail firms and investment houses? I mean, you wouldn't include Merrill Lynch, Shearson Lehman, Goldman Sax, E.F. Hutton, First Boston, Prudential Bache? How do you describe them? Retail houses?

Mr. GILBERT. Our industry is a combination of a lot of activities. We would view ourselves as being quite comparable in the line of business that we do with Goldman Sax and Salamon Brothers and First Boston.

We compete on a very intense basis with Merrill Lynch, Shearson and other firms.

Mr. BARNARD. Is it not true some of these firms which I have just identified see a benefit in the repeal of Glass-Steagall whereby the

investment community would be able to get into the banking business just as the banking industry would be getting into some securities investment?

Isn't your opposition sort of 50 percent of the issue rather than 100 percent of the issue? I am sure Morgan Stanley has not seen fit to ally themselves with the banking industry; but when you look at Merrill Lynch, Shearson Lehman, Goldman Sax, Drexel Burnham, E.F. Hutton, E.F. Hutton Bank, First Boston, Universal Trust Co., Payne Webber, Payne Webber Trust Co., Prudential Bank, Prudential Bank with Prudential Bank and Trust, wouldn't you say they are somewhat taking advantage of the privileges that you spoke of that banks have?

Mr. GERARD. I can address that, Mr. Barnard.

Mr. BARNARD. Let's talk about this question.

Mr. GERARD. Let's talk about it. I think those firms you cited really fall into two categories.

Mr. BARNARD. They are members of SIA?

Mr. GERARD. They are all members of the SIA as is Morgan Guaranty, Chase Manhattan and some of the commercial banks as well. One category are firms primarily, as Mr. Gilbert indicated, retail firms as we would characterize them in Wall Street, doing business with the general public who have insured institutions which perform some banking functions.

A number of the firms on that list have acted in a way that I would characterize as prudent, knowing that the law with respect to the so-called non-bank banks has been influx for some period of time.

Mr. BARNARD. Would you excuse me terribly for interrupting? I don't mean to, but you see what constraints of time are. I haven't got that much time. The point I am making is the financial structure of the country has changed.

You don't identify that, Mr. Gilbert, in your testimony, but whether it was right, wrong, or indifferent, the financial structure of the country has changed and it has permitted change. From what I can see, I don't see anything detrimental coming about because of that change.

We have closed the non-bank bank loop hole. All well and good. That, in itself, now has put investment houses—and I think these are pretty representative—in a position to unfairly compete in the marketplace with commercial banks.

Mr. GILBERT. Reasonably people can disagree on those issues.

Mr. BARNARD. That is true. I am looking for new arguments to support not repealing Glass-Steagall. I can go back 2 or 10 years ago when the banks were seeking one little small power to underwrite municipal revenue bonds. If you had offered the same testimony then as you did today, it would have had the effect—I would have had deja vu all over again.

I am hearing the same arguments without recognizing what is going on in the financial marketplace and what is going on in the financial structure of the country. I am sorry my time has expired. I will stick around.

Chairman ST GERMAIN. Did you finish your question?

Mr. BARNARD. Well——

Chairman ST GERMAIN. Did you get an answer?

Mr. BARNARD. Not necessarily. I didn't think I was going to get one.

The question is, Number one, don't you agree the financial structure of the country has changed? Number two, don't you agree the financial marketplace has changed? Number three, don't you recognize the fact that security houses would have equal advantage over banks if Glass-Steagall was repealed?

Mr. GILBERT. That is a longer series of questions. The financial world has changed. Has the system that we have in place allowed it to change? Permitted competition and provided competitive services to consumers of those services? I believe the answer is, yes. That is my testimony.

Have U.S. firms—whether banks or securities firms—been successful competitors on a global basis? I believe the answer is, yes. There are some fundamental concepts, I think, at the heart of our system, which is the safety and soundness of the banking system.

If that is not the case, everything else is going to fall. There is going to be a domino effect. I think the most important challenge that you all have is to try and come to a conclusion on what is necessary and desirable to have a banking system that is safe and sound. We feel it is a competitive banking system.

It has its privileges and we have a certain degree of flexibility because we are not part of it.

But the system works and has worked well. Changing it is something that has to be done.

Mr. BARNARD. May I just—in other words, you support then, your brothers in the industry disenfranchising themselves from these banks? You support them getting out of the banking business?

Mr. GILBERT. I will only speak for myself.

Mr. BARNARD. But, we talk fairness in the marketplace. If you did not want to see the banks get into investment houses, you would advise that members of the SIA who are in the banking business would have to get out of the banking business? I know Morgan Stanley said that before.

Mr. GERARD. That is an issue for them to decide. I think the principal we are talking about——

Mr. BARNARD. Oh, no. It is an issue for us to decide, Mr. Gerard. We will determine what is fair in the marketplace.

Mr. GERARD. Mr. Barnard, I would suggest that what we are not addressing today is the question of competitive equality. The fundamental issue of credit is critical to the functioning of the financial system. The commercial banks in this country because of Glass-Steagall are the independent arbiters of credit for the domestic and international financial system.

If you put them into the competitive environment outside the provision of credit, they will be in a position where they will be able to control lending to entities that are their competitors, both domestically and internationally. We are unconvinced, and we spent a lot of time thinking about this, that there is a way to sanitize that process without, at a minimum—and we are not even sure this would work—substantially more in the way of Federal regulation.

If you want the Fed to take over the functions that money center banks, both domestically and internationally, now provide in terms of the world's financial markets, that is an issue we can consider and debate whether you want to in effect have the Government be the arbiter and provider of credit to that system.

We think that is not the right way to go. We think the free market has functioned extremely well and made our market the strongest in the world. But if you change the system so that the independent arbiter of credit at the same time becomes a major participant and a major competitor of those who are dependent upon that credit, you are going to have an entirely new world. That is really the concern. Sure, you can structure legislation that will provide level playing fields, competitive equality, functional regulation and everything else.

The question is can we have a banking system that performs the traditional banking functions upon which the financial markets rely in that environment. We have struggled with it. We don't think it can.

Chairman ST GERMAIN. Mr. Parris.

Mr. PARRIS. Thank you, Mr. Chairman.

Mr. Gilbert, in your statement, on page 4, you allow as how commercial banks are able to perform the role of providing needed liquidity to the system at the urging of the Federal Reserve.

On page 8, you say we, meaning investment bankers, are required to have access to credit for market making activities in large amounts and so forth, all of which is certainly self-evident.

In his testimony yesterday, the Chairman of the Securities and Exchange Commission, Mr. Ruder, said, among other things, we did not have enough buying power in the market as of the Black Monday, and he is alleged to have suggested "that what we need is a creation of an emergency system to provide additional capital to brokerage firms during financial market panics."

I assume that you are reasonably familiar with the ABA proposal of expanded powers in the federally insured institutions and the creation of subsidiaries for securities, real estate and insurance, and other activities with what has come to be euphemistically termed to be a fire wall between the deposit taking, lending facilities of the bank vis-a-vis those other activities.

It seems to me that if we have responsible Federal agencies urging—including the Federal Reserve Board—urging commercial banking institutions to press capital on to securities firms in times of market panic, with those financial institutions being backed by the full faith and credit of the United States and unlimited access to the credit window, and so forth, doesn't it—would you suggest your interpretation of whether or not that fire wall is liable to melt when the heat is on?

You make the point in your comments, I think on page 8, again that recent experience indicates in financial times of crisis banks will contract credit to the securities industry and can be expected to favor their own securities activities over independent firms. Is that your principal concern, that this is in fact a Maginot Line—which is what some of us would call it. It is a paper protection between the credit window and the taxpayers of the United States? Is that a fair summarization of your position?

Mr. GILBERT. Yes sir. I think it is fair to say we are concerned whether that fire wall will operate on a long term continuing basis the way in principle, in theory, it might be constructed.

Mr. PARRIS. Then are we left with two untenable alternatives:

(a) Present conditions, current circumstances under existing law, or (b) I gather this is preferable, if not preferable to the status quo—in doing so, in some kind of an unaffiliated basis, with the regulation by SEC and so forth? That is basically our position in the testimony this morning?

Mr. GILBERT. If I understand the question correctly, Congressman, what we have said is that there should be some serious doubt and concern as to whether a system can be structured where there are effective fire walls.

Mr. PARRIS. In terms of one, two, three: (one), your preference is to do nothing, is that correct?

Mr. GILBERT. That is correct.

Mr. PARRIS. Number (two), if we are going to do this unholy act, we ought to do it in the—consistent with the outlines you provided us with in your testimony this morning?

Mr. GILBERT. That is correct. Set it up. See if it can work.

Mr. PARRIS. Number (three), would be the subsidiary arrangement, with perhaps the uninforcible limitations on tie-ins and extensions of credit and all that. Is that a fair statement?

Mr. GILBERT. Number three is really take a look at it after you set it up, and consider the issue of expanded powers. If you are satisfied, if it works to your satisfaction, fine.

Mr. PARRIS. Thank you very much.

I yield back the balance of my time.

Chairman ST GERMAIN. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

Just a couple of brief comments quickly, before my questions.

In reference to my good colleague, sometimes ally, sometimes friendly adversary, from Georgia, first, to ask Mr. Gilbert if he speaks for the SIA would be equivalent to asking Citibank if it speaks for the ABA? Both are broad organizations with many different concerns. We have seen that in the years we have been here.

Second, to talk about securities firms having some banking activities is certainly fair. I would be for getting rid of all of them.

Let's also talk about banking firms having securities activities as well, something my good colleague from Georgia didn't quite mention.

Finally, just one little comment. I agree with the gentleman from Virgina's comment. It is very difficult to construct a fire wall. But if you work by that premise, I would just ask my colleague to think about whether we will end up with a system—since we have a fake fire wall, no fire wall—that really re-regulates everything because we have the Fed guaranteeing everything for everybody, risky and non-risky activities. Is that the way we who do believe in the free market believe is the most competitive way?

I submit not. That is the direction we are headed in if we feel we can't build a tough fire wall.

I have a few questions for whoever chooses to answer them. The first question relates to denial of credit. You mentioned in your testimony that if we give those new powers so that banks have their

own securities subsidiaries, banks will be reluctant to treat other securities firms fairly when they are competing with those firms. A very logical assumption.

I asked that of Mr. Ruder yesterday. He said he was worried about it. Then the answer he gave sort of surprised me. He said that would be a natural worry, but I went to some of the banks and asked them if it would really occur and they assured me it would not.

What is your view, as a practical businessman, as to those assurances?

Mr. GILBERT. It certainly puts you in a funny position when one of your principal suppliers is also one of your principal competitors.

Mr. SCHUMER. Particularly when some of the supply—I would add for the record—some of that supply comes at the beneficence of the Federal Government. Federal insurance gives them the money to be able to lend.

Second question: What would be your view as to what might happen if an affiliate of a bank were subject to the kind of rumors that circulated concerning E.F. Hutton after October 19? Under those conditions, wouldn't other market participants draw back from doing business with the securities firm? But furthermore, isn't there a great risk people would avoid doing business with the bank, fundamentally threatening the safety and soundness of the bank, regardless of how tough a fire wall there was? If I were an European, Arab or Israeli investor wouldn't it be logical for me to say not only do I not want to do business with "X" bank's securities firm, but I am going to take my hundreds of millions of deposits out of the bank, because who knows what can happen? What do you think of that possibility?

Mr. GILBERT. At the very least, it would certainly heighten concerns.

One of the clear changes in the system with which we are all living is the speed and velocity at which interest sensitive funds can move. We certainly saw that in the case of the Continental Illinois some years ago.

Mr. SCHUMER. Final question. Well, we have a few more, but I am getting close to the end of my time, since my colleague from Georgia took some of mine.

If Glass-Steagall is repealed, wouldn't the most logical beneficiary as to who would move in and take over the securities firms be the various people who are cash rich, looking to get into the securities firms, unable to do it in their own country, that is, the Japanese banks?

Let's say tomorrow, assuming Morgan Stanley has stock out in the market, who would be the most logical person—and Glass-Steagall were abolished—who would be the most logical institution to bid for those? Would it be American banks or Japanese banks?

Mr. GILBERT. Today it would be Japanese banks.

Mr. SCHUMER. So we might find the effect of repealing Glass-Steagall would be for Japanese banks to come in and take over most of our securities firms? Is that a wild possibility, or a very real one?

Mr. GILBERT. It is somewhere in between.

Mr. BARNARD. Will the gentleman yield?

Mr. SCHUMER. With the Chair's permission, I would be happy to

Mr. BARNARD. I think the record will show Sumitomo has already bought 12 percent of Goldman Sacks. Now they are talking about a joint venture in London.

The answer to your question is it is not only possible it is, yes.

Mr. SCHUMER. I would say to the gentleman, the reason it is 12 percent, aside from the fact Goldman is a privately held company, the Yasudo, the people who buy the Van Goghs, if there was no Glass-Steagall and they could buy 51 percent, they would go right in and do it.

I yield back the balance of my time.

Chairman ST GERMAIN. Mr. Price, do you have any teriyaki?

Mr. PRICE. Thank you, Mr. Chairman.

Mr. Gilbert, I am somewhat puzzled by the account in your testimony of the events of October 19. I wonder if you could clarify that a bit. On page 4, for example, you say "the system worked."

"At the urging of the Federal Reserve, commercial banks were able to perform their role of providing needed liquidity to the system."

Four pages later, you cite a story in the Wall Street Journal saying, "Recent experiences with the October 19 crash reinforced our earlier concerns that in times of financial crisis, banks will contract credit to the securities industry . . ."

There seems to be a discrepancy in those two characterizations. Could you clear that up?

Mr. GILBERT. I think the best way to clarify it is to say that at the time of the crisis on October 19 and 20, the Federal Reserve acted in a very persuasive and encouraging way to put liquidity into the system and to encourage commercial banks, whose natural inclination was to either become more difficult or less responsive to the credit needs of the industry. The Federal Reserve encouraged the banking system to be as supportive as they possibly could be.

One of the concerns we have, all other things being equal, if the question is funding a related activity, a securities activity within a bank or funding a competitor, we think that that will present us some very difficult choices.

Mr. PRICE. You say, though, that in this instance the Federal Reserve was able to exercise its powers of persuasion and alleviate the situation?

Mr. GILBERT. Yes.

Mr. PRICE. Do you see any prudent reason why a bank would not have wanted to lend to you in this situation?

Mr. GILBERT. To Morgan Stanley, no. I don't want to give you too quick an answer on that. Clearly, we are suggesting that banks should be independent evaluators of credit. When you have the kind of situation that we had on October 19 and 20, it is perfectly reasonable for them to be careful in their evaluations.

Mr. PRICE. What are you exactly suggesting, though, for the Federal Reserve? In your own recommendations you stressed the importance of—let me cite it exactly—you stress the importance of implementing safeguards to preserve credit and liquidity to non-bank affiliated firms during times of financial stress. What kind of

measures do you have in mind? What kind of role ought to be mandated?

Mr. GILBERT. That is more of a concept at this point than a hard series of recommendations. I think what I am very clear on in that section of recommendations is that it should be an absolute that banks should not be able to extend credit to their own securities affiliates, because in doing that, it really brings into the Federal safety net the operations of the securities affiliate.

Mr. PRICE. Is it the possibility of favoritism and inequity that concerns you?

Mr. GILBERT. Together with the extension of the Federal safety net.

Mr. PRICE. Were the banks on the occasion of October 19, in extending this credit and in preventing the further ripple effects though the economy, were they extending credit from federally insured deposits?

Mr. GERARD. Well, the answer is yes in two senses. One, directly in the sense that all banks, including the largest banks, were the principal providers of credit do depend to some degree on federally insured deposits, directly.

But more importantly, given the scale of the transactions we are talking about, there is the safety net concept, the safety net concept basically saying there are a number of banks in this country, whether 10, 12 or 13—the Fed has never defined—that it is in the national interests never to allow to fail. Therefore, investors—and Congressman Schumer mentioned this earlier—particularly foreign investors are comfortable providing large deposits well in excess of $100,000 limit, to those banks on the assumption that irrespective of what happens, they will be paid in full with interest, and on time. That was the money obviously that provided the primary source of liquidity in the system.

So, again, the answer to your specific question is yes.

Mr. PRICE. Thank you.

My time has expired.

Chairman ST GERMAIN. Mr. McMillan.

Mr. ALEX McMILLAN. Let me come back to that same line of inquiry, Mr. Gilbert, with respect to a statement on page 4, in which you state "with a market drop of 23 percent and panic selling, the country's financial structured stood firm in no small measure because banks were not market participants."

Would you say that they were a substantial participant, however, in providing stability on October 19 through the extension of credit?

Mr. GILBERT. Yes.

Mr. ALEX McMILLAN. That extension of credit in terms of magnitude of risk and capital employed far outweighed any other direct market exposure that they ordinarily would have had or might have had?

Mr. GILBERT. Not necessarily. A great deal of the extension of credit is on a secure collateralized basis.

Mr. ALEX McMILLAN. Let me put it this way. Could you give us some idea of the magnitude of the credit that might have been extended, loaned on securities at that point in time relative to the net capital of the securities industry in the aggregate?

Mr. GILBERT. I don't have that information.

Mr. ALEX MCMILLAN. That, to me, is one way of measuring the risk of exposure on October 19. There is a credit exposure which the banks have anyway.

Mr. GILBERT. I can tell you from Morgan Stanley's standpoint, our credit requirements were not dramatically greater over the 19th and 20th than they were prior to that. So the issue there, for us, was whether the same credit that we had been using to conduct our business would be available to us on a continuing basis in view of the significant market deterioration.

I think other firms found themselves in somewhat different positions, which I really can't answer, except in the most general way, but it would depend on the mix of their business and the level of their inventories.

Mr. ALEX MCMILLAN. I guess I am trying to look at this in a broad sense on the assumption that Glass-Steagall did not exist on that date, what additional risks would the banks then have incurred that they didn't?

Mr. GILBERT. Let me put it this way. We all deal with risk. There are really two types of risk that we have to assess very carefully. Market risk, which is interest rate level of securities prices and how we deal as we do, in a market to market system, where every security that we own at the end of a day has to be priced according to its price in the market?

Our ability to do business, to access credit, to meet the regulatory standards depends on our ability to assess that market risk correctly and to have enough capital to stay in business and to earn a reasonable return.

Earning a reasonable return is important because that is at least one part of the important other equation, which is your access to credit. Credit risk most importantly deals with the issue as to whether somebody who has received credit has the capability to pay it off on the terms on which it was lent. Both are extremely important, but by their nature, both are also quite different.

The point we are trying to make here—and it is really fundamental to our testimony—is that the banking system, by virtue of the powers that Congress wanted it to have, has the key credit function. Our industry deals routinely across a broad range of securities around the world on market risk.

Now, banks deal in market risk too, and we deal in credit risk to some extent. But there is an order of magnitude here. The point on October 19 and 20 was that the banking system had to come to its conclusions on the credit risk, but they were not exposed to a broad spectrum of equity products around the world, broadly on the market risk.

In this case, one plus one can be a heck of a lot more significant when you are trying to measure safety and soundness than just the credit risks themselves.

Mr. ALEX MCMILLAN. My time has expired. I would like to examine that more in depth. I think I understand the conditions in which the market dropped 23 percent, the credit extension against securities converts very quickly from being strictly a credit decision to one based on market considerations, and that risk then really is assumed by the creditor.

Mr. GILBERT. No sir. I respectfully would say that that—a lot of the credit is collateralized and the value of the collateral does fluctuate and is justifiable.

There are elements to be sure, I mean, in assessing credit risk. One has to be acutely aware of what is happening in the marketplace, but the two are not completely linked on that basis.

Mr. ALEX MCMILLAN. Thank you.

Chairman ST GERMAIN. Mr. Hiler.

Mr. HILER. Thank you, Mr. Chairman.

Mr. Gilbert, do you think commercial bank management is incapable of dealing with the kind of issues you deal with?

Mr. GILBERT. I find it very hard to answer that question. What I could say is that we have been in the business for a long time. We have gone through an enormous period of growth and change in this business. It is a business where judgment and experience are important. It is a difficult business.

If you look at the changing nature of the securities firms in the business, those that have been acquired or gone out of business, if you look at an old, what we call tombstone, which is an advertisement on a public security offering 15 or 20 years ago, and you look at one today, you notice some extraordinary differences.

So that I think it is fair to say that management that is not capable can have a significant and rather traumatic effect on the ability of a securities firm to deal with the world in which it finds itself.

Now, having said that, I find it very difficult to comment on how bank management could deal in these kinds of dynamics.

Mr. HILER. I gather you are not saying that bankers intrinsically are incapable of dealing with these kinds of issues. Based on the person, experience, and so forth, that someone who is heavily in Morgan Stanley—for instance, you have been involved in your industry for the last 20 years. Chances are they would have gone through that same learning curve?

Mr. GILBERT. That is a perfectly reasonable assumption.

Mr. HILER. There is nothing intrinsically deficient about folks who work in banks that makes them incapable of dealing with the kinds of issues you are dealing with?

Mr. GILBERT. I would be hard pressed to take that seriously.

Mr. HILER. Would you say in your experience in going toe-to-toe with some of the U.S. banks, international banks in foreign securities markets that there has been any evidence those banks have tended to take more risks than you might or make pricing decisions that are just way out of line? Something that would lead us to believe that where they are dealing in some of these areas outside the United States, that there are problems developing?

Mr. GILBERT. That is a complicated question. I think there have been some indications where some degree of success has been achieved. There have been other areas where I think it has been extremely difficult. For example, when we went through the big thing of deregulation in the London market, the gilt market, treasuries securities, was opened up for anybody that wanted to compete in it.

Twenty-seven or 28 firms became recognized dealers, primary dealers. There were banks and some securities firms that went into

that. I think that experiment has not been successful at this point for any but just a very few over a market that——

Mr. HILER. A few being defined as banks and securities firms or just on the banks side?

Mr. GILBERT. This is those participants that went into that market. Banks and securities firms.

Mr. HILER. When you say it has only been successful for a few, who are the few? Not by name, but some of each group? Only one group?

Mr. GILBERT. I don't know. You would have to find out the information.

Mr. HILER. I wasn't sure exactly what your answer was.

Mr. GILBERT. Nobody breaks it out separately. The reason the question is a difficult question is that there is very little financial information or profitability information available to assess whether this has been success from a standpoint of enhancing profitability, and there are lots of different—I think your question was really directed to the international market.

There have been areas where people have taken significant losses. There have been areas where they haven't. So it is very hard to generalize on this issue, particularly in the absence of information. I think that is perhaps one of the advantages that would come out of putting into a separate subsidiary information that relates to banks insofar as their securities activities are concerned.

Chairman ST GERMAIN. Mr. Carper?

Mr. CARPER. Thank you, Mr. Chairman.

I want to welcome our guests. Thank you for your testimony. Let me start off by asking do you believe—do I understand it from your testimony, Mr. Gilbert, you are saying that if we proceed toward enhanced securities powers for banks, you think it is appropriate for banks to own securities firms but not for securities firms to own banks?

We have a number of proposals before us. We have Senators Proxmire and Garn saying we should repeal Glass-Steagall so banks can own securities companies and vice-versa. We have other proposals that say banks could own securities companies, but there could be no reciprocal activity.

If we are going to move in that direction—and my hope is that we will—which in your judgment is appropriate?

Mr. GILBERT. Well——

Mr. CARPER. Which policy is appropriate?

Mr. GILBERT. I think if you go move in that direction, it ought to be possible for either side to own something on the other side. Then the issue becomes whether that produces a system that is better than the one we have, more competitive, or more concentrated.

Mr. CARPER. Let me just ask about probations on lending between a bank and its securities affiliate. Trying to think of a way to insulate the one from the other, what do you think of the idea of simply saying that a bank cannot lend to its securities affiliate? That securities affiliate is simply going to be forced to go out into the market and make its credit arrangements elsewhere.

Mr. GILBERT. I think that is the essence of what I am recommending. We talk about fire walls and insulation. You will, undoubtedly, get all kinds of testimony on this subject, but another

point to keep in mind—and it is related to the question about what are the issues on safety and soundness. If you have a large securities affiliate that gets into trouble I think we should keep in mind when we are talking about some of these macro changes, about a holding company that owns various activities, and we are saying that it may be possible, although extremely difficult and controversial, to set up a fire wall system that satisfies you.

But one thing that I think will be extraordinarily difficult to do is to have a holding company that has access to capital markets which may indeed, certainly on the equity side, be the principal provider of equity to that system. It is very difficult to insulate that holding company from the results and achievements or problems of its parts.

Mr. CARPER. Some of our earlier testimony from witnesses talked about whether or not some kinds of securities activities can be conducted within the bank. As I understand it now, our general obligation tax exempt bonds can be underwritten, handled within the bank itself, not within a subsidiary of the bank or—by the holding company.

There have been recommendations certain activities could be done within the bank that are securities related. We heard some say that more risky activity should be either undertaken within an affiliate of the bank or within an affiliate of the holding company itself.

From your testimony, I think I read it basically should all be done outside the bank in a subsidiary of the holding company; is that correct?

Mr. GILBERT. Yes.

Mr. CARPER. Why? Have we had problems with banks underwriting general obligation bonds within the institution?

Mr. GILBERT. I think that obviously back at the time that the 1933 Act was put in place, Congress saw fit to extend some limited securities powers for reasons that probably were importantly related to liquidity of the market at that time.

As this issue continues to develop and as banks engage in additional securities activities—and the international activities are a perfect example of that—the Federal safety net and everything we have been discussing starts to extend to a broader and broader and broader framework of activities that is related to the securities business.

What we have testified to, or what I have testified to today, is that the point has come when it is certainly something that could be and should be considered and that was something that we would support.

Mr. CARPER. Thank you, sir.

Chairman ST GERMAIN. Mr. Vento?

Mr. VENTO. Thank you. Thank you, Mr. Chairman.

Mr. Gilbert, welcome to the committee. I understand we have been interrupted by a lot of votes. I have a lot of questions.

I note in your statement on page 5 you talk about Japanese banks and the need for being competitive internationally. As I recall, Japanese banks domestically are not able to do investment banking, are they?

Mr. GILBERT. Congressman, that is correct. We did discuss this a little bit earlier. We have agreed to provide a summary of what the powers are.

Mr. VENTO. Of course, I think, too, the Japanese economy is one much more controlled by the Japanese Government. That is to say, they artificially hold down interest rates.

I guess the whole question that comes to us as we compare this international and global competition is whether we ought to parrot the symmetry of the German or Japanese or other institutions. Obviously, the German economy is completely concentrated in banks. You cannot tell where the government ends and the banks begin.

That goes all the way right down into serving specific areas of the economy, whether it be electronics, or chemical production. Isn't that true, Mr. Gilbert? Is that your understanding? It certainly is mine.

Mr. GILBERT. I think if you wanted the other side of the coin in its starkest form—and I am not suggesting that—you would look to the German situation. The German banks are engaged in the full range of banking activities.

Mr. VENTO. I think to put it on the table in front of us, isn't this what we are talking about when we talk about bringing these together? We are talking about limiting the significant aspect of our economic structure?

The significant modification of the way that our economy works in terms of the commercial and banking sector?

Mr. GILBERT. Congressman, I was going to—maybe just my tone wasn't strident enough. I was going to get there.

The fact is in Germany that the banks control the extensions of credit, the securities markets. They have a significant ownership position in major German industrial enterprises. Quite often a senior banker is chairman of a supervisory board.

Mr. VENTO. That is the way the Germans like it. I don't know that the Americans like it.

Mr. GILBERT. The bottom line point is if you compare our capital markets from the standpoint of breadth, liquidity, creativity, innovation, any standard that I think is significant to the consumers, I think you will see there is also a very significant difference.

Mr. VENTO. I think that that is what we are talking about when we talk about the Federal insurance and the national Government being involved. We are involved with banks. We give them a franchise, a license to do business at the State or national level. We do it the same, I guess, for brokerage with self-disclosure and so forth.

There are additional restrictions and protections placed on accounts out of the experience we have gained through history. We tried a couple of attempts and banks that didn't work out. The thirties led to other incentives that occurred such as the Federal deposit insurance programs.

The concern here is to try to separate that. Insofar as we can separate it, that would mean that part of that insurance is extended to investment banking; is that correct?

Insofar as we could not stop it, it would be extended to investment banking, it is extended today insofar as we cannot prevent it to deposits over $100,000. We all started out with good intentions here, but now we are extended to prevent any bale out of anyone,

for instance, that loses money. The road to this particular reality is paved with a lot of good intentions, but we have to look at it the way the economy works, protection of the Hunt Brothers, protection of other things that get involved.

I think the question here is that we would be inviting, I think, without the proper limitations. So what can we do if we are going to extend these particular powers to banks to do this, you know. There are holding companies and then there are bank holding companies and we have got special rules for them.

One of them is, for instance, merger and anti-trust type of activity. Everyone who comes before the committee says the anti-trust laws are wonderful. They are working. They are there. There are other books and nobody pays any attention to them, and we go down the line and pretty soon we are going to have three airlines instead of 12 major airlines.

That is just the way they are administered. So I am concerned about that because I think that we might end up doing what happened to the north of us up in Canada. You think that is likely to happen or you think these banks are going to start these stock brokerage and investment banking on their own from scratch?

Mr. GILBERT. Well, I think what you have outlined is really the substance of my testimony, although not eyerybody is going to do exactly the same thing. There will be variations on the theme. But we are dealing in a world where there are an awful lot of banks, an awful lot of securities firms, but there are relatively few money lender banks and there are relatively few global world class securities firms.

Mr. VENTO. The bottom line is are we going to establish or increase the total equity capital available or are we just redistributing it under this. Are we going to have less in investment banking and more in bank holding companies? Are we going to attract more money with this on a global basis or are we redistributing what we have?

Mr. GILBERT. I think it is closer to the later.

Mr. VENTO. Mr. Chairman, thank you. My time has expired.

Chairman ST GERMAIN. Now, certainly, I don't usually wear this hat, let's say I am a multi-national, General Motors, Ford, one of those biggies. Won't my corporation benefit from the repeal of Glass-Steagall and won't there be more competition for my business if banks are allowed to enter the arena?

Mr. GILBERT. Well, Mr. Chairman, again, I think it is a little presumptuous of me to speak to somebody like General Motors or Ford, but from our perspective——

Chairman ST GERMAIN. You are overly polite. Come on. You are testifying before a congressional committee, and you have got to express your opinions. Don't worry about being presumptuous.

Mr. VENTO. There have been a lot of people speaking for them, Mr. Chairman.

Chairman ST GERMAIN. You will be surprised if you read the transcripts of the hearings to date. They don't mind being presumptuous. It is a question of giving your opinion.

Mr. GILBERT. My opinion is that the large global corporate enterprises that you mentioned have already in both the banking side and the securities industry side initiated, supported and encour-

ed intense competition and I can't imagine a situation that could more competitive than institutions with financial services trying provide them to large sophisticated corporations.

They have a number of different sources to choose from. They can do business in whatever part of the world produces the best results for them and that is to some of the things that were done in this market by the SEC with respect to registration statement and timing they can move instantaneously and they will find a large number of firms who are willing to bid extraordinarily aggressively to undertake business for them.

Chairman ST GERMAIN. Would the entry of additional participants, banks, again, into this arena, serve to lower the cost to General Motors, Ford, the other multi-national giants of borrowing money?

Mr. GILBERT. I would think not.

Chairman ST GERMAIN. Why not?

Mr. GILBERT. Because the profits are already down to a razor thin margin. The only sort of doubt that I have is at any point in time somebody may be trying to buy market share and be prepared to break even or take a level of risk that most others felt was inappropriate.

Chairman ST GERMAIN. In advocating reform of Glass-Steagall quite a few of our witnesses, including Under Secretary Gould, have stated that such reform would enable banking organizations to diversify their earnings, attract new capital, better meet the needs of their customers.

They contend that underwriting and dealing in securities could substantially reduce risk to the banks and they indicate that securities underwriting is no more risky, probably less risky than commercial lending. Is security underwriting just as, less than or more risky than commercial lending? If not, why not? Be presumptuous now.

Mr. GILBERT. The correct application of underwriting is to assess market risk. One knows in a matter of days or hours whether that is a correct assessment and if the markets go against you, the losses can be enormous. Any major securities firms that come before you can cite examples where significant losses in a particular underwriting have occurred. The extension of credit, as I tried to explain earlier, requires a different set of dynamics and at the time of the extension of credit, one would think that there should not be elements of market risk in that decision.

The credit decision is a decision as to whether credit can be extended safely and whether there is an opportunity or probability or high probability of repayment over the term of that credit. Credit can go back, as we all know, over a long period of time. The important thing to recognize, I think, goes back to my initial comments this morning, that we are operating systems that have significant differentiating characteristics.

I also said at that time that to be an important factor in the underwriting marketplace one had to be an important factor in the distribution and trading of those securities. It is absolutely clear that it is very difficult and probably unwise to do one without the other so that when one talks about underwriting and the risk of underwriting one gets into the question of market risk both from a

standpoint of the actual underwriting event itself and from the standpoint of a market-maker in like securities which is my complete conviction an underwriter has to be in order to have any chance of managing the market risk from underwriting.

I don't now if I answered your question, Chairman, but the two dynamics are different and I think that we have proved beyond a shadow of a doubt that volatility in our marketplaces exposes securities firms to significant risk and significant loss.

One can find that in mortgage backed securities. One can find it in Government securities. One can find it in clearing operations. One can find it in the market-making and underwriting activities. There are lots of ways to experience market risk.

Chairman ST GERMAIN. Is your answer that securities underwriting is riskier than commercial lending? Yes or no?

Mr. GILBERT. I have been trying to avoid the yes or no because I think that is arguable depending upon where you are coming from. Securities underwriting is an immediate risk. Credit is a longer term risk if it does not live up to the expectations at the time the credit was granted.

Chairman ST GERMAIN. Over the years, sitting up here as Chairman of the Subcommittee on Financial Institutions, as chairman of the full committee, particularly when we have looked into bank failures, people have sat at that table and we up here and we have used the term, "the prudent rule".

The banks, because of their special privilege, that is the fact that their deposits are covered by deposit insurance, are charged with a responsibility when making judgments as to whether or not they will extend credit to a borrower, be it a corporation or an individual, and at all times one of the elements included is the exercise of the prudent man rule for making that decision.

Often times when we have seen failures, we have seen that prudent man rule was thrown out the window, was not exercised and so this is why I ask you, do you have a prudent man rule in the securities business?

Mr. GILBERT. We try. We try and act like prudent men, but other than some of the fiduciary responsibilities we have, we do what we think is best. It is not a test to which we are subjected.

Chairman ST GERMAIN. Isn't securities underwriting a little more speculative?

Sometimes do you really know whether the collateral you think is there is really there because you have to make a judgment as to whether or not the public at large is going to agree that that product is a product that is worthwhile?

Mr. GILBERT. Yes, and the market. You have two judgments at all times. What is the right price at the moment and then what can come up and beat you is how that market may change at the next moment. Now, I certainly, to get back to your original question, would not accept the comment that our business and the underwriting and securities business is less risky than the banking business, nor would I accept that entrance into this business is going to be a panacea to help the profitability of the banking system.

Chairman ST GERMAIN. Mr. Morrison.

Mr. MORRISON. Thank you, Mr. Chairman. Thank you, Mr. Gilbert and Mr. Gerard, for being here today. I apologize if some of my questions are repetitive of ones that you were asked earlier. How dependent is the securities industry on commercial banks for the funding of its activities?

Mr. GILBERT. I am not aware, Congressman, of a general sort of global comment on that, though there could well be information that I haven't seen that gets to that question.

Chairman ST GERMAIN. Would Mr. Gerard as a result of his previous experience other than Morgan Stanley have an opinion on that one?

Mr. GERARD. Again, I would comment generally. I can't give you specific facts, but by and large, as we have discussed earlier this morning, the structure of our financial system is such that the commercial banking system is the primary supplier of credit. In recent years prudent—if you will pardon the expression, Mr. Chairman, prudent securities firms have chosen to fund a portion of their day-to-day liquidity requirements outside the commercial banking system.

For example, Morgan Stanley as a public company is able to issue commercial paper as a bank holding company would be as well and relies upon that, but on a day-to-day basis, to varying degrees, depending on the firm, much of the liquidity to perform market-making and underwriting functions is provided by what are called globally broker loans, which are collateralized loans from commercial banks to securities firms.

The availability of that credit on an instantaneous basis, given the existence of sound collateral, is critical to the functioning of the financial markets.

Mr. MORRISON. So would it be fair to say that we should worry about the independence of judgment of the banking sector to provide that kind of credit in order to maintain stability in the securities market?

Mr. GERARD. That is a concern which, in our judgment, must be addressed in connection with any modification of existing law. The message I think that your colleagues 50 years ago sent out is that there are certain judgments or functions that are so fundamental to human nature and ordinary business judgment that the risks were too great. That the concern, the potential conflict, that is, of being on the one hand the principal suppliers of credit to an industry, and on the other hand being a competitor in that industry, couldn't be dealt with by regulation.

That is what Glass-Steagall tells us. We have spent a lot of time thinking about it, because, like many Members of this committee, we abhor needless regulation, and we have spent a lot of time thinking about whether there is a regulatory structure that could work.

Mr. Price earlier asked Mr. Gilbert about a line in our written testimony regarding that subject and we said that all we could do was express the opinion that we had spent a lot of time talking about it, and we could not come up with a regulation that would insure that the banks would perform their traditional functions as an independent arbiter of credit, and at the same time, allow them to participate freely as competitors in the financial markets.

82-089 0 - 88 -- 8

Mr. MORRISON. Would you say that the decision that we have made and we made perhaps on behalf of the Japanese, but that defines the Japanese system as compared, say to the German approach, is that these are in fact two different types of businesses. That is, the credit extension business of banks and the market driven securities business.

Is it your advice to this committee that that distinction in fact ought to be maintained? Is fundamentally departing from that Glass-Steagall tradition or decision, if you will, a mistake?

Mr. GILBERT. Our advice and judgment is that there are two fundamentally different systems here. The credit risk and market risk are different and that is something that has been taken into account throughout the last 54 years and it is something that should be taken into account today.

Mr. MORRISON. One last question, and that is, I understand your testimony to say that one step we might properly take is to establish a holding company structure in which current securities powers of banks would be placed in a separately capitalized subsidiary. Why isn't that undermining the point that you have just made? Why isn't the existence of that kind of a structure just an invitation to continue to enhance the securities powers of such a securities subsidiary in violation of the very principle that you have just defended?

Mr. GILBERT. I am having a hard time understanding that question.

Mr. MORRISON. I guess the question is, if we are right about Glass-Steagall and we really ought to have a separation, either the securities power banks currently have are really banking functions that just happen to be what somebody has labeled securities, or they are securities activities they shouldn't be doing anyhow, but the kind of halfway answer to say that these particular securities powers don't undermine this fundamental difference—I am having a hard time understanding where you have drawn the line, and why putting these into a separate subsidiary solves the problem, when enhanced powers in a separate subsidiary would be a bad idea.

It seems to me both of those can't be true. At least that is what the question is trying to ask.

Mr. GERARD. Well, I am tempted to say, Mr. Morrison, that lawyers participated in the drafting of this testimony and that arguing in alternative is entirely appropriate. I think that is basically the point. We have some very fundamental concerns about this Congress doing anything in this area. But we are also realists and we also understand that there are strong political forces for some form of change. We felt it would be responsible in coming before this committee not only to express our fundamental concerns, but also to attempt, to the best of our ability, to suggest a framework if the committee and the Congress as a whole, rejects our judgment as to the fundamental problems. I think that is where the testimony lies.

What we have done is, we have taken another step as well. We have said don't change things. In fact, it may be appropriate to take a look at some of the existing things. If the forces of change are so great and if the forces of change tell you that there are ways of building in the protections so that you won't destroy the system,

find out whether that is true or not. Go ahead and build the protections in, with respect to the existing activities. Test it out for awhile, see whether the fire wall can work in times of crisis.

I mean, there is good evidence on the record—2 weeks or 3 weeks ago, it is now almost 2 months ago—that the fire wall doesn't work in times of crisis. Perhaps it was appropriate in the Continental situation for the officers and directors of that company to break the law. If they hadn't, I think there was a very real concern on the part of many that there would have been a run on the bank, and who owns the bank? The taxpayers happen to own that bank.

What we were trying to do was build a fire wall which doesn't exist today with respect to existing activities, test it out. If it works in times of crisis, and then the pressures for political change are so great, or I should say the political pressures for change are so great—then and only then consider any new powers whatsoever.

So I don't think the testimony is inconsistent, but we didn't think it would be entirely responsive to the request of this subcommittee for our testimony merely to come in and say no, and as a policy matter here are the reasons.

We wanted to try to work with some of the other issues that we know you had on the table.

Mr. MORRISON. Thank you, Mr. Chairman.

Chairman ST GERMAIN. Mr. Price, I understand you have some more questions.

Mr. PRICE. Thank you, Mr. Chairman.

I would like to return to the line of questioning that Mr. McMillan and I were pursuing earlier. As I understand your interpretation of the events of October 19, you are saying the system worked, the banks did extend credit although with some increased risk, and some exposure of insured funds.

You gave a great deal of credit for this to the Federal Reserve. You say that the Fed did act to prevent the denial of credit to securities firms and therefore the system worked. What I am trying to get at is how that system would have worked differently in the absence of the Glass-Steagall framework. Would there have likely been a substantially greater risk to the safety and soundness of the banking system? Would there have been greater risks to various securities firms? What did Glass-Steagall have to do with the way things went on on October 19?

Mr. GILBERT. Well, it certainly, to an important degree, insulated the banking system from the market risk. Let me make that point by saying that if we had a portfolio of equity securities that was worth a million dollars and the collateral worth of that from the standpoint of getting credit from the system, from the banking system to finance those securities was 50 percent, and had that package of securities declined in value from $1 million to $500,000, the collateral value would have been $250,000.

We would have had the loss on the value of the package of securities, the bank would have extended less credit because there was less collateral there against which it could extend credit. So in that example the bank is not exposed to the market deterioration of the collateral.

Mr. ALEX MCMILLAN. Would you yield to me?

Mr. PRICE. Yes.

Mr. ALEX MCMILLAN. I think we are on the same point. Suppose Glass-Steagall had not been in effect then, but any securities broker dealer subsidiary of a bank holding company had to conform to the same net capital rules that the industry does today. Would the banks then have been in a more risky situation than actually occurred on that date?

Mr. GILBERT. If the bank itself had had a security company?

Mr. ALEX MCMILLAN. Yes. Let's just presume that there were restrictions against extending credit to its own subsidiary and its subsidiary had to conform to the same net capital rules that currently exist?

Mr. VENTO. Would you yield?

Mr. PRICE. I would be happy to yield.

Mr. VENTO. The point is though that by that basis if the banks are going to be using their money, their capital in other areas, the banks would be considerably restricted in terms of size. They wouldn't be able to provide the credit in any case, especially because of the money multiplier effect of bank deposits versus security deposits.

Mr. GILBERT. Certainly in that particular case that you mentioned, if the fire wall was absolutely working at 100 percent effective, the lending of the bank to the securities industry would be comparable, whether or not it was to a bank affiliate or to an independent securities company.

One of the issues that is very hard to judge is what happens to that bank and that group if that securities affiliate gets to the point where it is in serious trouble. How does it affect the holding company, how does it affect its access to the capital itself, how does it affect the safety and soundness issues in the minds of depositors, and those are depositors who control enormous amounts of money that move very quickly.

Mr. GERARD. Can I add one more to that? It really gets back to a question that Mr. Schumer asked. Put yourself in the shoes, for a moment, of the chairman of a bank holding company which has a commercial banking affiliate and which also has a full scale securities affiliate. One way to look at his responsibility is that it is to maximize shareholder value. Implicit in maximizing shareholder value, is not only the performance of his company in the abstract, but the performance of his company relative to its competitors.

Nobody ever talks about Morgan Stanley and its stock as an abstract number. They talk about where we stand in the securities industry, what we are doing better than our competitors, what we are doing worse than our competitors, and it is the same for any bank, and that is the way it should be. That is the way the market system works. If you get into a situation—forget October 19, although it certainly heightens the issues—but if you get into a situation where the management of a private company which controls two separate financial institutions—one that supplies credit to the securities industry as a whole, the other that competes in that securities industry—if you get into a situation where the manager can give his subsidiary, and therefore his overall company, a competitive advantage in the marketplace by the way in which another subsidiary treats competitors, it is human nature, and it would

probably be a breach of the chairman of the holding company's fiduciary responsibility, not to employ that competitive advantage.

Even the most stringent set of laws that we have been able to devise or to think up, cannot effectively provide that any bank that has a securities affiliate has to stand willing to provide credit to the securities industry on fair and comparable terms. These are subjective judgments. No banker you will get before this committee will tell you anything other than the lending judgment is a subjective judgment. There are decisions at the margin and there are decisions not to lend in the heat of the moment, at the time of the crash, or whatever. That is the concern that we have, the concern that people will act in the way that they should act, as prudent businessmen, protecting their stockholders' interests.

The result of those actions will have an adverse effect on those firms that don't have the dual benefits of access to depositors' funds and participation in the securities industry.

Mr. PRICE. So your basic conclusion on recommendation number seven as to the implementation of safeguards is basically pessimistic, that they could never be adequately implemented?

Mr. GERARD. Precisely.

Mr. PRICE. Thank you, Mr. Chairman.

I know we have a vote on the floor.

Chairman ST GERMAIN. At the request of Mr. Vento, if there will be no objection, we will have placed in the record at this point an article from the Wall Street Journal indicated November 20, 1987, entitled "Terrible Tuesday."

At the request of the mortgage bankers, immediately following that article, I ask unanimous consent, if there be no objection, we will insert the letter from the Mortgage Bankers Association of America relative to mortgage bank securities.

[The article and letter referred to can be found in the appendix.]

Chairman ST GERMAIN. Gentlemen, we want to thank you for your appearance this morning. I am sorry about the delay, because of the infighting that was going on on the floor, the uncertainty of the voting schedule, but we did indeed manage to get your testimony in and a good amount of questions and answers.

We will have some additional questions that we will forward to you to be answered in writing. We would appreciate your cooperation in that.

The committee will be in recess until the call of the Chair.

[Whereupon, at 1 p.m., the subcommittee was adjourned, subject to the call of the Chair.]