STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
CONCERNING
REPEAL OF THE GLASS-STEAGALL ACT, S. 1886, AND S. 1891

December 3, 1987

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Regulation of Bank Broker-Dealer Activities. The Commission is unable to support repeal of the Glass-Steagall Act unless the securities investor protection concerns arising from increased bank securities activities are simultaneously addressed. Many of the Commission's concerns result from the dramatic expansion of banks into securities activities without Commission regulation, and not specifically from the current proposals to repeal Glass-Steagall. Neither of the bills currently under consideration by this Committee -- S. 1886 and S. 1891 -- meets these concerns. In order to ensure investor protection, banks must be required to conduct both their new and existing securities activities in separate securities affiliates, subject to Commission regulation.

Specifically, the Commission believes that the following activities should be permitted only in securities affiliates, subject to Commission regulation.

(1) publicly-advertised brokerage (buying and selling securities as agent for the accounts of others);

(2) brokerage services provided to advised accounts for which transaction-related compensation is received;

(3) corporate securities dealing or underwriting, including private placements of securities;

(4) municipal revenue bond underwriting and dealing;

(5) sponsoring, underwriting, and distributing unit investment trusts; and

(6) underwriting and distributing investment company securities.

In addition, those banks that choose to establish securities affiliates should be required to conduct their general obligation municipal securities activities in those affiliates subject to direct Commission oversight. The Commission does not propose, however, that banks be required to place their government securities or commercial paper activities in securities affiliates.

S. 1886 would only partially provide for Commission regulation of bank securities activities. Although the bill would require that most of the new securities powers given banks be conducted in separate affiliates subject to Commission regulation, banks could continue to

conduct their existing securities activities outside of the federal securities laws. Accordingly, the Commission recommends that S. 1886, or any other proposal to amend Glass-Steagall, include the substance of an earlier Commission legislative proposal, which was introduced by Senator D'Amato as S. 1175.

Investment Company Protections. If banks are permitted to underwrite and distribute investment company securities, the Investment Company Act and the Investment Advisers Act must be amended. Because the two Acts were drafted in the context of the separation between banking and securities mandated by Glass-Steagall, they do not adequately address the investor protection concerns that will arise if banks are permitted to engage generally in the investment company business. Concerns that must be addressed include bank custody of assets of affiliated investment companies, affiliated transactions, investment company borrowing from affiliated banks, bank advising of investment companies, the independence of directors, and the use of a bank's name by an affiliated investment company.

Bank and Thrift Issuer Activities. Legislation repealing Glass-Steagall should also implement the recommendations of Vice President Bush's 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 recommendations would aid in establishing uniform accounting standards and disclosure requirements and enable investors to receive the same disclosure protections with respect to securities issued by publicly-owned banks and thrifts as they now receive for other publicly-owned companies.

Protections Against Conflicts of Interest. If Glass-Steagall is repealed, conflicts of interest and related investor protection concerns will arise that will not be fully addressed by a separate affiliate requirement. Congress should consider measures to address concerns regarding misuse of confidential information, bank placement of underwritings in controlled accounts, bank extension of credit to purchasers of securities, and investor confusion between banks and their affiliates.

Bank Holding Company Regulation. The Commission generally supports the approach in S. 1886 and S. 1891 of permitting new securities powers only through a securities affiliate of a bank holding company, although it believes that it may be appropriate to allow small banks that engage in limited securities activities to do so through bank subsidiaries, subject to Commission regulation. The Commission also recommends a change to the limited exemption from Bank Holding Company Act regulation in S. 1886 for holding companies primarily engaged in securities activities. This change would key the exemption to the holding company having few resources devoted to banking.

The Commission would be happy to work with the Committee to amend the proposed legislation to address the Commission's investor protection concerns.

I. INTRODUCTION

The Securities and Exchange Commission appreciates this opportunity to present its views concerning the repeal of the Glass-Steagall Act, and to comment on S. 1886, the proposed Financial Modernization Act of 1987, and S. 1891, the proposed Financial Services Oversight Act. The Commission is unable to support repeal of Glass-Steagall unless investor protection concerns arising from increased bank securities activities are simultaneously addressed. Many of the Commission's concerns arise from the dramatic expansion of banks into securities activities without Commission regulation and not specifically from the current proposals being considered by this committee to repeal Glass-Steagall.

The policies underlying the federal securities laws have different objectives than those underlying banking regulation. While banking regulation seeks to ensure the safety and soundness of the banking system and to protect depositors, securities regulation seeks to protect investors and maintain fair and orderly markets. These policies are accomplished by a regulatory scheme that includes:

(1) full and fair disclosure in the purchase and sale of securities;

(2) registration and regulation of all broker-dealer activity; and

(3) protection against conflicts of interest and dishonest practices in the sale and management of professionally managed pools of capital.

Neither S. 1886 nor S. 1891, as currently drafted, adequately addresses securities law policies. In order to ensure investor protection, legislation repealing Glass-Steagall must require banks to conduct both their new and their existing securities activities in separate securities affiliates subject to Commission regulation and amend the Investment Company Act and Investment Advisers Act to address specific investor protection concerns caused by bank entry into the investment company business. In addition, to achieve full functional regulation, securities registration and reporting requirements should be consolidated within the Commission for all publicly-owned banks and thrifts. Congress also should consider additional safeguards regarding other conflicts of interest and related investor protection concerns created by Glass-Steagall repeal.

The Commission would be pleased to work with the Committee to implement the changes recommended in this statement in any legislation that would repeal Glass-Steagall or in legislation that would adopt the concepts of S. 1175.

II. S. 1886 AND S. 1891

The proposed Financial Modernization Act, S. 1886, would repeal Sections 20 and 32 of Glass-Steagall. Section 20 prohibits any bank that is a member of the Federal Reserve System from affiliating with an entity "principally engaged" in the issue, flotation, underwriting, public sale, or distribution of securities; Section 32 prohibits an officer, director, or employee of a member bank from serving as an officer, director, or employee of a company "primarily

engaged" in underwriting or other activities similar to those listed in Section 20.

S. 1886 would permit banks to engage in a wide range of securities activities (including securities underwriting and dealing) through separately capitalized affiliates operating within a holding company structure. Holding companies predominantly engaged in securities activities would be exempted from the Federal Reserve Board's examination, reporting, and capital requirements.

S. 1886 contains certain regulatory safeguards. These include a general prohibition against loans from banks to securities affiliates, mandatory disclosure by securities affiliates to customers that the securities sold by the affiliate are not backed by banks or subject to federal deposit insurance, and a prohibition on banks loans to customers for the purchase of securities underwritten by securities affiliates during underwritings and for 30 days thereafter. However, under the bill, a bank could continue to conduct within the bank all securities activities it lawfully engaged in before November 18, 1987. These include publicly-advertised brokerage services, brokerage for advised accounts, private placements of certain securities, mutual fund and unit investment trust distribution, and underwriting and dealing in general obligation municipal securities. The bill would also permit a bank to underwrite within the bank municipal revenue bonds and certain unit investment trusts. All these securities activities to be conducted within the bank would remain outside the Commission's jurisdiction.

S. 1891, the proposed Financial Services Oversight Act, would restructure the current financial regulatory system by creating three types of holding companies that could engage in specified financial securities activities. First, a bank (or thrift) holding company could own and control one or more banks or thrifts, and could engage in a broad range of financial services. Such a bank holding company could not, however, be owned or controlled by a nonfinancial commercial concern, nor could it engage in nonfinancial activities. Second, a "financial holding company" could offer noninsured transaction accounts and have access to the national electronic payments system. It could not, however, own a bank or a thrift, and, if it purchased an insured bank or thrift, would automatically become a bank or thrift holding company. Such a company could not be owned by a commercial firm. Finally, a "commercial holding company" would be permitted to engage in any commercial enterprise and could also engage in nonbank financial activities, but would not be allowed to own banks or thrifts.

S. 1891 would also establish a Financial Services Oversight Commission that would be composed, in part, of the heads of the federal financial regulatory agencies. The new commission would be charged with promulgating rules and regulations for the three different types of holding companies and with taking appropriate action to enforce compliance of its regulations, either directly or through referrals to other regulators. The bill would amend the Bank Holding Company Act, the Federal Reserve Act, the Glass-Steagall Act, and other laws to permit activities that would be lawful for each of the three types of holding companies established by S. 1891. Finally, the bill would create a National Electronics Payments Corporation that would establish, operate, and maintain a national electronic payments system.

III. INVESTOR PROTECTION CONCERNS RAISED BY THE REPEAL OF THE GLASS-STEAGALL ACT

Both S. 1886 and S. 1891 are primarily designed to permit banks to expand their securities activities while minimizing risks to the safety and soundness of our Nation's banks and banking system. These proposals do not adequately address policies relating to the protection of investors and the maintenance of fair and orderly securities markets that arise with bank entry into the securities markets. These policies have long been declared essential to the welfare of the Nation and must be addressed in the current legislation. First, these proposals for repeal do not require all bank securities activities to be conducted within the regulatory scheme for broker-dealers which Congress designed to ensure the protection of securities investors. Second, these proposals do not address the problems raised by bank entry into investment company activities.

A. Regulation of Bank Broker-Dealer Activities

The federal securities laws provide a comprehensive scheme of regulation for our Nation's securities markets. These laws have as their primary goals the protection of investors and the maintenance of fair and orderly markets. A major component of the regulatory structure established by Congress is the regulation of brokers and dealers -- that is, those entities engaged in the business of effecting transactions in securities, either for their own account or for the account of others.

Banks have been exempt from broker-dealer regulation since the enactment of the Securities Exchange Act in 1934. In recent years, banks have expanded dramatically their securities activities, but have continued to operate outside of the regulatory scheme for registered broker-dealers. If Glass-Steagall is to be repealed, banks must be required to conduct their expanded securities activities and their current securities activities in affiliates subject to Commission regulation, with certain limited exceptions. Among the specific activities that must be placed in such affiliates are:

(1) publicly-advertised brokerage activities;

(2) brokerage services provided to advised accounts for which transaction-related compensation is received;

(3) corporate securities dealing or underwriting, including private placements;

(4) municipal revenue bond underwriting and dealing;

(5) underwriting of unit investment trusts; and

(6) distribution of investment company shares.

1. The Regulatory Scheme for Broker-Dealers

The Exchange Act and the rules promulgated thereunder impose on broker-dealers

registered with the Commission extensive net capital, books and records, and customer protection rules, specifically designed to protect securities investors. Additional rules, which are subject to Commission approval, are imposed by the self-regulatory organizations, to which all registered broker-dealers must belong, such as the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange. Compliance with these rules and with the federal securities laws is monitored by both the Commission and the self-regulatory organizations. The self-regulatory organizations in turn are subject to regulation by the Commission.

To ensure that broker-dealers can meet their financial responsibilities to their customers and to other market participants, all registered broker-dealers must comply with the Commission's net capital rule, which is designed to ensure the solvency of securities firms. The net capital rule requires that broker-dealers maintain at all times a minimum capital level. The rule requires that, in computing their capital, broker-dealers value their assets at current market prices, rather than at historical values as banks are permitted to do. The rule also reduces capital allowances for large concentrations in particular securities. When a broker-dealer's net capital falls below required levels, it must immediately notify the Commission and cease operations unless additional capital is obtained.

To ensure that securities professionals meet their fiduciary responsibilities toward investors, the Commission and the self-regulatory organizations have developed a comprehensive scheme for qualifying, examining, and supervising persons employed in the industry. A registered broker-dealer's sales and supervisory personnel must meet the competency standards established by the Commission and the self-regulatory organizations. For example, registered representatives of NASD firms who are engaged in sales and trading activities are tested for product and market knowledge, and registered principals responsible for management and supervision are examined for knowledge of the securities laws. These examinations protect investors by assuring that registered representatives are knowledgeable about the products they recommend and sell to investors and that registered principals understand the laws and regulations with which they must ensure compliance. In addition, the self-regulatory organizations review the backgrounds of those seeking employment in the industry to determine whether there are legal impediments to registering them as securities professionals. Moreover, under the Commission's statutory scheme, federal securities law violators and others may be barred or restricted from participation in the securities industry.

These competency requirements are augmented by the obligations imposed on broker-dealers to supervise their employees to prevent securities law violations. The rules of the self-regulatory organizations provide for sanctions in the event of deficiencies in supervision, and the Commission has significant enforcement remedies available if brokerage firms fail to supervise adequately their employees to prevent violations of the securities laws.

As a further measure to promote compliance with the securities laws, the Commission imposes on registered broker-dealers an extensive examination and recordkeeping program. The Commission and the self-regulatory organizations inspect registered broker-dealers to ensure compliance with, among other things, financial responsibility requirements and maintenance of books and records. They also inspect to detect trading and sales practice abuses such as market

manipulation, excessive or unauthorized trading, and unsuitable recommendations to customers. Additionally, Congress has provided the Commission with specific authority to review disciplinary sanctions against self-regulatory organization members to ensure that the self-regulatory organizations perform their statutory oversight responsibilities. This authority, and the Commission's market regulation inspection and examination program, which audits surveillance and compliance programs of self-regulatory organizations, provide additional safeguards for investors.

The NASD's examination program is illustrative of the comprehensive scheme for inspection of registered broker-dealers to ensure investor protection. First, NASD inspections are conducted by a team of specially trained examiners who undergo extensive training to detect problems peculiar to the securities industry. Second, NASD inspections focus on, among other things, operational practices and seek to uncover abusive sales practices. Finally, NASD members must make their books and records available to the Commission and the NASD on demand. Violations uncovered by NASD inspections can lead to significant sanctions, including suspension or expulsion from the industry and heavy fines.

Broker-dealers must also comply with the detailed guidelines set by their self-regulatory organizations concerning the content and review of advertisements. These include requirements that all communications with the public be based on principles of fair dealing and good faith and that such communications disclose all material information in a non-misleading manner. In addition to these general requirements, the NASD requires that all advertising materials be approved by a registered principal prior to their use; that specific information be disclosed, including the name of the member, the preparer of the material, and the date on which the material was first published, circulated, or distributed, when materials are not current; and that the advertisements exclude references that might imply endorsement or approval of the securities being offered by the NASD or by any other regulatory body.

Under the Securities Investor Protection Act, customers are protected from loss of cash on securities held by broker-dealers registered with the Commission. Customers' accounts are insured up to $500,000 (including $100,000 in cash) by the Securities Investor Protection Corporation ("SIPC") To fund its insurance program SIPC tion imposes on registered broker-dealers assessments based on their level of business activity. SIPC also may borrow up to $1 billion from the United States Treasury, through the Commission.

2. <u>Current Status of Banks Under the Exchange Act</u>

As currently written, the federal securities laws generally do not regulate banks when they engage in securities activities. Banks are expressly excluded from the definitions of "broker" and "dealer" under Sections 3(a)(4) and 3(a)(5) of the Exchange Act. Under these exclusions, banks may engage in agency transactions on behalf of public customers and in principal securities transactions on their own behalf without registering with the Commission as brokers or dealers.

In 1934, when Congress excluded banks from the definitions of "broker" and "dealer" in the newly-enacted Exchange Act, it presumed that banks could not engage in retail brokerage

business under the banking laws as interpreted by the banking regulators, a presumption that essentially remained unchallenged for forty years. In 1934, the only brokerage activities in which banks could engage were "accommodation" trades, that is, trades for existing bank customers on a not-for-profit basis. The Act's legislative history demonstrates that this restriction on bank entry into the brokerage business was one of the principal factors in Congress' decision to exclude banks from the Exchange Act's definitions of broker and dealer.[1] In view of the limited nature of bank securities activities, Congress believed that the full panoply of the federal securities laws was unnecessary.

In the 1980s, however, banks have emerged as a significant component of the retail brokerage market through their discount brokerage operations. Moreover, recent decisions of bank regulators have allowed banks to combine brokerage with investment advisory services, increasing the potential for improper sales practices and similar abuses. In addition, banks have become major participants in the distribution of mutual funds and unit investment trusts. Furthermore, banks have begun to sell to their customers securities backed by loans originated by the bank.

All of these activities raise substantial investor protection concerns. The regulation of bank securities activities under federal banking law is not an adequate substitute for Commission regulation. The primary purposes of federal banking law are the protection of depositors and the preservation of the safety and soundness of the banking system. Banking law is not directed at the protection of investors and the maintenance of fair and orderly securities markets. Banking law does not provide for the testing and supervision of employees that sell securities to the public, nor does it provide for pervasive examination of bank brokerage operations by personnel trained to detect problems peculiar to the securities markets. Banks are not required to be members of securities self-regulatory organizations and may advertise their brokerage operations outside the guidelines of the self-regulatory organizations. The Federal Deposit Insurance Corporation does not protect the securities of customers held at banks.

The Commission believes that bank securities activities must be brought within the structure of the laws and rules designed by Congress, the Commission, and the self-regulatory organizations to ensure complete and effective regulation of the securities markets, investor protection, and the maintenance of fair and orderly markets.

3. Bank Broker-Dealer Activities and S. 1886

a. Existing Securities Activities

S. 1886 would provide only partially for Commission regulation of bank securities activities. Under Section 102 of the bill, most of the new powers extended to banks would be required to be conducted in separate affiliates, thus providing for appropriate regulation of those

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[1] See Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8920 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 86 (Feb. 16, 1934) (statement of Thomas G. Corcoran, an administration spokesman and a principal drafter of the Exchange Act).

activities to ensure investor protection. This requirement would also increase the insulation of insured bank deposits from the risks of the securities markets since securities affiliates would be subject to the Commission's net capital rule.

However, S. 1886 would not address the regulatory gaps created by existing bank broker-dealer activities. Significantly, banks' existing securities activities, which include publicly-advertised brokerage, brokerage for advised accounts, private placements of certain securities, mutual fund and unit investment trust distribution, and underwriting and dealing in general obligation municipal securities, could remain in the bank and would not be subject to Commission regulation. It is the Commission's position that Glass-Steagall should not be repealed unless the full range of bank securities activities are brought under the regulatory umbrella of the federal securities laws. Thus, S. 1886 should be amended to provide that current bank securities activities are regulated under the federal securities laws.[2]

b. Municipal Securities Activities

Moreover, if Glass-Steagall is repealed, banks that choose to engage in expanded powers should be required to transfer their current municipal securities activities to the separate securities affiliates that they will be required to establish in order to engage in the expanded powers. S. 1886 instead would allow banks to continue to underwrite and deal in general obligation municipal securities without forming an affiliate and also to begin underwriting of municipal revenue bonds within the bank.[3]

Under the current scheme as provided in the Securities Acts Amendments of 1975, the Commission and the bank regulators share examination and enforcement authority over municipal securities dealers, including banks. This shared responsibility resulted from Congress' decision not to require banks to set up separate affiliates to carry out municipal securities activities. Congress thought it would be burdensome for banks to have the Commission perform examinations of a bank's municipal securities activities that generally constitute only a small portion of a commercial bank's business.

However, if banks are allowed to expand their securities activities, the potential for inefficient and uneven regulation that results from shared responsibility will increase. This is of particular concern because of the somewhat greater "issuer" risk involved in municipal revenue bonds than in general obligation bonds. Accordingly, S. 1886 should be amended to require that bank municipal revenue bond activities be conducted in separate affiliates. Moreover, banks that do establish securities affiliates also should be required to conduct their general obligation municipal securities activities in those separate affiliates subject to direct Commission oversight,

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2 As discussed below, exceptions would be made for banks' government securities activities, and, under certain circumstances, for their general obligation municipal securities activities.

3 Section 108 (amending Section 16 of the Glass-Steagall Act).

since this would increase investor protection at little or no additional cost to those banks that form affiliates.[4]

c. Mutual Fund and Unit Investment Trust Activities

S. 1886 also would permit a bank to distribute mutual fund shares and to underwrite certain unit investment trusts[5] directly, rather than through a regulated securities affiliate.[6] This provision should be changed. Banks distributing mutual funds and unit investment trusts to their customers should be required to conduct these activities in separate affiliates subject to broker-dealer regulation by the Commission and the self-regulatory organizations. Without this regulation, unregulated entities using untrained personnel may sell investment company securities without Commission and self-regulatory organization oversight of their sales practices, advertising, and sales commissions, creating serious investor protection concerns.

4. S. 1175

To address the concerns posed by current unregulated bank securities activities, the Commission previously proposed that the Exchange Act's definitions of "broker" and "dealer" be amended to include banks that conduct certain securities activities. The substance of the Commission's proposal should be included in any legislation allowing banks increased securities powers.[7] The proposed legislation was introduced in the Senate on May 8, 1987, by Senator D'Amato as S. 1175.[8] S. 1175 would include within the definitions of "broker" and "dealer"

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4 However, the Commission does not propose that banks that restrict their securities activities solely to the underwriting of general obligation municipal securities and government securities be required to place their underwriting of general obligation municipal securities in separate affiliates. Nor does the Commission recommend that banks be required to place their government securities activities in separate affiliates, since it believes that the scheme of shared responsibility established by the Government Securities Act of 1986 is adequate to address the more limited investor protection concerns that arise in that market. Finally, the Commission does not recommend that banks be required to underwrite and deal in commercial paper through separate affiliates, since entities that deal exclusively in commercial paper, bankers' acceptances, and commercial bills are not required to register with the Commission as broker-dealers.

5 A unit investment trust is an unmanaged investment company that holds a portfolio of securities assembled by the trust's sponsor and issues redeemable interests in the trust to investors.

6 Section 108 (amending Section 16 of the Glass-Steagall Act).

7 The Commission urges that this legislation be enacted even if the Glass-Steagall Act is not repealed.

8 S. 1175 and the Commission's statement in support of that legislation are attached. The bill was introduced in the House as H.R. 2557, the "Bank Broker-Dealer Act of 1987."

those banks that (1) publicly solicit brokerage business, (2) receive transaction-related compensation for brokerage services provided to advised accounts,[9] or (3) deal in or underwrite securities.

S. 1175 also would amend Section 15(a) of the Exchange Act to require that banks establish separate entities, registered with the Commission, to engage in certain securities activities. This would separate the Commission's regulation of a bank's securities activities from the operation and regulation of the bank's banking activities. Without this requirement, a bank could, theoretically, register with the Commission as a broker-dealer, leading to regulatory conflicts. For instance, a bank could find itself subject to both the Commission's net capital rule and the bank regulators' capital requirements. In addition, in the event of a liquidation of a bank, both the Securities Investor Protection Corporation and the Federal Deposit Insurance Corporation could find themselves charged with liquidating the same entity.

The Commission recognizes that there may be some bank securities activities that do not require extensive Commission oversight. Accordingly, S. 1175 would permit the Commission to exempt certain banks, by rule, regulation, or order, from the definitions of "broker" and "dealer," either unconditionally or subject to certain terms and conditions. The Commission would also retain its authority to exempt banks from the registration requirements of Section 15(a) of the Exchange Act. These provisions would ensure that activities that fall within the terms of the statutory provisions, but are not necessarily appropriate for Commission regulation, may be exempted.[10]

B. Concerns Arising from Bank Investment Company Activities

If banks are permitted to engage in a broad range of securities activities, the Investment Company Act and the Investment Advisers Act must be amended. These two Acts address specifically many of the conflicts that arise when brokerage firms or their affiliates conduct mutual fund and unit investment trust activities. However, because the two Acts were drafted in the context of the separation between banking and securities mandated by the Glass-Steagall Act, they do not adequately address the conflicts and other investor protection concerns that will arise if banks are permitted to engage generally in the investment company business.

1. Custody of Investment Company Assets

Sections 17 and 26 of the Investment Company Act should be amended to clarify and strengthen the Commission's authority to promulgate regulations governing how banks may serve as custodians of affiliated management investment companies and as trustees of affiliated unit investment trusts. The Investment Company Act currently requires every management investment company to maintain its securities and similar investments in the custody of a bank,

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[9] "Brokerage services provided to advised accounts" include investment advice provided in conjunction with execution services.

[10] For example, banks that conducted a de minimus amount of brokerage transactions might be exempted under this provision.

or, subject to Commission rules, in a member of a national securities exchange or the investment company itself. To minimize the opportunities for misuse of investment company assets, the Commission has used its rulemaking authority to impose stringent safeguards on self-custodianship by management investment companies and on broker-dealer custodianship.

Similarly, the Investment Company Act requires the trustee of a unit investment trust to be a bank meeting certain criteria. If a bank's securities affiliate were to act as the sponsor or underwriter of a unit investment trust, the Investment Company Act would currently permit the bank to act as trustee with custody of trust assets. Because of the nature of unit investment trusts, security-holders must rely on the trustee to ensure that assets are safeguarded, disbursements are proper, and the trust otherwise operates in accordance with the trust indenture. Given the courses of dealing that develop between a sponsor and a trustee bank under the unit investment trust format, the independence of the bank trustee may be compromised if it is affiliated with the sponsor. For example, a sponsor could improperly influence the trustee's performance of its duties with respect to disbursements to the sponsor for services performed for the trust or in valuing units being redeemed by the sponsor.[11]

The Commission should be given explicit rulemaking authority to prescribe appropriate requirements for investor protection where a bank affiliated with a management investment company seeks to act as its custodian or where a bank affiliated with a unit investment trust seeks to serve as its trustee.

2. Affiliated Transactions

The current regulatory framework does not address the potential conflicts of interest involving bank-affiliated investment companies that will arise from the interrelationships that exist between banks and their commercial borrowers. Accordingly, the Investment Company Act should be amended to regulate these conflicts.

The most basic of these conflicts would arise when the affiliated investment company invests in a corporation in order to further the bank's interests as a creditor of the corporation. In most circumstances, the bank's corporate borrower and the investment company would not be "affiliated persons" for purposes of the Investment Company Act, and thus, not subject to the Act's prohibitions against transactions between an investment company and its affiliated persons. Therefore, a bank-affiliated investment company could be used by the bank as a source of readily available capital to bail out a financially troubled creditor. For example, a bank-affiliated investment company could purchase securities from a financially troubled corporation, and the proceeds of that purchase could be used by the corporation to repay its indebtedness to the bank. The bank would benefit by liquidating bad or illiquid loans at a potentially inflated price, but the investment company would be left with risky assets.

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[11] To prevent the trust from shrinking through redemptions by investors, the trust sponsor generally will maintain a secondary market in trust units, but from time to time will present to the trustee for redemption trust units it has accumulated in its secondary market activities.

Accordingly, the Act must be amended to prohibit generally a borrower and any of its affiliates having a substantial borrowing relationship with a bank from knowingly selling securities or other property to, purchasing securities or other property from, or borrowing from an investment company affiliated with the bank.[12] To eliminate potential disadvantages to the shareholders of the investment company resulting from this prohibition, the Commission should be given the authority to exempt proposed transactions from this new provision.

3. Borrowing from an Affiliated Bank

To avoid the potential abuse of overreaching by a bank affiliate in a loan transaction with an investment company, Section 18 of the Investment Company Act should be amended to prohibit a bank-affiliated investment company from borrowing from its affiliated bank or banks, except in accordance with Commission rules.

Currently, the Investment Company Act prohibits an open-end investment company from issuing any security senior to its common shares, but permits the company to borrow from any bank, provided that immediately after the borrowing there is an asset coverage of at least 300% for all borrowings. Therefore, absent new legislation, a bank-affiliated investment company could borrow money from its bank affiliate without restrictions.

4. Advising Investment Companies

Effective oversight by the Commission of the activities of registered investment companies requires that all advisers to investment companies -- including banks -- be subject to Advisers Act regulation. Accordingly, Section 202(a)(11) of the Advisers Act should be amended to remove the current exclusion from the definition of "investment adviser" for those banks that serve as advisers to registered investment companies. The exclusion for banks with no investment company clients may be retained.

Banks currently may serve as advisers to registered investment companies. However, because banks and bank holding companies are excluded from the Advisers Act definition of investment adviser, banks that advise investment companies are not subject to Advisers Act regulation.

Removing this exclusion would be consistent with Congress' removal in 1970 of certain Advisers Act exceptions that had previously been available to advisers to registered investment companies. These changes extended the bookkeeping and inspection requirements to all

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[12] Under Section 10(f) of the Investment Company Act, registered investment companies are prohibited, except under limited circumstances, from purchasing securities sold or underwritten by a syndicate where affiliated persons are involved in the syndicate, even though the purchase is not made from an affiliated person. However, unit investment trusts are generally excepted from the Section 10(f) prohibitions. The Commission believes that further study is necessary to determine whether the existence of bank lending and other relationships presents increased concerns that warrant re-examination of this exception.

investment company advisers other than banks. In addition, subjecting banks' management of investment companies to Advisers Act regulation would close substantive regulatory gaps by, for example, subjecting them to the Advisers Act's restrictions on performance fees and agency cross transactions.

5. Independent Directors

If a bank and the investment company sponsored by the bank are allowed to share directors, there is a danger that the directors will engage in self-dealing. Accordingly, the Commission recommends amending Section 10(c) of the Investment Company Act. This section currently provides that no registered investment company may have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank. This section should be amended to include, within the class of covered persons, directors, officers and employees of a bank holding company and any company affiliated with it. This amendment would eliminate the potential to circumvent the legislative intent of this subsection by a bank operating under a multiple bank holding company structure.

Also, the Commission believes that bank sponsorship of investment companies may require that additional persons, because of their business relationships with a bank, to be deemed "interested persons," disqualified from serving as independent directors of any investment company affiliated with the bank. Investment Company Act Section 10(a) currently provides that at least 40 percent of an investment company's board of directors must be composed of individuals who are not "interested persons." Accordingly, it may be appropriate to amend the definition of "interested person" in Section 2(a)(19) of the Investment Company Act to include within the term certain persons with significant relationships to a bank affiliated with an investment company.

6. Use of the Bank's Name

In order to prevent public confusion between a bank, the deposits of which are federally insured, and an investment company affiliated with the bank, the assets of which are subject to investment risk, Section 35(d) of the Investment Company Act should be amended to make it unlawful for a bank-affiliated investment company to use the bank's name as part of the name or title of the investment company.

IV. REGULATION OF BANK AND THRIFT DISCLOSURE

Legislation repealing Glass-Steagall should also implement the recommendations of Vice President Bush's Task Group on Regulation of Financial Services regarding bank and thrift issuer activities. The Task Group was formed in 1982 to address problems arising from the blurring of the lines between the banking and securities industries and the overlapping, excessive, and conflicting regulation of agencies with jurisdiction over the financial services industries. The members of the Task Group consisted of the heads of the financial regulatory agencies, including former Commission Chairman John Shad. Two important Task Group

recommendations concern securities issued by banks and thrifts. The Task Group unanimously recommended that:[13]

- o Public offerings of securities (but not deposit instruments) by banks and thrifts should be made subject to the registration requirements of the Securities Act by amending Sections 3(a)(2) and 3(a)(5);
 and

- o Administration and enforcement of disclosure requirements under the Securities Exchange Act should be transferred exclusively to the Commission by repealing Section 12(i).

The Commission continues to support these recommendations.[14] These recommendations would consolidate within the Commission the financial disclosure requirements for all publicly-owned companies, as well as for public offerings of securities. They would ensure that investors will receive the same disclosure protections with respect to securities issued by publicly-owned banks and thrifts as they now receive for other publicly-owned companies.

Under the current system, the bank and thrift regulatory agencies have jurisdiction over disclosure requirements for securities issued to public investors by about 400 banks and 300 thrifts and the Commission has jurisdiction over such requirements for securities issued by about 1,000 bank and thrift holding companies. This means that there may be differences in disclosures relating to banks and thrifts, depending on whether they are owned by holding companies. There also may be differences in whether audits are conducted by independent public accountants.

Uniform accounting standards and disclosure requirements facilitate comparative analyses of investment alternatives among individual institutions, as well as between industry groups such as banks, thrifts, finance companies, and securities firms. Such comparative

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[13] The Federal Home Loan Bank Board subsequently withdrew its support for these Task Group recommendations. See House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, 100th Cong., 1st Sess., Consolidating the Administration and Enforcement of the Federal Securities Laws within the Securities and Exchange Commission 18-19 (Comm. Print 1987).

[14] Earlier this year, in its report on the financial guarantee market, the Commission reaffirmed its support for these Task Group recommendations and also endorsed the Task Group's recommendation for Commission exemptive authority under the Securities Act of 1933. The Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee recently made recommendations substantially similar to the Task Group recommendations regarding the treatment of bank and thrift securities. See House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, 100th Cong., 1st Sess., Consolidating the Administration and Enforcement of the Federal Securities Laws Within the Securities and Exchange Commission 1-4 (Comm. Print 1987).

analyses are fundamental to sound investment decisions and efficient securities markets.

Enactment of the Task Group recommendations would result in more uniform regulation and enforcement of financial institution disclosure to investors. It would eliminate delays by the various agencies in conforming their regulations governing depository institutions filings with those adopted by the Commission. It would also provide for equivalent access to information concerning banks and thrifts and other publicly-owned companies.

V. CONFLICTS OF INTEREST AND RELATED CONCERNS ARISING FROM BANK SECURITIES ACTIVITIES

In enacting Glass-Steagall, Congress sought to address the abuses in the bank securities affiliate system identified in the extensive Senate hearings into stock exchange practices of the 1920's, including those involving serious conflicts of interest. The legislative history of the Act reflects Congress' belief that bank affiliates had engaged in a variety of serious abuses, including the issuance of unsound and speculative securities, the making of false and misleading statements in new issue prospectuses, and the use of affiliates to conceal bad loans. Congress was also concerned about apparent conflicts of interest arising from banks lending to affiliates to finance underwritings, to customers to purchase the securities underwritten by the affiliates, and to the corporations that used the affiliates for underwritings. In these situations, banks were forced to choose between their affiliates' best interests and those of the banks' depositors.

If Glass-Steagall is repealed, conflicts of interest and related investor protection concerns similar to those which led to the enactment of the Act will arise. These concerns will not be fully addressed by the separate affiliate requirement. The Commission's recommendations regarding measures needed to address these investor protection concerns are set forth below.

A. Misuse of Confidential Information

Improper sharing of nonpublic information between banks and their securities affiliates should be prohibited. Both banks and broker-dealers currently must prevent the internal misuse of non-public information. Securities firms use methods designed to restrict the flow of information between investment bankers engaged in financings and other transactional work, and traders and analysts.[15]

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[15] Most securities firms employ "Chinese Walls" to restrict the exchange of information between investment banking, trading, and investment adviser departments. Other securities firms may also use "restricted lists" that list the companies that the firm may be advising in a financial transaction, for which the firm may be underwriting an offering of securities, or with which the firm is negotiating a possible business relationship. Circulated on a regular basis, these lists generally prohibit firm employees from purchasing the listed companies' securities for the firm or themselves and from offering unsolicited recommendations regarding the companies and their securities. To supplement Chinese Walls and restricted lists, some securities firms also have "watch lists" that allow the firms to track the effectiveness of the Chinese Wall and restricted lists. A watch list is used by a firm to monitor trading activity within the firm in securities on the list.

Similarly, banks must maintain the separation between their commercial lending operations, their trust and other fiduciary operations, and traders responsible for banks' proprietary accounts.

However, banks have not until recently faced the problem of withholding from an underwriting affiliate information acquired by the bank in the course of extending or monitoring a loan, or screening off from the bank information received by an underwriting affiliate in the course of structuring a securities offering. These new combinations of activities present opportunities for misuse of client information for the benefit of the bank or its securities affiliate.

Existing fiduciary law and antifraud principles may deter the sharing of nonpublic information between a bank and its affiliates, as is generally the case with securities firms. However, in view of banks' extensive access to sensitive corporate information arising from their corporate lending activities, and the new opportunities for misusing this information inherent in trading and underwriting corporate securities, additional restrictions should be placed on the sharing of customer and related information between banks and their securities affiliates.[16]

S. 1886 partially addresses these concerns by limiting the flow of nonpublic customer information among affiliates. However, the bill allows nonpublic customer information to be shared by a bank, insured institution, or subsidiary with a securities affiliate, and vice versa, if the customer consents.[17] This approach protects institutions from claims that they have shared information without a customer's approval, but does not completely protect against possible abuse of material nonpublic information that the customer has allowed to be communicated for a particular purpose.

Accordingly, Congress may also wish to consider specifically authorizing the agencies that regulate banks, bank holding companies, and securities affiliates to adopt rules requiring these entities to adopt Chinese Wall procedures. This approach was used in S. 1323, proposed tender offer legislation, in which this Committee proposed amending Section 15(c) of the Exchange Act to authorize the Commission to adopt rules and regulations requiring broker-dealers to maintain Chinese Walls.

B. Bank Use of Underwriting to Dispose of Poor Loans

Conflicts of interest that will arise when a securities affiliate underwrites an offering of securities backed by the bank's own assets or the proceeds of which will be used to repay the bank for loans it has extended to the issuer should be addressed. Securitization of assets by

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[16] In addition, the Commission believes that, as a matter of good practice, holding companies should establish internal audit units to monitor the activities of the banks, lending affiliates, and underwriting affiliates, in order to ensure that information does not flow improperly among the affiliates, and that nonpublic information is not misused to profit an affiliate, the holding company, or any other person.

[17] Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph 15(E)(x)).

affiliated issuers and underwriters raises a potential conflict between the underwriter's obligations to use due diligence in examining the offering and its desire to repay affiliates through a successful offering. Offerings of securities of bank borrowers underwritten by bank affiliates present analogous concerns. Such conflicts may also result in inaccurate disclosure or pricing of the offering and heightened sales pressure during the distribution period.

Similar concerns currently exist with respect to merchant banking, where a broker-dealer may underwrite a securities offering, the proceeds of which are to be used pay off "bridge" loans extended to the issuer by an affiliate of the broker-dealer. The Commission is monitoring this practice.

The federal securities regulations now impose extensive disclosure requirements on all underwritings. The interests of all parties, including the underwriter and its affiliates, must be disclosed. Various provisions also require disclosure by the underwriter to its customers of its potential conflicts in relation to securities it is offering to sell.

These disclosure requirements enable investors to assess the conflicts inherent in underwritings conducted on behalf of or to benefit an affiliate. In addition, the NASD has recently proposed amendments to Schedule E of its by-laws to provide additional protections. Schedule E currently requires members distributing their own or their affiliates' securities to have an independent underwriter establish the price of the securities and conduct the necessary "due diligence" review, unless the offering is of investment grade debt or equity securities for which there is an existing, independent market. The NASD has proposed amending the Interpretation of the Board of Governors regarding Schedule E to require an independent underwriter's involvement if ten percent or more of the proceeds of a public offering are directed to NASD members participating in the distribution of the offering. This proposed amendment is designed to cover offerings made to refinance bridge loans extended by a broker-dealer's affiliate.

Requirements of this sort could provide valuable protections where broker-dealers are underwriting securities of, or to benefit, bank affiliates. Similar requirements could be applied to offerings of interests in pools of securitized assets or mortgages of a bank affiliate, or to syndicated loans, such as problem foreign loans. If bank affiliates are allowed to securitize the assets of affiliate banks and underwrite their securities, requirements similar to the NASD's proposal should be applied.[18]

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[18] In its recent decisions interpreting Section 20 of Glass-Steagall, the Federal Reserve Board limited underwriting by bank-affiliated broker-dealers of securities backed by consumer receivables and conventional mortgages, to situations in which the underlying assets do not originate from any affiliate of the underwriter. See Order Approving Applications to Engage in Limited Underwriting and Dealing in Consumer Receivable Related Securities [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,021 (July 17, 1987); Order Conditionally Approving Application to Underwrite and Deal in Mortgage Related Securities to a Limited Extent [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,027 (July 17, 1987); Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,957 (Apr. 30, 1987). The Board imposed this limitation

S. 1886 would require also that a securities affiliate that is underwriting or distributing securities secured by or representing an interest in mortgages or other obligations originated by its affiliate first obtain a rating for the securities from a nationally recognized rating organization, although the rating need not be investment-grade.[19]

C. Placement of Underwritings in Controlled Accounts

Because the potential for conflicts arising out of transactions between bank trust departments and their affiliates will be heightened by expanded bank securities activities, stricter prohibitions respecting bank-affiliate dealings may be needed to prevent banks from placing the interests of the bank and its affiliates ahead of those of its trust customers. For example, a bank could recommend or purchase for its trust accounts securities underwritten by its securities affiliate. This concern has historical precedent. The Senate investigations conducted in the early 1930s chronicled the use of a bank or its trust department as a repository for securities the affiliate could not sell.

Current federal banking law contains some general restrictions against self-dealing. State common law fiduciary standards are also applicable to banks acting as fiduciaries. Under federal banking law, purchases for trust accounts of securities underwritten by a bank or its affiliates are generally prohibited unless authorized by the governing trust instrument, by court order, or by the law of the jurisdiction under which the trust is administered. In addition, the Competitive Equality Banking Act of 1987 added a new Section 23B to the Federal Reserve Act, which prohibits the purchase of securities by the bank, either as principal or fiduciary (during the existence of any underwriting or selling syndicate), from an affiliate that is a principal underwriter of such securities unless a majority of the outside directors of a bank has approved the purchase.

With expanded bank securities powers, these limited safeguards may not be enough. One potential solution would be to prohibit banks from purchasing, in any fiduciary capacity, securities underwritten or dealt in by their securities affiliates or from recommending the purchase of such securities to their customers. The Commission does not recommend this solution, however, because such an approach could injure trust beneficiaries. If a bank's securities affiliate participated in underwritings of major, widely-held corporations, such a broad prohibition might cripple the bank's trust department by reducing the number and quality of issues available for investment by the department. A bank also might be precluded from recommending many highly rated securities to its trust customers. Finally, trust department investment in popular "proprietary" securities products developed and underwritten by a securities affiliate (e.g., stripped zero coupon treasury instruments such as TIGRs or CATS)

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based on concerns that the incentives for a conflict of interest would otherwise be substantial, citing specifically "the temptation * * * that the affiliates' least creditworthy assets would be securitized." The Board rejected the argument that these conflicts are adequately addressed by the Commission's disclosure requirements and the NASD's rules.

[19] Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph (15)(F)(X)).

would be barred. Under the circumstances, this approach might be detrimental to trust department customers as well as to bank trust departments.

The regulatory scheme under the federal securities laws for investment companies and investment advisers demonstrates one approach for dealing with these conflicts of interest. However, the Commission does not recommend that this approach generally be adopted as the regulatory framework for bank-affiliate dealings in this area. Although conflicts of interest in the securities business are addressed generally by the antifraud provisions of the securities laws,[20] the Investment Company Act of 1940 and the Investment Advisers Act of 1940 contain specific provisions designed to protect investors from the special conflicts of interest that may exist between registered investment companies and their affiliates, and between investment advisers and their clients.[21] Among the specific provisions of the Investment Company Act are the following:

(1) Section 17(a) generally prohibits an affiliated person or promoter of or principal underwriter for a registered investment company from buying or selling property or securities from or to the investment company unless the Commission approves the transaction (Rules 17a-1 through 17a-8 grant exemptive relief for certain transactions);

(2) Section 17(d) generally prohibits joint transactions between a registered investment company and any affiliated person of or principal underwriter for the company unless the Commission approves the transaction;

(3) Section 10(a) provides that no more than 60% of the board of directors may be interested persons of the investment company;

(4) Section 10(f) generally prohibits an investment company from purchasing securities when an affiliated person is a principal underwriter of the offering except as permitted by Commission rule or order (Rule 10f-3 permits certain investments, subject to price and quality restrictions and percentage limitations on the amount of the offering and the amount of the investment company's assets that are involved); and

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[20] The antifraud provisions require that an underwriter that also manages discretionary accounts disclose to its clients "not only that [the underwriter] proposes to deal with them for [its] own account but also of all other facts which may be material to the formation of an independent opinion by the client as to the advisability of entering into the transaction." Securities Exchange Act Release No. 10181 (June 1, 1973).

[21] Common trust funds maintained by banks are excluded from the definition of "investment company" under the Investment Company Act. Generally speaking, registered investment companies are subject to more detailed disclosure provisions under the federal securities laws than are required by the federal banking laws.

(5) Sections 36(a) and (b) authorize the Commission to bring an action against various persons associated with an investment company in the case of breach of fiduciary duty.

Fiduciary principles are incorporated into the Advisers Act,[22] principally by Section 206. Advisers are fiduciaries who owe a duty of undivided loyalty to their clients and must deal fairly and honestly with them. The duty of fair dealing implies a duty to disclose all relevant information and to avoid, or obtain a client's prior consent to, any conflict of interest. An adviser's fiduciary obligations include best execution, suitability, and exclusive loyalty to the client. In addition, the Advisers Act prohibits an adviser, acting as principal, from buying or selling any security to or from a client without written disclosure to the client and without obtaining the client's consent for each transaction.

In contrast, S. 1886 relies essentially on disclosure, without requiring an indication of understanding or consent. The bill would preclude a bank from recommending a security being sold by its securities affiliate without disclosing that the bank's securities affiliate is selling that security.[23] This provision does not contain specific consent requirements, perhaps on the assumption that existing federal banking regulations are sufficient. The Commission is concerned that existing bank regulation would permit securities sold by a securities affiliate to be placed in a bank's trust accounts if authorized by the governing trust instruments. Boilerplate language in trust agreements may permit such transactions without further informed consent of trust beneficiaries.

Also, there is little practical experience at this time regarding the operation of Section 23B of the Federal Reserve Act, which was enacted only a few months ago as part of the Competitive Equality Banking Act.

In view of these concerns, current safeguards combined with those provided in S. 1886 may not be adequate to meet all the issues raised by increased bank securities activities. In particular, it may be appropriate to require informed consent of the grantor of the trust or the primary beneficiaries of the trust prior to placement of underwritten securities, or securities in which an affiliate makes a market, in a trust account.

D. Credit to Purchasers of Securities

Bank lending to promote sales of securities by affiliates should be regulated. Through a combination of sales efforts and the provision of credit, a bank could encourage investors to purchase low-quality or otherwise hard-to-sell issues being underwritten by its affiliate. In addition, banks could cause customers to over-extend themselves on credit in an effort to unload underwritten issues. The securities laws address these concerns through a temporary prohibition

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[22] Banks are excluded from the definition of "investment adviser" under Section 202(2)(11)(A) of the Investment Advisers Act.

[23] Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph (15)(F)(viii)).

on extending credit for the purchase of underwritten securities. Section 11(d)(1) of the Exchange Act prohibits a broker-dealer from selling, or arranging for the sale of, a security on credit when the broker-dealer is also participating in a new issue distribution of the security. The prohibition extends for 30 days following the completion of the distribution. This prohibition applies when the broker-dealer's temptation to engage in sales promotion is greatest: when selling a new issue of securities during the initial underwriting period.

A similar prohibition should be extended to bank affiliates of broker-dealers. In that regard, the Commission notes that S. 1886 contains a provision that would prohibit a bank from knowingly extending or arranging credit secured by, or for the purpose of purchasing, any security that is underwritten by a securities affiliate during the underwriting period and for a period of 30 days thereafter.[24]

A related issue is margin regulation. Margin regulation is an area of particular concern because of the recent volatility in the securities markets. The existing margin regulations promulgated by the Federal Reserve Board that are applicable to banks and broker-dealers contain regulatory disparities that do not take into account the increased securities activities of bank affiliates.

Section 7 of the Exchange Act grants to the Federal Reserve Board the authority to adopt rules and regulations to prevent the excessive use of credit in connection with the purchase or carrying of securities.[25] Under Section 7, the Federal Reserve Board has promulgated Regulation T, applicable to registered broker-dealers, and Regulation U, applicable to banks.

As a general matter, banks and securities firms lending funds to customers to be secured by "margin" securities or for the purpose of purchasing or carrying "margin" securities are subject to the same numerical margin requirements. However, securities firms are regulated more stringently under Regulation T than banks are regulated under Regulation U. Regulation T essentially limits the kinds of securities broker-dealers can extend credit on to margin securities (i.e., listed equities and certain approved over-the-counter stocks). Under Regulation U, banks can loan money for a broader range of securities purchases and are accorded more flexible collateral requirements.[26] Regulation U does not apply to purchases of non-margin stock; nor does it apply when the collateral used is other than stock even if the purpose of the loan is to

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24 Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph (15)(F)(iv)). It may be appropriate to amend this provision to provide expressly that banks have an affirmative obligation to verify that loans are not being used to purchase securities underwritten by the bank.

25 Section 7 does not apply to exempted securities.

26 Section 7(d) of the Exchange Act grants the Federal Reserve Board broad authority to regulate any bank loan for the purpose of purchasing or carrying any security (except a loan "on a security other than an equity security"). However, Regulation U as promulgated by the Federal Reserve Board is more limited in scope and applies only to extensions of credit by banks on "margin stock" for the purpose of purchasing or carrying "margin stock."

purchase margin stock. In addition, banks can make unsecured loans for the purpose of purchasing securities.[27]

These disparities in margin regulation may have been rationally based when banks were engaged solely in a general lending business and were influenced only by normal lending considerations. However, as banks become more heavily involved in the securities business, both by directly acting as broker-dealers and by owning securities affiliates, any basis for the different treatment accorded banks and broker-dealers engaged in essentially the same activities is undercut. Bank extensions of credit to customers purchasing securities in transactions in which the bank (or its affiliate) is an active participant should be regulated as securities functions and in a manner comparable to broker-dealers.

E. Disclosure

Securities affiliates and banks must be required to make plain to customers that the securities affiliate of a bank is a separate entity from the bank itself, and that the securities that are sold, offered, or recommended by the securities affiliate are not guaranteed by the bank or by federal deposit insurance. To address this problem, S. 1886 would require that bank securities affiliates provide potential customers with disclosure statements clarifying the affiliate's separate status, pursuant to regulations promulgated by the Commission.[28] The Commission believes this safeguard is appropriate.

VI. THE HOLDING COMPANY STRUCTURE

A. The Proposals of S. 1886 and S. 1891

S. 1886 generally would require that expanded securities activities of banks be placed in subsidiaries of holding companies; they could not be conducted in the banks themselves, nor in the banks' subsidiaries. Under S. 1886, the Federal Reserve Board would have oversight authority over the holding company, including oversight over transfers of capital. S. 1886, however, would limit the Board's authority over those bank holding companies deriving 80% or more of their revenues from, and devoting 80% or more of their assets to, securities activities. For these entities, the Board could not conduct examinations, require periodic reports, or set capital requirements. S. 1891 would establish three categories of holding companies: bank holding companies; financial holding companies; and commercial holding companies. Each category of holding company would be authorized to engage in a different range of securities,

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[27] Securities margin loans made by a bank to customers of its securities affiliate could be governed by Regulation T (not Regulation U) if the broker-dealer arranged the loans from its affiliated bank.

[28] Section 102 (amending Section 4(c) of the Bank Holding Company Act to add paragraph (15)(F)(vii)).

banking, and commercial activities. The Financial Services Oversight Commission, to be created under the bill, would have authority to determine permissible activities for each type of holding company.

The Commission agrees generally that securities activities should be placed in affiliates that are subsidiaries of holding companies, rather than subsidiaries of banks.[29] The holding company structure has advantages over alternative structures, especially where the affiliate is engaged in corporate underwriting and dealing. First, under a holding company structure, the effect on an insured bank's capital would be less if its securities affiliate were to suffer financial difficulties than if the securities affiliate were a subsidiary of the bank. Similarly, under this structure, losses by a bank would be less likely to threaten the solvency of a securities affiliate.

Second, the holding company structure provides greater corporate separation between the securities affiliate and the bank. This will reduce the risk that the corporate veil will be pierced, resulting in the bank being held liable for the obligations of a securities affiliate. However, in the event of a failure of one subsidiary within the holding company structure, principles of equitable subordination, pension fund and tax liability of each member of the consolidated group, and controlling person liability could still cause liability to be shifted from one subsidiary within the holding company to another.

The Commission recognizes that creating a holding company imposes certain costs for small banks that do not currently have a holding company structure and may reduce their flexibility. In addition, the need for the additional insulation between a bank and a securities affiliate is less pressing where the securities affiliate is not engaged in corporate underwriting and dealing. For these reasons, it may be appropriate to allow a small bank to conduct its existing securities activities and underwriting and dealing in municipal securities (including municipal revenue bonds) in a subsidiary of the bank, so long as that subsidiary is subject to Commission regulation.

B. The Limited Exemption for Holding Companies Primarily Engaged in Securities Activities

The Commission believes that further consideration should be given to the limited exemption from holding company regulation in S. 1886 for holding companies primarily engaged in securities activities. Currently, that exemption is keyed to the relatively large size of a holding company's securities activities instead of the relatively small size of the holding company's banking activities. Because the Bank Holding Company Act's provisions are concerned primarily with the safety and soundness of banks, a holding company should only be fully subject to that Act where the company's banking activities are substantial. Accordingly, the Commission recommends that the limited exemption should apply to those holding

[29] To facilitate holding company formation, Section 202 of S. 1886 would exempt such transactions from the registration requirements of the Securities Act of 1933. This exemption would be limited to transactions in which bank shareholders receive the same proportionate interest in the holding company. In 1984, the Commission endorsed a similar provision in a bill that would have expanded bank securities powers.

companies that devote less than a certain percentage of their assets to, and derive less than a certain percentage of their income from, banking activities. Otherwise, a holding company that was primarily engaged in securities activities and also had significant subsidiaries engaged in other permissible nonbanking activities (such as certain insurance activities or commodity futures brokerage) could become subject to full Bank Holding Company Act regulation even if its banking activities were de minimis.

Moreover, those holding companies that qualify for the limited exemption will continue to be subject to the Bank Holding Company Act's restrictions on permissible nonbanking activities. Most existing securities firms therefore will be unable to affiliate with banks without divestiture of their insurance, real estate or other operations.

C. Role of Holding Company Regulation

S. 1886 would give to the Federal Reserve Board and S. 1891 would give to the Financial Services Oversight Commission substantive authority to regulate certain holding companies that have securities subsidiaries. If such regulatory authority is deemed necessary, the holding company regulator should be directed to coordinate with the Commission and to consider not only the safety and soundness of banks and the banking system, but also concerns related to orderly securities markets, the protection of the SIPC fund, and investor protection. Moreover, a holding company regulator should have no authority to regulate the activities of a holding company's securities subsidiaries or to affect the Commission's authority to require full disclosure by publicly-owned holding companies through the securities registration and reporting requirements.

Finally, the Commission believes that the creation of an additional financial regulator, as proposed in S. 1891, is unnecessary and that the proposed structure of the Financial Services Oversight Commission is unwieldy and impractical.

VII. CONCLUSION

The Commission is unable to support repeal of Glass-Steagall unless adequate safeguards are established to address the serious investor protection concerns raised by repeal. These safeguards include requiring banks to perform their existing and new securities activities in separate affiliates, subject to Commission regulation, and amending the Investment Company Act and Investment Advisers Act to address the concerns created by bank entry into investment company activities. In addition, the securities registration and reporting requirements of the securities laws should be consolidated within the Commission for all publicly-owned banks and thrifts. Congress should also consider providing additional safeguards to protect against other conflicts of interest and related investor protection concerns.

The Commission would be pleased to work with the Committee to implement the changes recommended in this statement in the legislation now being considered by the Committee.