STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND
FINANCE OF THE HOUSE COMMITTEE ON ENERGY AND COMMERCE

CONCERNING FINANCIAL SERVICES REFORM AND
MODIFICATION OR REPEAL OF THE GLASS-STEAGALL ACT

April 13, 1988

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EXECUTIVE SUMMARY

As the Commission stated in its report submitted to this Subcommittee on April 11, 1988, the Commission supports proposals to modify or repeal the Glass-Steagall Act so long as adequate safeguards are established to address investor protection concerns. Such safeguards include requiring banks to perform, with limited exceptions, their existing and new securities activities in separate affiliates or subsidiaries, subject to Commission regulation. Such safeguards must also include amendment of the Investment Company Act and the Investment Advisers Act in order to regulate banks engaged in advising and in promoting investment companies.

S. 1886, as passed by the Senate, contains adequate safeguards. Accordingly, the Commission supports modification or repeal of Glass-Steagall, if accompanied by the investor protection provisions of S. 1886. The Commission believes modification or repeal will result in increased competition in the financial services industry, without diminishing important investor protections.

The Commission also continues to support consolidation within the Commission of the securities registration and reporting requirements for all publicly-owned banks and thrifts.

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I. INTRODUCTION

The Securities and Exchange Commission appreciates this opportunity to present its views concerning possible reform of the financial services industry and related regulatory and supervisory issues. On April 11, 1988, the Commission submitted to the Subcommittee a report, as requested by Chairman Markey, that sets forth in detail the views of the Commission, as the agency primarily responsible for the protection of investors and the maintenance of fair and orderly securities markets, concerning the policy issues raised by bank securities activities, as well as the Commission's recommendations for financial services reform. The Commission requests inclusion of its report in the record. My statement briefly summarizes the Commission's recommendations presented in that report.

The Commission supports modification or repeal of the Glass-Steagall Act as long as the investor protection concerns arising from the entry of banks into securities activities are simultaneously addressed. In order to ensure investor protection, any legislation modifying or repealing Glass-Steagall must require banks to conduct both their new and their existing securities

activities in separate securities affiliates or subsidiaries subject to Commission regulation and must amend the Investment Company Act and Investment Advisers Act to address specific investor protection concerns raised by bank entry into the investment company business.

Also, the Commission recommends that Congress address in the context of financial services reform the consolidation within the Commission of the securities registration and reporting requirements for all publicly-owned banks and thrifts. However, the Commission's support for financial services reform is not conditioned upon enactment of legislation addressing this matter.

II. INVESTOR PROTECTION CONCERNS RAISED BY MODIFICATION OR REPEAL OF THE GLASS-STEAGALL ACT

Any proposal to reform the financial services industry must address issues relating to the protection of investors and maintenance of fair and orderly securities markets that arise with bank entry into the securities markets. Specifically, any proposal for modification or repeal of the Glass-Steagall Act must require all bank securities activities to be conducted within the regulatory scheme for broker-dealers which Congress designed for the protection of securities investors, and must also 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. A major component of the regulatory structure established by Congress is the regulation of brokers and dealers.

Banks have been exempt from broker-dealer regulation since the enactment of the Securities Exchange Act of 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 both their expanded and their current securities activities in separate entities subject to Commission regulation, with certain limited exceptions.

1. The Regulatory Scheme for Broker-Dealers

The Exchange Act and the rules promulgated thereunder impose on broker-dealers extensive net capital, books and records, and customer protection rules, specifically designed to protect securities investors. The Act also requires all registered broker-dealers to be members of self-regulatory organizations, such as the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange. These self-regulatory organizations impose additional rules on registered broker-dealers, subject to Commission approval. Compliance with such 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.

2. Current Status of Banks Under the Exchange Act

As currently written, the federal securities laws generally do not regulate banks when they engage in securities brokerage or dealing. 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 securities activities without registering with the Commission as brokers or dealers.

The recent involvement of banks in expanded securities activities such as discount brokerage, distribution of investment company securities, and combined brokerage and investment advisory services, without Commission and self-regulatory organization oversight of banks' sales practices, advertising, and sales commissions, raises substantial investor protection concerns. Accordingly, the Commission believes that existing bank securities activities, as well as any new powers extended to banks in legislation reforming Glass-Steagall, must be brought within the structure of the laws and rules designed by Congress, the Commission, and the self-regulatory organizations. This would provide for complete and effective regulation of the securities markets, investor protection, and the maintenance of fair and orderly markets.

3. The Proposed Bank Broker-Dealer Act -- H.R. 2557

In order to address the concerns posed by current unregulated bank securities activities, the Commission in 1987 proposed that the Exchange Act's definitions of "broker" and "dealer" be amended to include banks that engage in certain securities activities. The proposed legislation, entitled the "Bank Broker-Dealer Act of 1987" was introduced in the House by Chairman Markey on May 28, 1987, as H.R. 2557. The bill would include within the definitions

of "broker" and "dealer" those banks that publicly solicit brokerage business, receive transaction-related compensation for brokerage services provided to advised accounts, or deal in or underwrite securities, other than exempted securities. The substance of H.R. 2557 should be included in any legislation allowing banks increased securities powers.

4. The Commission's Agreement with the Bank Regulators Concerning Bank Securities Activities

In early 1988, at the request of Senator Proxmire, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, the Commission developed, in conjunction with the federal bank regulatory agencies, a proposed regulatory scheme for certain bank securities activities in the event Glass-Steagall were modified or repealed. This proposed regulatory scheme is based, in large part, on the provisions of H.R. 2557. The provisions of the agreement are set forth in Titles III and IV of S. 1886, the "Proxmire Financial Modernization Act of 1988."

Under Title III of S. 1886, the Exchange Act's general exclusion of banks from the definitions of "broker" and "dealer" would be removed, but certain exceptions for banks from the broker and dealer definitions would be provided. Exceptions from the "broker" and "dealer" definitions would be provided for:

(1) any bank effecting transactions for trust accounts, unless the bank both (a) received compensation in excess of the incremental costs of providing such services and (b) publicly solicited that business other than in conjunction with advertising its other trust activities;

(2) bank "networking" arrangements, where a bank contracts with a registered broker-dealer to provide brokerage services on bank premises, on a fully-disclosed basis, provided that bank

employees engaged in this activity whose functions are other than clerical or ministerial, or who are compensated on a commission basis, are suitably qualified and regulated under the Exchange Act as registered representatives of the broker-dealer involved;

(3) bank "sweep" accounts, where bank depositors' funds are periodically placed in no-load money market funds;

(4) bank transactions for employee stock option and similar plans;

(5) any bank effecting transactions in commercial paper or exempted securities other than municipal securities;

(6) any bank conducting certain primary private placements of securities;

(7) any bank effecting transactions for the investment accounts of affiliates; and

(8) any bank (that does not have a registered broker-dealer affiliate or subsidiary) effecting fewer than 1,000 transactions annually.

The compromise would also provide an exception from the definition of "dealer" for a bank that engages in the issuance or sale of securities backed by, or representing an interest in, obligations originated or purchased by the bank, its affiliate, or its subsidiaries. This exception would not apply to secondary trading in such securities and would only be available for those banks that do not have underwriting affiliates.

The proposal would require banks that already have or choose to establish separate securities affiliates that engage in underwriting of securities (other than exempt securities) to transfer any current municipal securities activities to registered broker-dealers. However, banks that do not have securities affiliates would be permitted to engage in municipal securities

activities directly in the bank, subject to the existing municipal securities regulatory scheme.

The proposal would give the Commission authority to exempt persons or classes of persons, including banks, from the definitions of "broker" and "dealer." The Commission also would retain its authority to exempt persons from the broker-dealer registration requirements of Section 15(a) of the Exchange Act. Thus, the Commission may elect to exempt activities that fall within the terms of the statutory provisions if an exception from Commission regulation appears to be appropriate.

B. Concerns Arising from Bank Investment Company Activities

If banks are permitted to sponsor investment companies and to underwrite and distribute investment company securities, the Investment Company Act and the Investment Advisers Act must be amended, even if such activities are conducted in separate affiliates or subsidiaries. These two Acts specifically address many of the conflicts that arise when brokerage firms or their affiliates conduct unit investment trust 1/ and other investment company 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

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1/ 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.

company business. Title IV of S. 1886 sets forth the Commission's agreement with the federal bank regulatory agencies concerning bank investment company activities.

1. Custody of Investment Company Assets

To minimize the opportunities for misuse of investment company assets, Sections 17 and 26 of the Investment Company Act would be amended to give the Commission explicit rulemaking authority to prescribe, after consulting with the appropriate federal banking agency, 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 or custodian.

2. Affiliated Transactions

To avoid the potential conflicts of interest involving bank-affiliated investment companies that would arise from the interrelationships between banks and their commercial borrowers, the Investment Company Act would be amended to prohibit an investment company from purchasing securities during an underwriting where any part of the proceeds of the offering will be used to repay a debt to an affiliated bank, except as the Commission may permit.

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 would be amended to

prohibit a bank-affiliated investment company from borrowing from its affiliated bank or banks, except in accordance with Commission rules.

4. Advising Investment Companies

In order to ensure effective oversight by the Commission of the activities of registered investment companies, all advisers to investment companies -- including banks -- should be subject to Advisers Act regulation and to Commission inspections and enforcement with respect to their investment company activities. Accordingly, Section 202(a)(11) of the Advisers Act would be amended to remove the current exclusion from the definition of "investment adviser" for those banks and bank holding companies that serve as advisers to registered investment companies. However, banks acting as registered investment advisers would be permitted to establish separately identifiable departments or divisions of the bank that would be deemed to be the adviser. Registration of a department or a division instead of the entire bank would reduce possible burdens on bank investment advisers. An exclusion for banks with no investment company clients would be retained in recognition of traditional bank advisory functions. Similarly, bank advisory services to non-investment company clients would remain outside the scope of the Advisers Act, even with respect to banks that advise investment companies.

5. Independent Directors

Section 10(c) of the Investment Company Act 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. In order to eliminate the potential of a bank operating under a multiple bank holding company structure to circumvent the legislative intent of this section, Section 10(c) would 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.

In addition, Investment Company Act Section 10(a) provides that at least 40 percent of an investment company's board of directors must be composed of individuals who are not "interested persons." Under current law, all registered brokers and dealers and their affiliated persons are "interested persons." A bank, however, may engage in certain securities transactions, such as transactions in government securities, without broker-dealer registration. Thus, when a bank effects such transactions, the bank's officers, directors, and employees are not deemed "interested persons." The definition of "interested person" in Section 2(a)(19) of the Investment Company Act would be amended to include within the term banks (and their affiliated persons) or other persons with certain other specified relationships with an investment company.

6. Federal Deposit Insurance

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(a) of the Investment Company Act

would be amended to give the Commission additional authority to require disclosures that make plain that a bank-affiliated investment company is not insured by either the FDIC or FSLIC.

III. REGULATION OF BANK AND THRIFT DISCLOSURE

Congress should implement the recommendations of Vice President Bush's Task Group on Regulation of Financial Services regarding bank and thrift issuer activities. The Task Group recommended that 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 that administration and enforcement of disclosure requirements under the Securities Exchange Act should be transferred exclusively to the Commission by repealing Section 12(i).

The Task Group recommendations would provide investors with the same disclosure protection with respect to securities issued by publicly-owned banks and thrifts as they now receive for other publicly-owned companies. Uniform accounting standards and disclosure requirements would facilitate comparative analyses of investment alternatives. Enactment of the Task Group recommendations also would result in more uniform regulation and enforcement of financial institution disclosure to investors, and would eliminate delays by the various agencies in conforming their regulations governing depository institutions filings with those adopted by the Commission.

IV. CONCLUSION

The Commission will support proposals to modify or repeal the Glass-Steagall Act so long as 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 or subsidiaries, 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. S. 1886, as passed by the Senate, contains those safeguards. Accordingly, the Commission believes that modification or repeal of Glass-Steagall accompanied by the investor protection provisions of S. 1886 will result in increased competition in the financial services industry, without diminishing important investor protections.

The Commission also continues to support consolidation within the Commission of the securities registration and reporting requirements of the securities laws for all publicly-owned banks and thrifts.