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SECURITIES AND EXCHANGE COMMISSION
Before the House Committee on Banking
and Currency (September 17, 1973)

I believe your hearings of recurring monetary and credit crises will focus on a number of areas in which the SEC has little expertise. Clearly, the relationship between the commercial banks, savings and loan associations, and credit unions in the monetary and credit system is in most cases not our concern. However, where commercial banks and other financial institutions are active in the securities markets and securities industry, the SEC has an obvious interest.

We are anxious to prevent any possible deterioration in our system of investor protection which could result from entry into the securities business by institutions not regulated by the SEC. A secondary, but also important, concern is the potential impact of this entry on the structure of the securities markets and the securities industry. At a time when the industry is experiencing substantial losses and facing dramatic change we cannot ignore the competitive threat of commercial banks with their huge financial resources. This is not to say that we necessarily believe that the securities industry should be protected from competition by commercial banks, insurance companies or others; however, all competitors should play under the same rules and be treated in a similar fashion under the securities, tax and other laws.

In addition to our concern about the entry of new forces into the traditional aspects of the securities industry, the Commission is focusing on certain aspects of the securities industry which have heretofore have been unregulated. As you are aware, we have recently suggested that the municipal bond industry, which has been exempt from most aspects of the securities laws, now be subject to SEC regulatory authority. This action would affect not only unregistered municipal securities dealers but also the municipal dealer arms of commercial banks, which are probably the most significant force in this industry. The municipal bond new issue market is a $25 billion a year business, excluding aftermarket trading; dealer practices are presently subject to nothing by the basic antifraud provisions of the Securities Exchange Act.

Commercial banks also provide a variety of longer term financing services which are not subject to SEC regulation because of exemptions in the securities laws, but are clearly in competition with services provided by regulated broker-dealers and underwriters. In addition to offering direct, long-term loans, banks arrange for private placements of securities and provide back-up agreements in connection with long-term lease financings and the sale of commercial paper. We clearly have an interest in all commercial bank activities which may have an impact of the health of the securities distribution system.

The sharp, continuing increase in the aggregate assets under management by bank trust departments and the aggressive expansion of the scope of services provided by banks directly to investors have been phenomena that the Commission has monitored closely, to the extent possible, since these trends presage broad structural change in the traditional methods by which securities are bought and sold in the nation's trading markets. I would like to address myself first to institutional trading activity and then to the regulatory problems arising from the expanding scope of services offered by banks.

Ad the end of 1969 trust departments of commercial banks administered approximately $280 billion in assets, of which $180 billion was in common stocks. The Commission's Institutional Investor Study, transmitted to Congress in 1971, found that the sum of assets that were invested in common stocks and managed by bank trust departments exceeded that administered by all investment advisers, insurance companies, self-administered employee benefit plans, foundations and educational endowments combined. As of 1971, I understand that the total assets managed by bank trust departments had increased to $336 billion, a figure which has probably grown considerably since that time. The significant growth of bank administered pension funds, related employee and dividend reinvestment plans, periodic investment plans and "mini-account" advisory services have also contributed to this increase.

The Commission views its administrative and regulatory responsibilities with respect to institutional trading activity in the perspective of facilitating the efficient flow of capital into the securities markets, protecting and providing fair treatment for the orders of all investors and maintaining adequate depth, liquidity and continuity in the nation's trading markets. The accumulation of vast sums of money, under the consolidated management of a single entity, such as a bank trust department, is almost always associated necessarily with the establishment of exceptionally large inventory positions in the securities of individual companies. The acquisition and disposition of these positions often produces temporary imbalances in supply and demand with short term price impacts. Such effects are most often observed when institutions buy and sell large blocks of securities at discounts or premiums from the prevailing market price, but a similar effect can result when institutions acquire, or dispose of, individual securities over a long period of time. As this Committee is aware, one of the major purposes of the market's specialist and market making machinery is to absorb temporary imbalances in supply and demand and thus provide continuity and liquidity to the trading markets in particular securities. But the institutional decision immediately to acquire, or dispose of, vast amounts of a particular security puts great strain on that mechanism and often results in potentially harmful, temporary price volatility.

Thus it was not surprising that, during out 1971 Hearings on the Future Structure of the Securities Markets, a number of suggestions were presented in respecting limitations on the quantity of stock which may be purchased or sold by a single security holder, limitations on the price raise or decline of a security in a given trading session and restrictions on the manner in which a block of securities may be sold. These suggestions are not new to this Committee, and were discussed in detailed Commission testimony here in 1971. Now as then there is a lack of any hard data which suggests that such impediments are either wise or necessary.

Nevertheless, while the Commission feels that all investors, including institutions, generally should be free to trade at a time and in a manner of their own choosing, we are aware of the increasing strains which institutional trading activity has placed on various market mechanisms. In our view, a two-pronged regulatory approach is necessary, indeed vital, to cope with this strain: (1) A strengthening of the nation's market making mechanisms -- a course within the Commission's present jurisdiction and authority and upon which we have already embarked in our proposals for a central market system; and (2) full and complete disclosure of institutional trading activity, including that of bank trust departments -- a course which demands legislative action to complement our existing but not necessarily complete authority to regulate such disclosure.

The Commission believes that full public disclosure of institutional trading and portfolio positions -- a subject which needs close Congressional consideration -- may partially dispell [sic] a growing public concern over institutional domination of market trading, will increase the information available to all market makers and possibly improve the efficiency of the trading markets and will provide important information from which subsequent decisions can be reached with respect to what, if any, additional steps may be necessary or appropriate in the public interest. As the Committee is aware, The Patman Report, the Banking Reform Act of 1971 and the Hunt Commission Report have presented proposals for institutions disclosure legislation, and one bill to this effect already has been introduced in the present session of the Senate (S. 2234).

The Commission is confident that this general approach to the problem of institutional trading patterns is prudent, feasible and in the best interest of the public at this time, although we do not support all of the provisions of the pending Senate bill.

The Commission is troubled also by the rapid expansion of banking facilities and services into traditional broker-dealer activities. We are cognizant of the fact, of course, that banks may be able to function as significant conduits through which additional funds can be channeled into our capital markets. Our concern rests with the undesirable prospect that securities investors who choose to utilize bank-sponsored securities-investment services may be requires to forfeit needed safeguards. Since 1933, the line between the securities business and the trust activities of banks has been fairly distinct. Indeed, the establishment of this separation was one of the major accomplishments of the reform legislation of the early 1930's. And, since this line was clearly drawn, Congress exempted banks from the statutes administered by the Commission -- a legislative approach which makes sense as long as that line is not erased. To the extent that banks engage in traditional trust department activities, and those activities are under the jurisdiction of appropriate bank regulatory authorities, the legislative scheme should work smoothly. We think it obvious, however, that if banks should become a major force in any traditional aspect of the securities industry, the prevailing regulatory scheme would be subverted, since the regulatory agency with the unique expertise to oversee and administer securities laws could be prevented from applying a number of the ordinary investor protection provisions in those laws to the activities of a major participant in the very industry it is charged to regulate. We certainly respect the expertise of the banking authorities and recognize that dual or overlapping regulation is not often in the public interest; however, it is not clear that the regulatory scheme applicable to bank accomplishes substantially the same objectives as the federal securities laws.

With this perspective in mind, let us turn to some of the recent innovations in services provided by banks. Banks can provide important services, as trustee or agent, to individual investors as well as larger investors, such as pension funds. Of late, such services frequently seem to involve much more than traditional custodian or accommodation functions. For example, a growing service provided by banks is a dividend reinvestment plan for stockholders of publicly held companies. Typically, the bank will enter into an agreement with each company involved pursuant to which the bank offers stockholders of the company an opportunity automatically to reinvest declared dividends in the company's stock.

Another recent innovation that, we believe, has broad potential ramifications is the so-called automatic investment service, through which a bank offers its checking account customers an opportunity to purchase any securities contained in a list of common stocks specified by the bank, through the vehicle of an automatic monthly deduction from participant's checking accounts.

In one such situation, the list is composed of the twenty-five corporations included in the Standard & Poor's 425 Industrial Index with the largest total market value. Customers specify which company or companies they are interested in and the amount they with deducted from their checking account each month. The shares of each company selected are purchased on a pooled basis for all participants, which saves each of them some brokerage charges.

Besides the aggressive marketing of employee and dividend reinvestment plans and automatic monthly investment plans, banks have found ways to expand their investment advisory services. For example, a recent development is the offering of so-called “mini-account” services, which purport to provide individualized portfolio attention and management to investors with as little as $10,000 to invest. The mass merchandizing of this discretionary management to individual investors raises the prospect of overlapping investment advice to clients and the spectre that these accounts are the functional equivalent of investment companies.

Although banks engaged in these functions appear to be furnishing traditional brokerage services, their customers -- who are no less securities investors than those persons who channel these securities investment dollars through regulated securities brokers, investment companies and investment advisers -- are not necessarily beneficiaries of the Commission regulations applicable to nonbank securities entities. And, as a matter of course, we have had to defer to federal banking authorities for the routing supervision of banking activities, including oversight of the implementation and operation of bank securities.

We are concerned with some of the expanded features of recent bank securities services and we are not oblivious to the prospect that an even wider variety of services, not presently offered, soon may be made available. Substantial cash contributions by a potentially significant number of participants in these plans could result in an increase of concentrated purchases and the likelihood that such purchases may disrupt ordinary trading in a security or otherwise lead or dominate the market. Similarly, a greater concentration of voting power, at least where plans allow the bank to vote fractional shares or vote proxies not returned by the participant, could result in significant regulatory problems.

Bank plans of this kind also could foster unreasonable fees and possible conflicts of interest problems, which are equally as relevant to the federal securities laws as they are to applicable banking law. Thus, a bank trust department could choose to hold stocks, for example, in companies with which the bank has commercial banking relationships.

Furthermore, unlike brokers and dealers registered and regulated by the Securities and Exchange Commission, banks have not been subjected, in all instances, to prevailing requirements that investments by suitable for the potential securities investor or otherwise held accountable for inappropriate advertising material, unless, of course, the advertising statements are fraudulent within the meaning of the federal securities laws' proscriptions against fraud. Even though a company may be well established and have very substantial assets, it does not necessarily follow that its securities are a suitable investment for all investors.

In addition, where unregulated entities engage in the business of effecting securities transactions, there are always additional questions which must be resolved, for example, whether the price to the customer is as favorable as possible under prevailing market conditions, whether customers will receive adequate confirmation of their purchases and whether individuals leaving securities with a bank pursuant to one of the above-mentioned services are protected in the event of any financial difficulties. With respect to his latter question, some plans voluntarily incorporate insurance protection; however, it does not appear that the Federal Deposit Insurance Corporation, which normally insures customer cash deposits at participating banks, would extend to securities held by a bank on behalf of a person participating in a plan. In contrast, the Securities Investor Protection Act of 1970 provides coverage of up to $50,000 resulting from the insolvency of regulated brokers and dealers.

The competition created between banks and traditional securities industry entities could well prove beneficial to the investing public. But we do not believe it is appropriate, if a decision is made to foster this form of competing, to encourage competition at the very heavy cost of sacrificing needed regulatory protection. It is our view that persons or entities engaged in comparable activities should be subject to comparable regulation.

The Commission's threshold concern with respect to the innovative services offered by banks, therefore, is not to prevent banks, or any other qualified business entity, from providing and marketing brokerage and investment management services to a broad segment of the public, but rather to ensure that the protections offered by the statutes which we administer be applied equally to <u>all</u> segments of the securities industry. To the extent that banks enter the securities industry, therefore, we believe that the Commission should be vested with clear jurisdiction to regulate their activities in the same manner as other securities business entities.