APPENDIX TO
STATEMENT OF JOHN SHAD
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE
SUBCOMMITTEE ON COMMERCE, CONSUMER, AND MONETARY AFFAIRS
OF THE HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

CONCERNING THE REGULATION OF FINANCIAL SERVICES

~~May 22, 1986~~
June 19, 1986

The following sets forth responses to the specific questions raised in Chairman Barnard's letter, dated May 1, 1986, inviting the Commission's testimony:

Question A. Broad philosophy: As a matter of broad philosophy, do you believe that banks or their holding companies should be allowed a larger role in (a) securities underwriting, (b) securities market making, and/or (c) investment management than is now possible under the restraints of the Glass-Steagall Act? In terms of the fundamental objectives of facilitating business capital formation and encouraging the free flow of capital funds in the economy, what functional distinction should be maintained as a matter of law between banks and securities firms?

Answer.

The response to this question is set forth at pages 1-5 of the Commission's written testimony.

Question B. Role of foreign banks in domestic securities markets: Attached to this letter is a list of foreign banks that we believe are currently empowered to conduct securities activities in the U.S. by virtue of a grandfather exemption from the Glass-Steagall restrictions applicable to other banks. What has been the scope of the domestic underwriting and market-making activities of these and any similarly situated foreign banks and their securities subsidiaries over the past 5 years? Also, during this period has the SEC taken any enforcement actions or had other unfavorable supervisory experience with any of these banks or their securities subsidiaries?

Answer.

The 15 banks named on the list attached to Chairman Barnard's letter are empowered to conduct underwriting and market making activities in the United States by virtue of the grandfathering language found in the International Bank Act of 1978, 12 U.S.C. 3106. Through registered broker-dealer affiliates, these banks have engaged in a wide range of securities activities, including brokerage for U.S. and foreign clients and advisory services, of which underwriting and market making constitute a very small part. Three enforcement actions have been brought against foreign banks in the relevant group during the past five years. None of the actions have raised significant or unique issues.

The International Banking Act of 1978 exempts certain foreign banks and their affiliates from the Bank Holding Company

Act of 1956. The statute permits the foreign banks and their affiliates to continue any non-banking business in which they were engaged prior to July 26, 1978.

Until 1978, foreign banks operating branches or agencies engaged in commercial banking activities did not technically fall within the National Banking Act or the Bank Holding Company Act. The foreign banks were not, therefore, within the definition of "bank" for purposes of these statutes and other statutes that rely on the definitions found in the National Banking Act and Bank Holding Company Act. Thus, because these banks had not been treated as "banks," for regulatory purposes, they were excused from the restrictions imposed by the Glass-Steagall Act, and subject to the broker-dealer registration requirements of the Securities Exchange Act of 1934 if they chose to engage in securities activities.

A number of the foreign banks on the attached list have registered broker-dealer affiliates that are used by their parent foreign banks for participation in the U.S. securities markets. In 1978, the decision was made that because foreign banks were becoming prominent participants in the U.S. credit markets, federal regulation of their activities was necessary. */ However, the International Banking Act ensured that from 1978 until at least 1985, when these foreign banks' non-banking

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*/ In 1973, 60 foreign banks operating in the U.S. had $37 billion in assets. By 1978, 120 foreign banks were operating in the U.S. with $90 billion of assets. S.R. No. 95-1073, 95th Cong., 2nd Sess. 2 (1978).

activities would be eligible for review by the Board of Governors of the Federal Reserve System, these foreign banks' non-banking activities would not be affected by newly imposed banking regulations.

The broker-dealers in question generally have engaged in underwriting and market making activities. They limit their underwriting activities to participation in selling syndicates, with certain exceptions. */ They underwrite both U.S. issuers' securities and "Yankee Bonds" (dollar denominated bonds issued by foreign entities and sold in the U.S. market). However, most of the broker-dealers contacted by the staff indicated that despite a growing underwriting business, underwriting presently constitutes under 10 percent of their business. However, Deutsche Bank Capital indicated that underwriting constitutes a substantial part of its business.

Until A.G. Becker was sold to Merrill Lynch & Co. in 1984, A.G. Becker/Paribas, another major broker-dealer that was previously owned by Banque Paribas, was very active in both underwriting and market making. In addition, Financiere Credit Suisse First Boston, jointly owned by Credit Suisse and First Boston, Inc., owns a substantial minority share of First Boston Inc., the parent of The First Boston Corporation. The First Boston Corporation has been a major underwriter and market maker for many years. Financiere Credit Suisse First Boston

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*/ The customers to whom the broker-dealers sell the securities they underwrite are generally domestic and foreign institutions.

is a major participant in the European securities markets. First Boston's prominence in the U.S. securities markets is due primarily to its substantial presence prior to its affiliation with Credit Suisse.

The broker-dealers' market making activities are also generally quite limited. Deutsche Bank Capital makes markets in seven NASDAQ listed foreign securities, and ABD Securities, a broker-dealer owned jointly by Bayerische Hypothekenund Weschel Bank, Dresdner Bank and Algemene Bank-Netherlands, is a specialist on various regional exchanges. The remaining foreign bank broker-dealers do not engage in any bona fide market making activities. Rather, their principal transactions are limited to acquisition of securities in riskless principal transactions, or purchases of particular issues which are known to be attractive to particular customers.

According to FOCUS reports */ submitted by the broker-dealer subsidiaries of the foreign banks qualifying under the grandfather clause, revenues from underwriting and selling securities over the past five years have been only a small portion of total revenues, as has market making. For instance, in the first three quarters of 1985, total revenues for all the firms was approximately $68 million, of which underwriting

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*/ The FOCUS report constitutes the basic financial and operational report required of those brokers or dealers subject to any minimum net capital requirement. See Question E. FOCUS reports are filed each quarter with the regulatory organization designated as the Examining Authority for the broker or dealer. The information filed includes a statement of earnings and a statement of profits and losses.

and selling groups produced $2,787,846, */ or 4 percent. Over-the-counter ("OTC") equity market making produced only $197,795, or .28 percent. **/ Trading in debt securities produced $7,287,187, or approximately 11 percent of total revenues. Underwriting, market making in equity securities and debt trading accounted for 16.28 percent of the firms' revenue in the first three quarters of 1985.

Prior years' reports produced records of similarly de minimis activity. In 1984, total underwriting revenue was $3,150,587, losses from market making in OTC equity securities totaled $41,010, and revenues from trading debt were $6,687,402. Total revenues were $57,604,685. Underwriting, market making, and trading therefore constituted less than 17 percent of the firms' total revenue. In 1983, underwriting, market making, and trading together accounted for about 19 percent of total revenue. In 1982, the activities accounted for 33 percent, the bulk of which was derived from trading debt securities; and in 1981, only 15 percent of revenue resulted from these activities.

During the past five years the Commission has brought three proceedings in which three of the banks had some level of involvement. Given the limited nature of that involvement, we do not believe this enforcement experience provides a basis for a

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*/ An individual broker-dealer produced over $2 million of the $2,787,846.

**/ Only two broker-dealers listed revenue in this area, and one of the two produced a loss.

determination that the banks are more or less likely than their domestic counterparts to engage in securities law violations.

On October 26, 1981, the Commission filed a complaint in the U.S. District Court for the Southern District of New York alleging that certain unknown defendants had violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder by purchasing the common stock of, and options to purchase the common stock of, Santa Fe International Corporation ("Santa Fe") while in possession of material nonpublic information concerning merger discussions and negotiations between Santa Fe and Kuwait Petroleum Corporation. SEC v. Certain Unknown Purchasers of the Common Stock of, and Call Options for the Common Stock, of Santa Fe International Corporation, et al., 81 Civ. 6553 (S.D.N.Y. 1981). The complaint sought, inter alia, injunctive relief enjoining the defendants from further violations of Section 10(b) and Rule 10b-5 and an accounting and disgorgement of all profits realized by the defendants from the violative transactions. In order to effectuate the relief requested by the Commission, the complaint also named as nominal defendants a number of entities through which the defendants, directly or indirectly, effected the transactions. These nominal defendants included two Swiss banks: Credit Suisse and Swiss Bank Corporation. The complaint sought an order (1) preventing the banks from disposing of any of the assets of the defendants relating to their transactions in Santa Fe stock and options and, (2) compelling them to reveal the identities of the accountholders who had directed purchases of Santa Fe stock and options through their accounts at the banks just prior to the announcement of a merger between Santa Fe and the Kuwait Petroleum Corporation.

On the same day the complaint was filed, the court issued a temporary restraining order granting the relief requested by the Commission. The Swiss banks refused to reveal the identities of the accountholders who had directed purchases in Santa Fe stock and options on the ground that to do so would violate Swiss bank secrecy laws.

In an effort to learn the accountholders' identities despite the Swiss bank secrecy laws, the Commission submitted, on March 22, 1982, a request for assistance to the Swiss government under the 1977 Treaty on Mutual Assistance in Criminal Matters Between the Swiss Confederation and the United States. The Swiss Federal Tribunal, to which the request was referred under the Treaty, initially denied the request because it was unable to determine whether the conduct alleged by the Commission violated Swiss law. After the Commission alleged additional facts in support of its request, the Tribunal granted the request for assistance and, in 1984, the accountholders' identities were revealed.

Pursuant to an Order entered by the court in which the identity of its customer was revealed to the Commission, Swiss Bank Corporation was dismissed from the action on July 23,

1982. Credit Suisse was dismissed on December 20, 1984, after the identity of accountholders had been ascertained pursuant to the Treaty request.

On December 15, 1983, the Commission initiated an administrative proceeding pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 against A.G. Becker Paribas, Incorporated ("Becker"), a registered broker-dealer. In the Matter of A.G. Becker Paribas, Incorporated, Admin. Proc. File No. 3-6316. At the time of these proceedings, Becker was a wholly-owned subsidiary of Banque Paribas. In late 1984, Banque Paribas disposed of its entire interest in Becker.

In the administrative proceeding, the staff alleged that Becker violated Commission Rule 15c3-3 by failing to meet its customer reserve account deposit requirements. The staff also alleged that Becker had violated the possession and control provisions of Rule 15c3-3, and had violated the extension of credit provisions of Regulation T, promulgated by the Board of Governors of the Federal Reserve Board. These violations, the staff alleged, contributed to violations by Becker of Commission Rules 17a-3, 17a-4 and 17a-5. Becker was also charged with failure to supervise its staff with a view to preventing the violations.

Simultaneously with the entry of the order instituting the proceedings, Becker submitted an offer of settlement, which was accepted by the Commission. Without admitting or denying the allegations made in the proceedings, Becker agreed to a censure and to an order directing it to comply with certain undertakings. These undertakings included provision of supervision and training for its employees, adoption of written procedures for compliance with the rules alleged to have been violated, and establishment of an internal audit program concerning compliance with the rules alleged to have been violated.

Simultaneously with the issuance by the Commission of its order and opinion in this matter, the New York Stock Exchange announced a $300,000 fine of Becker as the result of a disciplinary proceeding based on approximately the same violations.

On April 17, 1984, the Commission instituted administrative proceedings pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act against Becker and Owen V. Kane, a vice-president of Becker in Minneapolis, Minnesota. In the Matter of A.G. Becker, Incorporated, n/k/a A.G. Becker Paribas, Incorporated, and Owen V. Kane, Admin. Proc. File No. 3-6351. In the proceedings, the staff alleged that Becker and Kane acquired common stock of Grandma Lee's Inc. ("Grandma Lee's") from officers and employees of Grandma Lee's and others in Canada and distributed that stock in the United States without a registration statement being filed or in effect. The staff alleged that, as a result of this conduct, Becker and Kane wilfully violated Sections 5(a) and 5(c) of the Securities Act of 1933 in the offer and sale of 150,000 shares of common stock of Grandma Lee's. Grandma Lee's is a Canadian Corporation whose stock was traded over-the-counter in the United States.

On February 19, 1985, Becker submitted an offer of settlement which was accepted by the Commission. In the offer, Becker consented, without admitting or denying the allegations made in the proceedings, to the entry of findings by the Commission and to a censure. The Commission's acceptance of Becker's offer of settlement terminated the administrative proceedings as to Becker, but not as to Kane.

On March 22, 1985, an Administrative Law Judge issued an initial decision in the administrative proceeding finding that Kane willfully violated Sections 5(a) and 5(c) and suspending hi from association with any broker-dealer for a period of six months. Kane's appeal of that decision is pending.

Question C. Competitive situation in underwriting: How would you characterize the present competitive situations for domestic underwriting placements of (a) corporate debt and (b) corporate equity? Is there any basis for believing that bank participation could reduce costs or otherwise strengthen competition in the provision of underwriting services?

Answer.

Competition in underwriting placements of corporate debt and corporate equity is intense. The largest domestic underwritings of both debt and equity are handled primarily by large national investment banking firms. These major underwriting firms actively compete for underwriting clients on a transaction-by-transaction basis. This differs significantly from the traditional, long-term, full service investment banker-client relationship. Instead, many interested and adequately capitalized investment banks today compete to take an issuer's securities to market.

Since its adoption, the Commission's Rule 415 ("Shelf Registration") has saved corporations, for the benefit of their shareholders, well over $1 billion dollars a year in interest, underwriting and paperwork costs and has contributed to an increase in competition in the domestic underwriting market. A study by the Commission's Office of the Chief Economist concluded that shelf registration has increased competition among underwriters, and as a result has reduced issuance costs by about 13 percent for syndicated offerings and 51 percent for non-syndicated offerings. */ Industrial bond underwriter spreads have declined about 26 basis points, **/ and common stock underwriter spreads have declined 8.7 percent since the introduction of shelf registration. ***/ Issuers now register large amounts of securities, and subsequently solicit bids from underwriters for all or a portion of such securities.

Issuers' fixed costs under this form of offering are small. They can make multiple small offerings and take advantage of favorable market conditions, by soliciting competitive bids. Under Rule 415 securities are often sold directly to institutions without incurring any underwriting expenses.

Competitive bidding for corporate debt securities has lead to a reduction in the size of underwriting syndicates. Indeed, many debt offerings occur through "bought deals" by a single investment banking firm. ****/ Rule 415 has also reduced the

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*/ Office of the Chief Economist SEC, Update-Rule 415 and Equity Markets (December 1984) ("OCE Study").

**/ Kidwell, Marr, & Thompson, SEC Rule 415: The Ultimate Competitive Bid, 19 J. of Fin. & Quant. Anal. 183 (June 1984).

***/ Kidwell, Marr & Thompson, Shelf Registration, Competition and Market Flexibility, Tulane University & Virginia Polytechnic Institute and State University Working Paper, 1985..

****/ 31 percent of shelf underwriting through 1983 was non-syndicated compared to 9 percent for non-shelf underwriting. OCE Study, supra.

costs of certain equity offerings sold to single purchasers. Such sales eliminate the need for selling syndicates. Traditional underwriting techniques continue for many smaller issues, underwritten by regional investment bankers.

Securities firms also employ substantial capital and credit in initial public offerings, venture capital and other activities. Many securities firms are also actively involved in acquiring and packaging large numbers of loans and selling them as private mortgage-backed and other securities. This trend toward securitization includes car and a variety of other consumer loans.

These trends have substantially increased the capital needs of investment banking firms. As discussed further in Question F, however, investment banking firms have been successful in attracting substantial additional capital and credit with which to finance such activities.

While underwriting activities are intensely competitive, additional well capitalized participants, whether banks or other entities, could increase competition. Underwriters of public distributions of debt and equity often must carry substantial inventories of such securities at significant risks.

As discussed earlier in this testimony, the Commission believes that all underwriting and other securities activities should be conducted by entities that are regulated in the same manner, by the same regulator.

Question D. Competitive situation in market making: How would you characterize the present competitive situation regarding market making for outstanding unlisted issues of (a) corporate debt and (b) corporate equity? Is there any basis for believing that participation by banks as market makers for corporate debt and/or equity would enhance liquidity, reduce transaction costs, or otherwise strengthen competition in the provision of market making services?

Answer.

Market making in corporate debt and equities traded over-the-counter ("OTC") is keenly competitive. Most of the dollar volume of transactions in OTC stocks consist of over 2,200 issues that are traded by market makers through the National Association of Securities Dealers, Inc.'s ("NASD") NASDAQ automated quotation system. The less active, smaller companies' stocks are quoted in the "pink sheets," printed by the National Quotation Bureau. NASDAQ market makers publish quotation prices at which they are willing to buy and sell on a continuous basis. At the end of 1985, there were 500 market makers in the 4,785 securities quoted on NASDAQ, compared to 369 market makers in 2,579 NASDAQ securities in 1975 and 394 in 3,050 NASDAQ securities in 1980. Many of the most active NASDAQ securities have average inside quotation spreads of an 1/8th of a point, and some of these securities, such as MCI Communications, have 40 or more market makers. The average number of market makers in each

NASDAQ security was 8.4 in 1985, compared to 5.6 in 1975 and 7.3 in 1980. As these numbers suggest, few barriers to entry into market making exist; OTC market makers range from large integrated and wholesale broker-dealers that make markets in more than 1,500 securities to small regional firms that make markets in less than five securities.

Although the corporate debt markets have fewer active issues and dealers than the OTC equity markets, market making in corporate debt issues is keenly competitive. Corporate bonds are traded both OTC and on exchanges with the OTC market predominant. Exchange trading in the approximately 3,800 bonds listed on the New York Stock Exchange, Inc. ("NYSE") */ and 300 bonds traded on the American Stock Exchange, Inc., is generally limited to retail odd lots, usually 15 bonds or less. The vast bulk of trading in corporate bonds is institutional in nature and takes place in the OTC market between dealers and institutional investors. Over 90% of the trading in NYSE listed bonds occurs OTC.

Because the OTC market for corporate bonds, unlike the OTC equity market, does not employ last sale reporting or electronic quotation displays, the dimensions of the debt market are difficult to gauge. However, the bulk of the trading is conducted by

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*/ The NYSE operates an Automated Bond System, which compares newly entered orders to orders already in the system, executes matching orders, and reports the resulting trades to market information services.

30 to 35 major dealers in several hundred active issues at any given time. These dealers are generally the same major dealers as in the government, municipal, and agency debt markets. They include Salomon Brothers, Goldman Sachs, Merrill Lynch, Morgan Stanley and First Boston. In addition, there are a number of less active dealers, and eight to ten brokers' brokers that facilitate anonymous interdealer trading. Quotation spreads in the active issues usually are very narrow -- 1/8 or 1/4 of a point -- due to competition. Individual trades of $5 million in bonds are considered average in size. Dealers often conduct "swap" trades, in which an institutional investor switches bonds in its portfolio for other bonds, at prices between the quotes. Bond dealers also conduct portfolio dedication programs for institutions, in which an institutional portfolio is broadly restructured, using bonds of different yields and durations, with minimal disruption of the market.

Although both the corporate equity and debt markets are keenly competitive, it is to be expected that the introduction of new market makers would increase this competition. Studies have shown that spreads tend to narrow as the number of dealers in a security increases. */ There may be an equilibrium number

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*/ See, *e.g.*, Fabozzi, *Bid Ask Spreads for Over-The-Counter Stocks*, J. of Econ. & Bus. 56 (Fall 1979), Ho & Stoll, *On Dealer Markets Under Competition*, 35 J. of Fin. 259 (1980).

of dealers that can trade any given security profitably over the long term, */ it appears that this equilibrium dealer level is best arrived at through open competition among dealers in the security.

*/ See Stoll, The Supply of Dealer Services in Securities Markets, 33 J. of Fin. 1133 (1978).

Question E. Risk Control and Capitalization: What are the principal elements of regulatory structure that are intended to assure proper control of risk exposure and maintenance of adequate capitalization by securities firms that conduct active underwriting and market making operations? Should these same or functionally similar regulatory standards be applied to banking firms if they were permitted to conduct similar underwriting or market making operations? How should this be done?

Answer.

Section 15(c)(3) of the Securities Exchange Act of 1934 prohibits broker-dealers from effecting transactions in violation of the Commission's rules that "provide safeguards with respect to financial responsibility and, related practices of brokers and dealers." The Commission's principal financial responsibility rules are the uniform net capital rule, Rule 15c3-1 (17 CFR §240.15c3-1) and the customer protection rule, Rule 15c3-3 (17 CFR §240.15c3-3).

The purpose of the net capital rule is to promote the financial viability of the securities industry by protecting both customers and other broker-dealers from the risks of broker-dealer failures. The rule establishes minimum levels of capital that a broker-dealer must maintain in an effort to assure that broker-dealers have sufficient liquid assets to meet their obligations to customers, other broker-dealers, clearinghouses, exchanges and others.

In determining net capital, a broker-dealer deducts from its net worth, among other things, non-liquid assets, unsecured receivables and certain percentages of its securities and commodities positions ("haircuts") after marking such positions to the market. In addition to these deductions, to control risk exposure the rule requires the deduction of certain percentages for underwriting commitments.

The rule specifies absolute minimum levels of net capital based upon the nature of the firm's business. The lowest amount of net capital for a firm conducting an active underwriting and market making operation is $25,000. The amount of net capital required increases as a firm expands its business. The amount of required net capital is expressed (depending on the firm's election) as a ratio or percentage of (1) its "aggregate indebtedness" or (2) its "aggregate debit items" ("Alternative") as computed under Rule 15c3-3. Aggregate indebtedness is defined in the rule as, essentially, all the money liabilities of a broker-dealer. For broker-dealers using the aggregate indebtedness method, the firm's aggregate indebtedness may not exceed 1500 percent of its net capital, or stated another way, the broker-dealer's net capital must be at least 6 2/3 percent of the firm's aggregate indebtedness. Those broker-dealers using the alternative method are required to maintain net capital equal to two percent of the aggregate debit items as calculated under the Formula for Determination of Reserve Requirements for Brokers and Dealers ("Reserve Formula") under Rule 15c3-3.

Rule 15c3-3 (17 CFR §240.15c3-3) was adopted to act as a deterrent against the misuse and misallocation of customer funds and securities. The rule, in essence, requires broker-dealers to obtain and maintain possession or control of all fully paid and excess margin customer securities. The broker-dealers must make a daily determination to ensure that they are complying with this aspect of the rule. In addition, the rule requires every broker-dealer to make a weekly computation (as of the close of business Friday) of the Reserve Formula to determine how much money it is holding which is either customer money or money obtained from the use of customer securities (formula credits). From that the broker-dealer subtracts the amount of money it is owed by customers (cash or margin accounts) or by other broker-dealers because of customer transactions (formula debits). If the credits exceed the debits, the broker-dealer must deposit the excess by Tuesday morning in a Special Reserve Bank Account for the Exclusive Benefit of Customers. Rule 15c3-3 in effect prevents a broker-dealer from using customer funds to finance its business, except as related to customer transactions. The broker-dealer must, therefore, provide the capital to finance its underwriting and market making operations and may not rely upon working capital provided by customers' funds left with the firm.

If banking firms are permitted to conduct underwriting and market making operations, they should be subjected to the same regulatory standards. Customers' deposits with banks should be protected from the risks inherent in engaging in active underwriting or market making. Rule 3b-9 (*See* accompanying testimony at 7-9) provides the appropriate model for how this should occur. The financial responsibility standards could best be implemented by requiring banks to conduct their underwriting or market making business in subsidiaries or affiliates subject to the Commission's regulatory program under this functional regulation approach.

Question F. Capital as a binding constraint: To what extent does the present capitalization of securities firms impose a binding constraint that impairs or inhibits the degree of competition in either underwriting or market making? That is, to what extent do some firms that might otherwise increase the number of issues they handle or bid to underwrite find themselves unable to do so for lack of sufficient capital to support the expanded activity?

Answer.

As discussed in Question C, a number of investment banking trends require substantial additional capital commitments by brokerage firms; nevertheless, the present capitalization of securities firms does not unduly impose a binding constraint that impairs or inhibits the degree of competition in either underwriting or market making activities. Many brokerage firms have historically been limited in their access to capital by virtue of their partnership form. While some of the largest and most successful investment banking and brokerage firms, such as Goldman Sachs and Drexel Burnham, continue in partnership form, over the past fifteen years, there has been a steadily movement by such firms from partnership to corporate form. Recent developments which have enabled broker-dealers to expand their capital base further have included: (i) their acquisition by large, well capitalized financial institutions or other public companies, *e.g.*, Equitable Life Assurance Society of America's acquisition of Donaldson Lufkin & Jenrette, and General Electric's pending acquisition of Kidder, Peabody or (ii) offering their securities to the public such as in the cases of Bear Stearns & Co. and Morgan Stanley & Co. As of September 30, 1985, the amount of equity capital and subordinated debt of broker-dealers (other than options market makers which are exempt from the Commission's net capital rule) increased from $10 billion in 1980 to $28.2 billion. During the same period, the number of registered broker-dealers (other than options market makers) increased from 5,283 to 6,189.

Three firms which have increased or will shortly increase their capital through public offerings or acquisitions are described below. Bear Stearns & Company, a partnership until late 1985, increased its equity capital by $220 million through a public offering of its stock. In addition, it raised $80 million through a debt offering in Europe and increased its revolving subordinated loan commitment by $50 million. In effect, it increased its capital base by about 80 percent from $450 million in capital and subordinated debt to $800 million in capital and subordinated debt.

Morgan Stanley Group, Inc., then a non-public holding corporation of Morgan Stanley & Company, a registered broker-dealer, recently sold to the public over 5 million shares of its stock. It thereby increased its capitalization by $270 million. Kidder Peabody & Company recently agreed to be purchased by a subsidiary of General Electric Company which in addition has agreed to contribute about $140 million of equity capital to the broker-dealer. Kidder presently has capital and subordinated debt of $489 million. After the above contribution it would have capital and subordinated debt equal to $629 million.

In addition, the development of liquid secondary markets in options and futures has allowed firms to more effectively hedge risks, allowing for more efficient utilization of existing capital.

<u>Question G.</u> <u>Conflicts of interest</u>: How are customers of securities firms protected from being adversely affected by conflicts of interest between the firms' investment management and advisory obligations to investors and their underwriting and market making obligations to issuers of securities? Would the system of protection employed currently in the securities industry also be applicable -- and should it be applied -- to depository institutions if they also are permitted to engage more fully in securities underwriting, market making, and investment management and advisory services?

<u>Answer</u>.

Investment banking, by its nature, raises numerous potential conflicts of interest. Whenever an investment bank functions as adviser, managing underwriter, or simply as a member of the selling syndicate for a company or its securities, it performs many, often potentially conflicting, functions simultaneously. As adviser to an issuer, the investment bank seeks to ensure that the company maximizes its ability to raise capital, and sustains its financial standing in order to ensure access to capital in the future. As underwriter in a firm commitment underwriting, the investment bank seeks to ensure that the offering is priced so that it will be able to sell all the securities it underwrites. At the same time, as financial adviser to institutional and public customers, the investment bank must evaluate the investment merits of securities being underwritten.

In order to protect customers of securities firms from adverse effects of conflicts of interest between firms' investment management advisory obligations to investors and their underwriting and market making obligations to issuers of securities, three basic tools are available. The first is disclosure, the second, the "Chinese Wall" and the third, the "restricted list."

Disclosure, statutorily or regulatorily imposed, reaches most, if not all, corners of securities firms and their dealings with clients where conflicts of interest may arise.

Numerous statutory and regulatory safeguards currently exist so that appropriate disclosure to the public is made regarding conflicts that may arise during transactions. */ For instance, in order to issue securities to the public, registration statements containing extensive disclosure relative to the new issue, as well as the issuer, its affiliates, and

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*/ Certain requirements imposed on broker-dealers acting in an underwriter, dealer or broker capacity are in place to ensure that the broker-dealer always discloses any self interest it has in the issuer of securities or any offering of securities. Disclosure is required when the broker-dealer has an interest in the distribution of the securities it is selling. 17 C.F.R. 240.15cl-6. See, also, 17 C.F.R. 15cl-5. Moreover, the self-regulatory organizations require broker-dealers to ascertain the suitability of any investment in securities for each customer. See, e.g., NASD Rules of Fair Practice, Section 2, NASD Manual (CCH) ¶ 2152 (1985) ("Recommendations to Customers"), NYSE Rules of Board, Rule 405, NYSE Guide (CCH) ¶ 2405 (1983) ("Know Your Customer Rule").

its personnel, are required pursuant to Section 7, 15 U.S.C. 77g, see Regulation S-K under the 1933 Act. The registration statement for any new issue of securities must include, among other information, the nature of the underwriter's interest in the issuer, if any, and the terms of the underwriter's arrangement to distribute the securities on behalf of an issuer. Underwriters are required to disclose, among other things, the nature of their relationship to the registrant. 17 C.F.R. 229.508(a). In addition, underwriters' compensation, 17 C.F.R. 229.508(e), any arrangement whereby the underwriter has the right to designate or nominate members of the registrant's board of directors, 17 C.F.R. 229.508(f), indemnification of underwriters, 17 C.F.R. 229.508(g), and compensation, including discounts and commissions paid to dealers, in any form in connection with the sale of securities, 17 C.F.R. 229.508(h), must be disclosed.

Additional disclosure is required when an investment banker assists in effecting a tender offer or a "going private" transaction. In this regard, both the tender offer rules and the "going private" transaction rules require the identification of any person retained or employed to make solicitations or recommendations with respect to the transaction and a description of the terms of such employment. */ This disclosure is designed

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*/ See Schedule 13E-3 (17 C.F.R. 240.13e-100), Schedule 14D-1 (17 C.F.R. 240.14d-100).

to provide shareholders with information about the nature and extent of any financial interest that an investment banker engaged to make solicitations or recommendations may have in the success or failure of the transaction.

In addition, all registered entities acting in a principal capacity are required to disclose to customers for whom transactions are effected, a variety of information regarding the transaction. For instance, Rule 10b-10 under the Securities Exchange Act ("Exchange Act") (17 C.F.R. 240.10b-10) requires disclosure of the amount of any markups or other remuneration received in connection with the transaction. The dealer must also disclose whether it is a market maker in the security, Rule 10b-10(a)(8), as well as information such as the date and time of the transaction and the type, amount and price of the securities purchased. Rule 10b-10(a)(1),(2). */

"Chinese Walls" are used widely by brokerage firms to impose an intrafirm separation of personnel and services, the overlap of which would otherwise create possible conflicts of interest. Brokerage firms employ "Chinese Walls" as compliance procedures to reduce the possibilities that any

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*/ See, also, Rule 15c1-5 under the Exchange Act (17 C.F.R. 240.15c1-5) (Disclosure of broker-dealer's control relationship with an issuer); Rule 15c1-6 under the Exchange Act (17 C.F.R. 240.15c1-6) (Disclosure of a broker-dealer's interest in a distribution).

employee will trade while in possession of inside information. */ The "Chinese Wall" generally takes the form of a separation of trading and investment banking functions. The separation extends from physical location of the operations, to bans on the exchange of information, in particular material nonpublic information regarding capital formation, merger and acquisition activity, and the financial health of investment banking clients. Depending on the circumstances, it may be appropriate to advise clients of the use of this technique, because institutions may not use confidential information for purposes other than those for which the information was intended.

Securities firms use the mechanism of a "restricted list" to avoid conflicts of interest that may adversely affect their clients. Restricted lists are employed to prohibit recommendations relating to solicitations of orders to purchase or sell investments in the restricted securities for a firm's own account. A security may be placed on a restricted list when a principal or department of a firm obtains material, nonpublic information, in which case restrictions on transactions in that security will be imposed until the information is made public. A security may also be placed on a restricted list when the firm enters into an investment banking or other relationship likely to lead to the firm's acquisition of material, nonpublic

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*/ See 17 C.F.R. 240.14e-3.

information. Under that procedure, transactions in the security will be restricted until that relationship is terminated. Many firms employ Chinese Walls and restricted lists together in order to reduce the likelihood of conflicts of interest arising.

An additional safeguard against conflicts of interest is statutorily imposed upon members of national securities exchanges. Section 11(a) of the Exchange Act prohibits any member of a national securities exchange from effecting transactions on any exchange to which it belongs for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion. 15 U.S.C. 78k(a). The prohibition of Section 11(a) generally restricts an exchange member from effecting its own orders before it effects orders for customers. This provision does not extend, however, to transactions by dealers acting as market makers or transactions for the accounts of natural persons, the estates of natural persons or trusts created by natural persons. Section 11(a)(1)(A)(e). In addition, Section 11(a) allows exchange members to effect transactions for their own accounts provided that their primary business is underwriting and distribution of other issuers' securities. Section 11(a)(1)(G).

A broker-dealer underwriting its own securities must employ additional safeguards from potential conflicts of interests. If an NASD member engages in a self-underwriting, it is required to distribute the securities at a price no higher or yield no lower than that recommended by a qualified independent underwriter. See NASD By-Laws Schedule E, Section 3, NASD Manual (CCH) ¶1755 (1985). A New York Stock Exchange member issuing its own securities is restricted in the secondary market from effecting any solicited trades in its securities, and may not recommend any of its securities or securities of any corporation controlling, controlled by or under common control with the member. NYSE Rules of Board Rule 312(g), NYSE Guide (CCH) ¶ 2312 (1983).

When a broker-dealer or an affiliate which is registered under the Investment Advisers Act of 1940 renders investment advice, the fiduciary obligations imposed by the Advisers Act help mitigate conflicts of interest between advisers and their clients. Fundamental to the Advisers Act is the concept that an investment adviser has a fiduciary obligation to act in the best interests of its clients. This fiduciary duty implies more than honesty and good faith alone. An adviser must disclose all relevant information and avoid, or obtain a client's consent to, any conflict of interest. The fiduciary obligation is intended "to eliminate, or at least expose," all potential or actual conflicts of interest "which might incline an investment adviser consciously or unconsciously -- to render advice which was not disinterested." */ The "delicate fiduciary nature

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*/ Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 91-92 (1963); see also Section 206 of the Advisers Act; Rule 204-3 under the Advisers Act.

of an investment advisory relationship" was reiterated in In the Matter of Alfred C. Rizzo, Investment Advisers Act Rel. No. 897 (Jan. 11, 1984), where the Commission stated that an adviser's duty to have a reasonable, independent basis for his investment advice flowed from such a fiduciary relationship. Other fiduciary principles to be kept in mind are the adviser's duty of (1) best execution (see Interfinancial Corporation, pub. avail. March 18, 1985), (2) suitability and (3) utmost and exclusive loyalty to the client.

The Investment Company Act of 1940 ("1940 Act") contains specific provisions that address the conflicts of interest that can arise when an affiliated person of an investment company enters into transactions with the investment company. For example, one potential for abuse is that an affiliated person could cause an investment company to buy from or sell property to the affiliate at an unfair price. Section 17(a) of the 1940 Act therefore generally prohibits any affiliated person, promoter or principal underwriter of an investment company from buying or selling securities or other property from or to an investment company unless the Commission approves the transaction. Under Section 17(d), affiliates and principal underwriters are barred from entering into joint transactions with a registered investment company unless the transaction complies with Commission rules designed to ensure that the transaction is not disadvantageous to the investment company. In addition, Section 17(e) regulates the extent to which an affiliated person may receive compensation for acting as an agent or broker in any transaction for the investment company.

Section 10 of the 1940 Act, by restricting the activities and composition of a registered investment company's board of directors, also helps guard against potential conflicts of interest. For example, Section 10(a) provides that no more than 60% of the board may be interested persons of the investment company. Also, Section 10(f) limits the extent to which an investment company may purchase securities when an affiliated person is a principal underwriter of the offering.

Section 36(a) of the 1940 Act authorizes the Commission to bring an action for "breach of fiduciary duty involving personal misconduct" against various people associated with an investment company. Courts have described Section 36(a) as a "reservoir of fiduciary obligations imposed upon affiliated persons to prevent gross misconduct or gross abuse of trust not otherwise specifically dealt with in the Act." */ Section 36(b) imposes

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*/ Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981); Brown v. Bullock, 194 F. Supp. 207, 238-39 n.1 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961).

An officer, director, member of an advisory board, investment adviser or depositor of a registered investment company, and the principal underwriter of a registered company if it is an open-end company, unit investment trust or face-amount certificate company, are all covered by Section 36(a).

a specific fiduciary duty upon the investment adviser of a registered company with respect to the fairness of compensation for services provided by the adviser. A breach of a fiduciary duty under Section 36 may be enjoined by a court of law. In addition, Section 36(b) provides a private right of action against the investment adviser or any persons enumerated in Section 36(a) who have a fiduciary duty with respect to payments made to the adviser. Section 36(a), in contrast, has no such express provision, although some courts have implied a private right of action.

If depository institutions were to engage more fully in securities underwriting, market making, and investment management and advisory services, the means of protection discussed above, and others, should be applied. This could be accomplished if securities activities of depository institutions were placed in appropriately regulated subsidiaries and affiliates. If depository institutions function as both commercial lenders and underwriters to issuers, however, it would give rise to additional conflicts of interest concerns. For example, a depository institution with substantial loans to an issuer could face a direct conflict of interest if it functioned as the investment banker raising capital for the issuer, especially if the capital were to go towards repaying loans to the depository. Conversely, a depository institution engaged in a troubled underwriting for a corporate client might be pressured to lend the issuer funds to rescue the offering. As a prerequisite to bank entry into these new areas, these concerns must be addressed through prohibitions and disclosures of overlapping relationships. Proper resolution of these and other concerns requires careful consideration.

<u>Question H.</u> <u>Limits on bank involvement</u>: If present statutory limits on bank and bank holding company involvement in securities activities are relaxed, where should the line be drawn? Should banks and their holding companies be limited to certain classes of securities, such as corporate and municipal debt, or would the principle of admitting banks to the securities markets be equally applicable to all classes of securities?

<u>Answer</u>.

The Commission supports permitting banks to underwrite municipal revenue bonds, and mutual funds, subject to the conditions outlined at page 2 of the Commission's written testimony. The Commission has not considered where the line should be drawn with respect to further expansion of bank securities activities.

<u>Question I</u>. <u>Who should regulate the securities market activities of banks</u>: If banks and other insured depository institutions are permitted by legislation to expand the range of their securities market activities, is it appropriate for Congress to assign the federal regulatory responsibility for these new activities to the same agencies that now oversee their traditional banking activities? If not, why not?

<u>Answer</u>.

The response to this question is set forth at pages 2-6 and 8-10 of the Commission's written testimony.

Question J. Direction of Inquiry: What key elements of additional factual background and analysis would you particularly recommend that the subcommittee seek to assemble in the coming months in order to develop a comprehensive body of evidence on these questions?

Answer.

The issues set forth in Chairman Barnard's letter of May 1, 1986 and his supplemental letter of May 6, 1986 requesting the compilation of certain data related to the underwriting, market making, and investment advisory activities of securities firms are extensive. The Commission has no suggestions for further areas of inquiry at this time.