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~~
July 23, 1986

Chairman Barnard and Members of the Subcommittee:

As the federal agency responsible for regulating the Nation's securities markets, the Securities and Exchange Commission appreciates this opportunity to testify in support of permitting banks to engage in certain additional securities activities, subject to certain conditions, which are intended to assure equality of competition.

Your letter of May 1, 1986 requested testimony concerning the many issues suggested by the possibility of legislative relaxation of the prohibitions of the Glass-Steagall Act to permit securities underwriting, market making and investment management by banks. This statement covers the Commission's views on the principles that should govern such reform. The specific questions raised in your letter are addressed in the Appendix hereto.

Proposals to Expand Bank Activities -- Recommendations

The Commission has supported, and continues to support, certain legislative and regulatory initiatives that would permit banks to expand certain of their activities, some of which were contained in S. 2851, the Financial Services Competitive Equity Act, sponsored by Senator Garn and passed by the Senate in 1984.

The Commission supports the Treasury's recommendations to permit banks to underwrite municipal revenue bonds, and mutual funds, subject to the following conditions:

First, banks should be required to conduct these new and their existing securities activities (such as underwriting government and general obligation municipal securities), in separate corporate affiliates within holding company structures.

Second, such separate corporate affiliates should be subject to the same regulations, administered by the same regulator (the SEC), as all others that engage in such activities.

Third, banks and their securities affiliates should be prohibited from suggesting by advertising or other means that the federal government, through federal deposit insurance, stands behind the obligations of the securities affiliates.

Fourth, the tax treatment of bank securities affiliates should be identical to that of broker-dealers.

Fifth, broker-dealers and investment advisers that engage in no greater securities activities than those permitted banks should be permitted to establish affiliates that engage in banking activities, subject to the same regulations, administered by the same regulators, as all others that engage in such banking activities. This would be a consequence of requiring new bank securities activities to be conducted through separate affiliates.

Discussion

Competitive Equality

The conditions suggested above are necessary for a number of reasons. Banks that engage in securities activities through separate affiliates registered under the Securities Exchange Act of 1934 would compete under the same rules and regulations, administered by the same regulator, as all others that engage in such activities. Registered broker-dealers are subject to certain examination, recordkeeping, training, advertising and other requirements for the protection of investors. Bank regulations emphasize the safety and soundness of banking institutions for the benefit of depositors.

The conditions would facilitate competition on the basis of economic merit, rather than regulatory classifications. The depository institution regulators could now promulgate similar regulations applicable to the depositories and their employees, but such regulations can be interpreted and enforced more uniformly and at lower cost by a single agency.

In addition, requiring banks to conduct their securities activities in separate corporate affiliates would address certain competitive inequities. For example, banks that underwrite and deal in municipal securities currently are permitted to deduct for tax purposes the interest costs of carrying their inventories, an advantage that is not available to broker-dealers. The House version of pending tax legislation would generally repeal this provision, but we understand that the Senate Finance Committee proposal would not.

Limitations on advertising relating to deposit insurance by bank affiliates engaging in securities activities are necessary to avoid confusing investors and others who deal with those subsidiaries.

Bank-sponsored mutual funds also should be subject to the requirements of the federal securities laws. Under current law, some collective investment products offered by banks are subject to the federal securities laws. Others are not. The federal securities statutes provide a comprehensive scheme of investor protections for mutual fund investors. The Securities Act of 1933 provides for disclosure of financial and business information that is relevant to investment decisions. The Investment Company Act of 1940 regulates, among other things, the composition and accountability of management to shareholders, the approval of investment advisory contracts, changes in fundamental investment policies, transactions between investment companies and affiliated persons, and investment companies' capital structures. The Investment Advisers Act of 1940 has antifraud provisions and disclosure and recordkeeping requirements.

Differences in the regulatory structure of functionally similar bank and investment company products are difficult to justify. Consideration should be given to including in bank securities affiliates common trust fund interests that are publicly advertised, and pooled employee benefit plans. Such a regulatory scheme need not mirror the Investment Company Act. But these vehicles should compete on the basis of their economic merits, rather than their regulatory classifications. */

Functional Regulation

The SEC's mandate is to protect investors and maintain fair and orderly securities markets. From that perspective, the Commission believes the reform of financial regulation should be governed by the principle of functional regulation. Functional regulation means that regulation should be by functional activities, rather than by outmoded industry classification, and fragmented regulation of essentially similar activities should be ended. Functional regulation would neither promote nor deter the crossing of traditional lines between the banking and securities industries. It would, however, ensure that public investors are protected by the securities laws regardless of the entity with which those investors choose to deal with respect to their securities transactions.

Many of the recommendations discussed above would implement the principle of functional regulation. In addition, the Commission has been guided by functional regulation in other regulatory

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*/ The General Accounting Office has recently completed a study of the different securities and banking regulatory schemes that apply to two types of pooled investment funds -- mutual funds and bank-sponsored collective investment funds for corporate employee benefit plan assets. That study does not, however, address the larger question whether it would be desirable to create a consistent regulatory scheme for all collective investment vehicles -- bank common trust funds, bank pooled Keogh as well as corporate employment benefit plans, and investment companies. See General Accounting Office, Functional Regulation: An Analysis of Two Types of Pooled Investment Funds (May 12, 1986).

and legislative initiatives concerning bank brokerage activities and bank and thrift financial reporting and disclosure.

Commission Rule 3b-9

The Commission adopted Rule 3b-9 under the Securities Exchange Act on July 1, 1985. The rule, which became effective on January 1, 1986, requires banks that conduct certain securities activities to do so through broker-dealers registered under the Act.

The Exchange Act requires all brokers and dealers to register with the Commission, unless exempt. The Act as a general matter excludes "banks" from the definitions of "broker" and "dealer." For many years following enactment of the Glass-Steagall Act, this was not a problem. Because of the prevailing interpretation of the restrictions imposed by that statute, banks limited their brokerage activities to accommodation transactions, primarily at cost, for their trust accounts and other customers.

But the nature of bank brokerage activities has changed. Banks now advertise their brokerage services to the general public and compete directly with traditional brokerage firms. One estimate indicates that this year banks will handle 16% of the volume of securities brokerage transactions and that their market share will reach 21% by 1990. */

The American Bankers Association has brought a suit challenging the Commission's authority to adopt Rule 3b-9. In

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*/ Arthur Andersen & Co. and the Bank Administration Institute, New Dimensions in Banking: Managing the Strategic Position 19 (1983).

October, 1985, the District Court for the District of Columbia upheld the Commission's authority. That decision is currently on appeal.

The Commission's authority to adopt Rule 3b-9 is based on several statutory provisions. All of the Exchange Act definitions are preceded by the phrase "unless the context otherwise requires." The Act also gives the Commission the authority to define terms and general authority to adopt rules necessary or appropriate to make the Act work. Because of the fundamental changes in the nature of bank securities activities since the the Act was adopted in 1934, the Commission has found that there are sound reasons to believe that Congress never intended to exclude these activities from securities regulation.

Rule 3b-9 leaves traditional bank accommodation services untouched. Instead, it focuses narrowly on three types of bank securities activities that are functionally indistinguishable from those which all others are required to register with the Commission in order to conduct. Rule 3b-9 requires a bank's securities activities to be conducted through a broker-dealer registered with the Commission if it (1) publicly solicits brokerage business for transaction-related compensation, (2) receives transaction-related compensation for providing brokerage services for trust, managing agency, or other accounts to which the bank provides advice, or (3) deals in or underwrites securities. At the same time, the rule contains numerous exemptions to accommodate traditional arrangements and services where Commission regulation is not necessary.

The Commission is not a bank regulator and does not wish to become one. Indeed, no banks have registered directly with the Commission under Rule 3b-9. Many banks already have set up securities affiliates registered with the Commission, and others are doing so.

Bush Task Group Proposals

Another area of regulatory disparity that requires reform is that of bank and thrift securities reporting and disclosure requirements.

The Bush Task Group's Blueprint for Reform, on which this Subcommittee held hearings in March 1985, contains the unanimous recommendations of the key financial and administrative agencies. */ The Task Group's report contains a number of important proposals that would simplify and improve the regulation of financial services.

Two important recommendations concern securities issued by banks and thrifts. The Task Group has recommended that:

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*/ See Bush Task Group Report on Regulation of Financial Services: Blueprint for Reform: Hearings Before a Subcommittee of the House Committee on Government Operations, 99th Cong., 1st Sess. (1985). The Task Group was composed of the Vice President, the Secretary of the Treasury, the heads of the Federal Reserve Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the National Credit Union Administration, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Department of Justice, the Council of Economic Advisers, and the Office of Management and Budget, and the Assistant to the President for Policy Development.

- Public offerings of securities (but not deposit instruments) by banks and thrifts should be subject to the registration requirements of the Securities Act; and
- Administration and enforcement of disclosure requirements under the Securities Exchange Act should be transferred exclusively to the Commission.

These amendments would consolidate within the Commission the financial disclosure requirements for all publicly-owned companies, as well as for all public offerings of securities. If adopted, they will 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, depending on whether they are owned by holding companies. There also may be differences in whether audits are conducted by independent public accountants. Each of the depository regulators has staff performing the functions handled by the Commission for the 11,000 other publicly-owned reporting companies.

Uniform accounting standards and disclosure requirements facilitate comparative analyses of investment alternatives among individual institutions, as well as between industry groups such as banks, savings and loan associations, finance companies and securities firms. Such comparative 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 disclosure to investors at lower cost. It would eliminate delays by the various agencies in conforming their regulations governing depository institution filings with those adopted by the Commission. It would also provide for equivalent access to information concerning banks and other publicly-owned companies. The Commission is in the process of implementing the Edgar electronic disclosure system, through which public filings will be available on home and office computer screens nationwide, to investors, the media and others on a real time basis. Absent repeal of Section 12(i), about 400 banks and 300 thrifts will be the only publicly-owned companies outside of the Edgar electronic disclosure system.

Conclusion

The Commission's primary mission is to protect investors and maintain fair and orderly securities markets. The Commission's jurisdiction and regulatory activities are generally not concerned with the scope of depository institution activities or the regulatory framework necessary to protect bank depositors. Increasingly, however, the lines of demarcation between the banking and securities industries are eroding. The Commission believes that amendments to the existing structure of financial services regulation should implement the concept of functional regulation -- that is, comparable functions should be subject to comparable regulation by the same regulators, regardless of the entities that perform such functions.