MEMORANDUM
OF THE SECURITIES AND EXCHANGE COMMISSION
TO THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE OF
THE HOUSE COMMITTEE ON ENERGY AND COMMERCE
CONCERNING
FINANCIAL SERVICES DEREGULATION AND REPEAL OF THE
GLASS-STEAGALL ACT

April 11, 1988

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I. INTRODUCTION

On October 5, 1987, Chairman Ruder testified before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce concerning possible reform of the financial services industry and related regulatory and supervisory issues. At that time, Congressman Markey, Chairman of the Subcommittee, requested that the Commission respond to the questions regarding policy and regulatory issues raised by possible repeal of the Glass-Steagall Act. On October 7, 1987, Chairman Markey sent Chairman Ruder a list of specific questions to be addressed in the Commission's response. Those questions address issues of bank safety and soundness, the competitive effects of deregulation, and various other regulatory issues.

This Memorandum sets forth the views of the Commission, as the agency primarily responsible for the protection of investors and the maintenance of fair and orderly securities markets, on the policy issues raised by bank securities activities. Answers to the specific questions posed in Chairman Markey's letter are attached as Appendix A to this Memorandum.

II. SUMMARY OF THE COMMISSION'S POSITION

The Commission endorses repeal of the Glass-Steagall Act, provided certain investor protection concerns arising from the entry of banks into securities activities are simultaneously addressed. The Commission also suggests certain additional reforms, but its support for repeal is not contingent on their adoption.

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

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

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

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

In order to ensure investor protection, any legislation repealing Glass-Steagall must require banks to conduct most of 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.

In addition, to achieve full functional regulation, securities registration and reporting requirements should be consolidated within the Commission for all publicly-owned banks and thrifts. Congress also should consider additional safeguards regarding other conflicts of interest and related investor protection concerns created by Glass-Steagall repeal. The Commission's support for repeal, however, is not conditioned upon enactment of legislation addressing these matters.

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

Any proposal to reform the banking and financial services system must address policies relating to the protection of investors and the maintenance of fair and orderly securities markets that arise with bank entry into the securities markets. These policies have long been declared essential to the financial health of the Nation and must be addressed in the current legislation. Any proposal for repeal must require 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 -- that is, those entities engaged in the business of effecting transactions in securities, either for their own account or for the account of others.

Banks have been exempt from broker-dealer regulation since the enactment of the Securities Exchange Act in 1934. In recent years, banks have expanded dramatically their securities activities, but have continued to operate outside of the regulatory scheme for registered broker-dealers. If Glass-Steagall is to be repealed, banks must be required to conduct 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 the self-regulatory organizations to which all registered broker-dealers must belong, such as the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange, to impose additional rules, which are subject to Commission approval. For example, the NASD must have rules governing the conduct of its members that are designed to prevent fraudulent and manipulative acts and practices, to promote equitable principles of trade, to perfect the mechanism of a free and open market, and to protect investors and the public interest. 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.

To ensure that broker-dealers can meet their financial responsibilities to their customers and to other market participants, all broker-dealers must comply with the Commission's net capital rule, which is designed to address the solvency of securities firms. The net capital rule requires that broker-dealers maintain at all times a minimum capital level. It requires broker-dealers computing their capital to value their assets at current market prices, rather than at historical values as banks are permitted to do. The rule also reduces capital allowances for large concentrations in particular securities. When a broker-dealer's net capital falls below required levels, it must immediately notify its regulators and cease operations unless additional capital is obtained. 1/

To ensure that securities professionals meet their fiduciary responsibilities toward investors, the Commission and the self-regulatory organizations have developed a comprehensive scheme for qualifying, examining, and supervising persons employed in the

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1/ Of course, bank regulatory agencies require that banks and bank holding companies maintain certain levels of capital. These capital rules, however, are not specifically designed with securities activities in mind. For example, banks are permitted to treat certain securities as "investment securities." A bank may, for purposes of evaluating its capital adequacy, value these securities at historical cost, while broker-dealers are required to use current market values even if those values are significantly lower than historical cost. If the bank needed to liquidate these securities quickly, as securities market participants often must, it would not be able to realize the values set forth in its stated capital.

industry. A registered broker-dealer's sales and supervisory personnel must meet the competency standards established by the Commission and the self-regulatory organizations. For example, registered representatives of firms that are members of the National Association of Securities Dealers who are engaged in sales and trading activities are tested for product and market knowledge, and registered principals responsible for management and supervision are examined for knowledge of the securities laws. These examinations protect investors by testing registered representatives concerning their knowledge about the products they recommend and sell to investors. Registered principals are tested regarding the laws and regulations for which they have compliance responsibility. In addition, the self-regulatory organizations review the backgrounds of those seeking employment in the industry because the federal securities laws provide that securities law violators may be barred or restricted from participation in the securities industry. 2/

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

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2/ Of course, banking laws also contain safeguards regarding the employment of banking personnel. For example, 12 U.S.C. 1829 bars any person convicted of a criminal offense involving dishonesty or a breach of trust from serving as an officer, director, or employee of an FDIC-insured bank without the written consent of the FDIC.

enforcement remedies available if brokerage firms fail to supervise their employees adequately to prevent violations of the securities laws.

As a further measure to promote compliance with the securities laws, the Commission imposes on registered broker-dealers an extensive examination and recordkeeping program. The Commission and the self-regulatory organizations inspect registered broker-dealers to enforce compliance with, among other things, financial responsibility requirements and maintenance of books and records. They also inspect to detect trading and sales practice abuses such as market manipulation, excessive or unauthorized trading, and unsuitable recommendations to customers. Additionally, Congress has provided the Commission with specific authority to review disciplinary sanctions against self-regulatory organization members to ensure that the self-regulatory organizations charged with statutory oversight responsibilities fulfill those responsibilities. This authority and the Commission's market regulation inspection and examination program, which audits surveillance and compliance programs of self-regulatory organizations, provide additional safeguards for investors.

The NASD's examination program is illustrative of the use of self-regulation organizations for inspection of registered broker-dealers. First, NASD inspections are conducted by a team of examiners specially trained to detect problems peculiar to the securities industry. Second, NASD inspections focus on, among other things, operational practices and seek to uncover abusive sales practices. Third, NASD members must make their books and records available to the Commission and the NASD on demand. Violations uncovered by NASD inspections can lead to significant sanctions, including suspension or expulsion from the industry and heavy fines. 3/

Broker-dealers must also comply with the detailed guidelines set by their self-regulatory organizations concerning the content and review of advertisements. 4/ These include requirements that all communications with the public be based on principles of fair dealing and good faith, and that such communications disclose all material information in a non-misleading manner. In addition to these general requirements, the NASD requires: (1) that all advertising materials be approved by a registered principal prior to their use; (2) that specific information be disclosed, including the name of the member, the preparer of the material, and the date on which the material was first published, circulated, or distributed, when materials are not current; and (3) that the advertisements exclude references that might imply

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3/ While banks are subject to careful inspections by the bank regulators, see, e.g., 12 C.F.R. 4.11 (national banks), those inspections are not primarily focused upon compliance with sales practice regulation and other securities law matters.

4/ In addition, the Commission recently adopted new rules and amendments to several rules and forms concerning advertising by open-end investment companies and insurance company separate accounts. The new rules and amendments require standardized computation of mutual fund performance data in advertisements and sales literature and require certain risk and other disclosure in sales material. Securities Act Release No. 6753, 53 Fed. Reg. 3868 (Feb. 10, 1988).

endorsement or approval of the securities being offered by the NASD or by any other regulatory body. The NASD reviews all advertisements to ensure compliance with its requirements.

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

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 activities without registering with the Commission as brokers or dealers. 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.

In 1934, when Congress excluded banks from the definitions of "broker" and "dealer" in the newly-enacted Exchange Act, it presumed that banks could not engage in retail brokerage business under the banking laws as interpreted by the banking regulators, a presumption that essentially remained unchallenged for forty years. In 1934, the only brokerage activities in which banks could engage were "accommodation" trades, that is, trades for existing bank customers on a not-for-profit basis. The Act's legislative history demonstrates that this restriction on bank entry into the brokerage business was one of the principal factors in Congress' decision to exclude banks from the Exchange Act's definitions of broker and dealer. 5/ In view of the limited nature of bank securities activities, Congress believed that subjecting banks to the full panoply of broker-dealer regulation was unnecessary.

In the 1980's, however, banks have emerged as a significant component of the retail brokerage market through their discount brokerage operations. Moreover, recent decisions of bank regulators have allowed banks to combine brokerage with investment advisory services, increasing the potential for improper sales practices and similar abuses. 6/ In addition, banks have become major participants in the distribution of mutual funds and unit investment trusts. 7/ More recent decisions have allowed banks to sell asset-backed securities to their customers,

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

6/ See, e.g., OCC Interpretive Letter No. 353, [1985-87] Fed. Banking L. Reptr. (CCH) ¶85,523 (July 30, 1985).

7/ See, e.g., OCC Interpretive Letter No. 363 [1985-87] Fed. Banking L. Reptr. (CCH) ¶85,533 (May 23, 1986) (sale of unit investment trusts).

in principal transactions. 8/ The involvement of banks in these activities, without Commission and self-regulatory organization oversight of banks' sales practices, advertising, and sales commissions, raises substantial investor protection concerns.

The regulation of bank securities activities under federal banking law is not an adequate substitute for Commission regulation. The primary purposes of federal banking law are the protection of depositors and the preservation of the safety and soundness of the banking system. Banking law is not directed at the protection of investors and the maintenance of fair and orderly securities markets. Banking law does not provide for the testing and supervision of employees who sell securities to the public, nor does it provide for pervasive examination of bank brokerage operations by personnel trained to detect problems peculiar to the securities markets. Banks are not required to be members of securities self-regulatory organizations and may advertise their brokerage operations outside the guidelines of the self-regulatory organizations. Neither SIPC nor the Federal Deposit Insurance Corporation insures the securities accounts of customers held at banks.

To provide for adequate regulation of bank securities activities, in July 1985, the Commission adopted Rule 3b-9. Rule 3b-9 required any bank engaged in the business of effecting

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8/ *See* Letter from Robert C. Clarke, Comptroller of the Currency, to Donald J. Crawford, Senior Vice President, Securities Industry Association [current] Fed. Banking L. Reptr. (CCH) ¶86,994 (June 16, 1987).

brokerage transactions, or dealing in or underwriting non-exempted securities as defined in the Exchange Act, to either register as a broker-dealer or enter into a contractual or other relationship under which a registered broker-dealer would in fact be the provider of such services. Following the Commission's adoption of Rule 3b-9, over 170 banks and bank holding companies established registered broker-dealer subsidiaries.

On November 4, 1986, the United States Court of Appeals for the District of Columbia Circuit held that the Commission did not have authority to promulgate Rule 3b-9. 9/ The Court of Appeals was sympathetic to the goals which the Commission was seeking to achieve and suggested that the appropriate course would be for Congress to address the issue.

The Commission continues to believe 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 to ensure complete and effective regulation of the securities markets, investor protection, and the maintenance of fair and orderly markets.

Such action would also increase the insulation of insured bank deposits from the risks of the securities markets, since securities affiliates would be subject to the Commission's net

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9/ American Bankers Association v. SEC, 804 F.2d 739 (D.C. Cir. 1986).

capital and other rules designed to address the solvency of securities firms.

3. The Proposed Bank Broker-Dealer Act -- S. 1175 and H.R. 2557

To address the concerns posed by current unregulated bank securities activities, the Commission has proposed that the Exchange Act's definitions of "broker" and "dealer" be amended to include banks that conduct certain securities activities. The proposed legislation, entitled the "Bank Broker-Dealer Act of 1987" was introduced in the Senate by Senator D'Amato on May 8, 1987, as S. 1175, and was introduced in the House by Congressman Markey on May 28, 1987, as H.R. 2557. These bills would include within the definitions of "broker" and "dealer" those banks that (1) publicly solicit brokerage business, (2) receive transaction-related compensation for brokerage services provided to advised accounts, or (3) deal in or underwrite securities. The substance of S. 1175 and H.R. 2557 should be included in any legislation allowing banks increased securities powers. 10/

These bills would amend Section 15(a) of the Exchange Act to provide that banks engaging in certain securities activities must do so through separate entities that are registered with the Commission. This would separate the regulation of a bank's securities activities from the regulation of the bank's banking activities. Without this requirement to establish a separate

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

entity, a bank engaging in securities activities could be subjected to conflicting regulatory requirements. For instance, a bank could find itself subject to both the Commission's net capital rule and its bank regulator's capital requirements. In addition, in the event of a liquidation of a bank, both the Securities Investor Protection Corporation and the Federal Deposit Insurance Corporation could find themselves charged with liquidating the same entity.

The Commission recognizes that there may be some bank securities activities that do not require extensive Commission oversight. Accordingly, the House and Senate bills would permit the Commission to exempt certain banks from the definitions of "broker" and "dealer," either unconditionally or subject to certain terms and conditions. The Commission would also retain its authority to exempt persons from the registration requirements of Section 15(a) of the Exchange Act. Under this exemptive power, activities that fall within the terms of the statutory provisions, but are not appropriate for Commission regulation, would be exempted.

4. <u>The Commission's Agreement with the Bank Regulators Concerning Bank Securities Activities.</u>

At the request of Senator Proxmire, Chairman of the Senate Banking Committee, the Commission has negotiated an agreement with the federal banking regulatory agencies concerning a proposed regulatory scheme for certain bank securities activities if Glass-

Steagall is repealed. 11/ Under this agreement, 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.

First, an exception from the "broker" definition would be provided for any bank effecting transactions for trust accounts, unless the bank received compensation in excess of the incremental costs of providing such services and publicly solicited that business other than in conjunction with advertising its other trust activities. This exception would not apply to securities safekeeping, self-directed Individual Retirement Accounts, managed agency accounts, or functionally equivalent accounts.

Second, an exception from the "broker" definition would be provided for bank "networking" arrangements by which 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 as registered representatives. Similarly, exceptions from the "broker" definition would be provided for bank "sweep" accounts, where bank depositors' funds are placed in money market funds,

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11/ The statutory amendments needed to effect the agreement may be found in Appendix C.

and for bank transactions for certain types of employee benefit accounts.

Third, any bank that effected transactions in commercial paper, or exempted securities other than municipal securities, would be exempted from the definition of "broker." Thus, a bank that effected transactions in government securities, commercial paper, bankers acceptances, or commercial bills would not be deemed to be a broker by virtue of such activities. Under current law, entities that effect transactions solely in commercial paper, bankers' acceptances, and commercial bills are not required to register as broker-dealers. Of course, any bank that engages in brokerage of government securities is subject to the regulatory scheme established by the Government Securities Act of 1986. That scheme of shared regulation established by the Act is adequate to address the more limited investor protection concerns that arise in that market. A similar exception would be provided from the definition of "dealer."

Fourth, an exception would be provided from the definition of "broker" for any bank conducting certain private placements of securities. This exception would permit a bank to effect private placements of securities with banks; insurance companies; small business investment companies; investment companies; business development companies; savings and loans; charitable organizations with total assets in excess of $5 million; foreign banks, brokers, dealers, insurance companies, governments or government agencies; certain employee benefit plans; corporations with total assets in excess of $50 million and net worth in excess of $5 million; and natural persons with a net worth exceeding $5 million. This exception would be limited to primary offerings on behalf of an issuer not involving a public offering.

Fifth, the compromise provides an exception from the definition of "broker" for any bank that effects transactions for the investment accounts of affiliates.

Sixth, the compromise would provide a de minimis exception from the definition of "broker" for a bank that effected fewer than 1,000 transactions annually.

Seventh, the compromise provides an exception from the definition of "dealer" for a bank that engaged in the issuance or sale of "securitized assets." This exception, however, would not apply to dealing in such securities and would only be available for those banks that do not have underwriting affiliates.

Eighth, the compromise would require banks that already have or choose to establish separate securities affiliates that engage in underwriting of corporate securities to transfer their 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 without registration as broker-dealers. 12/

12/ Under the Securities Acts Amendments of 1975, the Commission and the bank regulators presently share examination and enforcement authority over bank municipal securities dealers. This shared responsibility resulted from Congress' decision not to require banks to conduct municipal securities

(footnote continued)

Ninth, the compromise would give the Commission authority to exempt persons or classes of persons, including banks, from the definitions of "broker" and "dealer," either unconditionally or subject to certain terms or conditions. The Commission would also retain the authority to exempt persons from the broker-dealer registration requirements of Section 15(a) of the Exchange Act. This authority would allow the Commission to assure that activities that fall within the terms of the statutory provisions, but are more appropriately exempted from Commission oversight, are not subjected to unnecessary regulation. For example, it may be appropriate to use this authority to exempt entities subject to Section 15(e) of the Exchange Act.

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

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12/ (footnote continued)

activities in separate entities. Congress believed it would be burdensome for banks to have the Commission perform examinations of a bank's municipal securities activities that generally constituted only a small portion of a commercial bank's business. However, for those banks that choose to establish underwriting affiliates, moving municipal securities activities to these affiliates will entail little or no additional costs.

affiliates conduct unit investment trust and other investment company activities. 13/

The Investment Company Act provides for Commission regulation of activities of companies engaged primarily in investing, reinvesting, and trading in securities, and whose securities are sold to the investing public. The Act requires that nonexempt investment companies register with the Commission. 14/ In addition, the Act imposes rigorous, substantive restrictions on the structure, operations, and activities of registered investment companies designed to prevent the abuses that led to its enactment. Among other things, the Act prohibits investment companies from changing the nature of their business or certain of their investment policies without shareholder approval; bars persons that have committed securities law violations and certain other offenses from serving as employees, officers, directors, underwriters, and investment advisers; generally prevents persons affiliated with an investment company's underwriter or regular broker or with any investment banker from constituting a majority of the directors of that investment company; prohibits transactions between investment companies and their directors, officers, or affiliated companies or persons, except in compliance

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13/ 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.

14/ Investment companies that publicly offer securities must also register these securities under the Securities Act of 1933.

with Commission rules or when approved by the Commission; prohibits the issuance of senior securities (including all forms of borrowing) by investment companies except under specified conditions and terms; and imposes recordkeeping and periodic reporting requirements on investment companies.

The Investment Advisers Act requires that persons or firms compensated for advising others about securities investments register with and be subject to examination by the Commission. The substantive provisions designed to protect advisory clients include restrictions on performance fees and on principal and agency cross transactions. 15/

However, because the two Acts were drafted in the context of the separation between banking and securities mandated by the Glass-Steagall Act, they do not adequately address the conflicts and other investor protection concerns that will arise if banks are permitted to engage generally in the investment company business. The Commission's recommendations to address those concerns are set forth below. 16/

15/ A "performance fee" is designed as an investment advisory fee that varies with the adviser's success in managing a client's money -- a fee based on a share of the capital gains or appreciation of a client's funds. An "agency cross transaction" generally involves an arrangement where the adviser acts as broker to both an advisory client and another person on the other side of the transaction at the same time as the adviser acts as an investment adviser in relation to the transaction.

16/ The Commission's agreement with the bank regulators contains statutory language to effect these recommendations. See Appendix C.

1. Custody of Investment Company Assets

Sections 17 and 26 of the Investment Company Act should be amended to clarify and strengthen the Commission's authority to promulgate regulations governing how banks may serve as custodians of affiliated management investment companies and as trustees of affiliated unit investment trusts. The Investment Company Act currently requires every management investment company to maintain its securities and similar investments in the custody of a bank, or, subject to Commission rules, in the custody of a member of a national securities exchange or in the custody of the investment company itself. To minimize the opportunities for misuse of investment company assets, the Commission has used its rulemaking authority to impose stringent safeguards on self-custodianship by management investment companies and on broker-dealer custodianship.

Similarly, the Investment Company Act requires the trustee of a unit investment trust to be a bank meeting certain criteria. If a bank's securities affiliate were to act as the sponsor or underwriter of a unit investment trust, the Investment Company Act currently would permit the bank to act as trustee and to have custody of trust assets. Because of the nature of unit investment trusts, security holders must rely on the trustee to ensure that assets are safeguarded, disbursements are proper, and the trust otherwise operates in accordance with the trust indenture. Given the courses of dealing that develop between a sponsor and a trustee bank under the unit investment trust format, the independence of the bank trustee may be compromised if it is affiliated with the sponsor. For example, a sponsor could improperly influence the trustee's performance of its duties with respect to disbursements to the sponsor for services performed for the trust or in valuing units being redeemed by the sponsor. 17/

The Commission should be given 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.

2. Affiliated Transactions

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

The most basic of these conflicts would arise when the affiliated investment company invests in a corporation in order to further the bank's interests as a creditor of the corporation. In most circumstances, the bank's corporate borrower and the

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

investment company would not be "affiliated persons" for purposes of the Investment Company Act, and, thus, would not be subject to the Act's prohibitions against transactions between an investment company and its affiliated persons. Therefore, a bank-affiliated investment company could be used by the bank as a source of funds to bail out a financially troubled creditor. For example, a bank-affiliated investment company could purchase securities from a financially troubled corporation, and the proceeds of that purchase could be used by the corporation to repay its indebtedness to the bank. The bank would benefit by liquidating poor or illiquid loans at a potentially inflated price, but the investment company would be left with risky assets.

Accordingly, the Act must 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. 18/ To eliminate potential disadvantages to the shareholders of the investment company resulting from this prohibition, the Commission should be given the authority to exempt proposed transactions from such a provision.

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

3. <u>Borrowing from an Affiliated Bank</u>

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

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

4. <u>Advising Investment Companies</u>

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

Banks currently may serve as advisers to registered investment companies. However, because banks and bank holding companies are excluded from the Advisers Act definition of investment adviser, banks that advise investment companies are not subject to Advisers Act regulation. Although relatively few banks currently advise investment companies, that number is likely to increase if banks are permitted to underwrite and sponsor investment companies. Accordingly, the substantive regulatory gaps that exist with respect to bank advisory activities to investment companies should be closed. Imposing Advisers Act regulation on bank management of investment companies would close such gaps by, among other things, subjecting them to the Act's restrictions on performance fees and agency cross transactions. In order to regulate these activities effectively, the Commission should have authority to examine the activities of banks acting as advisers to investment companies for compliance with the Advisers Act.

Removing the exclusion for banks and bank holding companies from the Advisers Act definition of investment adviser would be consistent with Congress' removal in 1970 of certain Advisers Act exceptions that had previously been available to advisers to registered investment companies. These changes extended the bookkeeping and inspection requirements to all investment company advisers other than banks.

5. Independent Directors

Section 10(c) of the Investment currently provides that no registered investment company may have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank. This section should be amended to include, within the class of covered persons, directors, officers and employees of a bank holding company and any company affiliated with it. This amendment would eliminate the potential to circumvent the legislative intent of this subsection by a bank operating under a multiple bank holding company structure.

In addition, Investment Company Act Section 10(a) currently provides that at least 40 percent of an investment company's board of directors must be composed of individuals who are not "interested persons." Under current law, all registered brokers and dealers are "interested persons." Banks, however, may engage in certain securities transactions, such as transactions in government securities, without being deemed "interested persons." Accordingly, it is also necessary to amend the definition of "interested person" in Section 2(a)(19) of the Investment Company

Act to include within the term banks or other persons with certain other specified relationships to 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 should 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 was formed in 1982 to address problems arising from the convergence of the banking and securities industries, and the overlapping, duplicative, and conflicting regulation of agencies with jurisdiction over the financial services industries. The members of the Task Group consisted of the heads of the financial regulatory agencies, including former Commission Chairman John Shad. Two important Task Group recommendations concern securities issued by banks and thrifts. The Task Group unanimously recommended that 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). 19/

The Commission continues to support these recommendations, which would consolidate within the Commission the financial disclosure requirements for all publicly-owned companies, as well as for all public offerings of securities. 20/ 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

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

20/ Earlier this year, in its report on the financial guarantee market, the Commission reaffirmed its support for these Task Group recommendations and also endorsed the Task Group's recommendation for Commission exemptive authority under the Securities Act of 1933. Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in Section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities (August 28, 1987). The Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee recently made recommendations substantially similar to the Task Group recommendations regarding the treatment of bank and thrift securities. See House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, 100th Cong., 1st Sess., Consolidating the Administration and Enforcement of the Federal Securities Laws Within the Securities and Exchange Commission 1-4 (Comm. Print 1987).

there may be differences in disclosures relating to banks and thrifts, depending on whether they are owned by holding companies.

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 among individual institutions, as well as between industry groups such as banks, thrifts, finance companies, and securities firms. Such comparative analyses are fundamental to sound investment decisions and efficient securities markets.

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

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

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

If Glass-Steagall is repealed, conflicts of interest and related investor protection concerns similar to those which led to the enactment of the Act will arise. These concerns may not be fully addressed by a separate affiliate requirement. The Commission's recommendations regarding measures needed to address these investor protection concerns are set forth below. 21/

A. Misuse of Confidential Information

Congress should consider whether, and to what extent, the sharing of nonpublic information between banks and their securities affiliates should be prohibited. Both banks and broker-dealers currently strive to prevent the internal misuse of nonpublic information. Most securities firms use methods

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21/ Additional safeguards to prevent conflicts of interest, such as a prohibition on bank guarantees of securities underwritten by an affiliate, also should be considered in any legislation repealing the Glass-Steagall Act.

designed to restrict the flow of information between investment bankers engaged in financings and other transactional work, and traders and analysts. 22/ Similarly, banks attempt to maintain the separation between their commercial lending operations, their trust and other fiduciary operations, and traders responsible for banks' proprietary accounts.

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

Existing fiduciary law and antifraud principles may deter the sharing of nonpublic information between a bank and its

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22/ Most full-service securities firms employ "Chinese Walls" to restrict the exchange of information between investment banking, trading, and investment adviser departments. Securities firms may also use "restricted lists" that list the companies that the firm may be advising in a financial transaction, for which the firm may be underwriting an offering of securities, or with which the firm is negotiating a possible business relationship. Circulated on a regular basis, these lists generally prohibit firm employees from purchasing the listed companies' securities for the firm or themselves and from offering recommendations regarding the companies and their securities. Some securities firms also have "watch lists" that allow the firms to track the effectiveness of their Chinese Walls.

affiliates or subsidiaries. This is generally the case with securities firms. However, in view of banks' extensive access to sensitive corporate information arising from their corporate lending activities, and the new opportunities for misusing this information inherent in trading and underwriting corporate securities, additional restrictions may need to be placed on the sharing of customer and related information between banks and their securities affiliates. 23/

One approach would be to limit the flow of nonpublic customer information among affiliates without customer consent. That limitation alone, however, would allow nonpublic customer information to be shared by a bank, insured institution, or subsidiary with a securities affiliate, and vice versa, if the customer consents. It would protect institutions from claims that they have shared information without a customer's approval, but it would not protect against possible abuse of material nonpublic information that the customer has allowed to be communicated for a particular purpose.

Accordingly, Congress may wish to consider specifically authorizing the agencies that regulate banks, bank holding companies, and securities affiliates to adopt rules requiring

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23/ In addition, the Commission believes that, as a matter of good practice, holding companies should establish internal audit units to monitor the activities of the banks, lending affiliates, and underwriting affiliates, in order to protect against information flowing improperly among the affiliates, and against misuse of information in order to profit an affiliate, the holding company, or any other person.

these entities to adopt Chinese Wall procedures.

In addition, such rules should afford protection similar to the protection provided in Section 15(b)(4)(e) of the Securities Exchange Act 24/ to entities that adopt and properly implement such procedures.

B. Use of Underwritings to Dispose of Poor Loans

The conflicts of interest that will arise when a securities affiliate or subsidiary underwrites an offering of securities backed by the bank's own assets or the proceeds of which will be used to repay the bank for loans it has extended to an issuer should be addressed. Securitization of assets and offerings on behalf on bank borrowers raise a potential conflict between the underwriter's obligations to use due diligence in examining the offering and its desire to repay affiliates or other issuers through a successful offering. Such conflicts may result in inaccurate disclosure or pricing of the offering and heightened

24/ Section 15(b)(4)(e) of the Securities Exchange Act authorizes the Commission to censure, limit or suspend activities of, or revoke the license of, a broker or dealer that has willfully participated in a violation of the Federal securities laws, the Commodity Exchange Act, or rules or regulations under these statutes, or has failed reasonably to supervise, with a view of preventing violations, a person subject to the broker or dealer's supervision. However, no person is deemed to have failed reasonably to supervise any other person if established procedures, and a system for applying such procedures, exist, which would reasonably be expected to prevent and detect violations, and the supervising person has discharged his duties pursuant to such procedures without reasonabbble cause to believe that those he supervised had failed to comply with the procedures.

sales pressure during the distribution period. 25/

These conflicts are addressed under the federal securities laws by disclosure requirements. The federal securities laws require disclosure of the interests of, and relationships between, all parties, including the underwriter and its affiliates. Various provisions also require disclosure by the underwriter to its customers of its potential conflicts in concerning securities it is offering to sell. These disclosure requirements enable investors to assess the conflicts inherent in underwritings conducted on behalf of or to benefit an affiliate, subsidiary, or the underwriter itself. These requirements would apply to underwritings by bank securities affiliates or subsidiaries.

In addition, the NASD has recently proposed amendments to Schedule E of its By-laws to provide additional protections. Schedule E currently requires members distributing their own or their affiliates' securities to have an independent underwriter establish the price of the securities and conduct the necessary "due diligence" review, unless the offering is of investment grade debt or equity securities for which there is an existing, independent market. The NASD has proposed amending the Interpretation of the Board of Governors regarding Schedule E to require an independent underwriter's involvement if ten percent or more of

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

the proceeds of a public offering are directed to NASD members participating in the distribution of the offering. This proposed amendment is designed to cover offerings made to refinance bridge loans extended by a broker-dealer's affiliate.

Requirements of this sort could provide valuable protections where broker-dealers are underwriting securities of, or to benefit, affiliated banks. Similar requirements could be applied to offerings of interests in pools of securitized assets or mortgages of a bank affiliate, or to syndicated loans, such as problem foreign loans. If bank affiliates or subsidiaries are allowed to securitize the assets of affiliate banks and underwrite their securities, requirements similar to the NASD's proposal should be applied. 26/

26/ In its recent decisions interpreting Section 20 of Glass-Steagall, the Federal Reserve Board limited underwriting by bank-affiliated broker-dealers of securities backed by consumer receivables and conventional mortgages to situations in which the underlying assets do not originate from any affiliate of the underwriter. The Board imposed this limitation based on concerns that the incentives for a conflict of interest would otherwise be substantial, citing specifically "the temptation * * * that the affiliates' least creditworthy assets would be securitized." The Board rejected the argument that these conflicts are adequately addressed by the Commission's disclosure requirements and the NASD's rules. See Order Approving Applications to Engage in Limited Underwriting and Dealing in Consumer Receivable Related Securities, [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,021 (July 17, 1987); Order Conditionally Approving Application to Underwrite and Deal in Mortgage Related Securities to a Limited Extent, [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,027 (July 17, 1987); Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities, [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,957 (Apr. 30, 1987), aff'd, Securities Industry Association v. Board of Governors of the Federal Reserve System, No. 87-4041 (2d Cir. Feb. 8, 1988).

C. Placement of Underwritings in Controlled Accounts

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

Current federal banking law contains some general restrictions against self-dealing. State common law fiduciary standards are also applicable to banks acting as fiduciaries. Under federal banking law, purchases for trust accounts of securities underwritten by a bank or its affiliates are generally prohibited unless authorized by the governing trust instrument, by court order, or by the law of the jurisdiction under which the trust is administered. In addition, the Competitive Equality Banking Act of 1987 ("CEBA") added a new Section 23B to the Federal Reserve Act. That Section prohibits a bank from purchasing, either as principal or fiduciary, securities from an affiliate that is a principal underwriter of such securities, during the existence of any underwriting or selling syndicate, unless a majority of the outside directors of a bank has approved the purchase. 27/

Existing bank regulation, however, generally would permit

27/ The regulatory scheme under the federal securities laws for investment companies and investment advisers demonstrates one approach for dealing with these types of conflicts of interest. Although the Commission does not recommend that this approach be adopted as the regulatory framework for bank-affiliate dealings in this area, it may provide useful guidance. The Investment Company Act of 1940 and the Investment Advisers Act of 1940 contain specific provisions designed to protect investors from the special conflicts of interest that may exist between registered investment companies and their affiliates, and between investment advisers and their clients. Investment Company Act Section 17(a) generally prohibits an affiliated person or promoter of or principal underwriter for a registered investment company from buying or selling property or securities from or to the investment company unless the Commission approves the transaction (Rules 17a-1 through 17a-8 grant exemptive relief for certain transactions). Section 17(d) generally prohibits joint transactions between a registered investment company and any affiliated person of or principal underwriter for the company unless the Commission approves the transaction. Section 10(a) provides that no more than 60% of the board of directors may be interested persons of the investment company. Section 10(f) generally prohibits an investment company from purchasing securities when an affiliated person is a principal underwriter of the offering except as permitted by Commission rule or order (Rule 10f-3 permits certain investments, subject to price and quality restrictions and percentage limitations on the amount of the offering and the amount of the investment company's assets that are involved). Finally, Sections 36(a) and (b) authorize the Commission to bring an action against various persons associated with an investment company in the case of breach of fiduciary duty.

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

securities sold by a securities affiliate to be placed in a bank's trust accounts if authorized by the governing trust instruments. Boilerplate language in trust agreements may permit such transactions without further informed consent of trust beneficiaries. Also, there is little practical experience at this time regarding the operation of Section 23B of the Federal Reserve Act, which was enacted only a few months ago as part of CEBA.

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

D. Credit to Purchasers of Securities

Bank lending to promote sales of securities by affiliates or subsidiaries should be regulated. Through a combination of sales efforts and the provision of credit, a bank could encourage investors to purchase low quality or otherwise hard-to-sell issues being underwritten by its securities firm. In addition, banks could cause customers to over-extend themselves on credit in an effort to unload underwritten issues. The securities laws address these concerns through a temporary prohibition on extending credit for the purchase of underwritten securities. Section 11(d)(1) of the Exchange Act prohibits a broker-dealer from selling, or arranging for the sale of, a security on credit when the broker-dealer is also participating in a new issue distribution of the security. The prohibition extends for 30 days following the completion of the distribution. This prohibition applies when the broker-dealer's temptation to engage in sales promotion is greatest: when selling a new issue of securities during the initial underwriting period.

A similar prohibition should be extended to bank affiliates or subsidiaries of broker-dealers that would prohibit a bank from knowingly extending or arranging credit secured by, or for the purpose of purchasing, any security that is underwritten by a bank's securities firm during the underwriting period and for a period of 30 days thereafter. 28/

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

Section 7 of the Exchange Act grants to the Federal Reserve Board the authority to adopt rules and regulations to prevent the excessive use of credit in connection with the purchase or

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28/ In addition, it may be appropriate for any reform bill to provide expressly that banks have an affirmative obligation to verify that loans are not being used to purchase securities underwritten by the bank's securities firm.

carrying of securities. 29/ Under Section 7, the Federal Reserve Board has promulgated Regulation T, applicable to registered broker-dealers, and Regulation U, applicable to banks.

As a general matter, banks and securities firms lending funds to customers to be secured by "margin" securities or for the purpose of purchasing or carrying "margin" securities are subject to the same numerical margin requirements. However, securities firms are regulated more stringently under Regulation T than banks are regulated under Regulation U. Regulation T essentially limits the kinds of securities eligible for lending by broker-dealers to margin securities (i.e., listed equities and certain approved over-the-counter stocks). Under Regulation U, banks can loan money for a broader range of securities purchases and are accorded more flexible collateral requirements. 30/ Regulation U does not apply to purchases of non-margin stock; nor does it apply when the collateral used is other than stock even if the purpose of the loan is to purchase margin stock. In addition,

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29/ Section 7 does not apply to exempted securities.

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

banks can make unsecured loans for the purpose of purchasing securities. 31/

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

E. Disclosure

Securities affiliates and subsidiaries of banks must be required to provide clear disclosure to customers that the securities firm is a separate entity from the bank itself, and that the securities that are sold, offered, or recommended by the securities affiliate are not guaranteed by the bank or by federal deposit insurance. To address this problem, any reform proposal should require that bank securities affiliates or subsidiaries provide potential customers with disclosure statements clarifying

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

by the Commission.

V. CONCLUSION

The Commission will support proposals to 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. In addition to these prerequisite safeguards, the Commission recommends that the securities registration and reporting requirements of the securities laws should be consolidated within the Commission for all publicly-owned banks and thrifts. Congress should also consider providing additional safeguards to protect against conflicts of interest and related investor protection concerns arising from bank securities activities.

APPENDIX A

RESPONSES TO CHAIRMAN MARKEY'S LETTER OF OCTOBER 7, 1987

Questions 1, 2, and 3:

How practically can we insulate bank deposits from the securities activities of banks or their subsidiaries or affiliates? Even given such insulation, what risks would remain for the deposits?

On a broader scale, how can we ensure that the safety and soundness of the nation's banks will be preserved in a more fully deregulated (in Glass-Steagall terms) environment?

How can we minimize the risk to a bank of securities activities, either conducted by the bank, any affiliate, or a subsidiary? In particular, how can we ensure that such activities will not threaten the stability of the bank? What types of corporate and regulatory structures are more resistant to such risk, and to what degree will inherent risks remain?

Answer: The Commission's statutory mandate is to protect investors and to maintain fair and orderly securities markets. The safety and soundness of the nation's banking system is the responsibility of the banking regulators, not that of the Commission.

The Commission has recommended that, in order to address securities law policies and ensure investor protection, legislation repealing Glass-Steagall must require banks to conduct both their new and existing securities activities, subject to certain limited exceptions, in separate securities affiliates or subsidiaries subject to full Commission regulation. Although this recommendation is intended to address investor protection concerns, it also would serve to insulate banks from the risks of expanded securities activities. An insured bank's capital would not be directly affected if its securities affiliate or subsidiary were to suffer financial difficulties. The corporate separation between the securities affiliate or subsidiary and the bank should minimize the bank's exposure to the risks of securities activities.

Commentators have proposed alternative structures to minimize the risks to banks of expanded securities activities. The House Committee on Government Operations, in its 1987 report on banking reform, advocated permitting banks to engage in expanded securities activities only through separate affiliates within a financial services holding company structure. 1/ The Committee concluded that this structure would insulate each bank within the financial services holding company from all other parts of the holding company. The Committee also concluded that the federal insurance protection of the bank's deposits would not directly or indirectly protect any other part of the holding company, and neither the bank itself nor the Federal Deposit Insurance Corporation would be put at risk of loss on account of the affairs of any other part of the holding company. 2/

Others have suggested that a holding company structure is not necessary. For example, the Federal Deposit Insurance Corporation in its report on restructuring the banking industry

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1/ *See* House Comm. on Gov't Operations, *Modernization of the Financial Services Industry: A Plan for Capital Mobility within a Framework of Safe and Sound Banking*, H.R. Rep. No. 324, 100th Cong., 1st Sess. 74-76 (1987).

2/ *Id*. at 75.

found that a bank may be effectively insulated if risky new activities are placed in either subsidiaries or affiliates of the bank and procedures are established to ensure that the operations of the bank and its affiliates or subsidiaries are conducted in truly separate corporate entities. 3/ The FDIC concluded that this would ensure that the banking system would remain safe and sound and that the bank would remain viable regardless of the condition of the bank's affiliates and subsidiaries. 4/

The General Accounting Office, in its report on the appropriate structure for insulating banks, observed that subsidiaries of banks and bank holding companies generally provide legal and economic protection to bank deposits from the risk of new activities, although neither structure fully protects against market perception risks. 5/ However, the General Accounting Office did not recommend any particular structure, concluding as follows:

> One cannot say that one structure insulates the bank while another does not. Rather, we found that the structure under which non-traditional activities are conducted falls along a continuum with increasing degrees of insulation provided the bank. Some organizational structures provide for greater

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3/ See FDIC, Mandate for Change: Restructuring the Banking Industry xi-xii, 74-75 (1987).

4/ Id. at 75.

5/ See GAO, Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities 4, 27-35 (1987).

> insulation than others. However, we found in practice that even the same type of structure could operate very differently and provide varying degrees of insulation, depending on the expanded activity conducted and the way it was implemented by management * * *. When Congress is considering giving banks expanded powers, it should recognize these differences and also that no one structure can provide a guarantee that an organizational structure will automatically protect the bank from the risks of the expanded powers. 6/

Question 4: In what ways will our national economy and the interests of our citizens be served if banks, their subsidiaries or affiliates are allowed to participate broadly in securities activities?

Answer: The repeal of the Glass-Steagall Act, if accompanied by adequate safeguards, could be beneficial for the U.S. economy and its citizens. Repeal of Glass-Steagall appears likely to increase competition in both the securities and the banking industries. Such increased competition may lower costs and increase the availability of various financial services and products. Repeal may also help enhance the competitive position of the U.S. economy, as is more fully discussed in the answer to Question 8 at pp. A-13 to A-14.

These benefits may be offset, however, if Glass-Steagall repeal is not accompanied by adequate regulation of bank securities activities. Certain of the pending proposals to repeal Glass-Steagall would not provide this adequate regulation. Of particular concern are those proposals that would permit banks

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6/ *Id*. at 36.

to expand the types of securities activities they could conduct directly within the bank without being subject to the full scope of the securities laws. The securities laws are designed to protect investors and to maintain fair and orderly markets. They accomplish this by a regulatory scheme that includes: (1) full and fair disclosure in the purchase of securities; (2) registration and regulation of all broker-dealer activity; and (3) protection against conflicts of interest and dishonest practices in the sale of interests in and management of professionally managed pools of capital.

To provide for adequate regulation of bank securities activities, the Commission has made a number of recommendations at pp. 13-27 of the Memorandum.

Question 5: In what ways will our product-line deregulation or financial services sector restructuring enhance the international competitiveness of the U.S. capital markets?

Answer: The prohibitions of Glass-Steagall may hinder the competitiveness of the foreign affiliates of United States banks and securities firms. Although United States banks and securities firms are free to engage abroad in activities prohibited domestically (*i.e.*, foreign affiliates of American banks can engage in securities activities, and foreign affiliates of United States securities firms may conduct commercial banking activities), securities firms cannot develop expertise in banking domestically before engaging in banking activities abroad.

Similarly, banks are unable to develop expertise in securities activities domestically before conducting such activities abroad.

Foreign banks are capturing an increasing share of the world banking market. In 1970, for example, there were seven U.S. banks in the largest 25; by 1985, there were only three. 7/ It has been suggested that the relatively small capitalization of United States banks hinders the ability of banks to compete with their foreign competitors. 8/ If United States banks had a larger capital base, it is argued, they would be better able to offer services at competitive fees and to absorb losses from the risks inherent in increasingly volatile markets. 9/ While several factors account for the smaller size of United States banks, many observers believe that regulatory factors, such as the broader product and service authority of foreign banks, give foreign banks a more diversified earnings base, allowing them to accumulate capital. 10/

7/ American Bankers Association, Expanded Products and Services for Banking: The Public Policy Perspective 12 (1986) (citing Am. Banker, July 30, 1986, July 30, 1971).

8/ See Gould, Arthritic Laws are Crippling United States Banks, N.Y. Times, Aug. 12, 1987, at 23.

9/ Id.

10/ Id. It should be noted, however, that the Glass-Steagall Act may have had a number of positive benefits in the area of international competitiveness of United States markets.

(footnote continued)

Moreover, if Glass-Steagall repeal results in greater competition in the United States capital markets, it should result in lower transaction and other costs and promote product innovation. These results should increase the attractiveness of our markets as compared to foreign markets and would encourage domestic and foreign issuers and investors to use the United States markets.

Question 6: **What problems have arisen as a result of the relatively free hand that U.S. commercial banks and bank holding companies have had in the international arena with regard to securities activities? Have there been any failures or financial difficulties encountered by these banks, their affiliates or subsidiaries? How have the foreign operations of these banks enhanced the competitiveness or asset base of the domestic bank and of the holding company?**

10/ (footnote continued)

The statutorily enforced separation of commercial and investment banking may have been a significant factor in the development of an independent securities industry and a regulatory framework that encourages innovation in the provision of financial services. See Address by Gill, Director of the Capital Markets Department of the International Finance Corporation, "Take Off Time for Thailand's Capital Market," Bangkok, (November 28-29, 1984). See also OECD Report: The Committee on Financial Markets International Trade in Services: Securities, at 13-15 (1987). The United States and Japan (which has laws similar to Glass-Steagall that separate commercial and investment banking) together account for a majority of the world's equity markets capitalization. See Internationalization of the Securities Markets: Report of the Staff of the U.S. Securities and Exchange Commission to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Energy and Commerce at II-16-17 (July 27, 1987).

Answer: The Commission has little information regarding the overseas operations of United States banking organizations, because the Commission has only limited regulatory authority over the operations of commercial banks and holding companies. 11/ Based on the information available to it, the Commission is not aware of any significant problems that have arisen as a result of the overseas securities activities of United States commercial banks and bank holding companies. It should also be noted, however, that the major United States banking organizations may not have engaged in overseas securities activities long enough to draw any meaningful conclusions on the overall effect of such activities.

The Commission does not regulate U.S. commercial banks' securities operations either domestically or abroad. As discussed at pp. 9-13 of the Memorandum, the Securities Exchange Act of 1934 excludes banks from the definition of "broker" and "dealer." In addition, as discussed at pp. 27-29 of the Memorandum, publicly-held banks file their periodic reports with the banking regulators, not the Commission. Publicly-held bank holding companies, however, file their periodic reports with the Commission. Thus, the Commission would receive information regarding a bank holding company's losses from foreign securities

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11/ In addition, the Commission has no direct authority over the overseas operations of United States securities firms, if those activities are conducted by separate affiliates of the United States firms.

activities if such losses were substantial enough to be material to the company's overall operations.

An unprecedented number of major deregulatory initiatives in the past two years have enabled United States banking organizations to expand their overseas operations and enter new areas of the securities business. The most significant change occurred in October 1986 when the United Kingdom's "Big Bang" abolished fixed commission rates, ended the traditional separation of order taking by brokers from market making by dealers, and permitted foreign ownership of British securities firms and participation in the British government bond business. A number of other European nations, including France, Germany, and Spain, have also taken steps to open their markets in an effort to copy the United Kingdom's success. In addition, 1987 saw the first real movement by Japanese officials to open their markets to United States firms. Finally, Canadian regulators have taken major steps toward relaxing the barriers between various aspects of the securities and banking businesses in their country.

The Commission is aware of two cases of financial difficulties encountered by United States bank holding company affiliates overseas, neither of which appears to have involved an entity registered with the Commission or to have endangered the financial integrity of the Unites States bank holding company. According to the Comptroller of the Currency, following the

October 1987 market break, "Security Pacific's London stock brokering affiliate experienced losses and the Bank of England requested a capital injection." 12/ The losses apparently did not present any risk to Security Pacific National Bank or the holding company.

In addition, Citicorp's European operations were reported to have lost at least $25 million following the market break. 13/ These losses reportedly resulted from violations of Citicorp's internal regulations by one or more members of the Dublin equity and bond trading unit. The losses do not appear to have reached the level of magnitude that would require disclosure in periodic reports under the securities laws.

Question 7: **What are the likely competitive consequences of product deregulation/structural reform? In particular, will there be a differential impact on small versus large banks? Will there be increased market concentration in the banking industry as a result? Explain whether such concentration is undesirable. What will be the impact on concentration in the securities industry? Should there be limitations placed on the kinds of affiliates, by asset size, for example, between commercial banks and securities firms?**

Answer: The Commission does not regulate banks. Accordingly, questions concerning the competitive effects on banks are more

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12/ Office of the Comptroller of the Currency, Issues in Financial Reform (Dec. 3, 1987).

13/ Day, "Citicorp Said to Suffer Trading Losses," Wash. Post, Dec. 13, 1987, at A51; Bus. Wk. Dec. 21, 1987, at 40.

properly addressed by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. With regard to the securities industry, the competitive consequences of reform are difficult to predict.

Because the American banking industry is much larger than the securities industry, repeal of the Glass-Steagall Act may lead to domination of the securities markets by banking organizations. As of December 31, 1986, the total equity capital of insured banks amounted to $179.8 billion, 14/ as compared to only $31 billion for broker-dealers. 15/

If Glass-Steagall is repealed, commercial banks that already own broker-dealers are likely to expand their securities activities. Currently, approximately 250 broker-dealers are owned by banks or bank holding companies. Other commercial banks may follow suit by establishing *de novo* securities affiliates or by buying existing securities firms.

Some securities firms may also purchase or establish banks. These are likely to be large securities firms that have sufficient capital to establish or purchase depository

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14/ 73 *Fed. Res. Bull*. 77 (July 1987).

15/ 46 *SEC Monthly Statistical Rev*. 5, (Aug. 1987).

institutions. 16/ However, as noted in the answers to Questions 8 and 14, if the Bank Holding Company Act is not amended to permit entities which own minimal banking operations to retain their insurance, real estate, and certain other operations that bank holding companies currently are prohibited from owning, most large securities firms will be precluded from acquiring banks, unless they drop these operations. 17/

The financial services industry is among the most competitive in the economy. An increase in concentration would be undesirable if it results in excessive risk taking or other behavior that would tend to undermine the integrity and stability of our financial markets. A modest increase in concentration would be acceptable, however, if it contributes to the efficiency, stability and integrity of our financial markets.

One proposal to repeal Glass-Steagall, S. 1886, the

16/ Analyses of economies of scale in the commercial banking industry suggest that a broker-dealer would need at least $800,000 of capital to establish a bank. Less than ten percent of broker-dealers now doing a public business have this amount of capital.

17/ To the extent that smaller firms would be at a competitive disadvantage, these firms might consolidate with larger firms or compete in specialized niches within the financial services industry. Many securities firms responded in this manner to the competitive pressures created by the deregulation of commission rates.

"Financial Modernization Act of 1987," 18/ as introduced contains restrictions that would prevent mergers between the 15 largest banks and the 15 largest securities firms in order to prevent undue concentration. The Commission notes that this provision may be unnecessary since federal antitrust regulators would be able to review proposed affiliations between banks and securities firms in order to prevent mergers having anticompetitive effects.

Question 8: Should securities firms be permitted to engage more broadly in traditional banking activities? Are there any particular banking activities that it would be in the nation's interest to participate in? What effect would this have on competition within the banking industry?

Answer: The Commission believes that if banks are permitted to engage in securities activities, securities firms should be allowed to engage in the full range of banking activities, subject to banking regulation. This is a logical consequence of Glass-Steagall repeal and would provide for fair competition between financial services firms.

Some of the proposed bills to repeal the Glass-Steagall Act would retain the Bank Holding Company Act's current restriction on activities not "closely related to banking." For example, S. 1886 as introduced contains a limited exemption from the

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18/ S. 1886, 100th Cong., 2d Sess. (1988). A similar bill has been introduced in the House of Representatives as H.R. 3800.

examination, reporting and oversight authority of the Federal Reserve Board for holding companies deriving 80% or more of their revenues from, and devoting 80% or more of their assets to, securities activities. However, holding companies that qualify for this limited exemption would continue to be subject to the Bank Holding Company Act's restrictions on permissible nonbanking activities. Since many of the larger securities firms currently engage in such nonbanking activities as insurance, real estate, and commodities futures brokerage, the continued separation of banking and commerce could create two classes of securities firms, one which engages only in securities and banking activities, and the other which engages in securities and all other types of activities except banking. As stated in the answer to Question 14 at pp. A-19 to A-22, the Commission believes that Congress should consider an exemption from this restriction for holding companies that engage in only limited banking activities.

<u>Question 9:</u> **How can we prevent tie-ins and other coercive forms of merchandising for banks' or securities firms' deregulated products? Is there any structural way by which we can eliminate such concerns or must we monitor or supervise them? What sorts of regulatory resources will such monitoring require?**

<u>Answer:</u> The segregation of financial institutions may have tended to limit the potential for tie-ins. Current proposals to allow financial institutions to engage in both banking and finance increase the potential for the introduction of joint marketing programs where banking customers can conduct "one-stop" shopping for the financial services and products they need. Most consumer and commercial sales involve the combinations of products that normally fulfill the purchaser's requirements (e.g., consumer appliances accompanied by servicing contracts; computer hardware sold with software). The ability to offer various financial products and services generally should be beneficial for consumers, since they will be able to obtain all their financial services at one location and reduce the time needed to gather information and purchase a variety of different services and products.

However, if the level of competition among providers of financial services is inadequate, coercive tie-ins may result. Consumers may be required to purchase products they do not want in order to receive services or products they need. In the banking area, concerns have been raised that a bank may condition the availability of credit on a prospective borrower's purchase of securities services from the bank's affiliate or subsidiary. Even where no formal requirements are imposed, potential borrowers may feel obligated to use a bank's securities services in order to maintain their access to the bank's credit, especially in times of tight money.

The best way to prevent coercive tie-ins is through competition. Because of the concern that tight money may reduce competition in the banking area, Congress included a provision to prevent tie-ins in the Bank Holding Company Act Amendments of 1970. These provisions generally hold banking organizations to a higher standard of care than other types of businesses. Section 106(b) of the Bank Holding Company Act Amendments of 1970 19/ prohibits a bank from conditioning extensions of credit or other services upon a requirement that additional services be obtained from or provided to the bank, its bank holding company, a subsidiary of the bank, or a subsidiary of the bank holding company. 20/

While this provision and the antitrust laws discourage coercive marketing activities by banks, the federal banking and antitrust regulators will need to continue to monitor banking practices in order to ensure that tie-in practices are not occurring. However, so long as the present level of competitiveness continues to exist in the banking industry, the amount of regulatory agency resources required to supervise bank marketing practices should be small.

Question 10. How should the bank and its affiliates be structured so as to restrict the flow of confidential information? Similarly, if securities firms enter the banking business, what structural modification would be required to

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19/ 12 U.S.C. 1972.

20/ The Competitive Equality Banking Act of 1987, § 101, Pub. L. No. 100-86, 101 Stat. 552 (1987) extends the coverage of the Bank Holding Company Act by including certain nonbank banks and other entities within the tie-in provisions of Section 106.

restrict the flow of confidential information? What are the risks of failing properly to restrict such flow?

__Answer__: The Commission's recommendations concerning the potential for misuse of confidential information by banks and their securities affiliates or subsidiaries are set forth at pp. 30-33 of the Memorandum.

__Question 11__: **To what extent should joint marketing of services be permitted?**

__Answer__: The Commission believes that joint marketing is appropriate, if adequate regulatory safeguards are provided to provide for investor protection. One important safeguard is that bank employees participating in "networking" arrangements between a bank and a registered broker-dealer and performing other than ministerial and clerical functions in connection with the offer or sale of securities would be considered to be "associated persons" of the bank securities affiliate. As associated persons, these employees would be required to meet the competency standards of the self-regulatory organizations, and the securities affiliate would be responsible for supervising the activities of these employees.

The Commission also recommends that any legislation repealing Glass-Steagall require that a bank provide its customers with disclosures clarifying the affiliate's separate status, and authorize the Commission to require disclosure to make plain that an investment company affiliated with a bank is not insured by FDIC or FSLIC. These recommendations are discussed at pp. 27 and 41-42 of the Memorandum.

<u>Question 12:</u> Is it necessary to have complete separation of officers, directors, and premises?

<u>Answer:</u> From the standpoint of investor protection, complete separation of officers, directors and premises does not appear to be necessary. However, to prevent customer confusion, the Commission has endorsed a provision in S. 1886 that would require a bank's securities affiliate or subsidiary to disclose to its customers, pursuant to regulations promulgated by the Commission, that it is separate from its affiliated bank, and that the securities that it sells, offers, or recommends are not guaranteed by its affiliated bank or by federal deposit insurance. Moreover, as discussed at pp. 26-27 of the Memorandum, if banks are allowed to engage in investment company activities, the Commission recommends that the Investment Company Act be amended to require that the majority of the board of directors of any investment company affiliated with a bank consists of directors independent from the bank and its affiliates.

In addition, for safety and soundness reasons, Congress may wish to require a degree of separation between the officers, directors, and premises of a bank and its securities affiliate or subsidiary to ensure corporate separateness. This legal separateness is essential to avoid the risk that a court will pierce the corporate veil and hold the bank liable for the obligations of its affiliate or subsidiary.

<u>Question 13</u>: How should current laws that restrict transactions among affiliates be amended in order to provide the enhanced protection that product deregulation may necessitate?

<u>Answer</u>: The Commission believes that, if banks are to engage in investment company activities, the Investment Company Act and Investment Advisers Act must be amended to address the conflicts of interests and other investor protection concerns that will arise. The Commission's recommendations for such amendments are set forth at pp. 18-27 of the Memorandum. Many of these amendments would address transactions among banks, their affiliates, and investment companies that they organize, sponsor, control, underwrite, or advise.

With respect to the question of transactions among banks and their securities affiliates generally, the Commission's suggestions for amendments to address conflicts of interest and related investor protection concerns are set forth at pp. 29-42 of the Memorandum.

Congress may also wish to consider other restrictions to protect the safety and soundness of banks.

<u>Question 14</u>: Finally, many observers and some commentators on these issues confuse deregulation with a lack of supervision; at times they use the terms synonymously. I reject this approach. If Congress determines that the national interest is best served by additional product-line deregulation in the commercial banking and securities industries, I believe that federal

supervision of these developments will be critical, at least during the early years. Therefore, please include in your report the types and extent of supervision that will be required under your plan, and identify the entities best suited to undertake such supervision.

Answer: Financial services should be regulated by functional activities, rather than by industry classification. As discussed more fully at pp. 3-18 of the Memorandum, the Commission has suggested amendments to the Securities Exchange Act to provide for Commission regulation of bank securities activities. These amendments would require that those activities be conducted under the regulatory scheme for broker-dealers which Congress designed to ensure the protection of investors.

By the same token, banking activities of securities firms should be conducted in separate entities, subject to regulation by banking authorities under state and federal banking laws. The Commission does not take a position on whether bank securities activities should be conducted within subsidiaries of bank holding companies or direct subsidiaries of banks.

Some studies have suggested that adequate supervision of a financial services organization may be achieved by regulating only the subsidiaries of holding companies and not holding companies themselves. 21/ Others have suggested that integrated financial services activities should be required to be conducted in holding company form, with one regulator having a degree of

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21/ See, e.g., FDIC, supra note 3, at 86-97.

oversight over the entity as a whole. 22/ Still others have advocated that oversight of financial services holding companies be restricted, except as is required for effective insulation. Otherwise, it is argued, such regulation could result in operating restrictions or regulatory burdens for component units of holding companies that are greater than those to which independent companies were subject. 23/

The Commission believes that if holding company regulation is deemed necessary, consideration should be given to providing differing regulation for holding companies primarily engaged in securities activities. Because the Bank Holding Company Act's provisions are concerned primarily with the safety and soundness of banks, a holding company should only be fully subject to that Act where the company's banking activities are substantial. Accordingly, the Commission recommends that an exemption would be appropriate for holding companies that devote less than a certain percentage of their capital to, and derive less than a certain percentage of their revenue from, banking activities. Otherwise, holding companies that were primarily engaged in securities activities and also had significant subsidiaries engaged in other permissible nonbanking activities (such as certain insurance or real estate activities) could become subject to full Bank Holding

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22/ *See, e.g.*, Corrigan, *Financial Market Structure: A Longer View* 43 (Jan. 1987).

23/ *See* House Comm. on Gov't Operations, *supra* note 1, at 75.

Company Act regulation even if their banking activities were *de minimis*. 24/

Also, if it is deemed necessary to authorize a single federal regulator to regulate bank holding companies that have securities subsidiaries, the holding company regulator should be directed to coordinate with the Commission and to consider not only the safety and soundness of banks and the banking system, but also concerns related to orderly securities markets, the protection of the SIPC fund, and investor protection. Moreover, a holding company regulator should have no authority to regulate disclosures of publicly-owned holding companies through the securities registration and reporting process.

24/ On March 2, 1988, the Senate Committee on Banking, Housing, and Urban Affairs voted to report S. 1886 to the full Senate. As approved by the Committee, the bill contains an exemption from bank holding company regulation for "diversified financial holding companies." Such companies would be those that engage exclusively in specific financial activities and devote less than 20% of their assets to insured banks and thrifts. The Commission takes no position at this time on the question whether this exemption provides sufficient relief from bank holding company regulation. It might, for instance, be appropriate to remove the "exclusively in specific financial activities" limitation on the exemption.

APPENDIX B

OTHER MATTERS THAT CONGRESS SHOULD CONSIDER IN CONNECTION WITH THE REPEAL OF GLASS-STEAGALL

Implementation of the Recommendations of Vice President Bush's Task Group on Regulation of Financial Services

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

- transfer administration and enforcement of disclosure requirements under the Securities Exchange Act exclusively to the Commission by repealing Section 12(i).

Conflicts of Interest and Related Investor Protection Concerns Arising from Bank Securities Activities

- consider means to limit the improper sharing of confidential client information among units of a diversified financial services company;

- examine potential conflicts of interest arising out of bank underwriting activities of securitized assets and of securities of bank borrowers;

- examine the conflicts of interest arising in transactions between bank trust departments and affiliated entities;

- consider prohibitions on banks from extending or arranging credit secured by, or for the purpose of purchasing, any security that is underwritten by a bank's securities affiliate or in which the affiliate is an active participant; and

- examine the possibility of requiring disclosure statements clarifying a bank affiliate's separate status.