

NEWS

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

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Remarks to
Association of Bank Holding Companies
Mayflower Hotel
Washington, D.C.
November 13, 1980

"Investment Management and the Glass-Steagall Act --
The Emperor's New Clothes"

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Evolution in the financial markets has outpaced our regulatory structure in form and in concept. I have elsewhere examined the implications of these changes for government regulators. Today, I would like to discuss another aspect of the impact of this evolution: the Glass-Steagall Act and, in particular, its application to investment management by banks.

It is very plain that the financial markets have changed so much that it is no longer possible to deal with the question of bank securities activities by simply invoking the talisman that Congress decided in 1933 to separate commercial banking and investment banking.

The lines drawn by the Congress in the Glass-Steagall Act zigged and zagged, and the result has shaped the banking industry. The internal contradictions of the compromises of 1933 -- for example, the decision not to separate commercial banking and trust activities, and the fact that banks may both invest in and underwrite municipal general obligation bonds, but may only invest in municipal revenue bonds -- have come to haunt the defenders of those boundary lines. Those contradictions, coupled with the development of new services and instruments by all intermediaries in the financial markets, mean that some, but by no means all, of the boundary lines may no longer serve any meaningful public policy function -- although they still have important competitive consequences.

In the area of investment management, these developments raise a number of questions:

- should banks and savings institutions continue to be excluded from mass-merchandised commingled investment vehicles?
- should bank investment management activities continue to be excluded from so much of the Federal securities laws?

I should emphasize at the outset that these are personal views. They do not reflect either the deliberations or judgments of my fellow Commissioners.

Why Revisit the Glass-Steagall Act?

Before looking more closely at bank investment management, I want to make a few general observations about the Glass-Steagall Act. The securities markets are healthy. There is plenty of competition. In that case, why should the Congress devote time and attention to the Glass-Steagall Act?

The growing disjunction between the assumptions that underly the Glass-Steagall Act and the facts of financial life cannot be ignored. It simply will not do to say that the system is working just fine now and that there is no compelling need for change. The system may be working, but it is not working the way the Congress envisioned in 1933. It is not so much that the Act's prohibitions have been evaded but rather that in some cases they have been overtaken by events. If we fail to face these changes squarely, then we shall be carried along on the wave of change. If the markets are not structured by action of the Congress, they will be structured by market forces.

We should not sit idly by and watch the markets effect regulatory change for no better reason than that our memory of the vulnerability of the banking system has dimmed. Unless we act consciously, we may lose through inaction parts of the Glass-Steagall concept that have continuing vitality, preserving only regulatory remnants whose only function is to protect market participants against competition. Indeed, the Congress has begun to come to grips with the consequences of change outside of the Glass-Steagall area. Recent legislation expanding the asset and liability powers of thrift institutions and extending reserve requirements to nonmembers of the Federal Reserve are good examples.

To say that Congressional attention is required is just the beginning of the inquiry. Wholesale reconsideration of the Glass-Steagall Act would be a very ambitious project in economic planning. One cannot review the Glass-Steagall Act in isolation. The Bank Holding Company Act, The Federal Reserve Act, deposit interest rate controls, and the securities laws and others must also be considered. I distrust our ability to do intelligent planning on such a grand scale. Thus, I do not believe it is wise to attempt the often-suggested "full-scale review of the Glass-Steagall Act." Rather, we should lower our sights a bit, recognize that the fundamentals of the system have served us well not only since 1933, but for over two centuries, and focus our energies on making the necessary adjustments to deal with changes as they force their attention upon us.

At the same time, it would be a terrible mistake to look at each issue through a microscope, tacitly assuming that each bite is so small that we need not pay attention to its larger consequences. There are public policy considerations in the current Glass-Steagall debate of great current importance, and they should be faced squarely. Moreover, they may well lead to different results in different aspects of this inquiry. For example, in my judgment the question of bank underwriting of commercial paper raises quite different problems from the question of investment management.

The Major Questions.

What is required, I think, is an identification of the major questions that bear on Glass-Steagall issues, and a thorough exploration of those questions by the Congress. Then Glass-Steagall issues can be examined against that background. I would think that the following considerations, among others, would be relevant.

- Bank power. Is there a reason to be concerned about the power of large banks? Are the financial markets growing more or less concentrated? In what geographical and sectoral markets should that question be examined: state, national or international? What is the significance of the fact that banks account for a diminishing share of our financial assets? Is there evidence of abuse of the power that large banks possess? If so, how do those concerns relate to specific Glass-Steagall Act questions, such as investment management?
- The experience of the last 45 years. What securities activities are banks actively performing? Some of these activities were explored in a study conducted a few years ago by the staff of the SEC. What does our experience with these and other bank and bank holding company activities teach us about whether this conduct raises the dangers that concerned the Congress in 1933? What does it tell us about whether fair competition between banks and nonbanks is possible?

- Incremental risks. To what extent would any given extension of bank securities activities pose risks that do not exist in already permitted activities? If they are not great, but the concerns endure, should the permissible scope of bank securities activities be narrowed?
- Securities regulation. What are the consequences of not regulating bank investment management and securities activities under the securities laws? Is there any continuing justification for treating bank securities activities as "banking" when they are doing virtually the same thing as securities firms?
- Changes in bank regulation. The structure and nature of bank regulation has changed dramatically since 1933. The Glass-Steagall Act was motivated in substantial part by concerns about bank safety and soundness. To what extent have the subsequent regulatory changes ameliorated some of the original concerns?
- Conflicts of interest and the usefulness of Chinese Walls. How successful is the Chinese Wall mechanism, which has been used so extensively to deal with the conflict-of-interest and inside information problems inherent in the combination of commercial banking and trust activities?
- Development of unregulated intermediaries. The explosion of nonbank intermediaries and nonbank lenders suggests that, if the Glass-Steagall Act's concerns endure, then the focus may be too narrow. Why bar securities activities to bank holding companies but not to sponsors of money market funds and insurance companies? There may be good reasons to make those distinctions, but they require a contemporary explication.
- The advantages of segregated markets. One of the consequences of an enforced separation between investment and commercial banking is pressure in each market to innovate in order to compete with the other. The development of the commercial paper market is a good example of the beneficial aspects of bifurcated markets. What are the lessons of that experience for the Glass-Steagall Act?
- The experience of other countries. Other economies structure their financial markets in very different ways. Germany and Canada come quickly to mind. Recognizing the cultural and historical differences that these institutions reflect, what are the lessons of those economies for our inquiry?

- Impact on the pricing and distribution mechanism. To what extent would further growth in the banks' market share of securities activities affect the pricing and distribution mechanisms? Assuming that a banking system as broad and as concentrated as those in Canada and Germany would drastically decrease the number of decision-makers and the liquidity of the markets, is that the likely result of further deregulation in banking? Could some of these concerns be met by releasing some of the constraints on classical banking while buttressing the separation of banking from other sectors of the financial markets? Is that alternative realistic?

Investment Management

Let us look at some of these considerations in the context of investment management by banks. In the first twenty years of this century, the investment management activities of banks were largely confined to traditional personal trust services. As the financial excesses of the Twenties wore on, the securities affiliates of banks were drawn to the formation of investment companies. But banks were not a major factor in investment company growth, and their investment management activities were not at the core of the problems that produced the Glass-Steagall Act. Indeed, the laws adopted in 1940 to regulate investment management assumed that the basic relationship was between market professionals and individuals; and the trust departments of banks were largely exempted in light of extensive bank regulation and common law fiduciary obligations.

Since that time, there has been a revolution in the institutionalization of private savings. Institutional trading on the New York Stock Exchange was recently reported to have reached the 70% level. Between 1960 and 1978 alone, the value

of the assets of private noninsured pension funds rose from \$6.5 billion to over \$200 billion. Life insurance companies managed an additional \$120 billion in pension reserves at the end of 1978. In contrast, the assets managed by mutual funds, which in 1940 were assumed to represent the prototypical pattern, peaked in 1975 at about \$55 billion until the explosive growth of money market funds in the late 1970s, which boosted the total to about \$95 billion in 1979.

The social concerns of the Great Depression have resulted in an enormous new class of customers for investment advisory services -- trusts established to fund employee pension, profit-sharing and other benefit plans. From the start, the commercial banks were in a good position to exploit the emerging market. In their traditional role as individual and corporate trustee, they were prepared to provide both investment advice and operational services for independent trustees as employee benefit plans grew. They were able to expand their existing customer relationships, mass merchandising skills, data processing and telecommunications capabilities to offer a sophisticated full line of services. Today, the range of investment advisory services offered by commercial banks and their holding companies is wide:

- individual voluntary and automatic investment plans
- individual and pooled trust accounts
- separate and commingled employee benefit plan trusts
- individual agency accounts
- pooled trust accounts funding individual HR-10 and individual retirement plans

Consider now the concerns that underly the Glass-Steagall Act against that background. Those concerns were well summarized in the Supreme Court's opinion in ICI v. Camp, in which the Court held that Citibank's merchandising of commingled agency accounts violated the Glass-Steagall Act. The Court began by stating that "no provision of banking law suggests that it is improper for a national bank to pool trust assets, or to act as a managing agent for individual customers, or to purchase stock for the account of its customers. But the union of these powers gives birth to an investment fund whose activities are of a different character."

Then the Court lists the consequences of that union:

- pressures to maximize fees by promoting the investment fund service to bank customers whose needs might be better met by other investments.
- pressures to sell new participations to raise capital to fund redemptions.
- impairment of public confidence in the bank through the imprudent or unsuccessful operation of the investment fund.
- pressures to rescue an ailing fund through "measures inconsistent with sound banking."
- pressures to make unsound loans to the companies in whose securities the fund has invested.
- pressures to exploit confidential relationships with the bank's credit customers to benefit the fund.
- pressures to make the bank's credit more freely available to the fund or to purchase interests in the fund.
- pressures to direct talent and resources from commercial banking to the promotion of the fund.

Many of these concerns are equally applicable to the extraordinarily competitive business of pension fund management. The notion that fiduciary services are offered in a passive way as an adjunct to an essentially custodial function belongs to a different era. They are sold aggressively, they are watched closely, the pressures for performance are great and the bank's name and reputation are deeply involved. Of course there are important differences between managing money for institutions and managing money for individuals -- although the creation and expansion of Keogh and IRA plans is reducing these differences. The impact on a bank's reputation from the bad performance of a mass-merchandised fund may be far greater than in the case of a commingled employee benefit trust. The question for the Congress is whether these differences are of a kind that suggest that the Glass-Steagall Act should apply in one case and not in another.

What is there about commingling that raises sharply different concerns from pension fund management? What public policy objectives are served by permitting banks to manage closed-end, but not open-end funds -- as some suggested after Camp. A closely related issue is now before the Supreme Court. What objectives of the Congress in 1933 are furthered by permitting banks to advise open- or closed-end funds, but not to distribute their securities -- a pattern we have seen emerging. The practical result of the current state of the law is to deny to individual investors the benefits of professional money management by banks -- a service that is available to institutions and to wealthy investors.

The growth of pension fund management by banks offers a laboratory for testing some Glass-Steagall concerns in this area. The Congress can inquire whether the conflicts of interest have caused problems, whether the Chinese Wall is secure and whether bank regulators have been able to avoid threats to bank solvency from investment management activities; and it can explore the importance of equal regulation.

Surely, the sad experience of many banks with REIT's in the 1974-75 period is part of that test and it deserves careful examination. How does that experience bear on these broader questions? Was the essential difference between the REIT experience and pension fund management simply the addition of public investors? Or was it the lack of the kind of protection afforded to public investors under the Investment Company Act? How much blame can be ascribed to the close relationship between REIT investments and the bank's mortgage lending activities?

In the same fashion, the Congress may inquire into the implications for this debate of the sponsorship of investment companies by life insurance companies. They are depositary institutions of sorts, albeit with long-term liabilities. Like banks, they manage vast amounts of pension assets. What danger does managing commingled funds for individuals present to banks that it does not present to insurance companies?

Competitive considerations also deserve attention. It is likely that if banks are permitted to offer commingled agency accounts, or to act as investment adviser or distributor for open- and closed-end funds, there will be a loss of

market share to the banks. Some observers think that competition with banks is inherently unfair, that there is an implicit tying arrangement in most business relationships with a bank because of the overwhelming importance of credit.

While that issue cannot be quantified, it can be studied. The Federal Reserve staff conducted such a study in the area of bank insurance services. Banks have made significant incursions into mortgage banking and finance companies, and the fairness of the competition in those industries can be examined. In pension management itself, there is strong competition among banks, insurance companies and independent advisers. The independent advisers have made gains in market share in spite of the fact that pension fund management is an area where one would think that a bank's lending relationship with the employer would be of special significance. Nevertheless, some observers believe that the high performance of independent advisers would have suggested an even greater shift.

On the other hand, in the case of mass-merchandised funds, the conventional wisdom holds that securities are sold, and not bought, and the distribution capacity of the mutual fund industry may be a real advantage. Moreover, the Congress might want to require that any bank expansion into this area take some form of extension of service rather than acquisition in order to increase competition.

Finally, the objective of equal regulation deserves the same attention. I cannot emphasize too strongly that the

same changes in the market that indicate a reconsideration of the market divisions effected by the Glass-Steagall Act also suggest a reexamination of the rest of the regulatory framework. The perfectly level playing field is a chimera. We should not waste our time seeking it. At the same time, neither investors nor intermediaries are served by material avoidable differences in the regulatory ground rules.

In general, the Investment Company Act and the Investment Advisers Act should apply to bank investment management. Why should an independent investment manager who manages funds for pension funds and other institutions be regulated by the SEC as an investment adviser while a bank is not? Why should they be subject to different rules regarding their ability to advertise or their fiduciary obligations?

If banks are managing an entity that is the functional equivalent of a mutual fund or a closed-end investment company there is no reason to have different rules regarding self-dealing, pricing, approval of investment management fees, and the like. The need for independent directors is as great as in a mutual fund complex. This is not simply a matter of competitive equity. The regulatory pattern for investment management is essentially sound. It responds to real problems that were rife in the investment company industry in the 1920's and were replicated in the REIT experience of the 1970s. Its logic and benefits are no less applicable to banks than to other investment managers.

Moreover, it is not clear to me that all of the past regulatory compromises regarding the Securities Act of 1933

continue to make a lot of sense. In those plans in which the employee has an investment decision to make, the result looks very much like an investment company. Whether or not any of the employee's money is invested in the employer's securities would seem to have little to do with what ought to be the result in terms of disclosure.

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These are not easy questions. But the process of answering them will inform all of us. It is an important first step toward making the regulatory system a conscious instrument of current policy toward the financial markets.