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"APPLYING SECURITIES LAWS TO BANKING ACTIVITIES"

Comments by

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This panel is an excellent opportunity for the expression of views concerning bank money management activities by those representing banks and non-bank securities firms and the Federal regulatory agencies. I have been asked to discuss the application of the securities laws to current bank activities and to comment on the future role of the SEC in this area. Time limitations prevent an in-depth analysis of the extent to which securities laws may apply to bank activities, including various securities services presently offered by banks, and I cannot precisely predict the future role of the SEC. However, I can give you some of my thoughts on these subjects and then perhaps respond to some questions.

You have probably heard the traditional Commission disclaimer a good number of times, but I want to make it very clear that the views I express do not necessarily reflect the views of the Commission or any of its members.

Competition between banks and non-bank securities firms for investment management dollars is not a new phenomenon but, without question, it has been escalating over the past few years. In fact, because of the recent more aggressive bank competition, many non-bank securities firms believe that their very existence is at stake.

Other members of the panel have already discussed and commented on Sections 16 and 21 of the Glass-Steagall Act regarding bank entry into the securities field and the various types of securities activities presently engaged in by banks. I have discussed these activities in various speeches which are available from my office, and I do not propose to go over that ground again except insofar as necessary to discuss the application of the securities laws to these activities.

The objectives of our Federal securities laws are to provide full and fair disclosure in the purchase and sale of securities, to ensure and maintain fair and honest securities markets, and to prevent inequitable and unfair practices in such markets. Along with the specific authority granted to the Commission under the securities laws, Congress also provided that these laws be administered in a remedial fashion as appropriate and necessary in the public interest and for the protection of investors. Since the Commission must determine what is necessary and appropriate to best serve the public interest and to protect investors, I believe it proper to examine whether, in view of recent market developments and the increased activity of banks in these

markets, the exemptions provided for banks under the securities laws should be continued.

One possible explanation for the bank exemptions is that Congress did not contemplate substantial securities activities by banks which would require the application of the securities laws since banks were prohibited from underwriting and dealing in securities under the Glass-Steagall Act. Another possible explanation is that Congress expected the bank regulatory agencies to implement investor protections equivalent to those provided by the Commission under the securities laws. Perhaps both of these explanations have some merit. A third possibility is that Congress did not intend to provide investor protections for individuals who obtained securities through a bank. As you might expect, I do not believe that there is any merit in this proposition.

It should be noted that the exemptions for banks under the securities laws are rather explicit. Section 3(a)(2) of the Securities Act exempts from the registration requirements "any security issued or guaranteed by any bank" as well as certain other security interests or participations offered by banks. Thus, banks need not comply with the numerous disclosure requirements presently applied to other

issuers subject to the registration process administered by the Commission. On the other hand, bank securities are not exempt from the anti-fraud provisions of the Securities Act or the Securities Exchange Act. It is quite clear that these provisions apply to all bank securities, notwithstanding the exemption from the registration requirements, and to all bank activities involving securities. The utilization of any fraudulent device, scheme, course of business, or untrue statement in connection with the purchase or sale of bank securities or in connection with any other bank securities activity clearly exposes a bank to liability under the anti-fraud provisions of the securities laws. The broad application of these provisions is somewhat controversial, and I will return to this subject in a few minutes.

The Securities Exchange Act reflects a concern for the integrity and honesty of the trading markets and requires market participants to meet certain standards. Thus, the Act imposes rigorous standards regulating the conduct of all persons dealing and trading in securities. However, Congress specifically defined the term "bank" and exempted banks from various provisions of the Act. Congress included within this definition all national banks, member banks of the Federal

Reserve System, and any other banking institution in which a substantial portion of its business consists of receiving deposits or exercising fiduciary powers similar to those permitted national banks and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of the Securities Exchange Act. While this latter limitation regarding the operations of a bank for the purpose of evading the provisions of the Exchange Act does not specifically refer to national banks and members of the Federal Reserve system, it is difficult for me to believe that Congress intended to allow any bank to operate in a manner contrary to or as a circumvention of the investor protection purposes of the Exchange Act.

The Exchange Act, among other things, requires persons acting as brokers and dealers to register with the Commission and comply with comprehensive regulatory standards primarily designed to provide essential investor protections. Banks, however, are specifically excluded from the definitions of broker and dealer in the Act. Because of this exemption, even though banks may engage in similar or competing brokerage activities, they are not

subject to the regulatory standards that apply to non-bank firms.

The Investment Advisers Act of 1940, which generally regulates the business practices of persons engaged in the investment adviser business, provides a similar exemption for banks in Section 202(a)(11) that excludes a bank or any bank holding company from the definition of an "investment adviser." Thus, if a bank or a bank holding company itself provides direct investment advisory services, it need not comply with the registration requirements. On the other hand, a separate non-bank investment advisory subsidiary of a bank holding company must register with the Commission under the Advisers Act. I believe that this difference in treatment represents form over substance and, as far as the advisory function is concerned, there does not appear to be any justification for such a distinction.

The growth in bank holding companies is another development which has increased the involvement of banking institutions with the securities laws. In contrast to the exemption provided for bank securities from Securities Act registration, public offerings of bank holding company securities are subject to the registration requirements of

the Securities Act and all its disclosure requirements.

As I indicated earlier, all persons, including banks, are subject to the anti-fraud provisions of the securities laws, particularly Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. These provisions have been applied rather broadly by the courts in finding violations of the securities laws. Generally, this expansive interpretation includes the concept of aiding and abetting violations of the anti-fraud provisions and does not necessarily require knowing participation in or knowledge of violative conduct. Stated briefly, any person who contributes to a fraud directly or indirectly is responsible to some extent for the fraud. A bank, although not charged with direct fraud violations, could find that conduct closely related to the violation may fall within this aiding and abetting doctrine.

To illustrate the broad application of this concept whereby related conduct may violate the anti-fraud provisions, banks were charged with fraudulent conduct in an instance where bank funds were utilized to purchase large amounts of securities which were resold to control persons in order to

keep the stock off the market and dry up the float, thus enabling manipulators to drive up the market price of the security. In another case where a bank acted as an escrow agent in a best efforts offering in which the prospectus represented that all proceeds would be refunded to purchasers unless a certain number of securities were sold, the Commission found in an administrative proceeding that the bank had participated in a fraud by releasing such funds when the securities were, in fact, not sold. Another instance where a bank was found to have violated the anti-fraud provisions of the securities laws involved a bank loan used by a company to present a false picture of liquidity. The proceeds of the loan, which extended over a period long enough that it could be classified as a long-term liability, were used to purchase a certificate of deposit which was pledged to secure the loan and was shown as a current asset. In another case, the Commission named several banks in an administrative proceeding for aiding and abetting a violation of the Investment Company Act of 1940. The Commission alleged that the banks were aware that the investment company was purchasing certificates of deposit to support loans made to an affiliate of the investment company. Such transactions between related parties

violated Section 17 of the Investment Company Act, and the banks were charged with aiding and abetting such violations.

The Commission has also enjoined persons from offering brokered bank certificates without complying with the registration requirements of the Securities Act. Although we have not brought any action against banks in this area, it is conceivable that bank participation in these arrangements could bring them within the aiding and abetting doctrine. In addition, bank transfer agents could be charged with aiding and abetting violations of the registration requirements of the Securities Act if they knowingly effect transfers for their principals in securities which are subject to the registration requirements but have not been registered. It is also conceivable that the failure of the bank as transfer agent to effect prompt transactions so as to reduce the float in a particular security may be held to have aided and abetted a manipulative scheme where the reduced float is a material factor

I could cite many other examples but in view of the time limitation, I believe these illustrate the possible broad application of the anti-fraud provisions to bank securities activities. In the time remaining, I would like to discuss the

future role of the SEC with respect to bank securities activities. There is no doubt in my mind that the role of the Commission in regulating such activities should and will increase in the future. Let me explain why I believe this to be the case.

First, the Senate has already passed and the House is presently considering legislation which would provide for SEC regulation of all securities transfer agents, clearing agencies, and depositories. While bank regulatory agencies would assist the Commission in the examination and the enforcement of various standards for banks, the SEC will have explicit rulemaking, examination, and enforcement authority over such bank activities.

Second, legislation has been introduced by Senator Williams to remove the exemption for municipal securities under the Exchange Act authorizing the SEC to establish appropriate standards and trading practices for persons underwriting and dealing in municipal securities. There has been some disagreement over the final form that this legislation should take, but there is general agreement that the SEC should provide regulation for both bank and non-bank dealers.

Third, Senator Brooke has introduced a bill which would subject bank automatic stock investment programs to SEC jurisdiction and the investor protection standards of the Exchange Act.

Legislation has also been introduced which would require disclosure under SEC rules and regulations of security holdings and transactions by institutions, including banks and insurance companies, similar to that now required of investment companies. There is a good deal of support for this legislation, and it can be expected to become law in some form. Interestingly, the Commission has recommended a more flexible and less burdensome approach that the proposed bills presently before Congress.

Another possible legislative proposal is one which may be introduced by Chairman Patman of the House Banking Committee to require trust departments with assets of $200 million or more to be divested by commercial banks. Governor Bucher of the Federal Reserve Board, a former chief officer of a major bank trust department, has also supported a separation of commercial banks from their trust departments as a method of resolving certain conflicts of interest and diffusing concentrations of economic power. If such a

separation were required by Congress, the SEC would be the natural candidate to regulate these investment advisory institutions.

Aside from Congressional action, there are questions as to what authority the Commission presently has and what additional action the Commission could take with respect to bank securities activities. In this regard, there are, of course, wide differences of opinion as to how far the Commission could move. In view of investor protection standards and the need for full disclosure of securities financing arrangements and other securities activities which frequently involve banks, one should not dismiss the possibility that rules and regulations over certain banking activities could be adopted under the Commission's anti-fraud provisions. With respect to the new bank services that we have been discussing today, it is conceivable that rules such as the following could be adopted:

1. Restrictions on transactions with affiliates, including perhaps a restriction on bank advisory services buying and selling securities of issuers with whom the bank has significant dealings;

2. Disclosure of bank dealings with issuers whose securities are being sold;

3. Restrictions against self-dealing by bank investment managers;

4. Disclosure of interlocking directorships.

I would like to point out that this approach has not been considered by the Commission. Nevertheless, it indicates a course of action which could be pursued if the Commission deemed it appropriate in order to provide adequate investor protections.

Conspicuous by its absence is the fact that I have not commented on whether banks should be allowed to offer securities services which some believe are unlawful under the Glass-Steagall Act. I am well aware that many of you would like the Commission to take a position against such bank activities. However, the Commission has not considered it to be our responsibility to make such a determination. Congress enacted the Glass-Steagall Act with its prohibitions and limited authorizations for bank securities activities. The bank regulatory authorities, and perhaps the Department of Justice, have the responsibility for interpreting and enforcing the Glass-Steagall Act. If

it requires clarification, Congress should bear the responsibility to either clarify the Act as it applies to bank securities activities or authorize some other Federal authority to make such determinations.

I should mention, however, that as the Federal agency charged with protection of investors in our securities markets and because of our expertise in securities matters, we have already received indications that Congressional Committees will expect us to testify on Glass-Steagall issues. We desire, of course, to have a well-founded basis on which to make recommendations if so requested, and solicit views from all interested parties on bank securities activities, their effect on our securities markets, and whether there may be a need for additional investor protections such as those provided under the securities laws.

Let me conclude by suggesting that to the extent banks or any other persons are engaged in securities activities, I expect that we will see regulation of these activities gradually come under SEC jurisdiction in order to assure adequate protections for all investors and equal regulation for all persons who offer similar securities services. This approach is rational and seems evident in many of the

legislative proposals presently pending before Congress. The Treasury Department also indicated support for this approach in a recent publication which stated:

> "All institutions which participate in any aspects of the process of buying and selling securities and effecting transfers of ownership should be subject to the authority of the SEC. Whether the institutions be broker-dealers, banks, depositories, non-bank transfer agents, or others, the SEC should have the authority to impose their rules, ascertain their degree of compliance, and impose appropriate sanctions."

If, as I have suggested, the SEC becomes more involved in the regulation of securities activities of banks which are subject to the jurisdiction of Federal banking agencies, we will need to work more closely with those regulators to assure that our actions consider fully their aims and purposes. Furthermore, it seems only appropriate that, to the extent practicable, all Federal agencies should work together to minimize duplication of effort and expense in providing necessary regulation. Based on past experience, I have the highest respect for the expertise and competence of the bank regulatory agencies and I believe that only through continual consultation and close cooperation between regulators will we be able to provide adequate and equal investor

protections without adversely affecting securities and non-securities activities. In my opinion, this is the Commission's responsibility and we must dedicate our efforts to achieving this goal.