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GLASS-STEAGALL IN TRANSITION

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Financial institutions have often made headlines during the past year. Some of the most well known events are the acquisitions of Shearson Loeb Rhoades by American Express, Bache by Prudential Insurance Co., Dean Witter Reynolds and Coldwell Banker by Sears, and three major savings and loan institutions by National Steel Corporation. In addition, the Bank of America announced its plans to acquire Charles Schwab & Company, the nation's largest discount broker with offices throughout the country, and New York Stock Exchange membership. These actions have focused public attention on the fundamental revolutionary changes that are occurring as financial institutions seek to provide a full range of financial services. Despite all the recent attention and some alarm, this is not a new phenomenon but a natural development in a saga that has been unfolding for many years.

An important chapter of the story began in 1933 when, because of bank solvency problems resulting partially from conflicts of interest, self-dealing and unsound lending practices, Congress decided to restrict the natural development of the financial services industry. It did this by enacting the Banking Act of 1933 ("Glass-Steagall Act"), which had the purpose of limiting the extent to which individuals and institutions could be engaged in both commercial banking and investment banking activities. For various reasons, however, the separation of activities was not complete nor clearly defined. Although banks were precluded from being affiliated with organizations engaged principally in underwriting or selling corporate securities, they were permitted to perform brokerage functions to the extent of purchasing and selling securities without recourse, solely upon the order and for the account of customers. In addition, banks were specifically permitted to underwrite and distribute securities issued by the United States Government and its agencies and general obligations of states and their political subdivisions.

The Act also made it unlawful for persons engaged in underwriting, selling or distributing securities to engage "to any extent whatever" in such banking activities as "receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt or upon request of the depositor . . . ." Along with legal restrictions on commercial bank securities activities, Congress provided exemptions from certain provisions of the securities laws. Any security issued by or representing an interest in or the direct obligation of a bank was made exempt from registration under the Securities Act of 1933; banks were excluded from the definition of a broker or dealer in the Securities Exchange Act; and they were generally exempted from the Investment Company and Investment Advisers Acts of 1940.

The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

These legal impediments to natural financial developments and significant differences in regulation set the stage for commercial banks and investment bankers to continually test, probe, and innovate in order to expand the range of services they could profitably provide. The pace of this activity has accelerated, particularly during the past 20 years, as spiraling inflation and increasingly high interest rates have caused individuals and businesses to seek ways of protecting their financial assets from loss of purchasing power, to become more sensitive to differential rates of return on financial assets, and to become increasingly sophisticated in financial asset management. Using advanced computer and telecommunications technology, banks, broker-dealers, insurance companies, and other financial intermediaries have developed innovative investment vehicles in an effort to attract funds. These new vehicles typically offer greater convenience and financial benefits to customers and are often structured to provide competition between dissimilar institutions despite anti-competitive legislation and regulatory barriers.

With the concurrence of bank regulatory agencies, banks have become involved in securities activities such as dividend reinvestments, private placements, automatic investment plans, providing investment advice to investment companies, operating common and collective trust funds, underwriting third-party commercial paper, and offering retail repurchase agreements.

Until recently, securities firms were not active in creating new investment vehicles that were similar to traditional banking or insurance services. However, faced with increasing competition in securities activities from other financial institutions, and the cyclical volatility of securities markets, major securities firms have diversified into other related financial services such as insurance, real estate, and financial planning, and, of course, interest is now being paid on free credit cash balances held by broker-dealers.

One of the most successful innovations has been the money market mutual fund. As interest rates continued to rise in the 1970's, traditional mutual funds experienced net redemptions and bank deposits increased rapidly due in part to certificates of deposit which paid money market interest rates. Such CD's, however, generally required a significant penalty if redemption occurred before the end of a specified term. The money market mutual fund is an ingenious financial instrument providing money market rates of return and the ability to invest and redeem at any time by electronic transfer or check without penalty. The popularity of these funds is shown by the fact that they now have assets totaling over $186 billion. The next development was the Cash Management Account, combining a securities account, a money market fund, and an account with a bank. Assets of the customer held in the Cash Management Account can be drawn upon through use of a check or a credit card. The

amount available for credit card purchases, cash advances, and checking is the total of uninvested free credit cash balances in the securities account, the net asset value of the money market fund shares, and the margin loan value of securities in the securities account.

The most recent innovation is a program which provides a revolving line of credit based on the equity in a single family residence or vacation home. This line of credit is to be accessible by means of a credit card or check and can be used for virtually any purpose.

Courts and commentators state rather absolutely that one of the objectives of the Glass-Steagall Act was to prohibit commercial banks from going into the investment banking business and securities firms from drifting into banking. However, considering the functions performed by financial institutions today, it is rather obvious that the Act has not been very effective. This, I believe, is due to the fact that the Act did not require a complete separation and that in order to be specific, its prohibitions applied narrowly to practices that existed in 1933. Certainly, the problems is in no small part a consequence of the play of the language in pertinent sections of the Act, such as the proviso in Section 16 that explicitly permits banks to "purchase[ ] and sell[ ] . . . securities . . . solely upon the order, and for the account of customers," and the language of Section 21 which relies on the term "deposit" to preclude securities firms from engaging in the business of banking. Moreover, the disparate analyses and subtle factual gradations in court cases, have not established consistent and manageable principles in the context of current business practices. This can be illustrated by a brief reference to some major cases.

The tension among the clear statutory proscriptions, the elusive exceptions thereto, Congressional intent and actual commercial practice is evidenced in two Supreme Court cases--Investment Company Institute v. Camp, 401 U.S. 617 (1971) and Board of Governors of the Federal Reserve System v. Investment Company Institute, ____ U.S. ____, 101 S. Ct. 973 (1981), which are referred to as "ICI 1" and "ICI 2." Their holdings can be expressed as a simple rule: Banks and bank holding companies can advise and sponsor closed-end investment companies but they cannot operate an open-end investment company, commonly called a mutual fund. To stop there however would be misleading because the apparent clarity is an illusion.

In finding bank operation of mutual funds illegal, ICI 1 stated, "there is a plain difference between the sale of fiduciary services and the sale of investments." Ten years later, ICI 2 concluded that since:

(1) the services of an investment advisor to a closed-end fund are not significantly

different from traditional fiduciary functions of banks, and

(2) under the Federal Reserve Board action at issue, a bank holding company was prohibited from certain activities, such as participation in the "sale or distribution" of investment company securities,

bank holding companies and their subsidiaries could act as investment advisors to closed-end investment companies. This seems plain enough, but let's go on.

In ICI 2, the Court was careful to distinguish between the two types of investment companies by stating that unlike a mutual fund, a closed-end investment company "would not be constantly involved in the search for new capital" and, accordingly, the advisory fee earned by the bank would provide little incentive to engage in promotional activities that lead to the "more subtle hazards" Glass-Steagall was meant to address. Since it is clear that under ICI 1 a bank could not sell mutual fund shares and equally clear that under the Federal Reserve Board ruling in ICI 2 a bank could not sell the shares of a closed-end fund, the Court must have meant that there are advisory services that a bank can perform for a closed-end fund that it can not perform for a mutual fund. Given present industry practice, however, this is not so clear.

Several open-end investment company prospectuses disclose subsidiaries of bank holding companies, including bank subsidiaries, as investment advisors that manage the funds' portfolios, and are responsible for, make decisions with respect to, and place orders for all purchases and sales of the funds' portfolio securities. In all of these instances, an investment banking firm acts as administrator and distributor for the fund and the advisor and the administrator are paid separate, but often identical, fees based on a percentage of average net assets of the fund. The question arises as to whether in these situations the bank holding company subsidiary is any less involved in the operation of the mutual fund than it is permitted to be with respect to a closed-end fund. Moreover, its advisory fee is dependent to a great extent on the success of the continual sales effort on behalf of the fund. Thus, the bank holding company subsidiary clearly has a pecuniary stake in the success of the fund's promotional activities. Whether this is the type of advisory fee arrangement that would provide sufficient incentive to engage in promotional activities that lead to the more "subtle hazards" addressed by Glass-Steagall is left unanswered by the cases.

New York Stock Exchange, Inc. v. Smith, 404 F. Supp. 1091 (1975) also raises questions about the utility of the language in Glass-Steagall in modern times. At issue in this

case were automatic investment services ("AIS") allowing bank checking customers to designate a sum of money to be deducted automatically from their accounts each month and invested in one of 25 selected "blue-chip" stocks. The U.S. District Court held that since the banks did not make investment recommendations this activity was within the confines of the Glass-Steagall exception that allows banks to effect agency orders of customers. I doubt, however, that Congress in 1933 contemplated a bank sponsored automatic computer assisted stock investment plan that would be offered not only to existing customers but also to the general public through national advertising and personal contact.

A. G. Becker v. Board of Governors of the Federal Reserve System, 519 F. Supp. 602 (D.D.C. 1981), is the most recent case dealing with bank securities activities. On September 26, 1980, the Federal Reserve Board issued a ruling which concluded that third-party commercial paper was not an "investment security" or "security" subject to the prohibitions contained in Sections 16 and 21 of the Glass-Steagall Act and therefore could be sold by banks for the issuers. Although we have no authority or responsibility to interpret Glass-Steagall, the Commission filed a memorandum, amicus curiae, in the U.S. District Court, urging that the term "security" in the Glass-Steagall Act should be cnstrued in pari materia with the definition of that term in the Securities Act which was enacted within 20 days of the Glass-Steagall Act.

Contrary to some comments I have heard, the Commission did not take this unusual step in the interest of protecting the securities industry from competition. Acceptance of the Board's reasoning that commercial paper is not a security because it is akin to a loan transaction and non-speculative in character could frustrate the SEC's ability to regulate securities markets. Not only would the scope of the term "security" be affected, but presumably banks would be free to engage in underwriting a potentially wide range of debt securities activities, indistinguishable from those of broker-dealers.

The primary reason Congress excluded banks from being regulated as "brokers" or "dealers" under the Securities Exchange Act is that securities activities of banks were restricted by the Glass-Steagall Act. Accordingly, the Commission argued that the fundamental alteration of the respective roles assigned to banks and securities firms is not the province of a regulatory agency, but should be left to Congress.

While substantially adopting the Commission's position by holding that commercial paper is a "security" for purposes of the Glass-Stegall Act, the U.S. District Court expressly declined to reach the question of whether Bankers Trust was involved in underwriting securities in violation of Glass-

Steagall. Not surprisingly, Bankers Trust announced that it would continue to market commercial paper. Thus, the narrow definitional ruling does not resolve the issue of the legality of the sales efforts involved in this case. The ultimate resolution will, no doubt, be based on the meaning to be given the phrase "underwriting, selling or distributing" as well as the scope of the exception in Section 16 allowing banks to effect agency orders. At present, this case is on appeal.

Activities of securities firms that are functionally equivalent to services that traditionally were offered solely by commercial banks are more recent and to my knowledge have not been the subject of litigation. However, there have been efforts on both the state and national level to restrict such ativities either through administrative action or legislation. Thus far, none of these efforts has been successful.

In December of 1979, the Assistant Attorney General, Criminal Division, of the United States Department of Justice, wrote an advisory letter to the SEC stating that money market funds providing checking privileges were not in violation of the Glass-Steagall Act as alleged in a letter from the Bowery Savings Bank of New York. In April of 1981, in response to the view of the Independent Bankers Association of America that the Justice Department's analysis was in error, the Department reviewed its position and concluded that its prior letter "correctly interpreted the statute." The Justice Department's interpretation was based almost entirely on the term "deposit" in Section 21 of the Glass-Steagall Act.

In my opinion, the cited cases and the Justice Department's letters supply ample support for the proposition that there is no natural division between banking and investment banking and that the artificial division imposed by statute is unclear.

Although the Glass-Steagall Act restricts activities that fall squarely within its terms, it does not stop functionally equivalent activities which, with the use of new technology, have been structured skillfully to avoid its prohibitions.

When Glass-Steagall was enacted, its phraseology may have been an effective way to describe activities limited by commercial banking. Today, with credit cards, NOW accounts, electronic transfer, money market funds, and combined asset management type accounts, functions that were performed solely by banks can be provided by other financial institutions without involving the prohibited activities described by "deposits subject to check," "presentation of passbook," "certificate of deposit," "evidence of debt," or "request of depositor."

It has been suggested that the one way to deal with this situation would be to clarify and strengthen the Glass-Steagall Act in order to establish a clear barrier between investment and commercial banking in today's financial markets. I submit that, whatever the case may have been in 1933, today with modern technology there is no natural dividing line between investment and commercial banking and that forcing an arbitrary division would impose economic costs far in excess of any benefits. In my opinion, the proper approach is to remove the antiquated anti-competitive prohibitions and confine government involvement to rules and regulations focused on appropriate operational standards for financial institutions and specific areas of possible abuse.

Concerns about soundness and solvency, depositor confidence, concentration of financial and economic power, self-dealing, conflicts of interest, fair competition and investor protection can be dealt with much more efficiently through means such as disclosure, deposit insurance, antitrust laws and limitations on certain transactions between financial affiliates, all administered by competent regulators with authority to be flexible under Congressional oversight. Such an approach would permit all financial intermediaries to offer all types of services in competition with each other and should result in greater operational stability, better financial services, and better prices.

It is certainly not surprising that banks would become concerned about their future as they see other financial institutions permitted to offer transition accounts with interest rates they are not permitted to pay, as they see commercial paper replacing bank loans, as state and local governments shift over 70 percent of their financing from general obligation bonds, which banks may underwrite, to revenue bonds, in which their participation is restricted, and as they see competitors operating offices throughout the country while they are not permitted to have nationwide branching.

Some securities firms are equally concerned that if banks are given incresed opportunities to engage in securities activities, investment bankers will be unable to compete because of bank financial power, lack of equal regulation, tax advantages, and access to less costly sources of money.

The complexity of these issues and their importance to our national economy has led to the suggestion that changes in Glass-Steagall should await a comprehensive study of financial intermediation and its regulation in this country, and that we should be sure we know what the effect of changes will be on various institutions before any action is taken. Reviews and studies have been going on for years and the resulting recommendations are legion. Additional information

is always helpful, but the suggestion that changes be delayed until their ramifications are fully understood is a prescription for inaction. Studies, however well intentioned, are unable to fully consider all economic variables and their interrelationships and to be useful must focus on limited segments of activity while making assumptions with respect to others.

One need only review the conflicting conclusions of studies on the costs and benefits of banks underwriting municipal revenue bonds or consider the strongly held opposing views relating to monetary and fiscal policy initiatives to recognize that economic studies have significant prognosticative limitations. Those limitations are particularly severe in this situation because of the virtual explosion in telecommunications and computer technology affecting financial institutions. Unfortunately, decision-makers virtually never have all the information they would like nor the luxury of being able to know the end at the beginning.

Moreover, from a procedural point of view, my experience working on legislative proposals while serving as an economics assistant to a ranking U.S. Senator and as minority staff director of the Senate Committee on Banking, Housing and Urban Affairs made it very clear to me that if progress is to be made on a subject as controversial as the Glass-Steagall Act, it is important to focus on finite issues and deal with them while, of course, keeping in mind the effect they may have on the financial community and the economy as a whole.

The step by step approach also makes sense from a substantive point of view. One need not resolve all of the questions raised by banks dealing in third-party commercial paper, for example, to reach meaningful conclusions regarding the operation of investment companies by banks. Similarly, because municipal revenue bonds are so much like general obligation bonds, which banks have been underwriting for decades, the problems relating to banks underwriting revenue bonds should be much easier to resolve than those relating to the underwriting of corporate equity securities.

Yesterday the Commission testified before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs on S. 1720 and a Treasury proposal which would amend the Glass-Steagall Act. Although both proposals would permit banks or their affiliates to sponsor and sell mutual funds and underwrite municipal revenue bonds, there are some significant differences. The Treasury approach would permit these activities only through a corporate affiliate, which would be subject to SEC regulatory jurisdiction and would require that, if such an affiliate were set up, certain other securities activities of the bank also be transferred to it. Title III of S. 1720 would permit banks to engage in these activities directly under the regulatory jurisdiction of the appropriate bank regulatory agency.

In my opinion, and the Commission so testified, the Treasury approach is preferable because it would bring about greater regulatory equality among institutions offering securities services. Shortly after being appointed to the Commission over nine years ago, I publicly stated my belief that Congressional action to amend Glass-Steagall was overdue. I also expressed the view that regulatory agency jurisdiction should be on the basis of functions performed by financial institutions rather than the type of institution involved in order that there be comparable regulation and enforcement of those engaged in securities activities. I am pleased that members of the Senate Banking Committee are interested in considering changes toward these ends and that the Administration, as part of its deregulatory efforts, has not only offered a proposal to remove some of the barriers between commercial banking and investment banking, but has proposed that greater regulatory equality be a condition of increasing bank securities activities.

I believe this is a good beginning and hope that Congress will soon enact legislation which brings about these results. It is only a beginning, however. Other anti-competitive restrictions also deserve careful consideration and Congressional action.

We are just starting to get a glimpse of what financial services may be like in the future. In the absence of restrictions, I expect competing institutions to offer a range of new alternatives based on factors such as amount of assets in the account and the volume of transactions. If the balance is large, and there are few transactions, for example, the rate of return might be the money market rate. Smaller, more volatile accounts would likely receive a lower rate of return. Perhaps there will be only one type of account on which the return will vary automatically on the basis of various factors. It would seem likley that at some point all assets, including real and personal property, could be factored into the account and all financial transactions, including insurance, securities investments, real estate purchases, personal expenditures, and loans for business or personal expenditures may be effected against the asset balance through electronic transfer terminals. These terminals will no doubt be located in commercial and financial institutions as well as wherever the account holder desires, such as at his home or office. Returns to the account holder and charges for credit would be computed on positive or negative balances according to prior agreements. There may be problems in reaching this or some other type of efficient transaction system, but in my opinion outmoded government restrictions and regulations should not be permitted to preclude their development.