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PROTECTING INVESTORS THROUGH COMPARABLE REGULATION

An Address By

Ray Garrett, Jr., Chairman

Securities and Exchange Commission

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THE BOND CLUB
Palmer House
Chicago, Illinois

Ladies and Gentlemen. It is indeed a pleasure for me to address this meeting of the Chicago Bond Club. Although the membership of this venerable group today consists of securities industry professionals generally, and not just bond brokers and dealers, you have maintained your ties with tradition by preserving your original name, reminiscent of those antique days when the bond business dominated the securities business. In these days, preservation of comfortable traditions is not something to scoff at. Many of us wish it were possible to maintain comfortable traditions relating to industry matters more substantial than the names of clubs. Why does everything have to change?

You had best save that question for next Sunday morning: Congress has legislated our expertise on many things, but not on the purposes of the Almighty. We only know they do change, and the rate of change seems to be increasing exponentially. As technology and attitudes change, so, too, must the securities industry.

Many of these changes seem to me to be quite exciting, and not just because we have initiated them. For one thing, they demonstrate the flexibility and adaptability of the administrative process to alterations in the operative facts concerning our markets. But these changes are intrinsically exciting as well. At the same time that we are about to usher in an era of competitively-determined commission rates, we are also making important strides toward the creation of a central market system and the development of a truly national securities clearing system. These changes are on the way and close at hand, not only because of Commission action, but also, and more importantly, because of changes in the technology available for the conduct of business, changes in both the domestic and world markets related to securities and money, and increasingly imaginative thinking on the part of many members of the industry itself.

We also are witnessing innovations in the packaging of new or infrequently tried securities investment opportunities. I have not observed any dissenters or prophets of gloom in your ranks when innovative investment proposals originate from the recognized or traditional components of the securities industry. But much of the innovation in the competition for securities dollars we have been witnessing recently has been generated by sources outside the securities industry -- most notably by members of the insurance and banking industries -- and as to these, I detect widespread alarm and despondency among traditional securities brokers and dealers and investment bankers. Indeed, I have been told by many worried men in your industry that banks, in particular, will gobble up the entire securities industry if not restrained by law.

The lot of a regulator, in this context, may not always be a particularly satisfying one. If policy formulations prove too readily acceptable by the industry we supervise, we probably are not far-removed from irate attacks by so-called public interest groups or searching questions from watchful Congressional oversight committees. On the other hand, if our policy decisions are at odds with industry suggestions or reports, we run the risk of sustained accusations by the industry that we shortly shall be overseeing the demise of the American capital market structure. We long ago gave up the thought of achieving "correct" policy judgments; our experience suggests that they just do not exist. But we can, and hopefully do, render sensible and reasonable policy judgments, at least often enough to justify our continued existence.

Recent attempts by banks and insurance groups to attract securities investment dollars have threatened our performance record, since they raise a number of serious policy questions concerning the true meaning of the standards “public interest” and “the protection of investors” that we are mandated to nurture. In the context of the Federal securities laws, where does the public interest and the interest of investors lie relevant to bank intrusions into areas of the securities business which have heretofore been the preserve of non-bank broker-dealers?

The recent introduction of a spate of bank-sponsored investment services for smaller investors appears to have engendered a groundswell of concern, both from the traditional components of the securities industry and from some members of the Congress. The issues certainly are complex and generate a great deal of emotion, as I recently learned after delivering some testimony on this general subject before Congressman Patman’s Banking Committee. While it is tempting to duck these sensitive issues, with the unjustifiably optimistic hope that someone else will resolve them or that the problems simply will disappear, since the Comptroller of the Currency gave his blessing to some of these bank programs earlier this year, we have been increasingly importuned by members of the securities industry to take an active role on their side. Banks have lots of friends in Washington, we are told, but we poor securities people have no one but the SEC. Who can we turn to if you turn away?

I should like to spend a few minutes exploring some of these bank forays into traditional securities activities and the possible application of the securities laws to them.

One of the first programs initiated by banks was the so-called automatic dividend reinvestment service, pursuant to which shareholders of a corporation assign their dividends to a participating bank for immediate reinvestment in additional securities of the same company. The banks assert that this program puts dividend payments directly to work for investors, because the banks will credit participants with purchases of fractional shares which also continues to earn dividends. And the banks claim that this service lowers the cost of investments by the participants, since securities are bought in larger quantities and therefore, subject to commission rate discounts for large volume transactions. The banks may also claim that the program results in a net increase in funds flowing into the securities markets, because most dividends received in cash would probably not be reinvested in securities.

The principal concern with dividend reinvestment programs under the securities laws has been whether registration is necessary under the Securities Act on the theory that the corporation is offering its shares to its shareholders. On this issue our staff has agreed that registration is not necessary if the bank is sufficiently independent of the issuer. So far, we have not had occasion to quarrel with this staff view, and I am not aware of any feeling among broker-dealers that this program constitutes unfair competition.

Recently, a number of banks have started to offer investors, with $10,000 or more to spend, professional money management. The advertisements I have seen leave no question that the banks are definitely engaged in recommending which stocks to buy or sell, as well as the appropriate magnitude of such transactions. Among the same line, at least one bank here in Chicago has instituted what it describes as an "Institutional Investment Service," designed to provide smaller investors with buy, sell or hold recommendations on 180 common stocks. In its advertisements, this bank reports that the financial and economic research it provides are precisely the same as that furnished to, and utilized by, the bank's own trust department.

These so-called "mini-accounts" raises several possible problems under the securities laws, principally whether the mini-accounts collectively constitute an investment company. This type of activity was the subject of our Advisory Committee on Small Account Investment Management Services which recommended, as our position, that no investment company is created where the securities in each mini-account are held separately without commingling. This subject is still under study. Obviously, the bank, as to these mini-accounts, is acting as an investment adviser and would be subject to the Investment Advisers act of 1940 except for their categorical exclusion from that Act. As we understand it, the bank does not act as a broker with respect to securities transactions for the mini-accounts.

But perhaps the one investment service offered by banks which has caused the greatest concern to members of the brokerage industry is the automatic investment service. Through this service, as I am sure you all know, banks offer their checking account customers an opportunity to purchase shares of certain designated listed companies, by an automatic monthly charge to their checking accounts. The banks have not limited their soliciting activities to existing checking account customers, but a participant must open a checking account. These automatic investment services have been aggressively marketed by banks through newspaper, radio and television advertisements, and the details of these services, as offered to date, are doubtless familiar to you all.

The securities industry's opposition to these bank programs essentially is predicated on two grounds -- first, that banks are prohibited from engaging in such broad-ranging brokerage services by virtue of the provisions of the Glass-Steagall Act; and, second, that bank programs such as these represent inherently unfair competition to brokers, since banks have a larger captive audience than do brokers and since banks may be able to perform services similar to those traditionally performed by brokers at greatly reduced costs. Of course, to the extent banks engage in any brokerage services, there will always be some residual advantage inuring to banks by virtue of their statutory hold on checking accounts and other services.

I really don’t know whether the Glass-Steagall Act was intended to, or in fact does, prohibit banks from offering these particular securities investment programs.

The intent of the banking legislation in 1933, generally embodied in Section 21 of the Glass Steagall Act, is usually started to be the separation of the securities business from commercial banking; that Act specifically prohibits firms engaged in underwriting, or syndicating participations in, corporate securities from engaging at the same time, to any extent whatever, in such traditional banking occupations such as receiving deposits. But other provisions of the Act specifically modify this seemingly ironclad prohibition against any combination of banking and securities activities, in the following language:

> "The business of dealing in securities and stock by the [bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers . . . ."

There is, therefore, nothing strange about the banks acting as agents for their customers' securities orders, they have done so for years. The burning question is whether banking participation in these automatic investment programs is permissible in light of the prohibitions contained in the Glass Steagall Act, a question the Congress did not authorize the Commission to determine. That is a matter, at least in the first instance, for bank regulatory authorities. We have no authority to prosecute violations of that Act, even if we were convinced that they are occurring.

As to the assertion of unfair competition, the Commission is vitally concerned about the health and continued viability of the securities industry, and we are, of course, taking reasonable steps within our power to promote them. But, the tools we were given to effect that general result do not include the ability to eliminate any competitors of securities brokers simply because they may be better able to compete for public business. Suggestions have been made that Congress should authorize the Commission to protect the securities industry from outside competition or, perhaps, create a new agency with that as its sole mission, but these are, at present, just speculations.

In addition, however, to our limited authority in this regard, it is not entirely clear that banks do represent unfair competition for brokers or that their products are superior to those which the brokerage industry can offer. Programs comparable to these bank automatic investment services, such as brokerage-sponsored monthly investment plans, have been in existence for some time; but they have not generated much investor participation and, with the exception of a small number of firms, have not been marketed by brokers as aggressively as the bank plans have been. This certainly indicates that we have an inadequate data base upon which to compare the merits of these respective programs, and suggests the possibility that these bank programs may attract investors who might not otherwise find their way to securities markets. Without any hard data, we are hard pressed to determine whether these bank programs are attracting new securities investors, as the banks suggest, or whether they are draining away established brokerage business, as the securities industry fears.

By the same token, there exists the possibility that, unless subject to some regulation, these bank programs could exacerbate serious structural imbalances in our markets.

For one thing, automatic bank investment programs are concentrated in the same small group of issues which generally are the favorites of large institutional investors. It has been urged that this phenomenon could aggravate the so-called "two-tiered market." If investment concentration should increase, the ability of many sound corporations to raise capital could be severely impaired. Similarly, while the pooling of orders by the bank sponsors of these automatic investment plans may result in some cost savings to investors, they also may serve to increase the percentage of large securities transactions and decrease the number of individual small orders that are critical if our markets are to exhibit necessary depth and liquidity.

Certainly of equal, if not greater, concern, is the status of those individual investors who choose to participate in these bank-sponsored programs. Although banks sponsoring these automatic investment plans are effecting transactions in securities for the accounts of others, they are excluded from the statutory definition of the term broker set forth in the Securities Exchange Act. As a result, other than certain generally applicable provisions of the federal securities laws, banks are not subject to the regulatory requirements imposed by the Commission upon registered brokers and dealers for the protection of their customers.

For example, unlike brokers and dealers registered with and regulated by the Securities and Exchange Commission, banks have not been subjected, in all instances, to prevailing requirements that recommendations be suitable for the potential securities investor or otherwise held accountable for inappropriate advertising material, unless, of course, the advertising statements are fraudulent within the meaning of the federal securities laws' proscriptions against fraud. Even though issuers may be well established and have very substantial assets, it does not necessarily follow that their securities are a suitable investment for all investors. Nor should we lose sight of the fact that a voluntary determination banks to offer only highly capitalized securities to their customers is not the same, either as a matter of law or practically, as an explicit regulatory requirement to that effect. If purchases should involve speculative or low priced securities, this problem may be compounded.

In addition, where unregulated entities engage in the business of effecting securities transactions, there are always additional questions which must be resolved; for example, whether the price to the customer is as favorable as possible under prevailing market conditions, whether customers will receive adequate confirmation of their purchases and whether individuals leaving securities with a bank pursuant to one of the above-mentioned services are protected in the event of any financial difficulties. With respect to this latter question, some plans voluntarily incorporate insurance protection; however, it does not appear that the Federal Deposit Insurance Corporation, which normally insures customer cast deposits at participating banks, would extend to securities held by a bank on behalf of a person participating in a plan. In contrast, the Securities Investor Protection Act of 1970 provides coverage of up to $50,000 resulting from the insolvency of regulated brokers and dealers.

Counsel for one bank sponsoring this kind of program and the data processing company involved in setting the program up submitted a “no-action” request to our staff on the question whether their automatic stock purchase plan is an investment company. On that narrow issue, the staff indicated it would not recommend any action to the Commission if the plan was not registered under the Investment Company Act. However, the staff also advised the bank that certain actions in connection with its plan might create fiduciary relationships requiring the bank to assure that investments were suitable for each customer. Although the staff prepared a no-action letter with respect to the Investment Company Act issue, as you are aware, the Commission has not formally considered these issues or expressed any views on them and is not bound by the staff’s informal, advisory letters. Moreover, the staff did not express any opinion on the status of the bank or the data processor involved with respect to the Securities Act, the Securities Exchange Act, or the Investment Advisers Act.

More recently, our staff has been asked by the Investment Company Institute to take the position that banks offering these automatic investment plans are brokers subject to Commission regulation, but has not yet responded to this request.

The competition created between banks and traditional securities industry entities could well prove beneficial to the investing public. But we do not believe it is appropriate to encourage competition at the very heavy cost of sacrificing needed regulatory protection. As I have previously noted, it is our view that persons or entities engaged in comparable activities should be subject to comparable regulation. The questions this poses, though, are what, if anything, the Commission should do to effect comparable regulation, and who should be charged with the responsibility for implementing any such regulations that might be imposed on banks engaged in these programs.

One thing we might do is sponsor legislation to that effect, although I believe we presently lack sufficient data to suggest a sensible approach. And, even though it appears unlikely that banks may be deemed to be brokers and dealers subject to our regulation, it is not entirely clear that our concerns with bank participation in the securities industry must be limited to sitting on the sidelines and rooting loudly for appropriate Congressional legislation. The federal securities laws are rather broad in their scope and have been given a rather hospitable reading by the courts. I don’t think we can foreclose the possibility that some administrative approach to these problems may be available to us if we do conclude that regulatory controls here are appropriate and should be administered by the Commission.

I guess this exposition leaves open a good many legal, policy and factual questions. The essential difficulty is to distinguish between fact and fiction and emotion and reason. The best context for doing so is not on the basis of the broad-based generalizations which appear to have proliferated concerning these bank services, but in a well-structured environment in which the Commission can obtain the considered views of members of the securities industry, the banking industry, interested government agencies, and the public generally. Needless to say, the bases for any decision making on this subject are not available to us now, and I will have to leave you hanging on the edge of your seats to find out how this melodrama will ultimately turn out. But you shouldn’t have to wait terribly long. The Commission has determined to notice these questions for public comment, and a release detailing the issues involved and procedures we shall follow will be issued shortly.

As I have indicated, I do not view it as our function to protect the securities industry from competition by banks or any other group. If Congress wants to make that decision it can, although its enactments to date do not appear to us to have done so. But we can legitimately be concerned whether investors in these bank programs will be afforded sufficient protection. If the securities industry can accept that framework for analysis, as I believe the statutory pattern of self-regulation requires, you can make a meaningful contribution to these Commission policymaking efforts. I, for one, certainly look forward to the discussions that like ahead.