Dingell file

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

March 30, 1988

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
Room 2125
Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Dingell:

This letter responds to your letter of March 17, 1988, concerning the Commission's negotiations with the bank regulatory agencies on amendments to the federal securities laws to address investor protection concerns caused by bank entry into the securities markets. As you requested, enclosed are a summary of the recommendations made in the Commission's December 3, 1987 testimony before the Senate Banking Committee and an explanation of the differences between those recommendations and Titles III and IV of S. 1886, the proposed Financial Modernization Act of 1988. Also enclosed is a draft of statutory amendments to implement the December 3, 1987 recommendations, prepared by the Commission's staff.

As always, the Commission's foremost concern is investor protection. The Commission continues to support S. 1886 and believes that, if enacted, it will provide adequate investor protection while encouraging increased competition in the financial services industry.

Sincerely yours,

David S. Ruder

David S. Ruder
Chairman

Enclosures

MEMORANDUM

March 29, 1988

TO: Chairman Ruder

FROM: Office of the General Counsel
Division of Investment Management
Division of Market Regulation

RE: Chairman Dingell's letter dated March 18, 1988 re Glass-Steagall reform

In his letter dated March 18, 1988, Congressman John D. Dingell, Chairman of the House Committee on Energy and Commerce requested an explanation of the differences between the Commission's recommendations as presented in testimony to the Senate Banking Committee on December 3, 1987, and Titles III and IV of S. 1886, the proposed Financial Modernization Act of 1988, as agreed to by the Commission and the federal bank regulators. Chairman Dingell also requested proposed amendments to implement the Commission's December 3, 1987 recommendations. Part I of this memorandum summarizes the December 3, 1987 recommendations. Part II sets forth the differences between the recommendations and Titles III and IV of S. 1886. Draft statutory language that would effect the Commission's recommendations is provided at Attachment A to this memorandum.

## I. Recommendations Presented in the Commission's December 3, 1987 Testimony

The Commission's written testimony before the Senate Committee on Banking, Housing, and Urban Affairs on December 3, 1987, stated that legislation repealing or modifying the Glass-Steagall Act must require banks to conduct both their new and their existing securities activities in separate securities affiliates subject to Commission regulation with certain limited exceptions. In addition, the testimony stated that such legislation must amend the Investment Company Act and the Investment Advisers Act to address specific investor protection concerns caused by bank entry into the investment company business. The specific recommendations set forth in the testimony are summarized below.

### A. Bank Broker-Dealer Activities

The Commission's testimony stated that banks must be required to conduct the following activities in affiliates subject to Commission regulation: publicly-advertised brokerage activities; brokerage services provided to advised accounts for which transaction-related compensation is received; corporate securities dealing or underwriting, including private placements;

securities dealing or underwriting, including private placements; municipal revenue bond underwriting and dealing; and sponsoring, underwriting, and distributing investment company securities. Also, banks that choose to engage in expanded powers should be required to transfer their current municipal securities activities to the separate securities affiliates that they would be required to establish if they engage in expanded powers.

The testimony indicated that some bank securities activities might not require Commission oversight. Specifically, the testimony indicated that banks need not be required to move their government securities and commercial paper activities to separate affiliates.

In addition, the testimony recommended that the Commission be given authority to exempt banks, by rule, regulation, or order, from the definitions of "broker" and "dealer," either unconditionally or subject to certain terms and conditions. This authority, together with the Commission's existing authority to exempt persons from the registration requirements of Section 15(a) of the Securities Exchange Act, would ensure that activities that fall within the terms of the statutory provisions, but are not necessarily appropriate for Commission regulation, may be exempted. The Commission suggested as an example that banks that conducted a de minimis number of brokerage transactions might be exempted under these provisions.

B. Bank Investment Company Activities

With respect to bank investment company activities, the testimony made six specific recommendations.

First, the testimony recommended that the Investment Company Act 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.

Second, the testimony recommended that the Investment Company Act be amended to prohibit generally a borrower and any of its affiliates that have a substantial borrowing relationship with a bank from knowingly selling securities or other property to an investment company affiliated with the bank, or purchasing securities or other property or borrowing from an investment company affiliated with the bank, subject to Commission exemptive authority.

Third, the testimony recommended that the Investment Company Act be amended to prohibit a bank-affiliated investment company from borrowing from its affiliated bank or banks, except in accordance with Commission rules.

Fourth, the testimony recommended that the Investment Company Act should be amended to provide that no investment company have a majority of its board of directors consist of persons who are officers, directors, or employees of any one bank holding company and its affiliates, and to expand the definition of "interested person" in the Investment Company Act to include within the term certain persons with significant relationships to a bank affiliated with an investment company.

Fifth, the testimony recommended that the Investment Company Act should be amended to make it unlawful for a bank-affiliated investment company to use the bank's name as part of the name or title of the investment company.

Sixth, the testimony recommended that the Investment 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.

### C. Other Matters Discussed in the December 3, 1987 Testimony

In addition to the specific recommendations made in the testimony, the Commission reiterated its support for the recommendations of Vice President Bush's Task Group on Regulation of Financial Services to consolidate within the Commission securities registration and reporting requirements for all publicly-held banks and thrifts. Because legislation to effect the Bush Task Group's recommendations has previously been submitted to Congress, specific language to address bank and thrift registration and reporting requirements is not provided in Attachment A.

The Commission also recommended that Congress consider additional safeguards regarding conflicts of interest and related investor protection concerns created by Glass-Steagall repeal. However, the Commission did not make specific recommendations regarding conflicts of interest and related concerns. Accordingly, Attachment A does not address those matters.

## III. Differences between Titles III and IV of S. 1886 and the Commission's December 3, 1987 Recommendations

### A. Bank Broker-Dealer Activities

Title III of S. 1886 provides for a number of exceptions from the definition of broker-dealer for certain bank activities that were not included in the testimony. Some of these exceptions were drawn from the Commission's Rule 3b-9.

First, S. 1886 would allow a bank that did not have a corporate underwriting affiliate (as provided in proposed new section 4(c)(15) of the Bank Holding Company Act -- Section 102 of S. 1886) to engage in municipal revenue bond activities within the bank, in addition to general obligation municipal bond underwriting.

Second, a bank could engage in primary private placements, so long as sales were limited to certain types of institutions and to individuals with a net worth over $5 million. This exemption would not extend to secondary transactions.

Third, a bank could effect transactions for its traditional trust accounts unless it both solicited brokerage and received transaction-related compensation in excess of its incremental cost. For other bank fiduciary accounts, such as managed agency accounts, securities safekeeping accounts, and self-directed IRAs, a bank could provide brokerage without broker-dealer registration only if it neither solicited brokerage business nor received transaction-related compensation in excess of its incremental cost.

Fourth, a bank could engage in the "securitization" of its assets without becoming a "dealer." (A separate provision in Title I of S. 1886 requires that any bank with a securities underwriting affiliate must transfer its securitization activities to the affiliate.)

Fifth, S. 1886 contains statutory exemptions that were not specifically discussed in the testimony. These include bank networking arrangements with broker-dealers, sweep accounts, transactions for employee benefit plans and for a bank's affiliates, and banks that effect fewer than 1,000 transactions per year.

B. Bank Investment Company Activities

First, Title IV of S. 1186 would not generally prohibit a bank borrower from knowingly selling to or purchasing from an investment company affiliated with the bank, or borrowing from such an investment company, as was recommended in the testimony. Instead, it contains a more limited prohibition against a bank-affiliated investment company from knowingly purchasing securities during an underwriting, where any part of the proceeds will be used to retire any part of an indebtedness to the bank.

Second, Title IV would not include within the definition of "interested person" persons with significant relationships to a bank affiliated with an investment company. Instead, it would include within the definition of "interested person" any person, including a bank, that has acted as custodian or transfer agent

or has executed portfolio transactions for, or engaged in principal transactions with, or loaned money to, an investment company or any other investment company in the same mutual fund complex.

Third, Title IV does not contain a prohibition on an investment company having a name that includes a part of an affiliated bank's name. Instead, it provides the Commission with additional authority to require disclosure that mutual funds are not federally insured.

Fourth, Title IV allows a bank to register a separately identifiable department or division as an investment adviser, in lieu of registering an affiliate or the bank itself. In addition, the Commission would be required to consult with the appropriate federal bank regulator prior to an examination, investigation, or enforcement action, unless consultation was not practical.

Attachment - Draft Amendments to S. 1886

ATTACHMENT A

DRAFT AMENDMENTS TO S. 1886 TO EFFECT
DECEMBER 3, 1987 RECOMENDATIONS

TITLE I - DELETE SECTION 108 [Deleting authorization for national banks to underwrite municipal revenue bonds, sponsor unit investment trusts, and distribute investment company securities]

TITLE II - NO CHANGES

TITLE III - BROKERS AND DEALERS

SECTION 301. DEFINITION OF BROKER

Section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) is amended to read as follows:

"(4) 'BROKER'. -

"(A) IN GENERAL. -- The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others.

"(B) BANK ACTIVITIES. -- A bank shall not be deemed to be a 'broker' because it engages in one or more of the following activities:

"(i) engages in trust activities (including effecting transactions in the course of such trust activities) permissible for national banks under the first section of the Act of September 28, 1962 (12 U.S.C. 92a) or for State banks under relevant State trust statutes or law unless the bank --

"(I) publicly solicits brokerage business other than by

advertising, in conjunction with advertising its other trust activities, that it effects transactions in securities, or

"(II) is compensated for such business by the payment of commissions or similar remuneration based on effecting transactions in securities (excluding fees calculated as percentage of assets under management) in excess of the bank's incremental costs directly attributable to effecting such transactions. This clause does not apply to securities safekeeping, self-directed individual retirement accounts, or managed agency or other functionally equivalent accounts of a bank;

"(ii) effects transactions in exempted securities, other than municipal securities, or in commercial paper, bankers' acceptances, or commercial bills; and

"(iii) effects transactions in municipal securities and does not have a securities affiliate as provided in section 4(c)(15) of the Bank Holding Company Act of 1956.

SECTION 302. DEFINITION OF DEALER

Section 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(5)) is amended to read as follows:

"(5) 'DEALER' --

"(A) IN GENERAL. - The term 'dealer' means any person engaged in the business of buying and selling securities for his own account through a broker or otherwise.

"(B) EXCEPTIONS. -- Such term does not include --

"(i) any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business; or

"(ii) any bank insofar as the bank (I) buys and sells commercial paper, bankers' acceptances, or commercial bills, or exempted securities other than municipal securities; (II) buys and sells municipal securities and does not have a securities affiliate as provided in section 4(c)(15) of the Bank Holding Company Act of 1956; or (III) buys and sells securities for investment purposes in the course of trust activities.".

SECTION 303. POWER TO EXEMPT FROM THE DEFINITIONS OF BROKER AND DEALER

Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c) is amending by adding at the end the following:

"(e) The Commission, by rule, regulation, or order, upon its own motion or upon application, may conditionally or unconditionally exempt any person or class of persons from the definitions of 'broker' or 'dealer,' if the Commission finds that such exemption is consistent with the public interest, the protection of investors, or the purposes of this title.

SECTION 304. REQUIREMENT THAT BANKS FALLING WITHIN THE DEFINITIONS OF BROKER OR DEALER PLACE THEIR SECURITIES ACTIVITIES IN A SEPARATE CORPORATE ENTITY

Section 15(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(a)) is amended to read as follows:

"(a)(1) It shall be unlawful for any broker or dealer that is either a person other than a natural person or a natural

person not associated with a broker or dealer that is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

"(2) It shall be unlawful for any bank to act as a broker or dealer, except in the course of an exclusively intrastate business. This section shall not preclude a subsidiary of a bank or an affiliate of a bank holding company other than a bank, as those terms are defined in the Bank Holding Company Act of 1956, that is registered in accordance with subsection (b) of this section from acting as a broker or dealer to any extent otherwise permissible by law.

"(3) The Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraphs (1) and (2) of this subsection any broker or dealer or class of brokers or dealers specified in such rule or order.".

## TITLE IV - BANK INVESTMENT COMPANY ACTIVITIES

### SECTION 401. CUSTODY OF INVESTMENT COMPANY ASSETS BY AFFILIATED BANKS

(a) Management Companies - Section 17(f) of the Investment Company Act of 1940 (15 U.S.C. 80a-17(f)) is amended by striking the word "trusts" the first place it appears and inserting in lieu thereof "trusts, but, where any such bank or an affiliated person thereof is an affiliated person, promoter, or sponsor of, or principal underwriter for, such registered company, only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors".

(b) Unit Investment Trusts - Section 26(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-26(a)(1)) is amended by inserting after the word "bank" the following: "not affiliated with such underwriter or depositor, or where such bank is so affiliated, only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors".

SECTION 402. AFFILIATED PERSONS AND TRANSACTIONS

(a) Affiliated Persons -- Section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(3)) is amended by --

(1) Striking "thereof, and" and inserting in lieu thereof "thereof,"; and

(2) by inserting after clause (F) a new clause (G) to read as follows: "(G) if such other person is an investment company, any person or class of persons which the Commission by order or rule or regulation shall have determined to be affiliated persons by reason of having had, at any time

since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with any person that is a principal underwriter for, or promoter or sponsor of, such company or any affiliated person (as described in clauses (A) through (F) of this paragraph) of such company.".

(b) Underwriting - Section 10(f) of the Investment Company Act of 1940 (15 U.S.C. 80a-10(f)) is amended by --

(1) inserting "(A)" immediately before "a principal under writer"; and

(2) inserting, "or (B) the proceeds of which will be used to retire any part of an indebtedness owed to a bank where the bank or an affiliated person thereof is an affiliated person, promoter, or sponsor of, or principal underwriter for, such registered company" after "for the issuer".

SECTION 403. BORROWING FROM AN AFFILIATED BANK

Section 18(f) of the Investment Company Act of 1940 (15 U.S.C. 80a-18(f)) is amended by adding a new paragraph (3) at the end thereof to read as follows:

"(3) Notwithstanding the provisions of paragraph (1) of this subsection, it shall be unlawful for any registered open-end company to borrow from any bank if such bank or any affiliated person thereof is an affiliated person, promoter, or sponsor of, or principal underwriter for, such company, except that the Commission may, by rules and regulations or order, permit such

borrowing which the Commission finds to be in the public interest and consistent with the protection of investors.".

SECTION 404. INDEPENDENT DIRECTORS

(a) Definition of Interested Person -- Section 2(a)(19)(A)(v) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)(A)(v)) is amended by striking out "1934 or any affiliated person of such a broker or dealer, and" and inserting in lieu thereof: "1934 or any person that, at any time during the last six months, has executed any portfolio transactions for, engaged in any principal transactions with, or loaned money to, the investment company or any other investment company having the same investment adviser, principal underwriter, sponsor, or promoter, or any affiliated person of such a broker, dealer, or person, and".

(b) Bank Holding Companies -- Section 10(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-10(c)) is amended by striking "bank, except" and inserting in lieu thereof: "bank and its subsidiaries or any bank holding company and its affiliates and subsidiaries, as those terms are defined in the Bank Holding Company Act of 1956, except".

(c) The provisions of subsection (a) of this section shall become effective after one year following enactment.

SECTION 405. PROHIBITION AGAINST USE OF A BANK'S NAME BY AN AFFILIATED MUTUAL FUND

Section 35. Section 35(d) of the Investment Company Act of 1940 (15 U.S.C. 80a-35(d)) is amended by inserting after the first sentence thereof the following: "It shall be deceptive and

misleading for any registered investment company which has as a promoter, sponsor, organizer, investment adviser, or principal underwriter a bank or affiliated person thereof, to adopt, as a part of the name or title of such company, or of any security of which it is the issuer, any word or words which are the same as or similar to, or a variation of, the name of such bank.".

SECTION 406. DEFINITION OF BROKER

Section 2(a)(6) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(6)) is amended to read as follows:

"(6) 'Broker' has the same meaning as in the Securities Exchange Act of 1934, but does not include any person solely by reason of the fact that such person is an underwriter for one or more investment companies.".

SECTION 407. DEFINITION OF DEALER

Section 2(a)(11) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(11)) is amended to read as follows:

"(11) 'Dealer' has the same meaning as in the Securities Exchange Act of 1934, but does not include an insurance company or investment company.".

SECTION 408. REMOVAL OF THE EXCLUSION FROM THE DEFINITION OF INVESTMENT ADVISER FOR BANKS THAT ADVISE INVESTMENT COMPANIES

Section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)) is amended -

(1) by striking out "investment company" and inserting in lieu thereof "investment company, except that the term `investment adviser' includes any bank or bank holding company to

the extent that such bank or bank holding company acts as an investment adviser to a registered investment company".

SECTION 409. DEFINITION OF BROKER

Section 202(a)(3) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(3)) is amended to read as follows:

"(3) 'Broker' has the same meaning as in the Securities Exchange Act of 1934.".

SECTION 410. DEFINITION OF DEALER

Section 202(a)(7) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(7)) is amended to read as follows:

"(7) 'Dealer' has the same meaning as in the Securities Exchange Act of 1934, but does not include an insurance company or investment company.".