



Remarks Of

**Richard Y. Roberts
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.**

Preserve Mutual Fund Market Integrity

**Bank Securities Association
1994 National Compliance Conference
Washington, D.C.
September 12, 1994**

***/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners, or the staff.**

**U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549**

Preserve Mutual Fund Market Integrity

I. Introduction

I appreciate the opportunity to address the Bank Securities Association's 1994 National Compliance Conference. It is my intention today to share with you some of my concerns pertinent to bank mutual fund activities and, to a lesser extent, to bank securities activities, and to emphasize how important I believe it is that these concerns are addressed appropriately. These concerns include: the risk of investor confusion; the potential for conflicts of interest to arise between banks and their affiliated mutual funds; and the need for regulation, examination, and enforcement programs that focus on investor protection, rather than bank safety and soundness and depositor protection.

II. Bank Mutual Fund Activities

I will start with bank mutual fund activities. Bank entry into the mutual fund business both in terms of managing mutual fund assets and in terms of selling mutual fund shares has generally increased at a rapid pace over the last decade or so. More specifically, there has been tremendous growth in the bank proprietary mutual fund area. In 1987, banks managed just over 200 investment companies with assets of \$35 billion. Banks now manage over 1,700 investment companies with total assets of about \$230 billion, a substantial increase to say the least. It has been reported that the biggest selling alternatives to certificates of deposit at banks are investment companies, even in an environment of rising interest rates. In particular, banks have taken to managing money market mutual funds.

I anticipate that the growth in the bank proprietary mutual fund area will continue, and I also anticipate that bank involvement in selling mutual funds will continue to increase, although it is difficult to acquire reliable statistics in this

latter category. I personally welcome bank involvement in the investment company industry. Investment companies have become America's investment vehicle of choice because they provide individuals with a wide array of liquid, low cost, and professionally managed investment alternatives. The increased competition and convenience offered by bank involvement in this industry should only benefit consumers. However, the growth that the banking industry has enjoyed in the investment company business is inextricably linked to investor comfort and acceptance, and I suspect that maintenance of a high degree of investor comfort and acceptance is much more challenging in a rising interest rate market environment. I imagine that some in the banking industry are now discovering what the securities industry already knew -- the mutual fund business is very competitive, particularly with a stagnant market.

In my opinion, the level of growth and prosperity that banks will enjoy in this industry in the future will be directly proportional to the level of investor confidence in bank mutual fund services. Thus, in addition to being attentive to your own individual mutual fund operations, bank mutual fund participants should be pointing out bad apples and questionable practices, such as identifying those stretching too far for short-term yield or engaging in inappropriate sales practices, that may be occurring in connection with bank mutual fund activities. Certainly, one of the banking industry's foremost challenges will be to maintain investor confidence in bank managed and bank sold mutual funds.

A. Regulatory Structure

Amidst this strong growth in bank mutual fund activity, it is perhaps ironic for me to state that Sections 16 and 21 of the Glass-Steagall Act ("Glass-Steagall") still prohibit national banks and their subsidiaries from underwriting and dealing in securities such as mutual funds. State-chartered banks are prohibited

under other federal provisions. Obviously, the Glass-Steagall prohibition has been interpreted flexibly, which accounts for the bank activity in the mutual fund area.

First, banks are not prohibited from acting as brokers for their customers. Generally, this is accomplished in one of three fashions. Either the bank routes its customer orders through a separate affiliated broker-dealer, enters into a networking arrangement with an unaffiliated broker-dealer, or it sells the funds directly. Although this difference in structure should not be significant from a regulatory standpoint, in fact the structural difference does have significant regulatory repercussions. Separate broker-dealers must register and be subject to the review of the Commission and the National Association of Securities Dealers ("NASD"), whereas direct bank sales are exempt from Commission and NASD oversight pursuant to Section 3(a)(4) of the Securities Exchange Act of 1934, which expressly exempts banks from the definition of "broker." This distinction does not make much sense to me, and thus I continue to argue that this statutory exemption should be deleted.

Second, banks generally are not prohibited from acting as investment advisers. I understand that the National Bank Act permits national banks to advise funds, the Federal Deposit Insurance Corporation ("FDIC") has permitted state-chartered banks to enter the field, and the Federal Reserve Board ("FED") has permitted bank holding companies and their nonbank subsidiaries to serve as advisers, with some safeguards to protect against conflicts of interest.

The major remaining obstacle to banks entering the mutual fund business is the prohibition against underwriting, sponsoring, and distributing funds. With other types of securities, banks have been able to engage in the securities business by establishing an affiliate under the bank holding company (as opposed to a subsidiary of the bank itself) under Section 20 of Glass-Steagall. Section 20

provides that affiliates of banks may underwrite and deal in securities so long as the affiliate is not deemed to be "principally engaged" in underwriting. The Fed has interpreted this provision to mean that no more than 10% of the affiliate's revenues may be derived from underwriting and dealing activities. The Fed has prohibited the underwriting of mutual funds because funds, by their nature, are under continuous registration.

State-chartered banks have an easier time in that they need only state and FDIC approval. It is my understanding that the FDIC granted conditional approval in September of 1992 for state-chartered nonmember banks to underwrite mutual fund shares through a subsidiary.

One issue in this area is whether banks should conduct their securities activities in subsidiaries or affiliates. There are considerable operational differences between these two types of entities under federal banking law. For example, under current federal banking law, I understand that a subsidiary of a bank is considered to be an extension of the bank itself. Thus, the nonbank subsidiary's capital is generally included in the calculation of the parent bank's capital. On the other hand, a nonbank affiliate of a bank holding company is entirely separate from any affiliated bank. The bank holding company must separately capitalize the nonbank affiliate, and the nonbank affiliate's capital is not counted as the capital of any affiliated bank. Further, bank subsidiaries are not subject to the conflict of interest and self-dealing restrictions that are applicable to bank holding company affiliates under Sections 23A and 23B of the Federal Reserve Act. Obviously, I would prefer to see bank mutual fund activities restricted, either legislatively or by regulatory order, to nonbank affiliates of the bank holding company rather than extended to bank subsidiaries.

Regardless of the corporate structure, however, national banks generally are limited to acting as an investment adviser, administrator, custodian, and transfer agent, as well as in other administrative capacities. I should note here, though, that bank investment advisers are not required to register with the Commission and therefore are not currently subject to Commission oversight. It is my understanding that this exemption, much like the broker exemption that I mentioned earlier, has its origin in the fact that the enacting legislators were of the view that these exemptions were appropriate because Glass-Steagall prohibited banks from entering the securities business. Since this rationale no longer exists, neither should the exemptions in my view. I am not aware of any valid reason for the continued existence of the bank investment adviser registration exemption.

B. Regulatory Concern

Various investor protection issues arising from expanded bank securities activities have sparked renewed interest in the issue of the appropriate regulation of bank securities activities. For example, Congress, the banking regulators, and the Commission have expressed concern about investor confusion as to "common name" mutual funds and the scope of federal deposit insurance protection. Recent surveys show that many investors misunderstand the uninsured status of bank-sold mutual funds. Customers also continue to be confused about the different type of protection afforded by the FDIC and the Securities Investor Protection Corporation ("SIPC").

These concerns have generated a number of initiatives by both lawmakers and regulators, and a steady stream of correspondence between Congressmen and regulators. While it appears unlikely that broad banking legislation will pass in the near future, two separate congressionally-requested GAO studies are

currently underway that will examine the bank mutual fund phenomenon and bank securities regulation; the federal banking agencies have issued guidelines designed to address investor protection issues raised by bank mutual fund sales; and several bills have been introduced and hearings held on the House side on the issue of bank mutual fund activities. Further, the announcement in December of last year of merger plans between Mellon Bank, N.A. ("Mellon"), and the Dreyfus Corporation ("Dreyfus") resulted in additional congressional scrutiny of bank involvement with mutual funds.

Bank brokerage and underwriting activities have also given rise to concerns and prompted congressional scrutiny. The House Energy and Commerce Committee, in response to new allegations that banks are "tying" underwriting services and credit products, has asked the GAO to study bank tying and the effectiveness of the anti-tying statute. Separately, two congressional committees have begun to investigate allegations of sales practice abuses and other violations of the federal securities laws by certain banks and their related broker-dealers.

I believe that the marked increase in the involvement of banks in securities activities has caused a corresponding increase in the risk that investors still may be unaware that securities purchased on the premises of a bank are not guaranteed by that institution or by any agency of the federal government. This concern, as well as concerns about proper customer information, is exacerbated by referral fees paid to unqualified employees. This practice has, of course, been in the news of late. These fees encourage bank employees who are not securities professionals to refer bank customers to registered broker-dealers or unqualified bank securities sales personnel and probably should be prohibited upon reflection.

Another regulatory concern in the bank mutual fund area that I have is the heightened existence of potential conflicts of interests between a fund and its adviser, custodian, and other administrative affiliates. I believe that these potential conflicts are aggravated in a bank setting. For example, since it is quite common for a bank to serve as a custodian for a fund, greater concern exists when the bank also advises the fund. It can be fairly argued that independent custodians ordinarily serve as a superior safeguard against self-dealing abuses. Of course, this concern is not just limited to banks, but is present to some extent with respect to any funds that use affiliated advisers and custodians. This may be an area ripe for further study and for a regulatory response.

While an independent custodian may be a better safeguard against misuse of fund assets, the Investment Company Act does not prohibit a fund from using an affiliated custodian. But when a fund uses an affiliated custodian, it essentially has self-custody, and must follow the rule on self-custody of assets. Investment Company Act Rule 17f-2 requires that the fund's securities be deposited in a vault or depository of a company subject to state or federal authority, such as a bank. The rule also requires limited access to the fund's securities by fund insiders. Further, an independent public accountant must verify the fund's securities at least three times a year, twice on a surprise basis.

When a fund uses an affiliated broker-dealer as its custodian, the Commission can promulgate rules regarding the broker-dealer's custody functions because the Commission regulates broker-dealers. When a fund uses an affiliated *bank* as its custodian, the Commission also has the authority under Rule 17f-2, in my opinion, to regulate the bank's custodial activities.

With respect to the Mellon-Dreyfus merger, it was reported that the Dreyfus Funds would use Mellon Bank as the Funds' custodian. Mellon can

expect substantial revenue from serving as the custodian of the Funds, and I suspect that this is one of the reasons why Mellon sought to acquire the Dreyfus Funds, and why other banks have pursued mergers with fund groups.

If the Dreyfus Funds use Mellon as their custodian, then the Funds would have self-custody because their adviser is a subsidiary of Mellon. Thus, the Funds would be required to comply with the procedures I have just mentioned. Mellon Bank stated, in its request to the Comptroller of the Currency for approval of the acquisition, that if the Funds used Mellon as their custodian, Mellon would recommend to the board of the Dreyfus Funds that the board use independent public accountants to prepare custody reports, in accordance with Rule 17f-2. In my opinion, any fund using an affiliated custodian, including a bank custodian, must comply with all the provisions of the self-custody rule, not simply the independent accountant provision. Fund boards of directors also should carefully consider whether shareholders are best served, both in terms of cost and quality of services, by the fund's use of an affiliated custodian.

It appears to me that the Commission should seriously consider promulgating a rule that establishes for any custodian of an investment company (including a bank), a federal standard of fiduciary duty in dealings between the fund and its custodian. This provision would recognize the need for an entity charged with safekeeping investment company assets to have a fiduciary duty toward that investment company.

I have spent the last few minutes describing some activities that banks can now engage in due to the eroding walls of Glass-Steagall, but I also wish to point out at least one area where bank mutual funds may be at a disadvantage as compared to other funds. Section 32 of Glass-Steagall bars any officer, director or employee of a member bank from serving as an officer, director or employee of

a mutual fund. This means that banks cannot have any bank insiders on the board of the fund that they are advising. This is in contrast to other funds that can have up to 60% of the board composed of "interested" persons.

The subject of fund board composition is of great interest to me. Given that boards of directors are the first line of defense against mutual fund self-dealing and investor abuse, it is very important that board members be objective and be alert. I have been a proponent of an amendment to the Investment Company Act to require all funds to have a majority of "disinterested" directors. The staff's 1992 Investment Company Act Study also made this recommendation. I do hope that Congress will consider the Study's legislative recommendation in this area in the not too distant future.

III. Functional Regulation

With the additional investor protection provisions which I have alluded to in place, I would support the elimination of the remaining Glass-Steagall restrictions on bank mutual fund activities. I suppose that my objective through this exercise is to make the point that securities activities need to be subject to one uniform set of rules, consistently applied by a single expert regulator to all market participants, which I believe should be the Commission, regardless of whether those participants are banks or securities firms. Chairman Levitt has stressed this same point on more than one occasion in congressional testimony.

Under current law, banks that engage in securities brokerage or advisory activities are generally excluded from regulation under the federal securities laws. When these exemptions were enacted, more than half a century ago, banks were severely restricted from participating in the securities business. Those days have passed, and investors today are increasingly likely to purchase mutual funds and other securities directly from a bank. Because the statutory exclusions remain in

place, however, banks that engage in securities activities have the option of conducting those activities outside the framework of the federal securities laws. As a result, investors who purchase securities directly from unregistered banks receive different standards of protection than those who deal with securities firms.

The resulting regulatory structure gives rise to regulatory inefficiency and duplication. It is confusing and unnecessary to have five separate federal regulators -- the Commission and the four federal banking agencies -- involved in the regulation of securities sales and mutual fund operations. Moreover, recently, the federal banking regulators have taken steps to apply their securities guidelines to registered broker-dealers and mutual funds that have some nexus to a bank. In an era of fiscal restraint, it simply makes no sense for the banking agencies to train "mini-SEC" staffs to examine broker-dealers and mutual funds that are already regulated by the Commission.

Today's market realities call out for an overhaul of the existing regulatory system for bank securities activities. I believe that bank involvement in the securities markets is here to stay. Although our nation's capital markets are the deepest and most liquid in the world, their continued success depends in considerable part on fair and effective regulation, and public confidence in that system of regulation. Investors should be provided with a single, consistent standard of protection whether they purchase securities from a bank or from a registered broker-dealer. To accomplish this, the problem of overlapping and potentially inconsistent regulation must be addressed.

Unfortunately, most of these steps are ones that only Congress can take. The Commission is pursuing several avenues to assess the extent of, and deal with, investor confusion relating to bank sales of mutual funds. In addition, the

Commission is in the process of taking some steps toward better cooperation and coordination of regulatory efforts with our counterparts at the federal banking agencies, although it remains to be seen whether better cooperation and coordination will result. Hopefully, these new channels of communication with the banking regulators can reduce the regulatory burdens that the members of this audience care about. In the final analysis, however, these efforts are stop-gap measures. Joint regulatory efforts cannot, in the long run, substitute for institutional relationships grounded in sound public policy and written into law. I believe that the only real solution is legislative action and that, unfortunately, does not appear to me to be forthcoming.

IV. Conclusion

In conclusion, I do wish to challenge everyone here today to take the steps necessary in your operations to maintain and even to enhance investor confidence in your products and in your services. Such action, in my judgment, would operate for the specific benefit of your bank and for the general benefit of bank securities and mutual fund activities.