HEARING ON H.R. 3447
"THE SECURITIES REGULATORY EQUALITY ACT OF 1993"

STATEMENT OF MATTHEW P. FINK
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BEFORE THE
TELECOMMUNICATIONS AND FINANCE SUBCOMMITTEE
OF THE
COMMITTEE ON ENERGY AND COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

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I. INTRODUCTION

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 4,582 open-end investment companies (mutual funds), 433 closed-end investment companies, and 13 sponsors of unit investment trusts. The Institute's mutual fund members have assets of over $1.9 trillion, representing approximately 95 percent of total industry assets, and have over 38 million individual shareholders. The Institute's members include over 800 mutual funds advised by banking organizations, accounting for over 85 percent of the assets of all bank-advised mutual funds.

I am pleased to be here today to testify in support of H.R. 3447 and to discuss issues raised by the increased participation by banks and their affiliates in the mutual fund business. The Institute supports the modernization of the federal securities laws to fully address current bank mutual fund activities and is committed to ensuring that appropriate steps are taken to provide for the uniform protection of investors in *all* mutual funds, whether advised by, or sold through, investment advisers, registered broker-dealers, insurance companies or banking organizations.

II. EXECUTIVE SUMMARY

Banks and their affiliates are now major participants in the mutual fund industry. At year-end 1993, over 100 banks offered mutual funds advised by the bank or an affiliated entity ("proprietary funds"). In addition, banks sell both proprietary funds and mutual funds advised by third parties ("nonproprietary funds") to their customers, although sales of nonproprietary funds continue to account for the majority of bank mutual fund sales. A recent study by the Institute found that 13 percent of the total new sales of long-term funds (*i.e.*, equity and fixed-income funds) in 1991 and 14 percent of all new long-term fund sales in the first half of 1992 occurred through banks.

In some cases, banks advise mutual funds through separate subsidiaries or affiliates that are registered with the Securities and Exchange Commission as investment advisers under the Investment Advisers Act of 1940. Similarly, many banks engage in mutual fund sales through separate subsidiaries or affiliates that are registered with the SEC as broker-dealers under the Securities Exchange Act of 1934, or through third-party broker-dealers that also are registered with the Commission. As discussed below, however, banks also may engage directly in both mutual fund advisory and sales activities exempt from registration under the Investment Advisers Act or the Exchange Act.

Bank entry into the mutual fund business has been a positive development for the banking industry, the mutual fund industry and the public. At the same time, the growth of bank participation in the mutual fund business highlights the need to ensure that:

- All investors in mutual funds are protected by a uniform, consistently applied set of investor protection standards under the federal securities laws.

- There are clear lines of authority and responsibility in the SEC over all aspects of mutual fund activity -- whether engaged in by investment advisers, broker-dealers, insurance companies, banks or anyone else.

- All participants in the mutual fund industry are held to the same high standards of supervision and law enforcement, administered by the SEC and self-regulatory organizations subject to the SEC's oversight, that build upon the strict controls imposed on mutual funds under the Investment Company Act of 1940.

Uniform Investor Protection Standards: Today, there is no uniform set of investor protection standards that protects all investors who purchase shares of mutual funds. When the federal securities laws were adopted, Congress understood that the Glass-Steagall Act barred banks from the mutual fund business. As a result, while Congress adopted restrictions in the Investment Company Act to protect a mutual fund and its shareholders from potential conflicts on the part of *securities firms* that sponsor or advise the fund, it did not have occasion to -- and thus did not -- address similar conflicts that may arise in situations where a *bank or its affiliate* serves as a fund's adviser. Similarly, banks were exempted from the definitions of "investment adviser" in the Investment Advisers Act and "broker" in the Exchange Act. Thus, investors in mutual funds currently receive varying levels of protection depending upon where and from whom they purchase their shares.

Clear Lines of SEC Authority and Responsibility: While the SEC has general regulatory authority over *all* mutual funds (including bank-affiliated funds), the federal securities laws do not require banks that advise mutual funds or sell shares of mutual funds *directly* to register with the SEC under the Investment Advisers Act or the Exchange Act, although bank-affiliated investment advisers and broker-dealers are subject to SEC registration requirements. Just as all mutual fund investors should have the benefit of uniformly applied investor protection safeguards, so too should the same agency apply the same rules and regulations to all entities engaged in mutual fund activities.

High Standards of Supervision and Enforcement: Under current laws and regulations, not all participants in the mutual fund industry are automatically subject to the same high standards of supervision or the same penalties for violations of these standards. While securities firms that advise a fund or sell mutual funds to customers are subject to the SEC's enforcement jurisdiction, banks that advise mutual funds or sell fund shares directly fall under the enforcement jurisdiction of one or more of the four federal banking agencies. Over the past year, banking regulators have responded to the growth of bank participation in the mutual fund industry by issuing guidelines to banks and instructions to examiners on bank mutual fund sales activities. These initiatives are an appropriate interim response to the rapid growth of bank involvement in the business, but do not establish a desirable long-term regulatory framework for several reasons:

- Federal banking laws and regulators are concerned primarily with the safety and soundness of banking institutions. The fundamental purpose of the federal securities laws and the SEC's exclusive mandate, however, is investor protection. While federal banking laws address certain transactions between banks and their affiliates, they are generally intended to ensure that such transactions are fair to banks and pose no threat to the federal deposit insurance system, rather than to protect investors.

- The federal banking agencies have limited experience with the regulation of mutual funds, which are marketed largely to retail customers.

- While the SEC has exercised its authority under the federal securities laws to bring public enforcement actions against persons found to have engaged in abusive practices, federal banking regulators traditionally have been reluctant to bring similar proceedings against banks based on concerns that such actions might threaten their financial stability.

In addition, the adoption of standards for bank mutual fund activities under federal banking laws results in two sets of rules for participants in the industry. Bank-affiliated broker-dealers and all other participants in the business *except* banks already must comply with uniform regulations administered by the SEC and the National Association of Securities Dealers. Although the guidelines issued by banking regulators are aimed primarily at banks, they also apply to sales activities involving registered broker-dealers (including bank-affiliated broker-dealers and third-party broker-dealers that have entered into contractual sales arrangements with banks). Thus, the many bank-affiliated broker-dealers that engage in mutual fund sales activities are now subject to duplicative (and increasingly divergent) regulations, while banks that sell mutual funds directly are subject to different standards than registered broker-dealers.

As federal banking regulators turn their attention from sales practices and begin to focus on the advisory activities of banks that manage mutual funds, the problems that result from the creation of a "parallel universe" of bank mutual fund regulations and regulators will intensify. At a time when banking regulators have acknowledged the need to consolidate the *four* principal federal bank regulatory agencies, it makes no sense to create a regulatory system where *five* federal regulators oversee the mutual fund industry (the SEC *and* the four federal banking agencies). This is particularly true since new entrants in the mutual fund industry historically have been subject to regulation and oversight under the federal securities laws by the SEC.

H.R. 3447 would address these concerns. The Institute strongly supports the goals and regulatory philosophy of H.R. 3447, which recognizes that investors are best protected if all participants in the mutual fund industry are fully subject to regulation under the federal securities laws, enforced in the same manner by the single federal agency that Congress created to protect investors in securities -- the SEC. H.R. 3447 would serve the paramount goal of investor protection, while promoting regulatory efficiency and facilitating the opportunity for banking organizations to succeed in the mutual fund industry by eliminating the need for duplicative regulations and examinations under federal banking laws.

In addition, the Institute believes that Congress should eliminate Glass-Steagall restrictions that prohibit banks from sponsoring, or underwriting and distributing the shares of, mutual funds and bar bank officers and directors from serving as fund directors. These restrictions are increasingly viewed as "statutory vestiges" that impede full bank participation in the mutual fund industry. If the reforms contemplated by H.R. 3447 are accomplished, these prohibitions would be unnecessary.

III. OVERVIEW OF BANK PARTICIPATION IN THE MUTUAL FUND INDUSTRY

A. Ability of Banks to Provide Mutual Fund-Related Services

1. Permissible Mutual Fund-Related Activities

Banks and their affiliates are currently permitted to engage in a wide range of mutual fund activities. These activities include (1) serving as a fund's investment adviser; (2) providing discount and full-service brokerage services with respect to sales of shares of mutual funds; (3) offering a range of administrative services to a mutual fund, such as maintaining the fund's books and records, calculating its net asset value and filing required reports with the SEC and state securities regulators; and (4) serving as a fund's transfer agent and custodian.

Banks and their affiliates can participate in the mutual fund industry in a number of different ways. First, banks may offer their own "proprietary funds" where the bank or an affiliate serves as the fund's investment adviser. Second, banks can make available to customers "nonproprietary funds" sponsored and managed by third-party mutual fund organizations. Under current law, sales of both proprietary and nonproprietary funds to bank customers may occur through a bank or a separate broker-dealer affiliated with the bank. An affiliated broker-dealer may either be a subsidiary of the bank or a separate bank holding company subsidiary. Alternatively, banks may enter into contractual arrangements (generally referred to as "networking" or "kiosk" arrangements) with independent broker-dealers, under which the bank leases space to a broker-dealer that sells mutual funds and other securities on bank premises.

Several factors appear to have contributed to the increased participation of banking organizations in the mutual fund industry. Banks and their affiliates view mutual funds as a natural extension of fiduciary and investment management services that bank trust departments traditionally have offered their customers.[1] In addition, banks have entered the mutual fund business in order to offer their existing customers alternative investment vehicles. Banking organizations have come to view the income generated from mutual funds and other fee-based investment products as an important component of their future profitability. In addition to fees from mutual fund advisory and sales activities, banks and their affiliates may obtain additional fee-based income from providing administrative, custodial or transfer agent services to mutual funds.

2. Impermissible Mutual Fund-Related Activities

Sections 16 and 21 of the Glass-Steagall Act restrict the ability of banks to sponsor, or underwrite or distribute the shares of, a mutual fund. Pursuant to Section 20 of the Glass-Steagall Act, these restrictions also apply to nonbank affiliates of national banks and state banks that are members of the Federal Reserve System. Nonbank affiliates of state non-member banks (*e.g.*, state chartered banks that are not members of the Federal Reserve System) are not subject to these limitations. Under rules adopted by the Federal Deposit Insurance Corporation, "bona fide" subsidiaries of state non-member banks are authorized to underwrite and distribute shares of mutual funds if certain conditions are met.[2]

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1 For example, bank trust departments have managed employee benefits trusts, institutional and corporate agency accounts and personal trust and agency accounts for many years. Banks also administer common trust funds that consist of the commingled assets of individual trust customers.

2 *See* 12 C.F.R. § 337.4.

In addition, the Federal Reserve Board has interpreted Section 32 of the Glass-Steagall Act to bar officers, directors or employees of any member bank from serving as an officer, director or employee of a mutual fund. The Board has stated that the prohibition on common or shared officers or directors also applies to "interlocks" between a member bank and a corporation that provides investment advisory and related services to a limited number of mutual funds, if the corporation was "created for the sole purpose of serving a particular fund, and its activities were limited to that function."[3]

B. Extent of Bank Participation in Mutual Fund Industry

1. Establishment of Bank Proprietary Funds

In recent years, the number of "proprietary funds" advised by banks or their affiliates and sold to the public has grown significantly. By year-end 1993, over 100 banks offered proprietary funds. According to data compiled by Lipper Analytical Services, Inc., bank proprietary fund assets exceeded $215 billion at year-end 1993, up from approximately $161 billion at year-end 1992.[4] A separate study by Cerulli Associates, Inc. concluded that total bank proprietary mutual fund assets increased from $168.8 billion in 1992 to $208.6 billion in 1993.[5]

Many bank proprietary funds are established through the conversion of a bank's existing trust assets. For example, Cerulli Associates recently found that approximately 70 percent of new bank proprietary funds established in 1992 and 1993 were "seeded" by converting trust assets. In comparison, Cerulli Associates found that only 14 percent of new proprietary funds created in 1992 and 1993 were established primarily by raising new retail assets.

3 *See* 12 C.F.R. § 218.114.

4 *See* "Investment Products," AMERICAN BANKER (Feb. 9, 1994).

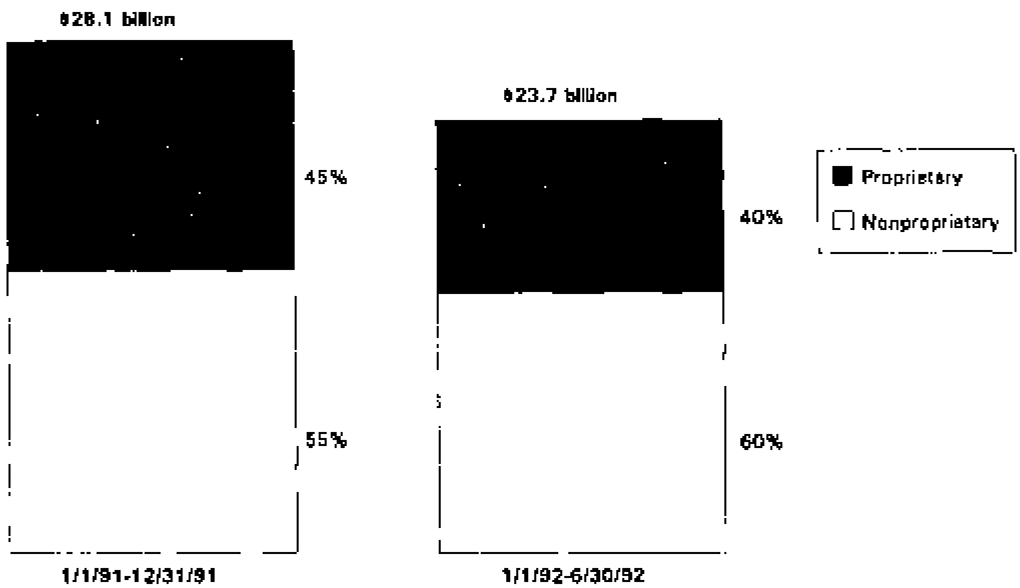
5 *See* "Major Trends in the Mutual Fund Industry," Cerulli Associates, Inc. (Dec. 7, 1993).

2. <u>Sales of Mutual Funds Through Banks</u>

In August 1992, the Institute conducted a detailed survey of bank mutual fund sales activities, collecting data for 1991 and the first six months of 1992.[6] The survey collected data on both new sales of proprietary and nonproprietary mutual funds by banks, as well as on assets of nonproprietary funds attributable to sales through bank distribution channels.

CHART 1

Bank New Sales of Proprietary and Nonproprietary Long-Term Funds



The Institute's study found that about one third of all mutual funds are available for sale through bank distribution channels. Nonproprietary funds accounted for approximately two thirds of funds sold through banks, with proprietary funds accounting for the remaining one third (*see* Chart 1).[7] The survey also found that new sales of long-term funds (*i.e.*, equity and fixed-income funds) sold through banks

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6 *See FUNDamentals*, ICI Research Department (May 1993). The Institute is currently compiling similar data for periods subsequent to the first half of 1992 and expects that such information will be available by the end of June 1994.

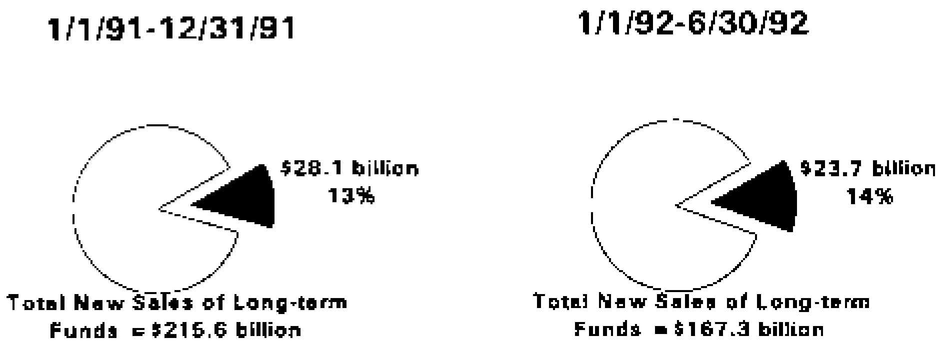
7 Most bank proprietary funds are money market funds, while most nonproprietary funds sold through banks are fixed-income funds.

represented 13 percent of all new sales of long-term funds in 1991 and 14 percent of all new long-term fund sales in the first half of 1992 (*see* Chart 2).[8]

CHART 2

New Sales of Long-Term Funds Through the Bank Channel

(percent of all new sales of long-term funds)



The Institute also asked survey respondents to identify the assets of money market and long-term mutual funds attributable to bank sales. The assets of money market and long-term mutual funds attributable to bank sales totaled $158.2 billion in 1991 and $175.5 billion for the first six months of 1992, accounting for almost 12 percent of all industry assets in both reporting periods.

Survey respondents also indicated that most bank sales of mutual funds are made in either the retail or trust departments of banks. It is important to note that a significant portion of the sales of proprietary funds are the result of banks investing trust and custody assets under their management in their proprietary funds. A far smaller percentage of new proprietary fund assets is attributable to retail sales, including sales made to existing bank customers reinvesting the proceeds of CDs and other time deposits in mutual funds.

8 "New sales" were defined as sales of mutual fund shares, excluding sales charges, exchanges or the reinvestment of dividends.

3. Shareholder Information

The Institute's study also identified shareholders who owned at least one mutual fund purchased through a bank. This research found that such shareholders were virtually indistinguishable from other mutual fund shareholders (*see* Chart 3).

CHART 3

WHO IS THE BANK MUTUAL FUND CUSTOMER?

	Shareholders Owning at Least One Fund Purchased Through a Bank	All Shareholders
Median Age (in years)	46	46
Median Income	$50,000	$50,000
Average Financial Assets *	$105,000	$114,000
Average Financial Assets in Mutual Funds	$48,200	$43,500
RESPONDENT CHARACTERISTICS		
Female **	48%	44%
College Degree or More	40%	50%
Employed Full-Time	64%	66%
Retired	26%	24%

* Excluding real estate and assets in employer-sponsored retirement plans.
** Refers to household's primary financial decisionmaker or codecisionmaker.

IV. REGULATORY ISSUES RAISED BY BANK MUTUAL FUND ACTIVITIES

A. Investor Protection Issues

With increasing numbers of investors purchasing shares of mutual funds through banks or their affiliates, it is essential to ensure that their interests are adequately protected. These investor protection issues fall into several categories: (1) issues that arise when banks or their affiliates *manage or advise* mutual funds; (2) issues that arise when banks or their affiliates *sell* mutual funds; and (3) issues relating to the *oversight* of bank mutual fund activities and the *enforcement* of relevant securities and banking laws.

1. Advisory Activities

Potential conflicts may arise whenever a portfolio manager -- be it an investment adviser, broker-dealer, insurance company or a bank -- has investment discretion over a large pool of securities and other liquid assets. The Investment Company Act addresses these conflicts by establishing a strict regulatory scheme for mutual funds. Thus, among other things, the Act (together with other provisions of the federal securities laws):

- restricts the ability of mutual funds to issue senior securities that have priority over any other class of securities;
- requires that mutual fund officers and employees with access to fund assets must be bonded against larceny and embezzlement;
- specifies stringent requirements for the custodianship for mutual fund assets;
- mandates that at least forty percent of a fund's board of directors must be independent of the fund's adviser;
- establishes a "mark-to-market" requirement, pursuant to which mutual funds must sell and redeem their shares at their current net asset value, determined by marking fund assets to their market value at least daily; and
- provides that mutual fund investors must receive a prospectus that includes information on the management of the fund, the fund's financial performance and fees associated with an investment in fund securities.

As a further discipline upon the activities of fund managers, Section 15 of the Act requires, among other things, that an investment adviser's contract with a mutual fund must (1) be in writing, (2) precisely describe all compensation to be paid thereunder and (3) be subject to termination "at any time, without the payment of any penalty" by the fund's board of directors or a majority of the fund's voting shareholders.

The Act also contains a number of provisions that address the risk that an investment adviser will enter into transactions that benefit the adviser or a related party to the detriment of the fund's shareholders. While these provisions apply to any entity that advises a mutual fund (including any bank), they are specifically directed toward conflicts that may arise when a *securities firm* advises a fund. For example, Section 10(f) of the Act prohibits a mutual fund from purchasing shares during the existence of an underwriting or selling syndicate if its investment adviser, or an affiliated person, is a principal *underwriter* of the offering. In addition, Section 17(a) prohibits securities *dealers* that advise a mutual fund from selling securities or property to the fund while acting as a principal. In turn, Section 17(e) is directed at *brokers* that advise mutual funds and limits the commissions that such brokers may accept in connection with the sale of securities to or for an affiliated fund.

In comparison, neither the Investment Company Act nor its companion legislation, the Investment Advisers Act, addresses the unique conflicts that may arise in situations where a *bank or bank affiliate* serves as sponsor or adviser of a mutual fund. This is most likely due to the fact that Congress understood that the Glass-Steagall Act operated to prohibit banks and their affiliates from serving as investment advisers to mutual funds when these Acts were adopted.

For example, no restrictions exist under the Investment Company Act on the ability of a bank-advised fund to purchase securities during a public offering where the sales proceeds would be used to repay the issuer's loan from an affiliated bank. Consequently, the risk exists that a bank-advised fund might acquire securities in order to benefit an affiliated bank rather than the fund's shareholders. In comparison, analogous conflicts of interest involving securities firms *are* addressed under the Act. In particular, Section 10(f) of the Act restricts the purchase of securities during an underwriting by a fund adviser if an affiliated firm is a member of the underwriting syndicate.

Furthermore, while Section 17(a)(3) of the Act prohibits a mutual fund adviser from *borrowing* from an affiliated fund, the Act does not restrict advisers from *lending* to the fund. Had Congress envisioned that banks would serve as fund advisers when it enacted the Investment Company Act, *both* potential conflict-of-interest situations would have been addressed.

In addition, banks and bank holding companies that advise mutual funds are exempt from registration under the Investment Advisers Act (although subsidiaries and affiliates of banks that advise mutual funds are not exempt).[9] As a result, the SEC can inspect the records of a bank-advised fund, but lacks authority to review other bank records that may be relevant to an examination of the fund's portfolio transactions. Thus, the SEC might be unable to determine whether a bank had favored its other customers or accounts over shareholders of an affiliated fund. Faced with these limitations on its ability to safeguard investors, the SEC has repeatedly called for the repeal of this exemption.[10]

Current banking laws fail to address these omissions and disparities under the federal securities laws. For example, Sections 23A and 23B of the Federal Reserve Act apply to certain transactions between member banks and their affiliates, but are intended only to protect the *bank*, not fund

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9 *See* Investment Advisers Act, § 202(a)(11).

10 *See, e.g., Hearings Concerning Merger Between Mellon Bank Corporation and Dreyfus Corporation Before the Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee*, 103d Cong., 2d Sess. (1994) (testimony of Arthur Levitt, Chairman, Securities and Exchange Commission).

shareholders. As a result, a lending arrangement between a bank and an affiliated fund on terms that are at least as favorable to the bank as it could obtain in an arm's-length transaction with another borrower would *not* raise questions under Sections 23A or 23B, even though it could be contrary to the interests of the fund's shareholders. Moreover, while the OCC has adopted general rules governing the exercise of fiduciary powers by banks, these rules do not set forth specific prohibitions on self-dealing transactions comparable to the restrictions set forth in the Investment Company Act.

2. Sales Activities

The principal issues raised by bank mutual fund sales include the risk of investor confusion when customers purchase mutual funds through banks or on bank premises, the regulation of the sales practices of bank employees and the potential for customer confusion when banking regulators adopt disclosure requirements that differ from or duplicate current SEC and NASD standards.

a) Potential Investor Confusion

Because bank customers may erroneously conclude that the "safety net" provided by federal deposit insurance extends to mutual funds and other investment products, Congress, the SEC, federal banking regulators and banks have all emphasized the need for appropriate disclosures to customers regarding the uninsured nature of such products. Recent surveys suggest that confusion among bank customers exists in this area. Some of this confusion is undoubtedly due to similarities in name between money market mutual funds and bank products of more recent origin that are federally insured, such as "Money Market Deposit Accounts." Confusion also may exist on a more fundamental level simply because the mutual fund is being offered by a bank.

The Institute believes that it is important to address the confusion -- real or perceived -- that exists among members of the public when they purchase mutual funds through banks or any other distribution channel. Accordingly, the Institute has undertaken a major public education program in 1994, involving registered broker-dealers as well as banks, to ensure that customers understand the nature of the mutual fund products they purchase, including the fact that mutual funds are *not* insured by the Federal Deposit Insurance Corporation, the Securities Investor Protection Corporation or other agencies of the federal government.[11] Among other things, the Institute's initiative includes a two-part

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11 In addition, the NASD recently issued a "Notice to Members" reminding members of their obligations under the NASD's Rules of Fair Practice with respect to mutual fund sales practices. *See* NASD Notice to Members 94-16 (March 1994). The topics addressed by the notice include (1) the need for members to make accurate and complete disclosures of material information in both oral and written communications with customers, (2) suitability requirements, (3) internal controls and (4) the requirement that all advertising and marketing materials be approved by appropriate regulatory authorities. With respect to SIPC coverage, members are expressly cautioned against stating or implying that SIPC provides insurance against the loss of a customer's investment. The notice states that

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video news release for distribution to 750 commercial television stations, a feature news release on mutual fund regulation for distribution to major news organizations, a news feature for distribution to 10,000 small weekly suburban and rural newspapers and a brochure describing fund risk and explaining the difference between insured and uninsured financial products. In recent years, the Institute has conducted similar public education programs to inform customers of the risks associated with bond and income funds.

In the absence of legislative proposals to address functional regulation and bank mutual fund sales activities, the Institute began to work with its members in early 1993 to develop detailed guidelines on bank retail sales of mutual funds. The Institute's proposed guidelines, which were released in July 1993 and were intended to serve as an important *interim* step to protect investors, covered:

- the need for appropriate customer disclosures regarding the uninsured nature of mutual funds;
- the location of sales activities on bank premises;
- restrictions on the role of bank tellers in sales activities;
- the training and supervision of sales representatives; and
- compensation arrangements for bank employees involved in sales efforts.

Each of the federal banking agencies issued guidelines last year on retail sales of bank mutual funds and other uninsured products.[12] The Institute submitted its guidelines to the agencies to assist the banking regulators in the development of their own guidelines and to encourage them to adopt uniform standards

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the sole purpose of SIPC is to protect customers against losses to their account that result from the financial failure of a member and that any representation to the contrary by a member or associated person "is false and will result in disciplinary action." It provides further that a member of the NASD that fails to inform its customers adequately about the nature of SIPC coverage and account insurance, "especially where the member is aware that the customer misunderstands such issues," may face disciplinary action.

12 *See* Federal Deposit Insurance Corporation, "Supervisory Statement on State Nonmember Bank Sales of Mutual Funds and Annuities," FIL-71-93 (October 8, 1993); Office of Thrift Supervision, "Guidance on the Sale of Uninsured Products," TB 23-1 (September 7, 1993); Office of the Comptroller of the Currency, "Retail Nondeposit Investment Sales," BC-274 (July 19, 1993); Board of Governors of the Federal Reserve System, "Separation of Mutual Fund Sales Activities From Insured Deposit-Taking Activities," SR 93-95 (June 17, 1993). On February 15, 1994, the federal banking agencies issued an "Interagency Statement on Retail Sales of Nondeposit Investment Products" (the "Interagency Statement") that supersedes prior statements issued by the various agencies and is intended to "provide uniform guidance to depository institutions engaging in [sales] activities."

that contain appropriate safeguards for investors, without unduly interfering with legitimate sales activities. While such guidelines (including the recent "Interagency Statement") are an appropriate short-term response, the Institute believes that legislation should be enacted to require the regulation of *all* sales of mutual funds, including sales by banks and their affiliates, under the federal securities laws by the SEC and self-regulatory organizations such as the NASD that are subject to SEC oversight.

b) <u>Regulation of Sales Practices</u>

Many banks sell mutual funds through separate broker-dealer affiliates that are regulated as broker-dealers under the Exchange Act and the NASD's Rules of Fair Practice. Similarly, third-party broker-dealers that enter into "kiosk" or "networking" arrangements with banks are also subject to SEC and NASD requirements. Among other things, employees of registered broker-dealers must pass an appropriate examination (such as the NASD's Series 6 or Series 7 examination) designed to ensure that they (1) understand the products they are selling; (2) determine what types of investments are suitable for customers with different investment objectives; and (3) provide customers with necessary and appropriate disclosures. Thereafter, such employees also must comply with the NASD's Rules of Fair Practice, which establish additional standards with respect to retail sales of mutual funds.

Banks that sell mutual funds *directly*, however, are exempt from the definition of a "broker" under the Exchange Act. As a result, their sales activities are not subject to SEC regulation. Likewise, by definition, banks are excluded from membership in self-regulatory organizations such as the NASD.[13] Thus, bank employees are not required to take the NASD's Series 6 or Series 7 examination or comply with the NASD's Rules of Fair Practice. Similarly, bank employees who assume supervisory duties with respect to other employees involved in sales activities need not pass a qualifying examination (unlike registered representatives of registered broker-dealers). Moreover, because such persons need not *obtain* a license to sell securities, they are not subject to *losing* their license if they engage in improper sales practices, as is true with respect to registered representatives.

Although federal banking regulators have urged banks to ensure that bank employees participating in sales activities are "adequately trained" and have received training "the substantive equivalent of that" required for registered representatives of registered broker-dealers,[14] they have not defined "adequate training" or the "substantive equivalent" of current SEC and NASD requirements.

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13 *See* NASD By-Laws, art. I, §§ (d), (g).

14 *See* "Interagency Statement," *supra* note 12, at 11.

Moreover, while banking regulators have asserted that bank employees should be allowed to take NASD-administered examinations, they have not agreed that such employees should be subject to ongoing SEC and NASD oversight and supervision. Thus, bank employees involved in mutual fund sales activities are not invariably subject to standards of training and supervision comparable to the standards to which employees of registered broker-dealers (including bank-affiliated broker-dealers) are held.[15] This is particularly troubling since these bank employees may have direct contact with mutual fund customers.

c) <u>Diverging Disclosure Requirements</u>

Investors in mutual funds should receive clear and concise disclosures regarding mutual funds and the nature of their investments. In order for this goal to be realized, one federal regulatory agency -- the SEC -- should have responsibility for establishing and enforcing disclosure standards. Conversely, if the SEC *and* the four banking agencies issue separate disclosure rules and guidelines, this goal will not be achievable. The guidelines issued by the federal banking agencies, however, attempt to specify the disclosure obligations of banks and broker-dealers involved in bank mutual fund sales in connection with advertising and other promotional materials, the opening of accounts and confirmation and account statements. In a number of instances, these guidelines conflict with current SEC and NASD requirements.

One early example of divergent disclosure requirements as between the SEC and the federal banking agencies involves money market mutual funds, which account for the majority of bank mutual fund sales. The SEC has required for several years that all advertisements containing performance information concerning money market funds and prospectuses for such funds disclose that:

> (1) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (2) there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share.[16]

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15 Banking regulations that address the responsibilities of bank employees generally with respect to brokerage activities are generally less comprehensive than rules adopted by the SEC and the NASD. For example, 12 C.F.R. § 9.5 provides generally that a national bank should adopt and follow "written policies and procedures intended to ensure that its brokerage placement practices comply with all applicable laws and regulations." Since banks are *exempt* from broker-dealer regulations, however, this rule does not require banks that engage in brokerage activities to comply with SEC or NASD requirements. In comparison, Section 26 of the NASD's Rules of Fair Practice imposes specific obligations on NASD members with respect to their mutual fund activities, including requirements relating to (1) dealer discounts and concessions, (2) sales charges, (3) refunds of sales charges, (4) principal transactions, (5) the execution of investment company portfolio transactions and (6) the disclosure of deferred sales charges.

16 Securities Act Rule 482(a)(7); Item 1, Form N-1A. This disclosure was mandated by the SEC in 1991 and is now standard throughout the industry. The SEC has also proposed to amend Rule 134 under the Securities Act to

Footnote continued

Apparently without reference to the disclosures required by the Commission to protect investors, the federal banking agencies issued separate disclosure standards for money market funds. In particular, the "Interagency Statement" states that when uninsured investment products (including money market mutual funds) are marketed to retail customers, there must be conspicuous disclosures that the products are not FDIC-insured or guaranteed by the bank and are "subject to investment risks, including possible loss of the principal amount invested." The SEC-mandated disclosures accomplish the same objectives as the "Interagency Statement," but are tailored more precisely to the characteristics of money market funds. Thus, customers who buy money market funds through banks may receive duplicative and confusing disclosures.

The "Interagency Statement" diverges from current SEC and NASD requirements in other respects. For example, the guidelines require that customers receive disclosures regarding both "the existence of an advisory or other material relationship between the institution or an affiliate of the institution and an investment company whose shares are sold by the institution" and "any material relationship between the institution and an affiliate involved in providing nondeposit investment products." The SEC already requires, however, that a mutual fund prospectus include information on the fund's investment adviser.[17] Moreover, the additional disclosures of "material relationships" required under the "Interagency Statement" may confuse investors by emphasizing the relationships that may exist between a bank and an affiliated fund or broker-dealer at the same time as investors are being provided with essential disclosures regarding the uninsured nature of mutual funds. As banking regulators establish additional guidelines for bank mutual fund activities, conflicts with current SEC and NASD disclosure requirements will undoubtedly multiply.

3. Oversight and Enforcement

In response to the growth of bank participation in the mutual fund industry, the SEC has continued to fulfill its historic role of protecting investors by addressing bank mutual fund activities when authorized to do so under the federal securities laws. For example, the Commission has required

Footnote continued

require inclusion of this disclosure in so-called "tombstone advertisements" that generally describe money market funds. *See* SEC Release No. IC-19959 (Dec. 17, 1993).

17 *See* Item 5, Form N-1A.

prominent, cover-page disclosure on every prospectus for a mutual fund sold by or through a bank that "shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank."[18]

More recently, the federal banking agencies also have attempted to address bank mutual fund activities to the extent permitted under the federal banking laws. The duties of banking regulators under federal banking laws, however, differ considerably from the investor protection responsibilities of the SEC under the federal securities laws. In addition, federal banking agencies have little experience with the regulation of mutual fund advisory activities and far less experience than the SEC with the supervision of retail investment sales activities. Consequently, banks that engage in mutual fund advisory and sales activities *directly* are subject to less comprehensive standards of securities oversight and enforcement than other industry participants (including bank-affiliated broker-dealers).

The mandate of the federal securities laws is to protect investors. In comparison, banking laws are designed to protect the safety and soundness of the nation's banking system. As former SEC Chairman William Cary aptly stated:

> The great objectives of banking regulation are controls over the flow of credit in the monetary system, the maintenance of an effective banking structure, and the protection of depositors. These objectives neither utilize the same tools nor achieve the same ends as investor protection.[19]

Although bank regulators have overseen the regulation of bank securities products such as common trust funds and collective investment funds, mutual funds are *retail* investments that raise different investor protection concerns. In addition to having varying degrees of experience with uninsured investment products, mutual fund shareholders include a large number of middle-income Americans and retirees (*see* Chart 3) who should receive the full benefit of the investor protection priorities of the federal securities laws.

The different approaches of the SEC and the federal banking agencies are illustrated by a comparison of the strict regulation of mutual funds under the Investment Company Act and the rules

18 *See* Letter to Registrants from Barbara J. Green, Deputy Director, Division of Investment Management (May 13, 1993).

19 *Hearings on SEC Legislation, 1963*, before a Subcommittee of the Senate Committee on Banking and Currency, 88th Cong., 1st Sess. 20 (1963). *See also* FDIC Annual Report (1987) at 3 (noting that the purpose of the FDIC, as established by the Banking Act of 1933, was to "restore confidence in the banking system, protect depositors in the nation's banks and promote safe and sound banking practices").

thereunder with the OCC's more general regulation of collective investment funds under 12 C.F.R. Part 9. Among other things:

- The restrictions against self-dealing set forth in 12 C.F.R. § 9.18 are less extensive than the prohibitions in Section 17 of the Investment Company Act and the rules thereunder. For example, while a national bank managing a collective investment fund may not purchase or sell securities or other property from or to the fund, affiliates of the bank are not subject to this restriction. Affiliates of an investment adviser to a mutual fund are barred from engaging in such transactions, unless expressly authorized by the SEC.

- Under the OCC's rules, fund assets held by a bank as trustee "pending suitable investment or distribution" may be placed in time or savings deposits with the bank. Thus, a bank may purchase certificates of deposit issued by the bank for the fund's portfolio. In comparison, the Investment Company Act prohibits a mutual fund from purchasing securities from its investment adviser on either a temporary or long-term basis.

- The OCC generally permits the unrestricted advertising of collective investment funds for retirement plans, although claims regarding future performance or comparisons to funds other than those offered by the bank are prohibited. In comparison, the Investment Company Act and the rules thereunder strictly regulate mutual fund advertising and prescribe, among other things, standardized performance information (including total return data for one, five and ten-year periods).

- National banks are not required to file copies of collective investment fund sales literature with the OCC. In comparison, investment companies must file copies of the full text of advertising and sales literature with the SEC and/or a self-regulatory organization subject to SEC oversight not later than 10 days after it is first transmitted or distributed to prospective investors.

- The Investment Company Act requires that at least forty percent of a fund's board of directors must be independent of the fund's adviser. No similar requirement applies to collective investment funds administered by a bank's trust department.

The less "investor protection-oriented" approach of federal banking agencies to the regulation of bank securities activities has carried over to their recent initiatives with respect to bank mutual fund activities. For example, Comptroller Ludwig stated in a recent speech that "[a]n advantage of guidance over regulation is that guidance sets a goal and allows bankers to use their discretion to find a way to achieve it."[20] In comparison, and particularly with respect to the requirements of the Investment Company Act, the SEC has been more likely to promulgate strict rules of general applicability, subject to detailed exemptive orders in appropriate cases. Furthermore, while the SEC adopts such rules after having provided the public with prior notice and an opportunity to comment, no similar mechanism for soliciting the views of investors typically precedes the issuance of banking agency guidelines.

Reflecting their separate statutory and historical responsibilities, securities and banking regulators have also followed different approaches to the *enforcement* of federal securities and banking laws. Under the Investment Company Act, the SEC is authorized to bring administrative cease-and-desist proceedings and to prohibit a person found to have willfully violated the Act (or other provisions of the federal securities laws) from serving as an employee, officer, director, member of an advisory board, investment advisor or principal underwriter of a mutual fund.[21] The Commission may also seek the entry of an injunction in federal court, as well as substantial monetary penalties in connection with both cease-and-desist and injunctive proceedings.[22] Pursuant to its authority under the Act and other provisions of the federal securities laws, the SEC has brought numerous, public enforcement actions against broker-dealers and other securities industry professionals.[23]

In comparison, the recent banking agency guidelines suggest that bank regulators would seek less significant penalties against banks for violations of investor protection standards than the SEC has typically imposed against participants in the securities industry in similar situations. In particular, the "Interagency Statement" states only that "[t]he failure of a depository institution to establish and observe appropriate policies and procedures * * * will be subject to *criticism and appropriate corrective action.*"

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20 *See* Remarks by Eugene A. Ludwig, Comptroller of the Currency, Before the Annual Convention of the American Bankers Association (Nov. 7, 1993).

21 *See* Investment Company Act, § 9.

22 *See* Investment Company Act, §§ 9 and 42.

23 During the fiscal year ended September 30, 1992, the SEC instituted 51 separate actions against investment advisers, investment companies and/or transfer agents and 115 administrative proceedings against broker-dealers. *See* Securities and Exchange Commission, 1992 ANNUAL REPORT, at 108-09.

A recent study by the General Accounting Office of situations in which federal banking regulators took enforcement steps following the detection of "insider violations" at banks also provides strong support for this conclusion.[24] The GAO concluded that, in such situations, "the regulators may have been able to take stronger enforcement actions, considering that 126, or 72 percent, of the banks had repeated insider violations." In addition, the GAO found that, with respect to the 286 banks that failed in 1990 and 1991, federal banking agencies took 167 post-failure enforcement actions against 167 officers and directors, with the most common enforcement action taken being a *letter of reprimand* (rather than other authorized penalties, including civil money penalties and orders banning officers or directors from the banking industry).[25]

Moreover, banking regulators are less likely to bring *public* enforcement actions against banks and bank employees, in light of their primary concern with maintaining the safety and soundness of the banking system. As former SEC Chairman John S.R. Shad has noted:

> A major thrust of the securities laws is full disclosure. By contrast, bank regulators are more concerned about the need for public confidence in banks, and therefore tend more toward confidentiality. The result is that the banking regulators' approach to their responsibilities under the securities laws is different from the SEC's.[26]

In recent years, federal banking regulators have been required to make additional information available to the public regarding enforcement actions brought under banking statutes or other provisions of law.[27]

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24 *See Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies*, United States General Accounting Office Report to Congressional Requesters (March 1994). The "insider violations" reviewed included (1) loans to insiders exceeding loan limits, (2) loans to insiders with preferential terms, (3) failure to maintain required records, (4) failures to obtain required prior board approval for loans, (5) overdraft payments exceeding limits and (6) exceeding restrictions on transactions to affiliates. *Id.* at 42.

25 *Id.* at 47-48. Of the 167 post-failure enforcement actions taken, 103 were either letters of reprimand or supervisory letters alerting the officers or directors of the need for corrective action. Only 64 of the 167 post-failure enforcement actions involved civil money penalties and/or orders banning officers or directors from the banking industry. *Id.*

26 *See Securities Activities of Depository Institutions, Hearings on S. 1720 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. 35 (1982).

27 Pursuant to Section 913 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, the federal banking agencies are required to "publish and make available to the public" final orders issued in connection with enforcement proceedings. In addition, under Section 2547 of the Crime Control Act of 1990, hearings on the record with respect to a notice of charges issued by the OCC in a banking enforcement action pursuant to 12 U.S.C. § 1818 shall be open to the public, unless the Comptroller, in his or her discretion, determines that holding an open hearing would be contrary to the public interest. *See* 12 U.S.C. § 1818(u).

Even so, OCC enforcement actions under the federal banking laws are typically made public just prior to the hearing, rather than at their inception (as is the case with SEC enforcement proceedings).[28] In addition, unlike the detailed releases published by the SEC upon the commencement or settlement of an SEC enforcement action, releases issued by the banking agencies frequently do not describe the nature of the violation or the enforcement action taken.

Thus, it remains open to doubt whether a federal banking agency would ever treat a major bank as severely in an enforcement action as the SEC has treated major brokerage firms, such as Drexel Burnham Lambert and, more recently, Prudential Securities. The knowledge that the SEC is prepared to bring such highly publicized proceedings, however, undoubtedly sends a strong signal to participants in the securities industry to conform their behavior to the requirements of the law. Unless similar enforcement standards apply across-the-board with respect to bank mutual fund activities, not all investors in bank-sold or bank-advised funds will enjoy comparable protections. The Institute strongly believes, however, that strict and uniform enforcement of the federal securities laws is a cornerstone of the mutual fund industry's success.

B. Safety and Soundness Issues

Appropriate amendments to the federal securities laws to address investor protection issues should mitigate substantially any risk to safety and soundness presented by bank participation in the mutual fund industry. As a corollary proposition, if any risk *does* arise from bank involvement in the mutual fund business, it will likely result from the failure to treat banks similarly to other participants in the industry that are fully regulated under the federal securities laws. Thus, if bank-sold or bank-advised mutual funds are subject only to partial regulation under the federal securities laws, there is a heightened risk that banks may incur liability in connection with their mutual fund activities. Such liability, in turn, might pose a potential threat to the safety and soundness of depository institutions.

The experience of bank-sponsored real estate investment trusts ("REITs") during the 1970s provides historical support for this conclusion . In the mid-1970s, many large REITs were sponsored or managed by commercial banks or their affiliates. In general, these REITs were exempt from regulation as investment companies, pursuant to Section 3(c)(5)(c) of the Investment Company Act. In the late

28 *See* OCC Policies & Procedures Manual 5310-5 (Rev.) ("Securities Activities Enforcement Policy") (July 7, 1993) at 5.

1970s, REITs began to incur substantial losses due to a downturn in the real estate market; abusive transactions between the REITs and their advisers and affiliates contributed to these losses.[29]

Although the REITs were legally separate entities from the banks that managed them, large commercial banks extended additional credit to affiliated REITs out of concern that a REIT failure would have a "spillover effect" on the banks.[30] Had the REITs been subject to full regulation under the Investment Company Act, however, many of these potential losses could have been avoided, since the abusive transactions between the REITs and affiliated banks would have been prohibited and the management fees charged by the banks serving as the REIT advisers would have been subject to review by an independent board of directors. Indeed, it is unlikely that the banks would have felt obliged to place their own capital at risk had these safeguards existed.

In a recent speech, Comptroller Ludwig commented that the sale of mutual funds by banks "raises few if any safety and soundness concerns."[31] If bank mutual fund sales activities raise few safety and soundness concerns, then *no* justification exists for the regulation of such activities under federal banking laws, rather than the federal securities laws. The experience with REITs in the 1970s, however, suggests that the potential safety and soundness concerns can be greatly reduced by subjecting such activities to full regulation under the Investment Company Act and other provisions of the federal securities laws.

Banking regulators have a legitimate need to assure themselves that bank mutual fund activities do not adversely impact the safety and soundness of financial institutions. There is no justification, however, for their attempting to regulate mutual funds directly, as they do traditional banking products and services. Such regulation by the banking agencies invariably will lead to duplicative and inconsistent regulations and impose unnecessary costs on banks and other participants in the industry. In the end, this will not serve the interests of investors, ensure the safety and soundness of financial institutions or facilitate the ability of banks to engage successfully in the business. Instead, bank mutual

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29 During hearings before Congress, it was noted that many bank-affiliated REITs paid excessive advisory fees, incurred high levels of debt to support new bank loans, and borrowed funds on terms that were advantageous to the bank, but not the REIT. *See Real Estate Investment Trusts, Hearings on S. 2721 Before the Senate Committee on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. (1974) at 107-25.

30 *See* Garten, "Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age," 57 FORDHAM L. REV. 501, 555 n.308 (1989).

31 *See* Remarks by Eugene A. Ludwig, Comptroller of the Currency, Before the Consumer Federation of America (Dec. 3, 1993).

fund activities should be conducted by separate broker-dealer affiliates or subsidiaries of banks, subject to full regulation under the federal securities laws. Consequently, primary responsibility for oversight and enforcement with respect to these activities should be vested in the SEC.

C. Costs and Burdens Resulting from Current Regulatory Structure

1. Duplicative Regulation Under Securities and Banking Laws

While all other participants in the mutual fund industry are subject to a consistent set of standards, adopted and enforced by the SEC and self-regulatory organizations such as the NASD, banking organizations are also expected to comply with an additional, largely duplicative and often inconsistent set of standards developed by bank regulators. These standards, in our view, not only fail to serve the interests of investors, but also impose unique regulatory burdens and additional costs on banks and their affiliates.

Concerns such as these are *precisely* what led the Clinton Administration to propose the consolidation of the four principal bank regulatory agencies. Treasury Secretary Bentsen has stated that it "makes no sense to have four separate agencies, overlapping, often in conflict, in charge of our financial institutions."[32] He also pointed out that banks face excessive compliance costs as a result of the overlapping and inconsistent regulatory requirements issued by multiple banking agencies and that consolidation of these agencies would cut down on "excessive, wasteful and contradictory regulation."[33] Similarly, Comptroller Ludwig has acknowledged that regulatory consolidation is "an idea whose time has come" and that "[o]ne bank supervisor offers the American people accountability, efficiency, and effectiveness."[34] Ironically, at the same time that the Comptroller has urged the consolidation of federal banking agencies to eliminate perceived redundancies, conflicts and unnecessary administrative burdens and costs, all the federal banking agencies are rushing to establish themselves as mutual fund regulators, thereby creating *precisely* the same problems with respect to mutual fund regulation as currently exist with banking regulation.

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32 *See* "Clinton Seeking to Consolidate Bank Agencies," THE NEW YORK TIMES (Nov. 24, 1993), at 1.

33 *See* "Bentsen Says Bank Regulatory Consolidation Plan Will Save Millions," BNA'S DAILY REPORT (Feb. 11, 1994); "Brother Against Brother; Banking Regulation," SAVINGS AND COMMUNITY BANKER (Feb. 1994) (comments of Treasury Secretary Bentsen).

34 *See* "Clinton's Bank Consolidation Plan Will Be Very Effective, Former Regulators Say," BNA'S BANKING REPORT (Feb. 7, 1994) (comments of Comptroller Ludwig); "Treasury Unveils Plan for Regulatory Consolidation It Hopes to Move Next Year," BNA'S BANKING REPORT (Nov. 29, 1993), at 825 (statement by Comptroller Ludwig). OTS Acting Director Fiechter has also gone on the record that federal insured depository institutions should be subject to "a more consistent set of operating rules." *Id.*

In an effort to avoid inconsistent regulations among themselves, the federal banking agencies issued an "Interagency Statement" on bank mutual fund sales activities in February 1994. This cooperative effort is commendable, as is the fact that the bank regulators looked to existing SEC and NASD precedents for guidance.[35] Bank securities activities *should* be regulated in a similar manner as the securities activities of nonbanks. This goal is best served, however, by ensuring that one set of regulations under the federal securities laws is enforced by a single regulator -- the SEC. Nonetheless, it is apparent that numerous aspects of the regulation of bank mutual fund activities will continue to be determined separately by each banking agency and the SEC. For example, the OCC issued its own "Nondeposit Investment Sales Examination Procedures" just nine days after the "Interagency Statement" was released.[36] Similarly, the Federal Reserve Board has announced that it is independently preparing its own examiners to review "the whole series of transactions or decisions that are made in the process of marketing and selling a mutual fund."[37]

Even if the banking agencies could coordinate *all* aspects of their bank mutual fund guidelines, their standards would still duplicate or conflict with existing requirements under the federal securities laws. For example, registered broker-dealers participating in bank mutual fund sales activities (including both bank-affiliated and third-party broker-dealers) are already subject to SEC and NASD regulations. The recent banking agency guidelines, however, also apply to sales activities of any registered broker-dealers on bank premises and require banks to take steps to ensure that such broker-dealers comply with the guidelines.

The requirement that banks monitor the sales activities of registered broker-dealers increases the likelihood that a bank will be held liable for a broker-dealer's activities, raising safety and soundness concerns. In addition, third-party broker-dealers may prove reluctant to enter into networking

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35 In a similar vein, the OCC issued a statement last summer on the agency's policies regarding the enforcement of the federal securities laws with respect to national banks. The statement noted the OCC's intent to "enforce[ ] the federal securities laws as they relate to the securities activities of national banks in a manner generally consistent with the discipline and treatment accorded similarly situated nonbank entities and their associated persons." *See* OCC Policies & Procedures Manual 5310-5 (Rev.) ("Securities Activities Enforcement Policy") (July 7, 1993) at 2.

36 *See* OCC Bulletin 94-13, "Nondeposit Investment Sales Examination Procedures" ("OCC Sales Procedures") (Feb. 24, 1994).

37 *See* "Fed Testing Procedure for Mutual Fund Inspections," AMERICAN BANKER (March 11, 1994) at 1 (statement by Governor John LaWare).

arrangements with banks if they must comply with regulations issued by the federal banking agencies, in addition to SEC and NASD requirements. As a result, more banks may opt to sell mutual funds directly, rather than through a registered broker-dealer. This result will not serve to protect investors and may actually contribute to potential safety and soundness concerns (since banks will be exposed *directly* to any litigation risk associated with their brokerage activities).

Significantly, federal banking regulators only recently began to address bank mutual fund activities, with a preliminary focus on sales activities. Banking agencies are *now* turning their attention, however, from bank sales practices to issues relating to fund management. At a recent hearing, Comptroller Ludwig stated that it is the OCC's intention to undertake "systematic examination and supervision aimed specifically" at bank-advised mutual funds.[38] It has also been reported that "now that [bank regulators'] guidelines for mutual fund sales are firmly in place * * * the [regulators'] spotlight will fall on bank proprietary mutual fund activities."[39]

Since fund advisory activities are already subject to extensive oversight and supervision under the federal securities laws, efforts by federal banking agencies to regulate such activities under federal banking laws -- no matter how well-intentioned -- will compromise the historical and exclusive authority of the SEC over investment companies under federal securities laws.[40] Banks and bank-affiliated broker-dealers that attempt to comply with the emerging standards will be subject to duplicative and inconsistent requirements, while banks that do *not* abide by the new standards may be subject to, at most, uneven enforcement. Moreover, in light of the national market for mutual funds (*i.e.*, shares of mutual funds are now sold through numerous distribution channels, including banks), this misplaced activism by the federal banking agencies stands to interfere with the effective regulation and business conduct of the *entire* industry.

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38 *Hearings on Bank Mutual Fund Activities Before the Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance of the House Committee on Banking, Finance and Urban Affairs*, 103d Cong., 2d Sess. (1994) (oral statement of Comptroller Ludwig).

39 *See* "Banks Funds Seen Gaining Attention," AMERICAN BANKER (Feb. 15, 1994) at 9.

40 The OCC's February 1994 examination procedures provide some indication of the types of issues that are likely to arise, although these procedures only represent the "tip of the iceberg" in terms of possible banking agency initiatives. For example, these procedures provide that examiners should ensure that, when selecting funds to be sold by or through a bank, bank management has evaluated a fund's "contingency plans for handling unusual surges in redemptions," the "stability of asset values over time" and the "continuity [and] tenure" of the fund's management. These requirements will not necessarily lead banks to recommend suitable investments for customers, but may lead to inappropriate efforts by a bank to interfere with ongoing fund management.

2. Restrictions Imposed by the Glass-Steagall Act

While the current regulatory structure contains certain significant gaps, it also presents impediments to banks wishing to engage in the mutual fund business. For example, under the Glass-Steagall Act, banks are prohibited from sponsoring mutual funds or underwriting and distributing the securities of mutual funds. In addition, the Glass-Steagall Act also prohibits officers, directors or employees of member banks from serving as an officer, director or employee of a mutual fund. As the federal banking agencies and the federal courts have allowed banks to engage in other mutual fund-related activities, these restrictions are increasingly perceived as "statutory vestiges."

V. H.R. 3447: "THE SECURITIES REGULATORY EQUALITY ACT OF 1993"

The Institute strongly supports the goals and regulatory philosophy of H.R. 3447, which recognizes that investors are best protected if *all* participants -- whether investment advisers, registered broker-dealers, insurance companies or banking organizations -- in the mutual fund industry are fully subject to regulation under the federal securities laws, enforced in the same manner by the single federal agency that Congress created to protect investors in securities -- the SEC. H.R. 3447 would serve the important goals of investor protection and safety and soundness, while promoting regulatory uniformity and reducing current costs and burdens.[41]

The Institute's views on key provisions of H.R. 3447 are summarized below:

Amendments to the Investment Company Act to Address Potential Conflicts When Banks Advise Mutual Funds: These amendments are appropriate because the Act addresses the potential conflicts that may arise in situations in which securities firms advise mutual funds, but fails to guard against the unique potential conflicts that may arise in situations where banks or their affiliates serve as investment advisers to funds. Current banking laws also fail to protect investors in such situations because they are generally intended only to ensure that transactions between banks and affiliated entities are at least as favorable to the *banks* as similar arm's-length transactions with third parties.

41 In the past, the Institute has supported similar reforms that were included in H.R. 797, "The Securities Regulatory Equality Act of 1991," H.R. 6, "The Financial Institutions Safety and Consumer Choice Act of 1991" and S. 543, "The Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991."

The Institute believes, however, that the amendments should be in the form of grants of rulemaking authority to the SEC, rather than prohibitions subject to the issuance of exemptive rules or orders by the Commission. If banks were only now entering the mutual fund business, the Institute would favor the adoption of prophylactic measures such as are contained in H.R. 3447, subject to SEC exemptive rules or orders. As banks are already major participants in the industry, however, the enactment of new prohibitions at this time could prove disruptive.[42] Thus, a more practical approach in the current environment would be to confer rulemaking authority on the SEC under the Act to address potential conflicts that may arise when banks or their affiliates advise mutual funds. Precedent for this approach is found in Section 12 of the Act, which authorizes the SEC to adopt rules governing the ability of mutual funds, among other things, to purchase shares on margin or engage in short sales.

Treatment of Publicly Advertised Common Trust Funds: The Institute strongly supports Section 119 of H.R. 3447, which would clarify the exemptions of bank common trust funds under the Investment Company Act, the Securities Act and the Exchange Act. In particular, the Institute agrees that common trust funds that are offered to the general public, or are used other than as an aid to the administration of *bona fide* fiduciary accounts (*e.g.*, through the imposition of double fees at the fund level to participating accounts), should be regulated as investment companies under the federal securities laws. At the same time, the Institute continues to support legislation under consideration by another Committee to provide for the tax-free conversion of bank common trust funds into registered investment companies.

Deletion of the Current Exclusion of Banks from the Definition of "Investment Adviser": The Institute agrees that banks and bank holding companies that advise mutual funds should be held to the same standards as other investment advisers, including SEC oversight (and access to the adviser's records) and restrictions on performance fees, agency cross-transactions and principal transactions. The Institute believes that H.R. 3447 should add a provision that provides that the registration of a separate division or department of a bank will be deemed to satisfy the Act's registration requirements. A similar provision allowing for the registration of a "separately identified division" or "department" of a bank was included in both H.R. 6 and S. 543.

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42 For example, many banks currently provide custodial services to affiliated mutual funds. Thus, a prohibition on the ability on banks to serve as an affiliated fund's custodian would interfere with existing business relationships by requiring many bank-affiliated funds to find new custodians.

Repeal of Current Exemptions of Banks from the Definition of "Broker": The Institute supports H.R. 3447's elimination of the current exemption of banks that engage in retail mutual fund sales activities from the definition of a "broker." In light of the expansion of bank mutual fund sales activities, this exemption no longer makes sense.

Establishment of Separate Corporate Entities to Conduct Securities Activities: The Institute supports the general requirement that banks falling within the amended definition of a "broker" under H.R. 3447 should also create separate nonbank affiliates or subsidiaries, subject to SEC and NASD oversight, to engage in retail mutual fund sales activities. As we have noted, many banks already conduct their mutual fund sales activities through separate subsidiaries or affiliates. In particular, the establishment of separate corporate entities should reduce potential conflicts that may arise when banks engage in mutual fund activities and facilitate the effective supervision of these activities by the SEC and the NASD.

Expanded Definition of Affiliated Persons and Transactions: The Institute remains concerned about the expanded definitions of affiliated persons and transactions contemplated by Section 112 of H.R. 3347. Mutual funds are subject to stringent limitations on transactions with affiliated persons, and both funds and their shareholders could be harmed if the class of "affiliated persons" is defined too broadly. Thus, the Institute does not believe that Section 112(a) should authorize the SEC to deem *any* person an "affiliated person" of a mutual fund by reason of such person's "material" business or professional relationship with the fund or an affiliated person of the fund during the fund's last two fiscal years. This might have the effect of causing a firm that a mutual fund dealt with precisely because it was *not* affiliated with the fund to become an "affiliated person" of the fund. If there is a specific class of persons that, because of their ability to influence the operations of a mutual fund, should be added to the definition of "affiliated person," the current, overly broad provision should be revised to cover that particular class.

In addition, while the Institute supports the objective of Section 112(b) -- addressing the conflicts that may arise when a banking organization advises a mutual fund and, in its separate capacity as a lender, has an interest in having its outstanding loans repaid -- the Institute believes that this objective can best be achieved by authorizing the SEC to adopt rules in this area, rather than by prohibiting any acquisition of shares by a fund during an underwriting where the proceeds are used to retire indebtedness to an affiliated bank.

Coordination Between the SEC and Federal Banking Agencies: The creation of separate corporate affiliates to engage in mutual fund activities serves to reduce the risk that the same entity will be subject to oversight by multiple regulatory agencies with different statutory responsibilities. To further guard against the risk of inconsistent and duplicative regulation under both federal securities and banking laws, however, the Institute would recommend that Congress mandate a mechanism in H.R. 3447 directing the SEC to coordinate with the federal banking agencies in appropriate circumstances. In particular, Congress might direct the SEC to develop examination procedures for bank advisory and sales activities in order to assure that the results of its reviews are made available to federal banking agencies on an as-needed basis.

Mechanisms for coordination between the SEC and federal banking regulators designed to reduce duplicative regulations and examinations exist in other provisions of the federal securities laws. For example, Section 17(b) of the Exchange Act, part of the 1975 amendments to the federal securities laws, authorized the SEC to conduct examinations of *any* registered clearing agency, transfer agent or municipal securities dealer. At the same time, however, Congress directed that the SEC give notice of its intention to conduct examinations of clearing agencies, transfer agents and municipal securities dealers that were primarily regulated by federal banking agencies to such agencies "with a view to avoiding unnecessary regulatory duplication or undue regulation burdens." In addition, Congress required in Section 17(c) that when an agency *other* than the SEC commences a proceeding against a registered clearing agency, transfer agent or municipal securities dealer, it must file a notice of the proceeding and a copy of any order entered by the agency with the Commission. Thus, even when Congress allowed federal banking agencies to share responsibilities for bank securities activities, it affirmed both the SEC's "ultimate responsibility in the area of compliance with the federal securities laws" and the need to "foster coordinated enforcement and assure an efficient and uniform regulatory structure."[43]

Section 17(h) to the Exchange Act, added by The Market Reform Act of 1990, provides another example of a similar mechanism for coordination. Section 17(h) directs the SEC to notify the federal banking agencies when it becomes aware of significant risks to a bank or bank holding company as a result of the activities of an affiliated broker-dealer. Similar procedures have also been included in other financial services reform proposals considered in recent years, including H.R. 6, "The Financial Institutions Safety and Consumer Choice Act of 1991." These examples suggest not only that there is ample precedent for the type of mechanism suggested by the Institute, but also that fully regulating bank mutual fund activities under federal securities laws -- a step *absolutely* necessary to protect investors -- need not interfere with the ability of bank regulators to carry out their responsibilities to protect the safety and soundness of the banking system. Moreover, fully regulating bank mutual fund activities

43 *See* S. REP. NO. 75, 94th Cong., 1st Sess. 51-53 (1975).

under the federal securities laws would eliminate the additional costs and burdens imposed upon participants in the industry under the current, duplicative system.

Additional Bank Mutual Fund Powers: The Institute believes that bank mutual fund legislation should include the elimination of the current Glass-Steagall restrictions on the ability of banks or their affiliates to sponsor, or underwrite and distribute the securities of, mutual funds and the ability of bank officers, directors or employees to serve as directors of an affiliated fund. If the reforms contemplated by H.R. 3447 were accomplished, these prohibitions would be unnecessary.

VI. CONCLUSION

The Institute supports comprehensive legislation to modernize the federal securities laws to reflect current bank mutual fund activities and establish a uniform set of investor protection standards. When the Investment Company Act was adopted, Congress understood that the Glass-Steagall Act barred banks from the mutual fund industry. Thus, the Investment Company Act addresses the potential conflicts that may arise in situations where a securities firm serves as an investment adviser to a mutual fund, but not where a bank or its affiliate serves as a fund adviser. With the growth of bank proprietary funds, however, banks have become major participants in the mutual fund business. Accordingly, Congress should amend the federal securities laws to address the evolution of the industry.

Furthermore, Congress should eliminate the current exemptions of banks from the definitions of "investment adviser" and "broker" under the federal securities laws. In addition, the Institute believes that banking organizations should conduct *all* retail sales of mutual funds through separate broker-dealer affiliates subject to oversight by the SEC and self-regulatory bodies such as the NASD. As we have noted in this testimony, many banks already conduct all of their retail mutual fund sales through such registered broker-dealers.

At the same time, Congress should grant banks full mutual fund powers by removing the existing restrictions on the authority of banks and their affiliates to underwrite and distribute mutual funds. In addition, the current limitations on the ability of officers, directors or employees of member banks to serve on a fund's board of directors should be repealed.

The future success of bank and nonbank participants in the mutual fund industry alike depends on the public's sustained confidence in mutual funds as a means to obtain the benefits of professional money management and diversification of investments. The Institute is committed to addressing the issues raised by functional regulation and the expansion of bank mutual fund advisory and sales activities, including the need to ensure that such activities are conducted in a manner consistent with the highest standards of the industry. We thank you for this opportunity to present our views and look forward to working with this Subcommittee as H.R. 3447 moves forward.