January 1995


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BANK GROWTH IN THE INVESTMENT COMPANY INDUSTRY: DO GUIDELINES ISSUED BY THE COMPTROLLER OF THE CURRENCY COMPENSATE FOR BANK EXCLUSION FROM STATUTORY PROVISIONS OF THE FEDERAL SECURITIES LAWS DEFINING "BROKER/DEALER" AND "INVESTMENT ADVISER"?

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Under the current regulatory scheme, banks directly engaged in mutual fund activities are regulated under the federal banking laws by the Office of the Comptroller of the Currency, whereas bank subsidiaries and non-bank affiliates engaged in mutual fund activities must be registered broker-dealers that are subject to Securities and Exchange Commission regulation under the federal securities laws. The regulatory tools provided to the banking regulators by the federal banking laws were designed to provide for the protection of depositors and for the safety and soundness of the bank. The remedies available under the federal banking laws dealing with violations involving the sales of securities, however, are not as comprehensive as those available under the federal securities laws. Mr. Caldarelli contends, in this very comprehensive Article, that while previous efforts to allow for functional regulation of securities have failed, the time is right to give the Securities and Exchange Commission the authority to regulate all securities activities regardless of whether the entity engaging in the activities is a bank or a securities firm. In conclusion, Mr. Caldarelli argues that because of several pivotal reasons the bank exclusion from the stat-

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utory provision of the federal securities laws defining "broker/dealer" and "investment adviser" should be eliminated, which, in effect, would result in the Securities and Exchange Commission obtaining functional regulation of all participants in the securities markets.

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I. INTRODUCTION

Since the early 1980's, when it was still believed that the Glass-Steagall Act barred bank mutual fund activities, a number of federal banking agency rulings and court decisions have interpreted the Glass-Steagall Act to allow banks to engage in virtually

1. An investment company is a corporation, trust, or partnership which invests pooled funds of shareholders in securities appropriate to the funds' objectives. Mutual funds, also known as open-end investment companies, are the most popular type of investment company.

A mutual fund is an investment company that pools money from shareholders and invests in a variety of securities, including stocks, bonds and money market securities. A mutual fund stands ready to buy back (redeem) its shares at their current net asset value. Most mutual funds offer new shares on a continuous basis.

A closed-end investment company issues a limited number of shares and does not redeem the shares. Closed-end shares are traded in the securities markets with supply and demand determining the price. See generally Bank Mutual Funds, Minority Staff of the House Banking Comm., 102d Cong., 2d Sess. (1993).
every phase of the mutual fund business. Every phase of the mutual fund business. Banks are now permitted to engage in the same mutual fund activities as a securities firm except that a bank cannot act as an underwriter for the mutual fund. The permissible bank mutual fund activities include acting as: (1) adviser for the fund by providing professional investment advice and implementing strategies and portfolio management; (2) custodian by maintaining the fund's securities; (3) broker by executing the purchase and sale of securities for the fund; and (4) administrator and servicing agent by providing reports to shareholders, recordkeeping, and accounting assistance.

Investment in mutual funds has grown substantially as investors, dissatisfied with low yields on federally insured bank certificates of deposit, are seeking higher yields and are moving their money out of bank deposits and into uninsured mutual funds. Mutual fund sales by commercial banks have shown a corresponding growth in an effort by banks to meet their customer's needs, preserve customer relationships, and generate fee income to off-set the loss of deposits.

The substantial growth in bank mutual fund activities has caused attention to be focused on the existing statutory regulatory

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3. Bank Mutual Funds, Minority Staff of the House Banking Comm., 102d Cong., 2d Sess. (1993). It is uncertain how "underwriting" applies to a mutual fund. Bank mutual fund experts believe that it is a misnomer to apply the term "underwriting" to mutual funds. The Federal Reserve stated that the underwriting falls to the fund's "distributor" in a mutual fund context. The distributor performs the following functions: (1) handling the distribution of the fund's shares; (2) conducting sales presentations to promote investment in the fund; and, (3) planning and implementing advertising, sales and marketing strategies. Mutual fund activities of a bank and a "distributor" have blurred in recent years to the point where it could be said that banks do "underwrite" mutual funds. Id.
4. Id.
5. Mutual fund assets have increased twenty-six percent since December 1992 and now exceed two trillion dollars. It is also estimated that about twenty-eight percent of U.S. households own mutual fund shares. See Investment Co. Inst. Press Release No. 94-02, at 4, Jan. 24, 1994.
scheme in which direct mutual fund activities by banks are regulated by the Office of the Comptroller of the Currency (hereinafter "OCC") and are excluded from the federal regulatory scheme which regulates broker-dealers and investment advisers. The concern on the part of the Securities and Exchange Commission (hereinafter "SEC") is due largely to the apparent conflicting focus of bank regulation, which is generally to ensure the safety and soundness of the bank and depositor protection, and that of the federal securities laws in which investor protection is of paramount importance. The SEC believes there should be functional regulation of securities activities whereby banks would be regulated according to their function rather than the type of charter they possess. Under this regulatory approach, the SEC would regulate both the securities activities of banks and securities firms.

Part II of this Article provides background information concerning traditional Glass-Steagall restrictions on bank securities activities, the erosion of these restrictions, and the authority of banks to engage in mutual fund activities. Part III discusses both the regulation of mutual fund activities which includes bank exclusions from the federal securities laws and the regulatory structure for mutual fund activities of banks, and it also reviews the recent Guidelines for National Banks Involved in Retail

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7. The debate over functional regulation of securities activities has been going on for some time. Congressman Markey introduced the "Bank Broker-Dealer Act" on May 28, 1987, but it was not passed. Also, Rule 3b-9 was struck down by the court. See ABA v. SEC, 804 F.2d 739 (D.C. Cir. 1986). Recently, similar reforms, that included House Bill 797, "The Securities Regulatory Equality Act of 1991," House Bill 6, "The Financial Institutions Safety and Consumer Choice Act of 1991," and Senate Resolution 543, "The Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991," were introduced by Congress.


9. Id.
10. Id.
11. Id.
Nondeposit Investment Sales. Part IV examines concerns of the SEC with the adequacy of these guidelines, and it looks at legislative proposals for changing the regulatory structure for banks involved in securities activities. Part V of this Article concludes that Congress should grant the SEC functional regulatory authority over direct bank mutual fund activities.

II. BACKGROUND OF BANK SECURITIES ACTIVITIES

The Glass-Steagall Act of 1933 was passed to protect depositors from the widespread bank closings that took place during the

12. There are five provisions of the Glass-Steagall Act dealing with the separation of banks and their affiliates from investment banking activities. They are:

(1) Section 16 limits the power of national banks in dealing in securities and stock to "purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account," and further provides that a national bank "shall not underwrite any issue of securities or stock." The section contains an exception which permits purchases of certain corporate securities for the bank's own account under regulations prescribed by the Comptroller of the Currency and contains exemptions which permit the purchase, sale, and underwriting of many types of government securities. 12 U.S.C. § 24(7) (1988).

(2) Section 20 prohibits affiliations of member bank of the Federal Reserve System with any entity "engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities." 12 U.S.C. § 377 (1988). For purposes of functional regulation, it is important to note that the Federal Reserve Board has permitted bank holding companies to own nonbank "section 20 affiliates," which are registered as broker/dealers subject to SEC oversight, that engage in limited underwriting of securities. Hearing Before the Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce, 103d Cong., 2d Sess. 6 (1994) (statement of John P. LaWare, Member, Board of Governors of the Federal Reserve System).

(3) Section 21 prohibits entities engaged in the business of "issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities" from receiving deposits, subject to the proviso that this Section shall not prohibit banks from "dealing in, underwriting, purchasing, and selling investment securities" to the extent permitted to national banks under section 16. 12 U.S.C. § 378 (1988).

(4) Section 9 subjects state member banks to the same limitations and conditions as national banks with respect to "purchasing, selling, underwriting, and holding of investment securities and stocks." 12 U.S.C. § 335 (1988).

(5) Section 32 prohibits officers, directors, or employees of an entity "primarily engaged in the issue, flotation, underwriting, public sale or distribution, at wholesale or retail, or through syndicate participation, of stocks,
Great Depression.\textsuperscript{13} One of the co-sponsors of the bill, Representative Steagall, explained:

[T]he purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe. They have a right to expect of Congress the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with reasonable expectations of being able to get them out again on demand.\textsuperscript{14}

Congress sought to separate commercial banking from investment banking activities in order to prevent securities firm affiliates of banks from engaging in risky underwriting operations, stock speculation, and maintaining a market for the bank’s own stocks, in many instances with the bank’s own money.\textsuperscript{15} In addition to the danger of banks using bank assets for speculative securities investments, the U.S. Supreme Court recognized the following “subtle hazards” involved in bank securities activities:

Because the bank and its affiliate would be closely associated in the public mind, public confidence in the bank might be impaired if the affiliate performed poorly. Further, depositors of the bank might lose money on investments purchased in reliance on the relationship between the bank and its affiliate. The pressure on the banks to prevent this loss of public confidence could induce the bank to make unsound loans to the affiliate or to companies in whose stock the affiliate has invested. Moreover, the association between the commercial and investment bank could result in the commercial bank’s reputation for prudence and restraint being attributed, without justification, to an enterprise selling stocks and securities. Furthermore, promotional considerations might induce banks to make loans to customers to be used for the purchase of stocks and might impair the ability of the commercial banker to render disinterested advise.\textsuperscript{16}

The pinnacle of the separation between commercial banking and investment banking functions occurred in the Supreme Court’s decision in Investment Company Institute v. Camp.\textsuperscript{17} The issue in Camp was whether Regulation 9, issued by the Comptrol-

\begin{itemize}
  \item S. Rep. No. 77, 73d Cong., 1st Sess. 6, 10 (1933).
  \item Federal Reserve Bd. v. ICI, 101 S.Ct. at 987, n. 38.
\end{itemize}
ler of the Currency authorizing a national bank to offer its customers the opportunity to invest in a stock fund created and maintained by the bank, was valid under the federal banking laws. The plan for the collective investment of managing agency accounts approved by the Comptroller and expected to be the model used by other banks entering this field was described by the Court as follows:

Under the plan the bank customer tenders between $10,000 and $50,000 to the bank, together with an authorization making the bank the customer's managing agent. The customer's investment is added to the fund, and a written evidence of participation is issued which expresses in 'units of participation' the customer's proportionate interest in fund assets. Units of participation are freely redeemable, and transferable to anyone who has executed a managing agency agreement with the bank. The fund is registered as an investment company under the Investment Company Act of 1940. The bank is the underwriter of the fund's units of participation within the meaning of that Act. The fund has filed a registration statement pursuant to the Securities Act of 1933. The fund is supervised by a five-member committee elected annually by the participants pursuant to the Investment Company Act of 1940. The [SEC] has exempted the fund from the Investment Company Act to the extent that a majority of this committee may be affiliated with the bank, and it is expected that a majority of this committee may be affiliated with the bank, and it is expected that a majority always will be officers in the bank's trust and investment division. The actual custody and investment of fund assets is carried out by the bank as investment advisor pursuant to a management agreement. Although the Investment Company Act requires that this management agreement be approved annually by the committee, including a majority of the unaffiliated members, or by the participants, it is expected that the bank will continue to be investment advisor.

The Court concluded that this plan was essentially an open-end investment company, which is known as a mutual fund, and "that the business of a mutual fund consists of buying stock 'for its own account' and of 'issuing' and 'selling' 'stock' or 'other securities' evidencing an undivided and redeemable interest in the assets of the fund." While it was well established that national banks had the authority to "pool trust assets, or act as a managing

18. Id. at 621.
19. Id. at 622-23.
20. Id. at 625.
agent for individuals, or purchase stock for the account of its customers," the combination of these activities was impermissible.\textsuperscript{21} In holding that the Comptroller did not have the authority to approve the bank activities as set forth in the plan, the Court relied on the plain meaning of the language of section 16 and section 21 of the Glass-Steagall Act.\textsuperscript{22}

It was clear from the Court's decision in \textit{Camp} that the Glass-Steagall Act was seen as a complete barrier to national banks entering the securities area. As the Court stated:

The Glass-Steagall Act was a prophylactic measure directed against conditions that the experience of the 1920's showed to be great potentials for abuse. The literal terms of that Act clearly prevent what the Comptroller has sought to authorize here. Because the potential hazards and abuses that flow from a bank's entry into the mutual investment business are the same basic hazards and abuses that Congress intended to eliminate almost 40 years ago, we cannot but apply the terms of the federal statute as they were written. We conclude that the operation of an investment fund of the kind approved by the Comptroller involves a bank in the underwriting, issuing, selling, and distributing of securities in violation of ss 16 and 21 of the Glass-Steagall Act.\textsuperscript{23}

A. \textit{Erosion of Glass-Steagall}

Ironically, the Court's concern about the "subtle hazards" of banks once again becoming involved in investment banking activities led to the eventual erosion of many of the Glass-Steagall restrictions on securities activities by banks.\textsuperscript{24} By structuring activities in a manner that avoids these "subtle hazards," banks have gradually been able to break through the Glass-Steagall barrier and have become increasingly involved in securities activities.

In \textit{Federal Reserve Board v. ICI}, the ICI, a mutual fund trade association, challenged the Federal Reserve's amendment to Regulation Y which allowed bank holding companies and non-bank

\textsuperscript{21} Id. at 625.

\textsuperscript{22} \textit{Camp}, 401 U.S. at 625. The Court explained that section 16 of Glass-Steagall prohibits a bank from underwriting securities and provides that a bank can only purchase securities upon the order and for the account of customers, without recourse. Section 21 prohibits any person or organization engaged in issuing, underwriting, selling or distributing securities to engage in the business of banking. \textit{Id.} at 623-24.

\textsuperscript{23} \textit{Id.}

\textsuperscript{24} See supra text accompanying note 16 which summarizes the "subtle hazards" discussed in \textit{Camp}.
subsidiaries to act as investment advisers to closed-end investment companies. The Court concluded that the "subtle hazards" as expressed in Camp would not be present where a bank acts as an investment adviser to a closed-end investment company subject to the restrictions imposed by the Federal Reserve Board. The restrictions prevented the bank from extending credit to the investment company, precluded the promotional pressure inherent in investment banking, and prevented the bank from underwriting or selling the stock of the closed-end investment company.

Furthermore, the Court has established that, in implementing the "subtle hazards" analysis to determine whether an activity is prohibited by Glass-Steagall, the existence of one of the "subtle hazards" will not prohibit the activity. A banking practice will be prohibited under Glass-Steagall only when all of the "subtle hazards" are present. Finally, courts will treat the "subtle hazards" analysis as a "specific instance of the Chevron principle that requires deference to an agency's reasonable construction of its statute's ambiguities."

Traditional commercial banking customers recently have found that the securities markets provide a more attractive source of financing and investment services than commercial banks. Depositors have moved their funds out of certificates of deposit seeking higher yields on their investments. Mutual funds, in particular, have emerged as a competitor to the commercial banks' traditional role as supplier of business capital and repository of

25. See supra note 1.
27. Id. at 986.
28. The bank was obligated to render impartial advice to its customers, it could not act as investment adviser to any investment company having a similar name to the bank, prospectuses and sales literature of the investment company could not be distributed by the bank, officers and employees of the bank could not express an opinion with respect to the advisability of the purchase of securities of the investment company, and the investment company could not locate its offices in the same building as the bank. Id.
30. Id.
31. Id.
33. Id.
In response to the competition for funds that were traditionally earmarked as bank deposits, the OCC has reacted by allowing banks to become actively involved in mutual fund activities under the authority to approve an activity that can be done by banks in a safe and sound manner, provide for the needs and convenience of bank customers by giving them a greater choice in shopping for mutual fund services, and permitting banks to compete on a level playing field with other providers of financial services, thus enhancing competition in the mutual fund market.

Another factor contributing to the gradual erosion of the Glass-Steagall restrictions has been the re-evaluation of the legislative history of Glass-Steagall concerning the justification of the Act. The re-examination of the legislative history has revealed little evidence that securities firms affiliated with banks had engaged in risky underwriting operations, stock speculation, or maintained a market for the bank's own stocks. Federal Reserve Chairman Alan Greenspan has also stated, "research over the past [fifty] years concludes, contrary to Congress' view at the time, that bank securities activities were not a cause of the Great Depression." The Senate Committee on Banking, Housing, and Urban Affairs agreed with Chairman Greenspan and concluded, "abuses by commercial banks that were engaged in securities activities were not a substantial cause of the collapse of the financial system in the early 1930's."
In retrospect, the enactment of Glass-Steagall seems to have been more a result of the public outcry for reform. The Act was an attempt by Congress to restore public confidence in the financial system following the stock market crash of 1929, rather than an attempt to prevent the perceived abuses and conflicts of interest on the part of banks involved in investment banking operations.\(^{39}\)

**B. Bank Authority to Engage in Mutual Fund Activities**

Section 16 of the Glass-Steagall Act was regarded as a severe restriction on the ability of national banks to engage in securities activities.\(^{40}\) However, while section 16 places limitations on bank securities activities, several activities were specifically preserved:

The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite an issue of securities or stock.\(^{41}\)

In addition, section 16 gives national banks a broad grant of authority to "exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking."\(^{42}\) National banks are also given the express trust powers to provide fiduciary and custodial services and to act as transfer agents.\(^{43}\) These statutory provisions have combined to provide the framework for the authority of national banks to engage in mutual fund activities.

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41. *Id.*
42. *Id.*
43. 12 U.S.C. § 92a (1988). Section 92(a) states:

The Comptroller of the Currency shall be authorized and empowered to grant by special permit to national banks applying therefor, when not in contravention of State or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardian of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which State banks, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the State in which the national bank is located.

*Id.*
The powers of banks to perform brokerage services has been well established by several court decisions.44 The OCC has correspondingly allowed national bank subsidiaries to include securities brokerage activities which include the purchase and/or sale, as agent, of mutual fund shares.45 National banks and their subsidiaries are also authorized to provide investment advice as part of the incidental activities to the business of banking.46 Banking entities are permitted to recommend mutual funds to customers and to act as investment adviser to the same mutual funds.47

The Court found that the ability of a national bank to attract customers by advertising and marketing the services and products offered to customers is an integral part of investment advisory and brokerage services.48 The OCC, therefore, has concluded that national banks are permitted to advertise their services relating to mutual funds.49 Finally, national banks and their operating subsidiaries are permitted to provide administrative and share-

45. Interpretive Letter No. 622 at 5, 6 (Apr. 9, 1993).
47. 12 C.F.R. § 225.125 (1990). Section 225.125(a) states:
Effective February 1, 1972, the Board of Governors amended § 225.4(a) of Regulation Y to add "serving as investment adviser, as defined in section 2(a)(20) of the Investment Company Act of 1940, to an investment company registered under that Act" to the list of activities it has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.
Id. Section 225.125(c) states:
Under § 225.4(a)(5), as amended, bank holding companies (which term, as used herein, includes both their bank and nonbank subsidiaries) may, in accordance with the provisions of § 225.4(b), act as investment advisers to various types of investment companies, such as "open-end" investment companies (commonly referred to as "mutual funds") and "closed-end" investment companies.
Id.
49. See Interpretive Letter No. 622 (Apr. 9, 1993) (making lobby materials available on services, placing newspaper advertisements, sending statement stuffers and providing other descriptions of the variety of services that are available); see also Interagency Statement on Retail Sales of Nondeposit Investment Products, (Feb. 15, 1994) (acknowledging banks advertise and
holder services in connection with the operation of a mutual fund.\textsuperscript{50}

It is clear that banks, their affiliates or subsidiaries may engage in most activities related to mutual funds. These acts include providing investment advice to mutual funds and to customers, brokering mutual funds, advertising and marketing their services, and providing administrative and shareholder-related services to mutual funds. Underwriting of mutual funds remains the only activity that banking entities cannot provide to mutual funds.

In 1987 the Federal Reserve Board approved the applications of several bank holding companies to utilize subsidiaries to underwrite and deal in bank in-eligible\textsuperscript{51} securities.\textsuperscript{52} The issue faced by the court was whether the Board's approval of this underwriting activity violated section 20 of the Glass-Steagall Act, which forbids a member bank of the Federal Reserve System from affiliating with an organization "engaged principally" in underwriting or dealing in securities.\textsuperscript{53} The Board relied on its order in \textit{Bankers Trust of New York Corp.}\textsuperscript{54} which held that the term "engaged principally" means any substantial activity.\textsuperscript{55} The Board concluded that a subsidiary would not be engaged substantially in bank in-eligible activities if no more that five to ten percent of their total gross revenues were derived from such activities over a two-year period.\textsuperscript{56} The court agreed with the Board's "engaged principally" analysis\textsuperscript{57} and with this decision began chipping away at the Glass-Steagall Act's remaining barrier to bank securities activities.

\textsuperscript{50} See, e.g., Interpretive Letter No. 386 (Jan. 19, 1987) (providing recordkeeping, accounting, and other services in connection with 12b-1 and similar plans); Interpretive Letter No. 332 (Mar. 8, 1985) (recordkeeping, order execution functions, and shareholder information).


\textsuperscript{53} Id. at 50.


\textsuperscript{55} SIA v. Board of Governors of the Fed. Reserve Sys., 839 F.2d at 50.

\textsuperscript{56} Id. at 50.

\textsuperscript{57} Id. at 60.
C. Concerns Raised by Bank Mutual Fund Activities

A widespread misconception exists that mutual funds, either purchased through banks or from stockbrokers, are covered by FDIC insurance and are riskless investments. An SEC survey revealed the magnitude of the consumer confusion in the marketplace by finding that thirty-nine percent of investors mistakenly believed that mutual funds purchased from a stockbroker are federally insured, forty-one percent mistakenly believed that money market funds sold through banks are federally insured, twenty percent mistakenly believed that all mutual funds sold by banks are federally insured and thirteen percent mistakenly believed that they cannot lose money in a money market mutual fund.

Banks selling mutual funds often contribute to consumer confusion by selling mutual funds in branches that have the FDIC seal on the door and by selling funds that have the same or similar name as the bank which create the false impression that the bank stands behind the funds. Because of the steady bull market during the past three years, the potential negative economic consequences that could result from customer confusion concerning the risks involved in mutual fund purchases have not been felt. Many analysts feel that a downward spiral in the equity markets would have a severe negative impact on the United States’ economy.

III. Regulation of Mutual Fund Activities

A. Bank Exclusion from the Federal Securities Laws

The Securities Exchange Act of 1934, (“1934 Act”) defines the term “bank” in section 3(a)(6) as:

(A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving

58. Jerry Knight, Bank Regulator Backs Mutual Fund Sales Probe; Undercover 'Shoppers' are Proposed, WASH. POST, Apr. 12, 1994, at C1, col. 6.
59. Id.
60. Id.
61. See Fromson, supra note 34, at C1, col. 2.
62. David D. Hale, chief economist at Kemper Corp., and Wall Street economist Henry Kaufman, believe a rise in short-term interest rates will cause a drop in stock prices. This could cause a sell-off of securities by mutual fund shareholders which could, in turn, cause a greatly magnified bear market. Id.
deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency pursuant to Section 92a of Title 12, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this chapter.63

The term “broker” is defined in section 3(a)(4) as “any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.”64 Likewise, a “bank” is excluded from the definition of “dealer” which is defined in section 3(a)(5) of the 1934 Act as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank.”65

Because banks were already subject to regulatory oversight at the federal and state level, Congress defined the terms “bank,” “broker,” and “dealer” in a way that made it clear that the SEC should not have regulatory jurisdiction over banks.66

ABA v. SEC involved the issue of whether the SEC had the authority under the 1934 Act to regulate banks as “broker-dealers.”67 In 1985, the SEC adopted Rule 3b-9 which required banks to register as broker-dealers if they engaged in the securities brokerage business for profit.68 The SEC used its rulemaking authority because of the phrase “unless the context otherwise requires” which proceeds all 1934 Act definitions.69 Although banks were excluded from the definitions of “broker” and “dealer” in the 1934 Act, the SEC believed that the context in which the bank exclusions were enacted had significantly changed since 1934.70

64. Id. at § 78c(a)(4) (1988).
65. Id. at § 78c(a)(5) (1988).
66. ABA v. SEC, 804 F.2d 739, 744 (D.C. Cir. 1986).
67. Id.
68. 17 C.F.R. § 240.3b-9 (1986). Rule 3b-9 provides in part:
The term “bank” as used in the definition of “broker” and “dealer” in Sections 3(a)(4) and (5) of the Act does not include a bank that: (1) publicly solicits brokerage business for which it receives transaction-related compensation; . . . (2) Directly or indirectly receives transaction-related compensation for providing brokerage services for trust, managing agency or other accounts to which the bank provides advice; (3) Deals in or underwrites securities.
70. Id.
The impetus given to the SEC to adopt Rule 3b-9 was the increase in the number of securities activities banks could perform as a result of rulings by the various bank regulators and the courts.\textsuperscript{71} The SEC concluded that all institutions performing brokerage services should come under the same regulatory scheme that Congress created for broker-dealers, pursuant to the objective of ensuring fair competition among securities participants. Congress felt that it was "in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . fair competition among brokers and dealers, among exchange markets, and between exchange markets."\textsuperscript{72} The SEC's mandate in administering the federal securities laws is to provide a system of securities regulation that will ensure "the protection of investors through full and fair disclosure concerning securities sold and the prevention of unfair and inequitable practices in the securities markets."\textsuperscript{73} Broker-dealer registration is an important aspect in assuring fair competition among the participants in the securities markets, and the SEC felt that because bank securities activities are regulated under federal banking laws, where the focus is on the protection of depositors and the safety and soundness of the bank, bank regulation would therefore be outside the federal system of securities regulation as administered by the SEC which could lead to regulatory disparities.\textsuperscript{74} Rule 3b-9 was an effort at functional regulation of securities activities, where banks would be regulated according to their function, rather than the type of charter they possess.

The consequences of requiring banks to register with the SEC as broker-dealers would also have subjected banks to many specific regulations in order to compensate for the differences identified by the SEC between the federal securities laws regulations and federal banking law regulations concerning bank securities activities. First, persons associated with broker-dealers must pass examinations before they can sell securities or become involved in the management of a securities firm.\textsuperscript{75} Second, the 1934 Act imposes an affirmative duty on broker-dealers to adequately supervise its employees in order to prevent violations of

\textsuperscript{71} Id. at 28386.
\textsuperscript{73} 50 Fed. Reg. at 28387.
\textsuperscript{74} Id.
\textsuperscript{75} Id. at 28387. See, e.g., NASD By-laws, Schedule C, NASD Man. (CCH) ¶ 1102A (1983).
federal securities laws. Third, the SEC and the self-regulatory organizations (hereinafter “SRO”) have adopted rules to prohibit broker-dealers from engaging in sales abuse practices such as “churning” customer accounts in order to increase brokerage commissions. Fourth, broker-dealers must comply with specific guidelines concerning the content and review of advertisements. Fifth, the SEC periodically examines and inspects broker-dealers as part of its supervisory authority to ensure compliance with the securities laws.

The SEC felt that Rule 3b-9 brought banks within the regulatory scope created “with a national public interest which makes it necessary to provide for regulation and control of such transactions . . . to insure the maintenance of fair and honest markets in such transactions. . . .” The SEC’s attempt at functional regulation over bank securities activities, however, was short-lived when the court held, in ABA v. SEC, that the SEC operated under the limitations of the 1934 Act and could not regulate banks as broker-dealers. The court supported its analysis of why the SEC did not have the authority to change the statutory definition of a bank for purposes of Rule 3b-9 by showing Congress’ intent to preclude the SEC from regulating institutions that met the statu-

76. Id. at 28388. Section (b)(4)(E) of the 1934 Act provides an affirmative defense for failure to supervise if:

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.


77. “Churning” in the context of securities law is “a course of excessive trading through which a broker advances his own interests over those of his customer.” Costello v. Oppenheimer & Co., 711 F.2d 1361, 1367 (7th Cir. 1983).


79. 50 Fed. Reg. at 28387.

80. Id. at 28388. While the SEC acknowledges that banks are regularly examined by the banking agencies, they contend that the focus of the examinations is on the safety and soundness of the bank rather than investor protection.


82. ABA, 804 F.2d at 755, 756.

83. See supra notes 63-69 and accompanying text.
tery definition of "bank" in order to avoid duplicative regulation. The legislative history was clear in stating that definitions in the bill were "self-explanatory," and the definitions of "broker" and "dealer" were the "most important . . . since many of the provisions of the act apply only to members of exchanges and brokers and dealers who do business through them." Congress' intent to exclude institutions that were not included in the definition of "broker" and "dealer" from the 1934 Act's regulatory provisions was made clear where the Senate Report stated that "banks are expressly exempted from the definition of 'broker' and 'dealer'." The court stated that the SEC could not amend the statute excluding banks from the definition of "broker" and "dealer" through the rulemaking process and only Congress could make this change through legislation.

While the court found that Rule 3b-9 was invalid based on the plain meaning of the statutory language concerning the definition of "broker," "dealer," and "bank" and because Congress had been clear in allocating the responsibility for regulating financial institutions and markets among various federal agencies, the court was also sympathetic to the SEC's concerns, when it opined:

Given the dramatic changes in the nature of financial institutions and market practices in the last fifty years, Congress might do well to undertake a comprehensive reexamination of the Glass-Steagall Act and the Securities Acts. Indeed, it might well determine from such a reexamination that banks should be allowed to engage in brokerage business like any other broker, but that banks should be regulated by the SEC like any other broker.

In the final analysis, however, the court would not allow the unilateral action of the SEC to extend its jurisdiction to institutions regulated by other agencies.

B. Regulatory Structure of Bank Mutual Fund Activities

Banking entities choosing to conduct securities brokerage activities such as mutual fund brokerage in separate subsidiaries or affiliates of the bank are regulated by the SEC and the National Association of Securities Dealers (hereinafter "NASD") in the

84. ABA, 804 F.2d at 744-45.
86. Id.
87. ABA, 804 F.2d at 750.
88. Id.
89. Id. at 755.
same manner as other non-bank brokers and dealers. Banks that choose to operate in this manner are also subject to regulation under the federal banking laws. Banks acting as an investment adviser through separate companies are regulated under the Investment Advisers Act and the federal banking laws.

The OCC is the primary regulator for national banks that are involved in the direct sales of mutual funds, and currently, these banks are examined every twelve to eighteen months, depending on the banks' assets size, their overall condition, and the occurrence of a change in control. Banks exempted from the federal securities laws, as a result of being excluded from the definition of broker/dealer under the 1934 Act and from regulation under the Investment Advisers Act of 1940, are still subject to: (1) the anti-fraud provisions of section 10(b) of the 1934 Act and Rule 10b-5; (2) the Interagency Statement on Sales of Nondeposit Investment Products (which will be discussed in detail later); (3) recordkeeping and confirmation requirements for brokerage customers; (4) fiduciary regulation under state and federal law; (5) the same restrictions that apply to non-bank investment advisers in the Investment Company Act of 1940, for national banks acting as investment advisers to registered investment companies; (6) restrictions on transactions with affiliates imposed by section 23A and 23B of the Federal Reserve Act; and (7) enforcement actions brought by their primary regulator, pursuant to section 1818 of 12 U.S.C. for violations of any law or regulation, for unsafe or unsound banking practices, or for any violation of any condition imposed in writing by the appropriate federal banking agency in connection with the grant of any application or other request by the bank.

The anti-fraud provisions under section 10(b) of the 1934 Act and Rule 10b-5 promulgated by the SEC were designed to protect investors, to assure fair dealings in the securities markets and to promote ethical business practices. Congress designed section 10(b) to be a catch-all provision which has an infinite variety of

90. See Ludwig Testimony, supra note 6, at 12.
91. Id.
92. Id.
93. Id. at 11.
94. The Federal Reserve is the primary regulator for a state-chartered bank that is a member of the Federal Reserve System. The FDIC is the primary regulator for a state-chartered, non-member bank.
95. Ludwig Testimony, supra note 6, at 12.
96. Rule 10b-5 states:
practices which are proscribed under the statute. 97 Although section 10(b) does not create an express private right of action, the federal courts have recognized a private remedy under section 10(b). 98

Another regulatory tool utilized by the OCC in the regulation of bank mutual fund activities is found in the recordkeeping and confirmation requirements for brokerage customers. 99 Every national bank effecting securities transactions for customers must keep records for each customer showing all purchases and sales of securities, keep a separate record showing whether each order to purchase or sell was a market order, limit order, or other special order, record the price at which the order was executed, and record the broker/dealer utilized. 100 Additionally, each bank must have written policies and procedures designed to prevent the practice of "front-running." 101

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240, 10b-5.


98. The Supreme Court recognized "[t]he existence of this implied remedy is simply beyond peradventure." MacLean v. Huddleston, 459 U.S. 375 (1983).


100. 12 C.F.R. § 12.3 (1993).

101. "Front-running" is the practice of executing an order by a broker or dealer to purchase or sell a security for his own account, prior to executing a like order for a customer, thereby placing his interests before the clients. Section 12.6 states:

That bank officers and employees who make investment recommendations or decisions for the accounts of customers, who participate in the determination of such recommendations or decisions, or who, in connection with their duties, obtain information concerning which securities are being purchased or sold or recommended for such action, must report to the bank, within ten days after the end of the calendar quarter, all transactions in securities made by them or on their behalf. . . . The report shall identify the securities purchased or sold and indicate the dates of the transactions. . . .
Furthermore, banks involved in mutual fund activities would be subject to fiduciary obligations imposed by state and federal laws.102 National banks exercising investment discretion must have written policies and procedures in place to ensure that their brokerage placement activities comply with all laws and regulations.103 These policies and procedures should address the selection of persons conducting these transactions and the reasonableness of brokerage commissions paid to them, any acquisition of research services in return for brokerage commissions, the allocation of research or other services among accounts, and the need to disclose these policies and procedures to customers.104

Another major regulatory tool available to banks' primary regulator is provided by the broad reach of section 1818 of the Federal Deposit Insurance Act. The primary regulator of a bank can bring a cease-and-desist proceeding against an insured institution or any institution-affiliated party if the agency believes either party:

[I]s engaging or has engaged, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to engage, in an unsafe or unsound practice105 in conducting the business of such depository institution, or is violating or has violated, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to violate, a law, rule, or regulation, or any condition imposed in writing by the agency. ...106

If a cease-and-desist order is issued, the institution or its institution-affiliated parties must take affirmative action to correct the violation or unsafe or unsound practice.107 Under the authority to issue an order to take affirmative action to correct

12 C.F.R. § 12.6(d) (1993).
104. Id.
105. There is no statutory definition of "unsafe or unsound banking practice." The concept of unsafe or unsound practice touches the entire operation of a bank. The legislative history indicates:

[An unsafe or unsound practice embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the insurance fund administered by the corporation.

107. Id.
any violation or unsafe or unsound practice, the agency may require the institution or affiliated party to make restitution for a loss if the institution or affiliated party was unjustly enriched or if the violation or practice involved a reckless disregard for the law or any applicable regulation. 108 This statute also gives the banking agency a wide range of other remedies to pursue, which include the authority to restrict the growth of an institution, 109 remove or suspend any party from the institution or affiliate of the institution, 110 or take any other action the banking agency determines is appropriate. 111

In addition, section 1818 provides for monetary damages for institutions or affiliated parties ranging from five thousand dollars per day up to a total of one million dollars, depending on the level of scienter, for the violation of laws or regulations, for engaging in unsafe or unsound practices, or for breaches of any fiduciary duty. 112 Finally, the statute provides that the federal banking agency must publish any final order that resulted from an administrative enforcement proceeding in an effort to deter improper conduct. 113

It is clear that section 1818 of the Federal Deposit Insurance Act gives the banking regulators a wide range of enforcement powers for violations of laws or regulations, engaging in unsafe and unsound practices, and for breaches of fiduciary duties. This section is heavily relied upon by bank regulators in their efforts to regulate the securities activities of banks.

C. Interagency Statement on Nondeposit Investment Products

In the past, the four federal banking agencies which includes the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, have issued separate guidelines for the retail sale of nondeposit investment products. 114 These agencies issued a joint statement on February

15, 1994, which was intended to consolidate the various guidelines.\footnote{115} The agencies’ action was a result of the recognition of the expanded role that financial institutions have taken concerning the selling of retail nondeposit investment products, including mutual funds, and the need to ensure that customers are clearly informed of the risks associated with these products.\footnote{116} The guidelines contained in the \textit{Interagency Statement} apply to recommendations or sales of mutual funds made by employees of the institution, sales made by employees of a third party which may or may not be a bank affiliate, or sales made from a referral of retail customers by the bank to a third party where the bank receives a referral fee (this is commonly known as a networking arrangement).\footnote{117}

The \textit{Interagency Statement} recommends that the bank adopt a written statement addressing the risks involved with a sales program along with a summary of policies and procedures of the institution’s program.\footnote{118} It is the responsibility of the institution’s board of directors to adopt and periodically review the policies and procedures.\footnote{119} The policies and procedures should contain compliance procedures, provisions for the supervision of employees involved in sales by senior management, review of the types of products sold, the permissibility of the use of the institution’s customer information in connection with retail sales of nondeposit investment products, and a designation of the employees authorized to sell these investment products. In fact, the thrust of the \textit{Interagency Statement} is to provide guidance to financial institutions concerning: (1) disclosure and advertising; (2) setting and circumstances under which recommendations or sales of mutual funds should take place within the banks; (3) qualification and training of personnel involved in the sales of these products; (4) suitability and sales practices; (5) compensation of the sales force; and (6) compliance procedures.\footnote{120}

\footnote{115. \textit{See Nondeposit Investment Sales Examination Procedures}, OCC Bulletin 94-14 (Feb. 24, 1994) (integrating the Interagency Statement on Retail Sales on Nondeposit Investment Products) [hereinafter \textit{Interagency Statement}].}

\footnote{116. \textit{Id.} at 20. The risks identified concerning these investment products are: "(1) the products are not insured by the FDIC; (2) they are not deposits or other obligations of the institution and are not guaranteed by the institution; and (3) they are subject to investment risks, including the possible loss of principal." \textit{Id.}}

\footnote{117. \textit{Id.}}

\footnote{118. \textit{Id.} at 21.}

\footnote{119. \textit{See Interagency Statement, supra} note 115, at 21.}

\footnote{120. \textit{Id.} at 22-26.}
The banking agencies are very concerned that the recommendation or sales of investment products are performed in a manner that assures these products are differentiated from FDIC insured products. \textsuperscript{121} Guidelines are provided concerning the content and form of the disclosures given to customers, the timing of the disclosures, type of disclosures that should be made in advertisements and promotional materials, and disclosure information concerning 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..." \textsuperscript{122} In addition, the nondeposit investment product must not have a name that is identical to the institution in order to avoid customer confusion. \textsuperscript{123}

Next, the Interagency Statement recommends that institutions should minimize the risk of customer confusion by conducting recommendations or sales of mutual funds in distinct physical areas from where retail deposits are taken. \textsuperscript{124} It is also strongly urged that tellers should not make general or specific investment recommendations concerning nondeposit investment products while the tellers are in their routine deposit taking areas. \textsuperscript{125}

Another major area addressed by the Interagency Statement is the adequacy of training provided for the personnel authorized to sell mutual funds for banks. Banks selling securities directly are excluded from the definition of broker/dealer found in the 1934 Act, and as a result, personnel selling securities for banks are not required to be registered with the SEC. \textsuperscript{126} The Interagency Statement recommends that sales personnel receive training which pro-

\textsuperscript{121} Id. at 22.
\textsuperscript{122} Id. at 23.
\textsuperscript{123} Id. Although the SEC has not adopted any rules or regulations prohibiting mutual funds' use of common names, the Division of Investment Management believes that "common names between federally insured institutions and funds sold or marketed by or through such institutions are presumptively misleading." See Memorandum from Barbara Green & Thomas S. Harman to former SEC Chairman Breeden, 824 PLI/Corp. 147 (May 6, 1993) (discussing bank mutual fund names). This presumption, however, can be overcome by a prominent disclosure on the fund's prospectus stating the shares are not deposits or obligations of the bank, and they are not insured by the FDIC or any other agency. Id.
\textsuperscript{124} Interagency Statement, supra note 115, at 24.
\textsuperscript{125} Id.
\textsuperscript{126} See supra text accompanying notes 63-69 which discusses bank exclusion from the 1934 Act.
vides for knowledge of the investment products offered, applicable legal restrictions and customer protection requirements.127 The type of training that should be given, according to the guidance for examiners reviewing bank nondeposit investment sales activities, is contained in the Rules of Fair Practice of the NASD.128 Even though these rules do not expressly apply to bank sales personnel, they should be the "appropriate reference for a bank compliance program designed to ensure that the bank's retail sales of all nondeposit investment products are operated in a safe and sound manner."129

In the area of investment suitability, it is recommended that bank personnel should have reasonable grounds for believing the recommended investment is suitable for a customer based on information disclosed by the customer.130 Again, the standard used by the bank examiners to determine if a recommendation or sale is suitable to the customer is the NASD Rules of Fair Practice.131 Suitability determinations should include information concerning the customer's financial and tax status, investment objective and other relevant factors prior to making recommendations to the customer.132 The examiners will pay particular attention to suitability determinations for elderly bank customers.133

In the area of compensation for employees of institutions involved in mutual fund sales, employees not involved directly in selling to customers, i.e. tellers, are allowed to receive a one-time nominal fee for referring customers to nondeposit investment products.134 Employees authorized to sell these products may

128. Id. at 3.
129. Id.
130. Id. at 25.
131. Id. at 10.
132. Interagency Statement, supra note 115, at 10. The examiners believe that a proper suitability inquiry will protect banks from dissatisfied customers who threaten litigation which could put the banks' capital at risk. Id. The OCC could determine that banks without appropriate suitability procedures are engaging in unsafe and unsound banking practice. Id.
133. Id. Many elderly customers are on fixed incomes and rely on savings for retirement income. These customers are susceptible to purchasing investments offering higher yields than bank certificate of deposits. It is important that banks make careful suitability judgments for these customers because it will be difficult for them to recover from a loss of principal. Id.
134. Id. at 25.
receive commissions as long as the compensation program does not result in unsuitable recommendations or sales. 135

Finally, the Interagency Statement suggests that institutions develop policies and procedures to ensure that sales activities are conducted in compliance with applicable laws and regulations. 136 These procedures should identify potential conflicts of interest and provide a system to monitor and resolve customer complaints. 137

The customers' interest will be the focus of bank examinations of institutions engaging in mutual fund activities. The main concerns are the potential for customer confusion as to the uninsured nature of nondeposit investment products and the potential for violations of the general anti-fraud provisions of the 1934 Act, which apply whether or not the sellers of those investment products are registered as broker/dealers with the SEC. 138 Banks that do not adequately address these issues could be operating in an unsafe and unsound manner, subjecting them to all the penalties of the federal banking laws. 139

IV. Adequacy of the Interagency Statement for Regulating Bank Securities Activities

Under the current regulatory structure for banks offering mutual fund investments, the SEC has regulatory oversight authority over bank personnel who sell securities on the premises of the bank if they are employed by registered broker-dealers. The SEC regulatory powers would encompass bank subsidiaries and affiliates because they are not covered by the bank exclusions found in the 1934 Act. 140 The authority to regulate personnel of banks that are involved in the direct sale of securities is vested with the federal banking regulators. 141 Because of the potential for regulatory arbitrage resulting from this split in the regulatory

135. The examiners suggest that mutual fund sales function and the certificate of deposit renewal function should be separate in order to avoid a compensation system that promotes mutual fund sales. Id. at 11.
136. Interagency Statement, supra note 115, at 3.
137. Id. at 25.
138. Id. at 2.
139. See supra text accompanying notes 92-113 discussing remedies available to bank regulators under the federal banking laws.
140. See Memorandum from Barbara Green & Thomas S. Harman to former SEC Chairman Breeden, supra note 123 (responding to question five concerning bank personnel compliance with federal securities laws).
141. Id.
scheme for banks, there has been a renewed effort to subject securities activities to functional regulation. 142

It is anticipated that the problems presented by regulatory arbitrage will increase as a result of the growing number of banks that are expanding their mutual fund activities, and this trend is expected to continue to grow at an accelerated rate due to the proposed merger between Mellon Bank Corporation and the Dreyfus Corporation. 143 The SEC feels that the current regulatory scheme and the tools available to the federal banking regulators are inadequate to deal with the risk of investor confusion, the potential for conflicts of interest between banks and affiliated mutual funds, and the need for a regulatory system that focuses on investor protection rather than the protection of depositors and the safety and soundness of the bank. 144

One major difference in the protection provided for investors between the Interagency Statement and the federal securities laws is apparent in the area of bank broker-dealer activities. Under the requirements of the federal securities laws, broker-dealers have been required to register with the SEC since 1935 because of the broker-dealer's role as an intermediary between customers and the securities markets. 145 Section 15(a) of the 1934 Act requires that any broker or dealer using the mails or any means or instrumentality of interstate commerce to induce or effect transactions in securities must register as a broker-dealer with the SEC. 146 Registered broker-dealers are subject to numerous regulations and supervisory structures intended to protect investors and the securities markets. They must be members of a SRO (self-regulatory organization), 147 and the Securities Investor Pro-

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142. Functional regulation would provide for uniform rules consistently applied to all market participants regardless of whether they are banks or securities firms. See Testimony of Chairman Levitt, supra note 8, at 4.

143. The Dreyfus Corporation is a registered investment adviser to mutual funds with $72.2 billion in assets. Mellon Bank Corporation, a bank holding company, and Mellon Bank also act as investment advisers. Once the merger is completed, Mellon Bank and its affiliates will be the largest bank mutual fund investment adviser, managing $76.8 billion in mutual fund assets. Id. at 1-3.

144. Id. at 4.


tection Corporation (hereinafter "SIPC"). In addition, broker-dealers are subject to statutory disqualification standards and disciplinary authority, which are designed to prevent persons with an adverse disciplinary history from becoming associated with registered broker-dealers. They are also subject to the net capital requirements to maintain sufficient capital to operate safely. Broker-dealers must also maintain adequate competency levels by satisfying SRO qualification requirements. Furthermore, broker-dealers have extensive recordkeeping and reporting obligations, fiduciary duties, antifraud rules, and the SEC's broad enforcement authority over broker-dealers.

The federal securities regulatory scheme provides a comprehensive set of regulations covering all aspects of broker-dealer activities. The federal banking laws, however, do not provide a comparable regulatory scheme for broker-dealer activities that are done directly by banks. The Interagency Statement provides only for "guidelines," "recommendations," and "suggestions" to cover many of the broker-dealer activities that are covered in the federal securities laws. These "guidelines" are not directly enforceable by bank regulators or by bank customers. In order for bank regulators to penalize a bank for violating the "guidelines," it must be shown that the bank was being operated in an unsafe and unsound manner or in violation of law or regulation.

The disparity of regulation in the area of suitability and sales practices is of particular concern to the SEC. The SEC is joined by members of Congress who also feel that the federal banking laws are not equipped to adequately deal with the potential

148. 15 U.S.C. 78ccc(a)(2) (1988) (SIPC is an insurance fund created to protect customers, in an amount up to one hundred thousand dollars in cash and up to five hundred thousand dollars for an amount of securities held by a broker-dealer on behalf of the customer, in the event the broker-dealer becomes insolvent. SIPC does not insure against the loss in value of securities due to broker-dealer misconduct.).
153. See Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969) ("A securities dealer occupies a special relationship to a buyer of securities in that by his position he impliedly represents he has an adequate basis for the opinion he renders.").
156. Interagency Statement, supra note 115, at 1.
157. See Testimony of Chairman Levitt, supra note 8, at 15.
abuses that could occur when banks are involved directly with the sale of mutual funds.\textsuperscript{158} For example, Congressman Dingell described how bank securities salespersons targeted the "weak, meek, and ignorant" while the Comptroller of the Currency stood "between the fox and the henhouse . . . without some of the most basic weapons that have evolved to protect securities investors - express suitability requirements. . . ."\textsuperscript{159} In addition, Chairman Levitt pointed out that the guidance provided in the Interagency Statement concerning suitability and sales practice does not directly refer to the NASD's Rules of Fair Practice.\textsuperscript{160} The Interagency Statement addresses these practices by stating that bank personnel involved in selling securities products "must adhere to fair and reasonable sales practices" and "they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer."\textsuperscript{161}

On the other hand, registered broker-dealers are subject to extensive regulation by the federal security laws and the SRO's rules in the areas of suitability and sales practices. The NASD Rules of Fair Practice were implemented to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors' and the public interests.\textsuperscript{162} Accordingly, broker-dealers must evaluate the financial circumstances and needs of their customers and make a determination that any security recommended is suitable for that customer in light of the customer's financial circumstances and investment intent.\textsuperscript{163} Practices that clearly violate the responsibility of fair dealing includes both "churning," which is the excessive trading in a customer's account, and the trading of mutual


\textsuperscript{159} Id.

\textsuperscript{160} Testimony of Chairman Levitt, supra note 8, at 15. However, bank examiners are instructed to use the NASD Rules of Fair Practice in their bank examinations to determine whether a recommendation or sale is suitable to the customer. See supra note 131 and accompanying text.

\textsuperscript{161} Interagency Statement, supra note 115, at 25.

\textsuperscript{162} NASD Rules of Fair Practice, Art. III. § 1, NASD Man. (CCH) ¶ 2151 (1989).

funds on a short-term basis.\textsuperscript{164} The Policy of the Board of Governors of NASD makes it clear that mutual funds are not proper trading vehicles, and trading on a short-term basis alone raises the question of a rule violation.\textsuperscript{165}

In addition, section 15(b)(4) of the 1934 Act gives the SEC the regulatory authority over a broker-dealer for the violation of the federal securities laws by any person associated with that broker-dealer.\textsuperscript{166} There is an affirmative defense available to the broker-dealer for failure to supervise if:

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.\textsuperscript{167}

This defense provides the broker-dealer with a strong incentive to establish and actively monitor procedures designed to prevent violations of the federal securities laws by associates of the broker-dealer.

Legislation was introduced in the House of Representatives that would effectively provide for functional regulation of bank securities activities by amending “the Federal securities laws to equalize the regulatory treatment of participants in the securities industry.”\textsuperscript{168} As could be expected, Chairman Levitt clearly supports this effort, which is evidenced by his following statement:

H.R. 3447 would serve investors by applying proven, legally enforceable broker-dealer competency standards, supervision requirements, suitability and sales practice rules, and financial responsibility requirements to banks and bank employees involved in securities sales. The legislation would address the conflicts of interest between banks and their affiliated investment companies . . . . In general, by eliminating the unconditional bank exclusions in the federal securities laws, H.R. 3447 would promote

\textsuperscript{164} Id.

\textsuperscript{165} Id.


\textsuperscript{168} H.R. 3447, 103d Cong., 1st Sess. (1993) [hereinafter H.R. 3447]. This bill was sponsored by Representative John D. Dingell, Chairman, Subcommittee on Oversight and Investigation of the Committee on Energy and Commerce, on November 4, 1993.
consistent, functional regulation of all market participants that offer the same products and perform the same functions.\textsuperscript{169}

In addition, Matthew P. Fink, president of the Investment Company Institute, has called for functional regulation of bank securities activities in order to avoid placing investors "in harm's way" by banks whose mutual fund activities are not subject to SEC regulation.\textsuperscript{170}

The portions of House Bill 3447 affecting bank mutual fund activities that will be discussed include: (1) the elimination of the federal securities laws' exemption for banks engaged in broker-dealer activities; (2) the elimination of the exclusions for banks under the Investment Advisers Act; and, (3) the attempt to eliminate customer confusion concerning the risk of loss due to the lack of FDIC insurance on mutual fund investments. For the most part, House Bill 3447 would amend section 3(a)(4) of the 1934 Act to include most bank securities activities in the definition of the term "broker."\textsuperscript{171} Also, the bill would remove the exclusion of banks from the definition of "dealer" in section 3(a)(5) of the 1934 Act.\textsuperscript{172}

\textsuperscript{169} Testimony of Chairman Levitt, supra note 8, at 16 (quoting Chairman Levitt in a letter to Chairman John D. Dingell and Henry B. Gonzalez concerning the proposed merger between Mellon Bank and the Dreyfuss Corp. (Jan. 7, 1994)).

\textsuperscript{170} Cope, Bank Regulators Said to Muddy Waters, AM. BANKER, Mar. 24, 1994, at 12.

\textsuperscript{171} H.R. 3447 § 101. Section 101 of House Bill 3447 states:

\textsuperscript{(A)} The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others.

\textsuperscript{(B)} A bank shall not be deemed to be a 'broker' because it engages in one or more of the following activities:

\textsuperscript{(i)} Engages in fiduciary activities (including effecting transactions in the course of such fiduciary activities) permissible under the first section of the Act of September 28, 1962 (12 U.S.C. 92a), or for State banks under relevant State trust law, except that a bank shall be deemed a broker if, in the conduct of such fiduciary activities, it-

\textsuperscript{(I)} publicly solicits brokerage business; or

\textsuperscript{(II)} is compensated for such business by the payment of commissions or similar remuneration based on effecting transactions in securities (excluding fees calculated as percentage of assets under management).

\textsuperscript{(ii)} Effects transactions in exempted securities, other than municipal securities, or in commercial paper, bankers' acceptances, or commercial bills.

\textit{Id.}

\textsuperscript{172} Id. at § 102. Section 102 states:
The proposed bill would require banks falling within the definition of broker or dealer to place most of their securities activities into a separate corporate entity that would be subject to the federal securities laws. Specifically, this would place the banks under the SEC and SRO rules designed to protect investors. In addition, all participants in securities activities would be placed on equal-footing in terms of regulation, thus reducing the existence of regulatory arbitrage presently available based on industry classification. The most significant benefit to investors of placing bank securities activities under SEC regulation would be that investors could seek redress for violations of federal securities laws by brokers and dealers through the SRO arbitration process. The resolution of disputes through arbitration, rather than by bringing actions in federal court, is a more practical way for an investor to settle most claims because it is less expensive and more expeditious.

Provisions are made in House Bill 3447 that would not place undue burdens on banks engaged in certain security activities. First, the Commission is given the authority to exempt persons from the definition of broker-dealer or from the requirement that bank securities activities must be placed in separate corporate entities if “such exemption is consistent with the public interest, the protection of investors, and the purposes of this title.” Also, banks engaging in traditional fiduciary functions where securities brokerage activities are not advertised publicly and transaction-

(5)(A) The term “dealer” means any person engaged in the business of buying and selling securities for his own account through a broker or otherwise.

(B) Such term does not include-

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

(ii) any bank insofar as the bank (I) buys and sells commercial paper, bankers’ acceptances, or commercial bills, or exempted securities other than municipal securities; or (II) buys and sells securities for investment purposes for the bank or for accounts in which the bank, acting as trustee, is authorized to determine the securities to be purchased or sold.

*Id.*

173. *Id.* at § 104.

174. *Id.*


176. H.R. 3447 § 103.
based compensation is not received, would be excluded from the definition of "broker." Additionally, section 102 of the bill would exempt banks from the definition of "dealer": "(1) [if the bank] buys and sells commercial paper, bankers' acceptances, commercial bills, or exempted securities other that municipal securities; or (2) buys and sells securities for investment purposes for the bank or for accounts in which the bank acts as trustee." 

Secondly, House Bill 3447 would remove the exclusion for banks and bank holding companies from regulation under the Investment Advisers Act of 1940. Under the current regulatory scheme, a bank acting as an investment adviser to a registered investment company would be subject to regulation under the federal banking laws in its fiduciary capacity. The SEC would have regulatory authority over the investment company advised by the bank, but not over the bank as an investment adviser because of the bank exemption from the definition of an investment adviser.

Section 202(a)(11)(A) of the Investment Advisers Act of 1940 would be amended to include any bank or bank holding company acting as an investment adviser to a registered investment company to be within the definition of an investment adviser. This amendment would allow the SEC to regulate a bank or a bank holding company acting as an investment adviser to a mutual fund in the same manner as any other investment adviser to a registered investment company.

Third, the requirement that banks place most of their securities activities into a separate corporate entity and the prohibition against the use of a bank's name by an affiliated investment com-

177. See supra note 171.
178. H.R. 3447 § 102; see supra note 172.
179. Section 202(a)(11)(A) of the Investment Advisers Act of 1940 states: Investment adviser means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analysis or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 which is not an investment company. 15 U.S.C. § 80b-2(a)(11) (1988).
180. See supra note 100 and accompanying text.
182. H.R. 3447 § 120.
183. Testimony of Chairman Levitt, supra note 8, at 18.
pany,\(^{184}\) are designed to eliminate customer confusion regarding the lack of federal deposit insurance on mutual funds sold by banks.\(^{185}\)

V. CONCLUSION

There is no doubt concerning the phenomenal growth in the mutual fund industry. Since 1980, mutual fund assets have increased twelve-fold, with most of the growth coming from net purchases of fund shares by the public rather than from price appreciation.\(^{186}\) Investors in these funds chose to move their funds out of depository institutions, as a result of a drop in interest rates on deposits, in order to take advantage of the rise in stock and bond prices that have generated higher returns.\(^{187}\) Banks have responded to the pressure placed on them by the deposit outflows by drastically increasing their activity in mutual fund alternatives.\(^{188}\)

Under the current regulatory scheme, banks directly engaged in mutual fund activities are regulated under the federal banking laws by the OCC, whereas bank subsidiaries and non-bank affiliates engaged in mutual fund activities must be registered broker-dealers that are subject to SEC regulation under the federal securities laws. All entities engaged in mutual fund activities are subject to the general antifraud provisions of the federal securities laws.

The regulatory tools provided to the banking regulators by the federal banking laws were designed to provide for the protection of depositors and for the safety and soundness of the bank. In order for banking regulators to deal with institutions heavily involved in securities activities, they adopted the Interagency Statement on Retail Sales on Nondeposit Investment Products which provides “guidelines” for banks to follow in their securities sales programs. Violations of these guidelines could be considered

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184. H.R. 3447 § 116. Section 116 states: “It shall be deceptive and misleading for any registered investment company which has as an investment adviser or distributor a bank or affiliated person thereof, to adopt, as part of the name, title, or logo of such company, or of any security of which it is the issuer, any word or design which is the same as or similar to, or a variation of, the name, title, or logo of such bank.” Id.

185. Testimony of Chairman Levitt, supra note 8, at 17.


187. Id.

188. See generally Ludwig Testimony, supra note 6.
unsafe and unsound banking practices which could invoke penalties under the federal banking laws. The remedies available under the federal banking laws dealing with violations involving the sales of securities, however, are not as comprehensive as those available under the federal securities laws.

The SEC made its first attempt at "functional regulation" of securities activities with the adoption of Rule 3b-9 in 1985. Although the U.S. Circuit Court of Appeals for the District of Columbia declared the rule invalid, most banks transferred their brokerage operations to registered broker-dealer entities prior to the invalidation of the rule. Many banks have retained this arrangement even after the rule was held invalid.

While previous efforts to allow for functional regulation of securities activities have failed, the time is right to give the SEC the authority to regulate all securities activities, regardless of whether the entity engaging in the activities is a bank or a securities firm. First, the regulatory arbitrage that exists in the current regulatory scheme would be eliminated. This would provide a consistent, uniform, standard of regulation regardless of whether an investor purchased a mutual fund from a bank or a registered broker-dealer. Next, functional regulation would eliminate the regulatory gap which results in the SEC being unable to regulate bank securities activities which represents a rapidly growing component of the securities markets in the United States. In order for the SEC to effectively oversee the securities industry and maintain fair and orderly markets, it is necessary for the SEC to have regulatory authority over all participants in those markets. Most importantly, investor protection would be enhanced by functional regulation. The federal securities laws provide for a wider range of private rights of action for investors who have been the victims of fraudulent sales practices. If bank sales of securities were required to be done through regulated broker-dealers, investors seeking compensation for violations of federal securities

189. Ludwig Testimony, supra note 6, at 9.
192. Testimony of Chairman Levitt, supra note 8, at 5.
193. Id. at 24.
194. Id.
laws by the broker-dealers would have access to the SRO arbitration process. This process is a more efficient method of resolving disputes than having to resort to the federal courts. For these reasons, the bank exclusion from the statutory provisions of the federal securities laws defining "broker/dealer" and "investment adviser" should be eliminated, which would result in the SEC obtaining functional regulation of all participants in the securities markets.