INVESTMENT COMPANY ACT AMENDMENTS OF 1967

BANK AND INSURANCE COMPANY COLLECTIVE INVESTMENT FUNDS AND ACCOUNTS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON COMMERCE AND FINANCE

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

NINETIETH CONGRESS

SECOND SESSION

ON

H.R. 14742

A BILL TO AMEND THE INVESTMENT COMPANY ACT OF 1940, AS AMENDED, AND THE INVESTMENT ADVISERS ACT OF 1940, AS AMENDED, TO DEFINE THE EQUITABLE STANDARDS GOVERNING RELATIONSHIPS BETWEEN INVESTMENT COMPANIES AND THEIR INVESTMENT ADVISERS AND PRINCIPAL UNDERWRITERS, AND FOR OTHER PURPOSES

MARCH 14 AND 15, 1968

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THURSDAY, MARCH 14, 1968

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 2123, Rayburn House Office Building, Hon. John E. Moss (chairman of the subcommittee) presiding.

Mr. Moss. The subcommittee will be in order.

The Subcommittee on Commerce and Finance this morning is continuing its consideration of amendments to the Investment Company Act of 1940 and the Investment Advisors Act of 1940.

Our consideration has to do with a proposal that the banks be allowed to enter into this field and be subject to the same regulatory jurisdiction of the Securities and Exchange Commission as now applies to the investment companies and investment advisers.

What we are considering loosely may be described as the McIntyre amendments, which were proposed by Senator McIntyre as amendments to S. 1659, a companion bill to H.R. 9510 and H.R. 9511, on which the subcommittee held hearings last fall.

The Senate has a procedure whereby hearings may be held on amendments that are proposed such as the McIntyre amendment. The House does not have the same procedure and, accordingly, I have introduced H.R. 14742 for the purpose of hearings on this proposal.

It seemed to me that this is of sufficient significance that it should be adequately discussed with an open record so that the subcommittee may have the benefit of the views of those who are concerned.

H.R. 14742 contains the so-called McIntyre amendments having to do with the four types of bank collective investment funds in sections 2, 12, 27, and 28.

In addition, it contains the amendments to 20 sections of H.R. 9510 and H.R. 9511, on which it is understood that the industry and the Securities and Exchange Commission have reached agreement.

Further than that, H.R. 14742 leaves alone the six sections of H.R. 9510 and H.R. 9511, which the hearing record shows are still in dispute between the industry and the Commission; namely, sections 8, 12, 16, 17, 20, and 23.

We have had adequate testimony on those matters which are in dispute and the subcommittee understands the issues which are involved.

It is our purpose, accordingly, in the consideration of H.R. 14742, to take up in these hearings solely those provisions which provide for the entry into this field of those who operate collective investment funds, especially those comprising assets of managing agency accounts and trusts for self-employed retirement plans.

The bill under consideration will be inserted in the record at this point.

(The bill, H.R. 14742, and report thereon, follow:)

[H.R. 14742, 90th Cong., second sess.]

A BILL To amend the Investment Company Act of 1940, as amended, and the Investment Advisers Act of 1940, as amended, to define the equitable standards governing relationships between investment companies and their investment advisers and principal underwriters, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Investment Company Amendments Act of 1967".

SEC. 2. Section 2(a) of the Investment Company Act is amended as follows:

(1) Paragraph (5) thereof is amended to read as follows:

"(5) 'Bank' means (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 or trust company, 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 deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, 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 title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph (5)."

(2) Paragraphs (19) through (42) thereof are redesignated as paragraphs (20) through (43), respectively.

(3) A new paragraph (19) is inserted immediately after paragraph (18) to read as follows:

"(19) 'Interested person' of another person means—

"(A) when used with respect to an investment company—

"(i) any affiliated person of such company,

"(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

"(iii) any interested person of any investment adviser of or principal underwriter for such company,

"(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company,

"(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer.

"(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two fiscal years of such company a material business or professional relationship with such investment company or with the principal executive officer of such investment company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities or (bb) membership in the immediate family of any person specified in clause (aa) of this proviso, and

"(B) when used with respect to an investment adviser of or principal underwriter for any investment company—

"(i) any affiliated person of such investment adviser or principal underwriter,

"(ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,

"(iii) any person who knowingly has any direct or indirect beneficial interest in or who is designated as trustee, executor, or guardian of any legal interest in any security issued either by such investment adviser or principal underwriter or by any controlling person of such investment adviser or principal underwriter,

"(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such investment adviser or principal underwriter,

"(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

"(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter, or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purposes of this paragraph (19), 'member of the immediate family' means any parent, spouse of a parent, child, spouse of a child, spouse, brother, or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vi) of subparagraph (A) or (B) of this paragraph (19) whenever it shall find that such order is no longer consistent with the facts. No order issued pursuant to clause (vi) of subparagraph (A) or (B) of this paragraph (19) shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this title or for any other purpose for any period prior to the effective date of such order."

(4) Redesignated paragraph (36) thereof is amended by inserting after "other mineral rights," the following: "interest or participation in any common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent,".

SEC. 3. (a) Paragraph (2) of section 3(b) of the Investment Company Act of 1940 is amended to read as follows:

"(2) Any issuer which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar types of businesses. The filing of an application under this paragraph in good faith by an issuer other than a registered investment company shall exempt the applicant for a period of sixty days from all provisions of this title applicable to investment companies as such. For cause shown, the Commission by order may extend such period of exemption for an additional period or periods. Whenever the Commission, upon its own motion or upon application, finds that the circumstances which gave rise to the issuance of an order granting an application under this paragraph no longer exist, the Commission shall by order revoke such order."

(b) Section 3(c) of said Act is amended as follows:

(1) The material preceding paragraph (1) thereof is amended to read as follows:

"(c) Notwithstanding subsection (a), none of the following persons is an investment company within the meaning of this title:"

(2) Strike paragraphs (4) and (8) thereof and redesignate paragraphs (5) through (15) thereof as paragraphs (4) through (13), respectively.

(3) Redesignated paragraph (5) thereof is amended to read as follows:

"(5) Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) Purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."

(4) Redesignated paragraph (8) is amended to read as follows:

"(8) Any company subject to regulation under the Public Utility Holding Company Act of 1935."

(5) Redesignated paragraph (9) thereof is amended to read as follows:

"(9) Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic plan certificates and substantially all of whose business consists of owning or holding oil, gas, or other mineral royalties or leases, or fractional interests therein, or certificates of interest or participation in or investment contracts relative to such royalties, leases, or fractional interests."

(6) Redesignated paragraph (11) thereof is amended to read as follows:

"(11) Any employees' stock bonus, pension, or profit-sharing trust which meets the requirements of section 401(a) of the Internal Revenue Code of 1954, or any collective fund maintained by a bank consisting solely of assets of such trusts."

SEC. 4. (a) Section 9(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) It shall be unlawful for any of the following persons to serve or act in the capacity of employee, officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company, registered unit investment trust, or registered face-amount certificate company:

"(1) any person who within ten years has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company;

"(2) any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security; or

"(3) a company any affiliated person of which is ineligible, by reason of paragraph (1) or (2), to serve or act in the foregoing capacities.

For the purposes of paragraphs (1), (2), and (3) of this subsection, the term 'investment adviser' shall include an investment adviser as defined in title II of this Act."

(b) Section 9 of said Act is further amended by redesignating subsection (b) thereof as subsection (c) and inserting immediately after subsection (a) a new subsection (b) to read as follows:

"(b) The Commission may, after notice and opportunity for hearing, by order prohibit, conditionally or unconditionally, either permanently or for such period of time as it in its discretion shall deem appropriate in the public interest, any person from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter if such person:

"(1) has willfully made or caused to be made in any registration statement application or report filed with the Commission under this title any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application, or report any material fact which was required to be stated therein; or

"(2) has willfully violated any provision of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act, or of this title, or of any rule or regulation under any of such statutes; or

"(3) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act, or of this title, or of any rule or regulation under any of such statutes."

SEC. 5. (a) Section 10(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company."

(b) Section 10(b) of said Act is amended to read as follows:

"(b) No registered investment company shall—

"(1) employ as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such brokers or affiliated persons of any of such brokers;

"(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an interested person, unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or interested persons of any of such principal underwriters; or

"(3) have as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any investment banker. For the purposes of this paragraph, a person shall not be deemed an affiliated person of an investment banker solely by reason of the fact that he is an affiliated person of a company of the character described in section 12(d)(3) (A) and (B)."

(c) Section 10(c) of said Act is amended to read as follows:

"(c) No registered investment company shall have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank, except that, if on March 15, 1940, any registered investment company shall have had a majority of its directors consisting of persons who are directors, officers, or employees of any one bank, such registered company may continue to have the same percentage of its board of directors consisting of persons who are directors, officers, or employees of such bank."

(d) Section 10(d) of said Act is amended to read as follows:

"(d) Notwithstanding subsection (a) and subsection (b)(2) of this section, and, if such registered investment company is a common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent, notwithstanding subsection (b)(3) and subsection (c) of this section, a registered investment company may have a board of directors all the members of which, except one, are interested persons of the investment adviser of such company, or are officers or employees of such company, if—

"(1) such investment company is an open-end company;

"(2) such investment adviser is registered under title II of this Act and such investment adviser is engaged principally in the business of rendering investment supervisory services as defined in title II, or such investment adviser is a bank;

"(3) no sales load is charged on securities issued by such investment company;

"(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

"(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

"(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

"(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

"(8) such investment company has only one class of stock outstanding, each share of which has equal voting rights with every other share."

SEC. 6. Section 11(b) of the Investment Company Act of 1940 is amended to read as follows:

"(b) The provisions of this section shall not apply to any offer made pursuant to any plan of reorganization which is submitted to and requires the approval of the holders of at least a majority of the outstanding shares of the class or series to which the security owned by the offeree belongs."

SEC. 7. Section 12(d) of the Investment Company Act of 1940 is amended to read as follows:

"(d)(1)(A) It shall be unlawful for any registered investment company (the 'acquiring company') and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the 'acquired company'), and for any investment company (the 'acquiring company') and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the 'acquired company'), if such acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate—

"(i) more than 3 per centum of the total outstanding voting stock of such acquired company;

"(ii) securities issued by such acquired company having an aggregate value in excess of 5 per centum of the value of the total assets of such acquiring company; or

"(iii) securities issued by such acquired company and all other investment companies (other than treasury stock of such acquiring company) having an aggregate value in excess of 10 per centum of the value of the total assets of such acquiring company.

"(B) It shall be unlawful for any registered open-end investment company (the 'acquired company'), any principal underwriter therefor, or any broker or dealer registered under the Securities Exchange Act of 1934, knowingly to sell or otherwise dispose of any security issued by such acquired company to any other investment company (the 'acquiring company') or any company or companies controlled by such acquiring company if immediately after such sale or disposition—

"(i) more than 3 per centum of the total outstanding voting stock of such acquired company is owned by such acquiring company and any company or companies controlled by it; or

"(ii) more than 10 per centum of the total outstanding voting stock of such acquired company is owned by such acquiring company and other investment companies and companies controlled by them.

"(C) It shall be unlawful for any investment company (the 'acquiring company') and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by a registered closed-end investment company, if immediately after such purchase or acquisition such acquiring company, other investment companies having the same investment adviser, and companies controlled by such investment companies, own more than 10 per centum of the total outstanding voting stock of such closed-end company.

"(D) The provisions of this paragraph (1) shall not apply to a security received as a dividend or as a result of an offer of exchange approved pursuant to section 11 or of a plan of reorganization of any company (other than a plan devised for the purpose of evading the foregoing provisions).

"(E) The provisions of this paragraph (1) shall not apply to a security purchased or acquired by an investment company if—

"(i) the depositor of, or principal underwriter for, such investment company is a broker or dealer registered under the Securities Exchange Act of 1934 or a person controlled by such a broker or dealer;

"(ii) such security is the only investment security held by such investment company; and

"(iii) in the event such investment company is not a registered investment company, the purchase or acquisition is made pursuant to an arrangement with the issuer of, or principal underwriter for, the issuer of the security whereby such investment company is obligated—

"(aa) either to seek instructions from its security holders with regard to the voting of all proxies with respect to such security and to vote such proxies only in accordance with such instructions, or to vote the shares held by it in the same proportion as the vote of all other holders of such security, and

"(bb) to refrain from substituting such security unless the Commission shall have approved such substitution in the manner provided in section 26 of this Act.

"(F) For the purposes of this paragraph (1), the value of an investment company's total assets shall be computed as of the time of a purchase or acquisition or as closely thereto as is reasonably possible.

"(G) In any action brought to enforce the provisions of this paragraph (1), the Commission may join as a party the issuer of any security purchased or otherwise acquired in violation of this paragraph (1) and the court may issue any order with respect to such issuer as may be necessary or appropriate for the enforcement of the provisions of this paragraph (1).

"(2) It shall be unlawful for any registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire any security issued by any insurance company of which such registered investment company and any company or companies controlled by such registered company shall not at the time of such purchase or acquisition own in the aggregate at least 25 per centum of the total outstanding voting stock, if such registered company and any company or companies controlled by it own in the aggregate or as a result of such purchase or acquisition will own in the aggregate more than 10 per centum of the total outstanding voting stock of such insurance company, except a security received as a dividend or as a result of a plan of reorganization of any company (other than a plan devised for the purpose of evading the foregoing provisions).

"(3) It shall be unlawful for any registered investment company and any company or companies controlled by such registered investment company to purchase or otherwise acquire any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under title II of this Act, unless (A) such person is a corporation all the outstanding securities of which (other than short-term paper, securities representing bank loans, and directors' qualifying shares) are, or after such acquisition will be, owned by one or more registered investment companies; and (B) such person is primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, or any one or more of such or related activities, and the gross income of such person normally is derived principally from such business or related activities."

SEC. 8. (a) Section 15(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) It shall be unlawful for any person to serve or act as investment adviser of a registered investment company except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and—

"(1) precisely and separately describes all compensation to be paid thereunder for (A) investment advisory services, and (B) for all other services;

"(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

"(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

"(4) provides, in substance, for its automatic termination in the event of its assignment."

(b) Section 15(b) of said Act is amended to read as follows:

"(b) It shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract—

"(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

"(2) provides, in substance, for its automatic termination in the event of its assignment."

(c) Section 15(c) of said Act is amended to read as follows:

"(c) In addition to the requirements of subsections (a) and (b) of this section it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment

adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of the directors who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may be reasonably necessary to determine the reasonableness of compensation provided for in any contract whereby a person undertakes regularly to serve or act as investment adviser of such company."

(d) Section 15 of said Act is further emended by striking subsection (d) thereof and inserting immediately after subsection (c) a new subsection (d) to read as follows:

"(d)(1) All compensation for services to a registered investment company received by an investment adviser, officer, director, or controlling person of or principal underwriter for such company and any affiliated person of such investment adviser, officer, director, controlling person, or principal underwriter shall be reasonable. This subsection shall not apply to sales loads for the acquisition of any security issued by a registered investment company.

"(2) In determining whether the compensation provided for in a contract whereby any person undertakes to serve or act as investment adviser of a registered investment company is reasonable, the factors considered shall include but not be limited to the following:

"(A) The nature and extent of the services to be provided pursuant to such contract, including separate evaluations of the compensation to be received for investment advisory services and of the compensation to be received for other services;

"(B) The quality of the services theretofore rendered to such investment company by the person undertaking to serve or act as investment adviser, or, if no such services have been theretofore rendered, the quality of the services rendered to other investment clients, if any, by such person;

"(C) The extent to which the compensation provided for in such contract takes into account economies attributable to the growth and size of such investment company and any such economies attributable to the operation of other investment companies under common management with such company, giving due consideration to the extent to which such economies are reflected in the charges made or compensation received for investment advisory services and other services provided to investment companies having no investment adviser, other clients of investment advisers and other financial institutions, but with due allowance for any relevant differences in the nature and extent of the services provided;

"(D) The value of all benefits, in addition to compensation provided for in such contract, directly or indirectly received or receivable by the person undertaking to serve or act as investment advisor by reason of his relationship to such investment company;

"(E) Such other factors as are appropriate and material.

"(3) In any action pursuant to this subsection, no finding shall be made that any compensation provided for in a contract or other arrangement approved or otherwise authorized in compliance with the provisions of this title (other than the requirement of reasonableness in paragraph (1) of this subsection (d)) is unreasonable unless the party seeking such finding sustains the burden of proving by a preponderance of evidence that such compensation is unreasonable.

"(4) No action shall be maintained pursuant to this subsection to recover compensation paid more than two years prior to the date on which such action was instituted.

"(5) No person shall be held liable in any action pursuant to this subsection for damages in excess of the difference between the amount of compensation actually received by such person and the amount determined to be reasonable compensation for the period for which the action is brought and the interest on the difference between such amounts.

"(6) A finding that any compensation subject to the provisions of this subsection is unreasonable shall not be deemed to be a finding of a violation of this title for purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, and section 203 of title II of this Act.."

(e) Section 15 of said Act is further amended by adding a new subsection (g) to read as follows:

"(g) It shall be unlawful for any investment adviser of a registered investment company or any affiliated person of such investment adviser to sell any assets of or any securities issued by such investment adviser or a controlling person of such investment adviser, or otherwise to receive any benefit, in connection with a transaction by which another person obtains control of such investment adviser or succeeds to any relationship between such investment adviser and a registered investment company, if any terms, conditions, or understandings, express or implied, in connection with such transaction are likely to impose additional burdens on the investment company or limit its freedom of future action or otherwise is inequitable to such investment company."

SEC. 9. (a) Subparagraphs (f) and (g) of section 17 of the Investment Company Act of 1940 are amended to read as follows:

"(f) Every registered management company shall place and maintain its securities and similar investments in the custody of (1) a bank or banks (including in the case of a registered investment company which is a collective fund maintained by a bank, the bank maintaining such fund) having the qualifications prescribed in paragraph (1) of section 26(a) of this title for the trustees of unit investment trusts; or (2) a company which is a member of a national securities exchange as defined in the Securities Exchange Act of 1934, subject to such rules and regulations as the Commission may from time to time prescribe for the protection of investors; or (3) such registered company, but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors. Rules, regulations, and orders of the Commission under this subsection, among other things, may make appropriate provision with respect to such matters as the earmarking, segregation, and hypothecation of such securities and investments, and may provide for or require periodic or other inspections by any or all of the following: Independent public accountants, employees and agents of the Commission, and such other persons as the Commission may designate. No such member which trades in securities for its own account may act as custodian except in accordance with rules and regulation prescribed by the Commission for the protection of investors. If a registered company maintains its securities and similar investments in the custody of a qualified bank or banks, the cash proceeds from the sale of such securities and similar investments and other cash assets of the company shall likewise be kept in the custody of such a bank or banks or in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors, except that such a registered company may maintain a checking account in a bank or banks having the qualifications prescribed in paragraph (1) of section 26(a) of this title for the trustees of unit investment trusts with the balance of such account or the aggregate balances of such accounts at no time in excess of the amount of the fidelity bond maintained pursuant to section 17(g) of this title, covering the officers or employees authorized to draw on such account or accounts.

"(g) The Commission is authorized to require by rules and regulations or orders for the protection of investors that any officer and employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities, unless such officer or employee has such access solely through his also being an officer or employee of a bank, be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe."

(b) Section 17 of said Act is further amended by adding a new subsection (j) to read as follows:

"(j) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company, or any affiliated person of an investment adviser of or principal underwriter for a registered investment company, to engage in any act, practice, or course of business in connection with the purchase or sale, directly or indirectly, by such person of any security held or to be acquired by such registered investment company in contravention of such rules and regulations as the Commission may adopt to define, and prescribe means reasonably necessary to prevent, such acts, practices, or courses of business as are fraudulent, deceptive, or manipulative. Such rules and regulations may include requirements for the adoption of codes of ethics by registered investment companies, and investment advisers of and principal underwriters for such

investment companies, establishing such standards as are reasonably necessary to prevent such acts, practices, or courses of business."

SEC. 10. Section 18(f)(2) of the Investment Company Act of 1940 is amended to read as follows:

"(2) 'Senior security' shall not, in the case of a registered open-end company, include a class or classes or a number of series of preferred or special stock each of which is preferred overall other classes or series in respect of assets specifically allocated to that class or series: *Provided*, That (A) such company has outstanding no class or series of stock which is not so preferred over all other classes or series; or (B) the only other outstanding class of the issuer's stock consists of a common stock upon which no dividend (other than a liquidating dividend) is permitted to be paid and which in the aggregate represents not more than one-half of 1 per centum of the issuer's outstanding voting securities: *And provided further*, That, for the purpose of insuring fair and equitable treatment of the holders of the outstanding voting securities of each class or series of stock of such company, the Commission may by rule, regulation, or order direct that any matter required to be submitted to the holders of the outstanding voting securities of such company shall not be deemed to have been effectively acted upon unless approved by the holders of such percentage (not exceeding a majority) of the outstanding voting securities of each class or series of stock affected by such matter as shall be prescribed in such rule, regulation, or order."

SEC. 11. Section 19 of the Investment Company Act of 1940 is amended to read as follows:

"SEC. 19. (a) It shall be unlawful for any registered investment company to pay any dividend, or to make any distribution in the nature of a dividend payment, wholly or partly from any source other than—

"(1) such company's accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties; or

"(2) such company's net income so determined for the current or preceding fiscal year;

unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment. The Commission may prescribe the form of such statement by rules and regulations in the public interest and for the protection of investors.

"(b) It shall be unlawful in contravention of such rules, regulations, or orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors for any registered investment company to distribute long-term capital gains, as defined in the Internal Revenue Code, more often than once every twelve months."

SEC. 12. (a) Section 22 of the Investment Company Act of 1940 is amended by striking subsection (b) thereof and redesignating subsection (c) thereof as (b).

(b) Redesignated section 22(b) of said Act is amended to read as follows:

"(b) The Commission may make rules and regulations applicable to principal underwriters of, and dealers in, the redeemable securities of any registered investment company, whether or not members of any securities association, to the same extent, covering the same subject matter, and for the accomplishment of the same ends as are prescribed in subsection (a) of this section in respect of the rules which may be made by a registered securities association governing its members, and any rules and regulations so made by the Commission, to the extent that they may be inconsistent with the rules of any such association, shall so long as they remain in force supersede the rules of the association and be binding upon its members as well as all other underwriters and dealers to whom they may be applicable."

(c) Section 22 of said Act is further amended by inserting immediately after redesignated subsection (b) a new subsection (c) to read as follows:

"(c)(1) No registered investment company, except an investment company operating under the Small Business Investment Company Act of 1958, shall offer or sell, through a principal underwriter or otherwise, any security issued by it at a public offering price which includes a sales load of more than 5 per centum of that portion of the proceeds from the sale of the security which is received and invested or held for investment by the issuer (or in the case of a unit trust by the depositor or trustee).

"(2) The Commission, by rules and regulations or by order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or

classes of persons, securities, transactions, from the provisions of paragraph (1) of this subsection (c), if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

"(3) The Commission is authorized to adopt rules and regulations to prohibit or restrict sales loads in transactions where the imposition of such charges would be inequitable to investors, including transactions where dividends declared by issuers of redeemable securities are applied to the purchase price of additional securities issued by such companies."

(d) Section 22(d) of said Act is amended to read as follows:

"(d) No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class or security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus. Nothing in this subsection shall prevent a sale made (i) pursuant to an offer of exchange permitted by section 11 hereof including any offer made pursuant to section 11(b); (ii) pursuant to an offer made solely to all registered holders of the securities, or of a particular class or series of securities issued by the company proportionate to their holdings or proportionate to any cash distribution made to them by the company (subject to appropriate qualifications designed solely to avoid issuance of fractional securities); or (iii) in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 12."

(e) Section 22 of such Act is amended by adding at the end thereof the following new subsections:

"(h) No registered investment company which is a common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent shall offer or sell, through a principal underwriter or otherwise, any security issued by it at a public offering price which includes a sales load.

"(i) No provision of law shall be deemed to prevent the creation or operation of a registered investment company which is a common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent if such fund is created and operated in compliance with any applicable regulations of the Comptroller of the Currency."

SEC. 13. Section 24(d) of the Investment Company Act of 1940 is amended to read as follows:

"(d) The exemption provided by paragraph (8) of section 3(a) of the Securities Act of 1933 shall not apply to any security of which an investment company is the issuer. The exemption provided by paragraph (11) of said section 3(a) shall not apply to any security of which a registered investment company is the issuer, except a security sold or disposed of by the issuer or bona fide offered to the public prior to the effective date of this title, and with respect to a security so sold, disposed of, or offered, shall not apply to any new offering thereof on or after the effective date of this title. The exemption provided by section 4(3) of the Securities Act of 1933, shall not apply to any transaction in a security issued by a face-amount certificate company or in a redeemable security issued by an open-end management company or unit investment trust, if any other security of the same class is currently being offered or sold by the issuer or by or through an underwriter in a distribution which is not exempted from section 5 of said Act, except to such extent and subject to such terms and conditions as the Commission, having due regard for the public interest and the protection of investors, may prescribe by rules or regulations with respect to any class of persons, securities, or transactions."

SEC. 14. Section 25(c) of the Investment Company Act of 1940 is amended to read as follows:

"(c) Any district court of the United States in the State of incorporation of a registered investment company or any such court for the district in which such company maintains its principal place of business is authorized to enjoin the consummation of any plan of reorganization of such registered investment company upon proceedings instituted by the Commission (which is authorized so

to proceed upon behalf of security holders of such registered company, or any class thereof), if such court shall determine that any such plan is not fair and equitable to all security holders."

SEC. 15. (a) Section 26 of the Investment Company Act of 1940 is amended by redesignating subsections (b) and (c) thereof as subsections (c) and (d), respectively, and inserting immediately after subsection (a) a new subsection (b) to read as follows:

"(b) It shall be unlawful for any depositor or trustee of a registered unit investment trust holding the security of a single issuer to substitute another security for such security unless the Commission shall have approved such substitution. The Commission shall issue an order approving such substitution if the evidence establishes that it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

(b) Redesignated section 26(c) of said Act is amended to read as follows:

"(c) In the event that a trust indenture, agreement of custodianship, or other instrument pursuant to which securities of a registered unit investment trust are issued does not comply with the requirements of subsection (a) of this section 26, such instrument will be deemed to meet such requirements if a written contract or agreement binding on the parties and embodying such requirements has been executed by the depositor on the one part and the trustee or custodian on the other part, and three copies of such contract or agreement have been filed with the Commission."

SEC. 16. (a) Section 27(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) It shall be unlawful for any registered investment company issuing periodic payment plan certificates, or for any depositor of or underwriter for such company, to sell any such certificate, if—

"(1) the amounts of sales load deducted from any one payment exceeds proportionately the amount deducted from any other payment;

"(2) the first payment on such certificate is less than $20, or any subsequent payment is less than $10;

"(3) if such registered company is a management company, the proceeds of such certificate or the securities in which such proceeds are invested are subject to management fees (other than fees for administrative services of the character described in clause (C), paragraph (2), of section 26(a)) exceeding such reasonable amount as the Commission may prescribe, whether such fees are payable to such company or to investment advisers thereof; or

"(4) if such registered company is a unit investment trust the assets of which are securities issued by a management company, the depositor of or principal underwriter for such trust, or any affiliated person of such depositor or underwriter, is to receive from such management company or any affiliated person thereof any fee or payment on account of payments on such certificate exceeding such reasonable amount as the Commission may prescribe."

(b) Section 27 of said Act is further amended by striking subsection (b) thereof and redesignating subsection (c) thereof as subsection (b).

SEC. 17. (a) Section 28(a)(2) of the Investment Company Act of 1940 is amended to read as follows:

"(2) such company maintains at all times minimum certificate reserves on all its outstanding face-amount certificates in an aggregate amount calculated and adjusted as follows:

"(A) the reserves for each certificate of the installment type shall be based on assumed annual, semiannual, quarterly, or monthly reserve payments according to the manner in which gross payments for any certificate year are made by the holder, which reserve payments shall be sufficient in amount, as and when accumulated at a rate not to exceed 3½ per centum per annum compounded annually, to provide the minimum maturity or face amount of the certificate when due. Such reserve payments shall amount to at least 95.24 per centum of the required gross payment during each certificate year. The company may at its option take as loading from the gross payment or payments for a certificate year, as and when made by the certificate holder, an amount or amounts equal in the aggregate for such year to not more than the excess, if any, of the gross payment or payments required to be made by the holder for such year, over and above the percentage of the gross annual payment required herein for such year for reserve purposes.

Such loading may be taken by the company prior to or after the setting up of the reserve payment or payments for such year and the reserve payment or payments for such year may be graduated and adjusted to correspond with the amount of the gross payment or payments made by the certificate holder for each year less the loading so taken;

"(B) if the foregoing minimum percentages of the gross annual payments required under the provisions of such certificate should produce reserve payments larger than are necessary at 3½ per centum per annum compounded annually to provide the minimum maturity or face amount of the certificate when due, the reserve shall be based upon reserve payments accumulated as provided under preceding subparagraph (A) of this subsection except that in lieu of the 3½ per centum rate specified therein, such rate shall be lowered to the minimum rate, expressed in multiples of one-eighth of 1 per centum, which will accumulate such reserve payments to the maturity value when due;

"(C) if the actual annual gross payment to be made by the certificate holder on any certificate issued prior to or after the effective date of this Act is less than the amount of any assumed reserve payment or payments for a certificate year, such company shall maintain as a part of such minimum certificate reserves a deficiency reserve equal to the total present value of future deficiencies in the gross payments, calculated at a rate not to exceed 3½ per centum per annum compounded annually;

"(D) for each certificate of the installment type the amount of the reserve shall at any time be at least equal to (i) the then amount of the reserve payments set up under section 28(a)(2) (A) or (B); (ii) the accumulations on such reserve payments as computed under subparagraphs (A) or (B) of this paragraph (2); (iii) the amount of any deficiency reserve required under subparagraph (C) hereof; and (iv) such amount as shall have been credited to the account of each certificate holder in the form of any credit, or any dividend, or any interest in addition to the minimum maturity amount specified in such certificate, plus any accumulations on any amount or amounts so credited, at a rate not exceeding 3½ per centum per annum compounded annually;

"(E) for each certificate which is fully paid, including any fully paid obligations resulting from or effected upon the maturity of the previously issued certificate, and for each paid-up certificate issued as provided in subsection (f) of this section prior to maturity, the amount of the reserve shall be at least 95.24 per centum of the gross consideration paid by the purchaser of such fully paid certificate and at any time be at least equal to (i) such amount as and when accumulated at any rate not to exceed 3½ per centum per annum compounded annually, will provide the amount or amounts payable when due and (ii) such amount as shall have been credited to the account of each such certificate holder in the form of any credit, or any dividend, or any interest in addition to the minimum maturity amount specified in the certificate, plus any accumulations on any amount or amounts so credited, at a rate not exceeding 3½ per centum per annum compounded annually.

"(F) for each certificate of the installment type under which gross payments have been made by or credited to the holder thereof covering a payment period or periods or any part thereof beyond the then current payment period as defined by the terms of such certificate, and for which period or periods no reserve has been set up under subparagraph (A) or (B) hereof, an advance payment reserve shall be set up and maintained in the amount of the present value of any such unapplied advance gross payments, computed at a rate not to exceed 3½ per centum per annum compounded annually;

"(G) such appropriate contingency reserves for death and disability benefits and for reinstatement rights on any such certificate providing for such benefits or rights as the Commission shall prescribe by rule, regulation, or order based upon the experience of face-amount companies in relation to such contingencies.

At no time shall the aggregate certificate reserves herein required by subparagraphs (A) to (F), inclusive, be less than the aggregate surrender values and other amounts to which all certificate holders may be then entitled.

"For the purpose of this subsection (a), no certificate of the installment type shall be deemed to be outstanding if before a surrender value has been attained

the holder thereof has been in continuous default in making his payments thereon for a period of one year."

(b) Section 28(d) of said Act is amended to read as follows:

"(d) It shall be unlawful for any registered face-amount certificate company to issue or sell any face-amount certificate, or to collect or accept any payment on any such certificate issued by such company on or after the effective date of this title, unless such certificate contains a provision or provisions to the effect—

"(1) that, in respect of any certificate of the installment type, at any time prior to maturity, the holder of the certificate, upon surrender thereof, shall be entitled to a value payable in cash not less than the then amount of the reserve for such certificate required by items (i) and (ii) of subparagraph (D) of paragraph (2) of subsection (a) hereof. The amount of the surrender value for the end of each year shall be set out in the certificate;

"(2) that, in respect of any certificate of the installment type, the holder of the certificate, upon surrender thereof for cash or upon receipt of a paid-up certificate as provided in subsection (f) hereof, shall be entitled to a value payable in cash equal to the then amount of any advance payment reserve under such certificate required by subparagraph (F) of paragraph (2) of subsection (a) hereof in addition to any other amount due the holder hereunder;

"(3) that at any time prior to maturity, in respect of any certificate which is fully paid, the holder of the certificate, upon surrender thereof, shall be entitled to a value payable in cash not less than the then amount of the reserve for such certificate required by item (i) of subparagraph (E) of paragraph (2) of subsection (a) hereof. The amount of the surrender value for the end of each certificate year shall be set out in the certificate;

"(4) that in respect of any certificate, the holder of the certificate, upon maturity, upon surrender thereof for cash or upon receipt of a paid-up certificate as provided in subsection (f) hereof, shall be entitled to a value payable in cash equal to the then amount of the reserve, if any, for such certificate required by item (iv) of subparagraph (D) of paragraph (2) of subsection (a) hereof or item (ii) of subparagraph (E) of paragraph (2) of subsection (a) hereof in addition to any other amounts due the holder hereunder.

"The term 'certificate year' as used in this section in respect of any certificate of the installment type means a period or periods for which one year's payment or payments as provided by the certificate have been made thereon by the holder and the certificate maintained in force by such payments for the time for which the same have been made, and in respect of any certificate which is fully paid or paid-up means any year ending on the anniversary of the date of issuance of the certificate.

"Any certificate may provide for loans or advances by the company to the certificate holder on the security of such certificate upon terms prescribed therein but at an interest rate not exceeding 6 per centum per annum. The amount of the required reserves, deposits, and the surrender values thereof available to the holder may be adjusted to take into account any unpaid balance on such loans or advances and interest thereon, for the purposes of this subsection and subsections (b) and (c) hereof.

"Any certificate may provide that the company at its option may, prior to the maturity thereof, defer any payment or payments to the certificate holder to which he may be entitled under this subsection (d), for a period of not more than thirty days. In the event such option is exercised by the company, interest shall accrue on any payment or payments due to the holder, for the period of such deferment at a rate equal to that used in accumulating the reserves for such certificate. The Commission may, by rules and regulations or orders in the public interest or for the protection of investors, make provision for any other deferment upon such terms and conditions as it shall prescribe."

SEC. 18. Section 32(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) It shall be unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant, unless—

"(1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a

majority of those members of the board of directors who are not interested persons of such registered company;

"(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the vote of a majority of those members of the board of directors who are not interested persons of such registered company, cast in person at a meeting called for the purpose of voting on such action;

"(3) the employment of such accountant shall have been conditioned upon the right of the company by vote of a majority of the outstanding voting securities at any meeting called for the purpose to terminate such employment forthwith without any penalty; and

"(4) such certificate or report of such accountant shall be addressed both to the board of directors of such registered company and to the security holders thereof.

If the selection of an accountant has been rejected pursuant to paragraph (2) or his employment terminated pursuant to paragraph (3) the vacancy so occurring may be filled by a vote of a majority of the outstanding voting securities, either at the meeting at which the rejection or termination occurred or if not so filled then at a subsequent meeting which shall be called for the purpose. In the case of a common-law trust of the character described in section 16(b) no ratification of the employment of such accountant shall be required but such employment may be terminated and such accountant removed by action of the holders of record of a majority of the outstanding shares of beneficial interest in such trust in the same manner as is provided in said section 16(b) in respect of the removal of a trustee, and all the provisions therein contained as to the calling of a meeting shall be applicable. In the event of such termination and removal the vacancy so occurring may be filled by action of the holders of record of a majority of the shares of beneficial interest either at the meeting, if any, at which such termination and removal occurs, or by instruments in writing filed with the custodian, or if not so filled within a reasonable time then at a subsequent meeting which shall be called by the trustees for the purpose. The provisions of paragraph (41) of section 2(a) as to a majority shall be applicable to the vote cast at any meeting of the shareholders of such a trust held pursuant to this subsection."

SEC. 19. Section 33 of the Investment Company Act of 1940 is amended to read as follows:

"SEC. 33. Every registered investment company which is a party and every affiliated person of such company who is a party defendant to any action or claim by a registered investment company or a security holder thereof in a derivative or representative capacity against an officer, director, investment adviser, trustee, or depositor of such company, shall file with the Commission, unless already so filed, (A) a copy of all pleadings, verdicts, or judgments filed with the court or served in connection with such action or claim, (B) a copy of any proposed settlement, compromise, or discontinuance of such action, and (C) a copy of such motions, transcripts, or other documents filed in or issued by the court or served in connection with such action or claim as may be requested in writing by the Commission—

"(1) if delivered to such company or party defendant, within five days of receipt; or

"(2) if filed in such court or delivered by such company or party defendant, within two days of such filing or delivery."

SEC. 20. Section 36 of the Investment Company Act of 1940 is amended to read as follows:

"SEC. 36. The Commission is authorized to bring an action in the proper district court of the United States or United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty in respect of any registered investment company for which such person so serves or acts:

"(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

"(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such person from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as it in its discretion deems appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title."

SEC. 21. Section 43(a) of the Investment Company Act of 1940 is amended to read as follows:

"(a) Any person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order in the court of appeals of the United States within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall be forthwith transmitted by the clerk of the court to any member of the Commission, or any officer thereof designated by the Commission for that purpose and thereupon the Commission shall file in the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record shall be exclusive, to affirm, modify, or set aside such order, in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission or unless there were reasonable grounds for failure to do so. The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If application is made to the court for leave to adduce additional evidence, and it is shown to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such additional evidence in the proceeding before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court affirming, modifying, or setting aside, in whole or in part, any such order of the Commission shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in section 1254 of title 28, United States Code."

SEC. 22. Section 44 of the Investment Company Act of 1940 is amended to read as follows:

"SEC. 44. The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this title or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this title or the rules, regulations, or orders thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. A criminal proceeding based upon a violation of section 34, or upon a failure to file a report or other document required to be filed under this title, may be brought in the district wherein the defendant is an inhabitant or maintains his principal office or place of business. Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, this title or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subjected to review as provided in sections 1254, 1291, 1292, and 1293 of title 28, United States Code. No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against the Commission in any Court. The Commission may intervene as a party in any action or suit to enforce any liability or duty created by, or to enjoy any noncompliance with, sections 15 (d) and (g) of this title or rules, regulations, or orders thereunder brought by or on behalf of a registered investment company at any stage of such action or suit prior to final judgment therein."

SEC. 23. Section 202(a) of the Investment Advisers Act of 1940 is amended by redesignating paragraphs (17) through (20) thereof as paragraphs (18) through (21), respectively, and inserting immediately after paragraph (16) a new paragraph (17) to read as follows:

"(17) The term 'person associated with an investment adviser' means any partner, officer, or director of such investment adviser (or any person performing similar functions, or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser, except that for the purposes of section 203 of this title (other than subsection (f) thereof), persons associated with an investment adviser whose functions are clerical or ministerial shall not be included in the meaning of such terms. The Commission may by rules and regulations classify, for the purposes of any portion or portions of this title, persons, including employees controlled by an investment adviser."

SEC. 24. (a) Section 203(b) of the Investment Advisers Act of 1940 is amended to read as follows:

"(b) The provisions of subsection (a) shall not apply to—

"(1) any investment adviser all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange;

"(2) any investment adviser whose only clients are insurance companies; or

"(3) any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act."

(b) Section 203(c) of said Act is amended to read as follows:

"(c) Any investment adviser, or any person who presently contemplates becoming an investment adviser, may register under this section by filing with the Commission an application for registration. Such application shall contain such of the following information, in such form and detail, as the Commission may by rules or regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:

"(1) information in respect of—

"(A) the name and form of organization under which the investment adviser engages or intends to engage in business; the name of the State or other sovereign power under which such investment adviser is organized; the location of his or its principal business office and branch offices, if any; the names and addresses of his or its partners, officers, directors, and persons performing similar functions or, if such an investment adviser be an individual, of such individual; and the number of his or its employees;

"(B) the education, the business affiliations for the past ten years, and the present business affiliations of such investment adviser and of his or its partners, officers, directors, and persons performing similar functions and of any controlling person thereof;

"(C) the nature of the business of such investment adviser, including the manner of giving advice and rendering analyses or reports;

"(D) the nature and scope of the authority of such investment adviser with respect to clients' funds and accounts;

"(E) the basis or bases upon which such investment adviser is compensated; and

"(F) whether such investment adviser or any person associated with such investment adviser, is subject to any disqualification which would be a basis for denial, suspension, or revocation of registration of such investment adviser under the provisions of subsection (e), and

"(2) a statement as to whether the principal business of such investment adviser consists or is to consist of acting as investment adviser and a statement as to whether a substantial part of the business of such investment adviser consists or is to consist of rendering investment supervisory services. Except as hereinafter provided, such registration shall become effective thirty days after receipt of such application by the Commission, or within such shorter period of time as the Commission may determine.

Any amendment of an application filed not more than fifteen days after the filing of such application shall be deemed to have been filed with and as a part of such application. Any amendment of an application filed more than fifteen days after the filing of such application and before such application becomes effective shall be deemed a new application incorporating by reference the unamended items of the earlier application. Any amendment filed after the application has become effective shall become effective thirty days after the filing thereof, or at such earlier date as the Commission may order."

(c) Section 203 of said Act is further amended by redesignating subsection (d) thereof as subsection (e) and redesignating subsection (e) as subsection (g) and inserting a new subsection (d) to read as follows:

"(d) Any provision of this title (other than subsection (a) of this section) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith shall also prohibit any such act, practice, or course of business by any investment adviser registered pursuant to this section or any person acting on behalf of such an investment adviser, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith."

(d) Redesignated section 203(e) of said Act is amended to read as follows:

"(e) The Commission shall, after appropriate notice and opportunity for hearing, by order censure, deny registration to, or suspend for a period not exceeding twelve months, or revoke the registration of, an investment adviser, if it finds that such censure, denial, suspension, or revocation is in the public interest and that such investment adviser or any person associated with such investment adviser, whether prior to or subsequent to becoming such—

"(1) has willfully made or caused to be made in any application for registration or report filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or who has omitted to state in any such application or report any material fact which is required to be stated therein; or

"(2) has been convicted within ten years preceding the filing of the application or at any time thereafter of any felony or misdemeanor which the Commission finds (A) involves the purchase or sale of any security, (B) arises out of the conduct of the business of a broker, dealer, or investment adviser, (C) involves embezzlement, fraudulent conversion, or misappropriation of funds or securities, or (D) involves the violation of sections 1341, 1342, or 1343 of title 18, United States Code; or

"(3) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or an affiliated person or employee of any investment company, bank or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security; or

"(4) has willfully violated any provision of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title I of this Act, or of this title, or of any rule or regulation under any of such statutes; or

"(5) has aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or the Securities Exchange Act of 1934, or of title I of this Act, or of this title, or of any rule or regulation under any of such statutes or has failed reasonably to supervise, with a view to preventing violations of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this paragraph (5) no person shall be deemed to have failed reasonably to supervise any person, if—

"(A) 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

"(B) 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.

"(6) is subject to an order of the Commission entered pursuant to subsection (f) of this section barring or suspending the right of such person to be associated with an investment adviser, which order is in effect with respect to such person."

(e) Section 203 of said Act is further amended by redesignating subsections (f) and (g) thereof as subsections (h) and (i), respectively, and inserting a new subsection (f) to read as follows:

"(f) The Commission may, after appropriate notice and opportunity for hearing, by order censure any person or bar or suspend for a period not exceeding twelve months any person from being associated with an investment adviser, if the Commission finds that such censure, barring, or suspension is in the public interest and that such person has committed or omitted any act or omission enumerated in paragraphs (1), (4), or (5) of subsection (e) of this section or has been convicted of any offense specified in paragraph (2) of said subsection (e) within ten years of the commencement of the proceedings under this subsection or is enjoined from any action, conduct, or practice specified in paragraph (3) of said subsection (e). It shall be unlawful for any person as to whom such an order barring or suspending him from being associated with an investment adviser is in effect, willfully to become, or to be, associated with an investment adviser, without the consent of the Commission, and it shall be unlawful for any investment adviser to permit such a person to become, or remain, a person associated with such investment adviser without the consent of the Commission, if such investment adviser knew, or in the exercise of reasonable care should have known of such order."

SEC. 25. Section 205 of the Investment Advisers Act of 1940 is amended to read as follows:

"SEC. 205. No investment adviser, unless exempt from registration pursuant to section 203(b), shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew any investment advisory contract, or in any way to perform any investment advistory contract entered into, extended, or renewed on or after the effective date of this title, if such contract—

"(1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client;

"(2) fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract; or

"(3) fails to provide, in substance, that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change.

Paragraph (1) of this section shall not be construed to prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period, or as of definite dates, or taken as of a definite date. Paragraph (1) of this section shall not apply to an investment advisory contract with an investment company registered until title I of this Act which provides for compensation based on the asset value of the company averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company over a specified period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify. For purposes of the preceding sentence, an index of securities prices shall be deemed appropriate unless the Commission by order shall determine otherwise. As used in paragraphs (2) and (3) of this section, 'investment advisory contract' means any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account of another person other than an investment company registered under title I of this Act."

SEC. 26. The Investment Advisers Act of 1940 is further amended by redesignating sections 208 through 222 thereof as sections 209 to 223, respectively, and inserting immediately after section 206 a new section 207 to read as follows:

"SEC. 207. The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person or transaction, or any class or classes of person, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public

interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

SEC. 27. (a) Section 2(1) of the Securities Act of 1933 is amended by inserting after "other mineral rights," the following: "interest or participation in any common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent or in any other collective fund maintained by a bank consisting of assets of retirement trusts for self-employed individuals which are exempt from Federal income taxation under the Internal Revenue Code and which the Commission determines requires the protection for investors of the provisions of this title,".

(b) Section 3(a)(2) of such Act is amended by inserting after "commission or similar official;" the following: "or any interest or participation in any common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian, or in any collective fund maintained by a bank consisting solely of assets of retirement, pension, profit-sharing, stock bonus, or other trusts which are exempt from Federal income taxation under the Internal Revenue Code except any fund consisting of assets of retirement trusts for self-employed individuals which are exempt from Federal income taxation and which the Commission determines requires the protection for investors of the provisions of this title;".

SEC. 28. (a) Section 3(a)(10) of the Securities Exchange Act of 1934 is amended by inserting after "certificate of deposit, for a security," the following: "any interest or participation in any common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent or any collective fund maintained by a bank consisting of assets of retirement trusts for self-employed individuals which are exempts from Federal income taxation under the Internal Revenue Code and which the Commission determines requires the protection for investors of the provisions of this title,".

(b) Section 12(g)(2) of such Act is amended by adding at the end thereof a new subparagraph as follows:

> "(H) any interest or participation in any common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian, or any collective fund maintained by a bank consisting solely of assets of retirement, pension, profitsharing, stock bonus, or other trusts which are exempt from Federal income taxation under the Internal Revenue Code except any fund consisting of assets of retirement trusts for self-employed individuals which are exempt from Federal income taxation under the Internal Revenue Code and which the Commission determines requires the protection for investors of the provisions of this title."

SEC. 29. The amendments made by this Act shall take effect as follows:

(1) The amendments to sections 10 (a), (b), (c), and (d), 15 (a), (c), and (d), 17(f), 19 and 32(a) of the Investment Company Act of 1940 and sections 203(b) and 205 of the Investment Advisers Act of 1940, contained in sections 5 (a), (b), (c), and (d), 8 (a), (c), and (d), 9(a), 11, 18, 24, and 25 of this Act, respectively, shall take effect one year from the date of this enactment.

(2) The amendments to sections 27(a) and 28(a)(2) and 28(d) of the Investment Company Act of 1940, contained in sections 16(a) and 17(a) and 17(b) of this Act, respectively, shall take effect six months from the date of its enactment.

(3) All other amendments in this Act shall take effect on the date of its enactment.

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., March 12, 1968.

HON. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your letter of January 24, requesting the Board's views on H.R. 14742, a bill "To amend the Investment Company Act of 1940, as amended, and the Investment Advisers Act of 1940, as amended, to define the equitable standards governing relationships between investment companies and their investment advisers and principal underwriters, and for other purposes".

From the standpoint of bank supervision, the chief question of legislative policy presented by the bill is whether it would be in the public interest for banks to establish and operate collective funds that would be similar to, and would compete with, mutual funds. Opponents of the proposal contend that permitting banks to engage in this activity would constitute an undesirable departure from the policies of the Banking Act of 1933 (the Glass-Steagall Act).

The Board continues to believe that the principle of separation of commercial banking from investment banking, which was recognized by the Congress in the Banking Act of 1933, is a sound and significant one. This separation, we are convinced, avoids certain conflicts of interests that might impair the ability of commercial banks to devote themselves single-mindedly to their primary function of serving their depositors, borrowers, correspondents, and trust accounts.

It must be borne in mind, however, that the service which would be performed by banks, if their collective funds were made available to the general public as investment media, would be similar in many respects to services already performed by banks for their individual trust and agency accounts. Moreover, the purposes of separating commercial banking from investment banking are not significantly relevant to operations of the kind under discussion, for the following reasons.

The principal dangers of combining operations in those two fields are that, if commercial banks were permitted to underwrite and deal in securities, (1) a bank might find itself holding, either in its underwriting department or in its investment portfolio, securities that are unsuitable for bank investment, and (2) a bank engaged in underwriting and dealing might have undesirable opportunities and temptations to overreach its correspondent banks and other customers by selling to them unsuitable or overpriced securities it had acquired (or contracted to acquire) in its investment banking operations.

When the nature and the anticipated mode of operation of banks' collective funds are examined, however, it appears that neither of these hazards would be present to any significant extent. In the operation of collective funds, the bank itself does not become the owner of any securities; it receives and invests the funds of the participants. In other words, an essential element of the dangers referred to—banks acquiring securities as underwriter or dealers—simply is not present in connection with the operation of a collective fund.

It might be contended, nevertheless, that a bank's management of a collective fund would permit it to "unload" on the fund poor investments that the bank had accumulated in its own portfolio, or to sell portfolio securities to the fund at inflated prices. The Board believes that these would not be real dangers, in view of provisions of the securities laws and other limitations on banks' selling assets to their own fiduciary accounts, the absence from banks' portfolios of the kind of assets that collective funds purchase (principally corporate stocks), the existence of day-to-day market prices for almost all securities purchased by collective funds, and the controls and protection resulting from governmental supervision of banks' operations.

Some who oppose bank operation of managing agency collective funds have advanced another possible drawback, somewhat related to the foregoing. Banks occasionally make loans that prove difficult to collect because of the financial situation of the borrower. In such cases, it has been argued, a bank might use money of a collective fund to purchase a new issue of stock or other securities from the weak borrower, or even to make a direct loan to that borrower, in order to enable it to discharge its indebtedness to the bank.

Although such conflicts of interest and consequent misconduct are not impossible, this area of risk is not regarded as significant. For many years banks have participated in the management of employee-benefit funds and other fiduciary accounts that hold stocks and other securities in an aggregate amount far exceeding those held by the entire mutual fund industry. The examinations conducted by bank supervisory agencies have disclosed practically no such misuse by banks of their investment advisory and management functions. In the case of managing agency funds, an additional safeguard is the prophylactic restrictions and requirements of the Investment Company Act of 1940, particularly publicity of the financial transactions of registered investment companies, which almost inevitably would expose such malfeasance. A further deterrent would be the adverse impact on a collective fund's performance—its comparative financial record—if any of its resources were used to make unprofitable investments; the detrimental effect on sales of participations might outweigh any benefits the bank could reasonably expect from its breach of fiduciary duty.

On the basis of the experience described and the additional safeguards that exist in the mutual fund field, the Board believes that this alleged risk is negligible.

The suggestion has also been advanced that bank operation of managing agency collective funds might, in certain circumstances, diminish banks' prestige and even public confidence in the banking system. An individual who invested $10,000, for example, in such a fund would feel that he had sustained a $3,000 loss if the market value of the stock held by the fund fell 30 per cent in a bear market. It is argued that this might be misunderstood (by persons who were not aware of the difference between bank deposits and mutual fund investments) as indicating that the bank was insolvent, and that undesirable consequences would result.

Whether there would be a material risk along these lines is, of course, a matter of judgment as to the extent to which investors and the banking public would be aware of the difference between (a) bank deposits and (b) investments in a diversified portfolio of securities. The Board believes that this basic distinction is well understood by most of the persons who would be concerned. It is also to be noted that Securities Act prospectuses, which must be furnished to persons to whom mutual fund shares are offered, call attention explicitly to the inevitable fluctuations in value—that is, the risk of loss as well as the opportunity for gain—as the market prices of the portfolio securities rise and fall.

Another argument that has been advanced against bank entry into the mutual fund business is that banks enjoy advantages of convenience, prestige, and economies which would enable them, in time, to gain control of the mutual fund field to the virtual exclusion of non-bank competitors. But the Board considers it improbable, for reasons indicated below, that banks' collective investment funds would enjoy advantages which would exclude others from the business of establishing and maintaining mutual funds.

Most of the billions of dollars that are invested annually in mutual fund shares are elicited from investors by brokers, dealers, or salesmen motivated by the commissions to be earned through selling shares of "load" type funds. It is contemplated that banks' managing agency funds would be of the "no-load" type, and the history of the industry idicates the unlikelihood that such funds would supplant mutual funds that have the benefits of commission-motivated selling efforts. (An analogous situation, in another field, is the limited sales of savings-bank life insurance, which has been available for many decades. Despite favorable rates, such insurance has not been a serious competitor in the life insurance field, perhaps because of the absence of aggressive efforts of agents eager to earn commissions.) Furthermore, an important factor affecting sales of mutual fund shares is their "performance" as measured by capital appreciation (that is, increase in the market value of the portfolio), and there is no present reason to believe that banks' collective funds would excel those of their competitors in this respect.

In the absence of convincing reasons for barring a segment of private enterprise from access to additional fields of activity, the Board doubts that such restrictive legislation is desirable. In this situation, moreover, participation by banks may yield valuable benefits in an industry that attracts the savings of millions of savers of limited means. Availability of such bank-operated investment media could be of service to those investors by providing (a) a means of performing a traditional banking function more efficiently and at less cost, (b) more competition for the funds of such investors, and (c) the opportunity to combine investment service and special fiduciary services when needed (a combination that is often less conveniently available when mutual fund shares constitute the investment vehicle).

To recapitulate, the Board recognizes that the operation of collective funds by banks involves elements of risk. This is true, however, whenever banks—or other organizations—expand the services they offer. If the possibility of adverse consequences, however slight or remote, were regarded as sufficient ground for prohibiting such expansion of activities, regulated industries could not adapt to changed circumstances and the new needs and demands of our economy. In every such situation, the ultimate judgment consists of weighing risks against prospective benefits. With respect to the instant proposal, the Board of Governors concludes that the probable benefits to the public from increased competition are substantial and that the risks are relatively less significant. The Board therefore favors the objective of H.R. 14742 to authorize banks to establish and operate investment funds substantially similar to conventional mutual funds. Our reasoning and conclusions are also applicable to collective investment

by banks of retirement trusts for self-employed individuals (so-called "Smathers-Keogh trusts" or "H.R. 10 plans").

The Board understands that H.R. 14742 is intended to place banks' collective funds for managing agency accounts in the same securities-laws status, broadly speaking, as the mutual funds with which they would compete—that is, they would be subject to those laws under the administration of the Securities and Exchange Commission. The situation would be otherwise, however, with respect to banks' Smathers-Keogh collective funds, if this bill were enacted in its present form. Under sections 27(a) and 28(a), funds of the latter type would be excluded from the *definitions* of "security" in the Securities Act of 1933 and the Securities Exchange Act of 1934 unless there was an affirmative administrative finding that a particular situation "requires the protection for investors" provided by those Acts. The bill has comparable provisions (sections 27(b) and 28(b)) with respect to *registration* of banks' Smathers-Keogh collective funds under the 1933 and 1934 securities laws.

The Board concurs in the criticisms of these provisions that were expressed in the testimony of Chairman Cohen of the SEC at the hearing before the Senate Banking Committee on the McIntyre Amendments to S. 1659 ("Mutual Fund Legislation of 1967", November 1967, pages 1327–1328). The exclusion of banks' Smathers-Keogh collective funds from the category of "security" seems unjustified for the reasons specified by Mr. Cohen, and there appears to be no sufficient justification for a general exclusion of those funds from the registration and related requirements of the Federal securities laws.

The Board also notes that under the proposed new section 22(i) of the Investment Company Act of 1940 the Comptroller of the Currency seemingly would be empowered to regulate the securities aspects of mutual funds maintained by banks. The Securities and Exchange Commission would also have such power under existing provisions of that Act. The Board questions the advisability of authorizing two agencies of the Federal Government to regulate the securities aspects of mutual funds maintained by banks. It seems clear to us that banks' mutual funds, as such, should be governed by a single Federal regulatory system—subject, of course, to the general supervision of State and Federal banking authorities from the standpoint of safe and sound operation. The Board believes that the applicable regulatory system should be that which governs mutual funds generally under the Federal securities laws, administered by the Securities and Exchange Commission. Accordingly, the Board recommends deletion of the final clause (beginning with the word "if") of the proposed section 22(i)

Sincerely yours,

WM. MCC. MARTIN, JR.

Mr. Moss. I am pleased to recognize at this time Mr. Keith, the ranking minority member of this committee, for any statement he might desire to make.

Mr. KEITH. Thank you, Mr. Chairman. I have no prepared statement but as these hearings develop I will be listening for argument concerning the overall question as to whether or not we want to have the banks more directly involved in efforts to market mutual funds.

If it is resolved in favor of having the banks in this business, I will be looking at what that does to the legislation, which has been before us for some time, adopting the SEC's recommendations to lower the commissions on the sale of mutual funds, and regulate the management fees that can be charged. It has been argued by the SEC and others, including Members of Congress, that it is advisable to regulate this industry in those two respects.

It is possible that the argument to that end would be lessened if we had the competition of the banks in this business. We may have that long-range result by our action on this newly introduced amendment.

Further than that I have no observation to make at this time.

Thank you, Mr. Chairman.

Mr. Moss. Our first witness this morning is Mr. Robert D. Ferguson, executive vice president, Pittsburgh National Bank, Pittsburgh, Pa., appearing for the American Bankers Association. Mr. Ferguson.

STATEMENT OF ROBERT D. FERGUSON, REPRESENTING THE AMERICAN BANKERS ASSOCIATION; ACCOMPANIED BY CECIL P. BRONSTON, PRESIDENT, TRUST DIVISION; JOHN WALLACE, CHAIRMAN, COMMITTEE ON COMMON TRUST FUNDS; AND LEO HERZEL, SPECIAL COUNSEL

Mr. FERGUSON. Mr. Chairman and members of the Subcommittee on Commerce and Finance, as the chairman has stated, my name is Robert D. Ferguson. I am executive vice president of the Pittsburgh National Bank of Pittsburgh, Pa.

I am accompanied today by Mr. Cecil P. Bronston, vice president of the Continental Illinois National Bank and Trust Co. of Chicago, Ill.; Mr. John Wallace, vice president and senior trust officer of the National Shawmut Bank of Boston, Mass., and Mr. Leo Herzel of Chicago, Ill., who is serving as a special counsel in this matter.

Mr. Bronston is currently serving as president of the trust division of the American Bankers Association, and Mr. Wallace is the chairman of our committee on common trust funds. I formerly served as the president of the trust division of the American Bankers Association.

The American Bankers Association is indeed grateful for this opportunity to appear before this distinguished subcommittee to present our views with regard to H.R. 14742.

H.R. 14742 relates in part to bank collective investment funds, which are created by the pooling of assets held by a bank in trust or other fiduciary capacities. These particular provisions of the Moss bill deal with some existing—and perhaps potential—questions concerning the legal status of certain bank collective investment funds under the Federal securities laws.

Three specific types of collective investment funds are covered by the provisions of H.R. 14742. They are:

(1) Common trust funds, exempt from taxation under section 584 of the Internal Revenue Code, which are comprised of assets held by a bank as trustee, executor, administrator, or guardian.

(2) Collective funds comprised of the assets of qualified trusts (within the meaning of section 401 of the Internal Revenue Code), which would include trusts established for employee pension, welfare, profit sharing, and bonus plans, as well as trusts for self-employed retirement plans under the Smathers-Keogh Act.

(3) Collective funds comprised of assets of managing agency accounts created by an agreement authorizing the bank (as agent) to exercise investment discretion in managing the assets of the principal. It is this managing agency fund which has become popularly described as a "bank mutual".

Our appearance today marks the second time in the past 4 years that the American Bankers Association has been privileged to testify before this distinguished subcommittee with respect to legislation designed to clarify the legal and regulatory status of bank collective investment funds under the Federal securities laws. Our previous testimony occurred on June 9, 1964, at hearings held on H.R. 9410 and

H.R. 8499, identical bills introduced in the 88th Congress by Congressman Fascell of Florida and Congressman Anderson of Illinois.

Our testimony today will, in certain important respects, reflect a marked—and we hope constructive—departure from our statement presented to this subcommittee in 1964. The contesting legal arguments which underlie the problems, here sought to be solved, have continued for a period now approaching 5 years. Speaking for ourselves, the American Bankers Association has no desire to cling fervently to old positions or give further sustenance to this prolonged debate. We are earnestly interested in solving the existing problems under the Federal securities laws so that we may get on with the business of providing fiduciary services to the public. We believe that the Moss bill with some modest amendments will offer a rational and reasonable means for attaining that objective.

HISTORY AND DEVELOPMENT OF COLLECTIVE INVESTMENT FUNDS

Before discussing the specific purposes and effects of these provisions of H.R. 15742 which relate to bank collective investment funds, it might be helpful if we touch briefly on the history and development of bank utilization of the collective investment medium. Banks have for generations been administering or managing funds and other assets held by them in a trust, agency, or other fiduciary capacity. However, it has only been in the past 30 or so years that banks have used pooling or collective investment procedures for the administration of certain trusts and fiduciary accounts.

The motivating purpose for adopting collective investment procedures has been to achieve more diversified, as well as more efficient, investment of fiduciary accounts than would be possible were these same accounts to be managed and invested individually. The pooled fund procedure has proved to be particularly useful and beneficial in the investment management of small or moderate-sized accounts. In addition to balanced funds, banks have developed specialized collective funds—such as common stock funds, State and municipal bond funds, and fixed-income funds.

Both the growth in the number of pooled funds and the number of banks maintaining such funds has been quite dramatic in recent years.

The Trust Division of the American Bankers Association conducts an annual survey of collective investment funds. According to the 1961 survey, there were 288 banks operating 421 pooled funds. By 1967, those figures had grown to 497 banks operating 1,702 pooled funds.

Now let us proceed to a review of the provisions of H.R. 14742, giving special attention to the particular treatment which is proposed to be given to each of the three types of bank collective investment funds under the Federal securities laws.

MANAGING AGENCY FUNDS

This type of collective fund is maintained for the pooling of assets held by a bank in the capacity of a managing agent, a relationship created by an agreement in which an individual as the principal places funds or other assets in the physical control of a bank and authorizes the bank as agent to exercise its discretion in the management and investment of those assets for the benefit of the principal.

The Moss bill would treat this type of fund as an open-end investment company and make such funds subject to the regulatory requirements of the Investment Company Act of 1940 and the registration provisions of the Securities Act of 1933. At the same time, the Federal banking agencies would continue to exercise their general authority to supervise these funds from the standpoint of safe and sound trust and banking practices.

Mr. Chairman, if I may for a moment depart from my prepared statement, I would like to amplify this point concerning the Federal banking agencies.

Despite the fact that managing agency collective funds will indeed be subject to the regulatory requirements of the 1940 Investment Company Act as administered by the SEC, it is nevertheless true that the banking agencies will in no sense be relieved of their continuing responsibility to supervise and examine these funds to assure that we continue to perform the obligations and responsibilities of corporate fiduciaries.

This means in the case of a national bank our collective investment funds will be examined at least once each year by the examining force of the U.S. Comptroller of the Currency.

The case of State-chartered banks, it means our collective funds will be examined by the examiners either of the Federal Reserve Board or the Federal Deposit Insurance Corporation depending on whether or not the State-chartered institution is a member of the Federal Reserve System.

Additionally, in the case of these State-chartered institutions, their collective investment funds will also be examined by the State banking authorities in each of the 50 States.

As you know, the insurance companies are subject to examination by the insurance department of the various States and we presume that this examination will continue, now that the insurance companies are in the mutual fund field.

Thus, it may be said that in the case of both a bank-affiliated mutual fund and an insurance company-affiliated mutual fund, the public will be adequately protected by on-the-premises examination provided by banking and insurance departments.

Now, if I may revert to my prepared statement.

The proposed amendments, however, place the principal regulatory responsibility in the Securities and Exchange Commission, to be exercised under the Federal securities laws.

Notwithstanding the fact that there is this examination by the banking authorities, additionally, H.R. 14742 would unconditionally prohibit such a fund when maintained by a bank from including a sales load in the public offering price of any security issued. Thus, a managing agency collective fund operated by a bank would be essentially similar to a "no-load mutual fund" and would be accorded the same treatment under the 1940 act.

In the past, the American Bankers Association had sought to have this type of collective investment fund declared by statute to be exempt from the Federal securities laws with regulatory responsibility placed in the bank supervisory agencies. However, after full deliberation, we have concluded that this type of bank fund can successfully be operated by us under the Federal securities laws on an equal basis

with mutual funds. Accordingly, we support the provisions of H.R. 14742, which deal with managing agency collective funds.

SECTION 401 TAX QUALIFIED FUNDS

This general classification of bank collective investment funds includes two subclasses which will be discussed separately since the proposed amendments provide for a differing treatment under the securities laws.

Funds for employee benefit plans

This first type of section 401 fund is comprised of assets of trust established for employee pension, welfare, profit sharing, and stock bonus plans, which have qualified for tax-exempt treatment of income under section 401 of the Internal Revenue Code.

In the main, the participating trusts in these funds are trusts covering the employee benefit plans of small companies and employers.

As is the case with personal trusts, the pooling medium is used to give these smaller employee benefit plans the advantages of diversification and more economical investment administration available to large plans through individual management.

This type of fund is already exempt under the Investment Company Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934, by reason of administration determination of the Securities and Exchange Commission. H.R. 14742 would give statutory affirmation to these administrative determinations.

In light of the existing administrative relief granted this type of fund, it may appear to members of this subcommittee that explicit statutory provisions are not required. This probably would be so were it not for the fact that amendments to the securities laws are being proposed for other types of bank collective funds, and to leave the statutes silent as to this particular type of fund might raise questions and ambiguities as to their future status under the securities laws.

Funds for self-employed retirement plans

This type of collective investment fund is one comprised of individual trusts created by self-employed individuals—farmers, lawyers, small businessmen, accountants, dentists, doctors, and others—for the purpose of providing future retirement benefits for themselves and their employees.

Tax qualified retirement plans for the self-employed were authorized by the Congress in 1962 through the enactment of the Smathers-Keogh Act. Bank-trusteed trusts were one of the specific means authorized by that act for establishing self-employed retirement plans.

I should say also that the bank-trusteed plans are the only authorized method of investment in the H.R. 10 plan. If a customer has an H.R. 10 plan he can walk in our door and discuss the trust with us, so to speak.

The purpose of the Smathers-Keogh Act was to provide self-employed individuals and their employees a tax treatment somewhat similar to that accorded employee-beneficiaries of corporate pension plans. The act places limitations on the amounts which an individual may contribute annually to such a retirement plan. If the cost to the individuals who set up retirement plans is to bear an economical rela-

tion to the amounts being invested, banks must administer these trust assets on a pooled basis.

Until recently there has been no great public demand for Smathers-Keogh services, due in large part to statutory limitations on tax deductions for the annual contributions. However, in 1966, the Congress liberalized the tax treatment of contributions to retirement plans for self-employed and their employees. This liberalized tax treatment became effective as of January 1, 1968. Based on inquiries received by our member institutions over the past several months, it now appears that the public's interest in the Smathers-Keogh services will be increasing significantly in the immediate future. For this reason, the banking and trust industry needs a resolution of the current uncertainties pertaining to the status of pooled funds of the Smathers-Keogh trust assets under the Securities Act of 1933 and the Securities Exchange Act of 1934.

In the past, our association has vigorously contended that pooled funds of this type, because they are comprised exclusively of assets held under bona fide trust instruments, should not be subjected to the requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934. On the other hand, the Securities and Exchange Commission has claimed that the operational characteristics of these pooled funds would be such as to involve a "public offering of securities" and should, therefore, be required to comply with the provisions of the 1933 and 1934 acts.

The provisions of H.R. 14742 relating to collective funds consisting of Smathers-Keogh trust assets reflect a compromise between our view and that of the SEC. Under these provisions, not all bank funds for Smathers-Keogh trusts will be required to register under the 1933 and 1934 acts.

Mr. KEITH. In the prepared statement it says, "Under these provisions, all bank funds," and you read——

Mr. FERGUSON. I changed the order, sir, in that sentence. It now should read, "Under these provisions, not all bank funds for Smathers-Keogh trusts will be required to register."

In other words, only a part of it may be required to register. To this extent, the provisions of H.R. 14742 recognize the view which we have consistently urged, that in the vast majority of trust departments, H.R. 10 trusts will be handled in a similar manner to other trusts established for bona fide fiduciary purposes, and thus will present no justification for requiring compliance with the Federal securities laws.

On the other hand, the provisions of H.R. 14742 reflect the concern which the SEC has expressed that the commingling of H.R. 10 trusts may in some instances be so conducted as to make appropriate the application of the registration provisions of the 1933 and 1934 acts.

That explains my comment, sir, in the previous sentence.

Accordingly, H.R. 14742 provides that collective funds consisting of H.R. 10 trust assets may be made subject to the registration provisos of the 1933 and 1934 acts when a determination is made that the application of these provisions is required for the protection of investors.

While we continue to believe that H.R. 10 trusts raise no greater justification for the potential applicability of the securities laws than

do other bona fide trusts, we recognize the genuineness of the SEC's concern and we are prepared to support the compromise approach which we have just described.

In one respect, however, we are in complete disagreement with the provisions of H.R. 14742. Under the provisions of the amendments to S. 1659 which have been introduced in the Senate by Senator McIntyre to deal with the problems relating to bank collective investment funds, the authority to determine when the operation of a particular fund consisting of H.R. 10 trust assets does require the protection for investors of the registration provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and to administer the registration provisions of these laws when such a determination has been made is vested in the Federal banking agencies. H.R. 14742, which is virtually identical in all other respects to the McIntyre amendments, vests this authority in the SEC.

We believe that the Federal banking agencies are ideally suited to carry out the necessary oversight to insure that investors are fully and adequately protected in connection with bank H.R. 10 trust opertions. The banking agencies are in constant contact with bank trust department operations; they are, therefore, uniquely situated to become aware of changing modes of operation in connection with the commingling of H.R. 10 trust assets and to respond quickly as the protection of investors requires. In addition, we believe that the greater familiarity of the banking agencies with bank operations over the years renders these agencies better equipped than the SEC to evaluate changing operational methods in the practical context of overall trust department activities.

We would point out that in 1964 when Congress determined that securities issued by banks should, under some circumstances, be subject to the Securities Exchange Act of 1934, the authority to administer the provisions of that act with respect to bank securities was specifically vested in the banking agencies. The 1964 amendments were concerned with ordinary bank stocks, which are in many respects comparable to the stocks of industrial and other business enterprises.

It seems to us much more clear in the case of H.R. 10 trusts and interests in the bank collective investment funds in which they may be invested—which are not traditional securities at all, but involve a particular aspect of the internal operations of a bank trust department—that the banking agencies, rather than the SEC, are the proper supervisory agencies.

We recognize, however, that there may be some force in the criticism made by Chairman Cohen that the approach of the McIntyre amendments, dividing the full residual authority over H.R. 10 trust funds among the three Federal banking agencies, may constitute an unnecessary fragmentation of responsibility and that differing standards among the agencies could pose some danger of creating confusion both among banks themselves and among investors.

To avoid this danger, we suggest that the residual authority to determine that a bank fund for H.R. 10 trust assets must be registered and to register the registration statements when such a determination is made be vested in the three banking agencies, but that the law itself make clear that this authority must be exercised in accordance with rules and regulations promulgated by the Comptroller of the Currency.

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The resulting regulatory scheme with regard to funds for H.R. 10 trust assets would, thus, be substantially similar to the present situation in regard to traditional common trust funds, which are regulated by the various banking agencies but which, by virtue of section 584 of the Internal Revenue Code, must be operated in accordance with the rules and regulations of the Comptroller of the Currency. We have attached as an appendix a draft of proposed technical amendments to H.R. 14742 which would carry out this recommendation.

We emphasize that there is no single feature of H.R. 14742 in which the public and the banking industry have such a deep interest as these provisions relating to Smathers-Keogh funds, due to the large number of individuals and institutions which will be affected. At present, there are at least 497 separate bank trust departments in the United States that maintain one or more common trust funds for the purpose of providing efficient and economical administration of the assets of modest-sized trusts. Most of these institutions can only be expected to provide fiduciary services under Smathers-Keogh plans on the same economical basis if the problems under the Federal securities laws are resolved.

I should like to interpolate here that many of the smaller or modest-size banks already have one common fund. It would be a great mistake for them to have to set up a separate fund just for the Smathers-Keogh funds. They should be able to put their Smathers-Keogh trusts into the fund that they are already operating and they should not, as we point out, be subject to registration, particularly these small funds, under the securities laws of their main, already existing fund which is now not subject to registration.

Mr. KEITH. Mr. Chairman.

Mr. MOSS. Mr. Keith desires to ask a question.

Mr. KEITH. In view of your interpolation, at this point may I comment that couldn't these small banks, if they felt it advisable, buy no-load mutual funds until the time they become large enough to have collective investment funds?

Mr. FERGUSON. I am sorry, sir, I missed one phrase of your question. May I have it again?

Mr. KEITH. You have argued that a small bank would not want to set up a small account for that purpose. I imagine there are some small banks, in an effort to get diversified portfolios for their accounts for which they are trustee, would then get a no-load mutual fund?

Mr. FERGUSON. I believe there are some investments by some small investment banks in a no-load mutual fund.

Mr. KEITH. My point is that they could similarly in this instance adopt similar procedures until such time as they got the H.R. 10 in a big way.

Mr. FERGUSON. I think the point I am making here is that many of these banks already have a common trust fund which they are operating under their own direct investment supervision.

I think the banks would prefer to operate their H.R. 10 funds under their own investment supervision and if they are able to do so, as many of them already are, they in effect amalgamate the investment in one collective fund.

Mr. KEITH. I can understand that. I don't think I am so naive as to accept that the sole purpose of these bank-operated common trust

funds is for more efficient and economical administration of these funds because in the initial stages they have an opportunity to buy no-load investment funds elsewhere if they want to. There must be a profit motive.

That is a point we will come to later on, I suspect.

Mr. FERGUSON. I say yes, when you are talking about any funds that are operated by a bank's trust department we have first the desire to operate it economically for the benefit of the customer and also we hope not to operate it at the expense of the bank, so to speak. We hope to either break even or make a profit on the operation.

Mr. KEITH. I notice on page 3 of your testimony where you said:

> The motivating purpose for adopting collective investment procedures has been to achieve more diversified, as well as more efficient, investment of fiduciary accounts than would be possible were these same accounts to be managed and invested individually.

But it is not exclusively that.

Mr. FERGUSON. That is right, sir.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Moss. Mr. Ferguson, you may proceed.

Mr. FERGUSON. To finish out the paragraph on page 11—hundreds of thousands of self-employed persons who may wish to establish retirement trusts for themselves and their employees will thus be directly benefited by the resolution of these problems, with respect to the Smathers-Keogh type funds.

COMMON TRUST FUNDS

Common trust funds are the oldest form of bank collective investment funds, having first received statutory recognition in the Federal tax laws in 1936. These funds are comprised of assets held by a bank in the capacity of trustee, executor, administrator, or guardian. Under section 584 of the Internal Revenue Code, a common trust fund, regardless of whether it is maintained by a national bank or a State-chartered institution, must be operated in conformity with rules and regulations promulgated by the Comptroller of the Currency.

Common trust funds enjoy explicit statutory exemption from the operation of the Investment Company Act of 1940. Moreover, the Securities and Exchange Commission has never attempted to exercise jurisdiction over these funds, under the 1933 and 1934 acts.

However, for the same reasons applicable to the funds comprised of employee benefit trust, there is a need for explicit amendments to the 1933 act and the 1934 act so as to avoid any future questions or ambiguities as to the status of common trust funds under these two Federal securities laws.

Here again to express in the act dealing with the number of kinds of collective funds and not to take care of the common trust funds might raise questions.

The Moss bill includes such amendments. The result is that bank common trust funds would continue to operate, as they do today, under the regulatory requirements of the Comptroller of the Currency and the supervisory oversight of the appropriate Federal and State bank supervisory agencies.

A recent decision in the Federal district court in *Washington Investment Company Institute, et al.* v. *William B. Camp, Comptroller of the Currency* has held that it is unlawful under the Federal banking laws for a national bank located in New York to operate a collective investment fund for managing agency accounts.

We believe that the decision in this case is based on an erroneous interpretation of the Banking Acts of 1933 and 1935. This case is now on appeal which causes us to conclude that the Department of Justice shares our view of the decision.

Nevertheless, the district court's decision does represent the case law of the moment on this subject; and we are, therefore, pleased to note that the Moss bill takes cognizance of this matter.

Section 12(3) of H.R 14742 provides that no provision of law shall be deemed to prevent the creation or operation of a collective investment fund of managing agency accounts by a bank if such fund is created and operated in compliance with applicable regulations of the Comptroller of the Currency. We support this provision and, in so doing, are satisfied that it does not do violence to either the language or the spirit of the Banking Acts of 1933 and 1935.

The primary purpose of the Congress in enacting the Banking Acts of 1933 and 1935 was to separate banks of deposit from investment banks. This objective was accomplished by making it unlawful for banks to deal as principals in securities other than Government obligations or securities of equivalent quality. But the Banking Acts of 1933 and 1935 did not prohibit banks from dealing in securities as a trustee or agent. In fact, these statutes explicitly permit a bank to purchase and sell "securities and stock" for the account of customers. This is precisely the function which a bank will perform in the operation of a collective investment fund of managing agency accounts. The bank will not be dealing in securities as a principal but rather as an agent for the account of customers.

Thus, section 12(e) of H.R. 14742 neither repeals nor amends the Banking Acts of 1933 and 1935, but rather overrides interpretations of those statutes that are inconsistent with the public interest.

Mr. Chairman, this concludes our analysis of the provisions of H.R. 14742 relating to bank collective investment funds.

As has been noted in our statement, the American Bankers Association has but one objection to the provisions of this bill. That objection relates to the appropriate Federal agency in which to locate the regulatory authority over pooled funds comprised of H.R. 10 trust assets.

We have expressed the view that we believe that this regulatory authority should properly be vested in the Federal banking agencies; and we have proposed certain technical amendments to H.R. 14742 designed to carry out this objective.

If our amendments are accepted, the American Bankers Association is prepared to give its full and unqualified support to H.R. 14742. Thank you.

(The appendix referred to follows:)

APPENDIX

PROPOSED AMENDMENTS TO H.R. 14742, SUBMITTED BY THE BANKERS ASSOCIATION

Add to Section 27 of H.R. 14742 a new subsection as follows:

(c) Section 25 of such Act is amended by inserting "(a)" after "SEC. 25.", and by adding at the end thereof a new subsection as follows:

"(b) In respect of any interest or participation in any collective fund maintained by a bank consisting of assets of retirement trusts for self-employed individuals which are exempt from Federal income taxation under the Internal Revenue Code, all of the powers, functions, and duties vested in the Commission under this title, including all of the powers, functions, and duties vested in the Commission under sections 2(1) and 3(a)(2), (1) with respect to funds maintained by national banks and banks operating under the Code of Law for the District of Columbia are vested in the Comptroller of the Currency, (2) with respect to funds maintained by all other member banks of the Federal Reserve system are vested in the Board of Governors of the Federal Reserve System, (3) with respect to funds maintained by all other banks whose deposits are insured by the Federal Deposit Insurance Corporation are vested in the Board of Directors of the Federal Deposit Insurance Corporation and (4) with respect to funds maintained by any other banks are vested in such one of the above-named agencies as any such bank may elect by filing with such agency a written declaration that it elects to maintain a collective fund consisting of assets of retirement trusts for self-employed individuals which are exempt from Federal income taxation under the Internal Revenue Code; *provided*, that the Comptroller of the Currency shall have power to make such rules and regulations as may be necessary for the execution of the powers, functions, and duties vested in the aforesaid officers and agencies as provided in this section, and such powers, functions and duties shall be exercised by such officers and agencies only in accordance with such rules and regulations as the Comptroller of the Currency may promulgate. None of the rules, regulations, forms or orders issued or adopted by the Commission pursuant to this title shall be in any way binding upon such officers and agencies in the performance of such powers, functions, and duties or upon any such funds in connection with the performance of such powers, functions, and duties. The Comptroller of the Currency may in his discretion conditionally or unconditionally exempt any class or classes of such interests or participations from any provision of this title or any rule or regulation promulgated hereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this Act."

Add to Section 28 of H.R. 14742 a new subsection as follows:

(c) Section 12(i) of such Act is amended by inserting "(1)" after "(i)", and by adding at the end thereof a new subsection as follows:

"(2) In respect of any interest or participation in any collecive fund maintained by a bank consisting of assets of retirement trusts for self-employed individuals which are exempt from Federal income taxation under the Internal Revenue Code, all of the powers, functions, and duties vested in the Commission under this title, including all of the powers, functions, and duties vested in the Commission under sections 3(a)(10) and 12(g)(2)(H), (1) with respect to funds maintained by national banks and banks operating under the Code of Law for the District of Columbia are vested in the Comptroller of the Currency, (2) with respect to funds maintained by all other member banks of the Federal Reserve System are vested in the Board of Governors of the Federal Reserve System, (3) with respect to funds maintained by all other banks whose deposits are insured by the Federal Deposit Insurance Corporation are vested in the Board of Directors of the Federal Deposit Insurance Corporation, and (4) with respect to funds maintained by any other banks are vested in such one of the above-named agencies as any such bank may elect by filing with such agency a written declaration that it elects to maintain a collective fund consisting of assets of retirement trusts for self-employed individuals which are exempt from the Federal income taxation under the Internal Revenue Code; *provided*, that the Comptroller of the Currency shall have power to make such rules and regulations as may be necessary for the execution of the powers, functions,

and duties vested in the aforesaid officers and agencies as provided in this section, and such powers, functions and duties shall be exercised by such officers and agencies only in accordance with such rules and regulations as the Comptroller of the Currency may promulgate. None of the rules, regulations, forms or orders issued or adopted by the Commission pursuant to this title shall be in any way binding upon such officers and agencies in the performance of such powers, functions, and duties or upon any such funds in connection with the performance of such powers, functions, and duties. The Comptroller of the Currency may in his discretion conditionally or unconditionally exempt any class or classes of such interests or participations from any provision of this title or any rule or regulation promulgated hereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this Act."

Mr. Moss. Thank you, Mr. Ferguson, for a statement of clarity and candor, and I think one which will be of the utmost assistance to the subcommittee in its present deliberation of the proposed legislation.

I do have a couple of questions that I have had prepared because of the desire to make it very clear on the record of this committee. I think I understand your testimony, but I believe it should be quite clear.

Your suggestion that your industry come under certain provisions of the Investment Company Act of 1940 and the Investment Advisers Act of 1940—am I to understand that you mean not only the acts as they are now on the books, but as they would be amended by the pending legislation namely, H.R. 9510 and H.R. 9511, and the bill now before the committee upon which you have just commented?

Specifically, do you have any reservations as to section 8(d) which would create standards of reasonable compensation by officers, directors, investment advisers, underwriters and affiliated persons, and that section is on page 23, line 11 of the bill?

Mr. Ferguson. No, sir; we do not have any objection. In the first place, we do adopt the acts as you have stated them. I think favorable to the adoption of the acts, specifically with reference to the amount of reasonable compensation, I think perhaps we should say that we in the trust business have lived for years with this type of provision.

Many of our trusts are subject to the jurisdiction of the local courts. We are accustomed to accounting to these courts for that trust, and part of that accounting involves the scrutiny of the fees and the reasonableness of them. So we have learned to live with this type of provision in most all of our fiduciary business.

In fact, in many of our accounts where we are agreeing with a living person to handle his business either in a voluntary trust or a agency relationship, we make a specific provision that our fees shall be reasonable.

Mr. Moss. Thank you, sir. I have one further question. This is an assumption that you would have no difficulty with the provisions of section 12(c), which provides for a statutory ceiling on sales charges in view of the fact that you are specifically designated as a no-load institution, or would be a no-load institution.

Mr. Ferguson. We are quite in agreement with that, sir. I don't know of any relationship which we have had in our trust department where we have a loading provision.

Mr. Moss. Mr. Keith?

Mr. KEITH. In your response you said many of your trusts are subject to fiduciary interpretation. Would you describe that?

Mr. FERGUSON. I am not sure I can give you a complete description because it may vary from State to State. But to use my own experience and background, as you know, we are in the business of settling decedents' estates. Many of those estates, when they are settled, the funds pass on into a continuing trust agreement for the benefit of the family.

Those States are subject, I think, in most cases to the scrutiny of the court and the following trust is subject to the scrutiny of the court.

In our State, we also have the right on the part of any person who has a trust relationship with us, such as the voluntary trust, if they are dissatisfied in any way with our administration of the trust, and I certainly believe that would include any dissatisfaction with the amount of the charges, they take it into, in our State, what is called an orphan's court and have a review made by the court.

So that in these two types of relationships which are rather extensive in their nature, we are always subject to a court review if the person so desires. There are, however, some relationships which do not customarily appear in court for review, where you have a specific agreement for a managing agency relationship.

We try in these relationships to provide in our agreement the kind of protection which the principal needs in establishing a relationship with us, either individual agreement made with each person who, as principal, leaves his funds with us as agent, and in this we tell him not only how we expect to do the job, but the nature and how our compensation will be taken.

Mr. KEITH. Mr. Chairman, quite a few questions come to mind. I wonder about the balance of the witnesses, their number and character.

Mr. Moss. We have one additional witness this morning, a representative of the National Association of Securities Dealers, Mr. Richard B. Walbert.

I have one question on page 11 of your statement. You made a comment regarding the collective investment funds of smaller institutions.

Mr. FERGUSON. Yes.

Mr. Moss. I would like your judgment as to what constitutes a smaller institution.

Mr. FERGUSON. Sir, I think partially it is a question of the size of the town in which the institution is operated, the extent of the market. There are many what we would call relatively smaller institutions in the town. I am not speaking of the big, urban centers such as New York, Boston, Cleveland, San Francisco, and so forth.

I tend to relate the nature of the smaller institutions to towns the size of, say, New Castle, Pa., 30,000 or 35,000 people, where the banks are much smaller and the trust departments are much smaller.

In the beginning, when we first had the common fund, I think the initial thrust toward the use of them was in the larger banks where you had millions and millions of dollars of people's investments, and trying to reach, in effect, many people through the use of the common funds.

Now the smaller banks, the moderate-sized banks who have moderately sized trust departments, some of them, $5 million, $10 million, or

$50 million total assets, have recognized the fact that they can best serve the relatively modest customer through the use of the pool fund because they can give them the kind of diversification which they cannot give to an individual account, say of $10,000 or $15,000.

In order to get that diversification, the modest-sized banks have really had to come to the device of the use of the pool fund as a means of investment.

I am not sure that I have answered your question exactly in the way you framed it. I would say it is partly the size of the bank, partly the size of the trust department. We have trust departments that have assets as small as $1½ million to $2 million. We have many of them that we consider modest-sized trust departments that perhaps have total assets of $25 million.

Mr. Moss. Of course, the exemption of institutions from provisions of law requires a precise definition. I was hopeful you might be able to give me a more specific answer.

Mr. Ferguson. I would think that the distinction which will be made here perhaps by the agency, hopefully the banking agencies, who administer the Smathers-Keogh funds, supervise the administration of the Smathers-Keogh funds, would be on the basis of how many people and the total dollar size of the Smathers-Keogh funds, whether it gets to the point where it needs the protection of the registration division.

If it is small, if it has a moderate number of people, if there is not, in effect, mass selling of people in that community toward the Smathers-Keogh fund, then it should not need the protection of the Federal securities laws.

It would be like any other trust where the man walks in your front door and sits down and makes an agreement with you to handle his funds. There could be, under the point of view of the Securities and Exchange Commission—which we are not in entire agreement with—there could be collective funds of this type which had so many people involved that under Chairman Cohen's point of view, they became a public offering of securities and they have a large number of people involved in the Smathers-Keogh trusts.

Mr. Moss. Thank you.

Mr. Bronston. Mr. Chairman, perhaps I could supplement Mr. Ferguson's comments with a few statistics. The trust division of the American Bankers Association consists of 3,400 institutions that have trust powers. Approximately 900 of those banks do not exercise the powers at all.

That means that in the next group who do exercise powers which may be very marginal, they will be administering estates probably in as full a range of their duties as the smaller areas.

As Mr. Ferguson has testified, there are 497 of these institutions which now have collective investment funds of one kind or another. The first 100 of these banks among the 497, or approximately that number, would cover banks that have assets running down to, shall I say, approximately $400 million. The remaining 397 of the banks with collective investment funds would operate rapidly to the very small institutions, some of which would have total resources of perhaps $15 to $20 million when you get down to that group.

You take an institution in an agricultural, partly agricultural, partly industrial area that has $25 million in assets for the bank.

They could have perhaps that much or more in trust assets and they would be able to use their common trust fund for these H.R. 10 trusts in a way that permits the individual that establishes the trusts to deal locally with the people who are investing this money.

Mr. Moss. Thank you.

Mr. FERGUSON. Could I add one other comment here?

I may have left the impression that the registration or nonregistration would depend on size. I don't think it necessarily would depend on size alone. It may depend on how the fund is being handled as to whether it becomes necessary to have it registered or not.

For instance, even in a large size fund you could have, in a community such as ours, where we are extending out to the suburban communities, you could have many self-employed people walk in our front door, as a number already have, and sit down and make an agreement with us.

We don't necessarily think the fact that there are many of them necessarily says they should be registered or subject to registration under the Securities Act.

Mr. Moss. Thank you. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman.

Would you enlighten me, and perhaps my colleagues on the committee, as to the essential role of a fiduciary compared to that of a trustee?

Mr. FERGUSON. Well, we look at all our relationships with customers in the trust department as being a fiduciary relationship. There may be a number of different particularized relationships. In all of them, we are subject to fiduciary standards, standards of good faith, good care, honesty and integrity, and everything else that we think comes with being trusted.

Mr. KEITH. But you did not mention judgment.

Mr. FERGUSON. That is pretty important, sir.

Mr. KEITH. Is it one of the characteristics of a fiduciary?

Mr. FERGUSON. Yes, sir.

Mr. KEITH. Of the fiduciary relationship?

Mr. FERGUSON. Yes, sir; it is a very important aspect.

Now, the particularized aspects of being a fiduciary could run in a number of directions. We could be trustee under wills which I have already mentioned. We could be trustee of a voluntary trust set up during a man's lifetime. We could be trustee of a pension or profit-sharing plan for a corporation.

We could be a trustee under an insurance trust where a man leaves his insurance policies with us during his lifetime and we collect them when he passes away and continue them in trust for his wife.

We are still a fiduciary when we act as a managing agent, because we sit down and we have the same characteristics——

Mr. KEITH. As managing agent, you are also acting as a fiduciary?

Mr. FERGUSON. Yes, sir; we are.

Mr. KEITH. So a trustee is the term that is used with reference to the relationship of the customer to the bank?

Mr. FERGUSON. To the bank.

Mr. KEITH. If you were advised that the mutual funds are fiduciaries and, therefore, their fees must be reasonable, would you say that a mutual fund that advertises to its prospective customers that

they are going to do some speculating in a particular field was acting as a trustee or fiduciary in the sense of the description which you have just stated?

Mr. FERGUSON. No; I don't think that a mutual fund is acting as a trustee in the sense of the words we have just described. They may have fiduciary duties in dealing with customers who participate in their mutual fund, but not the same kind of fiduciary duties that we have just described, that we are under in the trust department of a bank.

Mr. KEITH. You would not anticipate going into that kind of mutual fund activity, anyway?

Mr. FERGUSON. We do not. I would explain that in this way: I think when you are operating a trust department of a bank, there are many relationships which you have with that customer. He may be a depositor. He may be a borrower. He may have a safe deposit box with us.

He looks to the bank as his bank in many cases. Now, we have to operate our trust department as a fiduciary in line with that relationship. We do not expect to get our trust department out in some kind of venture which, in effect, will reflect on the other relationships which he has with the bank or reflects on our own trust department.

If you are talking about getting our people into some new speculative venture, this is not what we have in mind in creating a relationship between us and the customer as a managing agent. We are subject to his direction and he is going to know exactly the kind of operation that we are carrying on.

Mr. KEITH. This is a fine point, perhaps, but as I understood your last thought, it was that you are leaving a portion of this trust responsibility up to him.

Mr. FERGUSON. We do in some relationships. We would not in a commingled fund for managing agency accounts. It is obvious in that type of relationship we could not leave the discretion for investment to him, because we are pooling.

Mr. KEITH. In what capacity are you acting when you serve the employees of a pension plan, as the trustee or fiduciary?

Mr. FERGUSON. In most of our relationships where we are serving the employees of a pension plan, we operate as a trustee. We certainly operate as a fiduciary.

Mr. KEITH. In each case you act as a fiduciary?

Mr. FERGUSON. In each case we act in a fiduciary——

Mr. KEITH. Both are in the trustee relationship?

Mr. FERGUSON. Yes. In the H.R. 10 plans——

Mr. KEITH. I want to pursue a particular point here.

Are you fiduciaries for any pension plans the assets of which are invested in the firms in which the beneficiaries are employees?

Mr. FERGUSON. I think, yes, there are certain pension plans that do permit the investment in the stock of the company where these employees work.

Mr. KEITH. This has always been a matter of great concern to me. I have been unable to resolve in my mind how any trustee or fiduciary could allow an employee's future to depend on the same fortunes as the company in whihc he is employed.

It would seem to me almost imperative that he be given some diversification. I am glad to know that he has the bank back of him on this,

and if that firm for which he works goes sour and he loses his job, and his assets in that trust are lost, there is some liability on the part of the banks in his case.

Mr. FERGUSON. May I follow that through with you for a moment?

Mr. KEITH. I would like you to.

Mr. FERGUSON. If we are sole trustee, with full power and no direction as to how we are to invest assets, no direction from the company, I think certainly in my own experience we would not be investing in the stock of the company. We would give them a diversified investment in the stocks of many companies, and possibly in fixed income securities, also, because we do there recognize our complete responsibility as trustee and, as you have said, particularly if you are operating in a pension plan for a company that perhaps is not as well established as some other companies, and there is some danger of the company being able to make the grade over a period of years, you put the employees in a position of not only losing their jobs if the company goes out of business, but also not having a viable asset to take care of their retirements.

There are, however, certain plans, and there are not many of them, in which the company has the right to direct the trustee with respect to the purchase of its own funds and that is established in the original arrangement. There are, of course, companies—I think probably Mr. Bronston could tell you more about this than I—certain companies who are obviously very strong companies in our economy who have had their employees' retirement funds in the stock of the company and which have done very well. Sears, Roebuck, for instance.

Mr. KEITH. I am aware of the outstanding example of Sears, Roebuck, but it is a bad pactice, it seems to me. I don't see how you can charge fiduciary fees for services in connection with that.

How are those plans going to be regulated under the proposal we have here? Is there any special treatment?

Mr. FERGUSON. I don't believe in this particular part that there is any specific reference to the nature of the investments to be made in a pension plan relating, for instance, to the company's own stock.

Mr. KEITH. Are we not, if we amend the act, concurring in this practice?

Mr. FERGUSON. I don't think you are actively concurring in it. I think there are other means of getting at the problem which you have presented here. I think the fact that we go ahead with the legislation in prospect here does not put us on record as proving or disapproving the matters which you have discussed here.

Mr. KEITH. I have one final question.

Is there any difference in your fees rendered to the trust that has been created or the pension plan which has been created where it is in the assets of the corporation for which the beneficiaries are employed?

Mr. FERGUSON. I would have to answer that in this way, sir: Our fees for the trusteeship of the pension plan relate not only to the investment of the fund but to many other aspects of the operation of the pension plan.

Mr. KEITH. That part which is given for advice as to portfolio?

Mr. FERGUSON. We don't separate out our total fee.

Mr. KEITH. In other words they probably would be about the same?

Mr. FERGUSON. They could be somewhat similar, yes, sir; because of the fact that we have a large number of other duties to perform as pension trustees, keeping of the records, payment, and so forth.

Mr. KEITH. I understand.

Mr. FERGUSON. There may be trust companies who do separate out the charge for their investment fund and those who do not. If we are operating as trustees, we will look at the nature of the services that we are expected to perform, including the type of investment relationship we have to offer, and we will then come up with a fee which is commensurate with the services.

Mr. KEITH. Would that fee include recognition for capital appreciation and income?

Mr. FERGUSON. It could be. It depends. That would vary in different trust companies.

Mr. KEITH. Thank you.

Mr. MURPHY (presiding). Mr. Stuckey?

Mr. STUCKEY. Mr. Ferguson, the first question I have has caused me some concern; that is, isn't this subject properly within the jurisdiction of the House Banking and Currency Committee? This has given me some concern, too. I have had some correspondence with Chairman Patman.

Mr. Moss. I assure the gentlemen that the bill was properly referred to this committee, which reflects the judgment of the Speaker and the Parliamentarian of the House, and in anticipation of the fact that the question might be raised, I would point out that similar legislation introduced in 1964 also was referred to this committee.

So we have a precedent, and I think the question of jurisdiction is beyond any question of doubt clearly vested in the Committee on Interstate and Foreign Commerce.

Mr. STUCKEY. Thank you, sir.

One of the reasons is that this was raised on the Senate side on a Senate bill, that this goes to the Investment Act.

Mr. Moss. I believe the Senate rules being different, they would also receive in the same committee bills affecting the Securities and Exchange Commission. As the gentleman knows, that jurisdiction has been with this committee since the first reported original act, I believe under the leadership of the former distinguished Speaker of the House.

Mr. STUCKEY. Mr. Ferguson, may I ask you this: Basically, what the bankers are trying to do here is, in a sense, go into the mutual fund business?

Mr. FERGUSON. Yes, within the type of operations which we are accustomed to run in the trust departments. We don't expect to go out and have salesmen out selling these mutual funds, as such. We expect to establish management agency accounts with the individuals and then utilize the collective funds as a means of investing their funds.

Mr. STUCKEY. So in a sense, you are going into the mutual fund business.

Mr. FERGUSON. We are going into the mutual fund business in this regard.

Mr. STUCKEY. This comes back to another question which gives me concern. It goes back to some of the earlier hearings that we had in this committee about the size of the mutual funds. I believe their assets

are something like $50 billion. This was compared with the holdings of the banks of about $250 billion.

This gives me some concern right there in regard to the influence this would have on our securities markets, on the exchange volume. Would you comment on that?

Mr. FERGUSON. I think you have had a burgeoning market for mutual funds over the past 20 years. People, contrary to what seemed to be the custom back in the 1930's, wish to have part of their investment, at least, in common funds. For many people this has been done through the trust departments of the banks. For others, it has been done through the use of mutual funds and some of them do it directly, those who can get diversification.

So we have had a normal increase in the interest of the public in common stocks.

Now, at the same time that we have had that increase, we have had a great industrial expansion. There are many more stocks available today than there were in the 1930's. Our corporations are larger, they are more heavily capitalized, so that in order to feed the kind of economy that we are currently having here in the United States, we need the interest of the people in the common stock market.

We are already in this in an individual way. Our intention in this, I think, is to service our customers through the collective investment fund method by which we are able to give the advantage of a pool investment. We don't look on this as creating an additional demand for common stocks; it is already there. It is a question of how this service is going to be rendered to the public and we think that the insurance companies now in the mutual fund field, the mutual funds already in the mutual fund field, we feel we should be in the field at least with respect to the customers whom we normally service who are the customers of our banks.

Mr. BRONSTON. Mr. Chairman, may I supplement this with a point or two?

Mr. MOSS. If the gentleman desires, certainly.

Mr. STUCKEY. Certainly.

Mr. BRONSTON. If we assume that there are 1,000 trust institutions, banks that really operate trusts, and I said before 497 of them have collective investment funds, now this $250 billion is dispersed among these 1000 banks across the country.

Trust institutions are not monolithic in nature; that is, we have as many capacities in our trust department as we have accounts. Each of them has its own investment objective, and each of them is a separate investment operation.

Distinguish that, please, then, if you will, between an insurance company, for example, which has a unified investment policy that may apply to all of its assets or a mutual fund that may do so.

Now, of the 497 banks that have collective investment funds, the assets of all the funds aggregate about $10 billion today. The commingled investment account that we would set up for agency accounts, as Mr. Ferguson has said, would require the establishment of an account relationship with us. It would not be merely the issuance of a certificate. We would have to have this relationship in the first place with the customer.

Mr. STUCKEY. Now, we have the insurance companies in the mutual fund business and the banks in the mutual fund business. Would there be any great objection if the mutual fund business wanted to go into the banking business?

Mr. FERGUSON. Wanted to go into what, sir?

Mr. STUCKEY. Would there be any strong objection to the mutual fund getting into the banking business?

Mr. FERGUSON. Well, they might have some slight difficulties there, I think. If you want to go into the banking business, I think you have to be prepared to accept the kind of regulation, the kind of formation of corporations that is involved in the banking business. You have to set up capital to do it, which protects the depositors.

I am sure that this field is open subject to approval of the various State banking agencies and of the Comptroller of the Currency, for banks to be formed in various communities. But we are talking really about something that the mutual fund, as such, directly can't go into.

Mr. STUCKEY. You are saying if they commingled the requirement they could?

Mr. BRONSTON. If they met all the requirements they could. But they must subject themselves to the kind of supervision that the banks are already under. They become a bank, in other words.

Mr. STUCKEY. Right. There would be no objections if the mutual funds did want to enlarge and spread out, meeting all the requirements?

Mr. BRONSTON. We already have so much competition in the banking business, sir, I don't think a little more will make much difference.

Mr. STUCKEY. Thank you, Mr. Chairman.

Mr. Moss. Mr. Murphy.

Mr. MURPHY. Mr. Ferguson, did you discuss the McIntyre amendment when it first came out at any time with the mutual fund industry?

Mr. FERGUSON. I did not personally; sir. Whether there were others of the group here that have, I have to ask them to answer that.

Mr. BRONSTON. I think the answer to that question, generally speaking, is no. There may have been some casual references. If you mean did the American Bankers Association sit down with representatives of the mutual industry and talk about details of the McIntyre amendment? The answer is no.

Mr. MURPHY. Did you get an expression from that industry or feeling from that industry whether they would welcome the banks into the field or not?

Mr. BRONSTON. Do you mean did we ask them specifically? The answer to that is "No," we did not. Their attitude over recent years has been quite well known to us. It is evidenced in the actions which they have taken in their appearances before committees such as this, what they have said there, and the lawsuit which they brought against the Comptroller, things of that nature.

So it would not have been necessary for us to ask them to determine what their attitude was.

Mr. MURPHY. Would you agree with the McIntyre amendments, should the Securities and Exchange Commission continue its regulations of the fund activities as far as the banks are concerned, if the

amendments were not agreed to, as posed in Mr. Ferguson's statement this morning?

Mr. BRONSTON. I don't understand the question.

Mr. FERGUSON. The question is, If the amendments which we have, the technical amendments which we have attached to our statement were not adopted as part of H.R. 14742, would we be favorable to the act? Is that your question, sir?

Mr. MURPHY. Yes.

Mr. FERGUSON. We think the H.R. 10 provisions are most important, that we should not be in a position of subjecting the small, modest-size banks, not only to the expense of regulation by the bank supervisory authorities but also to the expense of registration with the SEC. We would be very reluctant to be in that position, sir.

Mr. MURPHY. How do the big banks feel about it?

Mr. FERGUSON. The big banks feel the same way about it. I would say the big banks can perhaps better afford some type of registration, preferably under the banking agencies than the small bank. But we are dealing here with a lot of moderately sized banks and we just do not feel that there should be this expense.

I would have to say that for those of us who are from large banks we do not see the necessity for it. A trust relationship with the H.R. 10—we do not see the necessity for it. We have been in disagreement with Chairman Cohen on this subject almost continuously.

Mr. BRONSTON. Mr. Murphy, I think it can be stated unequivocally that if it is necessary for H.R. 10 collective funds to be registered with the SEC this will freeze out the small bank, the local bank. Probably 350 of these banks that I spoke of, in the 497, will not be able to do what Congress intended by adoption of the Smathers-Keogh bill which would make banks trustees under the self-employed retirement plans.

There is no question in our minds about this.

Mr. KEITH. Mr. Chairman, would the gentleman yield?

Mr. MURPHY. I will be happy to yield to my colleague from Massachusetts.

Mr. KEITH. As I pointed out earlier, could not the small banks buy for their clients the collective investment funds of the larger banks.

Mr. BRONSTON. No; there is no means of doing that today.

Mr. KEITH. With their accounts, they could not?

Mr. BRONSTON. No, sir.

Mr. KEITH. As I understand the bigger bank could survive under supervision by the SEC but the smaller banks couldn't.

Mr. BRONSTON. The relationship that would have to be established by the small bank with the big bank would be for the small bank to establish an agency account with the big bank. We are not permitted to commingle agency funds.

I am sorry that I do not make myself clear.

Mr. KEITH. The American Bankers Association could come out with a common kind of trust instrument that would be suitable to the smaller banks; say a trust instrument authorizing the smaller banks to purchase no-load investment funds either from other national banks or from existing no-load funds.

Mr. BRONSTON. I can state it this way, that we would have to have Federal legislation to permit that.

Mr. KEITH. If we went ahead with the proposal as outlined by the bill, would there not be sufficient authority there?

Mr. BRONSTON. If this bill, H.R. 14742, were adopted with the amendments which we propose, then it would be possible for the H.R. 10 trusts in small banks to be invested through the commingled investment funds of the larger banks.

Mr. KEITH. Are you saying if the bill were not amended the way you wanted, the small bank could not participate in H.R. 10 trusts?

Mr. BRONSTON. If the part relating to managed agency funds were adopted, then the small bank would be able to invest its H.R. 10 funds in the commingled funds of larger institutions. They would then be able to establish an agency relationship with the major bank which would permit the major bank then to allow their funds in that agency account to participate.

Mr. KEITH. So that under the Cohen code, as modified by your proposal, they could take care of the small banks by that route?

Mr. BRONSTON. The small bank is not trying to bring its assets to the metropolitan institutions. It is trying to handle it in its own community.

Mr. FERGUSON. I do not believe even if what Mr. Bronston has stated happened to be the eventuality, that this would necessarily keep the small bank from the necessity of registering its fund. I think unless the total amendments are here, the act and its amendments are adopted, the small bank would still, I think, be under the registration requirement even though they invested in the fund of——

Mr. KEITH. You may be right. I am sure that point will come out later on when the SEC testifies. I thought the whole thrust of your testimony has been that the small banks were not wanting to keep the funds but wanted to serve their customers as they came in the bank door.

Mr. FERGUSON. I would say it is both, sir. They want the customers, sure. I think the small bank wants its customers to see that their business is being handled locally and that they have an adequate investment department in their trust department to handle these funds and that they can walk in the front door and talk about them, which if they invest in any other means, if they come to Pittsburgh or New York or Chicago and they buy somebody else's investment which may have 25 or 50 separate investments in it, the local man does not have the same relationship with the customer that he gets if he has his own fund.

Mr. KEITH. Thank you.

Mr. MOSS. Mr. Murphy, do you have any additional questions?

Mr. MURPHY. I have no additional questions.

Mr. MOSS. Mr. Ferguson, I want to express the appreciation of the subcommittee to you and your colleagues for your appearance today. I assure you it has been most helpful to us.

Mr. FERGUSON. Thank you very much, sir. You have been very patient and you have asked some very penetrating questions which we hope we have answered adequately.

Mr. MOSS. Our next witness is Mr. Richard B. Walbert, president of the National Association of Securities Dealers, Inc.

STATEMENT OF RICHARD B. WALBERT, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.; ACCOMPANIED BY PHIL E. PEARCE, CHAIRMAN, BOARD OF GOVERNORS; LLOYD J. DERRICKSON, GENERAL COUNSEL AND SECRETARY; AND JAMES W. RATZLAFF, ASSISTANT TO THE DIRECTOR, INVESTMENT COMPANIES DEPARTMENT

Mr. WALBERT. Mr. Chairman and members of the subcommittee, I am Richard Walbert, president of the National Association of Securities Dealers.

On my far right is Mr. Phil Pearce, chairman of the board of our association, also president of G. H. Crawford & Co., investment dealers in Columbia, S.C.

On my left is Lloyd Derrickson, general counsel and secretary of the association. The director of our association's investment companies, Mr. Moulden, unfortunately is ill today and unable to be here.

On my immediate right is his assistant, Mr. James W. Ratzlaff.

You are aware of the association's position as to those portions of the bill now before you which are identical to the provisions of the earlier H.R. 9510.

We support the changes in the present bill which we understand are also acceptable to the Investment Company Institute and the Securities and Exchange Commission. We oppose the new sections of the bill dealing with bank entry into the mutual fund business.

Those provisions of the bill which would permit bank entry into the mutual fund business are opposed because they are contrary to the Glass-Steagall Act which prohibits banks from engaging in the securities business. It is our position that a record has not been made upon which to base a fundamental change in the long-established congressional policy of separation of commercial banking from the securities business.

It is well known that the separation demanded by the Glass-Steagall Act arose as a result of abuses and conflicts of interest resulting from the dual role played by banks prior to 1933. Despite the obvious intention to permit bank entry into the mutual fund business there is no provision in the bill dealing expressly with the existing prohibitions of the Glass-Steagall Act.

We are inclined to believe that the bill in this posture, if enacted, would in all likelihood generate extended legal controversy as to its meaning and impact. Should the Congress desire to change its basic policy in respect to bank entry into the securities business, a thorough investigation and study of potential conflicts of interest in the context of the present-day securities market and banking practices should first be undertaken.

In addition, we oppose the banking amendments since they would change congressional policy as expressed in section 10 of the Investment Company Act of 1940 which prohibits bank-dominated investment companies. The enactment of section 10 of the Investment Company Act of 1940 followed a major study of investment companies by the Securities and Exchange Commission. Among other things, the study showed that interlocking relationships between investment com-

panies and banks created conflicts and resulted in abuses which were unhealthy both from the view of the bank and of the investment trust.[1]

Section 10(c) of the 1940 act now provides that a majority of the board of directors of an investment company may not consist of officers or directors of any one bank. We have opposed the Commission's grant to the First National City Bank of New York of an exemption from this provision. Our position was that the act did not fairly intend such exemption. A rehearing in this matter is pending in the Court of Appeals for the District of Columbia. The court, without reaching the merits of the case, originally decided that the association was not an aggrieved party with standing to appeal the Commission's decision.[2]

We wish also to note that the Securities and Exchange Commission was not unanimous in granting certain of the First National City Bank's requested exemptions. Commissioner Budge, in a dissenting opinion, raised the question of conflicts of interest created by bank entry into the securities business as follows:

> Because of the demonstrated conflicts as well as the potential conflicts of interest between a bank and an investment company it dominates, good reason existed in 1940 for the Congress to impose the restrictions of Section 10(c). There is no showing in this proceeding that those conflicts do not exist today, nor can the exact form of future conflicts be anticipated. (Investment Company Act Release No. 4538, page 12.)

We believe that the record fails to demonstrate the need for any change in congressional policy as expressed in the Investment Company Act of 1940.

In addition, we object to section 5(d) of the present bill. This section would permit banks to operate investment companies with only one unaffiliated person on their boards of directors.

The Securities and Exchange Commission in the *First National City Bank* case denied the bank's request for similar treatment.

It is our view that if banks are to be permitted entry into the mutual fund business, in the interest of investor protection, they should be required to comply with section 10(a) of the 1940 act and thereby have at least 40 percent of their boards of directors who are persons unrelated to the investment company or its managers.

Next, we see no reason why banks, as others, should not conform to the investor safeguards provided for in the Securities Exchange Act of 1934. Others who engage in the sale of investment company securities are required to conform to a basic regulatory pattern and the exclusion of banks from this regulation is alien to generally established concepts of investor protection. Presently, banks, by definition, are excluded from broker-dealer regulation under the 1934 act. However, we see no reason to continue this bank exemption should they be permitted to engage in issuance and sale of mutual funds since investor safeguards should apply equally to all who engage in the securities business.

Finally, we oppose those provisions of the bill which would exclude H.R. 10 or Smathers-Keogh-type plans for self-employed per-

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[1] Hearings before a subcommittee of the Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3d sess., p. 885. See also S. Rept. 1775, 76th Cong., 3d sess., p. 7.

[2] *N.A.S.D.* v. *SEC* (C.A.D.C., No. 20, 164). For a fuller description of the problems and issues presented in this case we make reference to briefs filed in the Court of Appeals by the association.

sons, from the 1933, 1934, and 1940 acts. In our opinion, no showing has been made that H.R. 10 plans require any less investor protection that other securities. Under the bill, H.R. 10 plans would be statutorily exempt from the disclosure and antifraud provisions of these acts except upon affirmative action by the Commission.

In our view, these plans should be subject to the statute and exempted only if the Commission finds it in the public interest to provide an exception, and even in that event there should be no exemption from the antifraud provisions.

We appreciate this opportunity to appear before the committee to express our views and welcome any questions you may wish to ask.

Mr. Moss. First, let me say that I would like to welcome you to your first appearance before the committee in your capacity as president of the National Association of Securities Dealers and extend good wishes to you for your successful term as president.

Mr. WALBERT. Thank you very much, sir.

Mr. Moss. On page 2, you footnoted the case at the bottom of the page. I would ask that you submit that to the committee for its information.

Mr. WALBERT. We will be very happy to.

(The case referred to was placed in the committee files.)

Mr. Moss. Mr. Walbert, I have no questions at this time. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman. I would like to have your comment as to whether or not you consider mutual funds' management companies are fiduciaries.

Mr. WALBERT. From my understanding of the term, I would. I think I would like to refer this to our counsel because it is touching on the legal aspects here. Mr. Derrickson.

Mr. DERRICKSON. I agree with you; yes, a management company would be a fiduciary.

Mr. KEITH. One of the basic questions that the committee is trying to get at is whether, in the public interest, further regulation of the fees paid to management companies are required or whether competition would take care of the question of compensation of management companies.

I think the industry position is that there is sufficient competition within the industry to take care of that factor.

There are those who feel that the advent into this business of banks and/or insurance companies would furnish a way for resolution of the problem by competition.

Mr. WALBERT. I think our basic attitude on this is that the conditions and reasons that prompted the passage of the Glass-Steagall Act were valid then and in our opinion, are just as valid today.

In all fairness, I think I should say that the abuses and conditions which existed within our own business which brought on the acts of 1933 and 1934 were valid, and we believe that they corrected many abuses in our area and that those corrections are still valid today.

Mr. KEITH. Do any other members of your panel wish to comment on that observation?

I have no further questions.

Mr. Moss. Mr. Murphy.

Mr. MURPHY. I would like to know just how you feel about the regulatory provisions of the proposal. I know you heard the response

of Mr. Ferguson earlier, if the banks did get into this business, whether you feel the SEC or another appropriate regulatory agency should supervise their activity.

Mr. WALBERT. Our feeling would be that the McIntyre amendment, in effect, allows the banks to offer securities and, as such, they should have the same regulation or the SEC regulation that the present members of the industry have.

Mr. MURPHY. That is, the SEC should have the jurisdiction to supervise those funds?

Mr. WALBERT. Yes, sir.

Mr. MURPHY. I have no other questions, Mr. Chairman. Thank you.

Mr. Moss. In view of the fact that there are no other questions, I want to express the committee's appreciation to you and your association for your appearance here.

I am sure the views you have expressed will be considered. It is the purpose of these hearings to undertake the establishment of an appropriate record on which the committee can base a decision.

The committee is very keenly aware of the responsibility in assuming an undertaking to amend laws which have long been a part of the investment system of this Nation and understanding the impact of some of the amendments that are proposed.

Best wishes to you in your present tenure.

Mr. WALBERT. Thank you, Mr. Moss. We appreciate very much being here.

Mr. Moss. The committee will now stand in adjournment until 10 o'clock tomorrow morning at which time we will hear first from the Investment Bankers Association.

The committee is now adjourned.

(Whereupon, at 12 noon, the subcommittee adjourned, to reconvene at 10 a.m., Friday, March 15, 1968.)

INVESTMENT COMPANY ACT AMENDMENTS OF 1967

Bank and Insurance Company Collective Investment Funds and Accounts

FRIDAY, MARCH 15, 1968

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 2123, Rayburn House Office Building, Hon. John E. Moss (chairman of the subcommittee) presiding.

Mr. Moss. The subcommittee will be in order.

The hearings today are a resumption of those that were held yesterday on legislation contained in H.R. 14742.

Our first witness this morning is Mr. W. Bruce McConnel, Jr., vice president for governmental relations, Investment Bankers Association of America.

Mr. McConnel, will you introduce for the record and for the benefit of my colleagues on the committee the gentlemen accompanying you.

STATEMENT OF W. BRUCE McCONNEL, JR., VICE PRESIDENT FOR GOVERNMENTAL RELATIONS, INVESTMENT BANKERS ASSOCIATION OF AMERICA; ACCOMPANIED BY FRANKLIN R. JOHNSON, CHAIRMAN, INVESTMENT COMPANIES COMMITTEE; AND GORDON L. CALVERT, EXECUTIVE DIRECTOR AND GENERAL COUNSEL

Mr. MCCONNEL. I will, sir. On my right is Franklin R. Johnson, chairman of the IBA Investment Companies Committee and senior vice president of the Keystone Co. of Boston, a mutual fund.

On my left, Gordon L. Calvert, executive director and general counsel of IBA.

We have presented a statement to your committee but in order to save time I would like to summarize my statement and request that the full text be included in the printed record of the hearing.

Mr. Moss. Without objection, the full text of the statement will be included in full at this point in the record.

Mr. MCCONNEL. Thank you.

(The statement referred to follows:)

STATEMENT OF W. BRUCE MCCONNEL, JR., VICE PRESIDENT FOR GOVERNMENTAL RELATIONS, INVESTMENT BANKERS ASSOCIATION OF AMERICA

INTRODUCTORY

The Investment Bankers Association of America (IBA) has a membership of approximately 675 firms in the United States and Canada. These firms have about 2,200 registered branch offices located in all parts of the United States. They collectively underwrite, deal in and act as brokers in all types of corporate and state and municipal securities. Our membership includes about 120 commercial banks which, through investment or bond departments, underwrite and deal in government and state and municipal bonds.

A large percentage of the firms which are members of IBA sell shares of mutual funds and the compensation from such sales is an important factor in the business of many firms engaged in underwriting, dealing in and acting as brokers in corporate securities and state and municipal bonds.

In previous testimony before this Committee on October 12, 1967, on H.R. 9510, representatives of the IBA summarized the functions and structure of the securities business and emphasized the serious effects which certain of the proposals in H.R. 9510 might have on investors, markets, small business and the securities industry. The record of that testimony is before the Committee, and we will not repeat it today.

To simplify our comments on H.R. 14742, we divide provisions of the bill into three groups:

(A) Four proposals which were in H.R. 9510 which we vigorously *oppose*.

(B) Certain new proposals to authorize banks to create and sell commingled investment accounts.

(C) Provisions from H.R. 9510 which are not opposed and certain revised provisions of H.R. 9510 which are not opposed.

(A)- Four Objectionable Provisions Retained from H.R. 9510

H.R. 14742 includes four objectionable proposals which are in H.R. 9510 against which we expressed strong opposition in our testimony on October 12, 1967, for reasons stated in detail at that time. To save the time of the Committee today, we simply identify those four proposals and summarize the reasons for our opposition to them:

(1) *Proposed 5% Ceiling on Sales Charge for Investment Company Shares*

Sections 12(a) and 12(b) of H.R. 14742 would delete the present section 22(b) of the Investment Company Act, which gives the NASD rule-making authority to prohibit "unconscionable or grossly excessive" sales charges, and would delete that portion of section 22(c) which gives the same rule-making authority to the S.E.C.

Section 12(c) would provide a new section 22(c) which would prohibit a registered investment company from offering securities issued by it if their public offering price includes a sale charge of more than 5%. Section 17 would amend section 28 to provide a ceiling of 5% on sales charges on face-amount certificates.

(a) This is clearly a proposal to impose on the highly competitive securities business a utility-type regulation of charges which is appropriate only when a restricted few are permitted to engage in that business. Such regulation of sales charges would be particularly unfair when competing industries are not subjected to similar restrictions in *undisclosed* sales charges.

(b) Sales charge is fully disclosed and competitive alternatives are available. The prospective investor can choose from over 250 competitive mutual funds about which information is readily available with a range of sales charges, including even many *no load funds* (no sales charge) if that is what the investor wants.

(c) Section 22(b) of the Investment Company Act already authorizes a securities association (such as the N.A.S.D.) to prohibit its members from charging an unconscionable or grossly excessive sales load in the ordinary distribution of redeemable shares of a registered investment company. Section 22(c) of the Act authorizes the Commission to impose the same restrictions by rules and regulations applicable to principal underwriters of, and dealers in, the redeemable securities of any registered investment company.

(d) On comparative acquisition costs for the small investor who wants to invest only $100 from time to time, the comparison is quite different from that presented in the S.E.C. Report. An investor with $100 buying five shares of a

$20 stock listed on the New York Stock Exchange would pay an odd lot differential of 63¢ and a commission of $6.00, an investment cost of 6.63% one way or 13.26% for purchase and sale—compared with an assumed investment cost of 9.3% on investment of a like amount in shares of an investment company.

(e) The "sales load" actually includes compensation for the underwriter, the retail dealer and the salesman. If the underwriter continues to retain about 2%, if the proposed 4.76% maximum sales load were adopted, less than 2.76% would be available for the retail dealer and his salesmen. The salesman's share would be about 1¼%.

(f) Effects of the proposal would be detrimental to investors, markets and small companies (halting the growth of "people's capitalism," reducing depth and liquidity of markets and impairing the mechanism for providing capital).

(2) *Reasonable Compensation for Management of Registered Investment Companies*

Section 8(d) of H.R. 14742 would amend section 15(d) of the Investment Company Act of 1940 to provide expressly that all compensation for services to a registered investment company received by an investment adviser, officer, director or controlling person of or principal underwriter for such investment company and any affiliated person of such persons shall be "reasonable." The "reasonableness" of compensation would be enforceable in U.S. district courts through injunctive suits instituted by the Commission and section 23 would also authorize the Commission to intervene as a party in any private action for that purpose.

The IBA firmly believes that compensation for management of registered investment companies should be reasonable; but we vigorously oppose as a matter of principal the introduction of this new concept, to authorize the Commission to institute injunctive proceedings and to authorize a Court to determine what shall constitute "reasonable" compensation in an area where there is full disclosure of compensation, approval at least annually of renewal of investment advisory and underwriting contracts, and vigorous competition from many similar investment companies.

(3) *Sales of Management Organizations*

Section 8(e) of H.R. 14742 would add a new subsection (g) to section 15 of the Investment Company Act to prohibit any sale of the assets of or a controlling block of stock in an investment company management organization if the sale, or any express or implied understandings in connection with the sale "are likely to impose additional burdens on the investment company, or limit its freedom of future action or otherwise is inequitable to such investment company." The Commission could institute actions to enforce this prohibition and would be authorized to intervene as a party in any private action brought for that purpose.

The IBA agrees fully that shareholders should have a remedy against an unfair arrangement in the sale of management organizations, but we question the inadequacy of present provisions and whether the proposed recommendation is a good remedy if present provisions are inadequate.

If the present remedy is inadequate, we believe that the proposal to prohibit sales of management companies if the sale "is likely to impose additional burdens on the investment company" or is "inequitable" is far too broad because it would *prohibit* any sale imposing additional burden on the investment company (i) *regardless of the amount of the burden* and (ii) even if there would be additional benefits to the investment company. We believe that such a sweeping statutory prohibition is patently undesirable and should not be adopted.

(4) *Broader S.E.C. Authority for Injunction Action*

Section 36 now authorizes the Commission to bring on action in a U.S. District Court to enjoin any officer, director, advisory board member, investment adviser, depositor or principal underwriter of investment companies from acting in such capacities if the court finds that such person has been *guilty* of "gross misconduct or gross abuse of trust." Section 20 of H.R. 14742 would amend Section 36 to eliminate the requirement of finding guilt of gross misconduct or gross abuse of trust and to authorize the Commission to seek injunctive or such other relief as the court deems appropriate if such persons have engaged or are about to engage "in any act or practice constituting a breach of fiduciary duty" in respect of a registered investment company.

"Breach of fiduciary duty" is a broad flexible term which would permit the S.E.C. to seek injunctive (or other relief) against whatever act or practice it concluded to attempt to establish as a breach of fiduciary duty. The proposed amendment would open the door for *endless litigation*, not only in actions by the S.E.C. to establish its new concepts of fiduciary duty, but by shareholders to recover from persons enjoined from engaging in actions believed to be perfectly proper when taken but subsequently held to be a breach of fiduciary duty under a new S.E.C. concept.

(*B*) *New Proposals to Authorize Banks to Create and Sell Commingled Investment Account*

Certain provisions in H.R. 14742 which were not in H.R. 9510 apply generally to interests or participations in bank (i) common trusts, (ii) collective managing agency accounts and (iii) retirement, pension, profit-sharing and certain other trusts which are exempt from Federal income taxation. There are highly complex legal and practical differences between interests in these several types of bank pooled or collective investment funds, and the proposed amendments would provide different treatment for some of them under different Federal statutes.

Section 12(e) of H.R. 14742 (pages 34–35) would provide:

"No provision of law shall be deemed to prevent the creation or operation of a registered investment company which is a common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent if such fund is created and operated in compliance with any applicable regulations of the Comptroller of the Currency."

This apparently is intended to establish a broad exception for bank collective investment funds from the prohibition of the Glass-Steagall Act against banks engaging in the investment securities business.

Section 27(b) of H.R. 14742 (page 65) apparently would *exempt* all such bank funds except collective managing agency accounts from the registration requirements of the Federal Securities Act of 1933 (except that retirement trusts for self-employed individuals might be made subject to the registration provisions of the Act if the Commission determines it required for the protection of investors).

We frankly believe that the proposed amendments would create broad gaps in the protection afforded to investors under the Federal regulation of securities by the S.E.C. and would repeal an important element of the Glass-Steagall Act prohibition against banks engaging in the investment securities business.

Our comments are directed to those provisions which would authorize banks to create and sell collective managing agency accounts; but many of the same considerations apply equally to common trust funds. For convenience, we refer simply to "commingled investment accounts."

Some of the commercial banks which are members of IBA support the proposals to authorize banks to create and sell commingled investment accounts; some do not; the attitude of others is unknown.

We accept open competition by entry of new organizations into the securities business if (a) there is no public policy prohibition against their entry into this business and (b) they comply with the same regulatory requirements applicable to the securities and persons engaged in the securities business. In the case of banks, we believe that the Glass-Steagall Act adopted a clear firm policy to divorce banks from engaging in the corporate investment securities business.

(1) *Bank Commingled Investment Accounts are "Securities"*

Commingled investment accounts issued by banks are "securities." Like mutual funds, each share represents an investment in common, preferred stocks or bonds of corporations, cash, government bonds or short-term notes, in such amounts as the judgment of the managers dictate.

As a concise description of the operation of a commingled investment account, we quote from the description of such an account in a recent decision by the U.S. District Court for the District of Columbia on September 27, 1967, in *Investment Company Institute, et al.* v. *Camp, Comptroller of the Currency:*

"The Account as established by the Bank, operates as follows: The investor-customer tenders his funds, $10,000 or more, to the Bank pursuant to a broad authorization making the Bank the customer's managing agent. There is thus created a principal-agent relationship between each individual investor-customer

and the Bank. The authorization includes specific authority for the Bank to invest the customer's funds, together with the funds of other customers who have given the equivalent authorization, through the commingled Account. Funds in the commingled Account are invested in a pool of securities, principally common stocks and securities convertible into common stocks, offering the opportunity for long-term growth of capital and income. The Account is divided into 'units of participation' of equal value in order to determine conveniently the proportionate interest of each participant. No certificates indicating the 'units of participation' are issued by the Bank; however, the participant is informed by a non-negotiable document as to how many 'units of participation' are contained in his account.

"A participation is transferable only to another person who has validly appointed the Bank as managing agent, and, because of the underlying agency relationship, the interest of a participant terminates upon his death or incompetency and his funds are withdrawn from the Account and held for his legal representatives. There is no sales charge imposed on amounts invested in the commingled Account nor is there any redemption charge incurred upon withdrawal from the Account. An investor-customer may terminate his participation in whole or in part on the basis of the net asset value of the units of participation being redeemed. The net asset value of each unit of participation is determined as of the close of business of each of a number of specified valuation dates by dividing the net asset value of the Account as of the close of business on the valuation date by the number of units of participation then outstanding.

"The operation of the Account is supervised by a Committee of five persons, who act essentially as a board of directors of the Account. Initially the members were appointed by the Bank, but hereafter are to be elected annually by the participants. Each participant will be entitled to vote at the election of the Committee members, and his vote will be weighted according to the member of 'units of paricipation' in his account. At least 40% of the members of the Committee must at all times be persons not affiliated with the Bank, but the majority of the members may be, and are expected to be, officers in the Bank's Trust and Investment Division.

"The Committee is authorized to enter into a management agreement with the Bank. The agreement and any amendments thereto must be approved by more than 50% of the participants at their annual meeting and the Comptroller's approval thereof must also be obtained.

"In accordance with the management agreement, the Bank serves as investment adviser and custodian for the Account. The Bank, therefore, maintains a continuous investment program consistent with the commingled Account's stated investment policy; it will determine what securities are to be purchased and sold, and will execute all transactions. The management agreement provides that the Bank will furnish all administrative, custodial and clerical services required by the Account and will pay all the organization costs and expenses. Subsequent maintenance fees, the cost of independent professional services, such as legal, auditing and accounting services, and the cost of preparation and distribution of notices to participants and proxy statements are to be borne by the commingled Account. The Bank will, however, reimburse the Account for the compensation and expenses, if any, paid by the Account to the members of the Committee who are not affiliated with the Bank; the other members of the Committee will receive no separate compensation for their services to the Account. For these services the Bank receives a fee equal to ⅛th of 1 per cent of the average of the net asset value of the Account taken on each valuation date during each fiscal quarter, which is approximately ½ of 1 percent on an annual basis."

The Court in that case went on to point out the many similarities between a mutual fund and a commingled Account and concluded that the Account "is an equivalent investment vehicle to a mutual fund and that the units of participation are in fact securities."

We strongly concur in the conclusion of the Court and believe that it is readily apparent that collective investment accounts (hereinafter referred to as C.I.A.) are securities and that proposals to authorize banks to issue and sell them involves the same considerations that exist with respect to banks dealing in any other type of securities.

(2) *Congress Intended to Divorce Banking from the Securities Business*

After careful review of the experience of bank affiliates in the securities business, Congress in 1933 in the Glass-Steagall Act concluded to divorce the banking business from the security investing business. Rather than repeat the many

reasons which were stated at that time for such a divorce of banking from investment securities, we simply include another quotation from the decision of the Court in the recent I.C.I. case, referred to above:

"The storms looming on the horizon were not within the contemplation of very many people in 1927. It was not until 1931 when the Congress, graced with hindsight, sought the primary causes of the debacle which enveloped the country and had its repercussions throughout the world. The Congressional inquiry generated various statutes in an attempt to avoid a repetition of the debacle which had transpired. Among these statutes were the Glass-Steagall Act and the Securities Act of 1933.

"The Glass-Steagall Act in particular redefined the powers of the national banks and imposed severe limitations on their activity in the investment security business by amending 12 U.S.C. § 24, P. 7, and adding 12 U.S.C. §§ 78, 377 and 378.

* * * * * * *

"The obvious purpose of these legislative enactments was to divorce the banking business from the security investing business. Congress was so emphatic in promulgating this divorce, that it included a criminal provision to assure the efficacy and continuity of the separation; see 12 U.S.C. § 378(b), *supra*, and in some instances it imposed money penalties and forfeitures; see 12 U.S.C. § 377 *supra*. The many pages of legislative hearings reports which preceded the final enactment of the Glass-Steagall Act contain and outline the potential dangers which the involvement of commercial banking in the investment security business created.

"These potential dangers were noted by the Comptroller of the Currency in his report of 1920, excerpts of which were cited by the Subcommittee of the Senate conducting the investigation:

"Some 'securities companies' operating in close connection with, and often officered by, the same men who manage the national banks with which they are allied, have become instruments of speculation and headquarters for promotions of all kinds of financial schemes. Many of the flotations promoted by the 'securities corporations' which are operated as adjuncts to national banks have proven disastrous to their subscribers, and have in some instances reflected seriously not only upon the credit and the standing of the 'securities companies' by which they are sponsored, but also in some cases have damaged the credit and reputation of national banks with which the 'securities companies' are allied.

"It has been established clearly by decisions of the United States Supreme Court that a national bank cannot, except as authorized by the Federal reserve act, hold the stock of other national banks or the stock of other corporations; but these adjunct or auxiliary companies whose stockholders are identical with the stockholders of the national banks with which they are connected by various ties and devices frequently deal actively in stocks, and they also sometimes acquire the ownership or control of other banks, National and State, through their stock purchases.

"In times of rising prices and active speculation some of these auxiliary corporations have made large profits through their ventures and syndicate operations, but their losses in other periods have been heavy, and they have become an element of increasing peril to the banks with which they are associated. The business of legitimate banking is entirely separate and distinct from the kind of business conducted by many of the 'securities corporations,' and it would be difficult, if not impossible, for the same set of officers to conduct safely, soundly, and successfully the conservative business of the national bank and at the same time direct and manage the speculative ventures and promotions of the ancillary institutions. These varying institutions demand a different kind of ability and experience on the part of those who manage them, and the two types of business when combined with one management are likely to be operated to the advantage of neither.

"These ancillary companies are being used with increasing frequency for promotion of speculation and for dealing in bonds and stocks, often those of new and unseasoned issues and which are attended with improper hazard risk, and as a means of enabling banks to do, indirectly through their instrumentality, things which they can neither safely nor lawfully do directly.' (See Hearings Pursuant to S. Res. 71 Before a Subcommittee of the Senate Committee on Banking and Currency, 71st Cong. 3d Sess. pp. 1067–1068 (1931)).

"The Senate Subcommittee Report also outlined the organization and functions of the security affiliates. Among one of these functions was the operation of

investment trusts which bought and sold securities purely for investment or speculative purposes, Hearings, S. Res. 71, p. 1057. These investment trusts were the equivalent of our present day investment companies."

The Senate in 1967 passed S. 1306, to authorize banks to underwrite and deal in municipal revenue bonds which are eligible for bank investment. The IBA opposed, and still opposes, this expansion of security dealer activity by commercial banks. However, the current issue raised by this amendment is an open entry by the banks into the sale and distribution of corporate securities—common stocks and bonds. We believe that the Glass-Steagall Act will be effectively abrogated and that rather than benefit from more competition the ultimate results will be detrimental to the public. More specifically, it seems to us that a few apparent dangers in authorizing banks to create and sell C.I.A.'s are the following:

(a) The potential acquisition of large dollar amounts of equity securities in bank C.I.A.'s will further strengthen the banks' potential authority to elect corporate directors and thereby increase the degree of bank control in corporate affairs.

(b) Since Congress this year has expressed some concern over the growing institutionalization of the securities markets, it is particularly important to note that the millions of depositors in the large banks would provide a built-in group of readily accessible customers for C.I.A.'s who might funnel their equity investments through the banks rather than into a wide variety of securities distributed by investment brokers and dealers.

(c) The possibilities of conflicts of interest within banks could develop as (1) companies whose securities are held in a bank C.I.A. portfolio apply for loans, and (2) banks consider investment in the securities of a company which has been a substantial borrower or depositor.

These are illustrative of some problems which may be created by banks in the proper administration of their banking functions as distinguished from its interest in sponsoring a collective investment account.

For the reasons summarized above, we strongly urge the Committee *not* to adopt the amendments which would authorize banks to create and sell commingled investment accounts.

(3) *Banks Selling Commingled Investment Accounts Should Be Subject to the Same S.E.C. Regulation as Any Other Person Selling Securities*

Banks engaging in any phase of the securities business should be subject to the same regulatory requirements and supervision by the S.E.C. as other persons engaged in that business. Such regulation is essential to provide to investors the protection intended in Federal regulation of securities and to avoid competitive advantages among those engaged in the same business.

At present, brokers and dealers subject to the Securities Exchange Act of 1934 are required (a) to pass examinations to demonstrate their knowledge of the securities business and (b) to comply with specified rules of conduct. The rules of conduct include detailed requirements for fair dealing with customers and that an investment be suitable for the customer under standards prescribed by the S.E.C. or the N.A.S.D.

At present, persons employed by banks in the sale of securities are not subject to any of these requirements because section 3(a)(4) of the Securities Exchange Act defining "broker" specifically provides that it "does not include a bank" and the definition of "dealer" in section 3(a)(5) likewise "does not include a bank."

It is no answer that banks and their employees are subject to supervision by other agencies of the Federal Government, or that other such agencies can impose requirements substantially like those administered by the S.E.C. The purposes and the experience of other Federal bank regulatory agencies are primarily aimed at protecting depositors and persons in a fiduciary relationship with banks, but not the protection of investors in securities.

Accordingly, we believe that the public will be protected in securities transactions as Congress intended and that there will be equality of regulation of transactions in the securities business only if banks and their employees are treated as any other "broker" or "dealer" when they engage in the securities business. Therefore, if banks are authorized to engage in the issuance and sale of collective managing agency accounts, which are simply a bank-sponsored mutual fund, we urge that sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act be amended to delete the exception for banks.

Mr. McConnel. In previous testimony before this committee on October 12, 1967, on H.R. 9510, representatives of the IBA summarized the functions and structure of the securities business and emphasized the serious effects which certain of the proposals in H.R. 9510 might have on investors, markets, small business, and the securities industry in general.

The record of that testimony is before the committee and we will not repeat it today.

To simplify our comments on H.R. 14742 we divide the provisions of the bill into three groups.

(a) Four proposals which were in H.R. 9510 which we vigorously opposed at that time and still do.

(b) Certain new proposals to authorize banks to create and sell commingled investment accounts.

(c) Provisions from H.R. 9510 which are not opposed and certain revised provisions of H.R. 9510 which are not opposed.

The present bill, H.R. 14742, includes four objectionable proposals which are in H.R. 9510 against which we expressed strong opposition in our testimony on October 12, 1967, for reasons stated in detail at that time.

In our prepared statement we review our objections. I would now like to turn to page 5 where we would like to present our comments on the new proposals.

We frankly believe that the proposed amendments would create broad gaps in the protection afforded to investors under the Federal regulation of securities by the SEC and would repeal an important element of the Glass-Steagall Act prohibition against banks engaging in the investment securities business.

Our comments are directed to those provisions which would authorize banks to create and sell collective managing agency accounts, but many of the same considerations apply equally to common trust funds. For convenience, we refer simply to "commingled investment accounts." Some of the commercial banks which are members of the IBA, our organization, support the proposals to authorize banks to create and sell commingled investment accounts. Some do not. The attitude of others is unknown.

We accept open competition by entry of new organizations into the securities business if there is no public policy prohibition against their entry into this business and they comply with the same regulatory requirements applicable to securities and persons engaged in the securities business.

In the case of banks, we believe that the Glass-Steagall Act adopted a clear, firm policy to divorce banks from engaging in the corporate investment securities business.

Commingled investment accounts issued by banks are "securities." Like mutual funds, each share represents an investment in common, preferred stocks or bonds of corporations, cash, Government bonds or short-term notes, and in such amounts as the judgment of the managing directors dictate.

As a concise description of the operation of the commingled investment account we call your attention to the description of such an account in the recent decision by the U.S. District Court for the Dis-

trict of Columbia on September 27, 1967, in *Investment Company Institute, et al.* v. *Camp, Comptrolled of the Currency.*

(A copy of the case referred to follows:)

UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF COLUMBIA

Civil Action No. 1083–66

INVESTMENT COMPANY INSTITUTE, ET AL., PLAINTIFFS

v.

WILLIAM B. CAMP, COMPTROLLER OF THE CURRENCY, DEFENDANT

OPINION

G. Duane Vieth, Esq., James F. Fitzpatrick, Esq., Charles R. Halpern, Esq., Arnold & Porter, Esqs., and Robert L. Augenblick, Esq., for plaintiffs.

Barefoot Sanders, Assistant Attorney General, Harland F. Leathers, Esq., Irwin Goldbloom, Esq., and Stephen M. Truitt, Esq., Department of Justice, David G. Bress, United States Attorney, and Joseph M. Hannon, Esq., Assistant United States Attorney, for defendant.

This action is brought against the Comptroller of the Currency by the Investment Company Instituute in its representative capacity of the open-end investment companies, investment advisers and principal underwriters which comprise its membership. The Investment Company Institute (hereinafter called the Institute) is an unincorporated association, having its principal place of business in the city, county and state of New York. The Institute is a national association, having as its members 177 open-end management investment companies and their 88 investment advisers and 78 principal underwriters. The open-end management investment companies which are members of the Institute have assets of $36 billion, representing about 94 percent of the assets of all such companies in the United States, and have approximately 3.5 million shareholders. The other plaintiffs in this action are several individual members of the Institute. They seek an injunction to restrain the Comptroller from authorizing national banks to collectively invest funds tendered to the bank as managing agent solely for investment purposes. They also pray for a declaratory judgment adjudicating the pertinent regulation promulgated by the Comptroller to be invalid.

The action is now before this court on cross motions for summary judgment, all of the parties agreeing that no factual issues exist and that the legal issues are ripe for disposition by summary proceedings.

It is first necessary to review and to delineate the factual background upon which the issues in this action arose and within which these motions are made. In September of 1962 the statutory authority to regulate the fiduciary activities of national banks was transferred from the Board of Governors of the Federal Reserve System to the Comptroller of the Currency. Publ. L. 87–722, 76 Stat. 668, 12 U.S.C. § 92 a. Pursuant to this authority, the Comptroller caused to be published in the Federal Register for February 5, 1963, a proposed revision of the fiduciary regulation, 12 C.F.R. § 9. In addition to the types of collective investment funds permitted under the prior regulation, this proposed revision provided that national banks were authorized to invest funds held in the capacity of managing agent in a collective investment account, 12 C.F.R. § 9.18(a)(3).[1] Moreover, the proposed revised regulation allowed the Comptroller to approve collective investment of such funds in manners other than those expressly provided by Regulation 9, 12 C.F.R. § 9.18(c)(5).[2]

[1] (3) In a common trust fund, maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as managing agent under a managing agency agreement expressly providing that such monies are received by the bank in trust;

[2] (5) In such other manner as shall be approved in writing by the Comptroller of the Currency.

The Comptroller invited national banks and other interested parties to submit comments pertaining to the proposed regulation. Plaintiff Institute, on behalf of its members, participated to the full degree permitted and submitted a statement in opposition to the proposed regulation. It premised its argument on the same basis that it is presenting before this court, namely, that the revised regulation would allegedly permit activity prohibited by 12 U.S.C. § 92(a), and certain provisions of the Glass-Steagall Act, as amended, 12 U.S.C., §§ 24, 78, 377 and 378. Notwithstanding this opposition the final regulation was adopted by the Comptroller on April 5, 1963, and revised by minor modifications on February 5, 1964, 12 C.F.R. § 9.18.

Pursuant to the regulation, on May 10, 1965, the Comptroller approved a plan submitted by First National City Bank of New York (hereinafter referred to as the Bank) for the establishment and operation of a collective investment fund, called the Commingled Investment Account, under Regulation 9, 12 C.F.R. § 9. The plan as outlined by the Bank differed from the specifically enumerated collective investment funds authorized by the Comptroller's revised Regulation, but the Bank, pursuant to 12 C.F.R. § 9.18(c)(5) sought and obtained the Comptroller's written approval of the plan.

On April 20, 1966, the Bank registered its Commingled Investment Account with the Securities and Exchange Commission pursuant to the Investment Company Act of 1940, 15 U.S.C. § 80 as an open-end management investment company. On the same date, the Bank filed a registration statement with the Securities and Exchange Commission pursuant to the Securities Act of 1933, 15 U.S.C. § 77, for the purpose of registering the participating interests or units to be issued by its Commingled Investment Account. The registration statement concerning those participating interests or units became effective on June 14, 1966. From that date the Bank has offered and sold to the public participating interests or units issued by the Commingled Investment Account by means of the prospectus for the First National City's Commingled Investment Account.

Before proceeding to the merits of this controversy, it is best at this time to specifically describe the operation of a mutual fund and the operation of the Commingled Investment Account (hereinafter referred to as the Account) so that a better understanding of the problem can be achieved.

Generally, "mutual funds" are open-end management companies engaged in the business of continuously issuing and offering for sale redeemable securities which represent an undivided interest in the fund's assets. Most mutual funds are corporate in form and the securities issued by them usually consist of capital stock. However, there are a number of mutual funds in a variety of noncorporate forms and the securities issued by some of them are variously denominated as beneficial interests, participating agreements, and the like. The proceeds from the sale of the securities issued by a mutual fund are invested in a portfolio of securities of various kinds, in accordance with the stated investment policy of the particular fund. Some funds invest primarily in securities offering current income; others concentrate on long-term growth securities; still others specialize in particular industries or classes of securities; and many offer various combinations of objectives. The shareholder in a mutual fund is entitled at any time to redeem his interest, usually at net asset value, or in a few instances upon payment of a charge. To facilitate this redemption privilege as well as to establish a price at which new shares are being offered, the value of a share in a mutual fund is calculated regularly, typically twice daily, on the basis of the market value of the securities held by the fund. Because of the continuous process of redemption, the mutual fund would be restricted and contracted in size, unless it continuously issued and offered new securities for sale.

Except in unique circumstances, virtually no shares in mutual funds are traded from one investor to another, and there is no significant trading market for such shares. In almost all cases, shareholders in mutual funds desiring to obtain cash for their shares redeem them with the issuing company. The securities issued by most mutual funds are offered to the public at a price which includes a sales commission or sales load. There are some mutual funds whose shares are sold with no sales commission being charged. These latter funds are frequently called "no load" mutual funds. The activities of mutual funds are under the control of a board of directors or board of trustees. Directors or trustees are elected annually by the vote of a majority of the fund's outstanding voting securities.

Mutual funds usually contract an outside investment adviser for investment advice and other management services, and with a principal underwriter for the distribution of the fund's shares, pursuant to the statutory pattern established by the Investment Company Act of 1940, 15 U.S.C. § 80a–15. The invest-

ment adviser of a mutual fund furnishes advice to the fund with respect to its investment portfolio and the securities it should buy, hold, and sell. In some cases the adviser is empowered to purchase and sell securities for the fund. Some investment advisers also furnish supervisory and administrative services to the mutual fund. The investment adviser receives compensation for its services, usually in the form of a fee based on the total value of the assets being managed.

The principal underwriter of a mutual fund is engaged in the business of selling and distributing the securities issued by the fund to the investing public through brokers or dealers, or directly through the underwriter's own salesmen, or both. The principal underwriter either purchases the securities issued by the fund for resale or acts as agent for the fund in distributing the securities. Except in the case of a no-load fund, the principal underwriter receives a fee for its services, usually in the form of a portion of the sales commission included in the selling price of the shares issued by the mutual fund.

Mutual funds are required to be registered with the Securities and Exchange Commission pursuant to the Investment Company Act of 1940. The activities of the mutual funds and their relationship with affiliated persons and others are all subject to regulation under the Act. The investment advisers and principal underwriters who are plaintiffs herein, perform their services for the mutual funds they serve pursuant to contracts, the terms, execution and continuation of which are subject to the provisions of Section 15 of the Investment Company Act of 1940, 15 U.S.C. § 80a–15. The securities issued by each of the mutual fund members of the Institute are registered with the Securities and Exchange Commission pursuant to the Securities Act of 1933, 15 U.S.C. § 77. All such securities are offered to the investing public by means of a prospectus which is initially filed with the Securities and Exchange Commission under the Securities Act of 1933 as part of the registration statement for the securities to which the prospectus relates.

As can be readily ascertained, the mutual fund community is composed of three principal members. First the body corporate of the fund itself whose membership is the general investing public. This relationship is analogous to the common productive corporate structure. However, the primary function of the investment corporation is to obtain the objectives which are outlined in their charter through the mutual investment of the funds contributed by the "shareholders." *Alfred Inv. Inst.* v. *S.E.C.*, 151 F. 2d 254 (1st Cir. 1945) *cert. denied* 326 U.S. 795, 66 S. Ct. 486, 90 L. Ed. 483 (1945). The relationship between the shareholder and the body corporate is plainly one of contract. *Stevenot* v. *Norbert*, 210 F. 2d 615 (9th Cir. 1954) ; see also *Schroeter* v. *Bartlett Syndicate Bldg. Corp.*, 8 Cal. 2d 12, 63 P. 2d 824, 825, *Ellingwood* v. *Wolf's Head Refining Co.* 38 A. 2d 743, 27 D. ch. 356 (1944), 154 A.L.R. 406, *Corporations*, 18 Am. Jur. 2d § 463 (1965).

The management function of the mutual fund lies with the board of directors. They have essentially the equivalent powers as any corporate board of directors. In the same manner they are also responsible to their shareholders as fiduciaries, *Pepper* v. *Litton*, 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1939), *Brown* v. *Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961) affirmed 294 F. 2d 415 (2nd Cir. 1961).

The board of directors within its broad scope of authority has the power to enter into contracts with the other two members of the mutual fund community, that is the investment advisers and the underwriters. The functions performed by the latter two members of the mutual fund community is essential for the propagation of the investment or the mutual fund corporation. The interrelationship of these independent entities is one of contract which essentially determines the respective position occupied within the structure by each member. The independence of each member is governed by statute as is their interdependence ; see the Investment Company Act of 1940, 15 U.S.C. § 80a–1, et seq.

The above few paragraphs outline the general operation of the mutual fund structure. A similar outline is now presented for the operation of the Account as created by the Bank and approved by the Comptroller pursuant to Regulation 9.

The Account as established by the Bank, operates as follows: the investor-customer tenders his funds, $10,000 or more, to the Bank pursuant to a broad authorization making the Bank the customer's managing agent. There is thus created a principal-agent relationship between each individual investor-customer and the Bank. The authorization includes specific authority for the Bank to invest the customer's funds, together with the funds of other customers who have given the equivalent authorization, through the commingled Account. Funds in

the commingled Account are invested in a pool of securities, principally common stocks and securities convertible into common stocks, offering the opportunity for long term growth of capital and income. The Account is divided into "units of participation" of equal value in order to determine conveniently the proportionate interest of each participant. No certificates indicating the "units of participation" are issued by the Bank; however, the participant is informed by a non-negotiable document as to how many "units of participation" are contained in his account.

A participation is transferable only to another person who has validly appointed the Bank as managing agent, and, because of the underlying agency relationship, the interest of a participant terminates upon his death or incompetency and his funds are withdrawn from the Account and held for his legal representatives. There is no sales charge imposed on amounts invested in the commingled Account nor is there any redemption charge incurred upon withdrawal from the Account. An investor-customer may terminate his participation in whole or in part on the basis of the net asset value of the units of participation being redeemed. The net asset value of each unit of participation is determined as of the close of business of each of a number of specified valuation dates by dividing the net asset value of the Account as of the close of business on the valuation date by the number of units of participation then outstanding.

The operation of the Account is supervised by a Committee of five persons, who act essentially as a board of directors of the Account. Initially the members were appointed by the Bank, but hereafter are to be elected annually by the participants. Each participant will be entitled to vote at the election of the Committee members and his vote will be weighed according to the number of "units of participation" in his account. At least 40% of the members of the Committee must at all times be persons not affiliated with the Bank, but the majority of the members may be, and are expected to be, officers in the Bank's Trust and Investment Division.

The Committee is authorized to enter into a management agreement with the Bank. The agreement and any amendments thereto must be approved by more than 50% of the participants at their annual meeting and the Comptroller's approval thereof must also be obtained.

In accordance with the management agreement, the Bank serves as investment adviser and custodian for the Account. The Bank, therefore, maintains a continuous investment program consistent with the commingled Account's stated investment policy; it will determine what securities are to be purchased and sold, and will execute all transactions. The management agreement provides that the Bank will furnish all administrative, custodial and clerical services required by the Account and will pay all the organization costs and expenses. Subsequent maintenance fees, the cost of independent professional services, such as legal, auditing and accounting services, and the cost of preparation and distribution of notices to participants and proxy statements are to be borne by the commingled Account. The Bank will, however, reimburse the Account for the compensation and expenses, if any, paid by the Account to the members of the Committee who are not affiliated with the Bank, the other members of the Committee will receive no separate compensation for their services to the Account. For these services the Bank receives a fee equal to ⅛th of 1 per cent of the average of the net asset value of the Account taken on each valuation date during each fiscal quarter, which is approximately ½ of 1 per cent on an annual basis.

Essentially, the commingled management agency Account as delineated by the Bank's plan consists of two principal members, the first being the membership of the Account consisting of the investor-customer, and the second being the Bank which occupies a dual position, one as investment adviser to the Account and the other as general agent to the participants of the Account. The Bank can also be considered to occupy the position of underwriter for the units of participation which are issued to the investor-customer. The Committee of the Account occupies a position equivalent to that occupied by the board of directors of the mutual funds.

The Account has been approved by the Comptroller, even though it does not essentially comply with all provisions of Regulation 9 as promulgated by him. This action indicates that even though the Account as presently structured does not meet every minute detail of the Regulation, any future plans similar to the one established by the Bank will obtain his approval under 12 C.F.R. § 9.18(c)(5). Therefore, it is not necessary for this court to analyze the differences between the Account as established by the Bank and Regulation 9. For the disposi-

tion of the issues before this court, the Account will be treated as if it completely meets the substantive requirements of Regulation 9. 12 C.F.R. § 9.

Before the merits of the issues in this case can be reached, two preliminary procedural matters must be noted. The Comptroller interposes the objection that the plaintiffs lack standing to sue, and that there is no justiciable issue before this court.

These issues—standing and justiciability—are nominally termed procedural only to differentiate between the initial hurdles which a plaintiff must overcome in order to obtain a judicial determination of his action on the merits, and the actual adjudication of the case on its substantive issues. This characterization often borders on mere semantics, since in order to obtain the proper perspective and focus upon the essence of these issues, as here, the substantive law upon which the plaintiffs premise their action must also be taken into account.

Standing has been, and remains, one of the most enigmatic areas of the law. 3 Davis, *Administrative Law Treatise*, § 22.18, at 291–92, n. 3. The courts have not developed a single formula which can be applied to a set of facts to determine whether a plaintiff has or does not have standing. The ever changing concepts which have been used in this area of the law can be readily ascertained by the many cases which have been cited in the briefs of both parties upholding their contentions. Due to the pervasiveness of definition in this area, the court is left with no alternative but to examine the long list of cases which hold that a particular plaintiff had standing on one hand, and on the other the long list of cases where the plaintiff has been denied his day in court because of the lack of standing.

Standing has been generally expressed by an indication that the alleged aggrieved party has asserted a legal right which was his to assert, or has been injured, or has been threatened with injury. *Perkins* v. *Lukens Steel Co.*, 310 U.S. 113 (1940), cf. *FFCC* v. *Panders Bros. Radio Station*, 309 U.S. 470 (1940), *Pierce* v. *Society of Sisters*, 268 U.S. 510 (1925). But standing should not be confused with the doctrine of standing to sue which provides that in action in a federal constitutional court, by a citizen against a government officer in his official capacity, there is no justiciable controversy unless the citizen shows that such conduct invaded or will invade a private substantive legally protected interest. *Associated Ind.* v. *Ickes*, 1334 F. 2d 694, 702 (2nd Cir. 1943) *vacated as moot*, 320 U.S. 707 (1943), but see *Scott* v. *Macy*, 121 U.S. App. D.C. 205, 349 F. 2d 182 (D.C. Cir. 1965). The former standing is basically a means by which courts can accept or refuse jurisdiction, and it generally alludes to the capacity of a party to obtain judicial review of an administrative action. See *U.S.* v. *Storer Broadcasting Co.*, 351 U.S. 192, 197 (1956) and Jaffe, *Primary Jurisdiction*, 77 Harv. L. Rev. 1037 (1964). The doctrine of standing to sue is generally directed towards the capacity of a plaintiff to present his case before a district court *ab initio*.

The question as to whether a plaintiff may obtain judicial relief in cases like this has been variously phrased, but the many appellations which have been devised do not detract from the underlying policy objective which permeates each of these cases. This policy is well enshrined in Article III, § 2 of the United States Constitution, that is, a "constitutional" federal court cannot be given power to sit in judgment and revise administrative action, since there is no justiciable controversy and the opinion thus issued would merely be advisory. See concurring opinion of Mr. Justice Frankfurter in *Anti-Fascist Committee* v. *McGrath*, 341 U.S. 123, 149, 150 (1951), *Muskrat* v. *U.S.*, 219 U.S. 346, 354 (1911), *C & S Airlines*, v. *Waterman Corp.*, 333 U.S. 103, 113 (1948), *United Public Workers* v. *Mitchell*, 330 U.S. 75, 89 (1947), *Associated Ind.* v. *Ickes*, *supra*.

Standing to challenge an administrative action can be premised on a statutory provision specifically appended to the statute under which the administrative action was promulgated or where the provision for review has been made generally applicable by the Administrative Procedure Act, 5 U.S.C. §§ 701–704 recodified by Pub. Law 89–554, 80 Stat. 378). Since there is no specific provision for review of the Comptroller's regulation within the terms of the enabling statute, Title 12, Section 1 *et seq.*, the terms of the Administrative Procedure Act will apply. *Citizens Nat. Bank of Maplewood* v. *Saxon*, 249 F. Supp. 557 (D.C. Mo. 1965), affirmed 370 F. 2d 381 (8th Cir. 1966). See also *United Gas Pipeline Co.* v. *F.P.C.*, 181 F. 2d 796 (D.C. Cir. 1950), cert. denied 340 U.S. 827 (1950).

The pertinent section of the Administrative Procedure Act specifically provides that:

"Any person suffering legal wrong because of agency action, or adversely affected or aggrieved by action within the meaning of a relevant statute, is entitled to judicial review thereof." 5 U.S.C. § 702.

Under this statutory provision a plaintiff must allege that he has suffered a legal wrong or that a legally protected right will be adversely affected or aggrieved by the agency's action in order to obtain standing before this court. The plaintiffs here are alleging that they are suffering a legal wrong by the allegedly illegal competition made possible by the Comptroller's regulation, thereby being adversely affected or aggrieved. The exact amount of damages which will be incurred by the plaintiffs is rather difficult to assess in precise figures, but the Comptroller has predicted that over the next five to ten years, commercial banks might capture as much as two billion dollars of mutual fund business.[3] The defendant interposes that the competition, even if illegally promulgated, does not create any legal wrong for which the plaintiffs may complain.

In support of its contention that the plaintiffs are not suffering any legal wrong and thereby lack standing to challenge the Comptroller's regulation, the defendant relies on a series of cases which contain the general principle that mere competitive injury made possible by governmental action does not confer standing on the injured party to restrain governmental action. *Tennessee Power Co.* v. *TVA*, 306 U.S. 118, 137 (1938), *Alabama Power Co.* v. *Ickes*, 302 U.S. 464, 479 (1937), *Perkins* v. *Lukens Steel Co.*, 310 U.S. 113 (1940), *Texas State AFL–CIO* v. *Kennedy*, 330 F. 2d 217, 218 (D.C. Cir. 1964)., *Benson* v. *Schofield*, 336 F. 2d 719 (D.C. Cir. 1965), *cert. denied* 352 U.S. 976, *Kansas City Power & Light Co.* v. *McKay*, 225 F. 2d 924 (D.C. Cir. 1955), *cert. denied* 350 U.S. 884, 76 S. Ct. 137, 100 L. Ed. 780 (1955). In these cases, the plaintiffs alleged that they were suffering economic loss from the government created competition, but it is significant to note that the competition created by government action in these cases was specifically authorized and sanctioned by Congress and was based upon specific statutory grounds.

Moreover, most of the cases cited by the defendant in support of his allegation that the plaintiffs lack standing have been assiduously distinguished by subsequent decisions of the Supreme Court, even though they have not been expressly overruled. In *Chicago* v. *Atchison, Topeka & Santa Fe Railway*, 357 U.S. 77 (1958), the Supreme Court gave explicit recognition to a competitor's standing to challenge illegal competition. That case involved two competitors, one of whom (Parmelee) had alleged that the other (Transfer) was operating illegally because it had not complied with certain licensing requirements imposed by the City of Chicago. Transfer argued that Parmelee had no standing to object to Transfer's allegedly illegal competition, but this argument was flatly rejected by the Court.

"It is enough, for purposes of standing, that we have an actual controversy before us in which Parmelee has a direct and substantial personal interest in the outcome. Undoubtedly it is adversely affected by Transfer's operation, Parmelee contends that this operation is prohibited by a valid city ordinance and asserts the right to be free from unlawful competition.

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"[Transfer] argues that a party has no right to complain about unlawful competition, citing *Alabama Power Co.* v. *Ickes*, 302 U.S. 464 and *Tennessee Electric Power Co.* v. *TVA*, 306 U.S. 118. We do not regard either of these cases as controlling here. It seems to us that Transfer's argument confuses the merits of the controversy with the standing of Parmelee to litigate them . . . Parmelee's standing could hardly depend on whether or not it is eventually held that Transfer can lawfully operate without a certificate of convenience and necessity." 357 U.S. 77, at 83–84.

With regard to some later cases holding that competitors had standing, see *American Trucking Ass'n.* v. *U.S.*, 364 U.S. 1 (1960), *National Motor Freight Ass'n.* v. *U.S.*, 371 U.S. 223, rehearing denied 372 U.S. 246 (1963), affirming 205 F. Supp. 592 (D.C.D.C. 1962) only on the merits but not as to the standing issue; *Philco Corp.* v. *FCC*, 257 F. 2d 656 (D.C. Cir. 1958), *cert. denied* 358 U.S. 946, 79 S. St. 350, 3 L. Ed. 2d 352 (1959), *Whitney National Bank* v. *Bank of New Orleans & Trust Co.*, 323 F. 2d 290 (D.C. Cir. 1963), rev'd on other grounds, 379 U.S. 411 (1965).

In two recent cases challenging the authority of the Comptroller to promulgate regulations under other sections of the banking statutes, the plaintiffs have been granted standing to challenge the regulations over the objections of

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[3] *Hearings on H.R. 8499, 9410 before the Commerce and Finance Subcommittee of the House Committee on Interstate and Foreign Commerce*, 88 Cong. 2d Sess. p. 26 (1964). See also Comment, *Of Banks and Mutual Funds:* The Collective Investment Trust, 20 Sw.L.J. 334 (1969).

the Comptroller. Since these cases are directly in point they will be discussed at length. In *Baker, Watts & Co.* v. *Saxon*, 261 F. Supp. 247 (D.C.D.C. 1966), a number of plaintiffs, engaged in underwriting and distributing revenue bonds, sought a declaratory judgment that the Comptroller's regulations authorizing commercial banks, for the first time, to enter the revenue bond business violated the Glass-Steagall Act. The Comptroller raised the standing defense, citing the identical cases as brought forth in his present argument. Judge Holtzoff summarily disposed of that contention by stating:

"The gravamen of the plaintiffs' claim for relief is that they are being subjected to competition by illegal activities of national banks. While no one may maintain a suit to restrain lawful competition merely because he is suffering an economic detriment, nevertheless, a person has a standing to complain against illegal competition, or specifically, against competition on the part of a person who lacks the legal right or power to pursue the competitive activities." 261 F. Supp. at 248.

Judge Holtzoff's opinion focuses not on the impairment of the plaintiffs' competitive position by the unlawfully created competition, but rather on the premise that but for the illegal competition condoned by the Comptroller's regulation, the plaintiffs would not have any economic detriment to base their complaint.

Likewise, in *Georgia Association of Independent Insurance Agents, Inc.* v. *Saxon*, 260 F. Supp. 802 (N.D. Geo. 1966), the district court denied a motion to dismiss for lack of standing. In that case the Comptroller had authorized, for the first time, national banks to sell insurance in towns with more than 5000 people, even though Section 92 of Title 12 of the United States Code permitted banks to act as insurance agents only in places with a population of 5000 or less. Plaintiffs were insurance agents and trade organizations representing insurance agents. Plaintiffs there alleged that the Comptroller was acting beyond his authority to issue the ruling which was in direct violation of 12 U.S.C. § 92 and that, as a result, national banks were able to illegally compete with the plaintiffs. The district court, in reaching its conclusion, observed that:

"In *Tennessee Power Co., supra*, and in *Alabama Power Co.* v. *Ickes*, 302 U.S. 464, 58 S. Ct. 300, 82 L. Ed 374 (1937), the plaintiffs alleged that they were suffering economic loss from the government created competition. In both cases the Supreme Court held that such economic loss alone did not confer standing on the aspiring plaintiffs. It is important to note that such competition was authorized by Congress and was based upon statutory grounds.

"In the instant case, the competition complained of is not explicitly authorized by statute, but rather is impliedly prohibited by the congressional grant of power. . . ." 260 F. Supp. at 803.

The district judge, in denying the Comptroller's motion to dismiss, further stated:

"The Court is of the opinion that the defendant's attack on the plaintiffs' standing is without merit. Title 12, U.S.C.A. § 92 has the effect of protecting insurance agents from certain competition. Surely, the plaintiffs have the right to their day in court to show that the protection afforded them by 12 U.S.C.A. § 92 has been violated." 260 F. Supp. at 804.

Subsequent to its finding of standing, the District Court ruled on the merits of the issues and granted the declaratory judgment and injunction which was sought by the plintiffs. 268 F. Supp. 236 (N.D. Geo. 1967).

Defendant places great reliance in his brief on the recent case of *Pennsylvania Railroad Co.* v. *Dillon*, 335 F. 2d 292 (D.C. Cir. 1964), *cert. denied sub nom, American Hawaiian Steamship Co.* v. *Dillon*, 379 U.S. 945 (1964).

In that case plaintiffs alleged not only that defendant Dillion had exceeded his statutory authority but also that the competitive activity which had been allowed was in and of itself illegal. The competing carriers challenged the authority of the Secretary of the Treasury to enroll certain vessels in the coastwise trade, allegedly in violation of the Merchant Marine Act of 1920, as amended, 46 U.S.C. § 883. That section prohibited the enrollment and documentation of vessels "jumboized" by installation of foreign-made mid-bodies. The Court of Appeals for the District of Columbia Circuit found that the carriers lacked standing even though they alleged the competition was illegal and in violation of the specific provision of the statute. The Court jointed out the dichotomy of Section 10(a) of the A.P.A., namely the "legal wrong" aspect and the "adversely affected or aggrieved" aspect, as it related to the issue of standing and it concluded that:

"Under either leg of Section 10(a), therefore, since appellants only complain of government enhanced competition, they must demonstrate 'statutory aid to standing'." 335 F. 2d at 295.

After analyzing the enabling statute the Court concluded that "Congress did not intend to insulate coastwise carriers from other domestic competition or to give them any legally protected right to be free from such competition." 335 F. 2d at 295.

A close analysis of the holding in the *Pennsylvania Railroad, supra*, case does not require a determination of the standing issue adverse to the plaintiffs. In that case the Court of Appeals found that the underlying purpose of the statute under which the regulation was promulgated was to stimulate and encourage resort to domestic shipyards and thus to ensure them sufficient business so that their facilities would be adequate at times of national emergencies. 335 F.2d 292, at 295. The statutes, under which the regulation in issue was promulgated, were enacted to establish a clear Congressional policy which sought to separate national commercial banking from the securities business.[4] The primary intent of Congress was to segregate these functions and to allow separate entities to engage in these business areas. This clarity of purpose is garnered not only from the Congressional hearings reports of the Glass-Steagall Act, but also from the exactitude with which Congress has delineated the areas of common interest in this financial structure.[5] This strong general policy against the invasion of either field of endeavor by either entity is sufficient to postulate an interest upon which standing to challenge the regulation may be premised, cf. *American Trucking Ass'n.* v. *U.S.* 364 U.S. 1 (1960).

Therefore, by implication, the plaintiffs here have a right to complain of the competition which is being condoned under the Regulation. This competition is illegal in the sense that Congress has indicated its policy of separating the two financial institutions and this Regulation allows in an indirect manner a joinder of these interests. The plaintiffs were the recipients by implication of Congressional protection.

Even if this invasion would not in fact cause a palpable injury [6] to be inflicted upon the plaintiffs which could be termed to be a legal wrong under the first leg of Section 10(a) of the A.P.A., now 5 U.S.C. § 702, the plaintifis could have standing to represent the public interest as held in *Sanders Bros. Radio Station* v. *F.C.C.*, 309 U.S. 470 (1940), *Scripps-Howard Radio, Inc.*, v. *F.P.C.*, 316 U.S 4 (1942), and *F.C.C.* v. *N.B.C.* (*K.O.A.*), 319 U.S. 239, 63 S.Ct. 1035, 87, L.Ed. 1374 (1943). See the application of this doctrine by Judge Frank in *Associated Industries* v. *Ickes*, 134 F.2d 694 (2nd Cir. 1943), *vacated* as moot 320 U.S. 707 (1943).

The practical effect of the doctrine advanced by those series of cases grants standing to challenge the legality of administrative action to one who is in fact adversely affected by administrative action. Standing in those instances is predicated upon the theory that the plaintiffs do not represent their own private property interests but rather the interests of the public. In the instant situation the plaintiffs could be classified as private "Attorneys General" based on the premise that the public policy dictated by Congress in the Glass-Steagall Act is not being adhered to by the agency charged with its enforcement. See *Philco Corp.* v. *FCC*, 103 U.S. App. D.C. 278, 257 F. 2d 656 (1958), *cert. denied* 358 U.S. 946, 76 S.Ct. 350, 3 L.Ed. 352 (1959), where the competitive interest of a manufacturer and not a broadcaster was held sufficient to satisfy the "person aggrieved" provision of the Federal Communications Act. See also Jaffe, *Standing to Secure Judicial Review: Public Actions and Private Actions*, 74 Harv. L.Rev. 1265 (1961), 75 Harv. L.Rev. 255 (1961), and Davis, 3 Administrative Law Treatise §§ 22.04, 22.05, 22.11 (1958), (Supp. 1965).

Finally, a denial of standing, as urged by the defendant, would leave the plaintiffs and all others similarly situated without a right to seek redress against capricious, arbitrary and unwarranted Regulations issued by the Comptroller, however flagrant and contrary to the intent of Congress. This court, there-

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[4] *Hearings Pursuant to S. Res. 71 Before a Subcommittee of the Senate Committee on Banking and Currency*, 71st Cong. 3d Sess. (1931).
S. Rep. No. 77, 73d Cong. 1st Sess. (1933).
H.R. Rep. No. 742, 74th Cong. 1st Sess. (1935).
See also 75 Cong. Rec. 9909 (1932) (remarks of Senator Bulkley).

[5] Not specifically amendments made to Section 24, par. Seventh of Title 12.

[6] *Bantam Book* v. *Sullivan*, 372 U.S. 58, 83 S. Ct. 631, 9 L. Ed. 2d 584 (1963)—see also the discussion of the "Adversely Affected in Fact" doctrine promulgated by Prof. Davis, 3 Davis, *Administrative Law Treatise* §22.02 (1965 Supp.)

fore, holds that the plaintiffs have standing to challenge the Comptroller's Regulation 9.

The Comptroller also asserts that there is no justiciable issue or controversy present in this case. This assertion is bifurcated on two grounds. The first is apparently premised upon the theory that the Comptroller's regulation permitting national commercial banks to establish the commingled Account does not regulate nor does it impose any obligation or duty upon the plaintiffs. The standards of justiciability are not limited to those situations in which the plaintiffs are directly regulated by the defendant government official. Indeed, in none of the branch bank cases in which the plaintiff was a state bank did the challenged regulations impose a duty upon or regulate the plaintiffs in any manner, e.g. *First Hardin National Bank* v. *Fort Knox National Bank*, 361 F.2d 276 (6th Cir. 1966), *First National Bank of Smithfield* v. *Saxon*, 352 F.2d 267 (4th Cir. 1965), *Union Savings Bank of Patchogue* v. *Saxon*, 118 U.S. App. D.C. 296, 335 F.2d 718 (D.C. Cir. 1964), *Whitney National Bank* v. *Bank of New Orleans & Trust Co.*, 323 F. 2d 290 (D.C. Cir. 1963), *rev'd on other grounds* 379 U.S. 411 (1965), *Commercial Security Bank* v. *Saxon*, 236 F. Supp. 457 (D.C.D.C. 1964), affirmed 343 F.2d 758 (D.C. Cir. 1965). However, the justiciability assertion made by the Comptroller in each of these cases was decided adversely to the Comptroller.

The district court in *Baker, Watts & Co.* v. *Saxon, supra*, summarily rejected the Comptroller's contention, stating that:

". . . a justiciable controversy obviously exists justifying the court in entertaining an action for a declaratory judgment. The plaintiffs claim that the defendant is authorizing national banks to conduct certain activities in violation of the law and that these activities transgress the powers of the banks and that they are injurious to the plaintiffs." 261 F. Supp. at 249.

The second ground for the lack of justiciability is premised on the theory that only the Comptroller can challenge the acts of a national commercial bank when it acts in excess of its powers. However, the primary thrust of the plaintiffs' allegation is directed not at the national bank which is acting under authority granted by the Comptroller, but rather at the scope of the authority under which the Comptroller promulgated the regulation in issue. The district court in *Georgia Association of Independent Insurance Agents, Inc.* v. *Saxon, supra*, simultaneous with its denial of the motion to dismiss for lack of standing, rejected the Comptroller's assertions on the issue of justiciability. It unequivocally stated that:

"The defendant further contends that . . . the Comptroller is sole enforcer of the National Banking Act. This contention is impliedly repudiated by the repeated decisions that banks have standing to challenge an allegedly illegal order . . . and was explicity repudiated in an opinion by the Fifth Circuit Court of Appeals which stated: 'The fact that the Comptroller is charged under 12 U.S.C. § 93 with the duty of enforcing the National Banking Act certainly does not have the effect of prohibiting actions to enforce the law by any other party who might have a legitimate interest. *Jackson* v. *First National Bank of Valdosta*, 349 F. 2d 71 (1965) at p. 75.'" 260 F. Supp. at 804.

A recent Supreme Court decision inferentially rejects the Comptroller's arguments on the lack of justiciability, *Abbott Laboratories* v. *Gardner*, 387 U.S. 136 (1967). The Supreme Court reversed and remanded to the Court of Appeals for the Third Circuit so that the Court of Appeals could consider the issues on the merits. The Court of Appeals had reversed the district court's decision without reaching the merits of the case, 352 F. 2d 286 (3rd Cir. 1965). The district court had found that "a justiciable controversy arises where a plaintiff is confronted with substantial present or imminent harm . . . the very presence of a threat of harm makes the regulations ready for review." 228 F. Supp. 855, 861 (D.C. Del. 1964). The Court of Appeals reversed on the basis that no "actual case or controversy" existed as required for justiciably under the Declaratory Judgment Act. However, the Supreme Court decreed that "the impact of the regulations upon the plaintiff is sufficiently direct and immediate so as to render the issue appropriate for judicial review at this stage." 387 U.S. at 152.

Having found that the plaintiffs have standing to seek redress and that they have presented a justiciable issue, we are now ready to seek a resolution of the subject matter involved in this litigation.

The principal issue involved in this controversy is whether or not the Comptroller has the statutory authority to empower national commercial banks to create, organize and manage the commingled Account. The gist of the activity of

managing the Account consists of the purchase and sale of equity securities, nominally for long-term growth of capital and income for the participating members. National banks have only such powers as are expressly given by federal statute or by necessary implication therefrom, 12 U.S.C. §24. *Houston* v. *Drake*, 97 F. 2d 863 (9th Cir. 1938), *Baltimore & O. R. Co., et al.*, v. *Smith*, 56 F. 2d 799 (3rd Cir. 1932), and in some trust activities they may be authorized to act by the Comptroller in any capacity in which competing state banks are permitted to act. 12 U.S.C. 92a(a). See *First National Bank in St. Louis* v. *Missouri*, 263 U.S. 640 (1923), and *Mercantile National Bank* v. *Langdeau*, 371 U.S. 55 (1962), *City of Yonkers* v. *Downey*, 309 U.S. 590 (1940), 60 S. Ct. 796, 84 L. Ed. 964, rehearing denied 60 S. Ct. 1071, 310 U.S. 656, 84 L. Ed. 1420; and *Condon* v. *Downey*, 310 U.S. 656, 60 S. Ct. 1071, 84 L. Ed. 1420, *U.S.* v. *Palmer*, 28 F. Supp. 936 (D.C.N.Y. 1939).

Authority to oversee trust activities of national banks which was vested in the Federal Reserve Board of Governors, 12 U.S.C. §248(k) was repealed in 1962 when authority to regulate the fiduciary activities of national banks was transferred to the Comptroller. 12 U.S.C. §92a, 76 Stat. 668, Pub. L. 87–722. Upon transfer of this authority the Comptroller issued Regulation 9 pursuant to which the First National City Bank established the commingled Account. In order to determine the validity of Regulation 9, it will be necessary to investigate each section of the relevant statutes and also to determine the intent of Congress when it enacted the relevant statutes. In order to complete the determination of the issues involved, it will also be necessary to determine whether or not the relevant state statute, here the N.Y. Banking Law Section 100, allows local state banks to act in a similar fashion as is presently being allowed by Regulation 9.

This Regulation authorizes national banks to commingle managing agent accounts, allowing, therefore, the bank to purchase equity securities for the Account in general and not for any specific participating member. The essence of this activity is the purchase and sale of securities deriving thereby a benefit for the participating members, and fulfilling the stated purpose of the Account.

The first statutory provision which is encountered along the logical progression to our conclusion is 12 U.S.C. §92a which delineates the trust powers which the Comptroller is authorized to grant to the national banks. Section 92a(a) provides:

"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."

and under 12 U.S.C. §92a(j) the Comptroller:[7]

". . . is authorized and empowered to promulgate such regulations as he may deem necessary to enforce compliance with the provisions of this section and the proper exercise of the powers granted therein." 76 Stat. 668, Pub. L. 87–722 § 1.

Pursuant to this statutory authority the Comptroller can empower national banks the right to act in a fiduciary capacity and to issue regulations controlling this activity. From the statutory language it can be concluded that the comptroller can grant trust powers to the national banks; but the real crux of this issue is whether or not the commingled Account can be considered a fiduciary activity as provided by the statute.

The Comptroller contends that there can be no doubt that the Bank's relationship to the participants in the commingled Account is a fiduciary relationship; however, this general statement, upon close analysis, is untenable. The principal-agent relationship arises from a contractual agreement between the parties. The nature of this relationship gives rise to certain duties which are implied by the law, namely, a fiduciary duty and a duty of loyalty. The trustee and the agent have an equivalent duty of loyalty. The fiduciary duty of the agent is similar to but not the equivalent of the fiduciary duty of a trustee.

The many differences as to the characteristics of a principal-agent relationship and a trustee relationship are notable especially as they relate to the issue in

[7] Section 11(k) of the Federal Reserve Act, as amended, 12 U.S.C. § 248(k) (repealed), empowered, in identical terms the Federal Reserve Board to issue regulations.

this case. Consent of both principal and agent is a necessary requirement for the creation of the relation whereas the beneficiary of a trust need not consent. An agent is subject to the control of his principal, but a trustee is not subject to the control of the beneficiary. An agent can bind his principal by contract or otherwise, but a trustee has no such power with regard to his beneficiary. The agency relationship is terminable by the direction of the principal or by his death without any express provision to that effect, but this is untrue with respect to a trust unless the instrument so provides. See *Restatement* (Second) of *Agency*, Section 13, comment *a*, Section 14B, comments *e* to *h*, and Section 425, comment *a*. Note also Bogert, *Trusts and Trustees*, § 15 (2d. ed. 1965) p. 70 and *Restatement of Trusts*, 2d § 8, comment *i*.

The Bank and the individual participant of the Account enter into an agency relationship prior to or simultaneous with the participant's engagement with the Account. The Bank's role in this relationship is one of managing agent, nor as trustee for the participant. A leading authority on the law of trusts has stated:

"The duties and powers of the institution [e.g. a bank] as agent are determined by the terms of the contract made with the customer; the duties and powers of the institution as trustee depending not only upon the terms of the trust but also upon the principles and rules of the common law and of statutes which are applicable to the trust relation. The liabilities of the institution as agent depend upon whether it has failed to use due care in the performance of the duties which it undertakes; its liabilities as a trustee depend upon whether it has committed a breach of trust. Ordinarily the responsibilities of the institution are more extensive where it acts as trustee than where it acts as agent, and it may incur no liabilities as agent for conduct which would render it liable if it were trustee." 1 Scott on Trusts, Section 8.1 Bank as Trustee or Agent (2d. ed. 1956).

The courts, as well as the recognized authorities in trust law, have distinguished sharply between the responsibilities of a true trustee and those of a managing agent, even where the latter is granted complete discretion in acting for his principal. It is, of course, established that the managing agent occupies a position of confidence, in which he must act with reasonable care and is held to a standard of conduct higher than that which prevails in the ordinary course of business in the marketplace. But the courts have stated plainly that this is not the high standard of care and strict accounting imposed upon a trustee, *Stephens* v. *Detroit Trust Co.*, 284 Mich. 149, 278 N.W. 799 (1933), *Anderson* v. *Abbott*, 61 F. Supp. 888 (W. D. Ky. 1945), *O'Connor* v. *Burns, Potter & Co.*, 151 Neb. 9, 36 N.W. 2d 507 (1949). In both the *Stephens* and *O'Connor* cases the principal brought suit for accounting against the defendant managing agent on the basis that they had breached the high duty of care imposed upon a trustee. The decisive factor in both cases was that the relationship which existed between the parties had been freely chosen and established and, having entered into an agency contract, the investor could not assert that the relationship was in fact a trust.[8]

Contrary to the contentions made by the Comptroller, the managing agent relationship is not a true fiduciary relationship as it has been defined by the courts and by the recognized authorities in this field. Therefore, it is concluded that the managing agency relationship does not fall within the traditional fiduciary powers as delineated in 12 U.S.C. § 92a(a).

Section 12 U.S.C. 92a(a), however, permits a national bank to act "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." This saving provision allows national banks to offer the equivalent fiduciary services to their customers that a local state bank might offer.

The Comptroller has authorized the First National City Bank, located in New York state, to establish a commingled Account pursuant to Regulation 9, and under the competitive provision of 12 U.S.C. § 92a(a) the authorization granted to First National City Bank may be legally valid, if the banking laws of New York state allow competing institutions to establish a commingled Account.

The general powers of state banks in New York state are contained in McKinney's Consl. L. N. Y. Banking Law § 96 as amended, L. 1966, c. 324. These general powers have been supplemented by specific statutory provisions which

[8] But see, Saxon and Miller, *Common Trust Funds*, 53 Geo. L.J. 994 1015, and Main, *Common Trust Funds*, 83 Banking L.J. 565.

grant state banks the power to act in a fiduciary capacity, N. Y. Banking Law §§ 100, 100–a, 100–b, 100–c, as amended. Each of these statutory provisions delineate the authorization of state banks with a definite degree of specificity, and none of the sections noted above allow a commingling of managing agency accounts. The only section which could even be deemed to inferentially grant this authority is Section 100–c, which relates to the power of banks to commingle funds held in a fiduciary capacity, specifically requiring that common trust funds be limited to moneys received and held "as executor, administrator, guardian, personal or testamentary trustee, donee of a power during minority to manage property vested in an infant or committee. . . ."

A search of the New York state case law has failed to reveal any relevant judicial interpretation of this statutory section. However, it has been held that state banks are prohibited to exercise any power which was not expressly granted, *O'Connor* v. *Bankers Trust Co.* 159 Misc. 920, 289 NYS 252 (Sup. Ct. 1936) affirmed 278 NY 649, 16 NE 2d 302; see also *Nassau Bank* v. *Jones*, 95 NY 115, 47 Am. Rep. 14, (Ct. of App. 1884). These decisions indicate that New York state courts follow the federal rule, applicable to national banks, as expressed in *Calif. Bank* v. *Kennedy*, 167 U.S. 362, 17 S. Ct. 831, 42 L. Ed. 198 (1897), that the exercise of power not expressly granted to a national bank is prohibited. This restrictive interpretation of the powers granted under Section 100–c is further substantiated by noting that when the New York legislature has wanted to broaden the categories of accounts held and administered by banks which could be invested in a common trust fund, it has amended Section 100–c to do so.[9]

It is the conclusion of this court that the commingling of managing agency accounts is not authorized either under the federal statutes or the New York banking laws.

Even if the managing agency accounts could be considered bona fide fiduciary activities, and, therefore, authorized by the present statutes, the commingling of these accounts would still be illegal under the provision of the Glass-Steagall Act. In order to arrive at this determination it is necessary to make an exact characterization of the Account which was established.

As noted in the early section of this decision, a mutual fund continuously issues its own securities as does the commingled Account. A mutual fund invests the proceeds from the sale of its securities in a diversified investment portfolio, in the same manner as the commingled Account. The mutual fund shares obtains for the investor an undivided interest in the fund's portfolio, as does a unit of participation in the commingled Account. Within certain limitations, a participating member of the Account can redeem his units of participation in a similar manner as the holder of mutual fund shares. A majority of the participating members elect the members of the Committee, who oversee the affairs of the Account in much the same manner as mutual fund stockholders elect their board of directors or trustees. The SEC has required the Account to register as an investment company under the Investment Company Act of 1940, 15 U.S.C. § 80. The SEC pursuant to its authority under 15 U.S.C. § 80 3(c), has granted certain exemptions to the requirements of the Investment Company Act as it relates to board membership;[10] nevertheless it has recognized the similarity between the Account and an investment company.[11] The Bank and the Committee have entered into a contractual agreement under which the Bank performs managing and advising functions for the Account. This contract is the equivalent of the contracts which are entered into by the mutual funds and their investment advisers. These contracts are subject to and must be submitted for review by

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[9] For example, that section was amended to permit a state bank acting as the "donee of a power during minority to manage property vested in the infant" to place the property so managed in a common trust fund, L. 1958, c. 496 § 1; L. 1965, c. 824 § 5. Note also the specific accounting and notice provisions which are contained in Section 100–c as strictly construed by the courts in *In re Linoln Rochester Trust Co.*, 201 Misc. 1008, 111 NYS 2d 45 (1952). See also New York Banking Board Regulation, 3 N.Y.C.R.R. 11.91 which states that a common trust fund "may be operated only for true fiduciary purposes."

[10] The exemptions which were granted are being challenged in the Court of Appeals for the District of Columbia Circuit, *National Association of Securities Dealers, Inc.* v. *Security Exchange Commission*, Appeal No. 20, 164.

[11] The similarity between mutual funds and the Account have been noted by many authorities in the financial community, see *Hearings on S. 2704 on Collective Investment Funds Before the Subcommittee on Financial Institutions of the Senate Committee on Banking and Currency*, 89th Cong. 2d Sess. (1966); *University of Pennsylvania Law School Conference on Mutual Funds*, 115 U.Pa.L.Rev. 669; and Comment, *Of Banks and Mutual Funds*, 20 Sw.L.J.

the SEC under the provisions of the Investment Company Act. There are some differences between a mutual fund and a commingled Account,[12] but these are not substantially sufficient to create a legal differentiation between the two investment vehicles. The similarities between these related activities are a sufficient basis to draw an analogy from which an equivalency can be premised.

The Comptroller attempts to differentiate between the mutual fund investment vehicle and the commingled Account by attempting to establish a major difference between a mutual fund share and a unit of participation. This differentiation is premised on the basis that the unit of participation is not a security as such. This is mere tautology and a matter of semantics.

The United States Supreme Court has noted that for the purposes of the Securities Act of 1933 the test for a security is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. *SEC* v. *Howey, Co.*, 328 U.S. 293, 301 (1946). See also *S.E.C.* v. *Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) and *Prudential Insurance Co. of America* v. *S.E.C.*, 326 F. 2d 383 (3rd Cir. 1964), *cert. denied* 377 U.S. 953 (1964). Under this all encompassing defintion, in its most comprehensive sense, whenever an investor relinquishes control over his funds and submits their control to another for the purpose and hopeful expectation of deriving profits therefrom he is in fact investing his funds in a security. The unit of participation in the commingled Account is in fact a security and has been so recognized by the SEC by its requirement that the Bank register the units of participation under the Securities Act of 1933.

The Comptroller argues, however, that the definition of "securities" for the purpose of the Securities Act of 1933 is not applicable to define "securities" as the term is used in the Glass-Steagall Act. He asserts that this defintion as judicially and administratively derived has no relevance to the meaning of the various provisions of the national banking laws. He bases this assertion on the allegedly different purposes which the laws have, namely that the securities laws were enacted to protect the interests of investors while the banking laws were enacted to protect the country's credit and currency and the solvency of the national banks. This differentiation fails to focus upon the primary essence of the complete regulatory scheme which the Congress enacted to mitigate the problems that the country faced in the 1930s. Congress, after extensive investigation, realized that the financial community needed stabilization in order to overcome the debacle which arose in 1929 and to prevent any further recurrences. It would be inconsistent to conclude that Congress did not intend to obtain the equivalent meaning for the term "securities" as used in the Securities Act of 1933 when it used the term in the Glass-Steagall Act which was enacted by the same Congress.[13]

By finding that the Account is an equivalent investment vehicle to a mutual fund and that the units of participation are in fact securities, it is, therefore, necessary to determine whether or not the Bank is barred from these activities by the provisions of the Glass-Steagall Act, Sections 16, 20, 21 and 32, codified in 12 U.S.C. § § 24, 377, 378 and 78 respectively.

The first relevant section is 12 U.S.C. § 24 dealing with the explicit powers granted to the national banks by the Congress. For our analysis only paragraph Seventh is pertinent. It states:

"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; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter. 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 any issue of securi-

[12] See *Hearings on S. 2704* (1966) *supra*, at p. 55 and 56.

[13] The Federal Reserve Board has repeatedly ruled that participations or shares in mutual funds are securities for purposes of the Glass-Steagall Act, and it has similarly characterized the units of participation in the bank sponsored commingled managing agency account. Federal Reserve Board Legal Memorandum, "Legal Considerations Under Section 32 of the Banking Act of 1933 in Connection With the Proposed Commingled Investment Account of First National City Bank of New York" (Dec. 15, 1965) reprinted in *Hearings on S. 2704* (1966) at 581–588.

ties of stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. . . ."

The power of national banks to deal in securities has had a motley history, both legislatively and judicially. In 1823 the Supreme Court held that a prohibition against a national bank's trading and dealing in stocks was nothing more than a prohibition against engaging in the ordinary business of buying and selling stocks for a profit and it did not include purchases resulting from ordinary banking transactions. *Fleckner* v. *Bank of the United States*, 8 Wheat. 351, 21 U.S. 351 (1823). In *First National Bank* v. *Nat. Exchange Bank*, 92 U.S. 122 (1875), the Supreme Court stated that "Dealing in stocks is not expressly prohibited; but such a prohibition is implied from the failure to grant the power." 92 U.S. at 128. The Court in the *First National Bank* case was interpreting, Rev. Stat. § 5136, par. 7, 15; 15 Stat. 101 § 8, the forerunner of 12 U.S.C. § 24, par. 7 which delineated the powers of the national banks.

The limitation on the national bank's power in security dealings was reiterated in subsequent decisions of the Supreme Court. *Concord First National* v. *Hawkins*, 174 U.S. 371 (1898), *California Bank* v. *Kennedy*, 167 U.S. 362 (1897), *McCormick* v. *Market National Bank*, 165 U.S. 538 (1896); see also *Birdsell Mfg. Co.* v. *Anderson*, 20 F. Supp. 571 (W.D. Ky. 1937) affirmed 104 F. 2d 340 (6th Cir. 1939), and *Michelsen* v. *Penney*, 135 F. 2d 409, 424 (2nd Cir. 1943).

This implied limitation caused the national banks to establish security affiliates, organized under state law, to profit from underwriting and dealing in stocks and other securities. In 1927 Congress passed the McFadden Act which added to the list of banking powers in paragraph Seventh of Section 5136 of the Revised Statutes the following proviso:

"*Provided*, that the business of buying and selling investment securities shall hereafter be limited to buying and selling without recourse marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation, in the form of bonds, notes and/or debentures, commonly known as investment securities, under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency. . . . [Act of February 25, 1927 (McFadden Act), Section 2(b), 44 Stat. 1226]"

This proviso was intended to be a confirmation and a regulation of the investment security business which was being conducted by the banks through their security affiliates. *H.R. Rep. No. 83*, 69th Cong. 1st. Sess. (1926). By the provisions of this Act, the national banks were authorized by statute to engage in the business of underwriting and dealing in investment securities.

The storms looming on the horizon were not within the contemplation of very many people in 1927. It was not until 1931 when the Congress, graced with hindsight, sought the primary causes of the debacle which enveloped the country and had its repercussions throughout the world. The Congressional inquiry generated various statutes in an atempt to avoid a repetition of the debacle which had transpired. Among these statutes were the Glass-Steagall Act and the Securities Act of 1933.

The Glass-Steagall Act in particular redefined the powers of the national banks and imposed severe limitations on their activity in the investment security business by amending 12 U.S.C. § 24, P. 7, and adding 12 U.S.C. §§ 78, 377 and 378. Section 24, paragraph Seventh, has been noted above. The other relevant sections are noted below. Section 32 of the Glass-Steagall Act, now 12 U.S.C. § 78, provides:

"No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments."

Section 20 of the Glass-Steagall Act, now 12 U.S.C. § 377, provides:

"After one year from June 16, 1933, no member bank shall be affiliated in any manner described in subsection (b) of section 221a of this title with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at whole-

sale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities; *Provided*, That nothing in this paragraph shall apply to any such organization which shall have been placed in formal liquidation and which shall transact no business except such as may be incidental to the liquidation of its affairs.

"For every violation of this section the member bank involved shall be subject to a penalty not exceeding $1,000 per day for each day during which such violation continues. Such penalty may be assessed by the Board of Governors of the Federal Reserve System, in its discretion, and, when so assessed, may be collected by the Federal reserve bank by suit or otherwise.

"If any such violation shall continue for six calendar months after the member bank shall have been warned by the Board of Governors of the Federal Reserve System to discontinue the same, (a) in the case of a national bank, all the rights, privileges, and franchises granted to it under the National Bank Act, may be forfeited in the manner prescribed in sections 141, 222–225, 281–283, 285, 286, 501a, and 502 of this title, or, (b) in the case of a State member bank, all of its rights and privileges of membership in the Federal Reserve System may be forfeited in the manner prescribed in sections 321–329 and 330–338 of this title."

Section 21 of the Glass-Steagall Act, now 12 U.S.C. § 378, provides:

"(a) After the expiration of one year after June 16, 1933, it shall be unlawful—

"(1) For any person, firm, corporation, association, business trust, or other similar organization, 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, to engage at the same time to any extend whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided*, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities to the extent permitted to national banking associations by the provisions of section 24 of this title: *Provided further*, That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank, trust company, or other banking institution, may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate;

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"(b) Whoever shall willfully violate any of the provisions of this section shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both, and any officer, director, employee, or agent of any person, firm, corporation, association, business trust, or other similar organization who knowingly participates in any such violation shall be punished by a like fine or imprisonment or both."

The obvious purpose of these legislative enactments was to divorce the banking business from the security investing business. Congress was so emphatic in promulgating this divorce, that it included a criminal provision to assure the efficacy and continuity of the separation; see 12 U.S.C. § 378(b), *supra*, and in some instances it imposed money penalties and forfeitures; see 12 U.S.C. § 377, *supra*. The many pages of legislative hearings reports which preceded the final enactment of the Glass-Steagall Act contain and outline the potential dangers which the involvement of commercial banking in the investment security business created.

These potential dangers were noted by the Comptroller of the Currency in his report of 1920, excerpts of which were cited by the Subcommittee of the Senate conducting the investigation:

"Some 'securities companies' operating in close connection with, and often officered by, the same men who manage the national banks with which they are allied, have become instruments of speculation and headquarters for promotions of all kinds of financial schemes. Many of the flotations promoted by the 'securities corporations' which are operated as adjuncts to national banks have proven disastrous to their subscribers, and have in some instances reflected seriously not only upon the credit and the standing of the 'securities companies' by which they are sponsored, but also in some cases have damaged the credit and reputation of national banks with which the 'securities companies' are allied.

"It has been established clearly by decisions of the United States Supreme Court that a national bank can not, except as authorized by the Federal reserve act, hold the stock of other national banks or the stock of other corporations; but these adjunct or auxiliary companies whose stockholders are identical with the stockholders of the national banks with which they are connected by various ties and devices frequently deal actively in stocks, and they also sometimes acquire the ownership or control of other banks, National and State, through their stock purchases.

"In times of rising prices and active speculation some of these auxiliary corporations have made large profits through their ventures and syndicate operations, but their loses in other periods have been heavy, and they have become an element of increasing peril to the banks with which they are associated. The business of legitimate banking is entirely separate and distinct from the kind of business conducted by many of the 'securities corporations,' and it would be difficult, if not impossible, for the same set of officers to conduct safely, soundly, and successfully the conservative business of the national bank and at the same time direct and manage the speculative ventures and promotions of the ancillary institutions. These varying institutions demand a different kind of ability and experience on the part of those who manage them, and the two types of business when combined with one management are likely to be operated to the advantage of neither.

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"These ancillary companies are being used with increasing frequency for promotion of speculation and for dealing in bonds and stocks, often those of new and unseasoned issues, and which are attended with improper hazard risk, and as a means of enabling banks to do, indirectly through their instrumentality, things which they can neither safely nor lawfully do directly." [See *Hearings Pursuant to S. Res. 71 Before a Subcommittee of the Senate Committee on Banking and Currency*, 71st Cong. 3d Sess. pp. 1067–1068 (1931).]

The Senate Subcommittee Report alo outlined the organization and functions of the security affiliates. Among one of these functions was the operation of investment trusts which bought and sold securities purely for investment or speculative purposes, *Hearings*, S. Res. 71, p. 1057. These investment trusts were the equivalent of our present day investment companies.[14]

Another drawback which the Subcommittee Report recognized was that "in the case of a trust company or a bank with a trust department, the possession of a security affiliate may adversely affect the independence with which fiduciary activities are exercised." *Hearings*, S. Res. 71 p. 1064.

There can be little doubt as to what Congress intended to do by the enactment of the Glass-Steagall provisions outlined above. Section 16, 12 U.S.C. § 24, par. 7 prohibits national banks from not only underwriting securities directly but also limits the capacity of the national banks in the purchase and sale of securities. *Awotin* v. *Atlas Exchange Bank*, 295 U.S. 209 (1935); cf. *U.S.* v. *Philadelphia National Bank*, 374 U.S. 231, 329 (1963), *First Natl. Bank* v. *Missouri*, 263 U.S. 640 (1923), *Genessee Trustee Corp.* v. *Smith*, 102 F. 2d 125, 127 (6th Cir. 1939), Guaranty *Trust Co.* v. *U.S.*, 44 F. Supp. 417, (E.D. Wash. 1942), affirmed 139 F. 2d 69 (9th Cir. 1943), *U.S.* v. *Palmer*, 28 F. Supp. 936 (S.D.N.Y. 1939). Section 20, 12 U.S.C. § 377 effectively provides that national banks may not be affiliated with an entity which is engaged principally in the business of purchasing, selling, or underwriting securities. Section 21, 12 U.S.C. § 378 specifically provides that it is unlawful for any entity which is engaged in the business of purchasing, selling, or underwriting to also be engaged in the banking business. Section 32, 12 U.S.C. § 78 prohibits banks and investment organizations from having interlocking directorates, and common officials and employees. Through this legislative scheme Congress intended to separate these previously integrated activities, and it made its intent explicitly clear. *Merchants National Bank* v. *Commissioner of Internal Revenue*, 199 F.2d 657 (5th Cir. 1952), *Commissioner of Internal Revenue* v. *Merchants Nat. Bldg. Co.*, 131 F.2d 741 (5th Cir. 1942), cf. *Paramount Pictures* v. *Langer*, 23 F. Supp. 890, 902 (D. N.D. 1938), reversed as most 306 U.S. 619 (1938), *Morgan Stanley Co.* v. *S.E.C.*, 126 F.2d 325, 329 (2nd Cir. 1942).

The Supreme Court has stated with specific relation to Section 32, 12 U.S.C. § 78, that "It [Section 32] is a preventive or prophylactic measure. The fact

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[14] *S.E.C.* Report on the Public Policy *Implications of Investment Company Growth*, *H.R. Rep. No. 2337*, 89th Cong. 2nd Sess. p. 33, Fn. 3 (1966).

that respondents have been scrupulous in their relationship to the bank is therefore immaterial," *Board of Governors* v. *Agnew*, 329 U.S. 441, 449 (1946), see also *U.S.* v. *Brown*, 381 U.S. 437, 454 (1965). This "prophylactic" aspect of Section 32 is also inherent in Sections 20 and 21. This is effective legislation against temptation, *National Maritime Union of America* v. *Herzog*, 78 F. Supp. 146, 171 (D.C.D.C. 1948) affirmed 334 U.S. 354 (1948), and it should not be derogated except by the Congress.

The Comptroller contends that the Account has been passed upon and approved by the Federal Reserve Board of Governors as far as its establishment would be contrary to the provisions of Section 32, 12 U.S.C. §78.[15] In order to support its conclusion the Board promulgated a "single entity" theory, that is, that the Bank and the Account would constitute a single entity for the purposes of Section 32, since the Account would be regarded as nothing more than an arm or department of the Bank. This proposition seems to be based more on nuances of language than on the factual ascertainment of the relationship of the Account with the Bank. The Account is to be governed by an independent board of directors, the Committee, with full policy making authority. The Committee is elected by a majority of the units of participation in the Account and is responsible only to the investor-participants in the Account and not to the Bank. The Bank serves as investment adviser to the Account and also provides administrative services. It performs these services pursuant to a contract which conforms to the requirements of Section 15 of the Investment Company Act, 15 U.S.C. §80a–15. The contract is terminable at any time, by either party, with sixty days notice and may be continued only upon annual approval of the investor-participants or of a majority of the Committee, including a majority of the members of the Committee not affiliated with the Bank. The contract will also terminate automatically if assigned by the Bank. When all these factors are taken into consideration, it is obvious that the Bank is contractually affiliated with the Account and cannot, therefore, be considered a department of the bank.[16] The prophylactic provision of Section 32 prevents the Bank from being affiliated with the Account.

Furthermore, since it is the conclusion of this court that the Account is in fact an investment fund, the complementary provisions of Sections 20 and 21, 12 U.S.C. §§377 and 378, prohibit the Account from being affiliated with the Bank and the Bank from being affiliated with the Account.

The Comptroller further contends that the inherent dangers with which the integration of these financial activities was previously fraught are not present in the instant relationship, since the Bank only receives a set fee for managing the Account and does not obtain any remuneration from issuing or underwriting the units of participation. This limitation in probable expected remuneration to the Bank may mitigate the possible aggressive use of the Account by the Bank, but this does not override the clear and unequivocal Congressional mandate that national banks be divorced from investment organizations.[17]

It is a legislative process which determines the newly evolving circumstances which require a change in the statutes. The courts can only enforce and interpret the legislative enactments. The statutes presently in force do not allow a national bank to establish, operate, or be affiliated with an investment fund.

In view of the statements and conclusions made above, this court holds that the provisions of Regulation 9 which allow commingling of managing agency accounts do not comply with the statutory provision of the Glass-Steagall Act and are, therefore, illegal. The promulgation of these specific provisions allowing a commingling of managing agency accounts is also beyond the power of the Comptroller under Section 92a(a) of Title 12, and it is ordered to be set aside.

The summary judgment motion of the defendant is denied and motion of plaintiffs is granted.

Counsel for plaintiffs will submit an Order in accordance with the foregoing.

JOSEPH C. MCGARRAGHY, *Judge*.

September 27, 1967.

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[15] *Hearings*, S. 2704 (1966) p. 580–588, *supra*.

[16] Under the provisions of the Account, the participants or a majority of the independent members of the Committee could sever relations with the Bank by electing not to renew the contractual management agreement; practically this may never occur; however, it is possible under the present structure of the Account.

[17] The possible conflicts of interests between the Account and other aspects of the bank's activities are still present, notwithstanding the precautions which were taken by the Comptroller in delineating the powers of the Account. See *Banks and Mutual Funds*, Comment, 20 Sw.L.J. 334, 341, 342.

Mr. McConnel. In our statement we have referred with quotes to that case. The court in that case pointed out many similarities between a mutual fund and a bank commingled account and concluded that the account "is an equivalent investment vehicle to a mutual fund and that the units of participation are in fact securities."

We strongly concur in the conclusion of the court and believe that it is readily apparent that bank collective investment accounts—hereinafter referred to as CIA—are securities and that proposals to authorize banks to issue and sell them involve the same considerations that exist with respect to banks dealing in any other type of corporate securities.

After careful review of the experience of bank affiliates in the securities business, Congress in 1933 in the Glass-Steagall Act concluded to divorce the banking business from the security investing business.

Rather than repeat the many reasons which were stated at that time for such a divorce of banking from investment securities, we call to your attention the decision of the court in the recent Investment Company Institute case referred to above.

Now if you will bear with me and turn to page 11.

The Senate, in 1967, passed Senate bill 1306 to authorize banks to underwrite and deal in municipal revenue bonds which are eligible for bank investment. The IBA opposed, and still opposes, this expansion of the security dealer activity by commercial banks. However, the current issue raised by this amendment is an open entry by the banks into the sale and distribution of corporate securities, that is, common stocks and bonds.

We believe that the Glass-Steagall Act will be effectively abrogated and that rather than benefit from more competition the ultimate results will be detrimental to the public.

More specifically, it seems to us that a few apparent dangers in authorizing banks to create and sell C.I.A.'s are as follows:

1. The potential acquisition of large dollar amounts of equity securities in bank C.I.A.'s will further strengthen the banks' potential authority to elect corporate directors and thereby increase the degree of bank control in corporate affairs.

2. Since Congress this year has expressed some concern over the growing institutionalization of the securities markets, it is particularly important to note that the millions of depositors in the large banks would provide a built-in group of readily accessible customers for C.I.A.'s who might funnel their equity investments through the banks rather than into a wide variety of securities distributed by investment brokers and dealers.

3. The possibilities of conflicts of interest within banks could develop as companies whose securities are held in a bank C.I.A. portfolio apply for loans and as banks consider investment in the securities of a company which has been a substantial borrower or depositor.

These are illustrative of some problems which may be created by banks in the proper administration of their banking functions as distinguished from their interest in sponsoring a collective investment account.

For the reasons summarized above, we strongly urge the committee not to adopt the amendments which would authorize banks to create and sell commingled investment accounts.

Banks engaging in any phase of the securities business, in our opinion, should be subject to the same regulatory requirements and supervision by the SEC as other persons engaged in that business.

Such regulation is essential to provide investors the protection intended in Federal regulation of securities and to avoid competitive advantages among those engaged in the same business.

At present, brokers and dealers subject to the Securities Exchange Act of 1934, are required to pass examinations to demonstrate their knowledge of the securities business and to comply with specified rules of conduct.

The rules of conduct include detailed requirements for fair dealing with customers and that an investment be suitable for the customer under standards prescribed by the SEC and/or the NASD.

At present, persons employed by banks in the sale of securities are not subject to any of these requirements because section 3(a) (4) of the Securities Exchange Act defining broker specifically provides that it does not include a bank and the definition of dealer in section 3(a) (5) likewise does not include a bank.

It is no answer that banks and their employees are subject to supervision by other agencies of the Federal Government, or that other such agencies can impose requirements substantially like those administered by the SEC.

The purpose and the experience of other Federal bank regulatory agencies are primarily aimed at protecting depositors and persons in a fiduciary relationship with banks but not the protection of investors in securities.

Accordingly, we believe that the public will be best protected in securities transactions as Congress intended and that there will be equality of regulation of transactions in the securities business only if banks and their employees are treated as any other broker or dealer when they engage in the securities business.

Therefore, if banks are authorized to engage in the issuance and sale of collective managing agency accounts, which are simply a bank-sponsored mutual fund, we urge that section 3(a) (4) and section 3(a) (5) of the Securities Exchange Act be amended to delete the exception for banks.

Thank you very much, Mr. Chairman.

Mr. Moss. Thank you, Mr. McConnel.

Mr. Keith?

Mr. KEITH. We have a very full schedule, particularly for Friday; I would like, if possible, Mr. Chairman, to waive my questions now with the thought that after we have heard other witnesses we might perhaps question this panel later on if time permits.

Mr. Moss. If time permits, the chairman is always willing to entertain the motion to recall any witness that the committee desires.

Mr. KEITH. I might ask as to the convenience of these panelists here. I am trying to suit the schedule of Congress as well as the witnesses.

Could you come back this afternoon?

Mr. MCCONNEL. We will make ourselves available.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Moss. Mr Murphy.

Mr. MURPHY. No questions, Mr. Chairman.

Mr. Moss. Mr. Stuckey.

Mr. STUCKEY. No questions at this time, Mr. Chairman.

Mr. Moss. Mr. McConnel, I have no questions at this time. I want to thank you and your colleagues. If Congressman Keith makes his request this afternoon, we will recall you.

Mr. McConnel. Thank you very much.

Mr. Moss. The next witness is Mr. John R. Haire, chairman of the board of governors, Investment Company Institute.

STATEMENT OF JOHN R. HAIRE, CHAIRMAN, BOARD OF GOVERNORS, INVESTMENT COMPANY INSTITUTE; ACCOMPANIED BY ROBERT L. AUGENBLICK, PRESIDENT AND GENERAL COUNSEL

Mr. Moss. I note you have a long statement and then you have a summary statement. Would you like to have the long statement included in the record at this point?

Mr. Haire. Yes, we would appreciate having the longer statement in the record at this point and then the shorter statement is designed to summarize for the committee the longer statement.

Mr. Moss. Without objection, and hearing none, that will be the order of the Chair.

(The statement referred to follows:)

Statement of John R. Haire, Chairman, Board of Governors, Investment Company Institute

My name is John R. Haire. I am Chairman of the Board of Governors of the Investment Company Institute, on behalf of which I am testifying. The Investment Company Institute is an association of 204 open-end investment companies, popularly called "mutual funds," and their investment advisers and principal underwriters. Our member mutual funds have about 4 million shareholders and over $42 billion of net assets, which represents 93% of the total net assets of the mutual fund industry.

Appearing with me is Robert L. Augenblick, the Institute's President and General Counsel.

The Institute appreciates this opportunity to express our views concerning the new provisions in H.R. 14742 which differentiate it from H.R. 9510 and H.R. 9511.

Institute representatives testified last October as to H.R. 9510 and H.R. 9511, which are similar to H.R. 14742 except that the latter substitutes certain amendments agreed to between the SEC and the Institute and also adds certain provisions relating to bank collective investment funds.

Last October we pointed out to this Committee that we had reached agreement with the SEC on 43 of the proposed amendments to the Investment Company Act of 1940. These agreements involved a major effort on our part and a sincere desire to cooperate with the SEC towards improving and up-dating the 1940 Act. We also pointed out to this Committee that we were continuing to work with the SEC to try and reach agreement on Section 8(e) of the Bill (relating to sale of a controlling interest in an investment adviser to a mutual fund) and on Section 20 of the Bill (amending Section 36 of the 1940 Act to permit injunctive action by the SEC on a charge of simple "breach of fiduciary duty"). We have not been able to reach agreement on these Sections 8(e) and 20, and on October 27, 1967 we filed with this Committee for the record the reasons why we believed Sections 8(e) and 20 should not be adopted.

Our testimony last October dealt principally with our opposition to Sections 8 and 12 of the Bill relating to management fees and sales charges and the reasons why we believed that these rate-making provisions were not in the public interest. Our position on these issues continues to be reflected by such testimony, which we shall not repeat today.

We limit our presentation today to a statement of our views concerning the new material in the Bill dealing with bank collective investment funds. We shall, of course, be glad to respond to questions dealing with any provision in the Bill.

Our testimony today deals with three points:

1. The mutual fund industry's position with regard to competition.

2. The major public policy questions which are raised by the Bill's provisions as to banks.

3. The equalization of competitive conditions among all participants if banks ultimately are permitted to enter the mutual fund business.

COMPETITION

I wish to emphasize at the outset that the mutual fund industry is characterized by extensive and intensive competition and does not shrink from newcomers in the field. There are over 200 mutual funds, and their organizations compete actively not only among themselves but with other financial institutions, such as investment counseling firms, banks, insurance companies, and savings and loan associations, in seeking to attract the investor's dollar.

Originally, the mutual fund industry was the child of investment counselors and securities brokers. In recent years, however, there have been many different newcomers to the business, including industrial companies such as International Telephone and Telegraph, Kansas City Southern Industries and Gates Rubber Company. Many major insurance companies, such as, for example, Travelers, Connecticut General, John Hancock and New England Mutual, have announced their intention to enter the mutual fund business, and other large insurance companies will inevitably follow in short order and join the competition.

We have already testified, in connection with H.R. 9510 and H.R. 9511, that we believe the increase of competition, which has accompanied the growth of our industry, is healthy and in the public interest. We pointed out that competition has been effective in substantially reducing costs and improving services to mutual fund investors over the years. We stressed that competition in the open market place is the best means of keeping mutual fund costs as low as possible and performance as good as possible. This was one reason why we saw no need for the extensive system of governmental price controls proposed by the SEC over such an open and competitive industry.

I want to reaffirm this position on competition today. I do wish, however, to point out that there are important public policy questions involved in whether or not banks enter the mutual fund business, and that these public policy questions do not apply to any other entrants into the business. We believe the Congress ought to examine these public policy questions on their own merits. This is quite separate from the matter of competition.

PUBLIC POLICY QUESTIONS

Two of the issues which we believe the Congress ought to examine quite carefully are:

1. Is it detrimental to or consistent with the public interest to permit the concentration in banks of power to conduct an increasing number of businesses which go beyond normal banking activities?

2. Is it detrimental to or consistent with the public interest to repeal the Glass-Steagall Act to the extent of permitting banks to underwrite and sell the securities of their own mutual funds? Do the lessons which led to the passage of Glass-Steagall in 1933 apply sufficiently today to warrant continuing the prohibition against bank entry into the mutual fund segment of the securities business? No mistake should be made about what you are being asked to do. What is proposed as an amendment to a securities law is in fact a partial repeal of the prohibition in effect for 35 years in the banking law against banks selling equity securities to the public.

These are questions of national concern on which the experts may differ. This very possibility of difference makes it important that before reaching a decision this Committee solicit and hear out the representative views of the most responsible and informed members of the business, financial, academic and governmental communities, who have studied the problems of concentration of economic power in large financial institutions and who can assess the lessons of Glass-Steagall in terms of the present day.

It was only about six months ago that the United States District Court for the District of Columbia ruled that the Comptroller's regulations permitting banks to operate mutual funds violated the civil and criminal restrictions of the Glass-Steagall Act which prohibit commercial banks from issuing, underwriting and selling securities. Judge McGarraghy of the District Court also

held that the operation of a bank mutual fund is not a *bona fide* fiduciary activity in which banks can engage under Section 92a of the National Banking Act. I ask permission to introduce, for inclusion in the record, the opinion of Judge McGarraghy in *Investment Company Institute v. Camp*, 274 F. Supp. 624 (D.D.C. 1967).

In light of the Glass-Steagall policies which have been recognized in this recent, authoritative opinion of the District Court, we believe that the burden naturally falls upon the proponents of the banking sections of H.R. 14742 to demonstrate that this bank mutual fund activity, illegal under present law, should be sanctioned by this Committee and by Congress.

In raising the public policy questions we are not attempting to answer them. It is not within our special competence to provide the answers. We also recognize that our views would be regarded as suspect because banks are potential competitors. But we think some general background related to the two public policy questions we have raised could be helpful to this Committee.

CONCENTRATION OF ECONOMIC POWER

The first issue is whether it is in the public interest for Congress to extend the power and influence of banks to widely diversified areas of business activities unrelated to normal banking activities. Over the last few years the commercial banking industry has in fact expanded or attempted to expand in the following businesses:

Insurance
Travel agencies
Leasing of trucks, automobiles, and equipment generally
Leasing of computer time and rendering of accounting services
Underwriting of revenue bonds
Issuance of credit cards
Underwriting and distribution of mutual fund shares, a form of equity security

All of these developments collectively represents a radial departure from traditional banking activities. We do not suggest that these developments are all good or are all bad. What we do suggest is that Congress in its oversight capacity should subject these matters to comprehensive review—to ascertain the facts and to explore them in the context of the present economic power of the banking industry. As banks move into other businesses, they also increase their economic and strategic power.

At the end of 1966, commercial bank trust departments held $210 billion under management—about $125 billion of this amount was invested in common stocks. On the deposit side, at the end of 1966 the 50 largest banks held $142 billion. The three largest banks alone held $43 billion—about the same as the assets of the entire mutual fund industry.

Consequently, there is a fundamental question posed by further bank expansion—a question which is an old one but very real—namely, the extent to which banks could dominate the financial and commercial affairs of the nation. The potential for domination does not rest solely on the money under bank control but also on their strategic position in the center of economic life. In every area their central position as lenders and receivers of deposits gives them information and relationships not available to others. For example, if banks were permitted to enter the mutual fund business they would have a unique built-in market among their own customers, including the many people daily streaming through their doors in connection with checking accounts, savings accounts, small loan departments and customer counseling services.

As the banks have entered new fields, their activities have tended to collide with existing legal restrictions. As a result there has been a spate of litigation in the federal courts throughout the country—travel agents have brought suit in Massachusetts; insurance agents sued in Georgia; data processing organizations sued in Minnesota; and suits involving bank underwriting of revenue bonds and bank entry into the mutual fund business were brought here in the District of Columbia.

Three of these cases have now been decided on the merits, at least by the District Courts—the insurance, revenue bond and mutual fund cases.[1] In each

[1] The data processing case was dismissed on the technical ground that the plaintiffs lacked standing to sue, and an appeal has been taken.

case the courts barred entry to the banks. After the decisions in two of these cases—revenue bonds and mutual funds—the banking industry sought legislative relief in Congress. Because the litigation in each case was commenced in a competitive context, it appears that only a narrow question was presented of adjusting the boundaries between specific industries. Thus, none of the cases has been viewed as part of the larger picture. This very hearing is an instance of this phenomenon. Since the Bill only concerns bank entry into one more industry, it is likely to be viewed as merely a question of competition between the two industries.

In considering the matter, this Committee should view it in the larger perspective of the appropriate power and influence of banks—and should also recognize that it is the second installment in the creeping repeal of landmark banking legislation—the Glass-Steagall Act. I suggest that this has not been given the attention it deserves. Probably this is because the Glass-Steagall Act so successfully solved the problem at which it was directed that the very problem it solved is now hard to recognize. It is almost like the medical cases one reads about from time to time of a physician who is unable to recognize a disease which has been all but wiped out by preventive medicine.

I will now turn to the Glass-Steagall issue.

THE GLASS-STEAGALL ACT

The second key policy question before this Committee is whether the reasons which prompted Congress in 1933 to enact Glass-Steagall and to sever commercial banking from the securities business apply today to bank-sponsored mutual funds.

It should be remembered that Glass-Steagall was one of the primary legislative responses to the financial and economic collapse of the late 1920's. As Judge McGarraghy noted in his opinion:

". . . It was not until 1931 when the Congress, graced with hindsight, sought the primary causes of the debacle which enveloped the country and had its repercussions throughout the world. The Congressional inquiry generated various statutes in an attempt to avoid a repetition of the debacle which had transpired. Among these statutes were the Glass-Steagall Act and the Securities Act of 1933.

"The Glass-Steagall Act in particular redefined the powers of the national banks and imposed severe limitations on their activity in the investment security business.

". . . The obvious purpose of these legislative enactments was to divorce the banking business from the security investing business. Congress was so emphatic in promulgating this divorce, that it included a criminal provision to assure the efficacy and continuity of the separation; and in some instances it imposed money penalties and forfeitures. The many pages of legislative hearings reports which preceded the final enactment of the Glass-Steagall Act contain and outline the potential dangers which the involvement of commercial banking in the investment security business created." 274 F. Supp. at pages 644–645.

The dangers of abandoning the well-established policies and prohibitions of Glass-Steagall have been summarized by Eugene V. Rostow, formerly Sterling Professor of Law and Public Affairs at Yale University and now Under Secretary of State, in a statement on S. 2704 in the 89th Congress. We ask that that statement in full be included in the hearings at the conclusion of this testimony. Dean Rostow described the serious issues presented by putting banks into the mutual fund business, as follows:

"The present proposal [for bank entry into the mutual fund business] is justified as a modest enlargement of existing practice and the 'common trust fund' exemption of the securities statutes. But the 'collective investment fund' proposals represent something quite different, and quite new. They would permit the banks to act as investment advisers and managers on a novel scale, going far beyond the historic limits of their fiduciary services. Here, as is often the case, differences of degree become differences in kind.

"The trust business of banks, in the nature of things, derives from the banks' relationships with its customers, with lawyers, and with insurance agents. While a bank's trust accounts hardly come to it from the skies, they do not, on the other hand, normally involve the active daily battle for business characteristic of the work of brokers and dealers. One of the purposes of the Glass-Steagall Act was to keep the banks out of this market, with its built-in and inescapable conflicts of interest. As the House Committee report on the 1935 amendments of the Bank-

ing Act makes clear, the policy of Glass-Steagall was not only to divorce commercial from investment banking, but from 'the securities business' more generally (H. Rept. 742, 74th Cong., 1st Sess. 17 (1935)). That policy stands out strongly in sections 16, 20, 21 and particularly 32 of the Glass-Steagall Act, 12 U.S.C. 24, 377, 378 and 78.

"In the conduct of a trust department of the classical kind, a bank is under no pressure to sell interests in its own 'collective investment trust'. Its fees and commissions as trustee, guardian, or executor do not depend on whether trust assets are managed in the common trust fund, or in a separate account. But if the law develops [permitting bank entry into the mutual fund business], the banks would have a pecuniary interest in advising their customers to purchase interests in their own collective investment funds. In order to assure the success of those funds, furthermore, they might well feel the pressure of an inducement to direct monies under bank control to investments that would not otherwise have been purchased. The bank's stake in the success of its fund could have further consequences. It could, for example, affect the lending policies of the banks, leading them to make loans to those who invested heavily in their collective investment funds. None of these conflicts, save possibly the last, would arise in the course of managing ordinary trust accounts of the older kind, and more especially smaller ones managed through common trust funds. In certain areas—the connection between bank-controlled investments and deposit accounts, for example—the development of collective investment funds would simply increase existing possibilities of abuse.

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"Every phase of economic life depends in the end on the integrity of bankers' decisions guided by the single standard of banking policy. A massive expansion of banks' present activities in the business of buying and selling growth stocks and speculative stocks would constitute a fundamental change in the nature of our banking system, and in its relationship to all parts of the economy." [2]

We believe that these problems which concerned the Congress in 1933, and which may be present as well today, require the most careful study and consideration by this Committee and the Congress in considering any amendment to the Glass-Steagall Act, particularly in light of the District Court's finding in the *Investment Company Institute* v. *Camp* case that:

"The possible conflicts of interest between [a bank mutual fund] and other aspects of the bank's activities are still present, notwithstanding the precautions which were taken by the Comptroller in delineating the powers of [such a fund]." 274 F. Supp., at page 648.

Since the Court has found that the Comptroller's present regulations are insufficient to preclude potential conflicts of interest, it would seem that bank regulatory officials have a burden to make clear to this Committee how—or whether—such conflicts can be avoided.

EQUALIZING COMPETITON

If Congress should, after adequate consideration, decide to permit banks to enter the mutual fund business, we urge, as we have done in the past, that the same rules govern the management of all mutual funds and the sale of their shares. Fairness, and the protection of the public, dictate that no competitive advantage or disadvantage be given to banks, as opposed to other mutual fund sponsors, by different rules resulting in uneven treatment.

The Bill raises serious questions of uneven treatment which discriminates in favor of banks and adversely affects investors.

For example, the effect of Section 5 of the Bill would be to exempt bank mutual funds from important provisions of Section 10 of the Investment Company Act of 1940—namely, from Section 10(a) (requiring that at least 40% of the fund's directors be independent of the investment adviser), of Section 10(b)(2) (requiring that a majority of the fund's directors be independent of the principal underwriter), of Section 10(b)(3) (prohibiting a majority of the fund's directors from being persons who are affiliated with investment bankers), and from Section 10(c) (prohibiting a majority of the fund's directors from

[2] Collective Investment Funds, Hearings on S. 2704 Before a Subcommittee of the Senate Committee on Banking and Currency, Eighty-Ninth Congress, 2d Sess., (March 8, 10 and 11, 1966) pp. 80–81.

being officers or directors of any one bank). Yet, all other mutual funds are subject to the restrictions of Sections 10(b)(3) and 10(c), and only certain no-load funds meeting prescribed conditions are exempt from the restrictions of Sections 10(a) and 10(b)(2). No valid reason appears for singling banks out for such preferred treatment. In fact, a bank in the mutual fund business would have inherent conflicts of interest, which would make the preferential treatment all the more anomalous.

The Bill would also exempt interests in bank-administered Keogh retirement plans for the self-employed from the Securities Act of 1933 and the Securities Exchange Act of 1934 unless the SEC should determine that such interests require the protection of these Acts. On the other hand, interests in Keogh plans which are not administered by banks are affirmatively subject to these Acts. The rules concerning exemptions from these laws should be uniform for interests in all these plans.

Under the Bill it is not clear to what extent, if at all, those bank employees who would sell shares in commingled funds for managing agency accounts would be subject to the requirements of the Securities Exchange Act of 1934 for registration, examination, training and supervision which apply to those who sell other mutual funds. There is no reason to suppose that a bank employee is any less in need of regulatory supervision than salesmen employed by broker-dealers. The protection of investors requires that it be made clear in the Bill that the existing requirements for training and supervision of mutual fund salesmen apply equally to the selling agents of banks which aggressively merchandise mutual funds.

We are seriously concerned over the dangerous implications of the absolute exemption from the Securities Act of 1933 and the Securities Exchange Act of 1934 that Sections 27(b) and 28(b) of the Bill would give to bank common trust funds.

A common trust fund has traditionally been a collective fund maintained by a bank for monies received by it in its strictly fiduciary capacity, as trustee, executor, administrator or guardian. These common trust funds have heretofore been excused by the SEC from registration under the Securities Act of 1933 on the theory that the bank was not making a public offering of participations in the fund.

Yet, banks might choose, as some have tried in the past, actively to merchandise participations in their common trust funds as an investment vehicle for the public at large. For example, the pooling in a "common trust fund" of funds received by the bank through documents in trust form but freely revocable at will by the investor, involves the equivalent of a mutual fund. I note that the use of common trust funds, including the device of revocable trust, as a public investment vehicle was recently referred to with approval by a Senior Vice President of the Pittsburgh National Bank in an address given on October 27, 1967 before the 41st Western Regional Trust Conference sponsored by the Trust Division of the American Bankers Association, as follows:

"The public deserves this [investment] service and they are going to get it. Whether they get it through our customary vehicles, the agency account and the revocable voluntary trust, or through the more novel approaches to them, such as the Common Fund operated in the nature of a mutual fund, or almost inadvertently through the Casner type revocable trust designed to avoid probate and giving investment advice almost incidentally, I don't know. I am inclined to think we are going to get into the small investor market one way or the other and when you consider the habit patterns we already have established with the depositor at our windows, it should be a relatively easy transition to persuade him to invest in one of our funds in addition to or in lieu of investing in one of our savings accounts or one of our other pieces of commercial paper. This may represent the mass market sales outlet we need to bring in big money with minimum mass sales hours per sale." (Trusts and Estates, November, 1967, page 1026)

The protection of the investing public requires that mutual funds operated under the guise of bank common trust funds should be subject to regulation under the securities laws just like all other mutual funds. Participations in such bank funds should also be sold to the public only when accompanied by a full-disclosure prospectus; their sales literature should also conform to the rigid SEC Statement of Policy which is administered by the NASD and the SEC;

investors should also receive periodic reports concerning the fund; and the other protections of the securities laws should not be denied to the investing public.[3]

Then, the indirect manner in which the Bill repeals the Glass-Steagall prohibitions against bank-sponsored mutual funds results in uneven treatment between the banking industry and the mutual fund industry. Paragraph (i) to Section 22 of the 1940 Act, proposed to be added by Section 12(e) of the Bill, provides that no provision of law shall prevent the operation of a bank-sponsored mutual fund which is operated in compliance with regulations of the Comptroller of the Currency. This leaves standing the prohibitions of Glass-Steagall—12 U.S.C. §§ 24, 378, 377, 78—which would prevent a mutual fund organization from engaging in the banking business. If banks are permitted to enter the mutual fund business, then fairness requires that mutual fund organizations, satisfying applicable requirements of banking law, should be permitted to enter the banking business. We believe that if Glass-Steagall is to be repealed, this should be done directly by repealing the applicable sections of the banking law, not indirectly by adding a section to a securities law.

Moreover, it would be anomalous, to say the least, to permit mutual funds sponsored by banks to have banking directors (only one non-banking director for a bank fund would be required by the Bill) and at the same time continue to deny to other mutual funds the right to have even a single bank director on the fund's board. Yet, this is what would happen because of Section 32 of the Glass-Steagall Act which prohibits an officer, director or employee of a bank from serving in a similar capacity in an organization "primarily engaged in the issue, flotation, underwriting, public sale, or distribution" of securities. The Federal Reserve Board has consistently held that a mutual fund is engaged in the issue of securities and has therefore interpreted Section 32 as a bar against a bank director serving as a director of a mutual fund. This has seriously hampered mutual funds in their search for competent independent directors. If a bank director is eligible to serve as director of a bank-sponsored mutual fund,

In any event, the proposed new paragraph (i) to Section 22 of the Act is much too ambiguous. It can possibly be interpreted as ousting the SEC from effective jurisdiction over bank-sponsored mutual funds in favor of regulatory jurisdiction by the Comptroller of the Currency. The proposed paragraph (i) states that "No provision of law shall be deemed to prevent the creation or operation of a . . . [mutual] fund maintained by a bank . . . if such fund is created and operated in compliance with any applicable regulations of the Comptroller of the Currency." The 1933 Securities Act, the 1934 Securities Exchange Act and the 1940 Investment Company Act are all "provisions of law." Read literally, paragraph (i) of the Bill could be interpreted to mean that no matter how a bank-sponsored mutual fund violated the securities laws or SEC rules, it could nevertheless be operated if it complied with the Comptroller's rules.

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[3] These protections are all the more important as banks treat their trust department relationships to their customers more and more on an assembly line rather than a personal basis. This adoption of the assembly line approach was advocated as early as 1963 in a talk by Mr. G. T. Lumpkin, Jr., vice-president of the Wachovia Bank and Trust Co. of Winston-Salem, N.C., at the Midwinter Trust Conference of the American Bankers Association on February 5, 1963, as follows:

"This is a dramatic change in the nature of trust business. We must meet it with a mind open to possible dramatic change in approach. Rather than the close personal basis on which other types of trust service have been handled, we must look toward an assembly line approach, a semiautomated approach, or even possibly a fully automated approach. Rather than a daily, weekly, or monthly personal contact with a trust customer, we must look to an indirect yearly contact, in many cases through an annual statement mailed to his home or business address. Rather than a trust customer judging us on his intimate knowledge of our service to him to fill his personal needs, he will be judging us strictly on the investment return he receives. Rather than a man-to-man relationship, we must consider a machine-to-man concept of fiduciary service." (Hearing on Common Trust Funds Before Subcommittee of Committee on Government Operations, May 20, 1963, pages 6–7).

Aggressive promotion of bank trust service is also illustrated by the article at pages 652–659 in the July 1964 issue of Trust and Estates by a vice-president of a large Philadelphia bank. The article is entitled "Contest for Trust Business" and urges the application of "corporate sales techniques to fiduciary services." The author points out that his bank has established quotas for its "trust development officers," that in his view that same sales principles that apply to "door-to-door selling of household appliances" can be adapted to "trust solicitation" including "seeking out the prospect and asking for his business;" that his bank has established a "100 Per Scenter Club" formed to "place adrenalin in the blood stream of the men in the trust new business division" and in addition a "Pointer and Setter" contest with prizes to the commercial officers furnishing leads contributing to new trust business; that over the years the bank has effected many changes and techniques "resulting in concepts that place many arrows in the salesman's quiver to

We have attached to this statement, for the record, an appendix which deals further with technical aspects of the banking provisions of the Bill and also with problems of unequal treatment.

APPENDIX TO STATEMENT OF JOHN R. HAIRE, INVESTMENT COMPANY INSTITUTE

In addition to its impact on the function of banks and the structure of the banking laws, the Bill would rewrite several important provisions of the securities laws—provisions which are essential to the adequate protection of investors. In certain areas, interests in funds sold by the banks to the public in the same manner as shares in mutual funds are afforded special treatment which is neither necessary nor appropriate. An example would be their immunity in certain cases even from the proposed requirement in H.R. 14742 that management fees be "reasonable"—or the possible, if not probable, exemption of personnel who sell bank-sponsored mutual funds from the requirements of registration, examination, training and supervision which apply to those who sell other mutual funds.

This Committee should look closely at any Bill which would alter in a fundamental manner the basic legislation of the securities industry and which would tend to dilute investor protection, while at the same time conferring competitive advantages on those funds sponsored by banks.

Our comments in this Appendix are divided into two parts: first, our suggestions for clarifying the basic sections of the Bill as they relate to the general treatment of bank collective funds under the securities acts; and, second, our comments with respect to those parts of the Bill and existing statutes which would give special treatment to banks as retail distributors and sponsors of certain types of bank collective funds.

I. GENERAL APPLICATION OF THE SECURITIES LAWS TO BANK COLLECTIVE FUNDS

A basic source of confusion in the Bill is its use of the term "common trust fund." That term is presently used in the 1940 Act in connection with collective funds maintained by banks for the investment of assets held by the bank in its traditional fiduciary capacity as trustee, executor, administrator, or guardian—Section 3(a)(3). While it is far from clear, it appears that the term is used in this Bill not only in this traditional sense but also to include a collective fund for managing agency accounts—see Sections 2(4), 27(a), 27(b), 28(a) and 28(b) of the Bill.

Although the Bill uses the term "common trust fund" in several senses, the Bill deals with four general types of collective funds. It would avoid confusion if these four types were the subject of four statutory shorthand definitions. A description of each type follows:

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assist him in the presentation and closing of his sale;" that to "assure continual awareness of the contest, an additive, or pep pill, was injected periodically" taking the form of brochures including "a jotter pad with a Bird-Dog Evaluator Estate Tax Table" and the article closes with the admonition "Happy Hunting."

Then, in the February, 1968 issue of Trust and Estates, Mr. W. Hayes Gowen, Jr., Trust Officer of First National Bank of Memphis,, Tennessee, wrote that bank trust departments should use advertising to sell their investment services and gave one of his bank's newspaper ads as an illustration, as follows:

"The more securities you own, the more details there are to cope with—keeping track of purchases, sales, dividend and interest payments, calls, options, deadlines, deliveries, etc.

" 'Fast, fast, fast relief from administrative headaches.

'Why not take the painless way out and let the professionals at First National Bank handle these chores for you? With a First National investment management account your records will be kept accurately, your rights exercised on time. Above all, you'll get a personal investment service of the first caliber, administered by a team of experienced, highly skilled specialists utilizing some of the finest research sources in the nation.

'Ask any bank officer.' "

and then added one of his bank's radio spots as an illustration, as follows:

" 'People are often better at making money they holding on to it. That's because there usually aren't enough hours in the day to do both. It takes every bit as much time, skill, watchfulness to manage money as it does to make it in the first place.

'Okay, what is the solution? One well worth looking into is the investment management service of First National Bank. The people at First have the collective skills, training, and seasoned judgment required to handle any size or type of investment program. They have fast, direct access to the nation's best research resources and they are set up to relieve you of all the time consuming details involved in exercising rights, collecting interest, and keeping records.

'In short, First National Bank of Memphis can offer you investment service of the highest professional caliber. Why not call one of our trust officers today and get the facts.' "

1. Common Trust Funds

This would apply to the present collective funds historically used by banks in their capacity as *bona fide* trustee, guardian, administrator or executor so long as no public offering is involved.

2. Collective Funds for Pension Trusts

This would apply to non-"Keogh" type pension trusts and to profit sharing or other trusts qualified under Section 401 of the Internal Revenue Code.

3. Collective Funds for Self-employed Individuals

This would apply to the collective trusts qualified under Section 401 and used to fund the individual retirement trusts for self-employed individuals which are also qualified under Section 401. They are commonly known as "Keogh" plans.

4. Collective Agency Accounts

This would apply to the bank's collective fund for its managing agency accounts, such as the mutual fund sponsored by the First National City Bank, and the other collective funds of banks not covered by the above three definitions.

We suggest that, if the substance of the Bill be approved, statutory definitions of these four types be included in the Investment Company Act of 1940 (the "1940 Act"), the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act").[1]

Assuming these definitions would be used throughout the statutory language, we have the following comments with respect to the appropriate application of the securities acts to the various types of collective funds:

A. *Common Trust Funds*

These funds have been exempt from registration under the 1940 Act since its enactment. On the theory that no public offering of a security involved, the SEC has not required participations in these funds to be registered under the 1933 Act. We agree with the Commission that this is appropriate. However, it should be realized that there is nothing in the present Bill to prevent a bank from using this trust form of security for wide-scale merchandising to the public of what in effect is a mutual fund. Massachusetts Fund[2] is an example of a type of fund which would be exempt under the Bill if it were sponsored by a bank. If such a fund is publicly offered or promoted, there is no reason why investors should not be protected by the disclosure requirements of the 1933 Act, and by the 1940 Act and 1934 Act as well. As the Commission has recognized, from time to time a bank has undertaken aggressively to promote and advertise the availability of its common trust fund as an investment medium.[3] For such cases the SEC has taken the position that the common trust fund so promoted is exempt neither from the 1940 Act nor from the 1933 Act.[3] In particular, if Congress believes that the proposed section of H.R. 14742 concerning reasonableness of management fees should be enacted, this should certainly apply to bank-sponsored common trust funds which are actively merchandised to the public.

It is suggested that this problem might be solved by excluding from the definition of a common trust fund, those funds in trust form which should be subject to the investor protections of the securities acts—for example, by adding at the end of the statutory definition of common trust funds "but not including such funds which the Commission determines are involved in a public offering."

There is a further problem in the proposed amendments to the 1933 and 1934 Acts. In order to establish that the anti-fraud provisions of Section 17 of the 1933 Act and Section 10 of the 1934 Act apply to participations in common trust funds these participations should be defined as securities. (The same comment applies to collective funds for pension trusts).

B. *Collective Funds for Pension Trusts*

Collective funds used by banks as a vehicle to solicit pension fund business from corporations are given an absolute exemption under the Bill from registration requirements of the 1933 Act and the provisions of the 1934 Act. They are presently exempt from the 1940 Act under Section 3(c)(13).

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[1] If the Committee believes that legislation along these lines is appropriate, the Institute would be glad to suggest appropriate statutory language.

[2] A Boston based open-end investment company in the trust form with $143,000,000 in assets and sold to the public with a conventional 8½% sales charge.

[3] See testimony of William L. Cary, Chairman, SEC, Hearings Before Subcommittee of Committee on Government Operations, House of Representatives, 88th Cong. 1st Sess. May 20, 1963, pages 4–5.

In the past the Commission has taken the position that the banks were not making a public offering of participation in these funds and thus did not require 1933 Act registration. This may be appropriate under the circumstances as they exist in particular instances. However, these collective funds may be utilized by thousands of small corporations for their pension funds. If large banks by themselves and through their many correspondent banks actively market and promote interests in these funds as part of their pension fund business, there is no good reason why these small businesses should not have at least the disclosure protection of the 1933 Act. The financial data of the collective fund, its operating expenses and its performance are certainly relevant to the corporate buyer.

The Commission has pointed out other instances where blanket exemptions from the 1933 Act are not appropriate—for instance, when a corporation's qualified pension plan is funded by stock of the corporation itself.[4] These types of funds can be aggressively marketed to small businesses which may be as unsophisticated in this field as are self-employed individuals. Both are in need of the protection of the 1933 Act. Rather than a blanket exemption the Commission should be given discretionary power to determine when and under what circumstances investors need the disclosure and other protection of the securities acts. Thus, as in the case of Keogh plans, the exemption from the 1933 Act and the 1934 Act for collective funds for pension trusts contained in Sections 27 and 28 of the Bill should be discretionary. Furthermore, it is appropriate and within the pattern of other discretionary exemptive powers under the securities acts that the determination which the Bill required of the SEC should be reversed so that the securities of both these funds and the Keogh plans would be subject to the 1933 and 1934 Acts unless the Commission determines that this is *not* necessary in the public interest and for the protection of investors.[5]

The Commission has suggested that if the banks are to be given a complete exemption, perhaps the insurance companies, selling identical products, should be put on an equal basis. However, the Commission attempts to distinguish bank collective funds for corporate pension fund monies from the insurance companies' group accounts on the basis of a possible sales load the insurance companies may charge.[6] This is untenable because the disclosures required under the 1933 Act are important to the investor whether or not he has paid a sales charge. There is also the possibility that banks will aggressively merchandise these funds if some of them are not already doing so. Nothing in the Bill prohibits the banks from charging sales loads for collective funds involving corporate pension plans (or Keogh plans). But whether compensated by internal bonuses or sales commissions, the distribution potential of the personnel of hundreds of branches of large banks and their many correspondent country banks is likely to outweigh that of the agents of many insurance companies.

C. *Collective Funds for Self-employed Individuals (Keogh Plans)*

The Bill provides that Keogh plans sponsored by banks should be exempt from the registration requirements of the 1933 Act unless the SEC determines that they require the protection of the Act. We agree with the SEC that collective trusts for Keogh plans should always be subject to the fraud provisions of the 1933 Act. This can be accomplished by defining these interests as a security.

It should also be made plan that these collective funds are subject to the fraud provisions of the 1934 Act. This can be accomplished by defining the participations in the funds as securities for 1934 Act purposes, even if the Commission determines that Sections 12, 13, 14 and 16 of the Act need not apply.

One may also raise the question why the partcipants in a bank-sponsored Keogh fund should not be given the protection of the 1940 Act such as those afforded by Section 17 and other conflict of interest provisions in the same manner as these sections protect participants in a mutual fund-sponsored Keogh plan. Moreover, it is difficult to see why a statutory standard of reasonableness for management fees, if adopted, should not apply to a bank-sponsored Keogh fund which aggregates the assets of individuals in the same way as plans sponsored by mutual funds.

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[4] Hearings before Senate Committee on Banking and Currency on Amendment No. 438 to S. 1659, 90th Cong., 1st Sess., page 1341.

[5] The SEC's discretionary exemptive power is framed in this manner in Sections 3(b) and 3(c) of the 1933 Act and Sections 12(e), 12(f)(6), 12(g)(3) and 12(h) of the 1934 Act.

[6] Hearings on Amendment No. 438 to S. 1659, page 1332.

D. *Collective Agency Accounts*

The Bill apparently intends to codify the views of the SEC in this area—namely, that these collective accounts are investment companies subject to registration under the 1940 Act and participations in such funds are considered securities for purposes of the 1933 Act and 1934 Acts. We agree with these SEC views.

II. SPECIFIC PROBLEMS

The Bill raises a number of other substantive problems with respect to dilution of investor protection and favoring the competitive position of banks.

A. *Banks Acting as Broker-Dealers under the 1934 Act*

The Glass-Steagall Act in 1933 prohibited banks from underwriting, selling or distributing securities and thus effectively excluded them from the securities business. Consistent with this statutory prohibition, when a year later Congress enacted the Securities Exchange Act of 1934, banks were exempted from the definitions of broker and dealer contained in Section 3 of the 1934 Act. The effect of this exemption relieves banks from those provisions of the 1934 Act which require training, registration and supervision of persons dealing with the public in the retail securities business. Such provisions, together with Commission rules, also impose duties on broker-dealers and their salesmen relating to the suitability of recommended investments for customers.

Under the Bill, banks which sponsor collective agency accounts and collective funds for self-employed individuals would be permitted to re-enter the securities business. They will naturally wish to attract assets to such funds and their personnel will solicit the investment of money in such funds. This involves the sale of the security to the investor. The bank will have an interest in seeing the fund grow, and it is reasonable to assume that personnel of the bank who are successful in bringing assets into the fund will be rewarded by the bank in some form. Such a reward could be effected through bonuses or increased salary in the case of all four types of collective funds discussed in Part I above.

Because of the definitions in Section 3 of the 1934 Act it is arguable that the personnel who sell the fund, as well as the bank, are exempt from the requirement of registration under Section 15(a) of the 1934 Act, are exempt from the requirements of training, qualification and supervision of sales personnel noted above, and are free of all of the other rules adapted by the Commission under the 1934 Act in the public interest and for the protection of investors.

For the protection of investors the banks which sell interests in these funds and their personnel should be held to the same requirements as to record keeping and examination, training and supervision as persons who sell shares of other mutual funds.

Accordingly, we believe that the definitions of broker and dealer in the 1934 Act should be modified so as to include a bank insofar as it maintains a collective agency account or a collective fund for self-employed individuals or a publicly offered common trust fund and any other bank which sells an interest or participation in any such fund.

B. *The Amendments to Section 10 of the 1940 Act*

The amendment to Section 10(d) of the 1940 Act, proposed by Section 5(d) of the Bill would, in its effect, undercut the investor protections of Section 10(c) and Section 10(b)(3) of the 1940 Act. Section 10(c) provides that a majority of the directors of an investment company may not be made up of officers and directors of any one bank. It was adopted as a response to the SEC's finding in 1940 that bank control of investment companies was inconsistent with the effective protection of investors. Section 10(b (3) requires that a majority of the directors of an investment company shall not be investment bankers or affiliated persons of any investment banker. This too was adopted on the recommendation of the SEC in 1940 as being necessary to protect investors. There has been no showing that the policy of assuring the independence of investment companies from such other financial institutions is irrelevant today or that it should be abrogated.

Although the SEC has granted an exemption from the prohibitions of Section 10(c) in the case of First National City Bank, its decision to do so was based on the specific characteristics of the FNCB's Account such as, for example, its policy of investing for long-term growth, its stated brokerage policy, and the $10,000 minimum investment. There is nothing in the Commission's opinion to

suggest that it would be appropriate to grant similar exemptions to all bank mutual funds in all circumstances.

Furthermore, Section 5(d) of the Bill in amending Section 10(d) of the 1940 Act which allows a fund which meets precise requirements to operate with only one independent director would free a fund from the requirement of Section 10(a) that 40% of the directors must be independent. The provision of Section 10(d) requiring only one independent director was specifically tailored to the investment counsel who sponsored an investment company as an adjunct to his investment counseling business. Yet, the Bill would permit bank collective agency accounts to operate with only one independent director. Even no-load funds which come within the terms of Section 10(d) do not receive this type of preferential treatment. They cannot have a board of directors with a majority of investment bankers, or officers, directors of any one commercial bank. We note that the SEC has opposed the proposal to delete the requirements of Section 10(c) in the case of bank mutual funds.[7]

It might be noted that the SEC rejected the application of the First National City Bank for an exemption to permit it to have only one independent director.

Moreover, in granting the exemption involving the composition of the Board of the First National City Bank mutual fund, the SEC imposed a condition on the bank in recognition of one of the conflict of interest situations in which a sponsor bank could be found. The FNCB mutual fund was prohibited from buying securities underwritten by a syndicate including FNCB so long as any member of the syndicate has not fully disposed of its allotment of securities. The Bill contains no such safeguard against this particular conflict of interest. There is no showing that investor protection does not require such a condition.

We believe that the reasons for the restrictions in Sections 10(b)(2) and 10(c) are just as valid today as in 1940. Moreover, we consider the requirement of Section 10(a) one of the essential features of the 1940 Act which should not be weakened. Accordingly, we urge that Section 5(d) of the Bill should not be adopted.

Mr. HAIRE. Mr. Chairman, my name is John R. Haire. I am chairman of the board of governors of the Investment Company Institute on behalf of which I am testifying today. Appearing with me is Robert L. Augenblick, the institute's president and general counsel.

The institute appreciates this opportunity to express our views concerning the new provisions in H.R. 14742 which differentiate it from H.R. 9510 and H.R. 9511 on which we testified last October.

We shall limit our presentation today to a statement of our views concerning the new material in the bill dealing with bank collective investment funds.

Our testimony today deals with three points:

1. The mutual fund industry's position with regard to competition.
2. The major public policy questions which are raised by the bill's provisions as to banks.
3. The need for equal competitive conditions if banks are permitted to enter the mutual fund business.

COMPETITION

The mutual fund industry is characterized by extensive and intense competition and does not shrink from newcomers in the field.

There are over 200 mutual funds, and these organizations compete actively not only among themselves but with other financial institutions, such as investment counseling firms, banks, insurance companies, and savings and loan associations, in seeking to attract the investor's dollar.

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[7] Hearings on Amendment 438 to S. 1659, page 1338.

One of the distinguishing characteristics of the mutual fund industry has been the large number of new entrants into the business. In recent years these have included industrial companies such as International Telephone & Telegraph, Kansas City Southern Industries, and Gates Rubber Co. Many major insurance companies, such as, for example, Travelers, Connecticut General, John Hancock, and New England Mutual, have announced their intention to enter the mutual fund business, and other large insurance companies will inevitably follow in short order and join the competition.

We have already testified, in connection with H.R. 9510 and H.R. 9511, that we believe the increase of competition, which has accompanied the growth of our industry, is healthy and in the public interest.

I want to reaffirm this position on competition today. I do wish, however, to point out that there are important public policy questions involved in whether or not banks enter the mutual fund business, and that these public policy questions do not apply to any other entrants into the business.

We believe the Congress ought to examine these public policy questions on their own merits. This is quite separate from the matter of competition.

PUBLIC POLICY QUESTIONS

Two of the issues which we believe the Congress ought to examine quite carefully are:

1. Is it really consistent with the public interest to permit the concentration in banks of power to conduct an increasing number of businesses which go beyond normal banking activities?

2. Is it really consistent with the public interest to repeal provisions of the Glass-Steagall Act to permit banks to sell common stocks to the public in the form of their own mutual funds? Do the lessons which led to the passage of the Glass-Steagall Act in 1933 still apply sufficiently today to warrant continuing the bar against bank entry into the securities business? No mistake should be made about what you are being asked to do. What is proposed as an amendment to a securities law is in fact a partial repeal of the prohibition in effect for 35 years in the banking law against banks selling common stocks to the public.

These are questions of national concern on which the experts may differ. This very possibility of difference makes it important that Congress solicit and hear the informed members of the business, financial, academic, and governmental communities who can assess the lessons of Glass-Steagall in terms of the present day.

It was only about 6 months ago that the United States District Court for the District of Columbia ruled that bank operation of a mutual fund violated the civil and criminal provisions of the Glass-Steagall Act which prohibits commercial banks from selling securities.

Attached to my statement is the opinion of Judge McGarraghy in *Investment Company Institute* v. *Camp*, 274 F. Supp. 624, 648 (D.D.C. 1967).

(The case referred to, previously submitted by the Investment Bankers Association of America, appears on p. 57.)

Mr. HAIRE. In light of the Glass-Steagall prohibitions which have been recognized in this recent opinion of the District Court, we believe that the burden must fall upon the proponents of the banking sections of H.R. 14742 to demonstrate that this bank mutual fund activity, illegal under present law, should be sanctioned by this committee and by Congress by repeal of these prohibitions.

In raising the public policy questions we are not attempting to answer them. It is not within our special competence to provide the answers. We also recognize that our views would be discounted because banks are potential competitors. But we think some general background related to the public policy questions we have raised could be helpful to this committee.

CONCENTRATION OF ECONOMIC POWER

Over the last few years the commercial banking industry has, in fact, expanded or attempted to expand into many business fields which represent a radical departure from traditional banking activities. We do not suggest that these developments are all good or all bad. What we do suggest is that Congress should subject these matters to comprehensive review—to ascertain the facts and to explore them in the context of the present economic power of the banking industry.

As the banks have entered new fields, their activities have tended to collide with existing legal restrictions. As a result there has been substantial litigation in the Federal courts throughout the country—travel agents brought suit in Massachusetts; insurance agents sued in Georgia; data processing organizations sued in Minnesota; and suits involving bank underwriting of revenue bonds and bank entry into the mutual fund business were brought here in the District of Columbia.

Three of these cases have now been decided on the merits by the District Courts—the insurance, revenue bond, and mutual fund cases. In each case the courts ruled that the law barred entry into this new business by the banks. After the decisions in two of these cases—revenue bonds and mutual funds—the banking industry sought legislative relief in the Congress. Because the litigation in each case was commenced in a competitive context, it may have appeared that only a narrow question was presented concerning the boundaries between specific industries. Thus, none of the cases has been viewed as part of the larger picture. This very hearing is an instance of this phenomenon. Since the bill only concerns bank entry into one more industry, it is likely to be viewed as merely a question of competition between two industries.

In considering the removal of the prohibition against commercial banks entering the mutual fund field, this committee should recognize that this is just another installment in the banks' continued attempt at creeping repeal of landmark banking legislation—the Glass-Steagall Act. I suggest that this has not been given the attention it deserves. Probably this is because the Glass-Steagall Act so successfully solved the problem at which it was directed that the very problem it solved is now hard to recognize.

It is almost like the medical cases one reads about from time to time of a physician who is unable to recognize a disease which has been all but wiped out by preventive medicine.

THE GLASS-STEAGALL ACT

The key policy question before this committee is whether the reasons which prompted Congress, in 1933, to enact the Glass-Steagall Act and to divorce commercial banking from the securities business still apply today to bank-sponsored mutual funds.

It should be remembered that Glass-Steagall was one of the primary legislative responses to the financial and economic collapse of the late 1920's.

A basic provision of the Glass-Steagall Act, section 21, is that "it shall be unlawful . . . for any person . . . engaged in the business of issuing, underwriting, selling, or distributing . . . securities to engage at the same time . . . in the business of receiving deposits . . .".

As Judge McGarraghy noted in his opinion:

> The Glass-Steagall Act in particular redefined the powers of the national banks and imposed severe limitations on their activity in the investment security business.
>
> . . . The obvious purposes of these legislative enactments was to divorce the banking business from the securities business. Congress was so emphatic in promulgating this divorce, that it included a criminal provision to assure the efficacy and continuity of the separation; and in some instances it imposed money penalties and forfeitures. The many pages of legislative hearings and reports which preceded the final enactment of the Glass-Steagall Act contain and outline the potential dangers which the involvement of commercial banking in the investment security business created.

The dangers of abandoning the well-established policies and prohibitions of Glass-Steagall have been summarized by Eugene V. Rostow, formerly Sterling Professor of Law and Public Affairs at Yale University and now Under Secretary of State, in a statement on S. 2704 in the 89th Congress which is attached to our statement. (See p. 95.)

Dean Rostow summarized the serious issues which would be presented by allowing banks to enter the mutual fund business, as follows:

> A massive expansion of banks' present activities in the business of buying and selling growth stocks and speculative stocks would constitute a fundamental change in the nature of our banking system, and in its relationship to all parts of the economy.

We believe that these problems which concerned the Congress in 1933 require today the most careful study and consideration by this committee and the Congress before it acts to repeal essential provisions of the Glass-Steagall Act.

EQUALIZING COMPETITION

If Congress should decide to permit banks to enter the mutual fund business, we urge, as we have done in the past, that the same rules should govern the management of all mutual funds and the sale of their shares.

Fairness, and the protection of the public, dictate that no competitive advantage or disadvantage be given to banks, as opposed to other mutual fund sponsors, by different rules resulting in uneven treatment.

I might add in this connection we were gratified at the testimony of the American Bankers Association yesterday when they said, and I quote:

> After all deliberation we have concluded that this type of bank fund can successfully be operated under the Federal securities laws on an equal basis with mutual funds.

The bill, however, raises serious questions of uneven treatment which discriminates in favor of banks and adversely affects investors.

First, the effect of the bill would be to exempt bank mutual funds from important provisions of Section 10 of the Investment Company Act of 1940; namely, from the requirement that at least 40 percent of the fund's directors be independent of the investment adviser and that a majority of the fund's directors be independent of the principal underwriter.

It would also exempt banks from the prohibition against a majority of a fund's directors being persons who are affiliated with investment bankers and the prohibition against a majority of a fund's directors being officers or directors of any one bank. Yet, all other mutual funds are subject to the last two restrictions and only certain no-load funds meeting prescribed conditions are exempt from the first two restrictions. No valid reason appears for singling banks out for such preferred treatment. In fact, a bank in the mutual fund business would have inherent conflicts of interest, which would make the preferential treatment all the more questionable.

Second, the bill would also exempt interests in bank-administered Keogh retirement plans for the self-employed from the Securities Act of 1933 and the Securities Exchange Act of 1934 unless the SEC should determine that such interests require the protection of these acts. On the other hand, interests in Keogh plans which are not administered by banks are affirmatively subject to these acts. The rules concerning exemptions from these laws should be uniform for interests in all these plans.

Witnesses for the American Bankers Association testified yesterday that subjecting bank collective funds for Keogh plans to SEC jurisdiction would freeze out of the business 350 of the 497 banks which operate collective investment funds. As SEC Chairman Cohen testified on the McIntyre amendments before the Senate Banking and Currency Committee on November 16, 1967, the SEC has developed a short form of registration statement designed to accommodate collective funds for bank-administered Keogh plans in order to insure that the public receives "adequate and understandable disclosure concerning the risks, obligations, right, and costs which are involved."

As Chairman Cohen pointed out:

> The Securities Act in no way intereferes with the establishment or operation by banks of collective investment funds for H.R. 10 plans.

I should like to add here, too, that for these same reasons we are opposed to a complete exemption from the securities laws for banks' collective funds for corporate pension business.

The SEC has recognized that there are instances where complete exemptions for such plans is not appropriate. One of these cases to which the SEC has referred is the same type of situation to which Congressman Keith referred yesterday; namely, when a corporation's

qualified pension plan for its employees invests in the stock of the corporation, itself.

This is the type of corporate pension plan which the SEC has said is one that should not be exempted from the Act and we would support the SEC's position on that.

Third, under the bill it is not clear that those bank employees who would sell shares in the bank's mutual fund would be subject to the requirements of the Securities Exchange Act of 1934 calling for registration of salesmen and their examination, training and supervision which apply to those who sell other mutual funds. There is no reason to suppose that a bank employee selling an investor a mutual fund is any less in need of training or regulatory supervision than other securties salesmen.

The protection of investors requires that it be made clear in any legislation that the existing requirements for training and supervision of mutual fund salesmen apply equally to those who sell bank mutual funds.

Fourth, we are seriously concerned over the absolute exemption from the Securities Act of 1933 and the Securities Exchange Act of 1934 that the bill would give to bank common trust funds.

A common trust fund has traditionally been a collective fund maintained by a bank for moneys received by it in its strictly fiduciary capacity, as trustee, executor, administrator or guardian. These common trust funds have heretofore been excused by the SEC from registration under the Securities Act of 1933 on the theory that the bank was not making a public offering of participations in the fund.

On the other hand, the SEC has made it very clear that active merchandising of interests in a bank's common trust fund would require full compliance with the Securities Act of 1933 and the Investment Company Act of 1940.

The statutory exemption of their common trust funds which banks are now seeking was portrayed yesterday as designed merely "to avoid any future questions or ambiguities as to the status of common trust funds."

In fact, this statutory exemption would free banks to aggressively merchandise interests in their common trust funds by means of revocable trusts or other devices without any of the protections afforded by the Federal securities laws.

In this connection, let me quote from a speech by a senior vice-president of the Pittsburgh National Bank given on October 27, 1967—just 4 months ago—before the 41st Western Regional Trust Conference sponsored by the Trust Division of the American Bankers Association. He said:

> The public deserves this (investment) service and they are going to get it. Whether they get it through our customary vehicles, the agency account and the revocable voluntary trust, or through the more novel approaches to them such as the Common Fund operated in the nature of a mutual fund, . . . I don't know I am inclined to think we are going to get into the small investor market one way or the other and when you consider the habit patterns we already have established with the depositor at our windows, it should be a relatively easy transition to persuade him to invest in one of our funds in addition to or in lieu of investing in one of our savings accounts or one of our other pieces of commercial paper. This may represent the mass market sales outlet we need to bring in big money with minimum mass sales hours per sale.

Let me point out in passing that one of yesterday's witnesses for the American Bankers Association is an officer of the same Pittsburgh bank. Witnesses for the American Bankers Association testifying yesterday stressed the personal relationship of a bank's trust department with its customers.

Yet another member of the American Bankers Association, speaking at an American Bankers Association Mid-Winter Trust Conference as early as 1963, emphasized the desirability of a trust department assembly line approach on a machine-to-man rather than a man-to-man basis. He said:

> This is a dramatic change in the nature of trust business. We must meet it with a mind open to possible dramatic change in approach. Rather than the close personal basis on which other types of trust service have been handled, we must look toward an assembly line approach, a semi-automated approach, or even possibly a fully automated approach. Rather than a daily, weekly, or monthly personal contact with a trust customer, we must look to an indirect yearly contact, in many cases through an annual statement mailed to his home or business address. Rather than a trust customer judging us on his intimate knowledge of our service to him to fill his personal needs, he will be judging us strictly on the investment return he receives. Rather than a man-to-man relationship, we must consider a machine-to-man concept of fiduciary service. (Hearing on Common Trust Funds Before Subcommittee of Committee on Government Operations, May 20, 1963, pages 6–7.)

The possible aggressive promotion of bank trust service is also illustrated by an article in the July 1964 issue of Trust and Estates magazine by a vice president of a large Philadelphia bank. The article is entitled "Contest for Trust Business" and urges the application of "corporate sales techniques to fiduciary services."

The author points out that his bank has established quotas for its "trust development officers"; that in his view the same sales principles that apply to "door-to-door selling of household appliances" can be adapted to "trust solicitation": including "seeking out the prospect and asking for his business"; that his bank has established a "100 Per Scenter Club" formed to "place adrenalin in the bloodstream of the men in the trust new business division" and in addition, a "Pointer and Setter" contest with prizes to the commercial officers furnishing leads contributing to new trust business; that over the years the bank has effected many changes and techniques "resulting in concepts that place many arrows in the salesman's quiver to assist him in the presentation and closing of his sales"; and that to "assure continual awareness of the contest, an additive, or pep pill, was injected periodically." The article concludes with the phrase "Happy Hunting."

Then in the February 1968 issue of Trust and Estates, Mr. W. Hayes Gowen, Jr., trust officer of First National Bank of Memphis, Tenn., wrote that bank trust departments should use advertising to sell their investment services and gave one of his bank's newpaper ads as an illustration, as follows:

> Fast, fast, fast relief from administrative headaches.
>
> The more securities you own, the more details there are to cope with—keeping track of purchases, sales, dividend and interest payments, calls, options, deadlines, deliveries, etc.
>
> Why not take the painless way out and let the professionals at First National Bank handle these chores for you? With a First National investment management account your records will be kept accurately, your rights exercised on time.

Above all, you'll get a personal investment service of the first caliber, administered by a team of experienced, highly skilled specialists utilizing some of the finest research sources in the Nation.

Ask any bank officer.

These are merely a few illustrations of the type of aggressive merchandising which would undoubtedly be used to sell interests in bank common trust funds if they were exempted by statute from the Federal securities laws.

Fifth, the indirect manner in which the bill repeals the Glass-Steagall prohibitions against bank-sponsored mutual funds would result in uneven treatment between the banking industry and the mutual fund industry.

The bill provides that no provision of law shall prevent the operation of a bank-sponsored mutual fund which is operated in compliance with regulations of the Comptroller of the Currency.

This leaves standing prohibitions of Glass-Steagall which would prevent a mutual fund organization from engaging in the banking business.

If banks are permitted to enter the mutual fund business then fairness requires that mutual fund organizations, satisfying the requirements of banking law, should be permitted to enter the banking business. We believe that if Glass-Steagall is to be repealed, this should be done directly by repealing the applicable sections of the banking law, thereby opening the banking business to mutual fund sponsors for the first time since 1933.

Moreover, it would be unfair, to say the least, to permit mutual funds sponsored by banks to have directors who are bankers and at the same time continue to deny to other mutual funds the right to have even a single bank director on the fund's board.

Yet, this is what would happen because of section 32 of the Glass-Steagall Act which prohibits an officer, director, or employee of a bank from serving in a similar capacity in an organization "primarily engaged" in the public sale of securities. The Federal Reserve Board has consistently interpreted section 32 as a bar against a bank director serving as a director of a mutual fund.

This has seriously hampered mutual funds in their search for competent independent directors. If a bank director is eligible to serve as director of a bank-sponsored mutual fund, he should certainly be eligible to serve as a director of any nonbank mutual fund.

Sixth, we submit that the proposed new paragraph (i) to section 22 of the Investment Company Act is dangerously ambiguous. It can be interpreted as barring the SEC from effective jurisdiction over bank-sponsored mutual funds in favor of regulatory jurisdiction of the Comptroller of the Currency.

The proposed paragraph states that—

No provision of law shall be deemed to prevent the operation of a . . . (mutual) fund maintained by a bank . . . if such fund is operated in compliance with any applicable regulations of the Comptroller of the Currency.

The 1933 Securities Act, the 1934 Securities Exchange Act and the 1940 Investment Company Act are all "provisions of law." This paragraph could therefore be interpreted to mean that no matter how a bank-sponsored mutual fund violated the securities laws or SEC rules,

it could nevertheless be operated if it complied with the Comptroller's rules. This should clearly be corrected.

We believe that in these six ways the present proposal is substantially deficient. Attached to our written statement is an appendix which deals further with technical aspects of the banking provisions of the bill.

Finally, Mr. Chairman, the fundamental public policy decision as to whether banks should be permitted to enter the mutual fund business is for the Congress to decide, but if the answer is affirmative, we strongly urge that the banks be compelled to operate under the same conditions as the rest of the industry.

(The statement of Professor Rostow, referred to on p. 90, follows:)

STATEMENT OF EUGENE V. ROSTOW, FORMERLY STERLING PROFESSOR OF LAW AND PUBLIC AFFAIRS, YALE UNIVERSITY, ON S. 2704, 89th CONGRESS

These "collective investment funds" would be exempted by S. 2704 from the tions of S. 2704 which authorize qualified banks to pool managing agency accounts into "collective investment funds."

These "collective investment funds" would be exempted by S. 2704 from the provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. The banks establishing such funds would, however, be required to file written "plans" with the appropriate supervisory agency as defined in the bill. These plans would set forth the character of the banks' investment funds, and the supervisory agency would approve such plans as in compliance with the statute, or allow them to become effective without specific approval. Regular financial reports would be required of the bank for each fund it maintains. And prescribed financial information would be furnished to investors, and to persons responsible for participation in a collective investment fund. The Comptroller of the Currency would be given power to make rules and regulations under the act, and to make exemptions as well.

The McIntyre bill contemplates that each bank manage its own collective investment fund or funds. (Sec. 4(a)(1).) No provision is made for investor election of directors of the fund, or for the duration or review of management contracts.

The bill would thus give the banks considerable, although not unlimited, authority to establish and conduct open-end investment funds, by pooling managing agency accounts. Such funds would not be regulated by the Securities and Exchange Commission under the Investment Company Act, but by the Comptroller of the Currency under the McIntyre bill, on a different footing, and pursuant to different policies.

S. 2704 raises a number of legal and economic problems. This statement is confined to one: Whether it would be sound public policy to shift the present boundary between mutual funds and banks, as S. 2704 proposes, so as to allow the banks to compete directly with mutual funds, insurance companies, and other financial institutions for a somewhat larger part of the flow of private savings.

The appeal of such a step is that it would encourage more competition among financial institutions for the saver's dollar. But the proposal would also weaken the protections afforded to bank depositors and to the entire financial system by the Glass-Steagall Act of 1933, and the legislation which has followed it. In view of the variety of investment programs now open to the saver, and the extent of competition among mutual funds, brokerage firms, insurance companies, savings banks, building and loan associations, and other financial intermediaries, I conclude on the basis of information presently available that the adverse effect of S. 2704 on the safety of the banking system would outweigh its probable impact in increasing the degree of competition in a market which is already quite actively competitive.

The McIntyre bill is an effort to resolve a controversy between the Securities and Exchange Commission and the Comptroller of the Currency over their respective regulatory jurisdictions. The solution it offers for this administrative problem arises far-reaching issues of policy, however, which in my opinion should not be decided inadvertently, or without benefit of full hearings.

The Glass-Steagall Act of 1933 is a declaration of policy, based on an extended congressional inquiry, and highlighted by the vivid experience of the great depression. It undertakes the statutory divorcement of commercial banking from investment banking, and from many other aspects of the securities business as well. In this respect it is like several statutes basic to the structure of the economy—the commodities clause of the Hepburn Act, for example, prohibiting railroads from engaging in most other forms of business, or the laws requiring a separation between shipping and air transport, between air transport and the manufacture of planes, and the like.

The Glass-Steagall Act, the Supreme Court remarked, is "a preventive or prophylactic measure," designed "to remove tempting opportunities from the management and personnel of member banks." *Board of Governors* v. *Agnew*, 329 U.S. 441, 449 (1947). It includes provisions dealing with a number of specific practices. But its broad remedial purposes are simpler and more comprehensive than the particular means chosen to carry them out.

The Federal Reserve System is the central nervous system of the economy. The possibility of distortion or disturbance in the flow of credit is a matter of absolutely fundamental importance to all aspects of economic life, and to the authorities charged with responsibility for governing it.

I propose to examine S. 2704 in the prospective of this concern.

One should consider the question from the point of view of the investor in a bank's collective investment fund, of the depositor in a bank conducting such a fund, and of the economy at large.

Chairman William L. Cary of the Securities and Exchange Commission discussed the problem definitely from the standpoint of an investor in a bank's collective investment fund before a subcommittee of the House Committee on Government Operations on May 30, 1963. His comments on the Comptroller's Regulation 9, which broadly parallels S. 2704, are cogent and persuasive to me, and I fully concur in them. At the last, Chairman Cary's views require, I conclude, that investors in bank-managed investment pools be protected by the substantive and adjective law of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940.

The problem raised by S. 2704 is quite as serious, however, if examined as a factor in the health of the banking system.

The proponents of the bill point out, quite correctly, that banks have always acted as trustees, and that law and custom have long accepted the propriety of such fiduciary activities on the part of commercial banks. The principle of pooling or commingling trust assets became poppular some 40 years ago. Under proper safeguards, there is no objection to the practice, which enables banks to offer fiduciary services to relatively small estates and trusts.

The present proposal is justified as a modest enlargement of existing practice and the "common trust fund" exemption of the securities statutes. But the "collective investment fund" proposals represent something quite different, and quite new. They would permit the banks to act as investment advisers and managers on a novel scale, going far beyond the historic limits of their fiduciary services. Here, as is often the case, differences of degree become differences in kind.

The trust business of bank, in the nature of things, derives from the banks relationships with its customers, with lawyers, and with insurance agents. While a bank's trust accounts hardly come to it from the skies, they do not, on the other hand, normally involve the active daily battle for business characteristic of the work of brokers and dealers. One of the purposes of the Glass-Steagall Act was to keep the banks out of this market, with its built-in and inescapable conflicts of interest. As the House Committee report on the 1935 amendments of the Banking Act makes clear, the policy of Glass-Steagall was not only to divorce commercial from investment banking, but from "the securities business" more generally (H. Rept. 742, 74th Cong., 1st sess. 17 (1935)). That policy stands out strongly in sections 16, 20, 21, and particularly 32 of the Glass-Steagall Act, 12 U.S.C. 24, 377, 378, and 78.

In the conduct of a trust department of the classical kind, a bank is under no pressure to sell interests in its own "collective investment trusts." Its fees and commissions as trustee, guardian, or executor do not depend on whether trust assets are managed in the common trust fund, or in a separate account. But if the law develops as S. 2704 proposes, the banks would have a pecuniary interest in advising their customers to purchase interests in their own collective investment funds. In order to assure the success of these funds, furthermore,

they might well feel the pressure of an inducement to direct moneys under bank control to investments that would not otherwise have been purchased. The bank's stake in the success of its fund could have further consequences. It could, for example, affect the lending policies of the banks, leading them to make loans to those who invested heavily in their collective investment funds. None of these conflicts, save possibly the last, would arise in the course of managing ordinary trust accounts of the older kind, and more especially smaller ones managed through common trust funds. In certain areas—the connection between bank-controlled investments and deposit accounts, for example—the development of collective investment funds would simply increase existing possibilities of abuse.

The policy of minimizing such conflicts of interest lies behind the language of the various provisions of the Glass-Steagall Act which I have cited. This language should not be interpreted in a restrictive spirit. The purposes of the act are remedial and plain. They are to keep the banks and the securities business apart, in order to prevent the bank's relationship with its customers from being compromised by conflicts of interest which could threaten the effectiveness of banking policy.

But Congress problem with S. 2704 is not to construe the various provisions of the Glass-Steagall Act. It is to decide whether the policy of those provisions should now be followed or modified.

In my opinion, clear rules minimizing the number of occasions when businessmen have to attempt to reconcile conflicting interests are just as necessary today as they were in 1933. To judge one's own case is no easier now this it was then. The consequences of overreaching and breach of trust—especially to the banking system—can be quite as harmful in the present period of prolonged boom as they were during the boom of the twenties and the depression of the thirties. A boom is by definition a period of easy profits—when ethical standards have a tendency to relax, and mistakes of investment policy are often concealed for a time by general prosperity.

Every phase of economic life depends in the end on the integrity of bankers' decisions guided by the single standard of banking policy. A massive expansion of banks' present activities in the business of buying and selling growth stocks and speculative stocks would constitute a fundamental change in the nature of our banking system, and in its relationship to all parts of the economy.

The Glass-Steagall Act is not a sacred text. But it was and remains, a major statement of policy. That policy should be modified or repudiated only on the basis of a full study, discussed in extended hearings. In 1933, the Glass-Steagall Act required the banks to elect whether they would remain in the business of commercial banking or choose to continue their affiliated investment banking and security houses. S. 2704 would allow the banks to take a considerable step toward restoring their security affiliates. Thirty years ago Congress found that relationship subversive to the possibility of good banking. Its decision should not be reversed sub silentio.

It may well be, as the Commission on Money and Credit and other recent studies have urged, that the times require a basic restructuring of the banking system. It is also possible that inquiries of the Securities and Exchange Commission and of other bodies will reveal the need for changes in the conduct and regulation of investment companies, investment advisers, and the business of dealing in securities. These are decisions which should rest on a considered reexamination of past policy in the light of experience.

On the basis of the evidence available to me, I conclude that a policy case for S. 2704 has not been made at this time. In view of the national and, indeed, international importance of the institutions and policies at issue, I should therefore recommend against the passage of S. 2704.

Mr. Moss. Thank you, Mr. Haire.

Mr. KEITH. Would it be convenient for you to stay around until early afternoon?

Mr. HAIRE. Yes, we will be happy to.

Mr. Moss. Mr. Murphy?

Mr. MURPHY. No questions.

Mr. Moss. Mr. Stuckey?

Mr. STUCKEY. Mr. Chairman, I have a couple of very brief questions and then maybe we can get on with the other testimony.

First, Mr. Haire, if you can help me on this, right now I have a tremendous fear of the control that a bank can exercise not only over certain industries, but our whole economy if they are allowed to go into the mutual fund business.

Right now I think the mutual funds control about $50 billion of stocks as compared to about $250 billion of stocks controlled in the trust departments of the banks. To me this is a danger not only in the purchasing power, but also the effect on the market.

I would like to bring up what I think really to be a point of conflict in interest and get your answer on this. I would like to quote, and this is taken from the remarks of Chairman Patman in a speech he made to the American Bankers Association. He says:

> Even the most surface analysis strongly suggests that investment through the Trust Department places the bank in a potential if not real conflict of interest situation. For example, suppose a major bank is invested heavily in a machine tool company. Suppose a competing machine tool company comes to the same bank seeking a large loan to expand its operation. What happens to the bank's loan-making judgment under such circumstances? Does it make the loan on its merits or does it remember it is heavily invested in a competing company and refuse to loan to protect its holdings?

This is an area that scares me tremendously. Also, in this same speech, I was looking at some of the holdings that the banks have now through their trust departments and controls they have over several companies.

To give you an example, and all these stocks are listed on the New York Stock Exchange, one bank controls 13.5 percent of Firestone Tire & Rubber; 12.3 percent of Sherwin-Williams Co.; 18 percent of Odessa Portland Cement Co.; 15 percent of Isle Creek Coal Co.; 14.3 percent of Reliance Electric Engineering Co.

Now, it looks to me as if this is really creating even more of a giant than $250 billion if they are allowed to go into the mutual fund business. Maybe I am running scared. Maybe I see some things where there really aren't any. But with this capacity to increase these holdings, I can perceive in a way that banks could pretty well control a great segment of our economy and, in a sense, force a lot of small banking people out of business.

I see no reason why a bank could not come to my company and say, "Now, we have a mutual fund department. We will consider buying your stock, or we would certainly like to have your account with our bank." Of course, if they purchased a large block of, say, X Company that I was involved in, that would tend to have the stock go up, it would be pretty hard to say no. However, one of these days they are liable to dump the stock on the market and then where am I?

I would like to hear from you. Are my fears unfounded or is this a danger that could come about?

Mr. HAIRE. Certainly this is one of the questions that should be explored very carefully with witnesses much more expert in the banking field than we, before the decision is made by Congress, if it is, to permit banks to expand the areas of additional common stock investment through money received from the public.

In essence, this change in the law would change their role of aggregating common stock investment money from a relatively passive role into one where they are free to go out and aggressively collect money from the public for common stock investment. So to the

extent they were successful in that, whatever problem may exist in the area you referred to would obviously be increased.

Mr. STUCKEY. This may be a partial answer, but if banks wish to create a mutual department in the banking system, it looks to me as if they would be better off by really having their trust departments purchase on the open market a mutual fund that is in existence.

No. 1, and I am sure any purchases would be in the half-million to million dollar price range, they could certainly come in with a no-load charge there, or let us say a load charge of 1 percent, which is to me a low charge, and for the performance that they would get—I was sitting here and looking at the average of all funds, which was 32.8, and it went as high as 115.6 percent. That certainly is an envious record. I wish I had as good.

For 1 percent, I don't see why the banks would not in the long run provide a better service to their customer and, dollarwise, would come out a lot better themselves. If they want to get in the mutual fund business, why not purchase a mutual fund without bringing up the question we have before us today?

Mr. HAIRE. Speaking for the mutual fund industry, I think we would be very happy for them to do so. I think the practical problem is that they are being compensated for providing investment management to those accounts and, therefore, they would not be willing to delegate that management function to someone else because they would then not be able to justify being paid for it themselves.

Mr. STUCKEY. I have no further questions.

Mr. MOSS. Along the same line, I have been interested in your testimony and the appendix which you have offered setting forth certain specific amendments to the bill in the event that the committee should consider favorably the introduction of the banks into the mutual fund industry.

I note that your discussion of the equalization of competition and the effect of section 5 of the bill in exempting the bank mutual funds from the requirement of at least 40 percent of the fund's directors being independent of the investment adviser is predicted upon there being no load.

I think that if you will note section 12(e) of the bill, on page 34, which would add a new paragraph to section 22 of the 1940 Act, you will note that the entire proposal is predicated upon there being no sales load. I note that you are aware of the fact that section 10 has different provisions for no-load funds.

I have also been stuck by your discussion of the conflict of interest arising in the banks' selling of "mutual funds" with the possibility that the bank might favor those who bought the funds by making loans to them, might make investments that otherwise the bank would make, might put some bad bank investments into the trust accounts, and so on.

Of course, it is this very conflict of interest which is the fundamental thesis underlying H.R. 9510 and H.R. 9511, namely, that you and the mutual fund industry are in a position to receive more remuneration as advisers as you, yourself, sell more securities, and in the selling of these securities, you get the assistance of more and more dealers by offering them part of the commissions that arise from the portfolio transactions which you, yourself, directly made.

I simply mention this without at this time stating any conclusion of what should be done, but to emphasize the fact that whatever conflict of interest you say there may be in the banks being in this field, the Commission clearly has testified that the same possibility of conflict of interest is inherent in your operations.

Mr. Keith, do you have any questions?

Mr. KEITH. Not at this time, Mr. Chairman.

Mr. MOSS. I want to thank you gentlemen for your appearance.

The next witness will be Mr. Davidson Sommers, senior vice president and general counsel of Equitable Life Assurance Society of the United States, appearing for American Life Convention and Life Insurance Association of America.

Mr. KEITH. Mr. Chairman, I would like to welcome Mr. Sommers here today and reveal the nature of my relationship to the witness before us.

I went with the Equitable Life Assurance Society in 1938, and to a limited degree I am still an authorized agent for that company. I think that Mr. Sommers and the witnesses here today will have evidence that my line of questioning will not reflect any conflict of interest, but that the knowledge I have obtained in business will be utilized in the public's interest.

Mr. MOSS. Mr. Keith, I want to commend you for the statement you have just made. It reflects credit upon you and upon your personal integrity.

Mr. Sommers, would you introduce, for the record and for the members of the committee, your assistants?

STATEMENT OF DAVIDSON SOMMERS, REPRESENTING AMERICAN LIFE CONVENTION AND LIFE INSURANCE ASSOCIATION OF AMERICA; ACCOMPANIED BY RICHARD J. CONGLETON; AND LAWRENCE J. LATTO, SPECIAL COUNSEL

Mr. SOMMERS. Thank you, Mr. Chairman.

I am accompanied on my left by Mr. Richard J. Congleton, senior vice president of the Prudential Insurance Company. On my right is Mr. Lawrence J. Latto, Washington, D.C., who is acting as our special counsel.

May I also thank Mr. Keith for that preliminary statement he made. Of course, Mr. Chairman, today I am appearing not on behalf of the Equitable Life, as such, but as you said, on behalf of the American Life Convention and the Life Insurance Association of America. These two associations have an aggregate membership of 351 life insurance companies in the United States and Canada which have in force approximately 92 percent of the legal reserve life insurance written in the United States. These companies also hold over 99 percent of the reserves of insured pension plans in the United States.

I would like to address my remarks to those provisions of H.R. 14742 which deal with exemptions from the three Federal securities statutes for bank-trusteed qualified corporate pension plans and H.R. 10 plans, sometimes called Smathers-Keogh plans or self-employed retirement act plans. These provisions to which my testimony will relate are primarily sections 3(b)(6), 27, and 28 of the bill.

We did not appear at the earlier hearings of your subcommittee, or at the hearings of the Senate Banking Committee, on those provisions of the bill which deal with mutual funds. We did, however, submit a statement to the Senate Banking Committee in connection with its later 1-day hearing on the amendments of Senator McIntyre relating to the collective investment of funds by banks. We are, for reasons I shall shortly explain, significantly affected by these amendments, and by the provisions of H.R. 14742 on the same subject.

I would like to take up first qualified corporate pension and profit-sharing plans—those employee benefit plans which meet the requirements of section 401(a) of the Internal Revenue Code—and then turn to H.R. 10 plans. The insurance industry takes no position on the provisions of H.R. 14742 which relate to collective managing agency accounts of banks, and my testimony will not treat with these provisions at all.

Mr. Chairman, having heard some of the other statements, I would like to add in the interest of clarity to my prepared statement to say that the collective managing agency accounts I have just mentioned are those referred to in paragraph No. 3 on the second page of Mr. Ferguson's statement on behalf of the American Bankers Association.

I would like to add that the insurance industry likewise takes no position on the provisions of H.R. 14742 relating to traditional common trust funds described in paragraph No. 1 on the same page of Mr. Ferguson's statement.

I would like also to add another explanatory remark. There has been some reference in these hearings to life insurance companies going into the mutual fund business. It is true that some companies have organized or acquired subsidiaries which are ordinary mutual fund management companies. I should like to emphasize that my testimony today is not concerned with that kind of company or activity. My testimony relates to pension funding, a traditional function of the life insurance business.

Furthermore, my testimony is not concerned with the individual variable annuity contracts that are sold, so to speak, to the man in the street. Those contracts, as you will remember, were the subject of litigation in the U.S. Supreme Court some years ago. I will be glad to go into that history in more detail later if the members of the subcommittee are interested.

At this time I want merely to make clear that that also is not the area I am talking about. My testimony is concerned with qualified pension and profit-sharing plans within the limits and meaning of the requirements of the Internal Revenue Code.

Now, sir, resuming by prepared statement and turning to the subject of corporate pension funding, H.R. 14742 would provide complete statutory exemptions for bank-trusteed qualified corporate pension or profit-sharing plans from all three Federal securities laws. We believe there is no controversy about these provisions. Our position is that they should first be broadened to provide comparable exemptions for the competing activities carried on by life insurance companies and, in that form, enacted.

The administration of qualified pension and profit-sharing plans in the United States is carried on primarily by banks and life insurance

companies. It is possible for other persons to perform this function, and to some very minor extent this is done, but the overwhelming bulk of this business is done by members of one of the other of these two industries. They are in active and vigorous competition with each other.

One of the more important decisions made by an employer in establishing a pension or profit-sharing plan is the selection of either a bank or an insurance company as his funding agency. Often competitive bids will be solicited from both types of institutions and these bids will be analyzed in detail with the help of pension consultants and other experts.

A bank-administered plan is usually called a trusteed plan. A plan administered by an insurance company is referred to as an insured plan. Frequently, a large employer will use both a bank and an insurance company to fund the same plan, and this is known as a split-funded plan. Employers pay close attention to the performance of the funding agencies and to the level of their respective operating expenses and charges.

The point I wish to make is that this competition is not theoretical or remote. It is direct and immediate, in the sense that banks and insurance companies are competing with each other for particular clients and are offering to provide essentially similar services. Any added complication, delay or expense, therefore, that is imposed upon insurance companies and not upon banks constitutes a serious handicap. The securities laws, as they now stand, create such a handicap and we are concerned that this bill, if enacted as it stands, will confirm and increase that handicap.

There are some differences between the services rendered and functions performed by banks and insurance companies in this area. I believe, however, that there is general agreement, and this includes the SEC, that so far as the Federal securities laws are concerned, the functions performed by these two classes of funding agencies in the administration of qualified retirement plans are essentially similar, and that the securities laws should apply basically in the same manner and to the same extent to both.

It happens to be the case, however, that these laws as they now stand, and have heretofore been interpreted by the SEC, provide significantly greater exemption for bank-established trusteed plans than for insured plans. The explanation is largely historical, and I do not feel that a full account of how this situation arose would be warranted here. I shall attempt, therefore, only a very brief summary. We will, of course, be happy to furnish whatever further explanations the subcommittee may desire.

Briefly stated, at the time the three major securities laws were adopted from 1933 to 1940, pension funding by life insurance companies utilized only conventional fixed-dollar contracts and these were given the same complete exemption from the securities laws that was provided for the trust vehicle employed by banks for this purpose. Within the past decade, however, life insurance companies have broadened their services, in order to compete more effectively with banks, to include facilities for investing the assets of retirement plans in common stocks or other equity securities, and for allocating the investment results directly to those plans.

This is done through what are known as "separate accounts" which have now been expressly authorized by the legislatures of most of the States. These separate accounts are the life insurance company counterpart of the collective pension trusts of the banks. Congress has already recognized the principle that the two funding agencies should enjoy competitive equality when, in 1962, it amended the Internal Revenue Code to provide tax treatment for income and gains on qualified retirement plan assets held in separate accounts comparable to that applicable to income and gains on qualified retirement plan assets held by collective investment trusts of banks. The purpose of this amendment was clearly explained in the Senate report as correcting a competitive discrimination.

These life insurance company separate accounts, however, which were not in existence or even contemplated in 1933, 1934, or 1940, do not enjoy the statutory exemptions accorded to qualified pension and profit sharing trusts, nor have they been given the same administrative exemptions from the securities laws.

I should explain that the Commission has not entirely refused to recognize our position that exemptions are warranted; on the contrary, substantial administrative exemptions have been given and further exemptions are under active discussion. The exemptions provided to date, however, are different from and less than the exemptions enjoyed by banks, and certainly less than the exemptions which would be provided by the pending legislation.

For example, insurance companies are subject to very stringent restrictions upon the manner and extent to which they may advertise their separate account pension funding facilities, restrictions which the SEC has not seen fit to impose upon our bank competitors.

For another example, exemption is not available for insurance companies with respect to plans which provide for employee contributions to be placed in separate accounts, so that employers who have adopted what are known as contributory plans enjoy greater flexibility if they choose a bank rather than an insurance company as the funding agency.

The Chairman of the Securities and Exchange Commission has suggested, in previous testimony, that while equality of treatment of banks and life insurance companies in this area is highly desirable, it might be preferable, because there are some differences between trusteed and insured retirement plans, to provide statutory exemption for the former and administrative exemption for the latter.

Mr. KEITH. Mr. Chairman?

Mr. MOSS. Mr. Keith has a question.

Mr. KEITH. This is a rather detailed question and one that might be interesting in the present context. Therefore, I am not waiting until the end of his entire statement before asking it.

On page 6, you talk about the greater flexibility that is permitted. Is this as to portfolio?

Mr. SOMMERS. No, sir. This is as to the kind of plan, the features of a pension plan which can be adopted by an employer without subjecting the plan to jurisdiction of the securities laws.

For example, under the administrative exemptions which we have so far obtained from the Commission which are contained in rules 156 under the 1933 act and 3C3 under the 1940 act, we do not get exemp-

tion from the 1940 act requirement of registering as an investment company if any employee money goes into a separate account, whereas the banks are completely exempted from the provisions of the 1940 act with respect to qualified pension plans.

Mr. KEITH. Does the SEC propose any regulation as pertaining to the portfolio at all?

Mr. SOMMERS. No, sir, the SEC regulations on us do not have any effect on the investment portfolio except to the extent mentioned by one of the speakers that the SEC has about investment of pension plan money contributed by employees in the stock of the employer.

This, however, is not a matter which would be germane to most insurance companies because in many States we are strictly limited in the amount of stock of any corporation that we can hold in the aggregate.

Mr. KEITH. Insofar as the investment portfolio of H.R. 10 plans which you are going to be discussing in more detail, would you, if the amendments are obtained that the SEC wants, so far as the mutual funds are concerned, in any way be affected as to compensation that could be paid to the officers? By any stretch of the imagination, could they have a bearing on the remuneration either of the sales force or the managers of the funds?

Mr. SOMMERS. Yes, sir. You are confining your question to the qualified pension plan in the H.R. 10 area or to one or the other?

Mr. KEITH. As I understand it, that is the only area in which the SEC would have any jurisdiction?

Mr. SOMMERS. No, sir. If we issue individual variable annuities, not qualified under the Internal Revenue Code, the SEC has asserted jurisdiction, the Supreme Court Court has said that these contracts, though having some of the aspects of insurance in the sense that they involve a mortality guarantee, also have some of the characteristics of a security and has held that the 1933 act is applicable and therefore at least as to the 1933 act there is this clear Supreme Court decision that in the individual variable annuity field the 1933 act would be applicable. That, however, does not affect compensation except by way of disclosure.

Going on to answer your question with regard to the load, in that area the Commission asserts jurisdiction not only with regard to the 1933 act but also with respect to the 1934 and the 1940 act and we are not objecting to that claim of jurisdiction with respect to individual variable annuity contracts in this testimony.

We have had several insurance companies who have started to sell individual variable annuities who have registered under the 1940 act as investment companies and who have registered as broker-dealers under the 1934 act and who would therefore be subject to the provisions of this bill and who would, therefore, be subject, coming back to your question, to the compensation requirements of this bill as far as sales load is concerned, and who would be subject to the management fee provisions of this bill as far as management fee is concerned.

Mr. KEITH. Do I understand that you are willing to subject yourselves to those provisions as a part of the package?

Mr. SOMMERS. Well, we would be subjected to these provisions.

Mr. KEITH. Do you have any objections?

Mr. SOMMERS. No, sir, we are not, in our statement here, taking any position with respect to that area of our business where we sell individual variable annuity contracts.

Mr. KEITH. Do you have any philosophical objection?

Mr. SOMMERS. No, sir. I have to answer you separately on that with respect to management fees. With respect to management fees as we have advised the Senate committee, we accept reasonableness as a standard of management fees.

I would like to add one comment to that which we also added in the Senate, namely, that the management of a variable annuity business involves additional elements to management of a mutual fund in that in addition to investment and administrative management it involves actuarial management since mortality guarantees are involved.

We think that the reasonableness of the management fee would necessarily take that additional factor into account because we understand the bill as leaving scope for the exercise of ordinary reasonable business judgment in fixing management fees.

As to sales load, we have no position, Mr. Keith, because I do not believe there would be any consensus in our business. We have 341 companies that are members of these associations. Of those, a few have started to issue individual variable annuities fairly recently. Some have established separate accounts but only for the qualified pension plan area.

Mr. KEITH. Has the State exercised any parallel jurisdiction with reference——

Mr. SOMMERS. Compensation?

Mr. KEITH. Yes, with reference to compensation for these two products now being regulated.

Mr. SOMMERS. The premiums on variable annuity contracts are not fixed so far as I know, in any State. Sales load and sales compensation is fixed by the laws of some States but I don't think by the laws of all.

Mr. KEITH. What about the management compensation?

Mr. SOMMERS. The management compensation so far as I know, is not directly regulated as such.

Mr. KEITH. You would feel, I would assume, that if the Federal Government would legislate within the area of management compensation, that a State could similarly act with reference to compensation for the executive group of insurance companies?

Mr. SOMMERS. Yes, sir. But we have been talking, in answering your question, about the field of individual variable annuities. Whereas our statement and suggested amendments relate to the field of the qualified pension plan where we are in direct competition with the banks, but where the securities regulation is different.

Mr. KEITH. I am talking about the larger view as to whether or not this is the kind of business which is not sufficiently competitive that it can be left to the laws of supply and demand, but instead is closer to that of a utility and in the public interest must be regulated as to compensation of the management group.

Mr. SOMMERS. We think the business is highly competitive.

In answer to your question, it could be regulated by the States.

Mr. KEITH. But you think it should be regulated by the Federal Government?

Mr. SOMMERS. No, sir.

Mr. KEITH. Insofar as the two products about which we have been having some discussion?

Mr. SOMMERS. We are not saying——

Mr. KEITH. I thought you said that you felt a regulatory agency could take you to court to determine whether or not the compensation was reasonable?

Mr. SOMMERS. Yes, sir; in the area that I am not talking about in my testimony today we have accepted that provision of the bill and the standard of reasonableness.

Mr. KEITH. Why does not the same logic obtain in other areas of the same business?

Mr. SOMMERS. You mean as to the load factors?

Mr. KEITH. As to the amount of management compensation.

Mr. SOMMERS. This is management compensation.

Mr. KEITH. This is only part of the load. Load comprises many things.

The law of competition may obtain within a company, itself, to try to get that load down in other areas. You may put in a machine instead of employees. At the same time the Government is going to be looking over your shoulders to see if the management fees are reasonable. If they find they are not reasonable, they will take you to court. Now, if it is fair in one area, why is it not fair in another? I gather you said it was.

Mr. SOMMERS. No, what we said was that in the area of load limitations I frankly could not quote an official position of our industry because I feel there are different opinions on the subject as far as subjecting ourselves in the individual variable annuity field to the load limitations of the proposed bill.

However, we have not objected to those provisions in the statement we are making here. I would like though, to complete this answer by saying that in the other part of our business, where our competition is not with the mutual funds who are subject to those provisions but with the banks in the insured pension plan area, there we think that if the banks are exempt from the provisions in respect to our competing business we should enjoy the same exemption.

Mr. KEITH. Do your associates concur in these observations?

Mr. SOMMERS. Would you like to add anything to that?

Mr. CONGLETON. No, other than the fact that as I understand your proposal on the management fees, it is the investment management fees and not the fees of the whole company.

A life insurance company, as such, is engaged in a variety of various enterprises. As I understood this provision and I, of course, may be wrong, it was going to be on the question of the investment advice we gave where this provision would apply.

Mr. KEITH. That is correct. But you have officers in your various companies that give this investment advice for which certain fees are charged or allocated. It would seem to me that it could be held, if the logic is proper in one area it could be similarly proper in another.

Mr. CONGLETON. Mr. Keith, if I may just add one thing; I think the test of reasonableness on these management fees that would be, under this bill, determined by the courts, would be what we charge.

I do not think it would make any difference if you paid one man $50,000 or paid 10 men $5,000, I don't think the court would go into that. I think the question is as to whether or not our fee charged is reasonable in relationship to what other people charge in the same area.

Mr. KEITH. I agree. I don't think it is going to get down to the amount paid. I think it will get down to the amount of the fees charged, but they may in seeking out that fee delve into the salaries that are paid in connection with the services rendered.

Mr. CONGLETON. That part I do not follow, sir. If our fee is reasonable that we charge, I don't think that there is any intent in this bill to go behind that to see how we get the reasonable fee.

Mr. SOMMERS. May I just add that in the field we are testifying about, the qualified pension plan area, the corporate pension plan area there is usually intense scrutiny of all our charges and when we bid on a competitive basis we have pension consultants, accountants, financial vice presidents of corporations, labor union advisers intensely interested in the magnitude of our charges.

It is an entirely different area from the area of selling individual contracts to the man on the street.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. MOSS. You may proceed, Mr. Sommers.

Mr. SOMMERS. Going back to my statement, Mr. Chairman, the Chairman of the Securities and Exchange Commission pointed to the fact that most banks are regulated by other Federal agencies, while life insurance companies are not, and also to the fact that the charges by the two types of institutions for their services are made in somewhat different fashion.

We are pleased, of course, to see that the Commission accepts the principle of equal treatment which we are espousing here.

We submit, however, that these suggested differences are not relevant ones and that there is no substantial reason why banks should be given a full statutory exemption while life insurance companies are restricted to an administrative exemption that is likely to be limited and conditional.

If these statutory exemptions are granted, qualified pension funding will, of course, still be regulated by Federal and State banking agencies, as to banks, and by State insurance departments as to insurance companies. This difference in regulatory responsibility results from a long standing fundamental congressional policy expressed in the McCarran Act (15 U.S.C. 1011–1015) that the insurance business is to be regulated by the States rather than the Federal Government.

The regulation prescribed by the States both before and after the McCarran Act is extremely comprehensive. It includes, among many other things, licensing of the companies to do business, establishment of standards of solvency, standards for valuation of assets, licensing of agents, filing and approval of policy forms, and prohibitions against unfair or improper practices. Also, insured plans are subject to extensive investment regulations.

In addition, all companies are required to file annual statements giving detailed information as to their operations, and all companies are subject to periodic examinations by representatives not only of

their home States, but also of several other State insurance departments.

The annual statements and the examination reports are open to the public for inspection. In fact, while we do not wish to suggest that regulation over banks is inadequate in any respect, we believe it is true that State regulation of insurance companies in many respects goes beyond that provided by the Federal and State Banking agencies insofar as concerns protection of pension plan participants.

Moreover, if I may make another addition to my prepared statement, life insurance companies would not only, under our suggestion, be subject to State regulation in respect to separate accounts for qualified pension plans, they would also be subject, like the banks, to extensive Federal regulation by the Internal Revenue Service under the provisions of the Internal Revenue Code with respect to pension plans, and by the Labor Department under the Welfare and Pension Plan Disclosure Act, these being two Government departments that have been given particular jurisdiction with regard to pension and employee benefit plans.

To continue with my statement, the revisions to H.R. 14742 needed to provide the full equality to which we believe we are entitled are comparatively simple.

For the convenience of the committee, we attach an appendix to this statement which sets forth the changes in H.R. 14742 that would be required. (See p. 110.)

For the most part these changes involve broadening those sections of the bill which refer to bank collective investment trusts which hold qualified retirement plan assets to include identical references to insurance company separate accounts which hold such assets.

Without the changes we propose, life insurance companies will continue under a serious competitive disadvantage. For example, employers who have adopted c ontributory pension or profit-sharing plans, and who wish to invest part of the employees' contributions in common stocks or use them to provide variable benefits, will have to continue to take into account the fact that by choosing a bank-trusteed plan they will avoid the expense and delays inherent in compliance with the securities law—expense and delays which may not be avoided if they choose a life insurance company as their funding agency.

Thus, an employer who prefers insured pension funding for other reasons might choose a bank to administer its plans solely because of the unequal applicability of the Federal securities laws—something that was never intended by the Congress and should not be permitted to continue.

Mr. KEITH. Mr. Chairman?

Mr. MOSS. Mr. Keith.

Mr. KEITH. Another technical question. I am getting now into the philosophy of the portfolio and the concept that the Congress had in mind.

You say, "for example, an employer who has adopted a contributory pension or a profit-sharing plan and who wished to invest part of the employee contributions in common stocks or use them to provide variable benefits will have to continue to take into account the fact that by choosing a bank-trusted plan," and so forth.

This would seem to indicate that the employer still maintains a right or prerogative to determine the nature of the investment.

Mr. SOMMERS. I think this is misstated in that respect, Mr. Keith. It should be "to have invested." It is true that the employer under the nature of his plan would have the right to say, "Of every hundred dollars we pay you we choose that $80 go into a conventional guaranteed fixed dollar life insurance product and the other $20 go into a common stock separate account."

It is not intended to convey the idea he can then tell us which stocks we invest in.

Mr. KEITH. I do not want to belabor this point. I am concerned as I indicated yesterday, about the pension plans that are invested in the stock of the corporation for which the employee is working and the obvious hazard involved in the absence of an arm's-length relationship. Although it may be very profitable, as has been the case with Sears, Roebuck for a couple generations, by and large, it is a bad practice to have your investment in the same company you are working for.

Mr. SOMMERS. I have two comments to make on that, Mr. Keith.

The first is that there is a proposal pending as a result of the executive branch studies of the pension business which I think is coming up before the Labor Committees which will include a provision limiting this practice that you mention.

Our industry has not given any statements on that but our position will be that we make no objection at all to such a limitation.

The second is, as I said before, under the laws of many of our States, we are confined to such a small proportional investment in the stock of any one company that this issue does not arise for us.

Mr. KEITH. Thank you.

Mr. Moss. You may continue.

Mr. SOMMERS. H.R. 14742 would also amend the securities laws to limit their applicability to bank collective investment funds utilized by Smathers-Keogh, or H.R. 10 plans.

Our position here is virtually identical to that just described. Life insurance companies compete with banks as funding agencies for H.R. 10 plans just as they do for corporate employee retirement plans.

I might supplement this by pointing out that this category of business includes not only some very large partnerships, accountants, law firms, and the like, but also, and most importantly, includes professional and trade associations, medical associations, bar associations, organizations of small tradesmen who buy these services, these pension plan services as a group rather than individually. And since they are self-employed, come within the terms of H.R. 10 rather than the corporate pension plan provisions.

Here, again, we urge that the Federal securities laws should be applied in an equal, evenhanded way to two classes of institutions that are in direct competition with each other.

The banks now enjoy a complete statutory exemption from the 1940 act, which would be strengthened by the bill. In contrast, life insurance companies using separate accounts now rely upon an informal "no action" position of the Commission, which is always subject to withdrawal or change. We ask that the same statutory exemption available to the banks should be extended to life insurance companies.

Turning to the 1933 and 1934 acts, there has been some difference of opinion in these hearings and in the Senate concerning the extent to which these acts should apply to H.R. 10 funding and also with respect to whether the Securities and Exchange Commission or one of

the Federal banking agencies should serve as the regulatory authority for bank-funded plans. We take no position on these issues beyond our request for equal treatment.

We accept the necessity for compliance with the 1933 and 1934 acts to the extent that the regulatory authority finds it necessary in the public interest.

We believe that regardless of whether the Congress chooses the banking agencies or the Securities and Exchange Commission to enforce these acts as they apply to bank-funded H.R. 10 plans, it should leave with the Securities and Exchange Commission the function of enforcing these acts as they apply to separate account-funded H.R. 10 plans.

We strongly urge, however, that whatever discretion is given to one regulatory agency should be given to any other agency that is administering the same act. So that if, for example, banking authorities should be given exemptive discretion with respect to banks, the Commission with respect to us should be given the same discretion.

We also urge that whether a single agency or several agencies are assigned the responsibility for administering the securities laws in connection with H.R. 10 plan funding, there should be a congressional directive that the objective should be to achieve uniform treatment for trusteed and insured separate account plans and that differences in regulatory requirements should be permitted only to the extent that the form of organization or method of operation justifies a difference in treatment.

I suppose that there is no principle more firmly ingrained in our jurisprudence than equal treatment under law, and that is all we are asking here.

If the proposed amendments relating to bank collective funds holding qualified pension and profit-sharing plan assets are to be enacted, these provisions should apply equally to life insurance company separate accounts which hold qualified plan assets.

I should like to thank the subcommittee for its courtesy in enabling us to make this statement, and we will be glad to furnish any additional information or assistance that may be thought necessary or desirable.

(The appendix referred to follows:)

APPENDIX A

AMENDMENTS TO H.R. 14742 PROPOSED BY AMERICAN LIFE CONVENTION AND LIFE INSURANCE ASSOCIATION OF AMERICA, REQUIRED TO PROVIDE EXEMPTION FOR THE FUNDING OF QUALIFIED PENSION PLANS BY INSURANCE COMPANIES COMPARABLE TO THE EXEMPTIONS PROVIDED FOR QUALIFIED PENSION FUNDING BY BANKS

On page 2 of the bill, revise lines 16 and 17 as follows:

(2) Paragraph (19) through [(42)] *(35)* thereof are redesignated as paragraphs (20) through [(43)] *(36)* respectively *and paragraphs (36) through (42) thereof are redesignated as paragraphs (38) through (44), respectively.*

On page 6 of the bill, add immediately after line 2 a new paragraph (5) to Section 2 of H.R. 14742 which would read as follows:

(5) A new paragraph (37) is inserted immediately after paragraph (36) to read as follows:

"(37) 'Separate account' means an account established and maintained by an insurance company, pursuant to the law of any State, or Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are credited to or charged against such account without regard to other income, gains or losses of the insurance company."

On page 8, expand the redesignated paragraph (11), on lines 15 through 19, so that it will read as follows:

"(11) Any employees' stock bonus, pension, or profit-sharing trust which meets the requirements of section 401(a) of the Internal Revenue Code of 1954, or any collective fund maintained by a bank consisting solely of assets of such trusts, *or any separate account the assets of which are derived from (i) contributions under pension or profit-sharing plans which meet the requirements of said section or the requirements for deduction of the employer's contribution under Section 404(a)(2) of said Code, (ii) from advances made by the insurance company in connection with the operation of such separate account, and (iii) from income and gains from the foregoing.*"

On pages 64 through 67, revise Sections 27 and 28 to read as follows:

Sec. 27. (a) Section 2(1) of the Securities Act of 1933 is amended by inserting after "other mineral rights," the following: "interest or participation in any common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent or in any other collective fund maintained by a bank *or separate account maintained by an insurance company* consisting of assets of retirement *plans of or* trusts for self-employed individuals which [are exempt from Federal income taxation under] *meet the requirements of Section 401(a) of* the Internal Revenue Code and which the Commission determines requires the protection for investors of the provisions of this title,".

(b) *Section 2 of said Act is amended by adding two new sections (13) and (14) to read as follows:*

"(13) The term 'insurance company' means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State or Territory or the District of Columbia; or any receiver or similar official or any liquidating agent for such company, in his capacity as such.

"(14) The term 'separate account' means an account established and maintained by an insurance company, pursuant to the law of any State or Territory or the District of Columbia, or Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are credited to or charged against such account without regard to other income, gains or losses of the insurance company."

(c) Section 3(a)(2) of such Act is amended by inserting after "commission or similar official;" the following: "or any interest or participation in any common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian, or in any collective fund maintained by a bank *or separate account maintained by an insurance company* consisting [solely] of assets of retirement, pension, profit-sharing, stock bonus, or other *plans* or trusts which [are exempt from Federal income taxation under] *meet the requirements of Section 401(a) of* the Internal Revenue Code except *any interest in* any fund *or separate account* consisting of assets of retirement *plans of or* trusts for self-employed individuals which [are exempt from Federal income taxation] *meet the requirements of said section* and which the Commission determines requires the protection for investors of the provisions of this title;".

Sec. 28. (a) Section 3(a)(10) of the Securities Exchange Act of 1934 is amended by inserting after "certificate of deposit, for a security," the following: "any interest or participation in any common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent or any collective fund maintained by a bank *or separate account maintained by an insurance company* consisting of assets of retirement *plans of or* trusts for self-employed individuals which [are exempt from Federal income taxation under] *meet the requirements of Section 401(a) of* the Internal Revenue Code and which the Commission determines requires the protection for investors of the provisions of this title,".

(b) Section 2(19) of such Act is amended by adding the words "'separate account,'" after the words "'affiliated person,'".

[(b)] *(c)* Section [12(g)(2)] *3(a)(12)* of such Act is amended by [adding at the end thereof a new subparagraph as follows:] *striking out the final semicolon and inserting in lieu thereof the following:*

"[(II)] any interest or participation in any common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian, or any collective fund maintained by a bank *or separate account maintained by an insurance company* consisting [solely] of assets of retirement, pension, profit-sharing, stock bonus, or other *plans* or trusts which [are exempt from Federal income taxation under] *meet the requirements of Section 401(a) of* the Internal Revenue Code except *any interest in* any fund *or separate account* consisting of assets of retirement *plans or* trusts for self-employed individuals which [are exempt from Federal income taxation under] *meet the requirements of said section* [the Internal Revenue Code] and which the Commission determines requires the protection for investors of the provisions of this title;"

[It should be noted that the proposed revision of Section 28(b) (which would become Section 28(c) under our revision) is somewhat different from the proposed revisions of the other sections. Section 28(b), as it now reads, would amend Section 12(g)(2) of the Securities Exchange Act of 1934 to ensure, among other things, that registration would not be required, under that Act, of any interest or participation in any bank-established qualified collective pension trust. There was no need to provide an exemption from the broker-dealer registration provisions of Section 15 of that Act, since banks are already excluded from the definitions of "broker" and "dealer" by Sections 3(a)(4) and 3(a)(5). We suggest, accordingly, that Section 28(b) of H.R. 14742 (modified, as we propose, to include the appropriate references to separate accounts that hold qualified retirement plan assets) be changed to amend Section 3(a)(12) of the 1934 Act rather than Section 12(g)(2). If this is done, exemption from both Section 12(g)(1) and Section 15(a)(1) would simultaneously be provided.

[The applicability of the anti-fraud provisions of the 1934 Act, Sections 10(b) and 15(c)(1), would not be affected by this change since these sections apply both to exempted and non-exempted securities.]

Mr. Moss. I want to thank you, Mr. Sommers, for a statement of considerable clarity and one which will be extremely helpful to the subcommittee in understanding the views of your industry.

Mr. Keith?

Mr. KEITH. In accordance with the pattern that has been established, I will waive questions at this time.

Mr. Moss. Mr. Stuckey?

Mr. STUCKEY. No questions at this time.

Mr. Moss. I have no questions, Mr. Sommers. I want to thank you and your associates for appearing this morning.

Now we have the Chairman of the Securities and Exchange Commission, Mr. Cohen.

Mr. Chairman, I don't believe you need to be identified for the benefit of the committee, but for the benefit of the record, you may do so.

STATEMENT OF HON. MANUEL F. COHEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY PHILLIP A. LOOMIS, JR., GENERAL COUNSEL

Mr. COHEN. Thank you, sir.

My name is Manuel F. Cohen, Chairman of the Securities and Exchange Commission.

On my left is Mr. Phillip A. Loomis, Jr., our General Counsel.

Mr. KEITH. Mr. Chairman, would it be in order, before he proceeds, and since many of these men have not had a chance to find out how the market is behaving today, to have Mr. Cohen make just a brief observation in that respect.

Mr. COHEN. I will be glad to do that, Mr. Keith, subject to the wishes of the chairman.

Mr. Moss. If the Chairman wishes to respond, I will be most interested in his observations.

Mr. COHEN. I think the market has been moving along pretty much as usual. In fact, gold stocks have dropped, if that is an indication of something. As far as I know, American securities here and abroad are firm and doing well. The market is off some. The volume is not greater, I don't think, than it was yesterday.

It appears to be a typical Friday. So far as I know, and I have been in touch with all the people this morning, everything is pretty much as usual.

Mr. Moss. Thank you.

We will be pleased to hear your statement.

Mr. COHEN. Thank you, sir.

Mr. Chairman and members of the subcommittee: We are pleased to testify today on H.R. 14742, which would amend the Investment Company Act of 1940 and provisions of other Federal securities laws to deal with the problems raised by the dramatic growth and size of the mutual fund industry.

The primary purpose of this bill, like its original version, H.R. 9510, is to provide fair treatment to the over 4 million Americans who own mutual fund shares and the uncounted millions who are likely to become mutual fund shareholders in the future.

The subcommittee has already heard extensive testimony concerning the provisions of the bill relating to advisory fees and sales loads during the hearings on H.R. 9510 in the last session of Congress. While I would be pleased to answer questions on any aspect of the bill, my testimony here today will deal primarily with the provisions of H.R. 14742 which relate to the application of the Federal securities laws to bank collective funds. These matters were not before the subcommittee during hearings on H.R. 9510.

At the outset, I should point out that these provisions of the bill raise the major policy question whether or not the banks should be allowed to enter the field of equity investments through the medium of collective investment funds. This issue was also before the Senate Committee on Banking and Currency on the McIntyre amendments to S. 1659, the Senate counterpart of H.R. 9510.

The McIntyre amendments would amend the national banking laws to provide that nothing in those laws should be construed to prevent a bank from being affiliated with a collective fund for managing agency accounts.

This bill does not amend the national banking laws; instead, it adds a new section 22(i) to the Investment Company Act for this purpose. We regard this difference as one of legislative technique, not substance. It does not change our view previously expressed in the Senate hearings on the McIntyre amendments, that the question of whether banks should be allowed to enter this field is a matter of national policy within the primary jurisdiction of the Congress and agencies of the Government other than the Commission.

The Commission does not consider that its responsibility extends to this question and neither expresses nor implies any views thereon. Our testimony will, therefore, be confined to those provisions of the bill which deal with the regulation of bank collective investment funds under the various securities laws. It is, of course, subject to the determination of the basic question by the Congress.

As the subcommittee is aware, trust departments of banking institutions for many years have offered investment management services to individuals, pension and profit-sharing plans and other clients both separately from and as a part of their services as trustees, executors, administrators, or guardians of trusts and estates. Banks, like other financial institutions, however, have shown a growing interest in equity investment, and in recent years they have sought to offer investment management services to a broader segment of the public.

The banking industry is seeking a clarification and modification of the application of the Federal securities laws and the banking laws in this area to the activities they seek to engage in. So far as we are concerned, we have always understood the policy of Congress, as expressed in the Federal securities laws, to permit any qualified person or organization to enter any phase of the securities business.

The Commission has no exclusive franchises to grant. The only qualifications under the securities laws for entry into the securities business relate to technical competence and the absence of a record of violations of law.

The provisions of the securities laws are intended to and should apply equally to all persons and organizations who offer securities to public investors. That is our concern.

Questions have been raised as to whether the Federal banking laws permit banks to engage in their proposed activities and, as I have stated, whether those questions should be resolved in favor of permitting such activities in any respect or to any extent is a question of policy for the Congress upon which we do not comment.

Insofar as the policies of the Federal securities laws which we administer are concerned, we believe that anyone entering the mutual fund business should be required to do so essentially on the same basis and subject to the same rules applicable to other persons. In some instances we believe that the proposed amendments to our bill give banks special treatment under Federal securities laws and are not justified under the basic principle of equal access subject to equal investor protection.

We also have a number of suggestions for dealing with various technical problems raised by the present draft of the bill. These are contained in a memorandum which I will submit for the record.

I should interpolate here, Mr. Chairman, to say that that memorandum is not available this morning, but we will submit it promptly after it has been completed.

Mr. Moss. Without objection, the record will be held open to receive that statement at this point in the record.

Mr. Cohen. Thank you, sir.

(The document referred to follows:)

SECURITIES AND EXCHANGE COMMISSION MEMORANDUM OF MARCH 25, 1968, WITH RESPECT TO CHANGES IN THE PROVISIONS OF H.R. 14742 DEALING WITH BANK COLLECTIVE INVESTMENT FUNDS

This memorandum is submitted by the Securities and Exchange Commission to the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce. It presents the recommendations of the Commission with respect to changes in the provisions of H.R. 14742, which deal with bank collective investment funds. The recommendations are designed to implement the views of the Commission as presented by the testimony of Chairman Manuel F. Cohen. They also would resolve a number of technical difficulties in the language of the bill as presently proposed.

Attached to the memorandum is a comparative draft of provisions of the bill showing the changes that would be made by these recomendations.

This memorandum also covers the recommendations of the Commission with respect to the amendments to the bill proposed by the life insurance industry in their statement of March 15, 1968 to the Subcommittee and appendices thereto and in that regard would carry out the views of the Commission as expressed in Chairman Cohen's second statement to the Subcommittee.

Section 2(a)(35) [*Section 2(4) of the Bill*]

Section 2(4) of the bill would amend the definition of "security" in Section 2(a)(35) of the Investment Company Act[1] to state expressly that any interest or participation in a bank collective fund for managing agency accounts is a "security". This amendment is unnecessary and undesirable. The present definition has been deemed broad enough to include such interests and participations, and the amendments to Section 10 of the Act granting certain exemptions for bank funds for managing agency accounts also will make this clear. Any amendment to the definition of security dealing only with bank funds for managing agency accounts may raise the unwarranted implication that interests or participations in other collective fund sponsored by banks, insurance companies or others are not securities.

Section 3(c)(13) [*Section 3(b)(6) of the Bill*][2]

This proposed amendment is designed to codify the Commission's basic position that bank collective trust funds which consist solely of assets of employees' plans which meet the conditions of Section 401 of the Internal Revenue Code are entitled to the exemption contained in Section 3(c)(13) of the Act for "[a]ny employees' stock bonus, pension, or profit-sharing trust which meet the conditions of Section 165 [401] of the Internal Revenue Code, as amended." The Commission's position has been based on the fact that the bank fund is a trust which itself meets the requirements of Section 401 of the Code. The amendment, as presently drafted, however, uses the term "collective fund." Accordingly, the Commission recommends that the amendment be modified to read "collective trust fund."

Section 10 [*Section 5(d) of the Bill*]

This section of the Bill would exempt a bank collective investment fund for managing agency accounts from existing provisions of the Act which require that a majority of the directors of such fund be persons who are unaffiliated with the fund's principal underwriter, any investment banker or any one bank. However, it would also exempt such funds from Section 10(a) of the Act, which requires that 40 percent of the persons performing the functions of directors of such funds to be persons who are not officers or directors of, or otherwise affiliated with, the bank managing such a fund. As Chairman Cohen indicated in his testimony on November 16, 1967 before the Subcommittee, the Commission in the *First National City Bank* case found it inappropriate under the standards of Section 6(c) of the Act to grant the exemptions from Section 10(a) requested by First National City Bank and would prefer that the requirements of Section 10(a) be retained in legislation relating to collective funds for managing agency accounts.

For this purpose, the attached comparative draft contains a new Section 10(e) to be added to the Investment Company Act in lieu of the amendments to Section 10(d) of the Act now proposed by the Bill. We emphasize that these suggested changes would be relevant only if the federal banking laws should be construed or changed to permit the operation of bank collective funds for managing agency accounts.

Proposed Section 10(e) contains provisions differing from the provisions of the present Section 10(d) of the Act in other respects. Section 10(e)(1) incorporates the provisions of the first phrase of Section 10(d)(6). The remainder of Section 10(d)(6) imposes a 1 percent limitation on the management fee charged by the investment adviser. Because the Bill would provide that management fees charged by an investment adviser be subject to a reasonableness standard, it seems neither appropriate nor necessary to include a specific limitation in the proposed amendment, particularly one as unrealistically high under present day conditions as one percent. Section 10(e)(3) restates the provisions

[1] Section 2(2) of the bill redesignates Section 2(a)(35) as Section 2(a)(36).
[2] Section 3(b)(2) of the bill redesignates Section 3(c)(13) as Section 3(c)(11).

of Section 10(d)(8) to avoid reference to interests in a commingled managing agency account as "shares" of "stock."

It should be noted also that Section 5(d) of the Bill would exempt bank commingled agency accounts from Section 10(b)(3) of the Investment Company Act. Section 10(b)(3) provides that at least a majority of the board of directors of an investment company shall be persons who are not affiliated with any investment banker. It may be expected that many, if not all, banks wishing to establish commingled agency accounts would be deemed investment bankers for purposes of Section 10(b)(3) since they participate in syndicate underwritings of United States government and municipal bonds.

Section 10(f) of the Act would prohibit a bank collective fund from acquiring securities being distributed by an underwriting or selling syndicate of which the sponsoring bank is a member, during the existence of the syndicate. In the *First National City Bank* case, the Commission, in granting an exemption from Section 10(b)(3), imposed a condition, to which the Bank had consented, extending the prohibitions of Section 10(f) to include any period after termination of an underwriting syndicate during which members of the syndicate still held unsold allotments of the security underwritten by them (Investment Company Act Release No. 4538, at pp. 10, 14).

We recommend that in this connection a condition be included in the proposed legislation similar to that imposed by the Commission in the *First National City Bank* case. This is even more important in the case of the proposed legislation than in the situation before the Commission in that case. It was the stated policy of the collective fund for managing agency accounts of First National City Bank that investments would normally be made principally in common stocks and securities convertible into common stocks. However, the proposed legislation would grant an exemption from Section 10(b)(3) to bank collective funds for managing agency accounts without regard to their investment policy, which in many cases might permit investment of all or part of the assets of the fund in United States government or municipal bonds. And it should be noted that the problem of conflict of interest with which Section 10(b)(3) is intended to deal may arise more acutely where unsold allotments are still held by members of an underwriting or selling syndicate when the syndicate is terminated, since the holding of such allotments indicates that the securities concerned have been difficult to sell. Accordingly, our suggested substitute "Section 10(e)" contains an additional subparagraph (4) aimed at preventing such conflicts.

Section 17(g) [*Section 9(a) of the Bill*]

This proposed amendment to Section 17(g) of the Investment Company Act would codify a position taken by the Commission in the *First National City Bank* case to permit an officer or employee of a bank collective fund for managing agency accounts to have access to assets of the fund held in the custody of the bank if such access is "solely through his also being an officer or employee of a bank." Solely as a matter of style, the Commission recommends that the phrase "position as" be substituted for the phrase "also being."

New Section 22(h) [*Section 12(e) of the Bill*]

This proposed amendment would prohibit a registered investment company which is a common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent from offering or selling through a principal underwriter or otherwise, any security issued by it at a public offering price which includes a sales load. The language of the proposed amendment expressly limits the prohibition to situations where a bank is acting in its capacity as managing agent. The Commission believes that this scope of the prohibition against the imposition of a sales load should not be limited by the legal form of the relationship between a bank and investors in its collective fund but should extend to all situations where a bank is offering interests in an investment vehicle subject to registration as an investment company under the Act. Accordingly, the Commission believes that the language limiting the scope of the prohibition should be deleted.

The life insurance industry proposals would amend Section 3(b)(6) of the bill to grant to separate accounts for pension and profit-sharing plans which meet the requirements of Section 401 of the Internal Revenue Code and for certain other separate accounts the same blanket exemption from the Investment Company Act which the bill would provide for bank funds meeting the

same requirements. These amendments are not included in view of Chairman Cohen's testimony that such a blanket exemption is inappropriate and that the Commission has ample power under the existing provisions of the Investment Company Act, particularly Section 6(c), to grant such plans administered by life insurance companies any exemptions which are warranted.

New Section 22(i) of the Bill [Section 12(e)]

Section 12(e) of the bill would add new Section 22(i) to the Investment Company Act to provide that no provision of law shall prevent the creation or operation by a bank of a registered investment company which is a common trust or other pooled or collective fund for the collective investment of managing agency accounts, if such fund is created and operated in compliance with "any applicable regulation of the Comptroller of the Currency." The language of the amendment, however, should make more explicit the clear intent of the legislative history that collective funds for managing agency accounts created pursuant to new Section 22(i) would be governed by applicable provisions of the federal securities laws. It should also make clear that any regulations adopted by the Comptroller of the Currency cannot be inconsistent with, but must be in addition to, the requirements of the federal securities laws. The Commission therefore recommends that the bill be amended to provide that a fund is authorized only if it is created and operated in accordance "with the Securities Act of 1933 and the Securities Exchange Act of 1934, and this title and rules and regulations thereunder and such additional regulations as the Comptroller of the Currency may adopt."

II. AMENDMENTS TO THE SECURITIES ACT OF 1933 SECTION 2(1) [SECTION 27(a) OF THE BILL]

This section of the Bill would amend Section 2(1) of the Securities Act to state expressly that an interest or participation in collective funds maintained by a bank as managing agent is a "security." It would also provide that interests in collective funds for H.R. 10 plans would be deemed "securities" only if and to the extent that the Commission affirmatively determines that investors in such funds require the protections of the Act.

There has always been little question that interests in bank administered collective investment funds are "securities" within the meaning of the Securities Act, and the amendments to other provisions of the Act granting or authorizing exemptions from registration for certain such funds will make this clear. For the reasons given in connection with the Investment Company Act definition, we recommend that the proposed amendments to Section 2(1) of the 1933 Act be deleted in their entirety as unnecessary and undesirable.

The controversy some years ago with respect to interests in bank administered commingled managing agency accounts did not revolve around the question of whether they were securities but rather around the question of whether they were exempt under Section 3(a)(2) as securities "issued by" a bank. The revisions we suggest in the proposed amendments to Section 3(a)(2) would merely codify our consistent interpretation of that section by making it clear that collective investment funds administered by banks are not exempt as securities issued by banks and by granting specifically appropriate exemptions or exemptive authority with respect to such funds. This, we believe, would not only be clearer but more logical since the exemption for securities "issued by" a bank is intended only for securities representing an interest in or an obligation of the bank rather than participation in a pool of non-bank securities administered by a bank.

The provisions of the Bill with respect to bank collective funds for H.R. 10 plans would permit the Commission to exempt interests in such funds not only from the registration provisions but also from the antifraud provisions of the Act. As indicated in the testimony of Chairman Cohen before this Subcommittee, an exemption from provisions of the Act protecting investors against fraud and deception is wholly unjustified. Since the proposed amendments to Section 3(a)(2) of the Act also provide the Commission with authority to exempt bank collective funds for H.R. 10 plans from the registration provisions, we believe that the additional exemptive authority should be deleted from Section 2(1).

The life insurance industry would propose to amend Section 27(a) of the bill to treat separate accounts of insurance companies for H.R. 10 plans in the

same way as the present provisions of the bill would treat such plans when administered by banks. For the reasons stated in the previous paragraph, we believe that this amendment also should not be adopted.

Section 3(a)(2) [Section 27(b) of the Bill]

Section 27(b) of the bill would amend Section 3(a)(2) of the Securities Act to provide an exemption from the registration provisions of that Act for bank collective funds consisting of (1) assets contributed by the bank in its capacity as trustee, executor, administrator or guardian; (2) assets of corporate retirement plans and (3) unless the federal banking agencies otherwise determine, assets of H.R. 10 plans. The Commission recommends a number of changes to the proposed amendments as follows:

Collective funds for assets held in a fiduciary capacity

The proposed amendments are designed to exempt from the registration provisions of the Act the traditional common trust fund maintained by banks as investment vehicles for the assets held by the bank in a bona fide fiduciary capacity. An exemption for such a "common trust fund or similar fund" is now contained in Section 3(c)(3) of the Investment Company Act. The exemption from the Securities Act proposed by the amendments, as presently drafted, however, extends not only to common trust funds but to "any other pooled or collective fund", and it does not contain the Section 3(c)(3) limitation that the fund be maintained "exclusively" for fiduciary purposes. The Commission considers it essential that the language of the proposed amendment to Section 3(a)(2) of the Securities Act be changed to conform in all respects to the language of the Section 3(c)(3) exemption in the Investment Company Act.

The Commission also recommends that the legislative history make clear that this exemption is limited to common trust funds maintained by a bank for the collective investment of assets held by it in a *bona fide* fiduciary capacity and incident to a bank's traditional trust department activities. It should not extend to situations where the bank is acting in a fiduciary capacity solely for the purpose of investment and reinvestment of assets in a collective fund.

Collective Funds for Corporate Pension Plans and H.R. 10 Plans

The proposed amendments to Section 3(a)(2) contained in the bill would provide a complete exemption from registration for bank collective funds for corporate pension plans and would also provide an exemption from such requirements for bank collective funds for H.R. 10 plans unless the Commission affirmatively determines otherwise. The amendments to the bill proposed by the life insurance industry would provide comparable exemptions or exemptive authority for separate accounts of insurance companies used for corporate pension plans and H.R. 10 plans. For the reasons stated in Chairman Cohen's testimony before the Subcommittee, we believe that both these provisions in the bill and the life insurance industry's proposed changes in them should be replaced by a provision giving the Commission authority to exempt by rule or order both bank administered and insurance company administered collective funds for these plans if and to the extent that the Commission determines that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors. This would eliminate automatic exemption for all collective employee funds administered by banks or insurance companies. As Chairman Cohen testified there may be situations where beneficiaries of such plans or even small employers themselves establishing such plans are in need of the disclosures which registration would provide. It would also allow the Commission to require registration where a plan makes significant investments in the employer's stock. Chairman Cohen expressed a concern with respect to this problem in his testimony before the Senate Committee on Banking and Currency and similar concern was expressed at the hearings before this Subcommittee by a member of the Subcommittee.

With respect to H.R. 10 plans, the changes we propose would place on the person seeking exemption a responsibility for showing that such an exemption is justified rather than placing the burden on the Commission.

The changes which we recommend would also provide for parity of treatment for plans administered by insurance companies and plans administered by banks insofar as exemption from registration under the Securities Act of 1933 is concerned. In order to provide this exemptive authority for separate accounts of insurance companies, it would be necessary to add to the Securities Act definitions

of "insurance company" and "separate account" as proposed by the life insurance industry.

We have certain other technical problems with the broad language now contained in Section 27(b) of the bill but do not think it necessary to discuss them at this time since the amendment we propose would eliminate them.

III. AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934

Section 3(a)(10) [*Section 28(a) of the Bill*]

This section of the Bill would amend Section 3(a)(10) of the Exchange Act specifically to define as "securities" interests in bank collective funds for managing agency accounts and, if the Commission so determines, collective funds for H.R. 10 plans. For the reasons stated in the discussion of proposed amendments to the definition of the term "security" in Section 2(a)(35) of the Investment Company Act and Section 2(1) of the Securities Act, we believe that this amendment is unnecessary and undesirable and should be deleted.

The life insurance industry would modify Section 28(a) of the bill to provide the same treatment for insurance administered funds for H.R. 10 plans. For the reasons stated above we believe that this change is likewise unnecessary and undesirable and should not be made.

Section 12(g)(2) [*Section 28(b) of the Bill*]

This section of the Bill would amend section 12(g)(2) of the Exchange Act to exempt from the provisions of Section 12(g) collective funds for (1) assets held by the bank in a fiduciary capacity; (2) assets of corporate pension plans and (3) if the Commission so determines, assets of H.R. 10 plans. These provisions are similar to the amendments to the exemptive provisions of Section 3(a)(2) of the Securities Act proposed by Section 27(b) of the Bill. The Commission recommends that changes be made to the amendments of Section 12(g)(2) comparable to those recommended for Section 3(a)(2).

The life insurance industry's proposed amendments to Section 28(b) of the bill would transfer the proposed amendment to Section 12(g)(2) of the Exchange Act to Section 3(a)(12) of that Act and add to the exemption separate accounts for corporate pension plans and unless the Commission determined otherwise, separate accounts for H.R. 10 plans. This, as explained in the appendix to the statement of the life insurance industry, would have the effect of granting exemption not only from registration under Section 12(g) of the Act but also from the broker-dealer registration provisions of Section 15 of the Act. For the reasons stated by Chairman Cohen in his testimony, we regard this proposal as undesirable and inappropriate. We accordingly recommend that Section 28(b) of the bill continue to be an amendment to Section 12(g)(2) as provided in the bill and that it be modified to provide for the exemption from Section 12(g) of separate accounts of insurance companies for funding corporate pension plans and H.R. 10 plans. As Chairman Cohen stated, we have no objective to exemption from Section 12(g) for both bank and insurance company collective funds for corporate pension plans and we do not think it necessary to differentiate for this purpose between corporate pension plans and H.R. 10 plans.

APPENDIX.—AMENDMENTS TO H.R. 14742 RECOMMENDED BY THE SECURITIES AND EXCHANGE COMMISSION

(Brackets indicate deletions, italics indicate additions.)

1. Delete Section 2(4)

2. Amend Section 3(b)(6) as follows:

"(11) Any employees' stock bonus, pension, or profit-sharing trust which meets the requirements of section 401 of the Internal Revenue Code, or any collective *trust* fund maintained by a bank consisting solely of assets of such trusts."

3. Delete Section 5(d) and insert the following:

"*(d) Section 10 of said Act is further amended by redesignating Subsections (e), (f), (g), and (h) as subsections (f), (g), (h), and (i), respectively, and inserting immediately after subsection* (d) a new subsection (e) as follows:

(e) The provisions of Sections 10(b)(2), and 10(b)(3) and 10(c) shall not apply to a registered investment company estbalished by a bank for the collective

investment of assets contributed thereto by such bank in its capacity as managing agent, if

(1) the investment adviser of such investment company is a bank, and such investment adviser is the only investment adviser to such investment company;

(2) the conditions of subparagraphs (1), (3), (4), (5) and (7) of Section 10(d) are met;

(3) such investment company has only one class of securities outstanding, each unit of which has equal voting rights with every other unit; and

(4) such investment company does not purchase any security during the existence of any underwriting or selling syndicate with respect to such security of which syndicate such bank is a member or during any period after the termination of such syndicate while any member thereof has any unsold allotment of such security.

4. Amend that part of Section 9(a) which amends Section 17(f) of the Investment Company Act to read as follows:

"(g) The Commission is authorized to require by rules and regulations or orders for the protection of investors that any officer and employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities, unless *the* [such] officer or employee *of the company* has such access solely through his [also being] *position as* an officer or employee of a bank, be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe."

(b) Section 17 of said Act is further amended by adding a new subsection (j) to read as follows:

5. Amend that part of Section 12(e) which adds a new Section 22(h) to the Act as follows:

"(h) No registered investment company which is a common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank [in its capacity as managing agent] shall offer or sell, through a principal underwriter or otherwise, any security isued by it at a public offering price which includes a sales load."

6. Amend Section 12(i) which adds a new Section 22(i) to the Act as follows:

"(i) No provision of law shall be deemed to prevent the creation or operation of a registered investment company which is a common trust fund or other pooled or collective fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as managing agent if such fund is created and operated in compliance with *the provisions of the Securitie Act of 1933 and the Securities Exchange Act of 1934 and this title and rules and regulations thereunder and* [any applicable] *such additional* regulations [of] *as* the Comptroller of the Currency *may adopt.*"

7. Delete existing Section 27(a) and replace it with the following:

"(a) *Section 2 of the Securities Act of 1933 is amended by adding two new sections (13) and (14) to read as follows:*

"(13) The term 'insurance company' means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State or Territory or the District of Columbia; or any receiver or similar official or any liquidating agent for such company, in his capacity as such.

"(14) The term 'separate account' means an account established and maintained by an insurance company, pursuant to the law of any State or Territory or the District of Columbia, or Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are credited to or charged against such account without regard to other income, gains or losses of the insurance company."

8. Amend Section 27(b) as follows:

"Section 3(a)(2) of the *Securities* [such] Act *of 1933* is amended by *deleting 'national before 'bank;' and 'or by banking institution organized under the laws of any State or Territory or the District of Columbia, the business of which is*

substantially confined to banking and is supervised by the State or Territorial banking commission or similar official;' after 'bank,' and inserting after *'bank;* ['commission or similar official;'] the following: 'or any interest or participation in any common trust fund or [other pooled or collective] *similar* fund maintained by a bank *excluively* for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian *or any employees' stock bonus, pension or profit-sharing trust which meets the requirements of Section 401 of the Internal Revenue Code, any collective trust fund maintained by a bank consisting solely of assets of such trusts, any separate account the assets of which are derived from (i) contributions under pension or profit-sharing plans which meet the requirements of said section or the requirements for deduction of the employer's contribution under Section 404(a)(2) of said code,* (ii) *from adcances made by the insurance company in connection with the operation of such separate account, and (iii) from income and gains from the foregoing, if and to the extent that the Commission determines as to any such collective trust fund or separate account that an exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this act,* [or *any interest or participation* in any collective fund maintained by a bank consisting solely of assets of retirement, pension, profit sharing, stock bonus, or other trusts which are exempt from Federal income taxation under the Internal Revenue Code, except any fund consisting of assets of retirement trusts for self-employed individuals which are exempt from Federal income taxation and which the Commission determines requires the protection for investors of the provisions of this title];' *and after 'Federal Reserve Bank,' the following: 'For purposes of this paragraph (2) a security issued or guaranteed by a bank shall not include any interest or participation in any collective fund maintained by a bank. The term 'bank' shall mean any national bank or any banking institution organized under the laws of any State or Territory or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or Territorial banking commission or similar official.'* "

9. Amend Section 28 as follows:

"Sec. 28[(b)] Section 12(g) of *the Securities Exchange* [such] Act *of 1934* is amended by adding at the end thereof a new subparagraph as follows:

"'(H) any interest or participation in any common trust fund or [other pooled or collective] *similar* fund maintained by a bank *exclusively* for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian, or *any interest or participation in any* collective *trust* fund maintained by a bank consisting solely of assets of *employees'* [retirement, pension, profitsharing,] stock bonus, *pension or profit sharing* [or other] trusts which [are exempt from Federal income taxation under] *meet the conditions of Section 401 of the* Internal Revenue Code, *as amended, or any separate account the assets of which are derived from (i) contributions under pension or profit-sharing plans which meet the requirements of said section or the requirements for deduction of the employer's contribution under Section 404(a)(2) of said Code, (ii) from advances made by the insurance company in connection with the operation of such separate account, and (iii) from income and gains from the foregoing.*"

Mr. COHEN. The bill deals with four different types of bank collective investment funds (1) collective funds for managing agency accounts; (2) common trust funds for assets held by banks in a bona fide fiduciary capacity; (3) collective investment funds for corporate employee pension, profit-sharing, or retirement plans; and (4) collective funds for so-called H.R. 10 plans for self-employed persons and their employees established pursuant to the provisions of the Smathers-Keogh Act.

With your permission, I shall discuss separately our views on the bill with respect to each of the four different types of bank collective investment funds.

A collective investment fund for managing agency accounts consists of assets entrusted to a bank by individual investors who enter into a so-called managing agency agreement authorizing the bank as agent

and manager to invest their money collectively in a diversified portfolio of securities.

Commingled funds for managing agency accounts, like mutual funds, offer investors the opportunity to share in the economies of size through the pooling of their funds and to obtain professional management of a diversified securities portfolio. Since they are essentially the same as mutual funds, the Commission traditionally has taken the position that investors in bank collective funds for managing agency accounts ought to receive the same protections under the Securities Act of 1933 and the Investment Company Act of 1940 as do mutual fund shareholders.

Although initially the applicability of these statutes to bank collective investment funds for managing agency accounts may have been a source of some uncertainty and controversy, we believe that these issues now have been resolved to the satisfaction of the banks, the Federal banking agencies, and the Commission in the Commission's opinion in the *First National City Bank* case, from which one Commissioner dissented. I offer a copy of that opinion for the record.

Mr. Moss. Is there objection to the request to place a copy in the record?

Hearing none, it will be made a part of the record at this point.

(The document referred to follows:)

Administrative Proceeding file No. 3–280

SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D.C., MARCH 9, 1966

IN THE MATTER OF FIRST NATIONAL CITY BANK (COMMINGLED INVESTMENT ACCOUNT) (812–1823) INVESTMENT COMPANY ACT OF 1940—SECTION 6(c)

Findings and Opinion of the Commission

EXEMPTIONS

Composition of Board of Directors of Bank-Sponsored Collective Investment Fund

Application by national bank, which proposes to establish and to act as investment adviser of no-load collective investment fund and to register fund as open-end investment company under Investment Company Act of 1940, requesting exemptions pursuant to Section 6(c) of Act from Sections 10(b)(3), 10(c) and 10(d)(2) so as to permit Committee acting as board of directors of fund to include only one member unaffiliated with bank, *granted* as to Sections 10(b)(3) and 10(c) so as to permit majority of Committee members to be affiliated with bank, but *denied* as to Section 10(d)(2) so that requirement that at least 40% of members be unaffiliated with bank will remain in effect.

Custody of Assets; Bonding of Officers and Employees

Where national bank, as sponsor and investment adviser of collective investment fund to be registered under Investment Company Act of 1940, proposes to maintain custody of fund's assets and to continue existing bonding procedures with respect to bank officers and employees having access to those assets, *held*, requested exemptions from Rules 17f–2 and 17g–1 under Act imposing certain requirements with respect to custody and bonding, granted in view of safeguards provided by banking regulations and supervision by banking authorities.

APPEARANCES

William Everdell III, Stephen Benjamin and *Theodore A. Kurz*, of Debevoise, Plimpton, Lyons & Gates, for First National City Bank.

Robert L. Augenblick and *G. Duane Vieth, James F. Fitzpatrick* and *Charles R. Halpern*, of Arnold & Porter, for Investment Company Institute.

Marc A. White, and *Joseph B. Levin*, of Brown Lund & Levin, for National Association of Securities Dealers, Inc.

Justin N. Feldman, George J. Solomon and *Peyton H. Moss*, of Poletti Freidin Prashker Feldman & Gartner, and *John A. Nevius*, for Association of Mutual Fund Plan Sponsors, Inc.

Solomon Freedman, John A. Dudley, Robert E. Olson and *William A. Kern*, for the Division of Corporate Regulation of the Commission.

First National City Bank ("Bank"), a national banking association, has filed an application pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act") for exemptions from various provisions of and rules under the Act with respect to a Commingled Investment Account ("Account") which the Bank proposes to establish and to register under the Act as a diversified, open-end management investment company.

No evidentiary hearing was requested or ordered by us. Briefs and reply briefs in support of the application were filed by the Bank and by our Division of Corporate Regulation ("Division") which proposed certain conditions, and in opposition to the application by the Investment Company Institute ("ICI"),[1] the National Association of Securities Dealers, Inc. ("NASD"), and the Association of Mutual Fund Plan Sponsors, Inc. ("Sponsors"),[2] hereinafter referred to as the objectors.[3] Statements in opposition were also submitted by the Chairman of the House Committee on Banking and Currency, the Investment Bankers Association of America, and the Association of Stock Exchange Firms, and in support by the Comptroller of the Currency ("Comptroller") and the Federal Deposit Insurance Corporation. Scudder, Stevens & Clark, investment counsel, filed a statement regarding the policy of one of the provisions of the Act involved. We heard oral argument.

The Application

It is proposed that the Account be operated as a collective investment fund pursuant to applicable regulations of the Comptroller and accept investments of $10,000 or more pursuant to agreements between investors ("participants") and the Bank. The funds in the Account will be represented by units of participation of equal value, and each participant will be entitled to one vote for each unit held.

Following registration of the Account as an investment company, the initial capital of $100,000 required by Section 14(a) of the Act will be obtained through a private offering, and additional participations will be offered pursuant to a registration statement under the Securities Act of 1933.[4] No broker or dealer will be engaged to underwrite or distribute the participations, and no sales load or redemption charges will be imposed.[5] Funds in the Account will be invested principally in common stocks and securities convertible into common stocks. The operation of the Account will be subject to the supervision of a committee of at least three persons ("Committee"). The initial Committee, which according to the Bank's brief will consist of seven persons, will be appointed by the Bank and thereafter the members of the Committee will be elected annually by the participants. At least one member of the Committee will be a person who is not affiliated with the Bank, and it is proposed in the Bank's brief that six of the initial members will be officers in the Bank's Trust and Investment Division. Under a proposed management agreement, subject to approval of the participants at their first annual meeting, the Bank will serve as investment adviser and custodian for the Account, will determine what securities are to be purchased and sold, and will execute all transactions. It will furnish all administrative and clerical services, office space and other facilities, and will pay all organization costs and expenses. For its services, the Bank will receive a fee equal, on an annual basis, to ½ of 1% of the average net asset value of the Account.

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[1] The ICI is composed of 159 registered, open-end management investment companies and also of underwriters and investment advisers to those companies.

[2] Sponsors has as its members some 20 sponsor companies of contractual plans for the accumulation of interests in mutual funds.

[3] In granting leave to the objectors to file briefs and present oral argument, we stated that we were not passing on the question, raised by the Bank, as to their standing to participate.

[4] Under Section 2(a)(8) of the Act, a "fund," such as the Account, is an investment company. Section 3(a)(2) of the Securities Act of 1933 exempts from that Act any security issued by a national bank. However, this exemption refers to an interest in or obligation of the bank, and woud not apply to the participations in the Account.

[5] It is assumed that the Bank will enter into an arrangement with the Account for the sale of participations in the Account. See Section 15(b) of the Act.

Background

The Bank has for many years offered to customers an investment advisory service whereby it undertakes to hold and manage for the customer in a so-called managing agency account a portfolio of investments pursuant to a power of attorney giving the Bank complete investment discretion. However, the smallest managing agency account which the Bank considers it can economically accept is about $200,000, and the Bank states that the purpose of the Account is to make available similar managing services to smaller investors. Prior to 1963, national banks, while authorized to commingle and invest trust funds held as trustee, executor, administrator or guardian,[5a] were not permitted to commingle managing agency accounts. In that year, the Comptroller revised Regulation 9 (12 CFR 9), which governs the exercise by national banks of their fiduciary functions,[6] so as to permit the collective investment by a national bank of funds received in managing agency accounts as a fiduciary if approved by the Comptroller in writing. (12 C.F.R. 9.18(c)(5).) Pursuant to that provision, the Comptroller has approved the arrangement proposed by the Bank, and the Board of Governors of the Federal Reserve System has ruled that such arrangement would not violate Section 32 of the Banking Act of 1933, which prohibits any individual primarily engaged in, or associated with a corporation or partnership primarily engaged in, the "issue, flotation, underwriting, public sale, or distribution . . . of . . . securities" from serving as an officer, director or employee of any member bank of the Federal Reserve System.[7]

Thus, the Federal Reserve Board, which has primary responsibility for passing upon questions under Section 32, has ruled that the proposed arrangement would not violate that Section, the Comptroller has approved the arrangement in writing pursuant to revised Regulation 9, and as mentioned above, the Federal Deposit Insurance Corporation as well as the Comptroller support the application. With all three bank regulatory agencies, either expressly or by necessary implication, regarding the arrangement as consistent with the statutes they administer, we do not deem it necessary to consider further the questions that have been raised as to the legality of the proposed arrangement under Section 32 as well as Section 21 [8] of the Banking Act by the Chairman of the House Banking and Currency Committee and some of the objectors.[9] With respect to Section 21, the office of the Attorney General of the United States, in response to an inquiry by the Committee Chairman, has indicated that it is not clear whether the proposal would involve criminal liability under that Section and that since banking agencies have approved the proposal, a prosecution against the Bank at this time could not be successfully conducted. We accordingly proceed to a consideration of the requested exemptions on the assumption that the proposal does not violate the banking laws.

Exemptions Sought

The principal exemptions sought for the Account, and the only ones which are contested, are those from Sections 10(b)(3), 10(c) and 10(d)(2) of the Act,[10]

[5a] Common trust funds are exempt from the Act. Section 3(c)(3).

[6] In 1962 the authority to permit national banks to act as trustees and in other fiduciary capacities and to regulate their exercise of such powers was transferred from the Board of Governors of the Federal Reserve System to the Comptroller. Publ. L. 87–722, 76 Stat. 668 (September 28, 1962).

[7] 12 CFR 218.111.

[8] Section 21 of the Banking Act prohibits any person, firm, association, business trust or other similar organization "engaged in the business of issuing, underwriting, selling, or distributing" securities from engaging at the same time "in the business of receiving deposits," and provides criminal penalties for willful violations. Under 12 U.S.C. § 24 national banks may purchase and sell securities upon the order and for the account of customers.

[9] *Cf. The Prudential Insurance Company of America,* Investment Company Act Release No. 3620 (January 22, 1963), *aff'd* 326 F.2d 383 (C.A. 3, 1964), *cert. denied* 377 U.S. 953; *Midland Enterprises, Inc.,* 40 S.E.C. 818, 821 (1961).

[10] Section 10(b)(3) provides that a registered investment company may not have a person affiliated with an investment banker as a director unless a majority of the board is not so affiliated.

Under Section 10(c), a majority of the board of a registered investment company may not consist of persons who are officers or directors of any one bank.

Section 10(d) provides that, notwithstanding the requirement of Section 10(a) that no more than 60% of the board members of a registered investment company be affiliated with the investment adviser, companies charging no sales load and meeting other specified conditions, including the conditions in Section 10(d)(2) that the investment adviser be registered under the Investment Advisers Act of 1940 and be engaged principally in the business of rendering investment supervisory services as defined in that Act, need have only one such unaffiliated director.

in order to permit all but one of the members of the Committee, which is the statutory equivalent of a board of directors,[11] to be affiliated with the Bank. Additional exemptions are requested from Rules 17 CFR 270.17f–2 and 17g–1 under Sections 17(f) and 17(g), and temporary exemptions, until the first annual meeting of participants, from Sections 15(a), 16(a) and 32(a)(2). We discuss first the requested exemption from Section 10(c).

1. Section 10(c)

Under Section 10(c), a majority of the Committee may not consist of persons who are officers or directors of the Bank. The objectors, in addition to urging a limited scope for our exemptive power under Section 6(c),[12] contend that Section 10(c) reflects a policy of prohibiting the domination of mutual funds by banks with its inherent potentialities for conflicts of interest and was intended to apply to all types of investment companies. They further contend that the asserted protections to investors resulting from the Bank's fiduciary position and from banking regulations and supervision are inadequate substitutes for the protections of Section 10.

We have held that the propriety of granting an exemption pursuant to Section 6(c) of the Act "largely depends upon the purposes of the section from which an exemption is requested, the evils against which it is directed, and the end which it seeks to accomplish." [13] Setion 6(c) was put into the Act for the purpose, among others, of permitting the exemption of persons " 'who are not within the intent of the proposed legislation . . .' [citing Sen. Rep. No. 1775 (76th Cong., 3rd Sess.) at p. 13] even though such persons come within the scope of the Act by virtue of its specific provisions . . . This was to take care of special situations that might have been overlooked or that could not be foreseen at the time the legislation was drafted." [14] In such situations the showing required in order to meet the public interest and related standards set forth in Section 6(c) is that the compliance from which exemption is sought is not necessary to accomplish the Act's objectives and policies.[15] The fact that Congress adopted in Section 10(c) a specific prohibition against bank domination of an investment company does not preclude an exemption from that section pursuant to Section 6(c). In *Transit Investment Corporation*,[16] we held that the " 'purposes fairly intended by the policy and provisions' of the Act obviously means something more than a literal reading only of the provision from which an exception is desired. Otherwise, the existence of a provision prohibiting a transaction, which in every case under Section 6(c) is the very reason why an application for exemption is necessary, would also be the very reason for denying the application, thus making it impossible to resort to Section 6(c) to exempt a transaction from any provision of the Act."

Although Section 10(c) is general in terms, it does not appear that it was directed at the type of open-end investment company represented by the Account. We have already pointed out that it was not until 1963 that a commingled account such as the Bank proposes to establish became possible. Moreover, as stressed by the Bank, it is clear that the Account is substantially different, both in purpose and nature of operation, from the bank-dominated investment companies described in this Commission's Report to Congress on Investment Trusts and Investment Companies, which led to the passage of the Act, and in the testimony at the Congressional hearings. As detailed in that

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[11] Section 2(a)(12) of the Act in pertinent part defines the term "director" to mean "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

The NASD contends that the true directors of the Account will be the directors of the Bank rather than the members of the Committee, and argues that the participants will therefore be denied the right to elect the directors of the Account as required by Sections 16(a) and 18(i) of the Act. However, it is assumed that the Committee or its members will discharge their responsibilities as directors or persons performing similar functions, under the securities acts or otherwise.

[12] Section 6(c) of the Act provides in pertinent part that we may exempt any person from any provision of the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act.

[13] *Transit Investment Corporation*, 28 S.E.C. 10, 16 (1948). See also *American Participations, Inc.*, 10 S.E.C. 431 (1941) and cases cited in n. 17 of the *Transit Investment* case.

[14] *The Atlantic Coast Line Company*, 11 S.E.C. 661, 666–667 (1942). See also *The Variable Annuity Life Insurance Company of America*, 39 S.E.C. 680, 685 (1960).

[15] *The Prudential Insurance Company of America*, Investment Company Act Release No. 3620 (January 22, 1963), p. 8.

[16] 28 S.E.C. 10, 17, n. 20 (1948).

Report,[17] the legal restrictions on the power of commercial banks to engage in investment banking activities gave rise to the development, particularly during the 1920's, of securities affiliates designed to enable banks to participate indirectly in such activities and thereby avoid those restrictions. Those affiliates, whose securities were usually sold or issued as stock dividends to the bank's shareholders, frequently took the form of closed-end investment companies, or the affiliates sponsored such companies. Part III of our Report, dealing with abuses and deficiencies in the organization and operation of investment trusts and investment companies, recited in detail the history of two bank-affiliated investment companies.[18] Flagrant instances of self-dealing to the injury of those companies were revealed, including loans by the investment company to the securities affiliate to enable the latter to pay for a controlling interest in the investment company, use of investment company funds to trade in the bank's stock, and investment of such funds in the bank's stock or in other securities in which the sponsors were interested.[19]

Recently, former Chairman Cary of this Commission, in testifying before a subcommittee of the House Committee on Government Operations on the desirability of registration and regulation under the Act of bank-sponsored collective investment funds, referred to areas of potential conflicts of interest, including the deposit of the fund's cash in the bank, the placement of the fund's brokerage business, the use of fund investments to "shore up" bank investments, and the acquisition by the fund of securities underwritten by the banks.[20]

In our opinion, the Bank has shown that substantial safeguards are present here against conflicts of interest which could arise as a result of the Bank's commercial banking activities. The Account, unlike the bank-sponsored investment companies with which Congress was concerned in enacting Section 10(c), is regarded by the banking authorities as one aspect of the Bank's fiduciary functions and as such will be subject to the supervision and regulation of those authorities. While banking oversight is of course not the same in scope or orientation as the protective provisions of the Act, it will provide participants in the Account with additional protections not afforded investors in other investment companies.[21] Among other things, the Comptroller's office, as part of its periodic examination of national banks,[22] examines the investments held by the Bank as fiduciary to determine whether such investments are in accordance with law, Regulation 9 and sound fiduciary principles.[23] And, as stressed by the Bank, while the funds of the participants will not be received by the Bank as trustee, the Bank will act as managing agent and as such will be subject to fiduciary responsibilities.[24]

With respect to the areas of potential conflicts of interest cited by Chairman Cary, to leave funds uninvested would, as pointed out by the Bank, be contrary to the stated policy of the Account to make investments for long-term growth of capital and income and its own interest having the Account's value increase, any any attempt by the Bank to use the Account's cash to increase the Bank's deposits would violate the Comptroller's regulations.[25] With respect to brokerage allocation, the Account's prospectuses will represent that the Bank's primary objective in placing orders for portfolio transactions for the Account will be to

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[17] See Report on Investment Trusts and Investment Companies, Part I, pp. 93–95 (1939).

[18] See pp. 115–181.

[19] See also Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess., pp. 207–9, 793–4 (1940) ("Senate Hearings").

[20] Hearings on Common Trust Funds—Overlapping Responsibility and Conflict in Regulation, 88th Cong., 1st Sess., pp. 11–12 (1963).

[21] Of course, important protections and restrictions in the Act itself with respect to transactions between an investment company and its adviser or other affiliated persons, providing safeguards against conflicts of interest, would remain applicable here. For example, Section 12(d)(3) and Rule 17 CFR 270.2a–3 would prohibit the Account from purchasing any securities issued by the Bank, Section 17(a) would prohibit the Bank or its affiliated persons from selling any securities to the Account or borrowing money from it, and Section 17(d), as implemented by Rule 17 CFR 270.17d–1, would prohibit the Account and the Bank from participating in any joint enterprise or other joint arrangement without our prior approval.

[22] Such banks must be examined at least three times in every two years. 12 U.S.C. § 481.

[23] 12 CFR 9.11(d).

[24] See *Restatement (Second), Agency* § 13, comment a and § 425, comment a (1958).

[25] Section 9.10(a) of Regulation 9 states that funds "held in a fiduciary capacity by a national bank awaiting investment or distribution shall not be held uninvested or undistributed any longer than is reasonable for the proper management of the account." The Comptroller's Representatives in Trust, who regularly examine the operations of national bank trust departments, are instructed that "it is a breach of trust for the bank negligently or otherwise improperly to withhold investment or distribution." Comptroller's Manual for Representatives in Trust 80 (1965).

obtain the most favorable prices, and that it is the Bank's practice to place such orders with brokers and dealers who supply it with supplementary research and statistical information or market quotations. Any use of Account investments to "shore up" Bank loans is forbidden by a regulation of the Comptroller which prohibits purchases of securities from and of organizations "in which there exists such an interest, as might affect the exercise of the best judgment of the bank" in acquiring them.[26] Moreover, we will have continuing oversight over any transactions involving a joint arrangement between the Bank and the Account within the meaning of Section 17(d) of the Act and Rule 17d–1 thereunder. The remaining area of potential conflict cited by Chairman Cary, involving possible acquisition by the Account of securities underwritten by the Bank, is more closely related to the requested exemption from Section 10(b)(3) discussed below.

In determining whether the requested exemption from Section 10(c) should be granted we have also taken into account the fact that Congress contemplated some relationships between banks and investment funds, including some which are quite similar to those involved under the proposed arrangement. For example, a common trust fund or similar fund maintained by a bank for the collective investment of moneys contributed thereto by the bank in its capacity as trustee, executor, administrator or guardian is expressly excluded from the definition of an investment company by Section 3(c)(3) of the Act, thus indicating that such funds, which are quite similar to the Account insofar as the policies of the banking laws are concerned, might otherwise fall within the definition of an investment company. In addition, Section 10(c) of the Act expressly permits a minority of the board of directors of a registered investment company to be officers and directors of a bank and nothing in the Act prohibits a bank from acting as investment adviser to an investment company, and a few investment companies registered with us do have banks as their advisers. Under all the circumstances, including the existence of the provisions designed to provide safeguards against conflicts of interests, we conclude that it is appropriate to exercise our exemptive power under Section 6(c) to grant the exemption.

2. Section 10(b)(3)

We also find that it is appropriate to exempt the Account from Section 10(b)(3), subject to one condition set forth below. Under that Section, the Committee may not have a member who is affiliated with an investment banker unless a majority of the Committee is not so affiliated. The Bank states that it might be deemed to be an "investment banker," defined by Section 2(a)(20) of the Act as any person engaged in the business of underwriting securities issued by other persons, since it participates from time to time in syndicates underwriting United States Government and municipal obligations.

The legislative history of the Act, particularly this Commission's Report and the Congressional hearings,[27] reflects instances where an investment banker used an affiliated investment company to promote its investment banking business to the detriment of investors in the investment company. For example, securities underwritten or held by the banker were transferred to the investment company, and the investment company was caused to make investments which gave the banker access to the investment banking business of the company whose securities were purchased.[28] It was this type of abuse that Section 10(b)(3) was directed against. We do not think there is any basis for concern that the Bank, *qua* investment banker, can or will use the Account to its advantage, particularly since the Account is primarily a stock fund and the Bank is limited to underwriting debt securities of governmental authorities.

Section 17(a) of the Act itself, as previously noted, would prohibit sales of securities by the Bank to the Account and Section 10(f) would prohibit the Account, with one limited exception if the conditions in Rule 17 CFR 10f–3 are met, from purchasing or otherwise acquiring, during the existence of any underwriting syndicate, any security for which the Bank is acting as a principal underwriter. In addition, the Bank has stated that it is agreeable to a condition, which we shall impose, extending the duration of the prohibitions of Section 10(f) under circumstances where a syndicate has been terminated while its members still have unsold allotments. Moreover, the additional safeguards provided by

[26] 12 CFR 9.12(a).
[27] S.E.C. Report, Part I, pp. 76–83; Senate Hearings, pp. 207, 209–214, 222–3, 887.
[28] See House Hearings, p. 110.

bank regulation and fiduciary principles discussed in connection with Section 10(c) are equally applicable here.

3. Section 10(d)(2)

Section 10(d) provides that, notwithstanding Section 10(a), which would limit the number of members of the Committee affiliated with the Bank to 60%, an investment company charging no sales load and meeting other specified conditions need have only one director who is not affiliated with its investment adviser. The Account would meet all such conditions except those in Section 10(d)(2) that the investment adviser be registered under the Investment Advisers Act of 1940 ("Advisers Act") and be "engaged principally in the business of rendering investment supervisory services" as defined in that Act.[29] The Bank states that while such services are an important aspect of its business, it may not be "engaged principally" in such business; and, by definition, a bank is not an investment adviser under the Advisers Act.[30] The Bank argues that the Account is similar to no-load mutual funds sponsored by investment advisers for which Section 10(d) was designed.

We are not persuaded on the basis of the submissions before us that an exemption from Section 10(d)(2) is necessary to enable the Bank to create and operate the Account under the rulings of the banking authorities or is otherwise necessary or appropriate in the public interest. The approval of the Bank's proposal by the Comptroller and the Federal Reserve Board does not appear to preclude more than one unaffiliated member on the Committee, provided, as stated by the Board, the Account will "be operated under the effective control of the bank."[31] We shall accordingly deny the requested exemption from Section 10(d)(2). In view of our conclusion we do not address ourselves to the conditions which the Division suggested we impose in the event we granted such an exemption.

4. Other Requested Exemptions

Section 17(f) of the Act provides that a registered management investment company may maintain its securities in the custody of a bank meeting certain requirements as to capital, surplus and undivided profits, or in its own custody in accordance with rules prescribed by us. Rule 17f–2 prescribes the conditions under which the company may maintain custody. The Bank's application states that under the proposed management agreement, the securities and other assets of the Account will be placed in the custody of the Bank, which meets the specified capital and other requirements, but that it might be contended that the Account was itself maintaining custody and that such custody must comply with the provisions of the Rule. An exemption is therefore requested from Rule 17f–2 so long as the securities and other assets of the Account are maintained in the custody of the Bank.

Rule 17g–1 requires that any officer or employee of a registered management investment company who may have access to securities or funds of such company, be bonded, prescribes the manner in which the amount of the bond is to be determined, and provides for certain filings and notices. The Bank's application states that although Rule 17g–1 may be inapplicable, because the Account will have no officers or employees, the Rule might be deemed applicable to the Bank's officers and employees having access to the Account's securities or funds. Accordingly the Bank requests an exemption from the Rule.

The Bank urges that the participants will be adequately protected without requiring its compliance with Rules 17f–2 and 17g–1. It states that it will maintain custody of the Account's investments in the same manner in which custody of investments is maintained for other fiduciary accounts of the Bank, that its officers and employees will be adequately bonded, and that its procedures and practices in these respects are subject to regulation and supervision by governmental authorities having supervision over banks. It appears that under the circumstances adequate safeguards will be afforded with respect to the custody of the Account's securities and the bonding of persons who may have access

[29] Section 202(a)(13) of the Advisers Act defines "investment supervisory services" as the "giving of continuous advice as to the investment of funds on the basis of the individual needs of each client."
[30] Section 202(a)(11).
[31] 12 CFR 218.111.

to such securities or to the Account's funds, and we find that it is appropriate to grant the exemptions requested.[32]

We also find that it is appropriate to grant the requested temporary exemptions from Sections 15(a), 16(a) and 32(a)(2). Section 15(a) requires initial shareholder approval of the investment advisory contract. Sections 16(a) and 32(a)(2) require, respectively, that directors of an investment company be elected by its shareholders and that the selection of an auditor be ratified by such shareholders. We have ordinarily granted temporary exemptions from these provisions to enable newly-formed investment companies to operate until the first annual shareholders meeting.

An appropriate order will issue.

By the Commission (Chairman COHEN and Commissioners WOODSIDE, OWENS and WHEAT), Commissioner BUDGE dissenting.

ORVAL L. DUBOIS, *Secretary.*

Commissioner BUDGE, dissenting:

The granting of the requested exemptions is contrary to the clearly expressed policy of the Congress against bank domination of investment companies. Section 10(c) of the Investment Company Act of 1940 specifically provides that " . . . no registered investment company shall have a majority of its board of directors consisting of persons who are officers or directors of any one bank . . . " The Bank in order to register its Account seeks to be exempted from that provision as well as others. Such exemption may not be granted under the authority of Section 6(c) until and after a finding is made that it is "necessary or appropriate in the public interest" and "consistent with the protection of investors" and that it is consistent with "the purposes fairly intended by the policy and provisions" of the Act. The language of Section 10(c) is unambiguous, and as the Commission has correctly emphasized on several occasions, the exemptive power under Section 6(c) must not be exercised to thwart the stated objectives of the Act.[1]

While it may well be that entry of the banking industry in the mutual fund business would be a healthy addition—a view not shared by the bank regulatory agencies until just recently—nevertheless, the banks should not enter until after they have met the conditions prescribed by the Congress. Because of the demonstrated conflicts as well as the potential conflicts of interest between a bank and an investment company it dominates, good reason existed in 1940 for the Congress to impose the restrictions of Section 10(c).[2] There is no showing in this proceeding that those conflicts do not exist today, nor can the exact form of future conflicts be anticipated. If the specific prohibition of the Congress in this broad policy area is to be avoided, it should be done by the Congress and not through the granting of ad hoc exemptions by the Commission.

Congressional action is particularly appropriate when, as here, there are contrary interpretations between federal agencies as to the very nature of the entity being created. On the one hand the Commission in considering this application finds the bank to be one creature and the proposed investment company to be a separate creature in order that they may be capable of bargaining and contracting with one another. On the other hand, the federal agencies administering the banking statutes have adopted a "single entity" theory, finding the investment company to be "nothing more than an arm or department" of the Bank.[3]

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[32] *Cf. The Prudential Insurance Company of America, supra,* at p. 20 of cited Release.

[1] *The Variable Annuity Life Insurance Company of America,* 39 S.E.C. 680, 685 (1960); *Petroleum and Trading Corp.,* 11 S.E.C. 389, 392 (1942); *American Participations, Inc.,* 10 S.E.C. 430, 437, n. 8 (1941).

[2] The chief counsel for the Commission's Investment Trust Study testified at the Congressional hearings that "there were very undesirable consequences flowing from interlocking directorships or interlocking relationships between commercial banks and investment companies. Some of the worst examples of abuses we had in the whole study arose out of that relationship and the Federal Reserve Board, as well as ourselves, felt that in the future there should not be that close relationship." Hearings on H.R. 10065 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Congress, 3d Sess., pp. 110–111 (1940).

[3] Federal Reserve Board interpretation at 30 Fed. Reg. 12836, 12837 (1965) adding 12 C.F.R. § 218.111 and memorandum "Legal Considerations under Section 32 of the Banking Act of 1933 in Connection with the Proposed 'Commingled Investment Account' of First National City Bank of New York," Federal Reserve Board, p. 24, December 15, 1965. The Comptroller of the Currency holds and has repeatedly urged the same single entity theory.

The "single entity" interpretation is a realistic appraisal of the true nature of the Bank's proposed operation.[4] We then have the strange result that even though the Investment Company Act prohibits bank officers or directors from constituting a majority of the board of an investment company, yet this proposed "investment company" will in fact be part and parcel and will "be operated under the effective control of the Bank."[5] The lack of any real separation between the interests of investors in this "investment company" and the interests of the Bank is apparent. It was to protect investors against such interlocks and and resultant conflicts of interest that the prohibition in Section 10(c) was aimed.[6] The protections of the 1940 Act vanish when the entities become one.

On the record here I am unable to conclude that it is "necessary or appropriate in the public interest" *and* "consistent with the protection of investors" *and* consistent with "the purposes fairly intended by the policy and provisions of the Act" to grant the exemption herein sought. For that reasons, I would deny the application.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 9, 1966.

Order Granting in Part and Denying in Part Applications for Exemptions

First National City Bank ("Bank") having filed an application pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act") for exemptions from various provisions of and rules under the Act with respect to a Commingled Investment Account ("Account") which the Bank proposes to establish and to register under the Act as a diversified, open-end management investment company;

Briefs and statements having been filed, and the Commission having heard oral argument;

The Commission having this day issued its Findings and Opinion; on the basis of said Findings and Opinion

It is ordered, That exemptions from Sections 10(b) (3) and 10(c), from Rules 17 CFR 270.17f-2 and 17g-1 so long as the securities and other assets of the Account are maintained in the custody of the Bank, and from Sections 15(a), 16(a) and 32(a) (2) until the first annual meeting of investors in the Account, be, and they hereby are, granted subject, however, to the condition with respect to Section 10(b) (3) that the prohibitions in Section 10(f) of the Act against purchases by the Account, during the existence of any underwriting or selling syndicate, of securities of which the Bank is a principal underwriter be extended to include the period after a syndicate has been terminated and while its members still have unsold allotments.

It is further ordered, That an exemption from Section 10(d) (2) be, and it hereby is, denied.

By the Commission.

ORVAL L. DUBOIS, *Secretary.*

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[4] The single entity theory is the premise on which the conclusion was reached that the Bank proposal was not violative of the banking statutes. See footnote 3. If the conclusion is adopted, it should embrace the premise.

[5] Federal Reserve Board interpretation at 30 Fed. Reg. 12836 (1965) adding 12 C.F.R. 218.111.

[6] The objective of Section 10(c) is consistent with one of the aims of the Banking Act of 1933; i.e., to eliminate abuses arising from conflicts of interest by separating most aspects of the banking business from the securities business. Section 21 of that Act (12 U.S.C. § 378) prohibits firms engaged in the business of issuing, underwriting, selling, or distributing securities from engaging at the same time "to any extent whatever" in the business of receiving deposits.

Section 16 of the Banking Act of 1933 provides that a bank "shall not underwrite any issue of securities." 12 U.S.C. § 24. The banking laws specifically permit banks to underwrite only a limited group of debt securities of governmental authorities. 12 U.S.C. § 24.

Sections 20 and 32 (12 U.S.C. § 377 and 12 U.S.C. § 78) of the Banking Act of 1933 were designed to separate banks from their security affiliates and to pervent interlocking relationships between bank officials or employees and security firms.

The Supreme Court in *Federal Reserve System* v. *Agnew*, 329 U.S. 441, 449 (1947) has stated that Section 32 was designed "to remove tempting opportunities from the management and personnel of member banks." The Federal Reserve Board in its interpretations of the latter Section has prohibited all bank personnel from serving as directors of investment companies continuously offering their securities. See e.g., 46 Fed. Res. Bull. 371 (1960), 37 Fed. Res. Bull. 645 (1951), and 27 Fed. Res. Bull. 399 (1941).

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 14, 1966.

Correction of Findings, Opinion and Order

The Commission's Findings, Opinion and Order in this matter issued March 9, 1966 (Release No. 4538) is hereby amended as follows:

1. Change footnote 5, p. 3 to read as follows:

[5] It is assumed that the arrangement for providing participations in the Account will be reflected in a written agreement between the Bank and the Account which will contain the protective provisions specified in Section 15(b) of the Act. As indicated in this opinion banking authorities view the Account as an integral part of the Bank's authorized banking functions, and regard the Bank merely as acting as managing agent for its customers. We assume therefore that the banking authorities do not deem the proposal before us to be precluded by the provisions of the banking laws. The statutory scheme and specific purpose of the securities acts, on the other hand, require that we regard the Bank as a statutory underwriter, and the provisions contained in the Investment Company Act with respect to relationships and transactions between a principal underwriter and a registered investment company are applicable. However, for the reasons set forth in this opinion in granting certain of the exemptions requested and in view of the no-load character of the Account, we do not consider that conformance with the provisions of Section 10(b)(2), which in effect prohibit a majority of the directors of a registered investment company from being affiliated persons of its principal underwriter, is necessary or appropriate here. Accordingly, and since the Bank's application includes a request for an exemption from Section 10(d)(2) which would, if granted, embody an exemption from Section 10(b)(2), we shall grant an exemption from the latter section as partial relief.

2. In the Order, insert "10(b) (2)" after the word "Sections" in the first line of the fourth paragraph.

By the Commission.

ORVAL L. DUBOIS, *Secretary.*

Mr. COHEN. In that case, the Commission considered and granted certain exemptions from the Investment Company Act of 1940 to permit registration of a collective investment fund for managing agency accounts sponsored by the First National City Bank of New York.

Interests in the fund, which were offered on a no-sales-charge basis, are registered under the Securities Act of 1933, and the fund is registered with the Commission as an investment company under the Investment Company Act of 1940.

An appeal by the National Association of Securities Dealers from that decision was initially dismissed for lack of standing by the Court of Appeals for the District of Columbia, but a rehearing has been granted.

The proposed amendments would codify in certain respects the position of the Commission in the *First National City Bank* case. Under the bill, both the disclosure and antifraud provisions of the Securities Act and the broader regulatory pattern of the Investment Company Act would apply to collective investment funds for managing agency accounts.

The amendments would also codify into law certain exemptions from the provisions of the Investment Company Act granted by the Commission in the *First National City Bank* case. These exemptions would permit a majority of the directors of bank funds for managing agency accounts to consist of persons who are affiliated with the bank which has organized and managed the fund.

A statutory exemption from these provisions would be consistent with the Commission's decision in the *First National City Bank* case, provided at least 40 percent of the directors are required to be unaffiliated with the bank.

In this respect, however, the bill goes further than the Commission considered necessary in the *First National City Bank* case. It would permit a bank fund to have only one unaffiliated director. This treatment, under existing law, is extended only to mutual funds which operate on a no-load basis and meet certain other conditions.

The First National City Bank's fund for managing agency accounts did not—and other bank funds would not—qualify for this exemption because the banks would not be investment advisers registered under the Investment Advisers Act of 1940 and because they would not be primarily engaged in the business of investment counseling.

Although the banks propose to operate their managing agency funds on a no-load basis, the Commission did not feel in the *First National City Bank* case that relaxation of the requirements of section 10(a) with respect to unaffiliated directors was necessary for the operation of the fund. We believe it would be preferable to maintain the existing requirement that at least 40 percent of the directors be unaffiliated with the managing bank.

For this and other purposes, we will submit in our technical comments a draft of proposed changes to the provisions of the bill dealing with the regulation of bank collective funds for managing agency accounts.

The bill also would amend section 22 of the Investment Company Act to provide that no provision of law shall prohibit a bank from operating a collective investment fund for managing agency accounts. This is in accord with the position of the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corporation, the three Federal banking agencies responsible for the administration of the Federal banking statutes.

Recently, however, in a suit by the Investment Company Institute, the District Court for the District of Columbia held that such activities are prohibited by the existing provisions of the Federal banking laws.

The Commission did not participate in this litigation and, as I mentioned above, we have no comment on the interpretation or the resolution of policy issues or statutes which are not within our regulatory jurisdiction or responsibility.

Insofar as the policies of the Federal securities laws are concerned, we feel that anyone entering the mutual fund business should be required to do so essentially on the same basis and subject to the same rules applicable to other persons. We assume, and the banks should recognize, that the proposed amendment to section 22 of the Investment Company Act does not excuse or authorize any Federal banking agency to excuse banks from complying with these rules in their managing agency activities, and we are submitting a technical change to make this clear.

Other provisions of the amendments would provide express statutory exemptions from the Securities Act of 1933 and the Securities Exchange Act of 1934 for bank common trust funds or other pooled or collective funds for the investment of assests held by a bank as a trustee, executor, administrator or guardian. Such a fund is already exempt from the Investment Company Act under section 3(c)(3) of that act.

We have viewed these common trust funds as incidental to the traditional bank trust department function of administering assets held by it in a bona fide fiduciary capacity as a trustee, executor, administrator or guardian and as not involving a public offering under the Securities Act.

With respect to bank collective funds for tax exempt pension, profit-sharing or retirement plans, other than H.R. 10 trusts are treated separately, the bill provides exemptions from registration under the Securities Act of 1933 and under section 12(g) of the Securities Exchange Act of 1934. It also codifies an existing Commission interpretation which construes the exemption for tax-exempt employee trusts in section 3(c)(13) of the Investment Company Act to include collective funds for the investment of the assets of such trusts.

The application of the Securities Act of 1933 to pension and welfare plans has presented difficult questions over the years. Such plans could be regarded as involving the public offering of securities requiring registration. On the other hand, the special characteristics of these plans and the fact that they are often an integral part of labor relations, often determined by collective bargaining, has presented difficulties, and in general the Commission has not heretofore required registration of such plans under the Securities Act of 1933, except where such plans are funded by investment in the employer's securities.

Consequently, we would not object in principle to certain exemptions from the Securities Act of 1933 for employee pension plans. We believe, however, that it would be unwise to grant the blanket statutory exemption for such plans provided by the bill. We, therefore, will submit in our technical comments an amendment which would give the Commission broad administrative authority to exempt such plans whenever the public interest and protection of investors permit.

Finally, the amendments would exempt from the Investment Company Act of 1940 collective investment funds created by banks for the funding of H.R. 10 plans and exclude such funds from the definition of a security in the Securities Act of 1933 and the Securities Exchange Act of 1934 except as the Commission determined otherwise.

The Commission has previously taken the position that collective investment funds for H.R. 10 plans and certain other types of employee retirement plans covered by the amendments are normally entitled to the exemption in section 3(c)(13) of the Investment Company Act for "employee stock bonus, pension or profit-sharing plans or pension trusts." Those last several words are the exact words of the statute.

This exemption extends to all employee pension trusts which meet the conditions of the pertinent provisions of the Internal Revenue Code, including H.R. 10 plans.

We are concerned, however, about the presumptive and broad exemptive authority vested in the Commission with respect to H.R. 10 plans. The bill would exclude H.R. 10 plans from the definition of security in the Securities Act and the Securities Exchange Act, except as the Commission determines otherwise.

While we do not object to administrative authority to exempt funds for H.R. 10 plans from registration, we must oppose those provisions of the bill which presumptively exclude, subject to a contrary Com-

mission determination, funds for such plans from the definition of security in either act. This would permit the exemption of bank funds for H.R. 10 plans from the antifraud provisions of both acts.

No provision of these acts now authorizes anyone to exempt a security from the prohibitions against fraud, which apply even to Government bonds, and we do not see why this should be done. Among other things, it would be an awkward type of authority to exercise because we can hardly see how any responsible agency would wish to exempt any security from the prohibitions agaist fraud and deception.

In our testimoy before the Senate Committee on Banking and Currency on the McIntyre amendments to S. 1659, we expressed particular concern with the provisions of those amendments which would have vested jurisdiction in the Federal banking agencies for the administration and enforcement of the disclosure requirements of the Securities Act and exemptions from those requirements with respect to H.R. 10 plans. We note with pleasure that the bill before you avoids this fragmentation of administration which would represent a departure from a long-standing policy of the Congress.

The Securities Act of 1933 has been administered exclusively by the Commission, thus insuring uniformity of disclosure in comparable situations and facilitating informed choice among alternative investments. Collective investment funds for H.R. 10 plans are offered by banks in competition with similar investment vehicles offered by mutual funds and insurance companies. Such plans involve a complex arrangement for the investment of funds by self-employed persons, small businessmen and their employees for retirement purposes in a diversified portfolio of equity securities.

There is a need for adequate and understandable disclosure concerning the risks, obligations, rights, and costs which are involved.

Fragmentation of the responsibility for providing this disclosure among four Federal agencies—the Commission and the three banking agencies—depending solely on whether the plan is offered by a national bank, some other type of bank, or, for example, an insurance company or a mutual fund, would in our view present a chaotic situation.

To the extent that the disclosure is not uniform or comparable, it would become more difficult for a small businessman or self-employed person to make an intelligent choice among competing plans. There could be a competitive advantage for those funding media who were subject to less complete disclosure requirements or were exempted from disclosure altogether. There could, therefore, be a tendency for the protections of disclosure in this area to be reduced to the lowest common denominator.

As the subcommittee is aware, the Securities Act of 1933, unlike the Investment Company Act of 1940, is simply a disclosure and antifraud statute. Compliance with the Securities Act is not unduly burdensome, particularly with respect to offerings of H.R. 10 plans, which must be relatively uniform in order to comply with the Internal Revenue Code.

The Securities Act in no way interferes with the establishment or operation by banks of collective investment funds for H.R. 10 plans. The Prudential Insurance Co. of America—and you gentlemen have just had the privilege of listening to a representative of that organiza-

tion—and the National Bank of Detroit have registered their commingled funding media for H.R. 10 plans under the Securities Act, and several professional associations, including the American Bar Association and the American Medical Association, also have effective registration statements on file with us for their plans, which, incidentally, are trusteed by banks.

In addition to the provisions relating to bank collective investment funds, H.R. 14742 incorporates the Commission's recommendations for changes in the provisions of H.R. 9510 other than those relating to advisory fees, sales loads, and front-end loads. These recommendations are in accord with agreements reached as a result of a series of discussions between the Commission's staff and representatives of the Investment Company Institute. They effectively resolve all but two of the differences between the mutual fund industry and the Commission on the secondary provisions of the bill.

I must emphasize, however, that these recommendations do not deal with the major provisions of this legislation, that is, those relating to advisory fees, sales loads, and front-end loads in the sale of contractual plans. On these essential provisions of the bill, the Commission and the securities industry have been unable to reach agreement.

I might add, however, that the opposition to these provisions is not shared by the banks. While the banks propose to offer mutual-fund type investments on a no-load basis, they will, of course, charge management fees. Their management fees, like those of all mutual fund advisers, would be subject to the statutory standard of reasonableness embodied in H.R. 9510.

In testimony before the Senate Banking and Currency Committee, representatives of the American Bankers Association testified that the standard of reasonableness was a good test "without any question" and that the banks "would expect to operate successfully under these provisions."

The representatives of the American Bankers Association also testified that the proposed amendments to section 36 of the act, which would permit the Commission to seek injunctions against a "breach of fiduciary duty" and which the established mutual fund industry opposes, is a reasonable standard to impose upon organizations which are operating funds of this type, and to use their words, "is a much more effective standard to apply."

In closing, and I should say I have a separate statement which relates to the insurance industry proposals that I would like to give as soon as I have completed this portion of my testimony, I want to emphasize again the importance of the passage of this bill, particularly the provisions relating to advisory fees, sales loads, and front-end loads. The growing interest of banks as well as insurance companies in offering mutual fund investments to a broad segment of the public emphasizes the growing importance of this investment media as an outlet for public savings. If mutual funds are to serve as a repository for the savings of millions of Americans in the same way that insurance policies and bank savings accounts have served in the past, the industry must put its house in order pursuant to a regulatory pattern which requires fairness in their dealings with the public shareholders.

The existing pattern of regulation, which lacks meaningful enforcement tools for basic standards of fiduciary duty and which encourages

perverse competition in the sales load area, is inadequate for this purpose.

It has been suggested that the entry of banks, and particularly insurance companies, into the mutual fund industry, will produce new competitive forces which will result in reduced costs to investors and will make unnecessary the provisions of the bill relating to management fees and sales loads. We believe that such an assumption is wholly unrealistic.

As we have repeatedly pointed out, there is and has been intense competition within the mutual fund industry among the managers and underwriters of different funds. This competition has not benefited public investors because it is a "perverse" competition which has raised, rather than lowered, the costs of mutual fund investment. This has been so because the unique external management structure of the industry and existing legal restraints—I must emphasize that "existing legal restraints"—on retail price competition effectively insulates the industry from meaningful price competition.

As far as management fees are concerned, the bank and insurance company mutual funds will be organized under the same structure as other funds. Twenty-seven years of experience has demonstrated that in this context neither competition nor arm's-length bargaining can operate as an effective substitute for a statutory standard of reasonableness.

In the sales load area, the banks propose to offer their funds on a no-load basis and, therefore, like other no-load funds, would not reach many of the potential customers for mutual funds sold by salesmen on a load basis, although—and I want to emphasize that—they have other substantial selling channels. Insurance companies, like most of the mutual fund industry, will be selling fund shares on a load basis primarily through salesmen. They would undoubtedly compete for salesmen by offering them greater and greater compensation.

The retail price maintenance provisions of the act will serve to prevent competition in the form of lower prices to public investors. Given this legally protected perverse competition, we believe that the entry of insurance companies into the mutual fund field will not lower costs to investors; indeed, unless the provisions of the bill with respect to sales loads are passed, it may only aggravate the pressures to raise sales loads.

Now, Mr. Chairman, in the light of some of the questions that I heard as I came in, with your permission, I would now like to testify with respect to the suggestions made—as we understand them—by the life insurance industry.

Mr. Moss. You may proceed.

Mr. Cohen. Thank you, sir.

The life insurance industry has submitted to the subcommittee certain proposals for amendments to H.R. 14742. These amendments relate to the status under the Federal securities laws of separate accounts maintained by life insurance companies for funding, by means of variable annuities, of corporate pension plans qualified under section 401 of the Internal Revenue Code and of qualified retirement plans for self-employed persons, commonly known as H.R. 10 plans.

These proposals raise important questions of policy, particularly with respect to the Investment Company Act of 1940 and the Securities Exchange Act of 1934.

The stated purpose of the proposed amendments is to provide for life insurance companies the same treatment with respect to these plans as is provided, either by the bill or by existing law, for the same types of plans when administered by banks.

The life insurance industry points out that there is active competition between life insurance companies and banks for the business of administering these plans and that the great bulk of corporate plans are administered either by banks or by insurance companies.

The life insurance companies contend that if plans administered by them are to be subject to greater regulation under the securities laws than are plans administer by banks, they may be placed at a competitive disadvantage.

We are entirely in accord with the general principle of promoting competition by giving equal treatment under the Federal securities laws to competing investment vehicles which are essentially the same, and we agree also that in the area of employee plans and H.R. 10 plans, the bank funds and the insurance funds are very similar and serve essentially the same purpose.

There are, however, differences both in the regulatory pattern now applicable to banks and to insurance companies, and in some instances, in the manner in which plans are offered and sold by banks and by insurance companies.

We believe, moreover, that it would be undesirable to achieve competitive equality by reducing investor protection to the lowest common denominator, and that other approaches to competitive problems merit consideration.

Before turning to the proposed amendments themselves, it is important, I think, to note the nature and significance of the plans which they would affect. These plans vary a great deal and are often quite complicated.

Additional variations are constantly introduced. This is particularly true of corporate plans. Unlike the traditional pension plan, which is designed to provide an employee upon retirement with a fixed-dollar pension usually determined by reference to his salary and length of service, these plans contemplate an investment in equities. Either the employer's contributions or the employee's benefits, or both, will vary depending upon the market performance of the equity securities in which the funds are invested.

With respect to these plans employees may or may not have a vested interest, employees may or may not make substantial contributions and may or may not have the right to make additional voluntary contributions.

Employees may be given the right to elect the type of benefit they will receive and the alternatives available to them may be fairly numerous and complex.

I know you gentlemen are aware of the fact that there is at least one bill already pending in the Congress, I think introduced by Senator Javits, which deals with funding and vesting, among other matters,

and there has been a suggestion that the administration may propose a bill in this area. I have no doubt that this will be a matter of lively consideration by the Congress in the coming months and session.

H.R. 10 plans are somewhat more standardized, because of the requirements of the income tax laws, but even as to these, self-employed persons and their employees may be called upon to make a fairly complex form of equity investment.

Finally, it should be emphasized that these plans are of tremendous importance to millions of Americans. The ability of these millions and their dependents to live in some comfort on retirement may well depend on the wise selection and fair administration of their plan.

THE INVESTMENT COMPANY ACT OF 1940

The proposals of the life insurance industry would provide a complete exemption from the Investment Company Act for insurance company separate accounts both for employee plans and for H.R. 10 plans.

This is based upon the premise that bank funds for these purposes are presently exempt under section 3(c)(13) of the Investment Company Act and the insurance industry wishes the same treatment.

Given the complexity, variety and importance of these plans we do not think a simple blanket exemption eliminating all the protections of all the provisions of the Investment Company Act for all insurance company plans is the right answer.

In many instances, pensioners and self-employed persons may have a real need for the protections of the Investment Company Act, particularly because, unlike mutual fund shareholders, they are "locked in."

They cannot sell their shares in the plan if it performs unsatisfactorily or is improperly managed; they must stick with it for life, literally.

In view of this, we would prefer to deal with the problem administratively, granting to various types of insurance company plans such exemptions under the Investment Company Act as appear consistent with the statutory purpose and the protection of the beneficiaries.

We have ample authority under the existing provisions of the Investment Company Act to proceed in this way and no statutory amendment would be required.

We recognize that this proposal, however, raises problems of competitive equality between insurance companies and banks. There are two possible answers to this problem. In the first place, Congress may well wish to consider whether the existing blanket exemption for bank-administered plans and other trusteed plans under section 3(c)(13) continues to be warranted.

When this exemption was provided in 1940, employee pension or profit-sharing plans usually contemplated fixed-dollar payments based on some formula and were funded largely by bonds and other fixed income investments.

Congress may well have then concluded that the protections afforded by the Investment Company Act were not very relevant in this context.

With the increasing emphasis in these plans in recent years upon equity investment and the attendant hope of capital gain and risk of capital loss, the Investment Company Act becomes increasingly relevant.

Where a plan is funded by a pool of equity securities administered by a professional investment manager for the benefit of persons who put their money into it, either directly or as a part of their employment compensation, you have something which closely resembles a mutual fund and it seems anomalous that availability of the protections of the Investment Company Act should depend upon who administers the plan.

Further, in considering competitive equality one must also think of mutual funds which might wish to enter this field, that is, by creation of a mutual fund solely for the purpose of funding a plan of this kind.

I am not suggesting that Congress necessarily should consider making bank-administered employee funds invested in equities subject to the Investment Company Act.

We are certainly not looking for that job and I must emphasize that a preferable solution might be to amend the banking laws so as to provide comparable protections for plan beneficiaries to be administered by the Federal banking agencies.

Another alternative would be the use of direct legislation regulating corporate pension and profit-sharing plans.

In that connection, I should emphasize that the section 3(c)(13) exemption from the Investment Company Act is not limited to bank-administered plans. It also includes plans administered by individual trustees or by trusts established by employers, unions, or both.

In these situations the beneficiaries do not even have whatever protections are afforded by existing bank regulation and there have been a number of scandals with respect to such independent plans, which application of the Investment Company Act or something comparable might well have prevented.

Several bills for direct regulation of employee pension plans have been introduced in Congress and the subject is receiving the active attention of the administration. I am inclined to believe that at some time in the not-too-distant future, Congress will find it appropriate to act in this area, and it could well consider the pattern of the Investment Company Act of 1940 as part of any such general regulatory scheme.

Pending any such reconsideration there remains the problem of competitive equality between banks and insurance companies. I think that the Commission could, and it is our intention to, provide exemptions for insurance company plans which would substantially eliminate any competitive disadvantage.

If you were to entrust this matter to us, we would undertake to do our best in that regard and it would be appropriate for you to make it clear in the legislative history that you so intend. Particularly as to corporate plans, I believe that the competitive disadvantage could be largely eliminated by exempting the funds from many of the substantive regulatory provisions of the Investment Company Act, such as the requirement of a board of directors, including disinterested directors, the requirement for shareholder voting on many matters, the requirement that all shares of an investment company be sold at a

price which includes the same sales load, subject only to quantity discounts, and similar matters.

The plans would thereby remains subject essentially only to what are sometimes referred to as the "antisin" provisions of the act, such as the prohibitions of self-dealing, conflicts of interest, fraudulent practices and abuse of trust together with necessary reporting procedures.

Application of these provisions could hardly create a competitive disadvantage for insurance companies.

I have already indicated that one insurance company has filed a registration statement with us under the Securities Act of 1933. We do not know that it has created any problem for them. Another insurance company, Travelers Insurance Co., has created a separate account which, among other things, funds H.R. 10 plans, and that has been registered with us under both the Securities Act and the Investment Company Act.

Alternatively we could consider exempting the insurance company plans from registration altogether upon condition that the "antisin" provisions and necessary reporting and administrative procedures remain applicable. Section 6(e) of the Investment Company Act expressly authorizes this procedure.

We have been discussing these matters with representatives of the life insurance industry and these discussions, which have been going on for some time, have been productive and helpful.

I believe that we are quite close to reaching an understanding with the life insurance industry as to a pattern of exemption under the Investment Company Act which would largely remedy any actual competitive disadvantages which might exist. Or which anyone might be concerned would exist.

Naturally, if Congress proposed to pass legislation increasing or confirming the exemptions afforded to banks, the insurance industry would prefer to be included in these exemptions.

Nevertheless, I believe, as a result of my conversations—and I do not wish to overstate it—with representatives of the life insurance industry, that a scheme of regulation and exemption along the lines which I have mentioned would largely satisfy their real competitive needs.

SECURITIES ACT OF 1933

I have already discussed the proposed amendments to the Securities Act of 1933 which would have the effect of exempting most bank-administered funds from that act and have indicated our disagreement with some of these proposals, particularly the blanket exemption for bank-administered funds, other than H.R. 10 funds, and the provision that H.R. 10 funds are exempt unless the Commission determines otherwise rather than placing upon those who seek exemption the responsibility for justifying it.

I believe, however, that it probably would be desirable to amend the Securities Act so as to authorize the Commission to grant exemptions from registration under the act to funds for employee plans and H.R. 10 plans when it finds this to be consistent with the protection of investors and the purposes of the act.

I might interpolate to suggest that a similar pattern, it is my recollection, was under consideration between the industry and the Commission in 1941 but the advent of the war concluded those discussions. But such a proposal was in the area of complete agreement, as I recall it.

I suggest this because there are a number of situations, particularly in respect to corporate employee plans, where registration under the Securities Act of 1933 may not serve any very useful purpose.

In this connection, I have in mind situations where a pension plan is negotiated between a substantial and knowledgeable employer advised by pension consultants and actuaries and a bank or insurance company.

In such a situation the employer probably has no need for the disclosures which registration would provide; however, there may be situations where the employees would need it.

A statutory exemptive power could be useful since we might find it difficult to provide relief by interpretation of the act in all of the situations where it is warranted, without at the same time possibly creating undesirable precedents.

Any such exemptive power should apply equally to plans administered by banks, life insurance companies and others and the legislative history should make it clear that this should be administered in a manner which would promote competitive equality among these funding media.

While the proposals of the life insurance industry for amendment of the Securities Act merely modify the existing bank fund provisions of the bill, and are thus subject to the same difficulties that we found in those provisions, I do not believe that the exact form of the exemptive provisions is a source of concern to the life insurance industry, and I believe they would be satisfied with the modifications which we have proposed.

In other words, I do not believe that there is any disagreement at all between the Commission and the life insurance industry as to Securities Act exemptions for employee plans and H.R. 10 plans.

I do appreciate the indulgence of the committee with this rather lengthy statement but as I stated at the outset, we are dealing with some increasingly complex regulatory matters.

As the representative of the life insurance industry has pointed out in the appendix to his statement, the proposed amendments to the Securities Exchange Act with respect to employee pension and profit-sharing plans and H.R. 10 plans, whether administered by banks or insurance companies, raise two separate questions—that of exemption of the plans from registration and reporting under section 12(g) of the Exchange Act and that of registration as broker-dealers under section 15 of that act for those who sell such plans.

Turning first to section 12(g), we would have no objection to exemption of both bank-administered plans and insurance company-administered plans under that section.

As to bank-administered plans, section 12(g) is administered by the various Federal banking agencies who already have broad power to grant exemptions from that section.

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As to insurance company-administered plans they would already be exempt from section 12(g) upon condition that they are subject to comparable regulation by the State insurance commissioners.

You gentlemen will recall this was the pattern adopted by the Congress in 1964. The power of the State insurance commissioners to grant exemptions, without subjecting the plans to regulation by the Commission, is accordingly limited but the Commission would have broad power under existing law to exempt plans administered by insurance companies.

I am inclined to believe that exemptions from section 12(g) for employee plans and H.R. 10 plans might well be appropriate and for this reason we do not object to such exemptions.

The situation with respect to broker-dealer registration is quite different. The banks are presently exempt from broker-dealer registration and regulation because sections 3(a) (4) and (5) of the Exchange Act have, from the beginning, excluded banks from the definition of brokers and dealers.

The insurance companies consequently suggest a comparable exemption for employee plans and perhaps for H.R. 10 plans, in the name of competitive equality.

We do not think a blanket exemption would be appropriate. In the Securities Act Amendments of 1964, Congress greatly strengthened the scheme of broker-dealer registration and regulation.

Under these amendments persons associated with those broker-dealers who are not members of the National Association of Securities Dealers, Inc., and who are engaged in the sale of securities, including mutual fund shares, are required to meet—and I now quote the relevant language:

> Such specified and appropriate standards with respect to training, experience and such other qualifications as the Commission finds necessary or desirable.

To that end the Commission may classify persons and require any members of a class to pass examinations and in other ways demonstrate their qualifications.

Such broker-dealers and their employees are also subject to Commission rules designed not only to prevent fraudulent and deceptive practices but also to promote just and equitable principles of trade.

The NASD, of course, has for years established similar standards for its members and their employees subject to Commission oversight.

Under these provisions, insurance companies and their salesmen who sell mutual fund shares or variable annuities, which have been held by the Supreme Court to be securities, are required in one way or another to effect registration with the Commission as broker-dealers and to meet the qualification standards and pass the examinations.

A number of insurance companies have either registered with us as broker-dealers or registered a wholly owned subsidiary under the relevant provisions of the Exchange Act.

The need for comparable standards of conduct and qualification for insurance companies and their salesmen selling H.R. 10 plans seems fairly clear.

These plans, which as I have mentioned can often be a fairly complex equity investment, could be sold to self-employed persons unsophisticated in the securities field, by insurance salesmen who, unless qualified in accordance with the requirements of the Exchange Act,

might also know little or nothing about equity investments. You could thus get a situation where, in effect, the blind were leading the blind into a rather intricate thicket.

Broker-dealer registration and regulation may not be so necessary in connection with the offering of corporate pension plans, particularly for large corporations.

On the other hand, to the extent that insurance companies sell any nonexempt security, be it a mutual fund share, a variable annuity or an H.R. 10 plan, broker-dealer registration would be needed.

Appropriate exemptions from the qualification requirements could be provided if needed for executives engaged solely in the sale of corporate plans to larger corporations.

In his statement to the committee today, the representative of the life insurance industry acknowledged these principles as applying to H.R. 10 plans, stating:

> We accept the necessity for compliance with the 1933 and 1934 Acts to the extent that the regulatory authority finds it necessary in the public interest.

If, however, insurance companies selling H.R. 10 plans and perhaps those selling small corporate plans are to be subject to broker-dealer registration and regulation, this again raises some question of competitive equality with the banks.

Broker-dealer registration, however, certainly does not make it more difficult for an insurance company to compete with a bank for the same piece of business.

All it means is that the insurance company has to go to the trouble and expense of qualifying its salesmen to understand what they are selling and to deal fairly with their customers.

Since, as I have mentioned, banks are exempt from broker-dealer registration, no provision of the Federal securities laws now requires a bank teller who sells H.R. 10 plans or participations in commingled managing agency accounts, to be similarly qualified.

Here, as in the case of the Investment Company Act of 1940, we do not believe that the remedy for any possible competitive problem created by the requirements of the Federal securities laws is to reduce investor protections to the lowest common denominator.

On the contrary, all competitors should meet minimum standards established by Congress.

Prior to the 1964 amendments to the Securities Exchange Act no particular purpose would have been served by subjecting banks to broker-dealer registration, since the existing scheme of bank regulation provided most of the protections which the more limited broker-dealer regulation then provided, and banks were not engaged in, and were in fact prohibited by law from, merchandising equity securities.

The 1964 amendments added something in the way of qualification standards for personnel and regulation of sales practices which, to the best of my knowledge and belief, has no counterpart in bank regulation.

As the legislation this committee is considering today indicates, banks now wish to enter the field of equity investment.

Again, I do not necessarily suggest that banks should be required to register as broker-dealers if they are selling H.R. 10 plans or even participations in commingled managing agency accounts.

Alternative procedures could be provided by amendment to the banking laws or otherwise, to require bank employees engaged in these activities to meet specified standards comparable to those established by Congress in 1964 for broker-dealer personnel and to be regulated in a similar way.

In any event, there may well be significant differences between the selling methods of banks and insurance companies in this field. Insurance companies presumably will rely to a considerable extent, as they traditionally have, upon agents selling on a commission basis.

Nevertheless, banks are not handicapped in selling. They have a built-in list of prospects in their regular banking customers, but we anticipate that they will not charge an initial sales load.

In summary, we believe that broker-dealer registration and regulation are needed for insurance companies selling variable annuities, H.R. 10 plans and perhaps small corporate plans and that the life insurance companies understand and accept this situation.

I regret that our response to the proposals of the life insurance industry, and indeed to those of the banking industry as well, may sound somewhat complex and perhaps controversial.

In that connection, I would like to remind the committee that this situation is none of our making.

The banks came forward with legislative proposals to facilitate their entry into the equity investment field. The life insurance companies, who were already seeking to enter the mutual fund field and related areas of equity investment, have come forward with their counterproposals and we understand that there are others waiting in the wings.

Our staff has had some discussions with representatives of the mutual savings bank industry which appears to be interested in coming into the mutual fund field in a somewhat different way and the staff was told that savings and loan associations might also have an interest.

This burgeoning desire on the part of various types of financial institutions to, in a sense, get into the mutual fund business creates problems, particularly insofar as they seek to enter on a basis different from that under which the existing mutual funds and securities dealers operate.

We believed it necessary for us to respond to these proposals in the most thoughtful way we could and we have been doing a lot of thinking about it.

In so responding we necessarily have an obligation to concern ourselves not only with competitive factors but also with avoiding an erosion of existing investor protections for the purpose of accommodating new entries into the field.

We must at the same time recognize that there are differences, many of them significant, between these new entries and the merchandise they offer on the one hand, and the securities dealers and mutual funds on the other, and that any scheme of regulation must recognize the differences as well as the similarities, but, I repeat not at the expense of equal protection of investors.

If our resulting response appears complex, so also is the situation to which we are responding.

I trust that it will not result in controversy. If it should, I think it important not to try to settle everything at once and, in the process, to encounter such difficulties that we wind up by settling nothing.

In other words, we have not only to deal with the problems of the banks and the insurance companies but also to deal with the problems of mutual fund investors which are the principal subject of the study we made and the legislation we proposed and the latter should not be overlooked in our concern with new institutions seeking entry to the business.

Mr. Chairman, I appreciate your indulgence and that of your colleagues.

This concludes my prepared remarks.

Mr. Moss. Mr. Chairman, it is quite obvious at this hour that we will not be able to conclude the hearings in one session. So, accordingly, the committee will now recess until 2:30 in order to permit you gentlemen and members of the committee to have lunch.

Mr. COHEN. Thank you very much, sir.

Mr. STUCKEY. I have a previous appointment. Would it be possible for me to submit some questions in writing for the record?

Mr. Moss. Yes, sir; the record will be held open at this point for the questions that Mr. Stuckey will submit and the responses.

Mr. COHEN. We will be glad to respond as quickly as possible.

Mr. STUCKEY. Thank you.

(The information requested follows:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 25, 1968.

Hon. W. S. STUCKEY, JR.,
House of Representatives,
Washington, D.C.

Dear Mr. STUCKEY: This is in reply to your letter of March 22 in which you ask certain questions in connection with H.R. 14742.

We are happy to endeavor to answer them. I will set forth below each of your questions followed by our answer.

Question 1.

On page 3 of your testimony before this Subcommittee on March 15, 1968, you stated that, "The provision of the securities laws are intended to and should apply equally to all persons and organizations who offer securities to public investors." Is this statement consistent with the exemption from Section 10(c) of the Investment Company Act of 1940 granted to a bank collective investment fund in the *First National City Bank* case?

Answer.

While I did say that the provisions of the securities laws are intended to apply equally to all persons and organizations, this was in the context of a thought that special types of persons or institutions should not receive special or preferential treatment. Naturally, as I said in my second statement, our regulatory requirements must take into account the special characteristics of the numerous and varying organizations to which the securities laws apply. Our reasons for granting an exemption from Section 10(c) of the Investment Company Act to the First National City Bank are set forth in our opinion, a copy of which I placed in the record. In general we felt that the Commingled Investment Account of the First National City Bank was not the type of investment company affiliate of a bank to which Section 10(c) was directed, since accounts of this type were unknown in 1940. Furthermore, a prohibition on the account having as a majority of its directors persons affiliated with the bank would have created difficulties for the bank under the rulings of the bank regulatory authorities with respect to the matter and we felt that it was sufficient under all the circumstances to have 40 percent of the directors unaffiliated with the bank. Section 10 of the

Investment Company Act contains various provisions designed for various types of investment companies concerning the affiliations of directors. For example, a majority of the board may be affiliated with the investment adviser but a majority may not be affiliated with the principal underwriter and certain no-load funds, subject to Section 10(d), need have only one unaffiliated director. Thus the Act itself contemplates some variations in this matter.

Question 2.

In its application to the Commission, the First National City Bank stated that it would charge a management fee of ½ of 1% of the average net asset value of the account. Why did not the Commission take this opportunity—an opportunity to set a precedent for all bank sponsored mutual funds—to object to ½ of 1% and insist upon a fee consistent with the SEC's standard of reasonableness?

Answer.

We have never taken the position that an investment advisory fee of ½ of 1% of the average net assets of the investment company would never meet the standard of reasonableness. In fact, the great majority of investment companies are charged a fee in the neighborhood of this amount and we do not believe that all such fees are unreasonable. One of our primary concerns in connection with this standard of reasonableness is that economies of scale have not been adequately shared with stockholders as the funds grew. We, consequently, do not object to small funds just starting out in business being charged a fee of ½ of 1% provided that, as they grow, suitable adjustments are made. First National City Bank was starting on that basis.

All of this is, of course, apart from the question whether under the circumstances which prevailed it would be appropriate to condition an exemption otherwise proper upon compliance with legislation not yet enacted.

Question 3.

On pages 14 and 15 of your testimony you stated your belief that the additional competition created by the entry of banks and insurance companies into the mutual fund industry will not exert a downward pressure on either management fees or sales loads. As the basis for your opinion you relied on past experience and what you call "perverse competition". Since banks, in particular, will be offering no load mutual funds plans, can it be said that this type of competition will be perverse? Furthermore, is not Congress being asked to act inconsistently when, on the one hand, it is asked to admit additional competitors into an industry and, on the other hand, asked to legislate with respect to management fees and sales loads as if this additional competition were not going to exist? At the very least, with the potential growth of the mutual fund industry resulting from the entry of banks and insurance companies, would it not be wiser to adopt a wait and see attitude rather than to over-legislate at this time?

Answer.

With respect to the first part of this question, my comments with respect to "perverse" competition were addressed to the sales load not to the management fee. My point was that those funds which charge sales loads, and whose shares are sold by salesmen, will not be led to lower their loads by the entry by banks or insurance companies; rather, this additional competition will lead them to bid even more aggressively for the services and favor of salesmen thus tending to create an upward pressure on the loads.

The considerations with respect to management fees are rather different. It is not a matter of "perverse" competition either raising or lowering the management fee. The problem is that for each individual fund its management fees are fixed without either competition or arm's length bargaining and are, in effect, determined by the management company. The entry of additional organizations into the field is not likely to have any effect upon this situation since it will not change the situation prevailing in any individual fund. Competition between funds has little impact on management fees because this aspect of the matter is not stressed in sales presentations and because, although the amounts involved are very large in the aggregate, the amount directly paid by the average individual small investor is not large enough to particularly attract his attention, especially if he is, as is often the case, somewhat unsophisticated.

As to the second part of your question, Congress is being asked to admit only one limited type of competitor into the industry, the bank administered com-

mingled fund for managing agency accounts. Other types of competitors are, as they always have been, free to enter without legislation. We do not feel that the needs of investors for fair treatment in the area of sales loads and management fees should be neglected in the hope that the problem will somehow go away as a result of competition, which for 28 years has not appeared or provided benefits for fund shareholders. Our experience demonstrates that such a hope is illusory.

Question 4.

You have supported legislation which would authorize the SEC to study the economic impact of institutional investors on the market. At the same time, you do not oppose the entry of the banks, huge institutional investors, into the market before the basic problems have been studied. How do you accommodate these two positions?

Answer.

As is pointed out in the answer to the previous question, the only proposed legislation permitting additional entry into the market relates to commingled managing agency accounts sponsored by banks. These would not, at present nor in the immediately foreseeable future, be significant compared with the other vehicles by which the banks are already in the market, such as pension and profit sharing trusts, common trust funds, and personal and testamentary trust. Consequently, this legislation would not admit banks into the markets for the first time. They are already there, and thus I believe there is no necessary inconsistency between this legislation and the proposed study of institutional investment. I also emphasize that the Commission did not propose the amendments that would admit banks and it neither supports nor opposes such amendments.

Question 5.

I understand from your previous testimony that bank salesmen would not be subject to the same rules as to training and supervision which apply to salesmen of mutual funds. Do you feel that this would be in the public interest from the standpoint of protecting the investor?

Answer.

As I pointed out in my testimony, banks are excluded from the definition of broker and dealer in the Securities Exchange Act, with the result that the provisions of that Act with respect to qualifications, training and supervision of sales personnel do not apply to bank employees and so far as I know these provisions have no counterpart in bank regulation. I asked that Congress give consideration to requiring appropriate standards of training and qualification for bank personnel engaged in selling participations in commingled managing agency accounts (if banks are permitted to enter this field), commingled funds for H.R. 10 plans and perhaps other types of equity investment. I suggested that this might be done not necessarily by subjecting banks to broker-dealer registration but could be achieved by appropriate amendments to the banking laws. The initial steps in considering such a possibility would presumably be to obtain the views of the federal bank regulatory agencies, to ascertain whether they would have the power to impose such requirements under their existing authority and presumably to make some inquiry into the methods used by banks in selling participations of the type referred to.

Question 6.

In answer to questions I asked you the last time you appeared before this Subcommittee, you did not have any economic data to support a statutory ceiling on sales charges. What steps have you taken to obtain such basic economic data since our last meeting in support of your recommendations to the Congress?

Answer.

My answers to your questions were inaccurate if they suggested that we have *no* economic data to support a statutory ceiling on mutual fund sales charges. The Commission's December 2, 1966 Report on Public Policy Implications of Investment Company Growth ("Report") did present data, at page 208, showing that between 1950 and 1966 the principal underwriters of nearly half the large funds increased the sales loads which are applicable to over 90% of lump sum purchases; that none reduced the basic sales loads; and that about two-thirds of the underwriters increased dealer discounts in many cases by proportionately more than the increase in the basic sales load. The perverse competition which results in consumers paying these sales load levels results from

dealers being prohibited by Section 22(d) from competing for customers by charging lower prices for shares of a mutual fund.

Other economic data in the Report, at page 210, demonstrated that in the exchange markets, only minimum charges are fixed and these are in the neighborhood of 1% on most transactions. Economic data in the Report showed that $1,120 (the amount invested in the median lump sum mutual fund purchase) were invested in a listed closed-end investment company, the exchange commission would be 1.8%. The exchange commissions on both purchase and sale would be 3.5%—less than two-fifths of the typical mutual fund sales charge.

The Report, at pages 211–212, also demonstrated that in the over-the-counter markets, where price fixing is illegal, the sales charges investors pay for purchases plus sales also are typically about two-fifths of what lump sum investors in mutual funds pay. And this substantial disparity exists despite the following statement at page 56 of the August 22, 1966, Over-The-Counter Markets Study prepared for the NASD by Booz, Allen & Hamilton, Inc.:

"The partners of numerous local firms in the five cities visited during the course of this study * * * pointed out that their salesmen had to work much harder to sell over-the-counter stocks than mutual fund shares * * *."

Further, the Commission's Report presented data, at page 203, which shows that existing shareholders' reinvestment of capital gains and their investment of income dividends in fund shares have usually accounted for from almost half to two-thirds of the sums paid out to those who redeem their fund holdings. Thus, based on the last few years' experience, a statutory ceiling would have to result in more than a two-thirds decline in new sales for it to cause the fund industry to go into a net redemption status.

Whether the 5% statutory ceiling we have recommended would cause sales volume to change and if it does, whether there would be a decline or increase, is an unanswered question. (You may recall that, in testifying in response to your questions, I expressed the opinion that lower sales load charges may cause sales to increase. The reason why the answer to that question remains a matter of opinion and the reasons why, since my appearance before the Subcommittee in October 1967, we have not taken steps to obtain additional economic data to discover the impact on sales of the proposed 5% ceiling are one and the same. It is simply this. The mutual fund industry has never operated under retail price competition. Under Section 22(d) perverse competition for dealers' and salesmen's favor in the sale of load fund shares has prevented cost-lowering price competition. In view of this, and the absence of any other action lowering basic sales load levels, we do not know—nor has the industry suggested—what economic data is available from which one might validly predict the impact of the 5% ceiling on sales.

As to data on the possible impact of reduced sales loads on sellers of mutual fund shares, see the Commission's response to Senator Wallace F. Bennett's Question 7, at pages 102–104 of the Hearings Before the Committee on Banking and Currency on S. 1659. See also, at pages 604–607 of the Hearings, the response of Professor Henry C. Wallich to Questions by Representative G. Robert Watkins and the tables produced by the Commission staff which he cites. Professor Wallich, a member of the Council of Economic Advisers during the administration of President Eisenhower, concluded:

"1) There is no evidence that even the smallest firms cannot survive a cut in the sales load from 9.3 to 5 percent, particularly at a time of expanding securities markets, even though some of these firms may have difficulties. 2) The cost of mutual fund buyers of keeping these firms in business, on the unlikely assumption that otherwise they would mostly go out of business, exceeds the total income of these firms by a multiple of about four. It exceeds the loss that these firms would suffer from the drop in the sales charge by a multiple of almost 17. I can see no justification, either social or economic, for such a policy."

Question 7.

With respect to the six sections of Mr. Moss' Bill, H.R. 14742, he has indicated that there is no present agreement between the industry and the SEC. Do you have any suggested alternatives for our Subcommittee to consider?

Answer.

I understand that the six sections to which you refer relate to (i) a reasonableness test for management fees, (ii) the proposed 5% ceiling on sales charges for lump sum purchases of fund shares, (iii) elimination of the front-end load, (iv) a requirement that transfers of management not be on terms unfair to

fund shareholders, (v) substitution of a "breach of fiduciary duty" standard for the "gross abuse of trust" standard in Section 36, and (vi) establishment of rule making authority respecting sales loads on reinvestment of dividends.

Both prior to and since the hearings, the Commission has taken every opportunity to invite industry representatives and other interested persons to discuss alternatives to these and other provisions of the Bill. Discussions have been going on, even recently.

Alternatives to the first three proposals mentioned above are discussed in a Memorandum on Principal Recommendations in the Commission's Report, a copy of which appears in the record of the Hearings, at pages 93–95. The Commission carefully evaluated those alternatives and concluded that, while there is much to commend some of these alternatives, our legislative recommendations on balance represent the best solutions. Of course, the Congress may reasonably come to different conclusions after fully considering those alternatives.

In addition to the alternative suggestions discussed in the aforementioned memorandum, another should be mentioned. This relates to the proposed prohibition of breaches of fiduciary duty. The principal concern of the industry appeared to be that the Commission might, by interpretation, extend this beyond instances of misconduct. This was not the Commission's intention and it was our hope that this difficulty could be resolved by appropriate language in the legislative history. I believe that this alternative is available to the Congress as a means of resolving this difficulty.

The Commission knows of no other alternatives it is prepared to suggest to the Congress.

Question 8.

Can you advise me as to the extent to which management compensation and sales commissions are regulated by Federal agencies insofar as such competitors of investment companies as bank trust departments, pension trusts, insurance companies, savings and loan associations, and similar financial institutions are concerned?

Answer.

While the Congress has enacted legislation, in the Investment Company Act of 1940, on the subjects of investment company management compensation and mutual fund sales loads, it has not legislated in respect of such charges by bank trust departments, pension trusts, insurance companies and savings and loan associations. Indeed, Congress has passed legislation exempting from Federal regulation the insurance business, the only one of the above-mentioned enterprises which imposes sales charges as an entrance fee for its services.

As you know, the management compensation of bank trust departments is subject to state legislative regulation and judicial supervision, and the Congress has not determined that their management compensation ought to be Federally regulated.

Nor are we aware of any demonstration that pension trusts are charged unreasonable management fees. In fact, the Commission's Report presented data showing that bank fee schedules for pension and profit-sharing plans provide greater economies of scale for far smaller sums of managed money than exist in the mutual fund industry. As the Report noted, at pages 114–118, the annual advisory fee charged by banks for a $100 million portfolio was 0.06% or 0.07% of total asset value, and even lower fee rates could be negotiated for portfolios the size of some of the large mutual funds. The lower management fees charged pension trusts by banks are in large measure due to the fact that banks engage in price competition for pension trust accounts among themselves and with life insurance companies. Unlike mutual fund managers, they do not effectively control the selection of the portfolio manager and the fee it is to receive.

Savings and loans can be viewed as charging a management fee—after allowing for overhead and administrative expenses (other than managerial compensation) and for reserve requirements, the difference between interest rates obtained on money loaned and the rates paid to savers. Except for the limits on the amount of interest they can pay to savers imposed by the Home Loan Bank Board, savings and loan management fees are not regulated by the Federal Government. However, *mutual* savings and loans do not have external management. As employees, their managers are subject to conventional limitations which obtain as to salaries. *Stock* savings and loans differ from externally managed mutual funds in two important respects. The first is that the stockholders of such a savings and loan make a substantial capital investment in the enterprise,

which supplies a margin of safety to the savers. The shareholders of a mutual fund management company make no such capital contribution to the fund. The other significant difference between the two situations is that competitive price pressures for saver favor are far more intense in the savings and loan field than they are in the investment company area. Since those who place their funds in savings and loan pay no sales charges, and since they can withdraw their funds without ever incurring a liability for capital gains taxes, they are free to move their money to other savings media where interest rates are more favorable. In the mutual fund case, on the other hand, the sales load, which can never be recovered, and the capital gains taxes, which often have to be paid, discourage investors from transferring their assets to lower cost companies.

Question 9.

What will be the effect on the free enterprise system generally, for Congress to establish the principle of Federal regulation of management compensation and sales commissions for non-public utilities, if it enacts into law the SEC's proposals respecting such regulations in the investment companies field?

Answer.

I think that all agree that private saving and private investment are at the heart of the free enterprise system. Hence legislation that protects savers and investors from overreaching is bound to strengthen that system by enhancing confidence in it and by encouraging productive investment.

As your question suggests, a free enterprise system is one in which economic activity is regulated for the most part by free prices set in free markets rather than by governmental fiat. This, however, is a general rule to which exceptions have traditionally been made in cases where because of special circumstances the market mechanism leads, if left alone, to inequitable results. The public utility field to which you refer is one such exception. But it is by no means the only one. For example, the business of lending money is not generally regarded as a public utility. Yet because there is a class of necessitous borrowers who are not as a general rule able to bargain on an equal footing with lenders, all states have usury laws. Similarly, a man who runs an employment agency is not operating a public utility. Yet his charges are regulated in many states because his strategic position is deemed to enable him to take undue advantage of those who are desperately searching for jobs. At the Federal level, producers of basic agricultural commodities have for more than a generation been aided by various types of governmental price support programs. Then, too, Federal law has since 1938 prescribed minimum wage and maximum hours for most areas of the economy. And, as your next question recognizes, quite apart from legislation, Anglo-American courts have long recognized that legal intervention is sometimes needed in order to restrain corporate managers from rewarding themselves with undue generosity at the expense of the shareholders whose money they manage.

Opinions differ as to the wisdom of some of these departures from total laissez faire. But, most believers in free enterprise would, I think, agree that there are special cases in which the law ought to try in a limited way to redress the grosser disparities in bargaining power and that the steps taken in that direction over the years have actually strengthened our basic institutions of private property and private enterprise.

The investment company field presents, I submit, one of those special cases. This is so because of the two unique characteristics of that field, both of which stem from existing law. The first such characteristic is a system of external management found nowhere else in the American economy that makes for far higher levels of managerial compensation than would prevail under the normal corporate model. The other is a system of resale price maintenance backed up by the full power and authority of Federal law, indeed by a Federal criminal statute. Experience shows that each of these institutions imposes unnecessarily high costs on the millions of Americans who invest in American enterprise through investment companies and who indeed in legal theory own those companies.

Under the status quo in the investment company world the law permits artificially high costs to investment company shareholders and confers artificially generous benefits on investment company promoters and managers. To call this "free enterprise" strikes me as possibly a misnomer. (As you may know, one witness before the Senate Committee on Banking and Currency said that it is more like "Socialism for the rich.")

It follows that:

(a) Thoroughgoing adherence to classic free enterprise doctrine would require that we scrap the external management system and the resale price maintenance provisions of the Investment Company Act so that: (i) the compensation of investment company managers would be subject to the same limitations (legal and conventional) that apply to other types of managerial compensation; and (ii) the sales charges paid by purchasers of investment company securities would find their own level in the marketplace just as most other types of sales charges do. (As you know, the investment company industry is even more opposed to this free enterprise solution to the problems created by existing law than it is to the far more moderate steps that the Commission has proposed.)

(b) Because H.R. 14742 seeks to cope with so peculiar a situation, a situation created in such large measure by earlier Federal legislation, it could not possibly become a valid precedent for Governmental interference with free market forces.

Question 10.

In connection with the above question, it is my understanding that every officer and director of every corporation, whether it is an investment company or not, has fiduciary responsibility and must meet fiduciary standards of conduct. Why is it not adequate for investor protection to rely upon existing laws plus the additional safeguard of the Investment Company Act of 1940, such as the requirement of 40% unaffiliated directors and the SEC's authority under Section 36 to regulate management compensation and sales commissions?

Answer.

Mutual fund advisory contracts, like arrangements for executive compensation generally, are classic examples of self-dealing transactions. If, like ordinary corporations, mutual funds were managed by their own officers, their shareholders would have the protection of the independent business judgment of the directors who can look to the guidelines set by competitive forces in the market for executive talent which is reflected in executive compensation patterns of other companies of like size and kind.

But the structure of mutual funds is unique and its managers are not compensated like managers of ordinary commercial corporations. They are compensated by management fees, which pay not only for executive salaries but for all or most of the management services required by a fund in its normal operations. In the mutual fund industry the only guidelines generally available to directors have been the traditional management fee rate of .50 percent of net assets, a fee rate established when the industry was only a fraction of its present size. Despite the substantial economies of size that have accompanied the tremendous growth of mutual funds in recent years, directors have been powerless to obtain a substantial departure from the traditional .50 management fee rate. The industry, while persisting in its argument that directors exercise an effective control over management fee rates, has cited only one instance where a director has been instrumental in securing reductions of management fees and we know of no others in almost three decades of experience since enactment of the Investment Company Act in 1940.

Recent reductions in management fee rates, which largely reflect the result of court litigation and the threat of such litigation, have not been substantial. This has been so because the courts have been precluded by existing law from effectively enforcing traditional fiduciary standards. The courts have held that because of the requirements of the Investment Company Act for approval of advisory contracts by shareholders and unaffiliated directors, the courts cannot inquire into the fairness of such fees unless they are so excessive as to constitute "waste" of the fund's assets. Proof of waste, as we have pointed out, requires not only a showing that fees are excessive, but that they are "excessively excessive". Thus, the Act's requirements for approval of advisory fees by unaffiliated directors, which the Congress intended as a protection to shareholders, have actually insulated the fees from judicial scrutiny.

Absent express recognition of a standard of reasonableness governing mutual fund management fees, the means provided in the existing provisions of the Act for the enforcement of fiduciary duties are unclear and inappropriate. Under Section 36 of the Act, the Commission has power to seek injunctions preventing investment advisers and other persons affiliated with an investment company from continuing to serve the company if they are "guilty" of "gross misconduct"

or "gross abuse of trust." But regardless of whether Section 36 can fairly be construed to affect current levels of advisory fee rates, the very harshness of the sanction impairs its usefulness as a means for enforcing fiduciary obligations in the management fee area. The failure of a mutual fund adviser to share the economies of size with the fund it serves does not suggest that it has otherwise failed to discharge its obligations faithfully. Pending consideration by the Congress of more appropriate means for achieving reasonableness in mutual fund management compensation, the Commission has been reluctant to ask the courts to stigmatize advisers with findings that they are "guilty" of "gross abuse of trust" solely for this reason. If investors are to receive fair treatment with respect to management charges, the "few elementary safeguards" that Congress has provided for the small investment company industry of 1940 must now be supplemented by a readily enforceable standard of reasonableness with respect to management compensation.

Although Congress in 1940 provided for approval of underwriting contracts by the unaffiliated directors of mutual funds, it believed that competition among the underwriters for various funds would take care of the problem of sales loads. In fact, however, sales loads have increased as the result of a process of "perverse" competition. This perverse competition, fostered by existing provisions of the Act, seriously inhibits retail price competition in the sale of mutual fund shares. Given the insulation from meaningful price competition provided by the provisions of existing law, which the industry strenuously seeks to preserve, I submit that only legal restraints on sales load charges such as contained in H.R. 14742 can protect investors against overreaching.

Question 11.

Since a mutual fund managment agreement terminates automatically upon assignment, and must be approved annually by the independent and unaffiliated directors or by the shareholders, and since the present proxy rules insure that the shareholders are advised of every detail of management compensation, and since these same shareholders must elect directors every year, it is not clear to me why the SEC feels it must substitute its judgment for that of the shareholders who own a mutual fund and the directors they elect annually on such internal matters as management compensation and sales commissions. I have studied your testimony and I cannot reconcile the SEC's proposals with the basic principles of corporate democracy. Can you explain this to me in some detail?

Answer.

Contrary to the suggestion contained in the question, I believe there is nothing in the Bill that would permit the Commission to "substitute its judgment for that of the shareholders." Under the statutory standard of reasonableness only the courts, not the Commission, would determine whether fees are unreasonable. A court could act only if it were convinced by a preponderance of the evidence that a particular advisory contract calls for the payment of unreasonable fees.

About three decades of experience under the Investment Company Act make clear that shareholder voting cannot be an effective control over advisory fee rates in the mutual fund industry. This is hardly surprising. It is well accepted that in the absence of organized opposition most shareholders either do not return their proxies or mark them in favor of management. In the case of mutual funds the possibility of organized opposition is particularly unrealistic. Advisers do not compete for advisory contracts with each other by organizing proxy contests and the possibility of a shareholder initiated contest is particularly remote in the context of mutual funds where no one shareholder or group of shareholders has a significantly large interest in the fund.

Shareholder acquiescence in the prevailing level of management fees reflects the fact that they have little alternative but to accept management's proposal. If shareholders should by any chance vote down an investment advisory contract proposed by management, they would leave the fund without any management and jeopardize their investment. Under these conditions shareholder democracy is not a realistic substitute for the effective enforcement of fiduciary obligations provided by a statutory standard of reasonableness.

Similarly, while directors are elected by shareholders, they are invariably persons who have been selected by the fund's adviser. When a person is nominated by management to serve as a director, all parties look forward to a

harmonious relationship. It is not unreasonable to understand that a director accepts the position on this assumption. Should an unaffiliated director vigorously propose to reduce the prevailing level of advisory fees, the harmony of the board would in all probability be disrupted. Thus, there are powerful forces which tend to prevent unaffiliated directors from taking effective steps in this area. Indeed, some unaffiliated directors do not consider bargaining with respect to management fees to be a part of their function.

This completes our responses to your question.

Sincerely,

MANUEL F. COHEN, *Chairman.*

Mr. KEITH. Could I ask one question prior to our recessing for lunch, Mr. Chairman?

Mr. COHEN. The only qualification I have, and if I may go off the record, you know my proclivity for making speeches when I answer questions. Whether or not you are hungry should determine whether you ask the question.

Mr. Moss. I have delayed a luncheon engagement for a considerable time. Accordingly, the committee will resume at 2:30.

(Whereupon, at 1 p.m. the subcommittee recessed, to reconvene at 2:30 the same day.)

AFTER RECESS

(The subcommittee reconvened at 2:30 p.m., Hon. John E. Moss, chairman, presiding.)

Mr. Moss. The subcommittee will be in order.

Mr. Chairman, will you take the seat of honor?

STATEMENT OF HON. MANUEL F. COHEN—Resumed

Mr. COHEN. Yes, sir. I would like to have Mr. Loomis come up again, too.

Mr. Moss. I believe Mr. Keith has some questions to ask you.

Mr. KEITH. We have heard a lot of discussion of the question of whether or not Congress should approve of the banks going into the mutual fund business.

Mr. COHEN. Did you ask me wether I heard the discussion?

Mr. KEITH. You commented with reference to the question as to whether or not the banks should be permitted to go into the mutual fund business that that was not your bailiwick; it was the rightful role of Congress.

Mr. COHEN. I think I said that it was the responsibility of the three banking agencies and the Congress, and I think I might have added the courts as well, and for all those reasons we were not commenting on it or implying any view one way or the other.

Mr. KEITH. But you did say certain banking agencies, together with Congress, had that as their responsibility?

Mr. COHEN. The three Federal banking agencies—the Federal Reserve System, the FDIC, and the Comptroller of the Currency, Congress, and I have added now the courts.

Mr. KEITH. I am talking about whether or not the law should be changed.

Mr. COHEN. The reason I mentioned the courts is because the decision of the courts raises the question whether the law needs to be changed.

Mr. KEITH. Did it defer to the Congress for that decision?

Mr. COHEN. No; it did not. As I understand it, the defendants in that lawsuit have filed a notice of appeal, so I suppose what they are doing is pursuing their rights in the court, but at the same time they are appealing to the Congress to deal with that problem.

Mr. KEITH. It seems to me that perhaps if the regulatory banking agencies of the Federal Government had, in your view, a responsibility to speak to this question, that you have a similar role in reference to the securities markets. You might comment as to whether or not, as a public policy question, it is wise to have banks in the business.

Mr. COHEN. That is a policy question as to which I decline to speak. Of course, to the extent that the securities markets and the securities laws are involved, we certainly do have a responsibility. This was the burden of my remarks this morning.

Mr. KEITH. I am looking as to the rightness or wrongness of it.

Mr. COHEN. I am not sparring with you, Mr. Keith. But that is just another aspect of the same question concerning which we feel that we should not speak or imply a position one way or another.

Mr. KEITH. I was very careful to make extensive notes this morning and they seem to have disappeared.

Mr. COHEN. Have you lost them, I hope?

Mr. KEITH. I find some of them here.

Just for the record, the H.R. 10 plans have been referred to at great length by most witnesses as though the normal pattern was that they would be invested in equities, whether it be the insurance companies or the mutual funds. I don't think that was the intent of Congress and I don't think that is necessarily the way they have been used thus far.

Mr. COHEN. I do not know that I can speak to that with as much conviction as I would like, but I do not think that the Smathers-Keogh Act precluded their dealing with equities. I agree that the Congress, in passing it, had in mind leaving that to the persons who would provide vehicles for this purpose and, indeed, there are, even among the mutual funds, various types of vehicles, some of which have a combination of debt and equity securities, some of which are oriented in one particular direction or another. Conceivably, the banks may, if they are engaged in the business, do essentially the same thing as maybe the insurance companies.

Mr. KEITH. I am not really at all intimately acquainted but it is my belief that you could have an insurance company use for a portfolio whatever investments the insurance company would choose.

Mr. COHEN. I think I adverted at the very outset to the fact that until the recent interest in equities, particularly by pension plans and H.R. 10 plans—a modern form of pension plan for individuals—pension plans had been funded, at least in one area, by typical insurance arrangements. I am not sure that that will be discontinued in some areas.

But I would assume that the insurance companies, the banks and the mutual funds will provide as wide a fare as possible.

Mr. KEITH. You might say "as the prospects warrant."

Mr. COHEN. Exactly.

Mr. KEITH. In your testimony, particularly in the supplemental statement, you went into a lot of detail as to the administrative aspects

of this broad authority that you would have. I am somewhat troubled by the same kind of phenomena that is now facing the country and the Congress with reference to industrial revenue bonds where, after 20 years, more or less, the Internal Revenue Service has determined that this practice which they have thus far permitted is no longer in the public interest and they are cutting it off, at the time Massachusetts amended its constitution so that they could get into this kind of thing.

Mr. COHEN. Bad timing, I would say.

Mr. KEITH. Now you have come here with arguments that the sales force was well compensated in the mutual fund field and made the point that to some extent the overhead for that sales force was handled by reciprocals.

Mr. COHEN. That is not quite what I said, Mr. Keith, if I may interrupt you. In an earlier appearance in connection with the main thrust of H.R. 9510, I did indicate that the sales charges were not the sole source of revenue to those dealers and their salesmen who do, in fact, engage in the business of selling mutual fund shares.

Mr. KEITH. I do not want to get into the merits or lack of them with reference to the ruling which you have just made, or excuse me, the tentative——

Mr. COHEN. You are talking about the industrial revenue bonds now?

Mr. KEITH. No, but I am talking about the same phenomenon. We have the Internal Revenue Service, which may be likened to the SEC, which allows States and municipalities to offer revenue bonds which offer a certain tax advantage and then they changed it, as you said, at a very inappropriate time.

Mr. COHEN. I said the timing was off. I did not say it was inappropriate.

Mr. KEITH. For years you have permitted reciprocals.

Mr. COHEN. We may be guilty of an error of omission or commission.

Mr. KEITH. The sales force has been organized, particularly those of independent brokers, on the basis of having as a supplemental source of income the reciprocals. You offered in evidence, I believe, that these independent firms have resources in the way of income from reciprocals which is a factor to be considered in determining whether or not 9 percent or 5 percent is a fair commission after looking at the overall expenses of doing business, and the revenue that comes in to offset that expense.

If you go through with the ruling, and by the way I am not speaking to the merits of it——

Mr. COHEN. Mr. Keith, I must interrupt you. There is no ruling, proposed or otherwise, which would eliminate these reciprocals or "give-ups" to which you refer, although this was suggested at one time.

Mr. KEITH. A letter of intent?

Mr. COHEN. No, sir. May I explain?

Mr. KEITH. Yes, sir.

Mr. COHEN. The New York Stock Exchange submitted to the Commission a series of proposals to reform its commission structure. Among the four or five items were two which relate to this matter. One is a suggestion to provide a volume discount, the exact dimensions of which or the manner in which it would operate were not disclosed.

As I understand their position, they merely want to know whether the Commission would consider this to be an appropriate step. At the same time, they said that there are many practices in this area of give-ups and reciprocal business which they believe to be improper and which they believe should be outlawed.

They further say they would undertake to deal with certain of those problems, but in effectuating them, they would require not only the concurrence of the Commission, but the active support of the Commission so that the ultimate decision in this area would be enforced as to the competitors of the New York Stock Exchange, that is to say——

Mr. KEITH. Pardon me, Mr. Chairman——

Mr. COHEN. I can repeat that last.

One aspect of the proposals related to this matter of reciprocals and give-ups. The proposals, as we understand it, reflects a recognition by the stock exchange that there are abuses in this area.

I don't think they are prepared to outlaw this practice entirely, but they would propose to make certain changes in the existing situation by outlawing or limiting certain practices. Now, in order to effectuate their purpose—it is very important to hear me, so I don't mind waiting.

Mr. KEITH. Fine. I agree.

Mr. COHEN. In order to carry out this purpose, the New York Stock Exchange, I think, recognizes that it is facing competition from the regional stock exchanges, including one in Massachusetts, in this area and, therefore, to carry out their purposes, they would want the Commission (1) to agree with their proposal, and (2) to enforce it on all the other competitors, that is to say, the regional stock exchanges.

Now, the Commission felt that the matter was of such moment and of such wide implication and effect that the Commission would be best served by getting the views of all persons interested, affected by, or concerned with this matter, and in connection with that, there was a proposal under consideration by the Commission—and that is the proposal to which I believe you have reference—which simply provides that, to the extent that there are procedures whereby there may be a sharing and thus ultimately a reduction in the actual cost of execution of transactions, there is a duty in effect on the part of the managements, those who direct the transactions, to get the excess back for the benefit of the person whose money is being used to generate these commissions, that is to say, the institution directly, and indirectly the shareholders.

Now, all of these things are in the posture of proposals. The Commission has solicited the views of all persons concerned, as I have explained. Under these circumstances, I do not think it would be appropriate for me to deal with the specifics or to express any view on any of those points except to the extent that the Commission has already done so in its release.

Mr. KEITH. I thank you very much, and I mean that sincerely. The problem is created in part by, of course, my schedule of activities——

Mr. COHEN. You are being very modest.

Mr. KEITH. But it is compounded by the fact that when you write, you are sometimes even more effusive than when you speak. You very nicely consolidated this, on both sides, in small type, 10 pages.

Mr. COHEN. I must say, Mr. Keith, I haven't. I appreciate the compliment. I accept it.

Mr. KEITH. Don't go on any further.

Mr. COHEN. I must. I must say this: First, I only dealt with two aspects of the problem.

Mr. KEITH. May I for just a second save your time——

Mr. COHEN. I have lots of time.

Mr. KEITH. Come around tomorrow morning. But let me just ask you this: What I am driving at is that we have before us a bill to which this amendment speaks and that bill contains certain recommendations which were made and understood by the committee to reflect certain income to the independent broker and others that came by reason of a practice which is perhaps going to be abandoned.

If there is any likelihood of additional evidence being required in order for us to further consider the nature and extent of your recommendations that we curtail the compensation from 9 to 5 and to cut off the front-end loads——

Mr. COHEN. Let me say that our concern is for the protection of investors. Our concern is really whether or not they are being fairly treated. We do agree, of course, that our recommendations will have an impact on people who are engaged in this business. As a matter of fact, because we felt we have to deal with the Congress and everyone else with the fullest candor, we determined not to wait until this committee completed its deliberations before we put out this release and discussed the related problems.

In my testimony at the very outset, I indicated that there were these areas as to which we have the authority and, therefore, the responsibility to deal with them, and that, indeed, we have been dealing with them for some 2 or 3 years now and we may be subject to some criticism for not having settled it by this time.

But you are quite right. We determined that we would not wait and do one thing at a time. We determined to open the situation so that you could see all aspects of the problem. Now when we will resolve the issues raised by the proposals of the New York Stock Exchange and the proposals that we included in that release, I cannot say. I hope it will be sooner, rather than later.

Perhaps I did not make clear that those are within our present responsibility and they are unrelated to the legislation except as they do have an impact of the kind you have mentioned.

Mr. KEITH. Thank you. How long have you had the problem?

Mr. COHEN. I am glad you asked me that, because that goes back to another point you made earlier.

First, I should say that the developments in the area of the give-ups and the reciprocals have been with us for some time. But the real urgency, their wider use and the greater ingenuity being used each day in developing them, are relatively new. I do not want to say this has just come on the scene, but they become terribly more important each year.

As these institutions are vying one with another for the favor of the dealer and the salesman, they are finding more and more ingenius ways to provide this perverse competition; thit is to to say, to reward the seller of the shares.

Mr. KEITH. Now getting back to your testimony, you say on page 6, "If you were to entrust this matter to us." You are speaking broadly——

Mr. COHEN. This is my testimony with respect to the insurance company proposals.

Mr. KEITH. Yes.

Mr. COHEN. Yes, sir.

Mr. KEITH. We had a bill before this committee setting up certain exemptions for the specialized automobile business, 500 cars or less; and it provided for certain exemptions when it was in the public interest so that these fellows would not have to test their vehicles to destruction.

To administer this law for a 2-year period would cost about three-quarters of a million dollars for the small number of automobile companies involved in this business. How do you feel with reference to personnel and money to administer the regulations which you would have here?

Mr. COHEN. You mean as far as the Commission is concerned?

Mr. KEITH. Yes.

Mr. COHEN. A minimum amount?

Mr. KEITH. Yes.

Mr. COHEN. We made some estimates and I think we thought we might need less than 10 additional people. This is based on our best estimate of the type of thing that would come in.

I must explain that in the area of testing, for example, which is now well established in the mutual fund industry and, of course, is required of all people who sell funds and, indeed, the NASD has now been joined by a number of insurance company organizations who have submitted themselves to the same procedure, that we are assisted in this endeavor in one way or another by the NASD in the spirit and in the letter of the statute which provides for cooperative endeavor in this area. It is for this reason that I believe that the need for additional personnel by us would be rather limited.

I have in mind the number six, which we thought of at one time. That may be underestimating it. It could be 16. But it certainly would not be a substantial number. I think in terms of dollar cost to the taxpayer, it would be not only minimal, it would be negligible in terms of the additional protection which this Congress decided many years ago should be provided the persons who are asked to buy these instruments and which in 1964 this committee and this Congress reaffirmed in very firm terms.

Mr. KEITH. You are now talking about the insurance companies alone?

Mr. COHEN. I am talking about the insurance companies but in my statement I raised an issue with respect to the banks, the banks' activities in selling these instruments.

Mr. KEITH. Would the banks be covered by the same six people?

Mr. COHEN. I think yes. Let me explain that if I may.

We have to develop rules. We have to develop procedures. There is a certain amount of additional paper work. We are rapidly programing our computer to utilize that information.

In the area of testing, we cooperate with the NASD and they in fact conduct the examination for us.

Further, in the area of testing, we have also accepted certain tests which are given by insurance commissioners and we have done this for some years now as meeting our requirements.

We grant them reciprocity, if you will, in this testing area and they in turn have granted some reciprocity to us.

So we have been able to keep our activity to a minimum.

Now we got this activity in 1964. We have built up a relatively small staff to deal with it. We have the pattern going. It is for this reason, while I believe there will be additional paper and additional work and maybe some new problems which I do not now envisage, nevertheless, I believe that the overall cost in the scale of things will be minor.

Mr. KEITH. I would hope that we would agre that it would be advisable whenever possible to handle this as a matter of law rather than a matter of administration.

Mr. COHEN. I am not sure I understand your question, Mr. Keith.

Mr. KEITH. I am talking about the exemption power and regulation supporting it.

Mr. COHEN. In my statement I have suggested that the statute provide to us administrative authority to grant exemptions where that seems to be appropriate in the public interest and in the investor interest.

Mr. KEITH. Such broad authority for exemption increases the administrative work.

Mr. COHEN. Indeed, it does. Some people tell me that I have rocks in my head. Actually, the additional authority we are asking for is to fashion more precise exemptions but under circumstances which would retain for the benefit of the investor, whether he be a pensioner or otherwise, certain of the protections which the Congress has decided should be available to persons who are asked to participate in these vehicles.

I should emphasize that there is no misunderstanding, that under the 1940 act, as I indicated earlier, we have all kinds of authority to provide exemption.

The additional authority that we are asking for is under the 1933 act.

Now under that statute the Commission has very limited exemptive authority. We can exempt issues of less than $300,000. It is in this area that the suggestion was made by me this morning that the Congress might consider it appropriate to vest in the Commission this authority so that the Commission can exercise flexibility appropriate to the situation, the offering and such matters, which is traditional and consistent with the attitude of this Commission and indeed the wishes of the various interests affected throughout the year.

Mr. KEITH. If you would care to comment, this will be my final question but perhaps the most important one, it is a philosophical question. Somewhere in today's testimony, someone spoke about the foresight of the investor in the 1920's and that nobody could see what lay ahead and Congress in its wisdom shortly thereafter enacted the 1933 act and 1934 act to assure honesty and full disclosure and registration, and we saw fit to take the banks out of the security business.

It seems to me that there are adequate ways for the individual to get into the stock market and, therefore, there is some question, whether we

don't want to maintain the integrity of the insurance company image as one prudent in the management of the portfolio and leave the insurance companies to their historical type of savings and leave the banks to their historical role where their trust departments act as trustees, and let the speculator get involved, if he wants, in a mutual fund.

If we try to solve the problems presented in these hearings by competition we bring the banks and the insurance companies into the field of mutual funds, where we are saying as a matter of public policy it is good for the country to have additional incentives to get into the market.

Would you have any observations to make on this?

Mr. COHEN. First, I just want to repeat something I said this morning which may not be implicit in what you said but if it is, I want to address myself to it, and that is the suggestion that if the banks and the insurance companies do enter this field that the competition thus engendered would resolve some of the basic problems to which the original bill was addressed.

I can't think of anything as far away from our understanding of what would happen than that suggestion.

Going to the other point, I think I must point out that there is nothing in any of the statutes to preclude the insurance companies from engaging in this activity. The insurance companies started this and quarreled with us when we said they were in the mutual fund business and the Supreme Court has laid that issue at rest.

But there is nothing in any of the statutes that I am aware of, Federal or State, which precludes that. There may be particular situations in the States where they have a problem, but I think those problems have been worked out through the years.

Indeed, there were State problems. But I believe most of them have been resolved. So, as far as the insurance companies are concerned, they can come in, the Commission has no authority to keep them out.

Now, this is an aspect of what I said earlier about the Federal securities laws being completely neutral as to the persons or organizations, the type, the character, which wish to engage in an aspect of the business at which the securities laws are directed.

Those acts, we believe, are always neutral. As I indicated, there are just two basic qualifications.

Now so far as the banks are concerned, the question is now before the courts and the question is now before you whether or not the banks should be permitted to enage in this activity.

This does indeed raise a number of policy issues, some of which you have mentioned.

As to this issue we, for the reasons I stated this morning, are not making any suggestions or any comment because there are the three Federal banking agencies, the matter is in the courts and it is now before you gentlemen as a matter of national policy.

Mr. KEITH. Thank you, Mr. Cohen. I said I only had one more question. I do now have only one more question.

Just prior to your coming into the chamber here I was asking representatives of the insurance industry, as to whether or not they were willing to buy the reasonableness concept with reference to compensation and some regulation with reference to the sales commission that could be levied.

Mr. COHEN. I am sorry, I missed that.

Mr. KEITH. I think they dismissed it rather casually. They are not positive about whether or not they would be included and if they were included in your determination as to what was due the broker whether or not you look beyond the size of the commission into the disposition or breakdown of that commission.

Mr. COHEN. To the extent that these vehicles, whether insurance oriented or sponsored or bank oriented or sponsored, are subject to registration under the act, this standard which we ask you gentlemen to put in the statute would apply to all of them.

As we have indicated, in any examination of this issue, whether by us or by the courts, all relevant considerations in terms of revenue from whatever sources that accrue to the manager as a result of its relationship to the investment company would be taken into account.

So, I think the answer to your question is yes, I believe, although it is a long ways getting there.

Mr. KEITH. Thank you.

Mr. MOSS. Mr. Chairman, I want to express my appreciation and the appreciation of the committee for your appearance. I am not going to direct my questions to you at this time. I am going to submit them to you in writing. I think that the testimony received by this subcommittee today has been very interesting.

But in order for me to be as incisive as I would like to be I think it is necessary that I go over the testimony and prepare very carefully the questions to submit to you.

Mr. COHEN. I appreciate that, Mr. Chairman, because it may give me an opportunity to deal with them a little more thoughtfully than I might off the top of my head.

I not only subscribe to it but I thank you very much.

Mr. MOSS. The record will be held open to receive both questions and responses. Without objection, that will be the order.

(Correspondence containing questions posed by Mr. Moss, and Commission reply thereto, follow:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
RAYBURN HOUSE OFFICE BUILDING,
Washington, D.C., March 18, 1968.

Hon. MANUEL F. COHEN,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR CHAIRMAN COHEN: It seems to me that it might be appropriate to elaborate on your testimony of last Friday on H.R. 14742 on the data which you have as to the amounts presently invested in the pension plans and in the H.R. 10 (self-employment) plans, with some disclosure, if you have it, as to whether the investment is in bonds or in equity securities.

It is my impression that these data are lacking although we had some estimate from the banks that they currently are operating collective accounts of the managing-agency type in an amount of some $10 billion.

It is my recollection that you indicated in your testimony that these pension plans, which are exempt under section 3(c)(13) from the 1940 Act (an exemption you thought might be reconsidered), were originally tied into fixed benefits and the funds were put into bonds where as you think there has been a change and investment in equity securities has increased.

Sincerely yours,

JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 25, 1968.

Hon. JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance,
Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to your letter of March 18 suggesting that I elaborate my testimony of last Friday on H.R. 14742 with respect to the extent to which pension plans and H.R. 10 plans invest, respectively, in bonds and in equity securities.

I attach a table showing the percentage of assets of private non-insured pension plans, common trust funds and, to the extent information is available, separate accounts of life insurance companies, which are invested in common stock. As you will note, the percentage of stock investment for private non-insured pension plans has been rising in recent years. The stock investment of common trust funds has tended to decline a little on a relative basis. We understand that this results from increasing investment by such common trust funds in tax exempt municipal securities primarily as a result of a change in 1963 in the applicable regulations of the federal banking agencies. With respect to separate accounts of life insurance companies, figures as to the percent of stock investment are available only for 1965. Since, however, separate accounts are authorized specifically for the purpose of funding variable annuities which are offered primarily as a medium for equity investment, it is probable that the 1965 figure is representative.

Unfortunately we have no information as to the investment practices of H.R. 10 plans as such. We hope that such data could be developed in the course of the proposed study of institutional investment.

The table with respect to pension funds and common trust funds goes back only to 1955 since comparable data for earlier years are not available. Other estimates, based on book value not on market value, for earlier years indicate a much lower proportion of common stock investment by private pension plans. These plans accounted for $50 million of assets in 1920, with 10 percent of these assets invested in common stock. These funds grew to $550 million in 1930, while reducing the proportion invested in common stock to 8 percent. The proportion was further reduced to 6.5 percent by 1940. The staff estimates that common stock as a percent of total assets (based on book value) had risen to 12.4 percent by 1950. I believe these estimates tend to substantiate my testimony to the effect that in 1940, when the Investment Company Act was passed, pension plans ordinarily contemplated a fixed dollar payment and the assets were primarily invested in fixed income securities, while the attached table reflects an investment of more than 50 percent in common stock in 1966.

Sincerely,

MANUEL F. COHEN, *Chairman.*

TOTAL ASSETS AND PERCENT INVESTED IN COMMON STOCK OF PENSION PLANS AND OTHER COLLECTIVE ACCOUNTS

[In millions of dollars]

	Private noninsured pension plans		Common trust funds		Life insurance companies separate accounts	
	Total assets	Percent	Total assets	Percent	Total assets	Percent
1955	18,053	30.2	1,869	48.7	----------	----------
1960	37,076	42.7	2,813	51.7	----------	----------
1961	45,842	48.3	3,551	56.0	----------	----------
1962	46,729	45.3	3,578	49.0	7	----------
1963	54,618	49.4	4,540	50.7	28	----------
1964	63,352	51.9	5,820	47.0	92	----------
1965	71,420	54.5	7,529	44.2	272	88
1966	70,976	53.2	7,612	40.5	591	----------

Mr. KEITH. Mr. Chairman, earlier I suggested that we might have the other witnesses back. I think I will be glad to follow the same procedure as you have outlined, particularly if I can be assured that the hearings would be available for reflection and study over the weekend prior to our going into executive session on this matter.

Mr. Moss. That is a matter I would have to reflect upon. In other words, we are asking that the hearings be held open to receive additional information. I would not want to print them until such time as the additional information which would be promptly requested is supplied and is in the record. Then the record would be ready for printing and for general availability.

Mr. KEITH. I have reason to believe there will be some timelag after the hearings close before we go into executive session.

Mr. Moss. I am hopeful of going into executive session in the next few weeks.

Mr. KEITH. Will you give some indication how much longer you will hold the record open to receive the information?

Mr. Moss. I would expect that the questions will be promptly prepared and answers supplied with equal diligence and that we could agree to hold the record open until a week from Monday. That should permit full response of all the witnesses to whom we might want to direct questions.

I intend to ask permission to direct questions to other of the witnesses and to have those included in the record. I will accord you the same right.

Mr. KEITH. With that time frame in mind, I will waive any further questions.

Mr. Moss. In that event, Mr. Chairman, I want to again express the appreciation of the committee. You are now excused and can go out and have a leisurely lunch.

Mr. COHEN. Thank you, sir. If I may take advantage of your indulgence, the ham in me always rises to the surface. I do not wish, by my testimony this morning, to be considered to be ungracious. I did advert to the fact that the banks and the insurance companies wished to engage in this activity.

Also, I said that it may be important not to try to settle everything at once and in the process run into some difficulties as a result of which we settle nothing.

Mr. Moss. I will say that that was advice of the highest wisdom.

Mr. COHEN. Thank you, sir.

Mr. Moss. Thank you.

At this point, I want to ask unanimous consent to place in the record, a letter from the Honorable Wright Patman, chairman of the House Committee on Banking and Currency under date of February 26, 1968, addressed to me as chairman of the subcommittee.

Mr. KEITH. Is he for it or against it?

Mr. Moss. He reflects mild disapproval. Also, a letter from the National Association of Mutual Savings Banks dated March 14, 1968.

Mr. KEITH. Do the savings banks want to go into the business, too?

Mr. Moss. They have indicated an interest.

Without objection, those items will be included in the record at this point.

(The documents referred to follow:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C., February 26, 1968.

Hon. JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, Rayburn House Office Building, Washington, D.C.

DEAR CHAIRMAN MOSS: In several letters to you during the last few months I have voiced my concern over the possible use of the mutual fund reform bills as vehicles for permitting commercial banks to enter the mutual fund business. As you know, this would reverse a recent court decision reaffirming the Congressional intent embodied in the Glass-Steagall Act's prohibition against commercial bank involvement in the securities business. This prohibition was adopted by the Congress in 1933 after exhaustive investigation showed that commercial bank involvement in the securities market was one of the major causes of the stock market crash of 1929 and the subsequent Great Depression.

Nothing has been revealed in recent years which would justify a re-entry into the securities business of commercial banks on the scale that would be possible if banks were allowed to operate mutual funds. In fact, you yourself indicated your serious concern over banks' and other institutional investors' growing involvement in the market and the economy in general when you introduced a resolution last session to study the impact on the economy of all institutional investors, including banks. On December 7, 1967, I wrote you praising the introduction of such a resolution. It seems to me that the best approach would be to study the entire problem of institutional investors before making any substantial change in the structure of the investment industry.

You may also be interested in the enclosed copies of letters I recently sent to the Federal Reserve Board, the Justice Department and the Securities and Exchange Commission requesting studies of the probable effects of a general downgrading of the Glass-Steagall Act to permit banks to underwrite investment company shares and revenue bonds. After detailed study and investigation of these problems have been carried out by the appropriate agencies, there is a good possibility that the Banking and Currency Committee may want to hold hearings on the Glass-Steagall Act restrictions.

In short, I feel very strongly that the role of all institutional investors in the securities market and in the economy in general must be studied carefully and in great depth before any major changes in the regulatory scheme established during the New Deal should be undertaken.

Since it now appears that I will not be available to testify before your subcommittee on H.R. 14742 between March 12 and 14, the following is a brief summary of my specific objections to the povisions of H.R. 14742 which affect the prohibition against banks operating mutual funds.

1. It would effectively amend section 24(7) of Title 12 U.S. Code and permit banks to maintain custody and management of investment funds in a commercial, as opposed to trustee, relationship, a nonbaking activity.

2. It would repeal sections 78,377 and 378 of Title 12 (Glass-Steagall) and permit a resumption of the outrageous conflicts of interest in bank securities operations which so clearly contributed to the 1929 crash.

3. It would further aggravate the serious problem of the "institutionalization" of the securities markets by the giant financial concerns, a subject about which I believe you have expressed alarm.

4. It would further aggravate the most serious problem of commercial bank control over other large financial and nonfinancial corporations through their mutual funds' portfolios. This is already being done through bank trust department holdings amounting to over $250 billion, and these proposed amendments would only add substantial additional economic power to the largest single institutional investor in the country.

Although I strongly object in any way to repealing the Glass-Steagall provisions by amendments to the securities laws, it is conceivable that, after careful investigation, a legislative or regulatory scheme could be devised whereby banks

were allowed to compete with mutual funds. If such a plan were devised, however, it must contain strong safeguards in the public interest against the domination by commercial banks of the securities market, as well as protection against banks gaining control of corporations in which they are investing funds for the benefit of others. In addition, strong safeguards for the protection of the beneficiaries of the funds over which banks and other financial institutions have control must be adopted.

The Federal bank supervisory agencies have neither the expertise nor have they demonstrated the will to adequately protect the public in these areas. At best, they are expert in protecting the public against unsound banking practices, principally in the area of commercial banking operations. They are not securities experts. They are not antitrust experts. Therefore, serious consideration should be given to broadening, as far as possible, the role of the Securities and Exchange Commission and the Antitrust Division of the Justice Department in regulating the role of institutional investors in our economy.

In addition, such specific standards as applying a maximum of from 5 percent to 10 percent of any one class of stock that can be held by any single institutional investor should be considered. Also, bringing common trust funds and pension funds completely under the disclosure and anti-fraud provisions of the securities laws should be studied.

In conclusion, the parts of H.R. 14742 dealing with enlarging the role of commercial banks as institutional investors may have serious questions which are both significant and extremely complex. Therefore, your original approach of studying in depth the role of all institutional investors before legislating in this area seems a much better first step than changing the structure of the investment industry at this time.

It would be appreciated if you would make this letter a part of the record of your subcommittee's proceedings in connection with hearings on H.R. 14742.

Sincerely yours,

WRIGHT PATMAN, *Chairman.*

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS,
New York, N.Y., March 14, 1968.

Hon. JOHN E. MOSS,
House of Representatives,
Washington, D.C.

DEAR MR. MOSS: I am writing on behalf of the National Association of Mutual Savings Banks which represents the more than 500 mutual savings banks in the nation. Our industry is concerned that the provisions in H.R. 14742 permitting commercial banks to enter the mutual fund business would increase the existing competitive imbalance between our industry and commercial banking unless changes are made in the bill to ensure that mutual savings banks will be able to compete as effectively in this field as commercial banks.

The problem we face is discussed in the report of the House Committee on Banking and Currency recommending the enactment of the Federal Savings Institutions bill, H.R. 13718. One of the principal reasons for that Committee's support of H.R. 13718 is the need to redress the existing competitive imbalance between thrift institutions and commercial banks. As the report states "The danger, rather, is that without this bill, commercial banks may displace thrift institutions from their traditional role in the economy. One of the means which is currently being employed to hasten that result is a mammoth campaign of institutional advertisting whose main theme is the archaic legal limitations which prevent thrift institutions from offering full service to their customers."

In general, under the present law all institutions which receive deposits are restricted in their ability to buy and sell securities for customers by provisions of the Glass-Steagall Act of 1933. The provision most directly relevant to mutual savings banks is 12 USC 378 which, in effect, limits their activities (as well as those of other financial institutions) to the purchase and sale of securities as an accommodation for, and at the request of, the bank's customers. As we understand the impact of the provision of H.R. 14742, the bill would only receive the abovementioned Federal banking law restrictions so as to authorize mutual funds operated as common trust funds or similar funds. Only a small number of savings banks enjoy trust powers and could therefore benefit from this change. For this reason, we would hope that the Committee would not limit the proposed change to authorizing only those mutual funds operated as common trust funds

but rather would make a general authorization allowing banks to operate mutual funds.

Further, the amendment as presently drafted is essentially of value only to large institutions. Under our approach, however, smaller institutions—and this is true of both savings banks and commercial banks—would be enabled to jointly organize a mutual fund and thus avail themselves of a competitive service that they could not practically provide as individual institutions because of their size.

In evaluating the benefits of banks affiliating in offering a mutual fund service to the public, rather than organizing one for each bank—you should be aware of the conclusions reached by Professor John Lintner of Harvard University. In his study of "The Desirability and Feasibility Of A Savings Bank Depositor's Mutual Fund," Professor Lintner concluded, "By virtue of the basic economics of a mutual fund operation, there must be *one central national fund* (or set of funds under common investment management). Cost would be prohibitive for each bank to have its own separate fund." Professor Lintner's conclusion is supported by the judgment of every one of the many mutual savings banking groups in Western Europe offering a mutual fund service to their depositors. In every case, either a central national fund or set of funds under common investment management has been established and individual mutual savings banks have offered their customers shares of the Fund.

For these reasons we would hope that your subcommittee will amend section 12(i) of the bill to read as follows:

(i) No provisions of law shall be deemed to prevent—

(1) The creation or operation of a registered investment company which is maintained by a bank or banks if such fund is created and operated in compliance with any applicable regulations of the Comptroller of the Currency, or

(2) A bank or banks from selling, underwriting, or distributing the securities of an issuer which is a "regulated investment company" as defined in section 851(a)(1) of The Internal Revenue Code of 1954 which shares are distributed only to banks and customers of banks; if—

any security issued by such company is issued at a public offering price which does not include a sales load.

We will be pleased to discuss this problem and our proposed amendments further with you or the staff of the Committee should you wish.

I wish to thank you on behalf of the mutual savings bank industry for the opportunity to present our views on this important legislation.

Sincerely,

GROVER W. ENSLEY,
Executive Vice President.

Mr. Moss. The request the chairman will make on behalf of himself and Mr. Keith is now made, and the record should show that the request has been granted.

The committee is now adjourned.

(The following statement was submitted for the record:)

STATEMENT OF MICHAEL E. TOBIN, PRESIDENT, MIDWEST STOCK EXCHANGE

The Midwest Stock Exchange has 422 members, and these members presently maintain over 2,885 offices in 700 cities and 49 states. Each of these member organizations, its employees and their clients—the investing public—would be directly effected by the passage of H. R. 14742.

The Exchange has opposed H. R. 9511 in its original form on the basis of certain primary principles. Since H. R. 14742 is an amended version of H. R. 9511 the same principles outlined briefly below are pertinent to an evaluation of H. R. 14742.

(1) It is our belief there is insufficient economic facts and supporting information available to justify action on these far-reaching proposals and, for this reason, we have recommended and continue to support a joint industry-SEC study to fill this information gap before legislative action is taken.

(2) The proponents of the original bill failed to state clearly and totally the objectives they were seeking and we recommended and continue to support a total evaluation of the objectives and ramifications of the bill.

(3) Finally, we opposed the adoption of H. R. 9511 because we feel it focuses in a limited way on areas where there may exist broader problems and these

legislative remedies for limited areas might postpone or frustrate consideration and solution of the broader problems. A specific example of what may be a broader problem is the "institutionalization" trend and its impact on market liquidity.

For these same reasons, our Exchange wishes to go on record in opposition to H.R. 14742.

In addition, H.R. 14742 contains provisions that, in effect, repeal the Glass-Steagall amendments to the Banking Acts. Our Exchange requests your sub-committee to consider very carefully the circumstances that brought about the Glass-Steagall Act and the objectives of that Act before you repeal Glass-Steagall to the extent of permitting banks to underwrite and sell the securities of their own Mutual Funds.

Finally, should your sub-committee decide to recommend to the Congress that you have determined it is in the public interest to remove the existing prohibitions against banks entering into the securities business through the underwriting and selling of Mutual Funds that were established by the Congress in Glass-Steagall, we recommend that under no circumstances should the banks be in the securities business under a double standard of regulation. Sec. 12 of H.R. 14742, which would amend Sec. 22 of the Act of 1940 by adding sub-section (i), appears to create the probability that bank activities in the securities industry will be regulated by the Comptroller's office rather than by the SEC.

This seeming creation of a double standard of regulation would, in our opinion, be unwise and would be contrary to recent steps taken by both the Congress and the SEC that have been designed to strengthen regulation of the securities industry by the setting of broader and deeper uniform standards.

STATEMENT OF ROBERT M. ROTH, PRESIDENT, MARK SECURITIES, INC., ON BEHALF OF THE INDEPENDENT DEALERS ASSOCIATION

This statement is made as an authorized representative of the Independent Dealers Association which is a trade association composed of 175 independent broker/dealers located in thirty states. Our association is devoted to the general improvement of the investment industry and the upgrading of the personnel in the business.

The bills you are now considering are obviously important pieces of legislation that must stand the rigors of time. To say that they are controversial is probably the understatement of the year. However, after having studied the legislation and the testimony, there are certain salient points I wish to make.

Of the original forty-six suggested amendments, I understand there has been agreement between the S.E.C. and the industry on forty-three of them. Our statement will deal with two of the three remaining issues, namely reduction of the sales charge to 5% and abolishment of contractural plans. We don't think the area of management fees is within our jurisdiction to comment. I believe the I.C.I. and others have done that.

A great majority of the members of our association receive most of their income from mutual fund sales. In fact, as was pointed out in the hearings, a very significant number of the approximately 3,000 non-New York Stock Exchange members receive substantial portions of their gross income from mutual fund sales. If the sales charge is reduced the 44% that the S.E.C. is recommending, to 5% what happens? How does the independent dealer recover his income?

You state, Mr. Moss, on page 458 of the printed hearing on H.R. 9510, ". . . you can do all sorts of things with statistics, and you can have some very interesting exercises, but to forecast that you are going out of business merely means that you would change the format of operation." This is an interesting comment.

We cannot swing our activities to other phases of the investment business, such as larger underwritings, commodities, listed stocks. The S.E.C. conjectures that the public will start running to our door to buy funds at 5%. If a dealer receives $100,000 in concessions from the sale of mutual funds at the present sales charge, he would then receive $56,000 in concessions at the new sales charge on the same amount of sales. To get back to $100,000 of concession income, he must increase his sales not 44% but 79% just to get back even. It is hard to believe this will happen. The S.E.C. conjectures, but they don't have to pay the penalty of going out of business if their conjecture is wrong. We do.

Statistics are intriguing. The S.E.C. keeps mentioning a 9.3% sales charge, not 8.5%. Using Dreyfus as an example, since their name keeps cropping up in the hearing, their current price shows Bid—13.37, Asked—14.59. The S.E.C.

maintains that if you buy one share at $14.59 you have $13.37 invested and that is how they arrive at 9.3%. That's interesting, since in actuality a person buys one share at $14.59 and is able to liquidate it at $13.37 for a loss of 8.5%. Also, Mr. Cohen, when figuring commissions on stocks on page 111 of the hearings (supra), uses my method of figuring the commission to make it lower. It seems as if it would be fairer to use the same method in comparisons. Yes, you can do all sorts of things with statistics.

The subject of monopolies and price competition appears to have been hotly debated during the course of the hearings. I am not a lawyer, but applying some commonsense to this matter leads me to this conclusion. S.E.C. contends that because of Section 22(d) of the Investment Company Act, the public must pay the public offering price of the fund and, therefore, there are no free market forces at work.

With monopolies such as railroads, airlines and gas companies, the consumer doesn't have the unlimited opportunity to shop around for better prices because of the limited number of companies engaged in those businesses. However, in the mutual fund field the customer can shop around to over 200 mutual funds. Sure, he is going to pay the same commission no matter where he buys Dreyfus; but he doesn't have to buy Dreyfus, he can buy a no-load fund like Loomis-Sayles or a closed end fund like Tri-Continental. This is a little different than public utilities.

The S.E.C. implies that the customer is ignorant of these other types of funds. I personally don't believe after 13 years in the business, that the public is that isolated and ignorant to these facts. Believe me, the S.E.C. and newspaper writers like Livingston have done a very effective job of giving these funds national plugs. To say that there is no competition in this business is just not true. There is fantastic competition between funds, between salesmen, between brokers, and between the investment community and other financial institutions for the customer's available dollars. The public still has to be sold mutual funds, they do not buy. To reduce the sales charge could be disastrous to us who are trying to do the selling.

My final comment on the sales charge is that (1) the investor doesn't seem to be complaining en masse that the charge is too high and that their investment costs haven't justified their investment performance, and (2) if it is so high, who is getting wealthy from the sales of mutual funds?

I hate to use the word, but statistics do show that the average individual representative's annual income isn't too smashing whether full time or part-time, the average independent dealer is not netting a fortune, and the fund's underwriting company doesn't appear to show big net profits. Both Mr. Cohen and Professor Wallich indicate an investor would have had just as good investment performance and cheaper by picking individual stocks. This again compares apples and oranges. A mutual fund is an investment vehicle unlike an individual security. Individuals generally don't like to make decisions on stocks and don't have enough money to adequately diversify, therefore they use mutual funds.

It probably won't come as a complete surprise to you that we are also opposed to the S.E.C.'s proposal to abolish contractual plans. Once again we could go on a long exercise on statistics, but I don't think that will prove anything since you cannot statisticize human nature.

For my purpose in defending the contractual plan, I would like to use a simple simile. I hate to mention the word "life insurance" since enough was said on that subject in the hearings. However, I would like to compare the contractual plan to a specific life insurance policy—any policy. Insurance companies offer many, many different types of contracts to the public including term, 20-pay life, ordinary life, endowments, etc. Now, for example, does anyone think it would be proper for the Federal or State Government to abolish, let's say, endowment policies because they don't think they are good contracts for the public for some reason? I don't think any regulatory agency has the right to determine what is right or what is not right for the public.

The same is true concerning contractual plans. Is the S.E.C. some supreme being who knows what is the best or worst for all the people? I don't think so. The public has the choice to buy contractual plans. They don't have to. It is not the only way to buy mutual funds. Let the individual investor decide what's good or bad for him, not the S.E.C.

In a general vane, I would like to comment briefly on the impression the S.E.C. gives that there is very little other regulatory forces involved in the mutual fund and securities business. Let me assert quite emphatically that I believe

Mr. Cohen is selling the State Securities Commissioners short. For example, as was brought out, there are States which do not allow contractual plans. Incidentally, as a parenthetical thought on why California is the leading State in mutual fund sales—there were many excuses or reasons mentioned in hearings (supra) including the fact that contractuals cannot be sold there—I would like to add my reasons. In deference to you, Mr. Moss, I don't think it is because California has a monopoly on good salesmen and good weather. Rather I think it is because (1) the existence of Insurance Securities, Inc. This is a unique company having a very large sales force located all in one State. According to the latest statistics I have, this company does between 20% and 25% of the sales in the State; (2) because the New York Stock Exchange is closed all afternoon California time, the member firms have more time to devote to mutual fund sales. As was stated in the hearings, the member firms do 40% of all mutual fund sales.

Mr. Cohen also commented about the ease with which people and dealers can get into the business. To become a dealer, for instance, the S.E.C. requires only a capitalization of $2,500. He negelected to mention that many States require much more—upwards to $25,000.

I know I have gone on too long, but it is difficult to be too concise on a subject that is threatening our economic survival. It is not merely statistics when I say that between the current legislation before your subcommittee and the S.E.C.'s proposed Rule 10B–10 dealing with give-ups, on which Mr. Cocchi has already submitted our association's views, we are fighting for our lives.

I don't believe any of us are deluded by our enthusiasm for this business to think our business is perfect and cannot be improved. However, it is inconceivable to me that the S.E.C.'s proposal, if enacted, would be an improvement unless the elimination of hundreds and hundreds of small independent dealers and thousands of salesmen is what they call progress.

I want to thank you very much for allowing the Independent Brokers to speak their piece. I would like to close with some possible food for thought—a quote from Balzac—"Laws are spider webs that catch little flies, but cannot hold big ones."

(Whereupon, at 3:20 p.m., the subcommittee adjourned, subject to call of the Chair.)

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