UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

March 2, 1998

The Honorable John D. Dingell
U.S. House of Representatives
Ranking Member, Committee on Commerce
2125 Rayburn House Office Building
Washington, D.C. 20515-6115

Dear Representative Dingell:

Thank you for your letter of February 26, 1998, seeking the Commission's comments on the proposed amendments to Title II, Subtitle A of H.R. 10 negotiated by the staffs of the Securities Industry Association and the American Bankers Association Securities Association. On Friday, February 27, 1998, we received a modified version of the SIA/ABASA proposal. As requested, my comments will refer to the modified proposal.

While I believe this proposal was prepared in a good faith effort to resolve outstanding issues, I am concerned that investors were not represented in the negotiations. The version of H.R. 10 reported out of the Commerce Committee was a balanced and responsible financial modernization bill that would help ensure the continued success of our securities markets. As you know, because we viewed financial modernization as a priority, the Commission reconsidered all of its previous positions and helped to develop new approaches to break the deadlocks that doomed legislative efforts in the past. We have made a series of unprecedented compromises that are reflected in certain provisions of H.R. 10 as reported out of the Commerce Committee and represent an appropriate balance between functional regulation for the protection of investors and the prudential regulation of traditional banking functions. Weakening these crucial provisions would, in my judgment, be a step backwards.

That brings me to the SIA/ABASA proposal. I believe that the proposal falls short of the mark in at least five areas: (1) the definition of banking product; (2) the definition of qualified investor; (3) the exception for private placements; (4) the exceptions for trust activities and certain stock purchase plans; and (5) the exception for safekeeping and custody services. Let me go through each one in turn.

First, the Commission has grave reservations about the definition of "banking product." With slight modification, the SIA/ABASA draft uses the definition of banking product set forth in the Banking Committee version of H.R.10. Under that definition, the term banking product potentially could be expanded by the Federal Reserve Board to include **all** debt and derivative products. By doing this, the Fed, and not the Commission, would decide if securities products may be sold by banks without the protections of the federal securities laws. The Commission and the courts have done a good job interpreting the federal securities laws for over fifty years. I believe it would be inadvisable to allow banking regulators to override these interpretations.

Second, the proposal expands the definition of "qualified investor" to cast a wider net, catching (1) any business with a net worth exceeding $1 million or with total assets exceeding $5 million; (2) any natural person with assets exceeding at least $10 million; and (3) any governmental entity, from a local school board to the largest pension fund. The proposal permits a bank to sell sophisticated financial products such as private placements, asset-backed securities and derivative securities to this expanded class of "qualified investors" without the investor protections of the federal securities laws. By replacing the list of businesses that are engaged in investing contained in the Commerce Committee version (e.g. investment companies, foreign banks) with financial thresholds, the bill assumes that wealth equals sufficient sophistication to protect against unscrupulous sales practices. In my view, investors do not benefit from this definition.

We should not, in my judgment, regulate sales by banks of these products differently than sales by independent broker-dealers. By doing so, we may well create incentives to move transactions out of registered broker-dealers into banks.

Third, as drafted by the SIA and ABASA, the private placement exception would permit banks to sell private placements directly even if they have a broker-dealer affiliate. Given that private placements can be sold through a dual employee of the bank and the bank's broker-dealer, there is no valid cost basis for extending this exception. Under the Commerce Committee version of H.R. 10, banks without a broker-dealer affiliate were exempted from registration to avoid imposing new costs on smaller banks. Further, banks with and without broker-dealer affiliates have 500 de minimis transactions available under another exemption. Now, under the SIA/ABASA proposal, banks and brokers are given the option to conduct this business outside the self-regulatory scheme, which includes substantial investor protections, including regulation of sales practices.

The private placement market is huge -- in 1996 almost $200 billion was raised using this method. For the most part, the intermediaries in this market have been regulated as broker-dealers. In 1996, the top 15 private placement agents were regulated as broker-dealers, six as broker-dealer affiliates of large banks, and nine as independent broker-dealers.

Investors need the assurance that the intermediary who is selling the security is trained and subject to the obligations applicable to other broker-dealers.

Fourth, there are some difficulties with the proposal in connection with the (1) bank trust activities exception and (2) the stock purchase plan exception. With respect to these exceptions, the biggest problem I see is that, under the SIA/ABASA draft, banks could charge commissions for these services, so long as they are "primarily" compensated on the basis of an annual or flat fee or a percentage of assets under management (which is the way that broker-dealers are often compensated). Also, with the trust exception, banks will be permitted to advertise such business, so long as the advertising is done in connection with other trust business. This concerns us because these brokerage activities could be conducted outside both the protections provided and responsibilities required by the federal securities laws. These duties include the responsibility to supervise employees, to ensure that products are suitable for investors, that undisclosed commissions are not excessive, and that investors can arbitrate disputes. The trust and stock purchase plan exceptions go beyond banks' traditional activities in these areas -- and give banks a "salesman's stake" for many new activities. The result of the SIA/ABASA proposal in this area is that banks would receive a competitive advantage over broker-dealers and customers would be denied the full protections to which they are entitled. I do not believe this is the correct approach.

Fifth, the SIA/ABASA safekeeping and custody exception makes an unsuccessful attempt to use the Banking Committee provision (which refers broadly to allowing banks to clear and settle transactions), while addressing the Commission's concerns that banks not be able to act as clearing brokers. The proposal adds new language to the Banking Committee safekeeping exception that appears intended to prevent banks from using the exception to act as clearing brokers. Unfortunately, this language does not achieve its intent and may nullify the carrying broker prohibition.

The SIA/ABASA proposal adds a new limitation for the trust, stock purchase plans and safekeeping exceptions that requires banks to execute the trade through a registered broker-dealer, or to execute it internally in a cross-trade. Although this limitation appears to improve these exemptions, I believe the legislation should go further. Nevertheless, further negotiations might resolve the remaining issues with these three exemptions.

I trust that you find these comments helpful as you continue to analyze the SIA/ABASA proposal. Please do not hesitate to contact me if I can be of further assistance.

Sincerely,

Arthur Levitt

cc: The Honorable Tom Bliley
The Honorable Michael G. Oxley
The Honorable Thomas J. Manton

NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
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March 3, 1998

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
2322 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Dingell:

The North American Securities Administrators Association, Inc. ("NASAA") is responding to your request, and appreciates the opportunity to provide analysis of the proposed SIA-ABASA Compromise ("Compromise") language to HR 10.

Thomas E. Geyer, Commissioner of the Ohio Division of Securities, presented NASAA's views on HR 10 before the Finance and Hazardous Materials Subcommittee on July 17, 1997. NASAA supports financial services modernization, provided that appropriate safeguards are put in place to provide investor protection and maintain the integrity of the securities marketplace.

NASAA continues to strongly support the principle of functional regulation along with a level-playing field between bank and non-bank participants, and believes the Compromise completely eviscerates both concepts. The exceptions set out in the Compromise definition of Brokers and Dealers expand the scope of securities activities that may be conducted outside the established securities regulatory framework. This bodes poorly for the protection of investors and, more importantly, for the efficient functioning of the securities marketplace.

Our July 17 testimony expressed concern about the exemptions for the activities banks will continue to engage in outside the securities regulatory scheme. What may have started out as a need to carve out "traditional" banking activities, has turned into a plethora of securities activities that may be conducted by banks outside the established state-industry-federal securities regulatory framework.

Key language in the compromise is vague and seemingly contradictory. Based on our analysis, NASAA believes the Compromise could harm investors – from individuals and small businesses, to school districts, towns and cities – and undermine decades-old securities laws that protect our financial markets. Ironically, under certain circumstances, the Compromise could even expose banks and their employees to litigation from investors. In short, NASAA believes this proposal is fatally flawed and that it could hurt the very people, institutions and markets it purports to help. Given the short time-frame within which we are all working, we have focused on those issues of most concern to state securities regulators, and we will continue to review the Compromise language for further comment.

1. Trust Activities

NASAA believes it appropriate that collective investment vehicles be subject to comparable regulatory regimes so that issuers of such securities are not placed at a competitive disadvantage with issuers of almost identical securities subject to less stringent regulation. Registered investment companies, required to comply with the provisions of the Investment Company Act, face significant compliance costs and limitations on business activities. Bank common trust funds are typically not subject to the Investment Company Act. However, to investors and to much of the marketplace, the two products appear comparable, even fungible. Bank common trust funds have long competed with investment companies for the same retail and institutional investors.

NASAA would note that the comparable provisions regulating common trust funds and investment companies are markedly different. The Investment Company Act provides, among other things, rigorous disclosure obligations, prohibitions against self-dealing, valuation and pricing requirements, and remedies available to investors. Issuers of common trust funds are subject to substantially fewer, if any, analogous provisions.

In response to a 1990 proposed administrative expansion of common trust fund activities, then-Securities and Exchange Commission ("SEC") Chairman Breeden indicated that "the same standards of investor protection and oversight of sales practices and other supervisory concerns should be applied to every entity operating as an investment company."[1] NASAA concurs. The written testimony of former Chairman Breeden provides a detailed description of the protections afforded investors by the Investment Company Act that simply are not present in either state banking regulations or the common law. While the proposal in question in 1990 is somewhat discernable from the proposed amendment to HR 10, the disparate regulatory structures governing investment companies versus common trust funds remain of central importance. This testimony is attached for your reference.

2. Third-Party Brokerage Arrangements

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[1] Written statement by Richard C. Breeden, Chairman, US Securities and Exchange Commission before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, Proposed Revisions to Rules Governing Bank Common Trust Funds, U.S. Representatives at 2 (Oct. 4, 1990).

Although proposed amendments to 3(a)(4)(B)(i) of the '34 Act are not the subject of proposed revisions by the SIA-ABASA, NASAA believes it necessary to provide comment on one important issue. With minor amendment, NASAA believes that this subsection could limit the exposure of bank personnel for providing advice beyond "clerical or ministerial" functions.

Proposed 3(a)(4)(B)(i)(V) would permit bank employees other than associated persons of a broker or dealer to perform certain "clerical or ministerial functions." One such function would be for unregistered bank personnel to "describe in general terms the range of investment vehicles available from the bank and the broker or dealer under the contractual or other arrangement." NASAA believes that this language disserves the interests of the banks and bank personnel. This language permits bank personnel, perhaps with innocent intentions, to provide advice to customers. Such advice could be the subject of private litigation and potential regulatory action.[2] If the bank personnel "crosses the line" from performing "clerical and ministerial" acts to engaging in unregistered activity, the individual, the bank, and the broker or dealer could be required to rescind the transactions in question. The burden for proving that such acts were "clerical or ministerial" would fall on the bank.

To prevent the financial institution from opening up what may become a bonanza for private litigants, NASAA would respectfully suggest that this subsection be amended slightly as follows:

(V) bank employees (other than associated persons of a broker or dealer who are qualified pursuant to the rules of a self-regulatory organization) perform only clerical or ministerial functions in connection with brokerage transactions including scheduling appointments with the associated persons of a broker or dealer, except that the bank employees may forward the customer funds or securities. ~~and may describe in~~

[2] States have noticed an increase in enforcement activity relating to the securities activities of banks. For example, the State Securities Board of Texas filed a Notice of Hearing against NationsSecurities, a subsidiary of NationsBank, alleging numerous fraudulent practices that were committed during the offer and sale of certain "government income" trusts. The alleged violations included misrepresentions made by NationsSecurities that the Trusts were backed by AAA-rated government securities and were a safe alternative to Certificates of Deposit and failing to disclose that the Trusts invested heavily in interest-rate sensitive mortgage-backed derivatives. Furthermore, unlicensed bank employees were trained to refer certain customers to NationsSecurities based on various cues such as large account balances and customers seeking a higher return than that offered. NationsSecurities entered into a Consent Order and Settlement Agreement on August 9, 1996. The Order required NationsSecurities to make $137,500.00 available in each of the next two years for a pilot investor education project to be overseen by the Securities Commissioner. NationsSecurities was also ordered to offer of rescission to certain investors, and undertake significant compliance enhancements, as recommended by an outside auditor. Consent Order and Settlement Agreement in The Matter of the Dealer Registration of NationsSecurities, Docket no. 96-011, Order No. CEN/SSO-1124 (August 9, 1996).

~~general terms the range of investment vehicles available from the bank and the broker or dealer under the contractual or other arrangement;~~

The bank personnel would still be permitted to perform those functions "clerical or ministerial" without providing an express means for these activities to be cast in terms of providing advisory services, which, without proper registration, could violate state and/or SEC rules and create a private right of action.

3. Distribution of Securities

The ability of banks to engage in the relatively unregulated offer and sale of securities is problematic for NASAA. First, NASAA has significant concerns regarding the level of an individual's wealth or sophistication that make them permissible recipients of an unregistered product sold to them by an entity not subject to the registration and regulatory provisions of the '34 Act. Second, NASAA believes that the exception for banks distributing nonpublic offerings removes the last securities stopgap of broker-dealer regulation and may inspire many of the same self-dealings and overreachings that justified the creation of the Glass-Steagall Act in the first place.

a. "Qualified Investor"

The standard suggested by the SIA-ABASA amendments relating to determining what individuals or entities are "qualified investors" is perhaps the most potentially harmful to investors and small businesses, and troubling to regulators. NASAA has significant concerns with the threshold proposed and the negative impact such proposal would have on the protection of individual and unsophisticated investors.

As an initial matter, NASAA concurs with the generally held view that some individuals and entities, because of their wealth or sophistication, or both, do not require the protections afforded by the securities laws. However, NASAA would note that the point of demarcation in other areas of the securities laws is at a dramatically higher level than that proposed by the SIA-ABASA.

The standards proposed by Insert G are a significant lowering of the standards to which other issuers and sellers are subject. Such a disparity creates an uneven playing field for bank and non-bank distributors of securities. These provisions are also a significant deviation from the well-established standards currently in place in the federal securities laws. Moreover, these and other thresholds were set either by Congress or administratively by the Securities and Exchange Commission ("SEC") with the entity offering or selling the securities to these subsets of investors being subject to applicable federal, state, and SRO registration provisions. This additional layer of investor protections and front-end screening is simply not present in the proposed exceptions.

NASAA would respectfully suggest that the standards enacted by Congress in 1996 when it created the "qualified purchaser" definition in the amendments to The Investment

Company Act is a more appropriate demarcation than those proposed in the SIA-ABASA amendments. NASAA has noted a significant increase in abuses committed in connection with offerings sold to "accredited investors" in reliance of Rule 506. Attached is a brief list of examples provided by the Pennsylvania Securities Commission.

1) Business Entities

What is suggested as Insert G would include as a "qualified investor" a corporation (or any other business entity) with a net worth exceeding $1,000,000. Virtually every small business in the nation could meet this test, and NASAA would note that there exist few segments of the marketplace more deserving of the full protections of the securities laws than these small business entities. For example, small businesses operating out of the founder's home could likely meet this test, as could any issuer that has raised the maximum amount permitted under SEC Rule 504.[3] See 17 CFR §230.504. NASAA believes that this proposal could have a significant and negative impact on small business development nationwide.

As noted, these suggested levels are significantly lower than elsewhere in the federal securities laws. Because individuals permitted to sell to "qualified investors" are excused from any regulation under the securities acts, it would appear that the levels of wealth and sophistication should be significantly higher than elsewhere in the securities acts (where sellers are required to comply with the registration provisions in the '34 Act). For example, "qualified purchasers," are required to have at least, in the case of a company, $5,000,000 in investments before it is deemed to not require the protections of the Investment Company Act. 15 USC § 80a-2(a)(51)(A)(ii).

NASAA would note that this insert also appears to suffer from internal inconsistencies. It seems incongruous for a natural person to be required to amass in excess of $10,000,000 in assets before he/she can be considered a "qualified investor" but another natural person, with only a net worth of only $1,000,000 (or assets of $5,000,000) can be a sole proprietor of a business (which would be an "other business entity") and suddenly be eligible for "qualified investor" status.

2) Governmental Entities

NASAA is very concerned with the proposal to treat as a "qualified investor" any governmental entity, without any dollar threshold or sophistication requirement. Such a provision is a notable departure from existing, well-established standards in the federal securities laws. For example, the definition of "accredited investor" at least requires that the entity have total assets in excess of $5,000,000. 17 CFR § 230.501(a)(1). The

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[3] These types of offerings, known as Small Company Offering Registrations ("SCOR") from the streamlined state registration provisions to which they are subject, are typically very small businesses engaged in the early stages of capital raising. Often times, these companies experience difficulties in obtaining the capital to hire an accountant to perform an audit of their financial statements. NASAA believes that such investors, as a class, are inappropriate for this proposed blanket "carve-out" from the securities laws.

proposed "qualified investor" standard would include most every school district, library, municipality, without regard to solvency or financial stability. States are noticing an increase in the solicitation of counties and other small municipalities (that often lack the budget to retain professional money management) of complex and potentially disastrous derivative securities. In Ohio, for example two counties suffered losses totaling $8.7 million in connection with an unsuitable derivatives investment strategy. Ohio has since taken action against the firm for the improper marketing of these securities and the counties have been made whole. NASAA has significant reservations regarding the long-term prudence of such a deregulatory effort.

b. Distribution Activities Permissible Under the SIA-ABASA Proposal

NASAA also has significant concerns with what will now become an entirely unregulated field for private placements issued and or distributed by banks. Individuals distributing these offerings will not be required to undergo any disciplinary check other than in the course of his/her employment with the bank. The bank will not be required to supervise the individuals selling the securities to the same stringency as its broker-dealer competitors. Individuals will not be subject to the same rules of fair practice enforced by the SROs and by the states, and investors will not be afforded the same remedies. In short, NASAA believes that this unregulated market could quickly devolve into one in which the investor/depositor will not be afforded the same protections and safeguards present in the regulated sector of the securities markets.

1) Private Securities Offerings

The exceptions created at proposed 3(a)(4)(B)(i)(vi) and 3(a)(5)(C)(i)(II) would permit banks to engage in various nonpublic offerings without registration as a broker or dealer. The proposed exception in what currently is a largely unregulated market could negatively impact investor protections, the private placement market generally, and the banks themselves.

As an initial matter, NASAA would note that these securities are already exempt from registration under the '33 Act, with minimal (if any) filings required to "perfect" the exemption. The most commonly used nonpublic offering exemption[4] is Rule 506 of Regulation D. 17 CFR § 230.506. Rule 506 requires, at the federal level, the filing of Form D not later than 15 days after the first sale. States typically have a similar filing requirement (securities offered in reliance of Rule 506 are "covered securities" by

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[4] It is NASAA's observation that securities transactions that would comply with 4(2) are typically offered under the safe harbor of Rule 506, or as a "fallback" position in the event the issuer cannot avail itself of 506 for whatever reason. The same could be said for 4(6) offerings. Rule 505, after NSMIA, has simply fallen into a state of disuse.

operation of Section 18(b)(4)(D) of NSMIA). States have noticed an increase in abuses committed in connection with offerings conducted in reliance of Rule 506.[5]

Exemptions from federal registration and exceptions from state registration for such transactions effected by non-banks are perhaps justifiable because the entities offering and selling such securities remain subject to federal, state, and SRO rules. Under the SIA-ABASA proposal, not only would the securities distributed continue to be exempt from registration provisions, but also those entities distributing the securities would not be subject to any federal, state, or SRO registration provisions. Banks would also be excused from the detailed recordkeeping or net capital provisions, for example, of the federal securities laws. The individuals distributing the securities would, under the SIA-ABASA proposal, be subject to no qualification requirements whatsoever. This outcome would not change if the bank had a broker-dealer subsidiary or not, which means that a bank could elect to distribute private placements itself merely in an effort to avoid any regulatory issues associated with distributing the same securities through a broker-dealer subsidiary. NASAA questions whether result, if intended, is beneficial to our markets or to investors.

NASAA believes that the registration and regulatory provisions provided under the '34 Act, state provisions, and SRO rules are an important component of the investor protection equation. Regulators use these provisions to monitor the activities of broker-dealers and to screen out those entities and individuals that are not deserved of engaging in the offer and sale of securities in our markets. NASAA is also concerned that, by excusing banks from virtually all of the '34 Act, registered broker-dealers will suffer a significant competitive disadvantage when seeking to distribute securities in a nonpublic offering.

One other issue that may not have been fully considered is the tremendous body of interpretive law that has developed over the years in the private placement area. All securities sold in a nonpublic offering, whether sold by a bank or by a broker-dealer or by the issuer itself, presumably would remain subject to this collection of no-action letters and administrative actions. For example, issuers of private placements are required to have a pre-existing, "substantive relationship" with offerees.[6] Does a bank have a pre-existing relationship with each and every depositor? Also, mass-mailings have been deemed to violate the prohibition against general solicitation contained in Rule 502(c).[7]

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5 See Pennsylvania memo (attached); see also Letter from Neal Sullivan, NASAA Executive Director, to Richard Wulff, Associate Director, Division of Corporation Finance, 04/24/97 (on file with NASAA).

6 A "substantive relationship" is established when an issuer or its agent possesses "sufficient information to evaluate the prospective offeree's sophistication and financial circumstances." Woodtrails-Seattle, Ltd., SEC No-Action (Aug. 9, 1982).

7 See, e.g., In re Harry Harootunian and Professional Planning & Technologies, Inc., Rel. No. 34-32981, 55 SEC Docket 221 (Sept. 29, 1993) (mass-mailing of solicitation letter to tens of thousands of individuals who had no prior relationship with either the issuer or the sellers resulted in public offering); In re Robert Testa, Rel. No. 33-7018, 55 SEC Docket 177 (Sept. 29, 1993) (mass-mailing

If a national bank mails information regarding a private placement in XYZ, Inc. to all of the bank's 500,000 accountholders, could it be deemed to have engaged in a general solicitation and thus foreclosed from claiming the exemption (and thus potentially foreclosed from claiming the exception from the definition of "broker" or "dealer")?

In the event that a bank engages in activities that would remove its exception from the "broker" or "dealer" definitions, the bank would presumably be subject to registration as a broker or dealer with the SEC, to membership in the NASD, and to registration as a broker-dealer in the states in which it is transacting business. The bank could possibly be subject to enforcement action by the SEC and the states for any unregistered activity in which it engaged. Similarly, the bank would be distributing securities in violation of federal and state registration provisions, unless another exemption applies. Investors of such unregistered securities could seek rescission under state and federal law. NASAA is unsure if the vagueness attendant to this exception will prove beneficial to the banks themselves.

2) Banks as underwriters

The exceptions from the definition of "broker" and "dealer" under the '34 Act permit banks to create, issue, and distribute securities of their choosing to a captive market of deposit-holders. NASAA has concerns about the types of products created and issued within this vertical distribution and the opportunities for abuse it may create. In the context of certain types of asset-backed securities, this prospect becomes particularly unsettling.

NASAA certainly understands that banks, like any other economically motivated entity, seek to minimize risks by shifting those risks to and among any number of different parties. Banks that hold loan portfolios, for example, have long discounted and sold those assets to other banks. Since the mid-to-late 1980s, banks have been permitted to place these assets into a trust and have fractionalized interests distributed to investors, SIA v. Sec. Pac. Nat'l Bank, 885 F.2d 1034 (2d Cir. 1989). These fractionalized interests, however, were generally required to be sold publicly through a registered broker-dealer (or through placements directly by the bank with institutional investors). Id. at 1037. Banks did not place these securities with their own deposit holders. Id.

Under the SIA-ABASA proposal, however, these interests can be offered to any qualified investor without the assistance of an outside underwriter. NASAA believes that the independent due diligence performed by members of the underwriting syndicate is crucial, particularly in connection with the distribution of certain types of asset-backed

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of solicitation letter to 80,000 to 95,000 physicians, none of whom had a relationship with the selling agent or the issuer violated Rule 502(c)); Pennsylvania Securities Commission, SEC No-Action Letter (Jan. 16, 1990) (Division Staff declined to issue no-action letter regarding whether the general solicitation prohibition under Rule 502(c) was violated by a mass-mailing of a brochure summarizing private placement memorandum using mailing list of statewide professional organization consisting of at least 200 members); In re Kenman Corp., Rel No. 34-21962, 32 SEC Docket 1352 (Apr. 19, 1985) (issuer engaged in general solicitation by sending solicitation materials to an unspecified number of persons with whom neither had a pre-existing relationship violated Rule 502(c)).

securities. It is the outside underwriters that are uniquely situated to perform independent analyses on issues central to debt service, such as default rates, bad debt estimates, liquidity issues, and the like. Regarding non-bank distributions of asset-backed securities, NASAA believes it as inappropriate for the issuer itself to be expected to perform these important functions in a wholly disinterested fashion as it would be for a public company to audit its own financial statements absent any independent "check."

NASAA is concerned that the hazards of permitting banks to engage in the unfettered distribution of securities absent the independent due diligence performed by an outside underwriter could re-emerge. These are some of the very same hazards that brought about Glass-Steagall legislation in the first place. This concern is perhaps heightened in instances in which there exists no market for the securities and the lone source of information regarding the securities issued is the bank itself. Such securities do not receive the benefits of information flow into and from the marketplace and the opportunity for price improvement afforded to securities traded publicly.

One effect of Glass-Steagall, in its original form, was to abolish the security affiliates of commercial banks.[8] The dangers in commingling the two functions unchecked were later described as "hazards" that arise when a commercial bank enters the investment banking business. ICI v. Camp, 401 US 617, 636 (1971).[9] Certainly the face of banking has changed a great deal since passage of Glass-Steagall, and since the Supreme Court decided Camp. Concerns of self-dealing, inappropriate distribution methods, and questionable sales practices, however, will continue to arise when the ability to produce, price, issue, distribute, and resell any product, including securities products, is concentrated in one entity, such as a bank.

4. Safekeeping and Custody

The proposed amendments would appear to permit banks to essentially "self-clear" their securities transactions or to clear on behalf of other "introducing brokers." In the securities industry, clearance and settlement activities are typically dispersed through a myriad of introducing brokers, clearing firms, and depository corporations that facilitate

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8 See Report on Investment Trusts and Investment Companies, pt. 2, H.R.Doc.No. 70, 76th Cong., 1st Sess., 59 (1939).

9 There, the U.S. Supreme Court observed that

> A bank that operates an investment fund has a particular investment to sell. It is not a matter of indifference to the bank whether the customer buys an interest in the fund or makes some other investment. ... Promotional incentives might also be created by the circumstance that the bank's fund would be in direct competition with mutual funds. ... The promotional and other pressures incidental to the operation of an investment fund ... involve the same kinds of potential abuses that Congress intended to guard against when it legislated against bank security affiliates. ... ICI v. Camp, at 636-638.

settlement. The increased numbers of participants in the clearance and settlement process may increase the likelihood of a settlement failure, the effect of a settlement failure will be minimized to that firm. However, by centralizing the clearance and settlement functions in one area, the risk of settlement failure is concentrated in one area.

In the context of commercial banks clearing securities transactions, there exists the possibility a settlement failure may effect the safety of depository accounts, unless adequate protections are in place. Specifically, NASAA is concerned that banks securities clearing activities may place undue strain on the FDIC. NASAA finds that the Safekeeping and Custody exemption raises serious concerns regarding what Federal Reserve Board Chairman Alan Greenspan refers to as the federal safety net – federal depositors insurance.[10]

As the Chairman as stated and NASAA concurs, the value of the safety net can only be fully valued at the stress point of the weakest bank during a financial crisis. This is precisely why the potential for market risk flowing upstream via brokerage and clearing functions is troubling.

The exemption outlined in the proposal creates a highway for the market risk to flow back upstream without the securities regulatory safeguards present in our capital markets today. For example, a bank could act s the introducing broker to a depositor and sell the same depositor securities from the banks own inventory. This transaction could be executed on-line between the banking depositor and the bank outside of any regulated trading market. The bank could also serve as the clearing and settling broker on the trades.

These transactions would be outside the margin rules of the self-regulatory organizations and thereby potentially incurring greater system risk. In the event of market risk flowing from the margined investor to the margined bank/broker to the bank/clearing broker, the last point for assumption of that market risk could be the depositors insurance, our national safety net. It seems unwise to expose depositors and U.S. taxpayers to the risk of poor investment decisions of investors and unregulated securities sales operating in a less transparent marketplace.

5. Conclusion

NASAA does support congressionally directed financial services reform and upholds the ideals of functional regulation of securities. However, permitting securities activities to take place outside the complementary state/federal securities regulatory system would have an untoward effect on the securities markets and on investor protection.

The federal-state securities laws are "balanced" in the sense there are "front-end and "after the fact" protections combined to create a national framework for local regulation.

[10] Testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce, U.S. House of Representatives at 4–5 (July 17,1997).

Front-end requirements such as securities registration, licensing, disclosure obligations, reporting requirements, etc are critical in addition to the after-the-fact anti-fraud standards and other enforcement tools. The exemptions to the definition of broker and dealer clearly diminish the front-end protections for investors. From a quick review of the available language, it appears the securities anti-fraud enforcement authority remains intact, but is clearly weakened by the elimination of many of the protections currently afforded consumers. The Compromise could harm investors including individuals, small businesses, school districts, towns and cities.

Thank you again for the opportunity to present our views on these crucial investor protection matters. Please do not hesitate to contact me if we can provide additional information or be of other assistance as you continue in your efforts to achieve meaningful financial services modernization.

Sincerely,

Neal E. Sullivan
Executive Director

Enclosures

TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING PROPOSED REVISIONS TO RULES GOVERNING BANK COMMON TRUST FUNDS

BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS & FINANCE
OF THE COMMITTEE ON ENERGY AND COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

OCTOBER 4, 1990

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

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STATEMENT OF RICHARD C. BREEDEN
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
OF THE COMMITTEE ON ENERGY AND COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING PROPOSED REVISIONS TO
RULES GOVERNING BANK COMMON TRUST FUNDS

October 4, 1990

I. INTRODUCTION

Chairman Markey and Members of the Subcommittee:

I appreciate this opportunity to appear today, on behalf of the Securities and Exchange Commission, to discuss the Commission's views on a proposal by the Office of the Comptroller of the Currency to eliminate certain restrictions on how national banks operate common trust funds. The Comptroller's proposal would permit banks to advertise their common trust funds to the general public and to charge a separate fee for managing common trust funds. Common trust funds taking advantage of these revisions would become the functional equivalent of public investment companies.

On July 9, 1990, I wrote to the Comptroller of the Currency regarding the proposed rule changes. My letter, a copy of which is attached as Attachment A, reiterated a longstanding position of the Commission. As described in the letter, the Commission believes that if common trust funds engage in general advertising or commingle bona fide common trust fund assets with other assets, then the funds will be ineligible for exemptions from the Securities Act of 1933 ("Securities Act") and the Investment

Company Act of 1940 ("Investment Company Act"). My letter also stated that, should the Comptroller adopt the proposed revisions to its rules, the Commission would expect to issue an interpretive release to apprise banks of the circumstances under which common trust funds must register under those statutes.

In Banking Circular BC-47, the Comptroller stated: "National banks that operate common trust funds must comply with the applicable provisions of the federal securities laws." The Comptroller's circular notified all national banks of the Commission's position with respect to the applicability of the Securities Act and the Investment Company Act to common trust funds. We appreciate the careful manner in which the OCC has proceeded to date, and the willingness of the OCC to work with the Commission in considering this issue.

I would like to emphasize at the outset that the Commission encourages competition in the securities industry, and it does not have any objection whatever to additional participants in the investment company business, including banking organizations. However, the Commission also believes that the same standards of investor protection and oversight of sales practices and other supervisory concerns should be applied to every entity operating an investment company.

Establishing fair competition and uniform investor protection in the investment company industry would be advanced by amending the Investment Advisers Act of 1940 ("Advisers Act") and the Securities Exchange Act of 1934 ("Exchange Act") to include bank securities activities within the regulatory system established by those acts. Under current law, banks performing advisory and selling functions are exempted from registration as advisers and broker-dealers. 1/ These exemptions were crafted in an era when the separations between investment and commercial banking mandated by the Glass-Steagall Act were clear and distinct, which is obviously no longer the case.

In the Commission's view, if a bank distributes shares of a mutual fund or interests in its common trust fund, it performs the functions of a broker or underwriter and should be registered under the Exchange Act. Similarly, a bank that becomes an investment company's investment adviser should probably also be registered, like any other adviser, under the Advisers Act.

This belief in so-called "functional regulation" is not simply a matter of competitive fairness. Rather, it reflects a belief in the overriding importance of protecting investors, which is the fundamental purpose of the federal securities laws. Investors considering a purchase of common stock in a bank should be entitled to every bit of protection -- and every bit as much disclosure under the Securities Act -- as investors considering a purchase of common stock in a computer firm, an airline, a public utility or a grocery chain. Similarly, a bank trying to sell its own stock or debentures to its customers ought to be subject to the same sales practice standards of the SEC and the NASD as

1/ Advisers Act Section 202(a)(11), 15 U.S.C. 80b-2(a)(11); Exchange Act Section 3(a)(4), 15 U.S.C. 78c(a)(4).

would govern the securities sales activities of any other type of company. Indeed, an insolvent bank or thrift, relying on deposit insurance for funding, should not be able to raise capital from investors without adequate disclosure of its true condition; and that makes the protections of the federal securities laws for investors in banks or thrifts absolutely essential.

The Commission believes that bank securities activities should be performed within a separate corporate entity. Such a structure would allow all investment company and securities activities to be overseen by the Commission. Conducting bank securities activities in a separate holding company affiliate maximizes the chances of preventing losses in securities activities from affecting the federal deposit insurance fund. 2/ This will also achieve the most consistent regulation. Perhaps as important, use of a separate holding company affiliate would minimize the risks that the substantial public subsidies of the bank, with its public safety net, could distort competition within the securities industry by providing the securities affiliate of a bank with either a subsidized cost of funds or protection against the consequences of inadequate capitalization.

2/ As I have previously testified before this Subcommittee, the Commission believes that conducting securities activities through a holding company affiliate would provide the greatest protection to the public and the deposit insurance fund, and permit regulatory efficiency. However, certain narrower securities activities, such as management of a money market fund offered to bank (including trust account) customers in lieu of an insured demand deposit account, could also be conducted in a bank subsidiary with appropriate safeguards.

It is a fundamental precept of our securities system that participants in the securities markets should not be shielded from the consequences of their risk-taking. The discipline of strict capital requirements, without taxpayer support or obligations, is vital to the structure of our securities markets. In the view of the Commission, expanding the moral hazards inherent in the deposit insurance program into the securities business would be a mistake, and would represent an unjustifiable new risk to the taxpayers.

In my judgment, with the right laws and regulatory structure, we can allow banking organizations the freedom to compete in securities activities. At the same time we would be able to prevent the very real dangers that would result from an intermingling of securities and banking activities <u>within</u> federally insured institutions. Of course these broader issues are not directly raised by the OCC's proposal, although they are important overall considerations.

In response to the Subcommittee's questions, I will first describe the specific implications of the Comptroller's proposals under current securities laws. I will then address the broader theme of how bank securities activities should be regulated in a modernized financial regulatory structure and discuss possible legislative changes to the Investment Company Act.

II. THE COMPTROLLER'S PROPOSED REVISIONS TO ITS COMMON TRUST FUND REGULATIONS WOULD ALLOW BANKS TO OFFER PUBLIC INVESTMENT COMPANIES

Banks historically have operated common trust funds to manage the assets of trusts and estates they administer more effectively. Pooling the assets of many individual trusts offers the opportunity to reduce both investment risk and expenses for each participating trust.

Congress has recognized the benefits to banks of pooling and collectively managing the assets of trust funds. As a result, Section 3(a)(2) of the Securities Act provides an exemption from registration under that Act for any interest or participation in any common trust 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" (emphasis added). 3/ Similarly, Section 3(c)(3) of the Investment Company Act exempts from the definition of investment company "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian" (emphasis added). 4/ In accordance with the clear legislative intent, 5/ the Commission has interpreted these

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3/ 15 U.S.C. 77c(a)(2).

4/ 15 U.S.C. 80a-3(c)(3).

5/ H.R. No. 1382, 91st Cong., 2d Sess. 43 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 27 (1969) ("[the Securities Act
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exemptions to apply only where a common trust fund is used solely as an accommodation for bona fide pre-existing trusts: that is, the exemptions rest on the assumption that a common trust fund is used only for a "bona fide fiduciary purpose" and not as a vehicle for general investment by the public. 6/

Until now, the Comptroller's regulations have prevented banks from crossing the threshold from statutorily exempt activities to those requiring registration under the securities laws, even if their common trust funds might have been willing to so register. Thus, under current banking regulations, banks are not permitted to advertise generally their common trust funds or to charge a separate fee for managing the trust fund if that would result in individual trusts paying higher total fees than they otherwise would pay. 7/

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exemption] is limited to interests in or participation in 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 would not exempt interests or participation in bank funds maintained as vehicles for direct investment by individual members of the public").

6/ Hearing on Common Trust Funds -- Overlapping Responsibility and Conflict in Regulations Before a Subcomm. of the House Comm. on Operations, 88th Cong., 1st Sess. 4 (1963). See also Investment Company Act Rel. No. 3648 (March 11, 1963).

7/ 12 CFR 9.18(b)(5)(v) and 9.18(b)(12). By its terms, Regulation 9 governs common trust funds maintained by national banks. However, common trust funds maintained by other banking organizations are required to comply with the requirements of Regulation 9 in order to obtain "pass-through" tax treatment under Section 584 of the Internal Revenue Code.

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The Comptroller's proposed revisions to the common trust fund regulations would remove these constraints. As a result, banks would be effectively allowed to advertise their common trust funds, place in them both assets held for a bona fide fiduciary purpose and other assets, and charge separate fees for managing common trust funds. However, the proposed revisions do not seek to change the standards under which a bank would lose its federal securities law exemptions.

It is important to emphasize that the Comptroller has not objected to Commission jurisdiction over publicly advertised common trust funds. The Comptroller's proposing release specifically recognizes the possibility of Commission jurisdiction over these funds. 8/ Moreover, two weeks ago the Comptroller issued Banking Circular BC-47 alerting affected banks

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8/ Bank common trust funds maintained for the investment of Individual Retirement Accounts have already registered under the securities laws. These funds were required to register under the Securities Act and the Investment Company Act because they did not meet the securities law requirement that they consist solely of bona fide fiduciary assets. Further, they did not qualify for the exemptions from registration for collective trust funds maintained by a bank because those provisions only exempt assets qualifying under Section 401 of the Internal Revenue Code, not Section 408. See Sections 3(c)(11) and 3(a)(2) of the Investment Company Act and the Securities Act, respectively. Beginning in 1982, the Comptroller granted these funds waivers from applicable banking regulations to permit them to comply with the independent audit requirements of the Investment Company Act and the prohibition against a majority of a fund's board of directors being officers, directors, or employees of one bank. The Comptroller's proposed revisions would codify these waivers.

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to several securities laws implications of the proposed revisions.

The efforts of the Comptroller and the Commission have provided national banks with ample notice of their obligations under the securities laws if they rely on the proposed rule revisions. However, I remain somewhat concerned that the Commission not be put to the expense of litigating the applicability of these statutes, and the possibility of delay in the application of statutory protections. Consequently, we would not object if the Comptroller wanted to add an explicit requirement to the common trust fund regulations requiring common trust funds relying on the revisions to register under the Secur...es Act and the Investment Company Act. In any event, banks considering whether or not to exercise the authority that they are given should be aware of their obligations under the Investment Company Act and the Securities Act.

III. THE SECURITIES LAWS PROVIDE CERTAIN PROTECTIONS TO INVESTORS NOT AVAILABLE TO BENEFICIARIES OF COMMON TRUST FUNDS

As discussed in further detail below, in insisting upon the registration of investment companies sponsored by banks, the Commission is not simply advocating uniformity for its own sake. Under the protections afforded by the Investment Company Act, a trillion dollar industry has grown and prospered, allowing tens of millions of investors to meet a wide variety of financial needs. These protections simply will not be available in the

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same degree to beneficiaries of publicly advertised common trust funds.

The Securities Act and the Investment Company Act require comprehensive disclosure regarding the offering and pricing of investment company securities and impose other obligations designed to assure management of customer assets untainted by self-dealing and other abuses. Other important protections provided by the securities laws, which I will also discuss in detail later, would <u>not</u> be available to participants in bank sponsored investment companies, even if those funds did register under the Securities Act and the Investment Company Act. The Advisers Act imposes certain fiduciary and disclosure obligations upon investment advisers that manage investment companies. The Exchange Act (and the underlying self-regulatory organization rules) provides significant customer protections concerning the manner in which investment company securities are distributed, traded, advertised, and sold. However, because banks are currently exempt under the Advisers Act and the Exchange Act, investors in investment companies advised and distributed by banks do not and would not receive these additional protections.

A. <u>Investment Company Regulation</u>

Before discussing the specifics of investment company regulation, it is important to make a few general observations. In 1940, Congress created a sound regulatory framework for investment companies. Within that framework, the growth and development of the investment company industry has been a

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resounding success. Investment management firms have provided individuals with a convenient and efficient means of investing in the economic future of our country. They have achieved this success without posing any threat to the federal deposit insurance system or to the taxpayer.

There is no reason not to allow others, including banks, to compete in this industry. It is important, however, that any entity functionally equivalent to an investment company be regulated as such to provide consistent protections to investors and to avoid investor confusion and misperception.

1. <u>Prohibitions Against Self-Dealing</u>

The Investment Company Act regulates three broad categories of affiliated transactions to protect investors from a variety of conflicts of interest that may arise when a passive pool of assets is in the reach of interested parties. The Act prohibits or significantly circumscribes transactions in which an affiliate: (1) purchases securities from or sells securities to the investment company ("principal transactions"); (2) jointly participates in a transaction with the registered investment company ("joint transactions"); and (3) acts as broker or agent for the investment company ("agency transactions"). In addition, to prevent an affiliate from unloading or "dumping" unwanted securities into an investment company, the Investment Company Act generally prohibits an investment company from purchasing securities in an underwriting in which any affiliated person participates.

While federal banking law also generally prohibits self-dealing transactions involving common trust funds and other trust accounts the prohibitions are neither as extensive nor as comprehensive as those in the Investment Company Act. 9/ For example, self-dealing transactions are permitted if authorized by the governing trust instrument, a court order, or the law of the jurisdiction under which the trust is administered. 10/ Moreover, banks are not prohibited from engaging in joint transactions with their common trust funds or from temporarily investing common trust fund assets in the bank's own time or savings deposits. 11/ In addition, banks may purchase securities on behalf of their common trust funds in an underwriting in which an affiliated person participates, if a majority of the bank's outside directors approves the transaction. 12/ Finally, banks

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9/ 12 CFR 9.12, 9.18.

10/ 12 CFR 9.12.

11/ 12 CFR 9.18(b)(8)(i).

12/ The Competitive Equality Banking Act of 1987 (Pub. L. No. 100-86) added Section 23B to the Federal Reserve Act, 12 U.S.C. 371c-1, which prohibits the purchase of securities by the bank, either as principal or fiduciary, from any underwriting in which an affiliate is a principal underwriter of those securities, unless a majority of the outside directors of the bank approves the purchase. It is important to note that Section 23B would not affect as many underwritings as the relevant Investment Company Act provision, Section 10(f), because the Investment Company Act contains a broader definition of the term "affiliate." For example, while the Investment Company Act defines "affiliate" to include any entity in which the investment company owns 5 percent or more of the voting securities, Section 23B defines "affiliate" to reach only entities in which the bank owns 25 percent or more of the voting (continued...)

may "cure" a self-dealing underwriting transaction through disclosure. 13/ We do not view these exemptions as appropriate for the adviser or sponsor of an investment company, particularly in the area of affiliated underwritings, because of the temptation to place unwanted underwritings in an affiliated fund's portfolio.

2. Valuation and Pricing

The Investment Company Act provides investors with substantial protections regarding the valuation and pricing of fund assets. Of first importance, investment companies must value their portfolios daily on a "mark-to-market" basis. This requirement assures that fund assets are valued accurately, in a timely fashion, and that sales and repurchases of fund shares occur at prices that prevent the interests of new, existing, or redeeming shareholders from being diluted. Common trust funds are only required to describe in their written plans the basis and method used to value the fund assets, and generally to value their assets at market value on a quarterly rather than daily basis. 14/

3. Disclosure

Registered investment companies must provide shareholders with a current prospectus that contains comprehensive information

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12/(...continued)
securities of any class.

13/ OCC Trust Banking Circular No. 19 (1981).

14/ 12 CFR 9.18(b)(1), 9.18(b)(15).

about the fund's performance, expenses, investment objectives and fundamental investment policies. Shareholders must also be given information about the fund adviser's background and compensation. Investment companies also must provide investors with complete financial information, including audited financial statements, in annual reports mailed to shareholders and publicly filed with the Commission. 15/

Common trust funds need not provide participants with any disclosure document. Instead, the bank must maintain a written plan that generally describes the bank's policies with respect to the fund, the allocation of profits and losses, fees and expenses, and the terms for admission and withdrawal. The bank must make the plan available for inspection at its principal office, and furnish copies of the plan upon request. 16/ Common trust funds must be audited annually, and banks administering a common trust fund must annually prepare a financial report. 17/ A copy of the financial report must be provided upon request to

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15/ Investment companies must also provide shareholders with semi-annual reports containing unaudited financial statements.

16/ 12 CFR 9.18(b)(1). Regulation 9 also requires a bank to file its written plan with the Comptroller, although the Comptroller's proposed revisions would eliminate that requirement.

17/ 12 CFR 9.18(b)(5)(i), (ii).

trust fund participants, although, unlike investment company financial reports, it need not be publicly filed. 18/

4. Accountants

While both investment companies and common trust funds must be audited at least annually, there are important differences between the role accountants play with respect to those entities and in the amount and type of financial information made available to investors. For example, the Investment Company Act requires that independent accountants certify the investment company's financial statements in disclosure documents provided to fund shareholders. In contrast, the Comptroller does not require the auditors of a common trust fund to be independent of the bank. Even where the auditors are independent, they report to the bank's board of directors, not to common trust fund participants. Further, independent accountants to a registered investment company are required to report to the Commission annually, in a publicly available document, on the material weaknesses in internal accounting controls noted during the audit. No comparable requirement exists for common trust funds.

5. Remedies

Common law primarily governs the duties of a bank acting as fiduciary, and the liabilities for breach of those duties. The only securities law remedy available to beneficiaries of a common

18/ 12 CFR 9.18(b)(5)(iv), 9.18(b)(1). A copy of the common trust fund's financial report must also be made available to others for a reasonable charge. 12 CFR 9.18(b)(5)(iv).

trust fund is an action for fraud under Rule 10b-5 of the Exchange Act 12/ against the bank as the fund's adviser.

In addition to Rule 10b-5, shareholders of registered investment companies have several express civil remedies under the federal securities laws. Under the Investment Company Act, a fund's adviser can be sued by shareholders for a breach of fiduciary duty with respect to the receipt of excessive or improper compensation. Under the Securities Act, a sponsor offering shares in an investment company can be sued for damages if the registration statement is materially misleading or defective, if the sponsor fails to deliver a prospectus in connection with the sale of a security, or if the sponsor or its employees offer or sell any security by means of a prospectus or oral communication that includes a material misstatement or omission.

In describing the differences between the regulation of registered investment companies and the regulation of common trust funds, I do not mean to suggest that all of the virtue is with the Investment Company Act framework. As this Subcommittee may be aware, at my direction the Commission is celebrating the fiftieth anniversary of that statute by undertaking a thorough review of its provisions. While that review takes place, the Commission will continue to use its ample exemptive authority

12/ 17 CFR 240.10b-5.

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under the Act in creative and sensible ways. 20/ So, I want to assure this Subcommittee that the Commission will work with the Comptroller, as it does with others, to eliminate any unnecessary restrictions in appropriate circumstances.

B. Adviser Regulation

Banks currently serve as investment advisers to both open-end and closed-end registered investment companies without registering with the Commission because they are excluded from the definition of investment adviser in the Advisers Act. 21/ Requiring bank advisers to register under the Advisers Act would, among other things, require them to maintain certain books and records, maintain and enforce written policies to prevent the misuse of nonpublic information, and subject the bank adviser to the antifraud provisions of the Advisers Act and to sanctions for failing to provide reasonable supervision of their employees. Further, Advisers Act regulation would limit a bank adviser's ability to deal as principal with its clients or to engage in certain agency cross transactions. 22/ Finally, bank advisers to

20/ Under Section 6(c) of the Investment Company Act, the Commission has broad authority to grant exemptions from provisions of the Act when it finds that they are necessary or appropriate in the public interest and consistent with the protection of investors.

21/ Over 450 registered investment companies employ a bank as adviser, subadviser, or administrator. The assets of those investment companies exceed 70 billion dollars. See Lipper Bank Related Fund Analysis.

22/ An agency cross transaction occurs when an adviser acts as broker for both its advisory client and the party to the other side of the transaction.

individual advisory clients would have to comply with certain advertising restrictions and provide clients with certain material disclosures.

C. Broker-Dealer Regulation

Banks generally are not regulated under the federal securities laws when they engage in the securities activities permissible under the Glass-Steagall Act and various other banking statutes. In adopting the bank exclusions in 1934, Congress presumed that the banking laws would not permit banks to engage in the retail brokerage business. Because of the restricted nature of bank securities activities, Congress concluded that broker-dealer regulation was unnecessary. 23/

Today, banks can act as retail brokers with few limitations. In addition to conducting discount brokerage operations, banks have been permitted to combine brokerage with investment advisory services and to sell securities backed by loans originated by the bank. Banks are major participants in the distribution of mutual funds and unit investment trusts. 24/ Finally, the Comptroller's common trust fund proposal would permit banks to make their common trust funds available to the general public, thus allowing

23/ See Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8920 Before the House Comm. on Interstate and Foreign Commerce, 73rd Cong., 2d Sess. 86 (1934) (statement of Thomas G. Corcoran, an administration spokesman and a principal drafter of the Exchange Act).

24/ In addition, the Federal Reserve Board has authorized bank holding companies under Section 20 of the Glass-Steagall Act, 12 U.S.C. 377, to establish subsidiaries to engage in securities underwriting and dealing activities.

banks to engage in the retail sale of their own investment company products.

These bank securities activities raise investor protection concerns. Whether the concern is the sale on bank premises of uninsured subordinated debentures or the "sweeping" of insured customer deposits into uninsured investments in a bank's commercial paper, 25/ banking law is simply not directed at the protection of investors and the maintenance of fair and orderly securities markets. Rather, it is directed at the preservation of the safety and soundness of the banking system. Thus, regulation under the Exchange Act is needed to assure compliance with key sales practice provisions and advertising rules.

Exchange Act regulation, which includes Commission and self-regulatory organization rules, directly attacks securities sales practice abuses. In addition, customer disclosure requirements are imposed in particular conflict-of-interest situations, such as where the broker-dealer controls the issuer of securities being sold or has an interest in a distribution. To ensure professional competence, all personnel handling securities trades for customers, even at discount brokers, must register and pass qualifying examinations. Finally, broker-dealers are required to create a supervisory system that actively monitors all of the activities of their securities sales persons.

25/ Brenner, MNC Financial Puts Customer Funds in its Own "Junk" Notes, Washington Post, Sept. 19, 1990, at D1 and D4.

Exchange Act regulation imposes special requirements on broker-dealers selling investment company securities. Self-regulatory organization rules limit the permissible sales charges for distributing investment company securities and specifically address suitability concerns in the sale of investment company securities by emphasizing the long-term investment nature of many investment companies. The rules prohibit a broker-dealer from recommending particular investment companies to its clients based on the receipt of commissions the broker-dealer received for executing portfolio transactions for those companies. These rules also require broker-dealers to submit their advertisements for investment company securities for self-regulatory organization review to prevent exaggerated, unwarranted or misleading statements or claims.

These regulatory requirements reflect the experience of the Commission and the self-regulatory organizations in protecting investors from sales practice abuses. Bank sales of their own investment company securities will not be immune from these abuses, especially where bank personnel receive compensation based on customer purchases. To provide these important protections to bank securities customers, banks that sponsor and distribute investment company securities should be regulated under the Exchange Act in the same manner as other broker-dealers.

IV. THE INVESTMENT COMPANY BUSINESS SHOULD BE CONDUCTED THROUGH APPROPRIATE ADVISORY AND BROKER-DEALER SUBSIDIARIES

When I testified before this Subcommittee just two months ago on the subject of general Glass-Steagall reform, I pointed out that "the real question is not whether the Glass-Steagall Act should be changed, but rather what other changes would need to take place either prior to, or simultaneously with, a formal change in Glass-Steagall." 26/ The same question may appropriately be asked regarding the movement of banks into the investment company business. While registered investment companies themselves are distinct legal entities separate and apart from the organizations that sponsor them, the advisory, management and selling activities they engender require a substantial commitment of resources from, and may pose substantial risks to, the sponsor. These activities should be conducted in entities that are separate from banks.

A holding company model offers the most obvious advantages. Of primary importance, the holding company structure will minimize risks to the federal deposit insurance fund resulting from the entry of banking institutions into the investment company business. While these risks are considerably less than those involved with other types of banking or finance activities,

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26/ Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (July 11, 1990).

they are nonetheless real, and segregating them from activities with access to the insurance fund would be a prudent measure. 27/

The holding company structure also will provide for fair competition between banking organizations and securities firms. If banking organizations engage in the investment company business through holding company affiliates, funding for the entrepreneurial risk will come from shareholders' equity and commercial borrowing. If banks are allowed to sponsor registered investment companies directly through the bank, they would also have access to lower cost federally insured funds provided by depositors in funding these entrepreneurial, non-banking activities.

A holding company structure also will contribute to regulatory efficiency. If the selling activities are conducted in an affiliate separate from the bank, the appropriate regulators will be able to oversee and inspect the activities of those subsidiaries, and to monitor their financial condition, without becoming enmeshed in the larger operation of the

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27/ For example, as a result of changes in the market, tax law, or customer preferences, an investment company may fail to reach an economical size, leaving its sponsor unable to operate the fund profitably or to recoup the promotional expenses it incurred in introducing the fund. Or, in response to competitive demands, an investment adviser may voluntarily absorb expenses or losses for an investment company, thereby diminishing the adviser's own profitability. Another risk involves the civil liabilities imposed under the federal securities laws on those who manage and sell registered investment companies. *See, e.g.*, Sections 11 and 12 of the Securities Act and 36(b) of the Investment Company Act. 15 U.S.C. 78k, 78l, 15 U.S.C. 80a-35(b).

conglomerate. In addition, the particular capital or recordkeeping requirements specific to the subsidiary may be maintained without conflict with the requirements of other affiliates, such as banks or insurance companies.

V. LEGISLATION IS NEEDED IF THE COMMISSION IS TO PROVIDE THE SAME LEVEL OF PROTECTION FOR INVESTORS IN BANK SPONSORED INVESTMENT COMPANIES AS IT DOES FOR INVESTORS IN NON-BANK SPONSORED INVESTMENT COMPANIES

For the reasons stated above, legislation is needed to require banks that underwrite and distribute investment company securities to conduct these activities in a separate entity subject to broker-dealer regulation. In addition to these structural reforms, the Investment Company Act should be amended to eliminate the additional conflicts of interest posed by bank sponsorship of investment companies that are not addressed by the current statute.

A. Bank Custody of Fund Assets

The Investment Company Act assigns a special status to banks as both custodians of management investment company assets and as trustees of unit investment trusts. In adopting the Act's custodial provisions Congress assumed banks would be independent custodians and trustees. Because banks are now advising investment companies, their special status under the Investment Company Act is no longer appropriate. While the Commission staff has informally acted to resolve this problem, 28/ the Commission should be given express authority to regulate banks when they act as the custodian or trustee for an affiliated investment company. 29/

B. <u>Portfolio Transactions</u>

The Investment Company Act contains prohibitions intended to prevent a fund sponsor or adviser from disposing of unwanted securities by "dumping" them into a fund's portfolio. 30/ However, not all possible dumping situations raised by bank involvement with investment companies are addressed by current law. For example, current law would not expressly prevent a bank-affiliated adviser from causing a fund it advises to purchase securities of an issuer that will use the offering

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28/ *See, e.g.*, Pegasus Income and Capital Fund, Inc. (pub. avail. Dec. 31, 1977).

29/ Currently the Commission regulates custody arrangements between banks and their affiliated investment companies by requiring compliance with rule 17f-2, the Commission's self-custody rule. That rule, among other things, requires certain records to be kept whenever securities or other investments are deposited or withdrawn. Most importantly, the rule requires two surprise audits annually by an independent public accountant who must certify that he verified by actual examination the assets of the investment company.

30/ The concerns regarding dumping securities into bank trust accounts are not unfounded. The Senate investigations conducted in the early 1930s detailed how bank trust departments became repositories for securities the bank or its affiliate could not sell. <u>Operation of the National and Federal Reserve Banking Systems, Hearings on S. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency</u>, 71st Cong., 3d Sess. 1063-64 (1931). <u>See also Investment Company Institute v. Camp</u>, 401 U.S. 617, 633 (1971).

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proceeds to retire a loan owed to the bank. It also would not expressly prevent a bank-affiliated adviser from causing a fund it advises to buy securities of an issuer with a substantial borrowing relationship with the bank in order to prop up the issuer.

A bank-affiliated investment company should not be used as a source of readily available capital to bail out a bank or its financially troubled debtors. Thus, the Investment Company Act should be amended generally to prohibit these types of transactions. We recognize, however, that the Commission may want to use its exemptive authority to permit certain transactions in appropriate circumstances where, for example, the existance of Chinese Walls would effectively insulate fund portfolio decisions.

C. <u>Prohibit Borrowing from an Affiliated Bank</u>

The Investment Company Act currently permits an investment company to borrow from <u>any</u> bank, provided that the investment company maintains asset coverage for the borrowing of at least three hundred percent. To avoid overreaching by a bank or its affiliate in a loan transaction with an investment company, the Act should be amended to prohibit bank-affiliated investment companies from borrowing from affiliated banks, except in accordance with Commission rules.

D. <u>Expand "Disinterested Director" Provisions</u>

Currently, no registered investment company may have a majority of its board of directors that consists of persons who are officers, directors, or employees of any one bank. Although rulemaking might resolve the issue, the Investment Company Act should be amended to provide explicitly that no registered investment company may have a majority of its board that consists of directors, officers, and employees of any one bank <u>and its subsidiaries or affiliates</u>. In addition, employees of banks that serve as custodian or transfer agent, or provide execution of securities transactions on behalf of the investment company should be ineligible to serve as "disinterested directors."

VI. <u>CONCLUSION</u>

The Comptroller's proposed regulations demonstrate once again how the lines between traditional banking and securities activities continue to erode. The Comptroller's proposal will allow banks to offer public investment companies that will be subject to regulation under the Investment Company Act and the Securities Act. While the Commission can, and will, require the registration under these laws of such bank common trust funds, there are broader issues that must be addressed.

Comprehensive financial services reform should not overlook reform of investment company regulation under the securities laws. This year the Commission initiated a comprehensive review of the current system of investment company regulation with a view towards streamlining the system to promote competition, while preserving the safety and integrity of investment companies. Among other things, any modernized system of

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regulation should seek to assure that investors in investment companies that are sold, advised or sponsored by banks are afforded pertinent protections under the federal securities laws.

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ATTACHMENT A

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 9, 1990

The Honorable Robert L. Clarke
Comptroller
Office of the Comptroller
of the Currency
490 L'Enfant Plaza East, S.W.
Washington, D.C. 20219

Dear ~~Mr.~~ Bob Clarke:

I am writing on behalf of the Commission concerning the proposed revisions to 12 C.F.R. 9.18, dealing with the management of collective investment funds by national banks exercising fiduciary powers. The Commission appreciates your requesting our comments on the proposed revisions, and we are taking this opportunity to express the Commission's views regarding one aspect of the proposed revisions of particular importance for its administration of the federal securities laws.

As the notice of proposed rulemaking indicates, the Securities and Exchange Commission has long interpreted Section 3(a)(2) of the Securities Act of 1933 (the "Securities Act") and Section 3(c)(3) of the Investment Company Act of 1940 (the "Investment Company Act") to exempt from registration only common trust funds that are used as an accommodation for bona fide, pre-existing trusts. Funds that are used as a vehicle for providing investment management services through the offer and sale of fund interests to the public are not exempt from the provisions of either Act. The Commission has viewed the marketing or advertisement of a common trust fund outside the promotion of the bank's general fiduciary services as indicating that the fund is established primarily as a vehicle for money management, and that it is therefore not exempt from registration.

The proposed revisions would, among other things, eliminate the current prohibition under the OCC's regulations on advertising of the availability and performance of common trust funds by national banks. Although the notice of proposed rulemaking states that participating accounts may not be established for the sole purpose of collective investment, it also states that the OCC does not intend to enumerate specific criteria to determine

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whether a common trust fund is designed solely for investment. Finally, the notice states that the OCC does not intend to adopt regulations designed to assure that all trusts participating in a common trust fund will be established for a bona fide fiduciary purpose.

Under the proposed revisions, bank common trust funds that currently are exempt under Section 3(a)(2) of the Securities Act and Section 3(c)(3) of the Investment Company Act would become subject to registration under those Acts if they engaged in general advertising or commingled bona fide common trust fund assets with other assets. Bank common trust funds that become subject to registration under the federal securities laws would be required either to restructure their operations to bring them into compliance with the Investment Company Act or to seek exemptions from certain provisions of that Act. Accordingly, banks should be advised that if they advertise a common trust fund outside the promotion of the bank's general fiduciary services, or place assets that are not held for a bona fide fiduciary purpose in a common trust fund, the fund would be subject to the statutory requirements of both the Securities Act and the Investment Company Act, and the Commission's rules and regulations applicable to registered investment companies.

Should your Office adopt the proposed revisions to 12 C.F.R. 9.18, the Commission would expect to issue an interpretative release describing the circumstances under which bank common trust funds are subject to the registration requirements of the Securities Act and the Investment Company Act. Because we would like to make such an interpretative release available to banks prior to the time that they may take steps that might result in a violation of these Acts, I would hope that you might be able to give us some reasonable notice when you determine to proceed with final changes to 12 C.F.R. 9.18. This would permit the Commission to issue an interpretative release concurrently with the adoption of the revisions.

Sincerely,

Richard C. Breeden
Richard C. Breeden
Chairman

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EXAMPLES OF RULE 506 OFFERINGS

1. Universal Turf, Inc.

With respect to SEC Form D filed with the PSC on April 23, 1997, the SEC obtained a permanent injunction against the president of the issuer on July 20, 1995 for violations of the anti-fraud provisions of the federal securities laws for misrepresentations made in the sale of securities of Mutual Mining I, Inc. The offering material did not disclose this disciplinary history.

2. Nitro Leisure Products, Inc.

With respect to SEC Form D filed with the PSC on April 11, 1997, an executive officer of the issuer was the subject of a SEC permanent injunction issued in 1993 for violations of the anti-fraud provisions of the federal securities laws by making material misrepresentations and failing to disclose material facts in connection with the sale of over $1 million of stock of Mundiger International, Inc., Mira Golf International, Inc. and undivided working interests in oil and gas wells. The SEC injunction was not disclosed in the offering documents given to the Pennsylvania investor.

3. Holding International Corp.; Limestone Energy Company; Webtech Venture Capital Corp.

The securities of these issuers, which filed SEC Form D with the PSC on September 29, October 20 and October 27, 1997, respectively, are being sold by an individual who was the subject of a SEC preliminary injunction on October 14, 1997 enjoining him from further violations of the anti-fraud provisions of the federal securities laws and providing for an asset freeze and appointment of a receiver in connection with the raising of $16-19 million in an alleged Ponzi-like scheme relating to oil and gas wells which the defendant allegedly does not own and allegedly has sold investments in the same group of wells to at least 3 different groups of investors. The SEC preliminary injunction was not disclosed.

4. Klein Engines & Competition Components, Inc.; JS Securities; Robert Balsamo

The securities of this issuer, which is engaged in the manufacture of engines and engine components for racing vehicles, were the subject of a Rule 506 offering filed with the PSC on February 3, 1998. SEC Form D stated that $5 million of securities were being sold by JS Securities (formerly First National Equity Corporation) through Robert Balsamo, who formerly was registered as an agent with JB Oxford & Co., Sterling Foster & Co. and VTR Capital, Inc. At the time of filing, over $400,000 of the securities had been sold in

Pennsylvania. JS Securities is the subject a SEC action in December 1997 alleging participation in the manipulation of prices set by market makers for the purchase and sale of micro-cap stocks, material misrepresentations about the issuers of the micro-cap stocks and payment and receipt of bribes made in relation thereto. JS Securities also is the subject of three actions by state securities regulators. JS Securities was terminated with the NASD on January 28, 1998. Balsamo was a registered agent of First National Equity Corp. until October 1997. According to the CRD, Balsamo currently is not registered with the NASD or with any state securities regulator.

GOVERNMENT FINANCE
OFFICERS ASSOCIATION
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March 2, 1998

Honorable John D. Dingell
Ranking Member
Committee on Commerce
2125 Rayburn House Office Building
Washington, DC 10515-6115

Dear Representative Dingell:

The Government Finance Officers Association (GFOA) appreciates the opportunity to review and comment on draft financial modernization legislation submitted by the Securities Industry Association and the American Bankers Association Securities Association. GFOA is a professional association representing over 13,500 state and local government officials and other public finance specialists involved in all the disciplines comprising public finance.

GFOA views the draft compromise language with some concern. The attached comments will address the specific concerns we have identified in this proposal, as well as provide some additional comment on the issue of functional regulation in general that directly affects GFOA members in their roles as debt and cash managers and investors of public employee pension funds. We hope the Committee on Commerce will act to ensure continued protection for state and local government entities and their taxpayers.

DEFINITION OF KEY TERMS

Banking Product

GFOA is concerned about certain key terms as they are used in explaining the scope of the exception for certain financial institution activities from broker-dealer designation and, presumably, broad-based securities regulation. The first term is "banking product." The reference to Section 18 of the Federal Deposit Insurance Act (12 U.S.C. §1828) includes in its definition "any other product that is available in the course of a banking business" which might be determined by banking regulators to be "more appropriately regulated as a banking product" than as a security. This is an almost open-ended definition which might draw in any number of new and as-yet undeveloped and undefined instruments and place them outside the scope of a more suitable regulatory scheme. In addition to instruments that might otherwise be considered securities subject to SEC or SEC-like regulation, there could arguably be other products more accurately classified as commodities, for example, that ought to be subject to Commodity Futures Trading Commission (CFTC) or CFTC-like regulation but would instead be considered a "banking product" under this language. GFOA would prefer to have a more precise statutory definition of the term "banking product."

Derivative Product

The second key term is "derivative product." The definition of "derivative product" contained in the draft language is overly broad. We do not know whether this category would include futures, options, over-the-counter, exchange-traded or other specific types of derivative instruments. Again, the precise nature of the instrument might be mischaracterized and the most appropriate regulatory scheme rejected due to the inclusion of this definition in banking legislation, to the detriment of investors in such products.

Qualified Investor

Perhaps the most troubling aspect of the draft language is that which affects much of the implementation of other aspects of this proposal. Many of the transactions that would be permitted to be undertaken by financial institutions under this language are allowed and removed from stringent securities laws protection as long as the transaction occurs with a "qualified investor."

The draft language includes a fairly extensive list of individuals, entities and institutions who would be considered "qualified investors." While we are curious about the inclusion of a number of the parties listed, GFOA notes with particular interest and concern the following, which apply to GFOA members: "§(55)(A)(v) *any State sponsored employee benefit plan...*" and "§(55)(A)(xi) *any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing.*"

The draft language would allow financial institutions to sell "banking products" and perhaps risky derivatives instruments, as well as private securities offerings, to a number of categories of investors, including public pension plans and state and local governments, without the full protection of securities laws and without any comparable regulatory scheme. Historically, the securities laws have in large part refrained from making distinctions among investors, including distinctions based on size of portfolio or supposed degree of sophistication. We know from the events of the past several years that size -- whether measured by value of assets, assets under management or value of a portfolio -- does not equal sophistication, and that whether or not an investor should be considered "qualified" under provisions similar to the draft language depends not only on the level of expertise, knowledge and ability of the investor, but on the facts and circumstances of a given case.

We offer the following examples to illustrate our position. In comments to the National Association of Securities Dealers, Inc. (NASD), the Securities and Exchange Commission (SEC) and financial institution regulators regarding a proposed suitability interpretation for government securities transactions, GFOA supported the applicability of sales practice rules for the protection of all investors, without distinction.

In 1994, GFOA submitted comments regarding a proposed CFTC rule regarding which entities should be included as "eligible participants" for purposes of entering into certain contract market transactions, and whether state and local governments should be excluded from participation in these transactions. In its comments, GFOA expressed its support for maintaining the eligibility of governments to engage in such transactions. It believed that any attempt by the CFTC to exclude such entities would have been an inappropriate federal intrusion into what is properly a state function -- that is, the regulation of the investment functions of a state or its political subdivisions. GFOA pointed out that the proper role of federal regulators was that of regulating those who deal with investors, including state and local governments.

However, in those same comments, GFOA also suggested that (1) oversight of all futures and options contracts be continued and strengthened, regardless of the type of investor involved in the transaction, and (2) that the CFTC require improved disclosure to customers regarding the types of contracts being entered into and possible risks associated with those contracts.

GFOA raised a similar issue with regard to the "professional trading market" exemption in its 1994 comments to the CFTC with regard to a proposed rule that would have relaxed existing standards for certain exchange-traded derivatives. It stated these concerns again to Congress with regard to the "ProMarket" exemption contained in the Commodity Exchange Act Amendments of 1997, which would permit futures exchanges to elect to operate a largely unregulated market designed for trading by "appropriate persons."

More recently, the GFOA submitted comments to the CFTC regarding another set of proposed rules which would have removed the requirements that futures commission brokers and introducing brokers provide certain disclosures regarding risk prior to opening a commodities futures account for certain categories of investors. In these comments, GFOA opposed any relaxation of the existing rule requiring such disclosure, but argued that in any case, governmental entities should continue to be provided with such information -- an argument supported by the CFTC in its modification to the proposed rule prior to its adoption. (See *Federal Register*, February 20, 1998)

As these examples demonstrate, whether the term used is "appropriate person," "eligible participant," or "qualified investor," each of these proposals and the current draft language seem to be based on an underlying assumption that certain categories of customers exist who are deemed to be "sophisticated investors." There is no indication in the current language as to how the drafters determined the listed investors/customers to be "sophisticated" enough to undertake complex transactions without the protection of securities laws; but by whatever measure used, even "sophisticated" investors are entitled to such protection. GFOA believes that, while a high level of protection is owed to all investors, protection of taxpayer funds is particularly critical.

PRIVATE SECURITIES OFFERINGS

The draft language would allow a financial institution to undertake private securities offerings directly even in those instances where it has established a broker-dealer affiliate. Thus, banks could offer private placements to public pension plans as is currently undertaken by securities firms but without the protections afforded by securities firms. The draft states that such offerings could be effected pursuant to sections 3(b), 4(2) or 4(6) of the Securities Act of 1933 and related rules. These sections concern exemptions from securities registration requirements; nevertheless, such transactions would remain subject to antifraud and other securities laws. However, because the transactions are not required to take place in a regulated affiliate, they would not be subject to the self-regulatory requirements of a regulated affiliate or brokerage. This means that, among other things, such private offerings would not be subject to sales practice rules which are currently enforced by the National Association of Securities Dealers, Inc. No comparable examination and enforcement process exists under banking laws. GFOA opposes this relaxed standard of regulation.

FUNCTIONAL REGULATION

Throughout an earlier debate concerning the applicability of sales practice rules to transactions in government securities undertaken by both broker-dealers and financial institutions, GFOA consistently maintained that transactions of a like nature should be governed by like regulatory schemes. That is, an investor who purchased government securities, whether from a brokerage or from a financial institution, should receive an equal level of protection regardless of which door the investor walks through to make the trade. It was our position that the investor -- whether retail or institutional -- should not be responsible for determining what set of rules governs the dealer and what level of protection each dealer offers, when all are functioning in precisely the same manner and carrying out precisely the same transaction. Even more difficult for investors is determining which financial institution regulator has jurisdiction over what type of financial institution.

GFOA continues to hold this position. This is the essence of functional regulation, but this is not the result that this compromise would achieve. Where banks are engaging in securities trading, there is no justification for the failure to protect investors in the same manner as those trading with traditional broker-dealers. The draft language would, however, leave state and local governments and their pension funds without the protection of federal securities laws if such transactions are undertaken directly by a financial institution and outside an established registered broker-dealer affiliate. This is an unacceptable risk for public investors and their citizen taxpayers.

The primary mission of bank regulators is to maintain the safety and soundness of banks and the banking industry, while the primary function of securities regulators is the protection of the investor. These roles are not contradictory. Indeed, in addition to the examination process undertaken by regulators, the Office of the Comptroller of the Currency, as well as state banking regulators, have procedures in place to respond to and act on customer complaints relating to financial institutions. The Municipal Securities Rulemaking Board (MSRB) successfully exacts compliance with rules with regard to banks that trade in municipal securities by the bank examination process, consistent with investor protection. However, without a complete regulatory scheme in place which is comparable to that which currently exists for securities regulation, too many risks arise from the draft proposal to give comfort to public investors charged with managing public funds.

CONCLUSION

GFOA is concerned about the implications that the compromise language would have for state and local government public pension funds, public investors, and their taxpayers. The draft is primarily characterized by its lack of protections for public investors. The overly inclusive and poorly conceived definition of "qualified investor" and the apparent loosened protection for public funds is troubling. Further, this lack of protection may undermine confidence in financial institutions and may prove to be a disincentive for public pension funds' and public investors' use of financial institutions. We urge the Committee on Commerce to continue to insist on a strong regulatory structure for securities transactions, wherever they are conducted and regardless of the type of institution by which they are undertaken. Where banks function as broker-dealers, the regulatory and enforcement structure must adapt to include and to make a priority the protection of investors, especially where state and local taxpayer funds are concerned.

We look forward to working with you and your staff in reaching an acceptable compromise that results in financial institution reform without endangering taxpayer funds.

Sincerely,

Betsy Dotson

Betsy Dotson
Director
Federal Liaison Center

Consumers Union
Publisher of Consumer Reports

CFA Consumer Federation of America

U.S. PIRG

March 2, 1998

The Honorable John Dingell
Ranking Member, Committee on Commerce
U.S. House of Representative
Washington, D.C. 20515

Dear Representative Dingell:

We are writing to respond to the proposed SIA-ABA drafted changes to section 201 of the Commerce Committee version of H.R. 10. Because the proposal undermines the pro-consumer intent of section 201 to bring most securities transactions by banks under the federal securities laws, we are opposed to it. Rather than weakening section 201, we believe the section needs to be strengthened to clarify that section 201(4)(B)(i) includes all brokerage activities and that all securities transactions are subject to the consumer safeguards consistent with those in section 308.

The proposed changes to section 201 would keep certain exemptions for bank securities activities intact. At a time when investment fraud is rampant, the loopholes must be closed, not preserved or expanded. Banks would be able to conduct certain private placement transactions outside the investor protections of the federal securities laws, including sales practice rules. The proposed changes would expand the universe of unprotected investors by exempting transactions involving any government entity, any corporation with a net worth of $1 million, or total assets exceeding $5 million, or any natural person worth more than $10 million. Individual consumers are ultimately the ones who are harmed if protections are not provided to the government entity or employer that make decisions which affect consumers' financial status.

Since "banking products" are exempt from federal securities laws, it is essential that the definition of them not include securities that should otherwise be subject to investor protections. The proposal authorizes federal regulators to determine whether additional products should be regulated as banking products, not subject to investor protections under federal securities laws. As we stated in testimony, we are concerned about a provision that would give regulators broad authority to exempt products from these protections.

These and other changes would weaken section 201. As we have stated, section 201 needs to be strengthened to 1) clarify that section 201(4)(B)(i) applies to all brokerage activities, not just when the bank contracts with a third party broker; 2) ensure that even the exempt transactions such as the de minimus exemption come under the disclosure, separation of activities and other requirements of section 201(4)(B)(i); and 3) make the consumer safeguards consistent with those in section 308.

We understand the sensitive nature of compromise in the financial services legislative debate. Industries fear the effects of changing rules of the road and are seeking to protect their turf. In the midst of special interest tug o' wars, we urge you to help ensure the consumer interest is protected.

Sincerely,

Stephen Brobeck
Consumer Federation of America

Mary Griffin
Consumers Union

Edmund Mierzwinski
U.S. Public Interest Research Group