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THE SEC'S CONCERN WITH BANK TRUST ACTIVITIES

An Address by

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In speaking to you this morning, I am not laboring under any delusions about my welcome. You are all very pleasant and polite, and many of you, I hope, would probably agree that, underneath it all, I am a nice guy. But, in my official role as Chairman of the SEC, I must seem to many of you more in the nature of the skunk at the garden party.

Our agency must appear as a lurking threat to the rapid and uninhibited development of much that is involved in going retail in trust. We have, in the past, asserted jurisdiction over certain activities that come under that general heading, and I and others before me have occasionally thrown up warning rockets that we may be planning a new attack.

My purpose this morning is not to put your minds and hearts at ease. It is not even to remove uncertainties as to what positions we may take as to specific activities in the future. We are not yet ready to take definitive positions on all of the new activities in which banks seek to engage and, in any event, I am not really sure you would want certainty from us at this juncture. The best that I can do today is to outline some of the problems, as we see them, and to give you a better understanding of the bases of our concerns with the more recent and innovative bank trust activities.

It seems very clear that, when it enacted the several federal securities laws which we administer, the Congress intended generally that we leave the regulation of banks up to the bank regulatory agencies.

Thus, securities issued by banks, unlike the securities of most other issuers, need not be registered with the Commission as a condition precedent to their public distribution. Banks are also excluded from the definitions of the terms “broker” and “dealer” found in the Securities Exchange Act. The former exclusion - - from the

definition of the term "broker" - - is particularly significant, since banks are permitted to effect securities transactions as agent for the accounts of customers under the Glass-Steagall Act. And, when the present Section 12(g) of the Securities Exchange Act was adopted in 1964, the administration of the registration of securities pursuant to that Section and the related consequences - - the filing of annual and periodic reports with the Commission, and the regulation of proxy solicitations - - were assigned to the appropriate federal bank regulatory agencies.

The Investment Company Act of 1940 also contains a general exclusion for banks, trust companies and common trust funds from the scope of that Act, most directly by excluding these entities from the definition of the term "investment company". And the Investment Advisers Act of 1940 excludes banks and trust companies from the definition of the term "investment adviser".

About the only certain thing within our jurisdiction from which banks, as such, are not exempt by statute is the application of the general antifraud provisions of the Securities Act and the Securities Exchange Act, including Rule 10b-5, which, by its terms, is applicable to "any person".

That is the way it all started out, as Congress envisioned it, and, for a generation or so, there were few major problems. Prior to 1964, banks did not list their own outstanding stocks on national securities exchanges, and thereby avoided the jurisdiction that we otherwise would have had under the Securities Exchange Act, when that jurisdiction depended, as it no longer does, upon whether securities were listed on an exchange. And trust departments and trust companies didn't complicate matters so much; they behaved themselves and stuck pretty closely to what had come to be regarded

as traditional trust functions. There was thus little or no occasion for the SEC to be concerned with what banks were doing.

The world as we fondly knew it, however, began to change in the early 1960's, when the authority over the trust powers of national banks was transferred from the Board of Governors of the Federal Reserve System to the Comptroller of the Currency, which brought with it the then Comptroller's expanded views concerning the proper scope, range and reach of bank trust activities. His broadening of the regulations, coupled with other developments, both national and international, changing attitudes among bankers themselves, and the rapid emergence of one-bank holding companies, have led to a significant expansion of bank investment services.

Since some of these services have involved banks in the world of equity securities, there is a concomitant continuous and increasing involvement, or threatened involvement, of banks and their affiliates with the federal securities laws. For a major historical example, consider the experience of banks with comingled managed agency accounts.

Under the Federal Reserve Board's Regulation F, the comingling of managed agency accounts was prohibited, except through common trust funds, which in turn were limited to operation for strictly fiduciary purposes for trusts that were created for a bona fide fiduciary purpose, not just as an investment vehicle. As most of you surely remember, when this Regulation F was replaced by the Comptroller's Regulation 9, the Comptroller at that time abandoned the concept of bona fide fiduciary purpose because he believed it had no defineable meaning, and thereby permitted the comingling of accounts under a managed agency agreement, even where the accounts of the individual

investors were created solely for investment purposes without any other trust or fiduciary purpose.

The Comptroller, in adopting his revised Regulation 9 in early 1963, urged banks to ignore the SEC in establishing common trust fund participations, or managed agency accounts to be comingled in the form of trusts, which were to be marketed frankly for investment purposes.

The then Chairman of the SEC responded promptly, in a public letter, in which he took the position that "any contemplated merchandising of interests in . . . collective investment funds as investment media, whether in the form of a trust or in the form of a managed agency account, as apparently would be permitted under the proposed revisions of Regulation 9, would place national banks squarely in the conventional investment business," so that registration would be required under both the Securities Act of 1933 and the Investment Company Act of 1940.

There was no question under the definitions in the securities laws that interests in a common trust fund or a comingled managed account were securities; the only question was whether the issuer of the securities was the bank itself, in which case there would be an exemption from Securities Act registration, or whether the issuer was the trust or the account. Partially drawing on the experience that the SEC had had with insurance companies - - which have exemptions under some of our laws analogous to those accorded to banks - - and the variable annuity policies these insurance companies had issued, the Commission concluded, as to the banks, that the issuer was the common trust fund or the comingled account, and that, therefore, no exemption from registration was available.

Having concluded that the securities had to be registered, the Commission employed comparable reasoning to conclude that the issuer - - that is to say the common trust fund or the comingled account - - was an investment company, required to register under the Investment Company Act of 1940, even though that Act, in terms, explicitly exempts "any bank or insurance company" and "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".

Surely, most of you recall the history of what followed. After much smoke and thunder in Congressional hearings and speeches, the First National City Bank ultimately registered a comingled managed agency account and participations therein under both Act, having been granted certain exemptions by the SEC from the Investment Company Act necessary to make their plan work, and then the Investment Company Institute and the National Association of Securities Dealers each attacked.

The NASD sough judicial review of the SEC's exemptive order in the Court of Appeals for the District of Columbia, while the Investment Company Institute sued the Comptroller of the Currency in the District Court of the District of Columbia for a declaratory judgment to the effect that permitting national banks to sponsor their own mutual funds violated the provisions of the Glass-Steagall Act's prescription of the total divorce of investment and commercial banking activities.

En route to its determination of some of these issues, the Supreme Court, in Investment Company Institute v. Camp, appears not to have challenged the Commission's determination that Citibank's "fund [be] registered as an investment

company under the Investment Company Act of 1940," assuming such activities by banks were proper. The Court, however, ultimately declared the total program which Citibank had established to be unlawful because Citibank, in offering the participations in its comingled account, was acting as an underwriter of equity securities - - one activity, at least, that clearly is prohibited by the Glass-Steagall Act.

This not only left open for definitive resolution the question whether such comingled accounts were themselves investment companies, it did not provide any guidance for the resolution of the problems of the application of our Acts to various other forms of trust activities aimed at serving the investment purposes of smaller accounts

That was left, in part, to the First National City Bank, again, which decided to test the boundaries of the bank exemptions in the federal securities laws, when it joined with Merrill Lynch to create a special investment advisory service for investors who could invest at least $25,000.

Because the service provided for the investor to give Citibank a power of attorney to place orders for its account with Merrill Lynch, which kept custody of the securities invested for the participating accounts; and because, although the investment advisory service was represented as individualized, there seemed in fact to be substantial parallelism in investing; the Commission, in a complain seeking an injunction, asserted the position that the Special Investment Advisory Service resulted in the formation of an investment company that was not entitled to exemption from registration, and that participations in the service were securities, also not entitled to exemption from registration. Citibank and Merrill Lynch entered into a consent decree and ultimately

abandoned the service, without, of course, admitting that the SEC's position was well taken.

Subsequently, in October of 1972, Mr. Casey, then Chairman of the SEC, appointed an Advisory Committee on Investment Management Services for Individual Investors with the mission of recommending certain clear guidelines and policies for the purposes of determining when the offering of investment advice to small accounts would result in the creation of an investment company and the public offering of securities by the investment adviser. While this committee did not deal primarily with the activities of banks in its report, filed in January of 1973, it did observe that its recommendations necessarily would apply to banks engaged in these activities, as well as other investment advisers. Among other things, the committee recommended that the following policies be adopted:

> (1) A small account investment management service [meaning one below $200,000 per investor] should not be treated as an investment company for the purposes of the Investment Company Act, if operated on a non-pooled basis;
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> (2) A small account service, which furnishes clients investment management based upon the individual needs of each client, should not be treated as a public offering of a security for the purposes of the Securities Act; and
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> (3) The Securities Act should not apply to a person who offers an impersonal (or non-individualized) investment service on a non discretionary basis.

The Committee also urged the Commission to publish guidelines suggested by the Committee, which would assist advisory firms, as well as banks, in determining whether and when their small account advisory services would or would not require registration under either the Securities Act or the Investment Company Act.

These recommended views would constitute at least a partial withdrawal from the position taken in the Citibank-Merrill, Lynch matter, but the Commission itself has not yet adopted these views nor any official guidelines.

I don't want to pursue these technical matters any further in a talk of this nature, except to point out that the problem of drawing the line as to where our responsibility and authority ends is not as simple and obvious as it might first appear. One cannot dispose of these complex questions merely by observing that banks and trust companies are exempt from the federal securities laws.

Our interpretations of the federal securities laws, fostered by hospitable judicial decisions upholding them, have been quite broad at times. In judging this process, it does not help much to ask whether Congress intended that some of these newer investment vehicles should be subject to the ambit of the federal securities laws. Congress, after all, could scarcely have foreseen the extent of the developments we have been witnessing over the last few years.

One might more appropriately ask, however, as many in the past have, whether the Commission has been justified in taking what might be described as an aggressive attitude toward the reach of its authority. Possibly, the Commission could have sat back and simply relied upon the proposition, for example, that a common trust fund is a common trust fund, and, as such, is exempt from our regulatory reach.

Did the public interest and the interest of investors, which we are generally charged with promoting, require that the Commission seek to bring these comingled agency accounts under the embracing arm of the Securities Act or the Investment Company Act? We were clearly urged to do so by groups representing persons that, at

the very least, felt injured by the proposed competition of the banks - - namely, the Investment Company Institute and the National Association of Securities Dealers.

Even apart from such industry pressure, it was the Commission's conclusion that the securities laws were clearly susceptible of being construed to imply that this type of comingled account or fund was a security and that applicable trust law and regulation were not designed, or effective, to provide investor protection to the extent provided by the federal securities laws. When we come to such a conclusion as this, it may be our duty to act, at least until stopped by the courts or Congress.

As for the matter of industry competition, while it may appear to bankers that we have been fighting the battle of the mutual funds and the securities broker-dealers, I can assure you that we do not get much credit from them on that score. It has been our traditional position that our concern is with investor protection and, at the most, equality of regulation. From a competitive point of view, this might be spoken of as equality of regulatory burden. We have not taken the position that mutual funds or securities broker-dealers are entitled to protection from bank competition, even if the rules of the game were the same for all groups. Whether we should and properly could change our position, in the light of the present state of both of those industries, is something which is under regular re-examination, but no contrary conclusions have, as yet, been reached.

With the recent upheaval our markets are undergoing, we present commissioners, perhaps more so than any of our predecessors, are also aware of our general responsibility to preserve and foster the fairness and efficiency of our markets - - a mandate often overlooked. Today, the investment policies followed by bank trust departments, the investment services they offer, and the spate of new investor services

being offered and proposed by banks generally, have come under closer scrutiny because of the potential impact upon the fairness and efficiency of our capital markets.

Our experience to date, as well as other matters we have under examination with respect to banks and the securities laws, lead to certain reflections on the separation of jurisdiction of the several federal regulatory agencies as it relates to various financial institutions and their conduct.

Looking back, it appears as though the allocation of responsibility and authority assigned to the several governmental agencies in the early 1930's reflected what, at that time, seemed a clear industry demarcation and separation. Banks were banks, trust companies were trust companies, mutual funds were mutual funds, securities broker-dealers were securities broker-dealers, and investment bankers were investment bankers. While there has always been some mixture of these categories, on the whole, these several financial institutions remained in separate and identifiable compartments. Accordingly, when Congress exempted a bank from the federal securities law, it presumably intended to exempt everything that the bank then did, on the assumption of the then more limited scope of banking activities.

But, whether or not that was the contemplation of Congress in the olden days, developments in the last decade suggest that such a mechanistic view of regulatory responsibility has become, to a degree, anachronistic. Today, it seems less and less appropriate to allocate regulatory responsibility according to corporate entity. If a bank operates and distributes shares of something that is indistinguishable from a mutual fund for all purposes, except legal form, should lit not be subject to the same regulation as the mutual fund itself?

One might respond that, perhaps, it should, but that, in such a case, the securities laws should be administered with respect to banks by the bank regulatory agencies, and not by the SEC. One wonders, however, how far this should go, especially in reverse.

Some time ago, I was discussing the then very new automated investment service being offered by banks with the head of a large broker-dealer firm. Since he complained of the inequality, and thus the unfairness, of the competition, I asked him what would be the most important legal or regulatory change to equalize the competition. I expected him to refer to suitability or some other burden we impose on brokerage firms. But his answer was clear and simple: "Let us cash checks!" He meant, of course, let brokers accept demand deposits upon which checks could be drawn.

Now, suppose our laws were interpreted or changed to permit a broker-dealer firm to accept deposits, without declaring it to be a bank. I have no doubt that the argument would be quickly pressed that such a firm should become subject to the laws and regulations imposed upon banks for the purpose of protecting depositors. If this argument seemed to be carrying, as it likely should, I suppose the broker-dealer might then respond, "Well, all right. But we want those laws administered as to us by the SEC" - - a proposal of dubious attractiveness.

The compromise notion of equal regulations but separate regulators is being pressed to resolve certain differences, with respect to pending legislation, and it is a possible legislative solution.

It is not, however, an available administrative solution. When we are of the view that the public interest or the protection of investors requires some regulation of recent securities investment activities or new securities participants not explicitly addressed by

the specific language of the laws we administer, our only available option, aside from the more passive alternative of recommending legislation, is to determine whether and how these innovative services or their sponsors can be made to fit under our existing regulatory scheme. The “fit” may not always be perfect, but it is all we have. And such a course has the saving grace of at least being consistent with our general notion that equal regulation is more equal when administered by the same agency, and perhaps not equal at all when administered by separate agencies.

Banks are naturally resisting the prospect of having to be regulated by any more federal agencies than is absolutely necessary. I have no difficulty understanding that desire, or even catering to it, when banks are engaged in the roles Congress understood they would play when the present regulatory scheme was enacted. But I am less sure that this desire should be indulged in when, and to the extent that, banks move away from those traditional banking activities and into activities subject to other regulatory patterns when engaged in by nonbanks.

There is, of course, more to it than the simple desire to avoid multiple regulation. There is a difference in philosophy and in approach, especially as to enforcement activities, between the SEC and the bank regulatory agencies that we know is a matter of great concern.

Whether or not we are tougher enforcers - - and I don’t intend to engage in any public competition with bank regulatory agencies in that regard - - we are certainly more public enforcers. Our procedures are generally geared toward airing securities industry misfeasance or malfeasance in full public view, while the banking authorities attempt to work out troublesome bank conduct away from the glare of an apprehensive public

audience. And, whether or not the banking agencies should reconsider their basic operating premise - - that banking activities are so sensitive as to require nonpublic solutions even when the conduct relates to "nonblank" activities - - or whether the SEC should review its traditional adherence to the notion that public investors feel more confident of our markets if they know, and have the right to know, when brokerage firms and mutual funds violate our laws, are issues that will require fresh review.

But you will be misjudging the importance of the broader issues I have discussed here today, if you perceive the question as one merely of jurisdictional imperatives or sophistic interpretations of black-letter law, and thus adhere to the regulatory parochialism that has characterized both the banking and securities industries' contemplation of these issues. If the banking industry wishes to expand its operations into more traditional securities activities, it should be willing to assist the Congress, the Commission and the banking authorities in a re-examination of the principles underlying the present regulatory framework, in an environment free of distracting jealousies and suspicions. As you know, we at the Commission are preparing to undertake such an effort, and we look forward to your much-needed cooperation.