MEMORANDUM FOR THE TASK GROUP ON THE
REGULATION OF FINANCIAL SERVICES

February 24, 1983

Subject: Harmonization of Regulation of Bank and Securities Firm-Sponsored Investment Vehicles

I. Nature of the Problem

A. Investment Companies and Banks

Securities firms organize, sponsor, and underwrite investment companies. These companies are regulated under the Investment Company Act of 1940, which applies to a variety of collective investment vehicles, most notably "open-end" investment companies, 1/ commonly known as mutual funds. The Act contains a number of requirements designed by Congress for the protection of investors. 2/

1/ In general, any investment company that offers redeemable shares at a price that reflects the current net asset value of the portfolio is an open-end investment company.

2/ Among the most significant requirements are:

(1) Provisions to ensure the independence of investment company management, such as restrictions on the number of interested persons that may serve as directors of an open-end investment company, and a requirement of annual approval of the investment company's contract with an investment adviser by a majority of the non-interested directors.

(2) Provisions requiring that financial statements must be certified by an independent auditor, and that a majority of the non-interested directors select the auditor.

(footnote continued)

Banks manage and offer interests in common and collective trust funds that compete directly and indirectly with investment companies. These collective investment vehicles grew out of services traditionally offered by banking institutions and are hybrid products affording investors an opportunity to obtain the advantages of collective investment services coupled with

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2/ (footnote continued)

(3) Provisions requiring the filing of a detailed registration statement, annual report and, under certain circumstances, quarterly financial reports with the Commission. A semiannual report to the investment company shareholders is also required.

(4) Several explicit prohibitions against self-dealing by affiliated persons by restricting transactions between affiliates and the investment company.

(5) Prohibitions on changes in fundamental investment policies without shareholder approval.

(6) Requirements for safekeeping of securities and capital requirements for bank custodians.

(7) Requirements that payment upon redemption of open-end investment company shares may not be postponed, nor redemption rights suspended for more than seven days, absent unusual circumstances.

(8) Requirements for filing of all advertising and sales literature with the Commission.

(9) Provisions subjecting the managers of registered investment companies to civil liabilities for breach of fiduciary duties.

See *Financial Institutions Restructuring and Services Act of 1981: Hearings on S. 1720 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. 379-388 (1981).

the traditional services and convenience of these institutions. Absent special exemptive treatment, bank-sponsored collective investment vehicles would be subject to the Investment Company Act.

B. Bank-Sponsored Collective Investment Services

Banks offer two types of collective investment services, common trust funds and collective trust funds. Common trust funds pool estate and personal trust funds. Collective trust funds combine the assets of retirement, pension, profit-sharing, stock bonus, or other trusts which are exempt from federal income taxation. 3/ Such funds are functionally similar to open-end investment companies or mutual funds, which may be, and often are, used for exactly the same purposes.

1. Common Trusts Funds

Common trusts funds are excluded from the definition of investment company under Section 3(c)(3) of the Investment Company Act. The SEC has taken the position that the exclusion in Section 3(c)(3) does not apply to common trust funds established exclusively for investment purposes, but is

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3/ In 1937, the Federal Reserve Board amended Regulation F to allow banks to operate collective investment funds but only if such funds were operated in furtherance of "bona fide fiduciary purposes" and not for purely investment purposes. These funds were excluded from the coverage of the Investment Company Act in order to avoid what was viewed as duplicative regulation.

available only for common trust funds which have estate planning or other non-investment trust activities, and which are not advertised as general investment vehicles for the public. Under the Comptroller's regulations, however, assets may be pooled for purely investment purposes.

2. Collective Investment Trusts

Trusts for employee benefit plans may be large enough to be individually managed, but the assets of several employee plans are often pooled for collective management.

a. Corporate Employee Benefit Plans

One category of employee benefit plans is the so-called "corporate" plans, including pension, profit-sharing, bonus, thrift, and savings plans. Almost all are established pursuant to Section 401 of the Internal Revenue Code.

Employee benefit plan trusts and collective investment trusts consisting solely of such trusts are exempt from the Investment Company Act, 4/ and from the registration provisions of the Securities Act, 5/ and from the Securities Exchange

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4/ Investment Company Act, §3(c)(11).

5/ Securities Act, §3(a)(2). Questions have arisen as to whether the employees' interests in individual trusts are securities subject to the registration and antifraud provisions of the federal securities laws. See e.g., Securities Act Release Nos. 6188 (Feb. 1, 1980); 6281 (Jan. 15, 1981). But it is clear that interests in pooled bank funds derived from assets of employee benefit plans are securities. Securities Act Section 3(a)(2); Securities Exchange Act Section 3(a)(12); Investment Company Act Section 3(a)(11).

Act. 6/ In order to qualify for the exemption from the Investment Company Act, collective investment trusts must consist solely of assets derived from qualified employee benefit plans and must be maintained by a bank that retains custody of and significant management responsibility for trust assets.

b. Keogh Plans

Keogh, or H.R. 10, plans are tax-deferred retirement plans established by self-employed individuals for their own benefit and for their employees. There are two types of securities that may be issued in connection with Keogh plans: (1) interests in collective funding vehicles arising from investments made by the plans, and (2) interests of employee participants in the plan itself.

The interests of Keogh plans in collective funding vehicles are securities, usually in the form of investment

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6/ Securities Exchange Act, §3(a)(12). Under ERISA, the Department of Labor ("DOL") has taken the position that banks which administer collective investment funds consisting of covered employee benefit funds are plan fiduciaries and are subject to all the duties and restrictions that ERISA imposes on such fiduciaries. These provisions include restrictions on conflict in interest transactions. However, DOL has broad authority to grant exemptions from the provisions of ERISA, and in fact, has issued a class exemption for banks from some of the provisions. There has recently been a proposal to increase the scope of the exemption. Investment companies which management collective funds of employee benefit plans are exempt from the fiduciary duties imposed by ERISA.

contracts. 7/ In 1981 the SEC exempted certain Keogh plan trusts from prospectus delivery requirements, providing that the plans and employees covered meet specific standards to ensure the protection of the employees covered in the plan. 8/ Although the interests of participants in voluntary, contributory Keogh plans are securities, the Commission has not required that they be separately registered.

3. Individual Retirement Accounts ("IRAs") and Simplified Employee Pension Plans

IRAs, tax deductible retirement savings plans authorized by ERISA in 1974, allow individuals to obtain tax benefits for their contributions to the IRA plan. Although IRAs commonly are established by individuals, they also may be sponsored by employers and unions. IRAs and collective investment funds for IRAs are not exempt from registration under the Securities Act of 1933 or the Investment Company Act. Although the availability of an exemption from otherwise applicable securities laws depends on the facts of each case, it is clear that IRAs which involve the placement of an

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7/ There is an investment of money by the plan in a common enterprise (the funding vehicle) with the expectation that the managers of the funding vehicle will generate earnings on that investment. Congress recognized that interests in collective funding vehicles maintained for Keogh plans are securities when it amended Section 3(a)(2) of the Securities Act in 1970 to require registration of such interest.

8/ Rule 180, 17 C.F.R. 230.180, *see* Securities Act Release No. 6363 (November 24, 1981).

individual's funds in the hands of another person with reliance on that person to produce profits are securities which are subject to the registration and antifraud requirements of the Securities Act.

Many IRAs involve a direct investment by an individual in an exempt security (such as one issued by a bank) or in a medium that is not considered to be a security (such as a traditional fixed annuity). In neither case would registration be necessary, and only in the former case would the antifraud provisions be applicable.

There are two other situations in which IRAs need not be registered. The first of these involves IRAs funded solely by specific mutual fund shares registered under the 1933 Act. So long as these shares are offered pursuant to current prospectuses, no separate registration of the IRAs is necessary.

So-called master trust or prototype plan arrangements used to market IRAs and Keogh plans are also exempt from 1933 Act registration. The sponsoring organization usually limits its own involvement to establishing the plan and/or setting up a separate account for each individual participant. The commingling of account assets is generally prohibited and, for the most part, complete investment discretion is vested in each account holder. Participants usually are afforded several investment alternatives, such as savings accounts or other bank instruments, insurance products or the like. The sponsor generally limits its role to that of a custodian and does not render any investment advice. 9/

B. Regulatory Disparities -- Banks and Investment Companies

The regulatory schemes under which bank sponsored collective investment vehicles and investment companies organized and sponsored by securities firms operate are substantially different. Some collective investment products offered by banks are subject to the federal securities laws; others are not. Those that are regulated exclusively under the banking laws are subject to standards that are not as rigorous as those of the federal securities laws. This disparity of regulation can be traced to the differing orientations of banking and securities regulation. Banking laws and regulations emphasize stability of banking institutions and protection of depositors' funds; securities laws and regulations focus on investor protection. A comparison of

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9/ The Comptroller recently approved the application of Citibank, N.A. to operate common trust funds for the collective investment of the assets of IRAs. Citibank would act as trustee of the IRAs, and in that capacity, proposes to invest fund assets in a common trust managed by the bank. Citibank has registered the common trust fund with the Commission pursuant to the Investment Company Act and the Securities Act. This is consistent with the Commission's position that pooled IRAs are not exempt from the federal securities laws, an interpretation with which the Comptroller took issue.

the securities laws and Regulation 9 of the Office of the Comptroller of the Currency demonstrates some of these disparities. 10/

1. Disclosure Requirements

The Securities Act requires filing of a detailed registration statement with the Commission and delivery of a prospectus to purchasers of securities. The Investment Company Act requires the filing with the Commission of a registration statement, including a prospectus, that discloses detailed information about the investment company. Registered investment companies are also required to file an annual report with the Commission, and open-end companies must annually update the data contained in the registration statement and prospectus. Investment companies may be required to file quarterly reports with the Commission, if certain events occur. In addition, the Investment Company Act requires that a semi-annual report containing a balance sheet and other financial and portfolio information must be sent to shareholders. Finally, every registered investment company

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10/ Common trust funds and collective investment funds of national banks are governed by Regulation 9 of the Comptroller of the Currency. Common trust funds of state-chartered banks are subject to state laws, but such banks voluntarily comply with Regulation 9 in order to take advantage of the pass-through tax treatment afforded by Section 584 of the Internal Revenue Code. State bank collective pension funds are subject to state and common law, but because of the lack of specificity of those laws, we understand that state banks generally voluntarily comply with Regulation 9 in operating such funds.

is required to file with the Commission copies of every periodic report or communication containing financial statements sent to shareholders.

Regulation 9 requires a bank to file with the Comptroller a written plan setting forth the manner in which the fund is to be operated, including provisions relating to investment powers and a general statement of investment policy of the bank with respect to the fund. The Regulation also provides that the annual report may be distributed to prospective investors and shall be furnished upon request. This annual report, however, does not approach in detail the reports and current registration statements required of investment companies under the federal securities laws.

2. <u>Advertising</u>

The Investment Company Act makes it unlawful for any registered investment company to transmit any advertising material to prospective investors unless the material is also filed with the Commission. Advertising of securities is generally constrained under the Securities Act during the offering period, although the SEC has removed some limitations on advertising of investment companies in recent years. Regulation 9 limits publicity concerning a bank's fiduciary services to promotion and distribution of its annual report. However, bank collective investment funds for employee benefit plans are not subject to this restriction. Thus, banks are free to advertise investment funds for retirement accounts through methods that would not be permissible to common trust funds or registered investment companies.

3. Investor Protection

The securities laws and the rules of the securities exchanges contain specific provisions to insure that recomended investments are consistent with the investor's objectives and financial resources. Although Regulation 9 alludes to the suitability concept, there are no specific banking analogs to these suitability and "know-your-customer" rules. Banks tend to concentrate on fulfilling the four corners of trust agreements in compliance with local law, which seldom contain specific requirements as to investments.

As noted above, the Investment Company Act contains specific provisions to protect investors against conflicts of interest. Although banks encounter numerous possible conflicts of interest in managing collective and common trust funds, the only requirement of the banking laws is that transactions involving trust accounts be fair and not prohibited by the trust instruments or local law. There are no specific provisions in Regulation 9 with respect to equal treatment of trusts under common management or best execution of trades.

Regulations governing self-dealing are also stricter for investment companies than for banks. Billions of dollars of pension trust assets are invested in the securities of sponsoring banks. It has also been claimed that banks often leave substantial funds from collective accounts under their management in non-interest paying accounts. Such transactions would be prohibited by the Investment Company Act. At the very least they raise questions about equality of regulation.

Nor do the provisions of the Investment Company Act designed to ensure the independence of investment company management have a parallel under Regulation 9, since bank collective investment funds are not required to have separate boards of directors. Finally, Regulation 9 contains no provisions for investor participation in approval of changes in fundamental investment policies as does the Investment Company Act. 11/

The regulatory provisions of the Investment Company Act, including those applicable to disclosure, advertising, investor protection and self-dealing, and limitations on advisory compensation, provide important benefits to investors, but they also impose substantial burdens on money market funds and other investment companies that differ from those applicable to pooled pension funds and common trust funds managed by banks.

11/ The Commission has issued an advance concept release on the desirability of regulations or legislation to enable all or certain types of open-end investment companies to be organized and operated without shareholder voting or boards of directors.

II. Proposals for Change

In order to eliminate the regulatory anomalies that arise under the existing structure of the regulation of investment management, it is necessary to create a new regulatory scheme that would subject all collective investment vehicles -- common trust funds, pooled employment benefit plans, and investment companies -- to comparable regulations, administered insofar as possible by the same regulatory agency. Amendments to the banking laws proposed by the Administration during the last session of Congress provide an ideal first step in that direction. Under the Administration's bill, banks would have been permitted to engage in a variety of new securities activities, including dealing in and underwriting state municipal revenue bonds and sponsoring, controlling, and advising investment companies. 12/ These new activities would be required to be conducted within separate corporate affiliates of a bank, and not within the bank itself.

The Administration's proposal should be extended to require that the management of all collective investment vehicles -- including common trust funds and pooled employee benefit plans -- be carried out within a separate corporate affiliate. The investment management activities of this

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12/ In addition, the subsidiary could deal in and distribute bank certificates of deposit and commercial paper of the holding company or of any other subsidiary of the holding company.

affiliate would be subject to a regulatory scheme designed to be coordinated as closely as possible with the regulatory scheme applicable to investment companies not affilitated with banks. Complete identity of regulation would be impracticable, given the differences in legal structure between investment companies -- which are normally in corporate form with a board of directors and shareholders -- and bank-managed collective investment vechicles -- which are generally in form of trusts organized under state trust law. It would nevertheless, be possible to conform the regulation of the various types of collective investment vehicles in several critical respects. For instance, bank common and collective pension funds could be organized as unitary trusts without boards of directors which would mitigate the objections of banks that it would be burdensome to have a separate board of directors. On the other hand, the subsidiary of the bank holding company could choose to register the common and collective pension funds as investment companies under the Investment Company Act.

The statutory scheme applicable to bank securities affiliates should include provisions regarding advertising, disclosure, and self-dealing that are comparable to those that apply to investment companies. In order to ensure equitable regulation, one agency should be charged with the principal responsibility for administering this statute and the Investment Company Act of 1940. This agency could be either the SEC or the principal federal bank regulator.

The Administration's proposal would also ensure equal competition between banks and traditional investment companies by requiring that transactions between a bank and its affiliates are conducted at arms-length and on similar terms as transactions between the bank and non-related companies. The proposal thus includes amendments to the banking laws that would strengthen restrictions already imposed on transactions between the bank and the holding company subsidiaries. Extending the Administrations' proposal to bank common trust collective pension funds would foster equal competition with respect to those funds. Both the Administration bill and the present proposal address several traditional and contemporary concerns. By requiring the banks to conduct securities activities through subsidiaries, the risks attendant to banks entering non-banking fields directly could be minimized. Banks would be subject to risk only to the extent that they were committed to the capitalization of the subsidiary through the bank's holding company. Clearly such risks to the financial stability of the bank could be further minimized by requiring that securities activities be conducted by a wholly separate subsidiary of the holding company and carefully limiting the capital commitment of the bank. Safety and soundness of the banking system could thus be maintained, while competition and development of new products is encouraged.

Kathryn B. McGrath

To: John Daniels
Alan Rosenblat
Russ Stevenson

Re: Section 36(b)

Date: September 23, 1983

Attached is a redraft of the Section 36(b) proposal along the lines we discussed.

cc: Brian Kaplowitz
Jeff Steele
Jerry Osheroff

Proposed Amendments to Section 36(b)

Section 36(b). For purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. Any determination of whether or not such investment adviser may be deemed in breach of such fiduciary duty shall take into account:

(a) the prevailing level of compensation or payments paid by investment companies of similar size and with similar objectives to such investment company for services comparable in nature and quality to those rendered by such investment adviser or affiliated person thereof;

(b) the nature, quality and extent of services in relation to the fee paid;

(c) the extent to which economies of scale are shared with such investment company or security holders thereof;

(d) direct or indirect costs and benefits to such investment adviser, or affiliated person thereof, resulting from the provision of services to such investment company or its security holders;

(e) direct or indirect costs and benefits to such investment company or its security holders resulting from the provision of such services; and

(f) such other factors as are relevant and material under all the circumstances.

An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

1. It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

2. In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, shall be given substantial weight, provided that such directors have been fully informed of all relevant factors with respect to such compensation or payments, or with respect to any such contracts or other arrangements, and their approval thereof is in the opinion of the court a fair reflection of an arm's length agreement.

3. Ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company shall be given such consideration by the court as is deemed appropriate under all the circumstances.

4. While any damages awarded in such action shall be paid to the registered investment company on whose behalf the action is brought, such action shall not be deemed one which is derivative of the rights of such company. Accordingly, for such action to be maintained no demand need be

made upon directors of such registered investment company that they enforce such company's rights, and directors of such registered investment company may not terminate any such action.

5. No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

6. This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

7. Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

8. No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this title for the purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, or section 203 of title II of this Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

(d) For the purposes of subsections (a) through (b) the term "investment adviser" includes a corporate or other trustee performing the functions of an investment adviser.