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News Release

LEGISLATIVE AND REGULATORY UPDATE: BANKS AND MUTUAL FUNDS

By

Kathryn B. McGrath
Director, Division of Investment Management

February 6, 1989

1989 American Bankers Association
National Trust & Financial Services Conference

San Francisco Hilton
San Francisco, California

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Thank you, Mr. Dillon, for the very nice introduction. I'm Kathie McGrath, and I'm from the SEC. I've got a cold, and laryngitis. It seems to be the fashion in Washington these days. Or maybe you'll think I'm just pretending, trying to fool you into thinking I'm really part of the kinder, gentler folks in Washington. Please bear with me.

I've been asked to give you a "Legislative/Regulatory Update", on banks and mutual funds.

Before I begin, I want to make plain that my remarks are only my own views and not necessarily those of the SEC, its members or the rest of its staff. If you don't like what I have to say, I may even deny that I'm speaking for myself.

In the last few years, more banks have become involved in giving mutual funds investment advice, and making funds sponsored by others available to bank customers. Many banks have set up separate subsidiaries or affiliates to manage pension plans and other large accounts, outside the trust department. These units have registered with the SEC as investment advisers. Bankers also have been pressing to get the Glass-Steagall law changed to allow them to sell mutual fund shares to the general public, just as securities firms do, provided the price extracted by the Congress, for the privilege, isn't too high.

I head the Division at the SEC that is responsible for regulating investment advisers and investment companies. So when you get involved in these businesses, you'll be dealing with me or my staff.

The part of the money management industry that we regulate under the Investment Company Act and Investment Advisers Act has grown enormously over the last five years. Let me give you some numbers. In 1983, we had about 5,500 registered investment advisers, managing $670 billion in assets. Today, there are nearly 15,000 advisers, with $4.4 trillion in assets under management. And there are over 3,500 registered investment companies, representing about 15,000 separate portfolios. In 1983, there were only 1,800 investment companies. Investment company assets have grown even more, from $315 billion dollars in 1983, to over $1 trillion today. To be sure, investment company growth has tapered off since October 1987. Net sales of investment companies shares, excluding money market funds, were only $2.8 billion in 1988. Money market funds, on the other hand, have grown by $32 billion since September 1987, a growth rate over three times that for passbook savings during the same period.

The number of investment company shareholder accounts has also gotten larger, increasing from about 25 million in 1983 to 55 million today. According to the Investment Company

Institute, shares of mutual funds are owned by 25% of all U.S. households. That's a lot of people. Without question, mutual funds are very popular with individual investors.

Well, with all this money and investor interest, it's no surprise that bankers are interested. You've probably noticed - perhaps with amazement - the large amounts of money that can be made managing mutual fund assets, selling their shares and providing them other services.

I think mutual funds can be a good vehicle for small investors, in many cases better than trying to get into the stock market directly. The investor gets a certain amount of safety through diversification; professional money management, if he picks a good fund; tax flow-through treatment for dividends; and possibly lower costs of investing.

Should commercial banks be allowed to sell funds? I think so. Commercial banks serve more people, in more communities throughout the U.S., than securities firms. In Luray, Virginia where I have a farm, there are two national banks. The larger one will help you set up an account with a brokerage firm in Boston. But you have to go about 50 miles north to Winchester or 50 miles west to Harrisonburg to find a stand-alone broker-dealer. You usually don't see broker-dealers in towns located on blue highways. But banks are there, and I think people ought to

be able to buy mutual funds through their local bank and the bank ought to be paid for the service.

The customer, in turn, ought to be able to deal directly, face to face, with bank staff over any problems that arise, and hold the bank responsible. Having an account in Boston is O.K., but when things go wrong, all you can do is try to get through on that toll-free number. I always seem to reach Sargeant Schultz. You know - from the old Hogan's Hero's TV show. "I know nothing -- nothing." It would be far more satisfying to march into my bank in the East Luray shopping center and put my hands around the neck of a real person like the branch manager. Of course, banks which get into retail sales of securities, including mutual funds, ought to be regulated like brokers, particularly in regard to sales practices, advertising, and other customer protections like suitability and "know your customer" rules.

Many banks already act as investment advisers, custodians or servicing agents for mutual funds, and sell fund shares to bank customers, for a so-called "administrative" fee. To me, these "administrative" fees look pretty much like what securities firms call underwriting fees or brokerage commissions, and for all practical purposes, the selling of fund shares is being done by the banks and their employees. However, a securities firm is usually involved somewhere, taking a cut of the fees for serving as the way around Glass-Steagall. I'm offended by the

"administrative fee" charade. I know that it is up to bank regulators, not me, to say what banks can do under Glass Steagall, but I think it would be better government to get the law changed. I'm for the end result, but not the way we've gotten there.

The SEC has supported changing Glass-Steagall to permit banks to underwrite mutual fund shares. We worked very closely with our colleagues, the bank regulators, to develop a legislative proposal that would do this, and at the same time protect investors. The compromise we worked out is in Senator Proxmire's bill, S. 1886, which passed the Senate last year. Other versions of Glass-Steagall reform bills were considered over the summer by the House Banking and Interstate and Foreign Commerce Committees. For a while, I thought Glass-Steagall reform would be enacted in the 100th Congress. But in the end, nothing happened.

Predicting what the new Congress will do isn't easy. We have some new players on the Hill, and, of course, a new President. The key bank regulators are staying on, although there may be new faces at the SEC. Nevertheless, I expect the SEC will continue to support the compromise. So if the new Congress takes up Glass-Steagall reform, S.1886 is a likely starting point.

Right now, Congress seems to be in no hurry to deal with Glass-Steagall. The thrift crisis has to come first. Also, the big money center banks are relatively happy with what they have gotten (and what they think they can get), by administrative action of the bank regulators. In fact, some people think there is a real risk that Congress could cut back on the powers banks have been given, or impose unattractive conditions, in any new law. So it looks like the big banks, who were most interested in new securities powers, aren't pushing anymore for Congress to act on Glass-Steagall.

The real action will be on the regulatory front. I expect the banking agencies to continue to do what they can to respond to the desires of bankers to expand their securities business. The Federal Reserve Board's January 18 Section 20 decision is a major step in that direction.

The FED's ruling, authorizing the securities subsidiaries of four bank holding companies to start underwriting corporate debt, also appears to permit those companies to underwrite, starting in 1990, shares of closed-end investment companies and unit investment trusts, provided they do not act as investment adviser to the same fund or serve as sponsor to the same UIT. Underwriting of open end investment companies, or mutual funds, was referred to in the FED's opinion, but not approved. One

applicant had asked to underwrite mutual funds, but withdrew that request, so the question was not before the Board.

The Comptroller of the Currency is rumored to be moving to liberalize the advertising and marketing limits on bank common trust funds. This, I can assure you, will be strenuously contested by your competitors in the mutual fund industry, and the SEC may seek to force any common trust funds that are publicly marketed to register under the Investment Company Act of 1940, and the Securities Act of 1933. If public marketing of common trust funds were permitted without SEC registration, the folks in the mutual fund industry probably would move over into your turf and offer their money management services to the public through common trust funds, at the state-chartered trust companies that many have established and use to manage corporate and pension accounts -- once again levelling the playing field.

That was the long version of my legislative regulatory update. The short version is: Nothing happened in the Congress, and don't hold your breath waiting for something to happen anytime soon. Watch the bank regulators!

Under the version of Glass-Steagall reform that passed the Senate last year, banks that advise and underwrite mutual funds would be treated much the same as their competitors from the securities and insurance industries.

Well, how do we regulate investment companies? What should you expect if you get involved in the fund business and have to deal with us?

There are three key parts to investment company regulation:

1. Disclosure;
2. Fiduciary principles, and conflict of interest restrictions; and
3. Sales practice regulation.

If investment companies sell their shares to the public, they must register the shares under the Securities Act, and provide a prospectus to purchasers. They also must file semiannual reports under the Securities Exchange Act and comply with our proxy rules.

The disclosure required for investment companies, as well as their accounting treatment, is far different from that required of industrial companies. An investment company is in the business of investing, reinvesting and holding securities. It doesn't have factories, it doesn't make toasters or cars, so all the things we make other issuers disclose don't fit an investment company. Instead, we ask that they tell investors, up front, what they plan to do with the money, and after they've been in

business a while, what happened. Funds also must describe the fees investors will pay. And we require that portfolio securities be valued at market, not cost.

Both the Investment Company Act and the Advisers Act apply fiduciary principles to fund managers for the benefit and protection of shareholders. A fund adviser owes a duty of undivided loyalty to the shareholders, and must deal fairly and honestly with them. This implies a duty to disclose all relevant information and to avoid any conflict of interest, or at least obtain a client's prior consent to it.

Banks are exempt from registration as investment advisers and banks that are not registered may nevertheless manage mutual funds. S. 1886 would have changed this, by requiring a bank or a separately identifiable department of a bank that is advising an investment company to register as an investment adviser with the SEC.

Investment companies must give shareholders annual audited financial statements, and submit changes in fundamental investment policies and certain other matters to a shareholder vote before they are made. Advisory contracts must be in writing, precisely describe the adviser's compensation, and are subject to annual renewal by fund directors, including a majority of independent directors, and the contracts may not have

more than a two year initial term. The Investment Company Act also provides for election of directors by a vote of shareholders and sets forth the procedures.

In general, investment companies cannot pay performance-based fees, except fulcrum fees that increase or decrease in proportion to an index. At least 40% of an investment company's directors must be independent and a majority may not be affiliated with the fund's principal underwriter or regular broker. The law also automatically bars persons who have been enjoined or convicted for violating securities, commodities, insurance or banking laws, from the fund business, and gives the SEC authority to discipline people in administrative proceedings for law violations. There are extensive restrictions on self-dealing between funds and their affiliates and specific prohibitions against loans by investment companies to controlling persons. And there are limits on the amount of leverage a fund may incur.

Open-end funds are not permitted to invest more than 10% of their assets in illiquid investments. This is to ensure that they will be able to redeem shares without unnecessary disruptions or portfolio losses. Open-end funds must redeem shares within 7 days, at a price based on the current net asset value of the fund which is computed <u>after</u> receipt of the redemption request. Investment companies must calculate their

net asset value per share at least once each day when there is enough trading in the portfolio to materially affect the value.

There are strict provisions governing custody arrangements for portfolio securities. The securities must either be kept in the custody of a bank, or if they are held by the fund or an affiliate, they must be verified by a complete audit by an independent CPA at least three times a year. At least two must be surprise audits and the SEC must be sent a certificate by the auditor describing each exam. For those of you thinking that you could combine the functions of managing a mutual fund or distributing its shares with custodian services -- BEWARE --. We consider such arrangements among affiliates to fall under our more restrictive, self-custody requirements.

The Commission's staff, principally in our regional offices, conducts periodic routine and cause exams of investment companies. We check to see that they are complying with regulatory requirements and the representations they made to investors in their prospectuses. We also check calculations of net asset value, fees being charged and look to see that the securities claimed to be in the portfolio are in fact all there.

In many respects, the requirements of the Investment Company Act as to investment companies themselves, and the Advisers Act as they apply to the managers, are very similar to the

Comptroller's Regulation 9. There are some differences, mostly reflecting that investment companies have a corporate structure, while bank trust funds do not.

The third major piece of investment company regulation comes through the Securities Exchange Act of 1934. This Act regulates, as broker-dealers, people who sell fund shares to public investors, as well as those who engage in portfolio transactions for or with funds. Broker-dealers are obligated to deal fairly with their customers, and these obligations are policed jointly by the SEC and the National Association of Securities Dealers. Mutual fund salesmen must pass an exam testing their knowledge of the business and the law, before they can inflict themselves on the public. The level of sales commissions is regulated, and sales persons are required to know their customer and recommend only investments suitable for that particular customer. Mutual fund advertising and sales literature is carefully screened by the NASD. The NASD also oversees the ongoing activities of brokerage firms and their employees who sell fund shares, through on-site inspections, and disciplines those who violate the rules, sometimes with heavy fines or by kicking them out of the business.

Repeal of Glass-Steagall to permit banks to underwrite mutual funds raises a number of investor protection concerns. One is maintaining the independence of mutual fund custodians.

Today, most investment companies use banks as custodians and because of Glass-Steagall, these banks usually are independent of the fund underwriters or sponsors. Maintaining the independence of the custodian is an important protection for investors that I want to see continued, when banks get further into the fund business.

Another concern is name confusion. Banks have federal deposit insurance, and no one wants mutual fund investors to think they are buying shares that also carry that insurance. Name confusion will be a particular problem if banks advertise or describe, in the same literature, insured bank money market accounts and uninsured money market funds. In fact, last March the Wall Street Journal ran an ad for some mutual funds being distributed by the Chase Manhattan Bank, with a banner headline proclaiming that an investment in these funds was "just like having money in the bank". Outrageous!

Another worry is affiliated transactions. For example, there is a need to guard against the possibility that fund portfolio investments could be made in new issues of corporate securities, and the proceeds used to repay loans the company owes to a bank advising or underwriting the mutual fund.

Most of these areas were addressed in last year's compromise legislation. S.1886 picked up disclosure under the Securities

Act and the Exchange Act, and fiduciary and substantive regulation under the two 1940 Acts. The compromise isn't perfect, but it's a good, solid regulatory approach, and I am confident that any gaps can and will be filled in by cooperation between the SEC and bank regulators. If the compromise has a weakness, in my personal opinion, it lies in the sales practices area. I mention this not to suggest that I would back-off the compromise, nor to undermine it. A deal is a deal. But mutual fund sales practices and advertising are areas that banks and bank regulators are going to need to deal with. We have problems with them. You will too. In fact, I wish more were being done now, since banks already sell lots of mutual fund shares.

We know there is a tension between the desire by banks, particularly small banks, to sell fund shares using existing bank employees, and the need to protect customers from ignorant or unscrupulous sales people. We also recognize that it would be costly to train and qualify all bank tellers to sell mutual funds, even under the simplified NASD requirements for those who sell only mutual funds. At the same time, there are a lot of mutual funds out there that are pretty risky and that are not suitable for everyone. Some probably aren't suitable for anyone. The need for training and ethical standards, and the ability to enforce those standards, exists no matter who is selling mutual fund shares. I can see no reason why a bank teller couldn't rip

off a customer as easily as a securities salesman, and this will be particularly true if commissions are paid to bank employees.

In the debate over Glass-Steagall, the SEC's main concern has been investor protection. Everyone else seems to be worrying about "safety and soundness" and protection of bank depositors. I don't know how many times I have heard people say that banks should be allowed to underwrite mutual funds, without more, because this activity poses little risk to the bank or its depositors. That may be true, but what about the bank's other customers, the ones that buy mutual fund shares? What's to protect them? This is where the need for broker-dealer regulation, or something comparable, comes in.

The sales practice area is going to require further attention, one way or the other, as banks get more involved in selling mutual funds to the general public. There will be problems, and the banks themselves, or bank regulators, will have to police them, with or without the SEC and the NASD. Advertising can be a real headache, and must be subject to close scrutiny. Making sure that sales people understand, and then explain to customers, the risks of the funds they are selling is important too. For example, some mutual fund investors don't seem to appreciate the risk in a government bond fund that principal value may drop if interest rates rise. They see the high promised yields, and assume that their initial investment is

government guaranteed, or the equivalent of a T-Bill. Sales loads, particularly those that come into play when an investor wants to redeem shares, are another headache, and can be glossed over or not explained at all by the sales person at the time the investor goes into a fund. And when investors get burned, not having understood these things, they get mad, and you lose customers.

For banks, drawing distinctions between funds, especially money market funds and insured deposit accounts, will require close scrutiny of marketing efforts and the sales force.

I think bankers probably will have more difficulty with the business end of the mutual fund business than they do complying with our rules. Mutual fund customers are used to good service and, to its great credit, the fund industry has figured out how to deliver truly excellent service, most of the time. Also, many individual banks are going to find that entry into the fund business just isn't practical from an economic point of view. Most people will tell you that a fund isn't profitable until it has assets of at least $50 million, given the expenses of marketing, legal compliance, administration and shareholder servicing. Many bankers will be better off entering into joint ventures, than trying to start their own funds.

There will obviously be some cultural adjustments in getting used to the SEC. We are disclosure freaks and banks may have some trouble adjusting to our notion that you've got to hang it all out there for the public to read.

We also recently put into effect some pretty strict disclosure rules that require mutual funds to spell out plainly all fees they charge in a table in the front of each prospectus. And we put the screws to yield and performance advertising by mutual funds.

It takes time and costs some money to prepare and file prospectuses and comply with other SEC rules. But, on balance, most people find that the time is well spent, if for no other reason than the rules force people to think through their business plans in advance, and then operate in a responsible way.

To the extent the SEC does a good job of policing the investment company industry, we help maintain investor confidence in the industry's products. That, of course, is critical to the industry's growth and success. There is no deposit insurance to protect fund investors.

For this reason, good compliance programs and high ethical standards, policed by firms themselves, characterize the U.S. mutual fund industry. Scandals of the kind we've seen recently

in the thrift and banking industries would be a disaster for mutual funds. You bankers have [Uncle Sugar] to pick up the pieces. The mutual fund industry has only its good reputation.

If you do get into the fund business, count on having the SEC looking over your shoulder. We know that millions of ordinary Americans have invested a significant part of their savings in mutual funds, and that's money they can't afford to lose. Also count on having your competitors in the fund business watch you closely, ready to turn you in to the SEC at the first hint of trouble.

And if you happen to be in the neighborhood of Federal prisons where the bank regulators have sent the crooks who caused bank and S&L failures, tell them, from me, DON'T EVEN THINK of getting into the fund business.

Regardless of what the Congress does, I'm sure bankers will continue to pursue the fund business, so long as this is what the customers want.

If you do decide to come our way, or if you're already involved with one of our registrants, let me say "Welcome to the SEC." Just bear in mind, when dealing with us, that our focus is on protection of investors, and we'll get along fine.

Now before I shut up and sit down, I want to mention two things, of a regulatory nature, that might interest you.

The first is the proposed settlement of an administrative proceeding now before the SEC. If the settlement is approved by the Commission, the College Retirement Equity Fund (or CREF) will eliminate the restrictions on transfers that now apply to retirement money that teachers have accumulated in CREF. This will permit teachers to transfer CREF accumulated funds to other funding vehicles, if alternatives are offered by the school. Today, CREF accumulations cannot be withdrawn or transferred, except to CREF's companion fixed annuity program, TIAA, (Teachers Insurance and Annuity Association of America). Lump-sum distributions of CREF accumulations also will be allowed upon termination of employment, again if permitted by the school's pension plan. In addition, TIAA has agreed to permit, within two years, transfers out of TIAA to other funding vehicles, over a 10 year period, to allow more time for liquidation of the long-term investments held by TIAA.

If these changes are made, there are likely to be more opportunities for other insurance companies and mutual funds to compete for the retirement plan business of tax exempt organizations like the colleges and universities served by TIAA-CREF, hospitals, foundations, other charities, and some public school systems. Because tax exempt organizations usually

organize their pension plans under Section 403(b) of the Internal Revenue Code, their choice of funding vehicles is limited to insurance company annuities and shares of regulated investment companies. Bank trust funds aren't on the list of eligibles. But if banks get the ability to establish their own mutual funds, or can work out a way to qualify a common trust fund as a regulated investment company, by registering under the 1940 Act, you could compete for this business. This was done, a few years back, by a number of bank-sponsored IRA funds, and I think these banks that did register IRA funds with the SEC have found us to be reasonable folks.

Today, TIAA-CREF serves 4,200 educational and research institutions, and more than a million individuals and has $67 billion in assets. You may want to have your marketing people and your lawyers take a look at what happens in this SEC proceeding.

Another recent development, that we are following closely, is the Financial Analysts Federation's "performance presentation standards", released in December. The FAF hopes these standards will be used voluntarily by money managers in portraying their performance results to clients. The FAF developed these standards in response to what it called very uneven and, in some cases, dishonest methods of showing investment performance. The FAF effort, I think, reflects the frustration many analysts and

pension consultants have experienced in evaluating money manager performance and drawing comparisons. The basic idea is to eliminate sleaze and provide greater comparability. The SEC had the same objective in mind last year when we adopted rules spelling out, in detail, how mutual funds that choose to advertise yields and other performance numbers must calculate and display those numbers.

The FAF's approach is much less specific, really just a set of general principles that should be applied. For example, the FAF recommends that

- all accounts be included, including terminated accounts;
- performance calculations be time weighted, to more fairly portray results;
- figures should be given for no less than 10 years and up to 20, if practical (and if you have been in business that long);
- performance be tracked on an account by account basis and also on a composite basis; and
- separate figures or slices may be shown for various types of accounts, so long as the categories are explained and make sense.

The FAF also suggests that money managers agree with clients from the outset of the relationship when they are going to start measuring performance, and how.

The FAF principles would not require that performance be shown net of advisory fees, but instead that the fee schedule be included with the presentation. As you may know, the SEC staff has opined that a registered investment adviser must deduct fees from performance figures, although we were later persuaded that this was not necessary in one-on-one presentations with clients, so long as the individual fees to be charged are clearly explained.

In regulating investment advisers, the SEC approach has been to rely on general antifraud prohibitions, and our ability to take enforcement action when needed. We have not adopted anything comparable to our mutual fund advertising rules, to mandate or suggest a particular form of presentation of performance data.

We will, however, be very interested in the industry's response to the FAF's standards. The FAF hopes that there will be voluntary compliance, but seems to suggest that if the industry doesn't volunteer, then perhaps the government should step in.

It would be nice to see the problem of accuracy, reliability and comparability of performance numbers solved voluntarily by the regulated industry, before we regulators feel compelled to step in and hit people up side the head with a two-by-four. We are not into heavy-handed regulation these days. We're a kinder, gentler SEC. But we still have a pair of hobnailed boots in the closet and are ready to put them on if worse comes to worse.

Now it's time to go, before somebody gets an old vaudeville hook and yanks me off the podium.

Thank you very much for your attention.