BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

OFFICE OF THE CHAIRMAN

March 12, 1968.

The Honorable Harley O. Staggers, Chairman,
Committee on Interstate and Foreign Commerce,
House of Representatives,
Washington, D. C. 20515

Dear Mr. Chairman:

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

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

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

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

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

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

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

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

Although such conflicts of interest and consequent misconduct are not impossible, this area of risk is not regarded as significant. For many years banks have participated in the management of employee-benefit funds and other fiduciary accounts that hold stocks and other securities in an aggregate amount far exceeding those held by the entire mutual fund industry. The examinations conducted by bank

supervisory agencies have disclosed practically no such misuse by banks of their investment advisory and management functions. In the case of managing agency funds, an additional safeguard is the prophylactic restrictions and requirements of the Investment Company Act of 1940, particularly publicity of the financial transactions of registered investment companies, which almost inevitably would expose such malfeasance. A further deterrent would be the adverse impact on a collective fund's performance - its comparative financial record - if any of its resources were used to make unprofitable investments; the detrimental effect on sales of participations might outweigh any benefits the bank could reasonably expect from its breach of fiduciary duty.

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

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

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

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

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

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

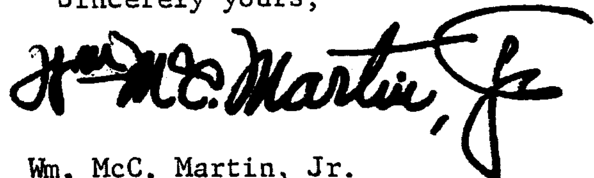
To recapitulate, the Board recognizes that the operation of collective funds by banks involves elements of risk. This is true, however, whenever banks - or other organizations - expand the services they offer. If the possibility of adverse consequences, however slight or remote, were regarded as sufficient ground for prohibiting such expansion of activities, regulated industries could not adapt to changed circumstances and the new needs and demands of our economy. In every such situation, the ultimate judgment consists of weighing risks against prospective benefits. With respect to the instant proposal, the Board of Governors concludes that the probable benefits to the public from increased competition are substantial and that the risks are relatively less significant. The Board therefore favors the objective of H.R. 14742 to authorize banks to establish and operate investment funds substantially similar to conventional mutual funds. Our reasoning and conclusions are also applicable to collective investment by banks of retirement trusts for self-employed individuals (so-called "Smathers-Keogh trusts" or "H.R. 10 plans").

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

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

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

Sincerely yours,



Wm. McC. Martin, Jr.