U.S. House of Representatives
Committee on Energy and Commerce

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, DC 20515-6119

MEMORANDUM

TO: Members & Staff, Subcommittee on Telecommunications and Finance

FROM: Staff, Subcommittee on Telecommunications and Finance

DATE: April 13, 1994

RE: Hearing On H.R. 3447, The Securities Regulatory Equality Act of 1993

GENERAL OVERVIEW

On April 14, 1994, at 10:30 a.m., in Room 2322 of the Rayburn House Office Building, the Subcommittee on Telecommunications and Finance will hold a hearing on H.R. 3447, the Securities Regulatory Equality Act of 1993. This legislation is co-sponsored by Chairman Dingell, Chairman Markey, Representative Moorhead and Representative Fields, and is intended to respond to the continually expanding role of banks as participants in virtually every aspect of the securities business. While some argue that bank involvement in the securities business ultimately will enhance competition and thus serve the interests of consumers, it is also true that these expanded *securities* powers for banks have come through a few court cases and a series of ad hoc decisions made by four different federal *bank* regulatory agencies. And these decisions have been issued notwithstanding the fact that the Glass-Steagall Act – a post-Great Depression law which for fifty years was thought to severely restrict the ability of banks to participate in the securities business – is still on the books. H.R. 3447 does not try to reverse this regulatory emasculation of Glass-Steagall. It simply attempts to insure that banks that participate in the securities business are subject to the same laws and regulations as all other securities firms. To promote uniform interpretation and enforcement of those laws, the Securities and Exchange Commission ("SEC"), the independent agency whose highest responsibility is to protect investors and the integrity of our securities markets, is logically assigned the task of regulating these activities.

The movement of banks into the securities business has been gaining momentum for many years. See Attachment A. Thus this is not the first time that legislation has been proposed that attempts to equalize the regulatory treatment afforded all participants in the securities business. The most recent of these previous proposals, H.R. 797 in the 101st Congress, attracted substantial support as part of a broad effort to restructure the financial services industry.

Like its predecessors, H.R. 3447 proposes to establish a "functional" approach to regulating entities involved in the securities business. The bill would achieve what is frequently characterized as "functional regulation" by providing that anyone engaged in the securities business – regardless of whether the business is incidental to another regulated commercial activity like banking – should be subject to a uniform set of laws which should be interpreted, administered and enforced by a single federal regulatory body, in this case the SEC. The bill's most important provisions remove archaic exemptions from the securities laws that were the product of an earlier and simpler time, when the federal government took the position that banks were prohibited from participating in most aspects of the securities business. As previously noted, that understanding has dramatically changed, and this bill reflects those changes. Thus the basic idea underlying the legislation is that the appropriate federal regulatory response to increasingly complex financial market activities should be determined by the actual nature of the business activity, rather than by the sign hung outside the business' front door.

The key exemptions for banks are contained in the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. Because of these exemptions, banks which participate *directly* in the securities business are not necessarily subject to the same laws as non-bank securities businesses, and in any case the bank's securities activities are not subject to comprehensive regulation by the SEC. Banks which participate in the securities business *indirectly*, through a registered broker-dealer subsidiary or an affiliate, face the slightly different problem of being subject to multiple layers of comprehensive regulation. In some cases this results in unnecessary and wasteful redundancies; in other instances the result may be confusing and conflicting regulations, which ultimately could be harmful to investors, bank depositors, and taxpayers. In an era characterized by expanding consumer interest in financial market investments, increasingly sophisticated financial frauds, and limited federal resources available for oversight, the argument for regulating our marketplace "functionally," based on the nature of the activity rather than the sign on the front door, has never been stronger.

In addition to establishing functional regulation, H.R. 3447 also seeks to remedy several unusual and relatively unknown anomalies in the securities laws. Some banks and S&L's enjoy privileges unknown to any of the 12,000 or so publicly held companies registered with the SEC (a figure which includes 1250 publicly-owned bank holding companies and thrifts). First, approximately 500 publicly-held banks and thrifts are permitted to file their routine disclosure documents with one of the four federal bank regulators rather than with the SEC. Thus quarterly and annual reports (known as 10Q's and 10K's), special reports (8K's), insider trading reports, proxy statements, and disclosures about tender offers mandated by the Williams Act, are all sent to one of the bank regulators instead of the SEC. This represents a significant fissure in our disclosure system, which is otherwise viewed as the best in the world. The outdated anomaly creates obstructions to the flow of meaningful comparable information about financial institutions, and may give rise to potentially serious conflicting interpretations of the securities laws. H.R. 3447 would repeal the provision in the Securities Exchange Act of 1934, Section 12(i), that is the source of this counterproductive statutory quirk. The Federal Reserve, the FDIC, and the OCC have on at least two previous occasions joined with the Commission in support of repealing Section 12(i).[1]

The second anomaly in this part of the bill concerns the fact that securities issued by banks and S&L's do not have to be registered with SEC. That means that the shares of stock of these banking companies, that are traded in our markets everyday just like IBM and Exxon, are not registered with the SEC. The exemptions from registration are contained in Sections 3(a)(2) and 3(a)(5) of the Securities Act of 1933. H.R. 3447 proposes repeal of both of these outdated provisions.

WITNESSES

Nine witnesses will testify on two panels at the hearing. The first panel consists of securities and banking regulators, including the head of a securities self-regulatory organization ("SRO"). The second panel consists of a state securities regulator, representatives of banks that have moved aggressively into the securities business, especially through the sale of mutual funds, and representatives of securities industry trade associations.

First Panel:

Mr. Joseph R. Hardiman, President and Chief Executive Officer, National Association of Securities Dealers, Washington, D.C.

The Honorable John P. LaWare, Board of Governors, Federal Reserve System, Washington, D.C.

The Honorable Arthur Levitt, Jr., Chairman, Securities and Exchange Commission, Washington, D.C..

The Honorable Eugene A. Ludwig, Comptroller of the Currency, Department of the Treasury, Washington, D.C.

Second Panel:

Mr. Philip A. Feigin, Securities Commissioner, State of Colorado. *Mr. Feigin is testifying on behalf of the North American Securities Administrators Association.*

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1 See Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services, p. 91 (1984) (chaired by Vice President Bush); Department of the Treasury, Modernizing the Financial System: Recommendations for Safer More Competitive Banks (1991).

Mr. Matthew Fink, President, Investment Company Institute, Washington, D.C.

Mr. Richard Jones, President, Fleet Financial Services, Providence, Rhode Island. *Mr. Jones is testifying on behalf of the American Bankers Association and the Consumer Bankers Association.*

Mr. Marc E. Lackritz, President, Securities Industry Association, New York, NY.

Mr. W. Keith Smith, Vice-Chairman, Mellon Bank Corporation, Pittsburgh, Pennsylvania.

OVERVIEW OF KEY PROVISIONS IN H.R. 3447

A section by section analysis of H.R. 3447 is attached to this memo. We recommend that you review it in order to obtain a thorough understanding of the goals and regulatory philosophy underlying the legislation. In the meantime, here is a brief discussion of the bill's key provisions:

Broker/Dealer Exemption: Title I of the bill contains the provisions that would help establish functional regulation and would subject most bank securities activities to the federal securities laws. The most important provisions in Title I relate to the removal of existing exemptions from the securities laws. The bill eliminates the exemption from the definitions of "broker" and "dealer" for banks that engage in many (but not all)[2] types of securities activities. Banks that fall within the amended definitions would then be required to conduct their securities activities through nonbank subsidiaries or affiliates that have to register with and periodically report to the SEC.

Investment Adviser Exemption: Another provision in Title I would eliminate a similarly broad exemption if the bank serves as an investment adviser to an investment company.[3] Banks presently enjoy an exclusion from the registration requirements of the Investment Advisors Act, notwithstanding the fact that some banks rank among the largest providers of such services.

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2 Banks will still be able to undertake certain securities activities without falling within the definition of "broker." Specifically exempted are (1) transactions in "exempted securities" like commercial paper, and (2) fiduciary securities activities, such as advising trust accounts, providing that the bank does not publicly solicit brokerage business, receive commissions, or receive other types of transaction based compensation. The bill is, however, intentionally limited to these two specified exemptions. The reason is to minimize opportunities for creative lawyering that might seek to stretch additional exemptions far beyond their intended application. Instead, the bill contains a general provision (in Section 103) authorizing the SEC to grant exemptions that are consistent with the public interest. The Subcommittee expects, for example, that the SEC will use this authority to exempt from the definition of "broker" banks whose securities transactions are limited to accommodation trades.

3 "Investment companies" can take many forms, but 95% of the time they are organized as mutual funds. As you may know, a mutual fund usually consists of nothing more than a board of directors that oversees a series of contractual relationships with various entities that provide services to the fund. The fund's relationship with its investment adviser is typically the most important of these relationships.

Section 120 of H.R. 3447 proposes to remedy this artificial distinction by requiring that banks comply with the same registration provisions that apply to all other entities that advise investment companies.

Conflicts of Interest: Title I contains additional provisions directed at potential conflicts of interest that banks might encounter when serving as investment advisers to mutual funds. These provisions are designed to remedy what now appears to be a substantial gap in the protections afforded by the securities laws. The authors of the Investment Company Act of 1940 ("1940 Act") appear not to have contemplated the emergence of banks as investment advisors. This is evident because the 1940 Act addresses at length the potential conflicts that might arise when securities firms advise mutual funds, but is silent about the conflicts that could arise just as easily when a bank advises a fund. Banking laws also fail to fill the gap because, to the extent they address transactions between banks and affiliates, they are intended to ensure that the bank, not necessarily the affiliate, has been adequately protected. To address this problem, H.R. 3447 erects firewalls that prohibit several specific types of transactions between investment companies and bank affiliates. The SEC, however, is granted authority to issue exemptive rules or orders.

Publicly Advertised Common Trust Funds: The bill clarifies the exemptions that presently exist for common trust funds under the securities laws. Section 119 of the bill provides that common trust funds offered to the general public must register with the Commission as investment companies. Since common trust funds are the functional equivalent of mutual funds if they are offered to the public, the bill treats them as such and requires appropriate registration.

Registration and Reporting of Bank Securities: Finally, as noted in the first section of this memo, Title II of H.R. 3447 repeals Section 12(i) of the 1934 Act, the provision which allows some banks and S&L's to file their disclosure documents with bank regulators rather than the SEC. In addition, Title II of the bill repeals the exemptions that allow banks and thrifts to forego the registration of their publicly traded stock with the SEC.

POSSIBLE SUBJECTS FOR QUESTIONS

It has been correctly pointed out that in many cases, banks have chosen (or in some cases have been required) to conduct their securities activities through subsidiaries or affiliates that are registered with the SEC. In addition, many bank mutual funds are in fact advised by entities registered with the Commission as investment advisers. Thus it is perfectly legitimate to inquire of the Commission and the NASD about the steps they are taking to help reduce the confusion depositors often experience when buying a mutual fund through a bank.

We think the larger policy question, however, relates to the substantial structural problems that result from the continued existence of the bank exemptions from the securities laws. One of these problems is that approximately one-third[4] of all banks engaged in securities brokerage or advisory activities have taken advantage of the aforementioned exemptions and are largely beyond the reach of the securities laws as interpreted and enforced by the SEC. This fact can give rise to a series of questions to bank regulators about their experience and expertise (and relative lack thereof) in regulating retail securities products; the problems of inconsistency, inefficiency and conflict inherent in several different regulators administering, interpreting and enforcing rules governing identical activity; and the possibility that the public interest will be compromised as bank regulators attempt to balance the need to protect investors with their larger responsibility to promote the safety and soundness within the banking system.

The second problem is more subtle but creates significant practical difficulties. Even if a bank is presently registered with the SEC, our present legal structure gives it the permanent option of opting out and reorganizing their securities activities in a manner that fully exploits the exemptions. According to officials at the SEC, this creates an unacceptable amount of pressure on securities regulators. They are constantly aware that if they press bank officials too hard, the bank may choose to shut down the subsidiary or affiliate and conduct the securities activity directly. In effect, these banks are in the unique position of being able to legally banish the SEC from their premises.

Bank regulators are aware of these arguments and will no doubt advance some strong rebuttals. They note, for example, that mutual fund investors appear equally confused about the insured status of funds purchased at banks, regardless of whether the fund is sold through an SEC registered subsidiary or affiliate. Indeed, although the empirical evidence is sketchy at best, Comptroller Ludwig contends that investors who purchase mutual funds through brokers (like Merrill Lynch) and direct marketers (like Fidelity) are as confused as those individuals who buy funds in banks. See Attachment B. Some of the bank regulators are also likely to draw attention to the relatively bountiful resources that they have available to oversee the securities activities of banks. As you know, the SEC has been seeking additional funding and personnel to increase their staffing in a number of critical areas, including the oversight of mutual funds and investment advisers.

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If you have any questions about the hearing, the legislation, or the matters discussed in this memo, feel free to contact Timothy Forde or Gayatri Bhalla of the Subcommittee staff at 226-2424.

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4 Reliable statistics about the number of banks that engage in securities activities under the banner of these exemptions are hard to come by. Obviously the SEC is hard pressed to quantify the number of banks that do not register with them because they operate pursuant to the exemptions. And the bank regulators apparently do not maintain records that would allow them to assemble this data. However, information supplied to the Subcommittee by Lipper Analytical Services and Cerulli Associates Inc. suggest that the figure cited above is reasonably accurate.