MUTUAL FUND SERIES
TUESDAY MARCH 8, 2005

MATTHEW FINK: Good afternoon. I'm Matthew Fink, and it's my honor to moderate the first of our four online programs on developments in the mutual fund industry, presented by the Securities and Exchange Commission Historical Society. The Securities and Exchange Commission Historical Society is a non-profit organization, separate from and independent of the SEC. The Society preserves and shares the history and historic records of the SEC and of the securities industry through its virtual museum and archive at www.sechistorical.org. Today's program will be preserved in the museum so you can listen to the discussion or read the transcript later.

Today's program, the first in our series, looks at bank entry into the mutual fund business. Originally, the only firms which managed mutual funds were those whose sole business was advising mutual funds and in some cases, other clients. But over the years, other types of firms, including insurance companies, broker-dealers, commercial banks and foreign companies have entered the mutual fund industry. Each type of new entrant raised legal, regulatory and public policy issues, but no area was nearly as controversial as the entry of commercial banks. In a nutshell, one of the first of the New Deal laws, the Glass-Steagall Act of 1933, was aimed at separating commercial banking and investment banking. Beginning in the early 1960's, commercial banks sought to break down this legal separation before Congress and before regulators. There were four decades of Congressional hearings, administrative proceedings, and litigation. When the dust cleared, it appeared that the banks had achieved just about full entry into the securities business, including mutual fund activities, but the way in which this happened and particularly the length of time it took maybe as important as bank entry itself.

Our panel today will discuss these past events, their significance today, and the likely future. Our panelists are Michael Bleier of Mellon Bank, and Martin Lybecker of Wilmer Cutler Pickering Hale & Dorr. The Developments in the Mutual Fund Industry four-part series is made possible in part through the support of the Richard and Elda Phillips Fund. The remarks made today are solely those of the speakers and are not representative of the Society. Our speakers cannot give investment or legal advice.

So let's start by identifying the various players and their motives. First, Mike, why did commercial banks want to enter the mutual fund business?

MICHAEL BLEIER: Thank you, Matt. Well there are two aspects to this issue. First, there was the movement in the 60's when the legal constraints that were thought to exist were challenged by banks including Citibank and actually those are going to be touched on by Marty; then I'm going to touch on the economic changes that made the mid to late 90's different so that business issues became more of a driver and those resulted in the Mellon-Dreyfus merger that played an important role in getting us to where we are today, and Marty's going to pick up at least on the first point.

MARTIN LYBECKER: On the technical level, the principal problem that banks faced was frustration with the law as it existed in 1960 when this all began. There was an exemption for common trust funds. There was an exemption for a pension fund, but not for collective investment funds. It wasn't really until 1970, in the 1970 Amendments Act. The common trust and collective funds got express exemptions even from the '33 Act, so prior to 1970, interest in common trust funds were sold in reliance on the non-public offering exemption in Section 4-2, and interest in collective funds were offered pursuant to a Commission interpretive position. As a practical matter facing the businessman, this meant there were two separate marketing channels, two separate sets of investment portfolios, two separate sets of business development officers and marketing material, and yet the end product was exactly the same. It was still investment management. The other thing that was frustrating was the arrival in 1962 of HR10-Keough Plans as they were called. They were pension plans for self-employed

professionals and they didn't fit into any of the pigeonholes neatly. They didn't match up with what the SEC thought a common trust fund ought to be. They weren't a pension fund in the way that was described in the existing '40 Act and in order to market to those people would have required maintaining yet a third set of investment portfolios marketing channels and the like. It was frustration.

MICHAEL BLEIER: And actually when you think of also the economic imperatives for banks getting into the mutual fund business, those were precipitated by changes in consumer savings and investment habits. You had the aging of the baby boomer population and the movement into investing years, and their focus on wealth creation, saving for retirement. There was a desire by the banks to be responsive to consumer demand for a wider range of financial services, easily accessible at more convenient locations, such as one-stop shopping. There was also a new form of disintermediation that they were concerned about by the outflow of bank deposits into mutual funds, and also the desire by banks to have a more increased fee income which would be more stable than the interest-based income, and an attempt to deal with the concern over safety and soundness.

MATTHEW FINK: Okay, well that's what was driving the banks, this is Matt Fink, I will answer the second question, the second player which is why the mutual fund industry was so adamantly opposed to bank entry. Going back to the '60's and '70's, the fund industry feared that banks, if allowed to enter the fund business, would dominate it and there were a number of reasons. There was concern that every day, millions of customers visited their banks and would become easy candidates for banks to sell to. Second, a lot of these customers were relying on banks for loans and other credit, and therefore the banks would have a leg up in attracting customers, and when we looked at other areas, we found where banks had entered, they surely had come to dominate. One example is one Marty mentioned, the management of pension funds was largely dominated by the banks putting aside investment performance and when the mutual fund industry looked overseas, it found in other countries where banks were able to engage in the mutual fund business, they were the dominant players. So putting aside public policy reasons, the mutual fund industry in the '60's and '70's was concerned that if banks were to enter the business, they would shortly dominate it. Let's turn to the third player – bank regulators. Marty, what role did the bank regulators play?

MARTIN LYBECKER: The Comptroller of the Currency was the principal player in the '60's and we always have to remember that every federal agency has at its disposal a whole variety of tools with which to communicate its views. They could adopt rules and regulations. They can issue position statements. They can issue no-action letters. The Comptroller himself can give a speech, and of course the last two are the least pleasant and the least predictable, and that's either legislation or litigation. Saxon, not Camp, was actually the Comptroller at the time. He was followed by Camp, and he was very eager to embrace bold new ideas and authorize national banks to engage in new activities. So the original position the Comptroller took was that if it could authorize a bank to offer commingled managing agency accounts, and that was the product name for the offering to the HR10 accounts. If they could offer commingled managing agency accounts by amending their Regulation 9, their regulation for common trust funds, then their view was that the fund was not subject to the federal securities laws because common trust funds weren't either. It boiled over into a legislative debate between the Comptroller and the SEC, with the SEC arguing that commingled managing agency accounts were the functional equivalents of mutual funds and had to be registered under the Investment Company Act and the '33 Act. Of course we all know the legislative debate didn't actually get over until 1970. Citibank was pragmatic, as Citibank proved to be throughout this entire era. They simply registered a mutual fund, sought exemptive relief as necessary from the OCC, from the common trust fund rules, from the SEC, from the mutual fund rules and moved on. When the NASD sued the SEC over its exemption, the ICI, Matt, your group sued the Comptroller of the Currency on the theory that the offering of commingled managing agency accounts violated

the Glass-Steagall Act. It's interesting that both agencies had choices, and yet the OCC stuck to its guns and insisted that the law allowed commingled managing agency accounts, notwithstanding the SEC's position and ultimately even legislation wasn't passed. At the very last minute with the Senate Banking Committee poised to adopt the Bank Holding Company Amendments of 1970 and what became the 1970 amendments to the Investment Company Act, it was decided that the issue would be pulled out of the legislative process and we'd let the Supreme Court decide in ICI vs. Camp.

MATTHEW FINK: Marty, why do you think the bank regulators or the Comptroller in that case was pushing to expand bank powers?

MARTIN LYBECKER: For the reasons that Mike said, if during the '60's we had economic expansion, net investment income is certainly one way, classically that banks have made income. Foreign loans, other kinds of lending experiences have losses. It's natural and normal, that's why bank balance sheets are the way they are. If you look around, the Comptroller was trying to find different types of business, travel agency, mutual fund, insurance agency, and ultimate stock brokerage where it was fee income, where he would have taken the position that there was relatively little risk attached to it. It moderates the swing in net investment income.

MATTHEW FINK: Okay, so we had the banking agencies on the side of the major banks trying to help bank entry into the mutual fund business, and as Marty said into other financial businesses. Let's look at our fourth player. We've talked about the banks, the mutual funds and the bank regulators. The fourth one is the SEC, and Marty, let me ask a series of questions – What role did the SEC play? Did it act as an advocate, as the bank regulators acted? And probably most importantly with the benefit of hindsight, should the SEC have played a different role?

MARTIN LYBECKER: I agree that that's the point. Agencies have alternatives and they can decide how they want to portray themselves. In this instance, the Comptroller was so adamant in his position that the SEC responded to the stridency of the Comptroller's position by seeking to testify on the Hill. Their positions were conservative and careful, and they did no more than assert jurisdiction. I don't think it would be fair at all to say they acted as an advocate for the mutual fund industry or investment advisors or broker-dealers, and in the end, they issued the exemptive relief that Citibank asked for, the only act they actually had to do. And they stuck by their promises in the legislative arena. As you know, Manny Cohen desperately wanted to have the mutual fund amendments go through in 1970. The only way to get there was to have the banks testify in favor in the mutual fund amendments, and he freely admitted that the quid pro quo was he got the banks to testify in favor of fiduciary duties being imposed on investment advisors and the SEC didn't opposed banks being involved in the mutual fund industry. That's the deal that got upset at the very last minute by the Senate Banking Committee.

MATTHEW FINK: Okay, there we have the four players and their motives, and as Marty said, one of the first major developments in the controversy was the Supreme Court's decision in 1971 in the case of Investment Company Institute vs. Camp, which invalidated the regulation by the Comptroller, that Marty mentioned, which had authorized banks to establish and operate commingled managing agency accounts, a type of mutual fund. In that case, the Supreme Court held that the Glass-Steagall Act prohibited a bank from operating a mutual fund, and in its opinion, the Court cited both a statutory provisions and what it called "subtle hazards" that would arise. Let's look at that case a second. Mike, in its opinion, the Supreme Court chided the Comptroller of the Currency for its failure to articulate a position at the administrative level as the impact of the Glass-Steagall Act's provisions on the proposed activity. Why did the Comptroller fail to express a position? And if the Comptroller had given a position, might the case have come out differently?

MICHAEL BLEIER: The OCC, you know, has always been a single-headed agency, who has the ability to act on his own, although within the broader Treasury Department, and that

both have negatives and positives. A single individual, particularly on the positive side, clearly where you have an agency that's headed by an individual, the agency can act promptly and focus very much on the agency's agenda. That's very good in the case of an emergency. Clearly here, I think you had an agenda that the Comptroller was seeking to make the national charter more attractive. It can also be a negative where you have unbridled authority and it can be heavy-handed.

Just to digress slightly, the concern about unbridled authority actually is readily noted in the removal action legislation with respect to the ability of the Comptroller to remove a national bank's officer or CEO. For example, in that case the Fed would be the agency that is authorized to initiate such action, not the Comptroller because the Fed is basically a body of members, the seven member Board of Governors, and the concern that the Congress had was to remove the potential of an agency taking such action due to a personal animus. Now that has been subsequently done away with as too cumbersome a process, and clearly the Comptroller has had a history of being fairly activist and less restrained than other industries such as the Fed for instance in the case of the Dreyfus-Mellon merger.

Frankly in that case the Fed did not want to consider the Dreyfus transaction and that was one of the reasons we went to the Comptroller. They were willing to consider the proposal, and what that means is the OCC in the case of the Dreyfus-Mellon merger could be the leader in innovation and more aggressive if it chose to do so. In ICI v. Camp, the OCC clearly was not concerned with developing a clear regulatory record and what's interesting is one of the obligations we had at the Board, particularly those of us in the legal department where I advised at the Board and the Fed's legal division, we had to make certain that the Board's position could be yea or nay, but no matter what we had to have a record so that the position could be substantiated and not overturned. In the Dreyfus-Mellon matter, which you should note, is maybe the Comptroller learned from the ICI v. Camp experience because in that case in our merger with Dreyfus, the OCC published an operating subproposal in the *Federal Register* and also offered the opportunity for people to protest and even to consider holding a public hearing. Not only that, but the order was preceded by two sets of hearings in the House, one before Congressman Dingel's Subcommittee on Oversight and Investigations. The hearings were on March the 2nd and 3rd of '94, and there was a subsequent hearing before Congressman Markey's Subcommittee on Telecommunications and Finance on April 14 of '94. Only then did the Comptroller issue its order on May 4th 1994 approving the transaction. Clearly there was a full record and if you read that order, which I'm sure, I know you have, it is a fairly well laid out rationale as to why they took such action.

On your second question, had the Comptroller expressed a position, would the case have come out differently? What's interesting when you read the opinion, and I'll quote from it, the court said "the difficulty here is that the Comptroller adopted no expressly articulated position at the administrative level." That suggests to me with hindsight that very possibly had they articulated their position, they would have been approved and the world would have been quite different.

MATTHEW FINK: Marty?

MARTIN LYBECKER: The Chevron case comes way after this, and it articulates the concept that the courts shouldn't try and redress or reconsider what agencies have decided if the plain language of the statute is available to interpret. The Chevron case comes literally two decades after this. All the points Mike makes are very fair. As a matter of fairness, it's also true that he was doing this in 1962, 1963. The idea of procedural fairness certainly has been in the Constitution forever, but the idea that it had to be there for an administrative procedure or administrative process wasn't really, and there's also as Mike pointed out, a huge difference. I grew up on the SEC staff, he grew up on the Fed. We were both taught, maybe not explicitly, but certainly implicitly that you were supposed to make sure that, in my case the Commission, in his case the Board, could always make whatever decision they wanted when they made that

decision. When you have a single agency head, it's much harder to have that kind of tradition within an agency because he is the sole decision maker. Same point Mike made on having offices reviewed, he can't have prosecutorial, investigatory and adjudicatory capacities all at the same time. It's simply not possible to believe that with different parts of his brain he can sort all that out. You know the modern equivalent of trying to rethink the same kind of point is coming up in the insurance industry. There has been since Gramm-Leach-Bliley quite an interest in having a federal insurance regulator, and people have debated seriously whether the Fed model's the better model, the SEC's model's the better model, the OTSOCC model's the better model, whether it should be in the administrative independent agency. I think all of those things had an effect on the way Camp made his decisions.

MATTHEW FINK: So in a funny sense, the Comptroller's very activism that Mike mentioned. He could be active. He was the sole arbiter. Also, in a sense, he might have gone a bridge too far here. Had there been more thought, and again it is the benefit of hindsight and the later case as Marty mentioned, he might have had a more reasoned decision, and Camp might have come up differently.

MARTIN LYBECKER: There's a *Law Review* article the Deputy Comptroller of the Currency and the Comptroller published in the *Georgetown Law Review* explaining the history of common trust funds. Prior to 1962, trust powers resided at the Board of Governors, not at the OCC, so they had no history of interpreting them and this is pre-no action letters, it's pre- all sorts of things that we take for granted today, including LexisNexis and research. Not only does Saxon adopt this regulation by just saying I hereby decree it, but there was no reasoning attached to it and the *Law Review* article was an attempt to make up for part of that, so was the reasoning that the Supreme Court agreed, said they would have agreed with had it come from his mouth, but it was in appellate briefs.

MICHAEL BLEIER: Yes, and you read the ICI v. Camp opinion and Marty, they cite that history of the Fed having jurisdiction in '62, and then in '63 it turned to the Comptroller and then immediately thereafter you had the order issued or the Regulation 9 issued, allowing this for Citibank and clearly that is one of the issues. There was no need for consensus which was often the case at the Board.

MATTHEW FINK: Okay, well Camp may have happened, I don't know if the word is accidently, but there were a bunch of fortuitous circumstances because of lack of explanation by the Comptroller when he adopted his position, but at that time, and this is just about when I joined the Investment Company Institute, right after Camp, at that time I think most of us who looked at that situation back in 1971 thought that the Camp case looked at a very formidable roadblock to the bank entry into the mutual fund business, and that banks would need legislation to overturn Camp, yet over the next 10, 15, 20 years, banks gradually gained entry through a series of administrative rulings often upheld by the courts. Marty, I'm giving you a hard job here because we're talking about 15 years and a new rule cases, but could you describe this process of, I'll call it erosion or advancement or whatever, and the two or three major decisions.

MARTIN LYBECKER: Well, the cases are all decided in the '80's, but the events start in the '70's, you're absolutely right about that. The first one, the first decision is ICI vs. Board of Governors. Your case. It starts in 1971 with the Fed literally months, four months, three months after ICI vs. Camp was rendered deciding to adopt amendments to its Regulation Y allowing a non-bank affiliate of a bank holding company to act as investment advisor to a closed-end fund. As you know, Glass-Steagall doesn't have any rulemaking power in it. There's no obvious reason why an agency would be allowed to interpret it, other than through prosecution, and yet the Fed chose in Regulation Y, not only to approve the power of being an investment advisor to a closed-end fund, but attached several long paragraphs to its Regulation Y that these days we would characterize as safety and soundness conditions, but they were things mean to

ameliorate what they could read in ICI vs. Camp. Of course they also went at great lengths in adopting Reg Y to explain what they were doing.

You all sued them, as I recall around '72 or '73 and initially went through Federal District Court. It was remanded and you ended up in an appellate court and the DC Circuit Court and ended up in ICI vs. Board of Governors and believe it or not, that case is seminal to virtually everything else that happens, as will happen in things that get briefed. It was my disadvantage to have it happen to me in the so-called Valley case. The Supreme Court decided to answer a bunch of questions in footnotes that you hadn't asked, that the Board of Governors hadn't asked, and yet they decided they would explain things, so while the case is about being an investment advisor to a closed-end fund, they end up deciding that if a bank is doing whatever the Fed said it's okay to do in a regulation, why that doesn't violate Section 16. So while the narrow holding is it's okay to be an investment advisor to a closed-end fund, the practical holding was a bank could be an investment advisor to any kind of fund, so long as it followed what the Fed had put down in Reg Y. I'm going to get the footnotes wrong, but it's around footnote 12 where I presume one of the clerks writes this long footnote explaining what Section 20 is, and I think most of us, at least at the time, didn't think Section 20 would ever have any role to play. For reasons that are completely historical and hard to figure out, when Congress did the Glass-Steagall Act, the four sections being 16, 20, 21 and 32, in two of them, 16 and 21, they didn't use any adverbs. It was just flat prohibition. In 32 and 20, there are adverbs, and it says you can't be affiliated with someone who's engaged principally, which of course leads to the question of what principally means, and when you figure out what that means, whatever the obverse of principally is, something that's not prohibited. I don't know that anybody prior to that footnote would ever have thought about that, but that actually spawned cases that became known as the Section 20 affiliates that spawned the underwriting case, but to do this in the right sequence because that's what you asked for.

Reg Y came first with ICI vs. Board of Governors and on its heels came the collective investment IRA cases. IRAs were the fabulous product of the early '80's. Anybody could have one at the time. There was a limit on how much money you could put in, but it was the product. It worked for every family. Anybody could have one. But the product disappeared by 1985 when, in the Reagan administration, they capped the amount that could be contributed and capped who could have one, making it very hard to collect assets, but the collective investment IRAs were basically a repeat of ICI vs. Camp because the Comptroller took the position they were legitimate common trust funds. The SEC took the position they weren't. Citibank once again did the practical thing, registered the fund, got the exemptive relief, and then you all litigated in three different circuits and the Supreme Court didn't take action. Section 16 has in it for historical reasons the language that allows the bank to execute a transaction at the request of a customer and then the rest of the words are basically and it can't be at risk in terms of committing its capital. But it plainly describes a brokerage function in the middle '70's in New York Stock Exchange vs. Bloom there was sort of an abortive attempt to have banks become involved as brokers. By the early 1980's, B of A had acquired Schwab, so we now had a bank holding company that was asking for approval to have a holding company affiliate that was only a broker. You always have to remember that Schwab was a discount broker at the time, not an underwriter and certainly not a wire house, and brokerage was all it did. To go back to the point that Mike was making earlier, that transaction went to the Fed, and the Fed borrowed an SEC administrative law judge, had a hearing. There was testimony. There were transcripts. They wrote up a huge order. It went to the DC Circuit Court and the Supreme Court also approved it. The Supreme Court went out of its way to say how wonderful the Fed was and to give it great deference. It's still before the Chevron case, but they got enormous deference to the choice they made. Security Pacific went the other route and got a quickie operating subsidiary order from the Comptroller of the Currency and ended being in litigation for three more years over

whether you could do the discount brokerage at a branch. The McFadden Act questioned the geography, questioned not even a bank powers question.

On the underwriting side, Bankers Trust started the party in 1981 by offering to Mike's treasurer, I'm thinking of him now, pretending he's the general counsel of an operating company, by offering his treasurer an alternative to going to Wall Street. We will underwrite, we will sell your commercial paper and if we can't get it all sold by the end of the first night, we'll make you a loan for the difference, so the functional equivalent, Matt, would have been for your treasurer. He had all the money he would have gotten by going to Wall Street, and in underwriting, the part of it came from commercial paper, part of it came from a loan, and then Bankers Trust would sell off the remainder of the commercial paper. That case went to the Supreme Court with a decision that commercial paper meant what it meant under the '33 Act, meant what it meant under the '34 Act, and since it was plainly a security and what Bankers Trust was doing was underwriting it, that it was illegally engaging in underwriting activities, and it was remanded to the Fed. And once again, following exactly the pattern that Mike described, they had a hearing, they had testimony, they had witnesses, and Bankers Trust and the Board both changed their position. Glass-Steagall Section 16 authorized brokerage activities if you read it that way. It doesn't say who the customer is, and naively I think many of us thought the customer had to be a retail person. There's nothing in Section 16 that says it can be the corporate treasurer.

So round two of Bankers Trust was the corporate treasurer being approached by Bankers Trust and Bankers Trust would say here's the deal. You're the client. On your behalf, we're going to sell your commercial paper and they sold it in brokerage transactions. It was still exempt from the '33 Act, still exempt from the '34 Act, but Bork, who was the DC Circuit Court judge who wrote the opinion, justified Bankers Trust on the grounds, a) that it was a private placement, not a public offering, and b) Bankers Trust wasn't underwriting it.

The third case was decided in 1988 and it's the SIA vs. Board of Governors. That's the same name on all the cases because SIA was the common plaintiff; Board of Governors was the common defendant. By that time, the idea of banks selling commercial paper, being involved in commercial paper had found its way into Section 20 orders. It's fair to say from everything that we all know that Chairman Volcker really didn't like the Section 20 affiliates at all, and even though this is oral and not visual, if I was to, if you could see my hands, I'd have a holding company on top, a bank on the bottom, and I'd have the diagram with the affiliate off to the side. In order to put, the way the Section 20 analysis would go is that there is some good underwriting activities, underwriting activities like underwriting treasuries, underwriting activities like underwriting commercial paper. Those are good activities. So the question is how many naughty activities you can have, or bad activities you can have and still fit into the Section 20 engaged principally test. What people propose to do is take regular commercial lending activities, push them essentially upstream to the holding company over to the affiliate to expand the base of revenue that the affiliate would have. Then the Fed's view was that they could authorize naught underwriting as a percent. They chose the, initially because of Volcker, they chose the percent to be 5%, so it had to be 95% good underwriting, 5% naughty underwriting, and they also put on a percent of market test. In a very surprising decision, the 2nd Circuit approved the first one of those tests, but denied the second one, and what you have thought is they would have remanded it to the Fed for further proceedings to see if the Fed still wanted to go forward with Section 20 affiliates getting only half of the loaf they cooked. The reason this makes a difference, and we're sort of getting all the way to the end of this story, is that the percent of market test would have prevented Citibank from acquiring Salomon Smith Barney. It would have prevented Citibank from being acquired by Travelers and the way the actual transaction was characterized it would have stopped all of that because the percent of the market was huge. What people don't remember is that banks like Citibank not only had huge treasury functions, but huge municipal bond functions because they had an exclusive on the general obligation

bonds while Wall Street had an exclusive on the revenue funds, anecdotes have it that when Citicorp first approached the Fed in the middle 1980's after ICI vs. Board of Governors, your case, that they went to them arguing that principally engaged should be a 49% test or something very close to 50% and because of the amount of good underwriting they already had, forget the Bankers Trust commercial paper stuff, the amount of capital they could have brought to the party underwriting, that one bank on that one theory would have been more than all of the capital Wall Street brings to the party altogether at that time. They would have been the biggest underwriter on Wall Street. That's what made Volcker unhappy and it got squeezed back to the 5%, and of course as we know, it got expanded to 10% then got expanded to 25% at which point virtually every decently sized regional bank could afford to buy an underwriter and we saw the wave of that.

MATTHEW FINK: Marty, you've taken us all beyond the mutual fund area, but I think it's fair to say this, that in a series of administrative rulings largely upheld by the courts, discretion, the fact that the regulator, usually the Fed had built such a record below led to deference and a series of cases that led banks not only in the mutual fund business, but into securities underwriting.

MARTIN LYBECKER: Well those other businesses are relevant to this. If you can't, it's one thing to be, there are broker-sold funds. We all know that, but for the banks to be able to put a broker in the lobby as Bank One, Mellon, Bank of America, others did, very aggressively put kiosks in the lobby, sell in the lobby, use your own people, you had to have the brokerage powers to do that. I don't know that anybody from a mutual fund standpoint cared about the underwriting because very few banks funds are sold with a sales log. But the other part, the brokerage absolutely had to be there.

MICHAEL BLEIER: Let me give you one historical footnote. When one of these cases was presented at the Board I happened to be at the Board table that day and Volcker made the comment, he laughed when he saw it, it was commercial paper underwriting. He said that, "when I started my career at the Federal Reserve Bank of New York, the first project I was assigned was as an economist to do an analysis of bank activities in the underwriting business, commercial paper." And that was like 30 years before.

MATTHEW FINK: It happened 30 years later. Well let me go ahead. We've now got gradual bank entry and full bank entry de facto by 1990 or so and then came the act that ratified it, the passage of the Gram-Leach Bliley Act in 1999, Congress essentially ratified bank entry into the securities business in general and into the mutual fund industry in particular. Mike, did the Act have any affect on banks' mutual fund activities?

MICHAEL BLEIER: I just wanted to go back to one point before we did the Dreyfus transaction which I think formally broke down barriers that were clearly collapsing. Prior to that transaction, we did in '93, we received Fed approval to acquire the Boston Safe Deposit and so that we could, therefore, provide a broad array of administrative services to unaffiliated mutual funds and this is basically doing all the infrastructure work for a mutual fund, the back office work, the fund accounting, the books, the records, the SEC's state blue sky filings, Board documentation. We did that under 4(c)8 of the Bank Holding Company Act. And that actually was submitted to the Board. The Board actually approved it based on their interpretation 225/125 in that when the Fed, we argued that when they approved investment advisory activities that administrative services were part of that activity, and then subsequently we had, after doing that, we thought we could do the Dreyfus-Mellon transaction. And as part of that actually we addressed what we thought some of the subtle hazards that were cited by the Supreme Court in the ICI v. Camp case. We developed a policy on mutual funds, self-imposed 23A and 23B restrictions dealing with dealings between a Mellon entity and an advised fund. We had restrictions on sharing of customer information. We had a fairly detailed securities trading policy. We made certain that the boards were independent, no director or officer

interlocks, and then there were the sort of the icon that mutual funds are not FDIC-insured. They're not a bank application.

MARTIN LYBECKER: The Miranda warning.

MICHAEL BLEIER: Right, exactly. Can lose value, and they are not bank deposits. We also said that we would keep Dreyfus under the SEC's jurisdiction and that we would not use an affiliated distributor, which still was an open issue but we said that we would use a third party as the distributor.

MARTIN LYBECKER: The only other point I was going to make, Matt, before we got to Gramm-Leach Bliley is that it's not as if the Congress and the SEC were sitting still during all this time. The bank brokerage activities clearly frustrated the SEC staff. By 1984 they had done several bank studies and in 19… it was either '84 or '85, proposed and then adopted Rule 3(b)9. Rule 3(b)9 would have required that all bank brokerage activities in the language that we use today be pushed out into an affiliated registered broker-dealer or the bank itself would have to register as a broker-dealer. The legal theory was based on the words that begin all of the definitional sections of all the federal securities laws that unless the context otherwise requires and what the SEC wanted to argue was that the context, which is that banks hadn't been allowed to be brokers in 1933 had changed, therefore the definition of broker and dealer that says a bank, a broker is a person who does …, but does not include a bank, had to change too. The SEC lost that case in the DC Circuit in 1987 and the solicitor decided not to appeal. At the same time, in the summer of 1987, Congress passed the Competitive Equality Banking Act that brought everything to a halt, put a suspension on all new activities for a significant period of time. You can question whether any kind of legislative gambit like that that brings things to a halt doesn't advantage some people and disadvantage others, but literally in terms of passing things, it was 1987 all the way to 1999. The other side of the coin that we're not talking about of course because it's not relevant here is that while all of this stuff was going on in the securities area, an equal amount of litigation was going on about banks being involved in the insurance area. To the extent that Gramm-Leach Bliley involved securities, banks and insurance, all three had to come together in order to get the passage of the Gramm-Leach Bliley Act.

MATTHEW FINK: Well, Mike, let me ask you, did Gramm-Leach Bliley make any difference in your business?

MICHAEL BLEIER: Not really. It really had a minimal effect. I think a lot of that is due to the fact that the economic environment changed shortly after Gramm-Leach Bliley was enacted and you had the relatively poor performance of the equity markets since Gramm-Leach Bliley basically became law in November '99. The stock market's performance started to decline significantly and then subsequently you have the issue of the late trading, the market timing, directed brokerage and that would clearly increase regulatory costs which would cause one to pause before I think taking the plunge.

MATTHEW FINK: So you might say, looking back historically at an irony this kind of was almost closing full circle because when Glass-Steagall was passed by that time, most banks had gotten out of the securities business because of the Depression and the Crash, so in a sense Glass-Steagall was ratifying what had happened on the ground, and how many years later Gramm-Leach Bliley, 66 years later again ratified what had happened. Banks had gotten into the securities business, the mutual fund business, the insurance business and Gramm-Leach Bliley largely was a ratification. Now let's look at the current situation. Marty, we've had banks in the mutual fund business, depending on what date you want to pick, but it's been 20 or 25 or 15 years, have we seen any of the subtle hazards that Camp warned us about?

MARTIN LYBECKER: People have talked about that. Judge Bork in his decision, Bankers Trust 2, took the position which is I think not a terribly fair reading of the Supreme Court's opinion in Camp and decided that you had to have all of the subtle abuses in order to violate the Glass-Steagall Act, so if you had just one, that was okay and the Comptroller's office used that interpretation to expand bank brokerage into riskless principal and other kinds of

transactions. Bringing it up to the modern times, I don't know that Gramm-Leach Bliley would have made any difference, but of course you can look out and look at JP Morgan, you can look at Citibank, you can look at Bank of America, and you can see at least three major banks who had very serious relationships in virtually every possible capacity with Enron, MCI, and some of the really spectacular frauds in 2002. Newspaper writers, others have questioned whether life would have been different had the Glass-Steagall Act been there and banks not engaged in all those activities. I think technically speaking, every single activity that we're talking about was permissible before Gramm-Leach Bliley that was involved in Enron. What's very hard to tell is whether the synergy of all of those powers created anything different than what would have been there because of Glass-Steagall.

MICHAEL BLEIER: But one point though is that in part because of Gramm-Leach Bliley and in part because of other laws that allowed banks, particularly those banks, to expand, they were able to sustain the negative impact of those actions. Imagine if that had occurred 10 years earlier. Those banks would have failed.

MARTIN LYBECKER: Maybe another way to look at this is to figure out what banks have missed by not being in the right place at the wrong time. The 1970's, I remember as a time of terrible net redemptions from the early 1970's to the late 1970's. I think we all remember the early '80's as a time when the market went up and then took a 25% hit in October of 1987. That day, that Friday that the market crashed, the Chase people brought out their Vista funds and because they bought at the bottom, at the 25% trough, for the next 10 years on rolling performance, they outperformed everybody else in the industry. Banks have also been, well, there's irony, banks have also been much more conservative in the types of funds they offered because in large part, they're funds that are made available to fiduciary accounts. So for better, for worse, while everybody chased technology stocks like crazy, in the late 1990's and early 2000's with the market crash in April 2000, bank funds have not done as badly as the retail mutual funds who had the super duper all-technology, all-the-time funds that just lost a ton of money.

MICHAEL BLEIER: Let me, if you don't mind, pick up on that point. One of the reasons we were very attracted to Dreyfus is because of its conservative nature. It's very big in money market funds, very big in municipal bond funds, small in equities which at one point we were viewing it as sort of a negative and that was one of the reasons actually because of its conservative nature it had basically missed the boom that Fidelity had picked up on because Dreyfus was the biggest fund at one time, by a lot. We found its conservative nature attractive. And during the bad times in the 2000/2001 hits, money market funds went through the roof. And when the market turned up, when equities became more attractive, you know, its performance was not as strong as it had been.

MATTHEW FINK: Well let me ask a question about that. I talked before about why the mutual fund industry was concerned about bank entry, and at that time the fund industry was concerned that banks would dominate the business. Yet the latest numbers that I have are today banks only manage about 15 or 16% of total mutual fund assets. As both of you said, a lot of it, maybe 50% for all I know, but a lot of it is in money market funds, and a lot of it, as Marty just indicated, did not come really from new retail sales, but from custodial accounts or trust accounts or others. So you could say on the one hand, the banks have been in the conservative sector of the fund industry, yet they have not done nearly as well as a lot of people feared or I guess some people hoped. Do either of you share that view, or do you have an explanation for it?

MICHAEL BLEIER: I think there are a couple of answers to it, but one clearly is that scale is very important. I think Marty and I both agree that at a minimum you need to have about $20 billion of assets under management to be able to bear all the infrastructure costs and make money in the business, and as the regulatory burden increases that actual minimum size in reality grows. And you know, as we all know, the equity markets the past few years were not

performing as well as they had in the late '90's and that, the more recent years would have been the time when banks would have expanded their presence and I think that has a lot to do with the fact that they haven't been as large a factor as one would have guessed in the mid- to late-90's.

MATTHEW FINK: Let's go back on our earlier discussion of Camp. Marty, what if the banks had won, what if the Comptroller had laid out his case, the Supreme Court had affirmed the Comptroller back in '71 and banks had largely mutual fund powers way back then. Do you think banks would have a different status size in the fund industry then they do today where they're only about 16% of the fund industry assets today?

MARTIN LYBECKER: That's a hard question. There's for whatever reason, there doesn't seem to have been much benefit from being able to sell through banks. To fiduciary accounts, yes, there's certainly a huge benefit to banks in being able to rationalize the way they offer their investment management power, so to go back to the very first point I made, if it was hard to figure out how to sell common trust funds, collective funds, and it was going to have to be hard to sell Keogh's, one easy way to do that is to sell something everybody can buy, and they're all clearly eligible to buy mutual fund shares. So from an administrative standpoint, it certainly makes it easier. It gives you a common platform, makes it easier to sell. It just may not be that selling through bank branches is the optimum way to actually penetrate the retail market. Certainly bank customers have turned out to be more conservative than the person who self-selects, goes into Schwab or buys the Fidelity select portfolios. I'm thinking of people who are willing to take a lot more risk.

MICHAEL BLEIER: The growth in the funds has very much been on the equity side as opposed to the banks as we said. I think they're much more focused on money market funds and the person who wants to do that kind of investment is a different kind of person than is willing to go into a bank branch.

MATTHEW FINK: I'll give you my own contrary view. I think if the banks had entered in '71, they would dominate the industry today because in 1971, fund assets were I think below $50 billion or less. It was a tiny, tiny industry and I think banks either entering or certainly buying, we would have had a lot more Mellon-Dreyfuses back then than we had since. You look at the size of the industry is up, I can't even do the math. $50 billion to $8 trillion today, I think the industry in a sense was in its infancy and I think had the banks come in they would have become dominant then.

MARTIN LYBECKER: That may still be a good prognostication. For the same reason that Mike just mentioned, whether you look at rule 38-8-1, you anticipate how bad it's going to be when Section 404 of Sarbanes-Oxley requires internal controls certifications, or you just look at the groups that have had their reputations tarnished in the recent last couple years. It didn't surprise me at all that Wells-Fargo turned out to be the buyer for Strong. Among other things, banks still have acquisition capital. I know we're all lawyers although I'm the only one in private practice, but when you bill by the hour, whether you're a barber or a lawyer or a plumber, there's a kind of direct relationship between what you do and how much you get paid. The mutual fund industry and the asset management industry inside fiduciary accounts, they're the only ones who get paid a percent of assets in our management. As Bill Clinton likes to say or used to like to say, when everything goes up, everybody's boat floats up. I didn't get the quote quite right, but you understand the point. Well if the market goes up 25%, income goes up 25%, whether you're a lousy investment advisor or a great one. By contrast you could be shooting the lights out if the market goes down 25%, it's going to be hard for your gross not to go down 25%. It makes infrastructure much more expensive when the gross is volatile. So it leads to his point that you need scale.

MICHAEL BLEIER: One of the things is I know where 90% of our revenue is fee-based. As part of our filings we indicate that depending on how the S&P 500 does will really determine

sort of how we do from a revenue standpoint. The S&P 500 goes up a certain percent, we think our revenue will increase X amount.

MATTHEW FINK: Let me ask you. There's been a lot of predictions, both the size of the fund industry, the future likely, people think there'll be less stock market returns in the next 20 years than the past 20 years, and there's regulatory burdens you both talked about, Sarbanes-Oxley and another wave of mutual fund regulation. I guess one thing I thought of, we have a lot of banks, banks with relatively small mutual funds in the business and I was going to ask, do you think that some of those people will drop out, merge, get out of the business? But on the other hand, I think one of you just mentioned you may have banks as buyers now, like you said Wells Fargo buying strong.

MARTIN LYBECKER: Well, the big banks buying, but the little banks are going to have a very hard time with the infrastructure cost. I think they're going to end up buying other third party funds and making that available. In going down that path, Title 2 of Gramm-Leach Bliley has still not yet been implemented. Title 2 of course is the provisions that will require banks to register as broker-dealers or again in the language of today, push out the brokerage functions into an affiliated broker-dealer. That's been an extremely controversial set of proposals starting in 2001 and just last summer with new proposed Regulation B, I think, my personal view is the cost of trying to figure out how to comply with Regulation B. I mean leaving aside as Mike said before we started, figuring out how it's actually going to come out, but the cost of complying with it, however it comes out is going to be very burdensome and make it very uninteresting for small banks to be doing much in the brokerage business. If they can't sell it, then I don't know why they want to own a mutual fund family.

MICHAEL BLEIER: One other point there is that I think a lot of those banks, they're going to turn to a third party as we mentioned, have them provide the mutual fund product and likewise though when you think about scale, how many banks really have $20 billion of assets under management in the mutual fund world? There really is a handful of institutions. Not only that, how many mutual fund complexes are $20 billion or larger in size? And with increasing regulatory burden and cost, they themselves are going to be selling out as well, or looking to the larger banks to provide the funding.

MATTHEW FINK: What's interesting is for years, I guess I got involved about 1971, almost every year, people have predicted merger and consolidation in the fund industry. I haven't seen the 2004 figures. To date, we haven't seen it. But it could be now, we may see it. Let me ask a thing that did surprise me. There was an article in the *New York Times* six weeks or so ago saying that the leader, we mentioned this a bunch of times, the leader in bank entry into the mutual fund business was Citibank and there was a *Times* article speculating that just as Citibank is getting out of the insurance business by selling Travelers, Citicorp, I should say, Citicorp may be getting out of the mutual fund business. I think the article said some people at Citicorp think it does better as a distributor than as a manufacturer and therefore just as it got out of the Travelers insurance business, it would get out of the proprietary fund business. Maybe it would sell other people's funds. Do you think there's any chance, we're talking about large banks buying smaller banks, mutual fund operations, do you think there's any chance any of the large banks, take the 10 large banks, 10 largest banks in the fund business would get out of the business?

MICHAEL BLEIER: I think that's a possibility. If Citi gets out, I hope they certainly look to distribute the Dreyfus funds, but I think it depends on the reason why they got into the business. If they really viewed it as sort of a constant revenue stream, in effect an annuity, as long as you do the business well, you run a good shop, you have good performance, it's almost like an annuity stream. If they weren't looking at it that way and this is another product to be offered to their customer, then it really doesn't matter who's offering it.

One other point I just want to make before I forget is, and people don't really take this into account, is the impact the capital rules on the mutual fund business. You know, the banks

are subject to, bank affiliated funds are going to be subject to the capital rules which are really going to impose significant costs on them, which will be greater than those that the SEC's going to impose under their consolidated supervisory entity and I don't know how that's going to play out because the bank rules have not been finalized by the regulators, won't be for a while. The SEC's consolidated supervisory entity rules have basically been finalized. It'll be interesting to see how that plays out.

MARTIN LYBECKER: On a more prosaic level, the last couple of years really have been hard on everybody who has multiple functions, so whether it was Citibank or it was Merrill Lynch or it was Bank of America, having multiple regulators interested in multiple things simultaneously has caused a great deal of anguish about conflicts of interest between the business needs of different units within a large group, how they're counseled, who has the attorney-client privilege, what's in the best interest of who. Those questions, while they're easy to ask, are not easier to answer and you could see as you well know, prior to 1975, more or less '75 because it was more valuable for Wall Street to be able to sell things, the Wall Street wire houses were generally not in the mutual fund business and they flipped and went into the asset management business, finding that more attractive for many of the reasons that Mike's mentioning the banks found them attractive. You could see people re-deciding that the investment advisory business is a basic conflict with a distribution business and deciding they don't want that to be in the same house and the problems of the last couple of years have just sort of rammed that into a lot of people's throats.

MICHAEL BLEIER: Yes, and I think that's when we bought the Boston company, one of the subsidiaries that we acquired was in providing mutual fund back office services to funds, primarily to Smith Barney funds and there was a discussion about should we retain that entity, continue in that business, or would the asset management side of the house view that as potential customers of the institution, institutional customers as a conflict. And ultimately we decided to divest of it and sold it.

MATTHEW FINK: Well it will be interesting after the drive to create financial department stores is it headed the other way toward boutiques, which is not unusual. It probably goes through phases. Marty and Mike, do any of you have any last thoughts you'd like to leave on this whole subject? We've covered a lot here, both on business and legal. Do you have any? I have one question, and you mentioned, Marty, part of the mess is between a lot of different businesses you have a lot of different conflicts and you have a lot of different regulators. At the same time the Glass-Steagall debate was going on about bank powers, there was another thing about regulation, and there was a lot of talk about once we get people engaged in multiple financial businesses, banking, insurance, securities, underwriting, mutual funds, that we ought to move to a consolidated regulator. Did it make any sense to have the major financial institutions in the country engage in five lines of business facing at least five, if not 50, regulators? I haven't heard much talk about that lately. Mike, you've really been through this. You have a number of regulators.

MICHAEL BLEIER: Yes, we have a number, in actual fact, one point to note is that even before the Dreyfus transaction, we were subject to SEC regulation because we had a number of investment boutiques subject to SEC regulation. The one concern I would have with the single regulator is precisely the reason why the Comptroller should not be allowed on his own to remove a director is that it's hard to, you need to make certain that someone is acting rationally based on the facts, not out of personal animosity. I would favor multiple regulators.

MATTHEW FINK: That is our last word. Mike and Marty, I'd like to sincerely thank you for a very good discussion on bank entry into the fund business and a reminder to our audience today. Today's program is now archived in the Society's virtual museum. You can listen to the discussion again at any time, or read the transcript later on. Our four-part series on Developments in the Mutual Fund Industry will resume on Tuesday, March 22nd. Gary Cohen of Foley and Lardner, and Dick Phillips of Kirkpatrick and Lockhart will debate their differing views

on that topic. Please join them at 2 PM Eastern Standard Time and thank you very much for being with us today.