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"Banks and Mutual Funds: Addressing Conflicts of Interest"

Remarks delivered to
American Bankers Association's
Legislative Liaison Advisory Committee

Naples, Florida
February 11, 1993

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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Banks and Mutual Funds: Addressing Conflicts of Interest

I. Introduction

I appreciate the opportunity to participate in this Winter Conference of the American Bankers Association's Legislative Liaison Advisory Committee. While I primarily intend to focus on the issue of the potential legislative expansion of bank involvement in the mutual fund area and on the conflicts of interest deriving therefrom, there are a couple of other issues of mutual interest (no pun intended) that I wish to mention first.

II. Market Value Accounting

It would be inappropriate for a member of the Securities and Exchange Commission to address a banking audience without mentioning the subject of market value accounting. The Financial Accounting Standards Board ("FASB") has recently decided to continue deliberating its proposed rules in order to fine tune them, thus retaining historical cost for those securities that will be held to maturity and applying fair value accounting to other investments in debt and equity securities.

Since I am a member of the Commission, it should come as a surprise to no one that I am a market value proponent. Historical cost accounting does not result in a realistic measure of the capital of a financial institution in my opinion, and the marketplace is entitled to have better and more timely information on which to base investment decisions than is provided by historical cost accounting.

As I understand it, the principal objection to the FASB's proposed rules is that fair value accounting is only applied to certain assets and not to liabilities. According to this objection, extending fair value accounting only to the asset side of the balance sheet produces an inappropriate balance sheet mismatch resulting in a distorted picture of the capital position. This "asymmetry" objection appears to me to be a valid concern. As the FASB decides to move forward, in the future, I hope that it will attempt to address and to minimize these "distortion" concerns. I would suggest that, in the future, some portion of liabilities should be fair valued along with the assets.

I do believe quite strongly that the historical relationship between the FASB and the Commission should be maintained. Thus, the establishment of accounting standards, including decisions concerning the scope, the implementation, and the timing of any implementation of fair value accounting, properly belong in the first instance with the FASB.

While a number of other objections have been raised to the application of market value accounting to the banking industry, I wish to mention just one more briefly. Many individuals have asserted their concern that imposition of market value accounting would weaken the demand of financial institutions for long-term debt securities, including Treasury and municipal bonds. I am uncertain as to how to respond to such a concern as a general proposition since I am unable to predict the economic behavior that would result from a change to a fair value accounting standard. However, I will note that it is my understanding that commercial bank ownership of municipal bonds decreased by over $130 billion

during the years 1986 to 1992, an amount equal to almost 60 percent of their holdings at year-end 1985.

I submit that the reason for this drop in commercial bank ownership of municipal bonds was not related to any change in accounting standard, but rather to the Tax Reform Act of 1986. The Tax Reform Act apparently sapped any appetite which may have once existed for municipal bonds on the part of commercial banks. It is obvious that if our tax laws were modified to broaden the eligibility of "bank-qualified" bonds, the demand of banks for municipal bonds, whether or not long-term, would increase dramatically, regardless of the imposition of fair value accounting. I am pleased to see that the banking industry is now pressing Congress to change this provision of the Tax Reform Act because I believe it would be beneficial, for a number of reasons, for banks to own municipal bonds. I do not know that it makes any difference whether banks own long-term and short-term municipal bonds as opposed to just short-term municipal bonds.

III. Bank Tying

The other subject that I wish to mention briefly is my familiar refrain regarding bank tying violative activity.

Section 106 of the Bank Holding Company Act ("BHCA") prohibits a federally-insured bank from requiring a customer to purchase any other product or service from the bank or its affiliates, or to refrain from purchasing products or services from a competitor, as a condition of obtaining credit or any other service from the bank. Both the federal bank regulatory agencies and the Department of Justice are responsible for the enforcement of this provision. These agencies have a variety of enforcement tools available for this purpose including district court injunctions, cease-and-desist orders, and civil money penalties. For whatever reason, enforcement actions in this area have rarely been brought. There are indications though that this historical enforcement inaction may be changing. I hope that is the case.

I am reasonably convinced that some bank tying violations are occurring, but I am unable to quantify the level of abusive activity that is taking place. The complaints that I have received in the past generally allege that a bank is tying its credit enhancement services to the use of its underwriting or other services in a securities transaction. I do believe that the majority of banks are not violating the tying limitations.

The Commission, of course, has no authority to enforce federal banking laws. Commission jurisdiction to promulgate a rule to reach tie-ins of this nature does not appear to exist. Current regulatory provisions empower the Commission only with sufficient rulemaking authority to address tie-in arrangements in connection with the offer, purchase, or sale of a security and not, for example, in connection with the offer of underwriting or other services themselves. I do not anticipate that Commission jurisdiction in this area will be made broader in the near future.

I suppose that the Commission could ultimately become unduly concerned that issuers using the services of securities

affiliates of commercial banks to underwrite securities may not be accurately portraying the total amount or value of direct or indirect fees, inducements, or other compensation or consideration being paid or received in connection with an underwriting. Arguably this information could be of interest to potential investors in evaluating the performance of the underwriter. Accordingly, in order to fully disclose these related fees, the Commission could encourage the National Association of Securities Dealers ("NASD") to view these fees as underwriter compensation such that disclosure would be required in Item 508(e) of Regulation S-K. I am not advocating such an action at the present but merely allude to the potential for such an action. Rather, at this time, I support reliance on an existing less intrusive means of reducing the incidence of bank tying violations, namely, increased enforcement of bank tying restrictions.

I am of the view that whatever level of bank tying violative activity is taking place could be discouraged through increased enforcement of existing rules. This would not

require amendments to, or new interpretations of, those or other rules. It appears to me then that it would be in the best interest of the banking industry to press for more aggressive enforcement action in this area, when the facts so warrant, in order to ensure that the majority of banks are not tainted by the activities of a minority.

In the past, I have challenged the banking industry to bring possible tying violations to the attention of the bank regulators for enforcement consideration. Initially my challenge was more hotly opposed than warmly accepted, which left me rather puzzled and confused. I do not believe that this was too much to ask. Surely banks are generally aware of the activities in which their competitor banks are involved. If a competitor has either crossed, or is stretching the boundaries of, Section 106 of the BHCA, a bank should notify the federal banking regulators. Certainly industry self-policing appears to me to be far preferable to the other alternatives which have been advocated in the past to prevent bank tying violations.

One such alternative that has been advocated is the provision that was contained in the 1991 bank reform bill which would have barred a bank from extending credit to, or for the benefit of, an issuer of securities distributed by a securities affiliate until 90 days after the end of the distribution, unless the bank created an extensive paper trail demonstrating non-tying. I know that the banking industry would not welcome such a provision. So again, I encourage the banking industry to accept my challenge and to step up its self-policing efforts. It is not too much either to ask or to expect, and I believe that self-policing represents the most appropriate as well as the least intrusive method to address bank tying abuses.

IV. Bank Mutual Fund Legislation

I wish to spend the remainder of my time today focusing on legislation to expand the involvement of the banking industry in the mutual fund area and on some suggestions to address the conflicts of interest presented by such expanded bank involvement.

Congressman Hoagland of Nebraska has recently reintroduced legislation that would permit national banks, state member banks, and bank holding companies to engage in the business of dealing in, underwriting, and distributing the shares of investment companies, and to organize, sponsor, manage, or control investment companies by conducting those activities through nonbank subsidiaries or affiliates. While I support the thrust of this legislation, I believe that certain additional amendments to the Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisers Act of 1940 ("Investment Advisers Act") are necessary to address certain potential conflicts of interest that would arise if the bill was enacted. I will now discuss several such suggested amendments.

V. Investment Advisers Act

The bill should be amended to require a bank that advises a registered investment company to register with the Commission as an investment adviser. The Investment Advisers Act currently excludes banks from the definition of

investment adviser. Consequently, banks that advise investment companies are not required to register as investment advisers or to comply with the Investment Advisers Act's antifraud, disclosure, and other provisions. All other financial service providers that advise registered investment companies are required to register under the Investment Advisers Act.

Registration of banks that advise registered investment companies would strengthen the Commission's oversight of investment companies. Currently, the Commission's examiners may examine the books and records of an investment company advised by a bank, but generally not the adviser's records. The examiners need to review both sets of records in order to obtain a more complete picture of the investment company's operations. In addition, banks that advise investment companies are not required to show the Commission's examiners records relating to their private advisory clients and trust customers. Therefore, Commission examiners are able only to see one side of any transaction

between a registered investment company advised by a bank and the bank's trust customers and other advisory clients. As a result, Commission examiners do not have ready access to the information needed to detect front-running by the bank, joint transactions involving the registered investment company and the bank's other clients, or other violations of the securities laws.

The Commission's examiners also are not now permitted to look at a bank's records relating to the extension of credit to customers. This prevents examiners from detecting relationships between the customers to whom the bank extends credit and the issuers whose securities the bank causes its investment companies to purchase.

Registration of banks that advise investment companies under the Investment Advisers Act would further functional regulation. It would subject these banks to the same requirements as other investment advisers, including the Act's antifraud provisions and restrictions regarding payment of cash solicitation fees, agency cross transactions and

principal transactions. Such banks also would be subject to restrictions regarding performance fees. Moreover, such banks would be subject to the Investment Advisers Act's disclosure requirements.

VI. Investment Company Act

A. Affiliated Bank Custodians

The bill also should contain a provision amending the Investment Company Act to give the Commission authority to adopt regulations governing the conditions under which banks may serve as custodians of affiliated investment companies. Without this provision, a bank could cause its affiliated investment company to select the bank as the fund's custodian, thereby depriving the fund of an independent custodian and thereby creating the potential for abuse and self-dealing. Investment companies that use affiliated custodians other than banks are already subject to Commission rules governing the conditions under which those entities may serve as custodians.

Further, the bill should be amended to contain a provision that establishes for any custodian of an investment company (including a bank), a federal standard of fiduciary duty in dealings between the fund and its custodian. This provision would recognize the need for an entity charged with safekeeping investment company assets to have a fiduciary duty toward that investment company.

B. Self-dealing Transactions

Moreover, the bill should contain a provision amending the Investment Company Act to prohibit an investment company from knowingly acquiring a security, during the existence of an underwriting syndicate, if the proceeds from that acquisition would be used to retire an indebtedness owed to a bank where the bank or an affiliated person thereof is an affiliated person of the investment company. This amendment would address the potential conflict of interest that arises when a bank acts both as lender with an interest in loans being repaid and as adviser or underwriter of an investment company.

In addition, the bill should contain a provision amending the Investment Company Act to prohibit an investment company from borrowing from an affiliated bank except as permitted by Commission rule. This amendment would permit the Commission to adopt regulations addressing the potential conflicts of interest that arise in such an situation.

The bill also should give the Commission authority to adopt regulations designating any person or class of persons as "affiliated persons" of an investment company by reason of having had, at any time since the beginning of the last two completed fiscal years of the investment company, a material business or professional relationship with the investment company or with any person that is a principal underwriter for, or promoter or sponsor of, the investment company.

C. Pass-through Voting

The bill should be amended to contain a provision addressing a conflict that arises when a bank holds a controlling interest in a fund that it advises. In that situation,

an adviser should be required to either pass through the power to vote the shares of the investment company to the beneficial owners of the shares, vote the shares of the investment company held by it in the same proportion as shares held by all other shareholders, or make some other arrangement for voting the shares as permitted by the Commission.

This provision would address the potential conflict of interest that exists when a bank both advises an investment company and owns a controlling interest as trustee to shareholders of the investment company. The bank has an incentive to vote any investment company shares that it controls as a trustee in favor of retaining itself as investment adviser. Restricting the advisers's ability to vote fund shares should ameliorate this concern.

D. Independent Directors

The bill should be amended to strengthen the independence of investment companies' boards of directors. First, the bill should amend the definition of "interested

person" in the Investment Company Act to include any person (or any affiliated person of that person) that, at any time during the preceding six months, has executed any portfolio transactions for, engaged in any principal transactions with, or loaned money to, the investment company or any other investment company having the same investment adviser, principal underwriter, sponsor, or promoter. The bill also should amend the definition of "interested person" to include any employee of a bank that acts as custodian or transfer agent for the investment company. These interested persons would not be prevented from serving as directors of that investment company; rather, they would merely be considered "interested persons" for purposes of the required percentage of independent directors of that investment company.

Second, the bill should amend the Investment Company Act to provide that no registered investment company may have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank

and its subsidiaries or any one bank holding company or its affiliates and subsidiaries. The Investment Company Act currently prohibits a registered investment company from having a majority of its board of directors consisting of officers, directors, or employees of any one bank. Such an amendment would prevent banks from circumventing the legislative intent of this prohibition by operating under a bank holding company structure.

E. Double-charging of Advisory Fees

The bill should be amended to contain a provision that makes it unlawful, with certain exceptions, for a bank or its affiliate to exercise discretion over fiduciary accounts to purchase as fiduciary any securities issued by the affiliated investment company unless any investment advisory or similar fee received with respect to the fiduciary assets invested in securities of the investment company is waived. This amendment would prevent a bank from collecting two advisory fees in this situation and should prevent a bank from

using its fiduciary accounts as a captive market to increase the bank's advisory fees.

The bill also should be amended to contain a provision that prohibits, with certain exceptions, the conversion of bank common trust funds into affiliated investment companies unless the bank waives any advisory fee received from the investment company. This provision would protect common trust fund participants from overreaching and from unfairness that may occur in the conversion process.

F. Chinese Wall

The bill should be amended to contain a provision that prohibits a bank that is an investment adviser to an investment company from providing access to material nonpublic information to employees or agents that provide investment advisory services to the investment company. Such a provision would protect against any unfair advantage that might be gained from disclosing material information that would be available solely because of the bank's unique access to customer information.

G. Extending Credit to Facilitate Purchase of Investment Company Shares

The bill should be amended to contain a provision that prohibits a bank from making loans to customers to be used to purchase shares in an investment company that is affiliated with the bank. The bill also should be amended to prohibit a bank from extending credit to customers on investment company shares they already own except under certain specified circumstances. This second provision would place banks on an equal footing with a broker-dealers' ability to extend credit. When a bank sponsors or advises an investment company, or underwrites securities issued by an investment company, the bank may be tempted to make unsound loans to customers to enable them to purchase shares of the fund in order to increase the underwriting and/or advisory fees to the bank or its affiliate. The amendments that I suggested should address this concern.

VII. Other Concerns -- Federal Reserve Act

Finally, I wish to point out that the Hoagland legislation would permit a bank to engage in investment company

activities either through a nonbank subsidiary or an affiliate, despite the considerable operational differences between these two types of entities under federal banking law. For example, under current federal banking law, a subsidiary of a bank is considered to be an extension of the bank itself. Thus, the nonbank subsidiary's capital is generally included in the calculation of the parent bank's capital. On the other hand, a nonbank affiliate of a bank holding company is entirely separate from a bank affiliate. The bank holding company must separately capitalize the nonbank affiliate, and the nonbank affiliate's capital is not counted as capital of any affiliated bank. Since bank subsidiaries are not subject to the conflict of interest and self-dealing restrictions that are applicable to bank holding company affiliates under Sections 23A and 23B of the Federal Reserve Act, this highlights the need in my judgment for appropriate amendments to the Investment Advisers Act and to the Investment Company Act to protect mutual fund shareholders from conflicts of interest.

VIII. Conclusion

In my opinion, the Hoagland bill as amended by my suggestions should benefit both the banking industry and mutual fund investors. That is an objective everyone should support.