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FUNCTIONAL REGULATION

An Analysis of Two Types of Pooled Investment Funds

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The Honorable Jake Garn
Chairman, Committee on Banking, Housing
and Urban Affairs
United States Senate

The Honorable Fernand J. St. Germain
Chairman, Committee on Banking, Finance
and Urban Affairs
House of Representatives

The Honorable John D. Dingell
Committee on Energy and Commerce
House of Representatives

There has been public debate by federal regulators, trade associations and congressional committees on whether the current federal structure for regulating financial institutions should be changed. This report examines the implications and considerations associated with applying a regulatory concept commonly referred to as "functional regulation" to two similar financial products--mutual funds and bank-sponsored collective investment funds. The functional regulatory concept would subject similar financial products and services to similar regulatory schemes regardless of the historical industry classification of the institution offering the product or service.

Copies of this report are being sent to the Comptroller of the Currency, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Securities and Exchange Commission, and interested Committees of the Congress.

William J. Anderson
Director

Executive Summary

The regulation of financial products and services has been based largely upon the industry classification of the institutions providing the product or service. The concept of functional regulation proposes to change this historical regulatory scheme. Regardless of whether the financial institution providing the product or service is a bank, investment company, or insurance company, functional regulation would subject similar financial products and services to similar regulatory treatment. Otherwise, historical regulatory differences ascribed to similar financial products and services which compete in a common market place may give one product or service an unfair competitive advantage over another.

This report focuses on the regulation of two similar financial products—mutual funds and bank-sponsored collective investment funds. In this report, GAO describes their product and regulatory characteristics, GAO illustrates product similarities and regulatory differences, and GAO discusses the implications of two contrasting means to implement a functional regulatory scheme for these two types of pooled investment funds.

Background

The Securities and Exchange Commission (SEC) and securities industry representatives have identified mutual funds and collective investment funds as suitable for functional regulation because they share certain product characteristics and, in some cases, can compete for the same customers. These two products pool customer assets for diversified investment purposes using similar investment objectives and portfolios. Competition among the funds is most prevalent for the investment of employee benefit plan assets.

Collective Investment Funds

A collective investment fund is a trust product offered by bank trust departments to fiduciary accounts which may derive a benefit from the collective management of their assets. Other trust services include safekeeping customer assets, providing investment advice, providing accounting or recordkeeping services, and serving as administrator for personal estates or employee benefit plans. Collective investment funds, however, are only available for assets held in trust.

Collective investment funds dominated by federally tax-exempt employee benefit plan assets are known as commingled investment funds. These funds are regulated under state and federal fiduciary laws and regulations. Essentially, these laws impose stringent fiduciary duties and responsibilities on managers of commingled funds. GAO concentrated its analysis on commingled investment funds because they compete directly with mutual funds for the investment of employee benefit plan assets.

Mutual Funds

Mutual funds are investment companies that offer common stock to the public and are primarily in the business of investing in securities. Mutual funds offer for sale to shareholders redeemable securities of which they are the issuer. Mutual funds are regulated under state and federal securities laws. Essentially, these laws impose fiduciary duties on officers, directors and advisers to mutual funds. Further, they impose penalties for fraud; require full, fair and accurate disclosure of investment information; and regulate a fund's corporate structure, accounting procedures, and sales practices. As shareholders, mutual fund investors have an ownership share in the investment company and a vote on certain fundamental policies and issues.

Results in Brief

In order to apply the concept of functional regulation to mutual funds and commingled investment funds, current regulation must be changed. The efficacy of functional regulation for these two pooled investment products will be determined by what changes are made to resolve current regulatory differences.

GAO's Analysis

Functional regulation has been proposed as a regulatory concept in different contexts. During congressional hearings over the last several years, a variety of bills have been introduced which would expand the securities activities of banks into new areas. Officials at the SEC and the Department of Treasury, as well as representatives in the securities industry, have proposed to subject these new bank products to regulation by the SEC under existing securities laws in order to achieve functional regulation. In this instance, the same products offered by providers in different financial industries would be subject to the same regulations and oversight by the same regulator. In another context, which is the subject of this report, the SEC and securities industry representatives have also proposed to apply the concept of functional regulation to two existing similar products—mutual funds and collective investment funds. In this second context, a range of choices exists concerning which regulatory changes may be necessary to achieve a more similar scheme of regulation. (See p. 59)

GAO found basic regulatory differences between these two products. For example, commingled investment funds can only be offered to trust customers. Shareholders in a mutual fund have a vote on the advisory contract with the firm that manages the mutual fund, whereas participants in commingled investment funds do not. Other regulatory differences exist in the areas of liquidity, portfolio diversification, registration fees, and advertising. (See pp. 53 to 59)

Applied Functional Regulation

Although proponents of functional regulation assert that similar products and services should be subjected to similar regulatory treatment, they do not offer a framework within which to implement functional regulation. Because of this GAO constructed two scenarios that illustrate the application of the functional regulatory concept to the two types of pooled products included in its study. In one scenario, GAO discusses conflict-of-interest and other concerns that will arise if commingled investment funds are replaced by mutual funds. In the other scenario, GAO describes how functional regulation might be achieved by creating a new type of financial product without changing the current regulation of commingled investment funds and mutual funds. Either scenario could achieve the goal of functional regulation. (See pp. 62 to 71)

Agency Comments

GAO received comments from the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (OCC). The only significant objection that any agency had to the report was a concern expressed by OCC that functional regulation can best be achieved through product deregulation in which banks, through affiliates, could offer mutual funds and securities firms, through affiliates, could offer collective investment funds. It believes that, by using two scenarios in which supervision for investment companies will prevail, readers may be misled. GAO believes, however, that the report prominently states that there are many ways to achieve functional regulation.

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Abbreviations

DISA	Depository Institution Securities Affiliate
ERISA	Employee Retirement Income Security Act
FDIC	Federal Deposit Insurance Corporation
FRS	Federal Reserve System
GAO	General Accounting Office
ICI	Investment Company Institute
IRC	Internal Revenue Code
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission

Chapter 1

Introduction

Financial institutions and the products and services they provide to consumers are undergoing rapid change. Traditionally, each type of financial institution was limited largely by either law or interpretation of law to specific products and services in well defined markets. However, these barriers are eroding either through legal change or new interpretations of existing law. Different types of institutions are becoming more similar and competing more directly.

The federal regulatory system for financial institutions has evolved over many years in a piecemeal manner in response to specific problems or concerns. The present system can be characterized largely as one with different regulatory agencies for different types of financial institutions. The Securities and Exchange Commission (SEC) and securities trade associations perceive this regulatory system as varying significantly among different types of institutions. Their concerns are that there is little difference between some financial products and services other than the way they are regulated and that competitive advantages may be determined by regulatory differences rather than market forces.

During the early 1980's, these concerns have given rise to discussions before congressional committees, at a major issues conference sponsored by the SEC, and by a vice-presidential task group on regulation of financial services about the need for regulatory reform. During these discussions, a concept commonly referred to as "functional regulation" was advocated by some proponents of reform. In general, this concept would subject similar financial products and services to similar regulatory schemes regardless of the historical industry classification of the sponsoring organization, that is, regardless of whether the sponsor is in the banking industry, the securities industry, or one of the other financial service industries. The principal rationale for suggesting such a regulatory change is that similar products compete in the marketplace yet a difference in laws or regulations may give one competitive advantages. Functional regulation would help to minimize such advantages by equalizing regulatory treatment of competitors—commonly referred to as creating a "level playing field."

However, there is no consensus on the specific characteristics of functional regulation. Financial products and services that are identical would be regulated identically under this concept, but the application of a similar regulatory scheme to products and services that are merely "similar" is more problematical. To implement a functional regulatory system, decisions would be required concerning what factors would make these products sufficiently similar to warrant a similar regulatory scheme and how similar their regulation should become.

Despite the lack of a common definition, a good deal of attention has been given to this concept. Government and industry officials continue to question whether the present regulatory structure is appropriate. In light of the many changes occurring in the industry, it is likely that the Congress will consider proposals to allow institutions to sponsor products outside of their traditional industry base. Indeed, some past proposals would have required a realignment of the regulatory structure along functional lines.[1] While none of these proposals has been enacted, there is a strong likelihood that initiatives to eliminate perceived regulatory variations will continue to be generated until Congress acts on the matter in some way. For example, on July 1, 1985, the SEC adopted a rule, to become effective on January 1, 1986, that generally requires banks which offer brokerage services to the public to register those operations with the SEC. Banks are exempt from broker-dealer definitions under the Securities Exchange Act of 1934, but the SEC adopted its rule not as a result of bank abuses but out of a belief that two competing businesses should be governed by the same rules.

Because of public debate by congressional committees and regulators on proposals involving functional regulation, we elected to analyze some of the implications of applying the general concept to two similar products offered by two different types of financial institutions. We examined the application of functional regulation to open-end, managed investment companies (commonly referred to as mutual funds) and certain collective investment funds operated by trust departments of commercial banks. Both mutual funds and collective investment funds are pooled investment products. A collective investment fund is created within a bank's trust department to pool and manage collectively the assets of separate trust accounts for which the bank acts as fiduciary. A mutual fund is formed to pool and manage collectively money invested by shareholders drawn from the general public. The critical distinction here

[1] A series of bills has been introduced in the Congress including S.1720 (97th Congress), S.1609 (98th Congress), S.2181 (98th Congress), and S.2851 (98th Congress) which to varying degrees would have authorized depository institution holding companies to engage in securities activities. These securities activities include dealing in, underwriting, and purchasing government and municipal securities and sponsoring, underwriting, and managing investment companies. The holding company structure was required to assure that all firms in a particular business (i.e. the securities business) would be treated the same in terms of regulation. Further, one objective stated in a July 2, 1984, report by the Vice-President's Task Group on Regulation of Financial Services entitled, Blueprint for Reform, was that regulation by function should be implemented where practicable so that comparable activities conducted by different types of financial institutions would be regulated equivalently to the maximum possible degree.

is that while general public customers of mutual funds can include trust assets, customers of collective investment funds are limited solely to trust assets.

Mutual funds are primarily regulated at the federal level by the SEC. As bank products, collective investment funds are regulated by the Office of the Comptroller of the Currency (OCC) at the federal level and supervised by the various federal bank regulators.[2] Bank regulation and mutual fund regulation is not identical. Bank regulators protect trust customers by seeking to assure the safety and soundness of banks and by assuring that fiduciary responsibilities are carried out in a prudent manner and in accordance with laws and regulations so as to preclude events that could adversely impact either the account customers or the bank. SEC emphasizes protecting investors and the stability of securities markets through assuring full and fair disclosure and through structural safeguards. Bank regulators' procedures stress frequent examination and evaluation of bank management and operations. SEC's procedures stress full and accurate disclosure to investors, specific operating procedures (e.g. restrictions for capital structure, custody of assets, transactions with affiliates), and periodic on-site examinations.

Mutual funds and collective investment funds do have operational similarities that can be viewed as serving a similar economic function: they each pool money from others for investment purposes. By pooling assets, both types of funds can achieve (1) greater diversification, and thus reduced risk, (2) increased access to professional money management for small investors, and (3) economies of scale in relation to fees charged that may benefit the customer.

Objectives, Scope and Methodology

We decided to compare mutual funds and collective investment funds because proponents of functional regulation have cited these financial products as particularly suitable for a functional regulatory approach. SEC, the primary regulator of the securities industry, said in its October 6-8, 1982, "Conference on Major Issues Confronting the Nation's Financial Institutions and Markets in the 1980s," that a functional regulatory approach is needed in some areas to simplify and rationalize our outdated regulatory system. It specifically cited mutual funds and collective investment funds as suitable for more similar regulation because

[2]The Office of the Comptroller of the Currency (OCC) supervises nationally chartered banks; the Federal Reserve System (FRS) supervises state-chartered, system member banks; and the Federal Deposit Insurance Corporation (FDIC) supervises state-chartered, insured, non-member banks.

they serve similar functions under different regulatory requirements. Further, the Investment Company Institute (ICI), in its February 12, 1982, testimony before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, suggested that, to enhance competitive equality, all bank collective investment funds be transferred to a securities affiliate of a bank and be subjected to full SEC jurisdiction. At the same hearings, the Securities Industry Association essentially had the same recommendation.

In order to examine the complex issues surrounding functional regulation involving similar and competitive products offered by different financial institutions under different regulatory requirements, we elected to use a case study approach. The case study method characteristically involves a detailed description and analysis of a complex phe nomenon by examining one or more of its component parts. The value of this approach is that it provides detailed information about the phenomenon under study. However, a case study methodology cannot lead to generalizations or projections beyond the limited area examined. The phenomenon in this case study is the concept of functional regulation. The component part of functional regulation we examined in detail was the regulation of certain pooled investment products.

For reasons discussed previously, proponents of functional regulation contend that bank-sponsored collective investment funds and mutual funds offered by investment companies should be subject to similar regulatory treatment. Therefore, as one component of our case study, we describe in detail the regulation of mutual funds under securities laws. In the United States in 1983, there were approximately 1,000 mutual funds, excluding the money market mutual funds, with total assets of approximately $113.6 billion. Although SEC does not collect data on the extent to which pension and profit sharing plans invest in mutual funds, ICI indicates that these plans have invested approximately $6 billion in its members' mutual funds.

On the other hand, we found that there are a number of different types of bank-sponsored collective investment funds, the regulation of which differs depending upon participating account categories. The case study approach, in this situation, dictated that we limit our scope to one type of collective investment fund because of the complexities involved with an examination of all types of collective investment funds. As a result, we compared the regulation of mutual funds with the regulation of collective investment funds which contained the largest volume of a single category of account assets. We found that the largest single category of account assets participating in all classifications of bank-sponsored collective investment funds was employee benefit plans. We also found that mutual funds compete with banks for the investment of employee benefit plan assets.

The four major bank-sponsored collective investment fund classifications represented by participating account categories are employee benefit, personal trust, Keogh, and charitable trusts.[3] Approximately 68 percent ($106 billion) of the total account assets participating in all classifications of bank-sponsored collective investment funds ($155 billion) are employee benefit category assets. Ninety-nine percent of these assets are corporate employee benefit plan assets, as opposed to Keogh Plan, Individual Retirement Account (IRA), or government employee benefit plans assets.

Of the remaining 32 percent ($48.6 billion) of total account assets participating in all classifications of bank-sponsored collective investment funds, 90 percent ($43.8 billion) are composed of personal trust assets. The remainder is composed of Keogh, charitable, and other account categories.

Although commercial banks in 1983 held an estimated $30 billion[4] in total Keogh Plan and IRA assets combined, no more than $1.5 billion[5] of these account assets were invested in bank-sponsored collective investment funds. This means that only 1 percent ($1.5 billion) of the total account assets participating in all classifications of bank-sponsored collective investment funds ($155 billion) in 1983 were Keogh Plan or IRA account assets.

In this case study, therefore, we further concentrated our examination on comparing the regulation surrounding mutual funds and bank-sponsored commingled[6] investment funds for corporate employee benefit plan assets. We did this because over two-thirds of the total assets participating in all classifications of bank-sponsored collective investment

[3]Except for where identified in the following text, the figures reported here are derived from data compiled by the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of the Comptroller of the Currency for subject banks and are contained in the Federal Financial Institutions Examination Council's publication, Trust Assets of Banks and Trust Companies-1983.

[4]American Council of Life Insurance publication, Pension Facts, 1984-1985. This figure corresponds to Federal Reserve Board estimates.

[5]According to Federal Reserve Board estimates.

[6]GAO used this term to differentiate these funds from common trust funds.

funds are corporate employee benefit plan assets and these assets usually participate in commingled investment funds as defined by OCC Regulation 12 C.F.R. 9.18(a)(2).[7] We describe common trust funds defined by OCC Regulation 12 C.F.R. 9.18(a)(1)[8] as a contrast to commingled investment funds because they can and do include some employee benefit plan assets under different regulatory requirements. Because they are dominated by personal trust account assets, however, common trust funds are viewed by some bank regulators, SEC officials, and securities industry representatives to be less competitive with mutual funds than commingled investment funds.

Our objective in this case study was to identify and examine the implications and considerations associated with applying a functional regulatory scheme to two apparently similar and competitive financial products. We compared the regulation of mutual funds with the regulation of collective investment funds for employee benefit plan assets because of their operational similarities and because they compete for the investment of employee benefit plan assets.

In attempting to define functional regulation, we examined past legislative proposals and related testimony and met with regulatory officials. However, we have not commented on any specific legislation which allows banks to sponsor securities products.

Our purpose was not to recommend any particular mode of regulation. Rather, we point out some of the issues which will be encountered if a functional regulatory scheme is considered for these two particular financial products.

In conducting our analysis, we compared and contrasted several key characteristics of pooled investment funds including characteristics of the funds themselves, the institutions sponsoring them, and the regulation to which they are currently subjected. Elements we examined in our analysis include:

- Product characteristics.

[7] A fund consisting solely of assets of retirement, pension, profit sharing, stock bonus or other trusts which are exempt from federal income taxation under the Internal Revenue Code.

[8] A common trust fund is maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as trustee, executor, administrator, guardian, or custodian under a Uniform Gifts to Minors Act.

- The organizational structures within which mutual funds and collective investment funds are offered.
- Federal legislation and statutory requirements.
- Federal regulatory objectives, policies, and methods.
- State regulatory activities.

These elements are listed in appendix I.

We identified similarities and differences in many of these areas under the existing regulatory structure. We assessed specific product similarities and regulatory differences and explored the implications of functional regulation involving mutual funds and collective investment funds with securities and banking industry representatives and these industries' respective federal and state regulatory officials.

To obtain a better understanding of pooled investment funds, we met with industry representatives and examined pertinent laws and available literature including government and industry publications. We spoke with employee benefit plan administrators in an attempt to pinpoint where mutual funds and collective investment funds actually compete. Additionally, we spoke with Department of Labor officials about their requirements for employee benefit plans and with Internal Revenue Service officials about tax aspects of collective investment funds. We did not, however, attempt any comparison of the performance of these pooled funds.

We gathered information about the supervision of pooled funds at the headquarters of the primary federal regulators—SEC, OCC, FRS, and FDIC. We verified our understanding of regulatory policies and procedures (although we did not actually evaluate their implementation) through interviews, direct observation of an examination, and a review of policy documents at the headquarters and the New York and Chicago regions of the regulators. Further, we met with responsible New York State and Illinois regulatory officials and contacted similar officials by telephone in other states including West Virginia, North Carolina, Kentucky, Maryland, Florida, New Jersey, Virginia, Delaware, and Georgia. New York and Illinois were the focal points of the study because the trust assets held by banks in these states were significantly greater than in most other states.

Collective investment funds managed by savings and loan associations were not included because these institutions only recently received authority to offer trust services and their collective investment funds are not exempted from the Investment Company Act of 1940. Further, we did not include pooled investment funds offered by limited purpose trust companies in our work because there did not appear to be a significant number of these funds supervised by a federal bank regulator.

Agency Comments

We obtained comments from the Securities and Exchange Commission and the three federal bank regulatory agencies—the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency. The full texts of these comments appears in appendices II through V. SEC had no major problem with this report. However, it offered numerous suggestions for technical improvements, many of which have been incorporated throughout the report. FDIC made several comments regarding this report but neither agreed nor disagreed with its contents. FDIC stated that the draft report implied that collective investment funds are not subject to fiduciary standards, whereas mutual funds are. In response, we have placed greater emphasis on the applicability of fiduciary standards to collective investment funds on page 2 of the executive summary of our report. We believe, however, that our treatment of fiduciary standards pertaining to collective investment funds and mutual funds in the body of our report is adequate and accurate. Also, in response to FDIC comments, we recognize, on pages 9 and 10 of the report, that the difference in the application of fiduciary standards for the two types of funds is due to the different customer base for each. The Federal Reserve agreed with the contents of this report. OCC's only criticism of our report was that they felt a different scenario should have been presented in chapter 5. Both the Federal Reserve and OCC provided us with some oral editorial and technical suggestions, most of which we used to make refinements to the text.

OCC criticized our draft report because they felt that the scenario comparisons we used in chapter 5 were not parallel and left a biased impression in the mind of the reader. OCC states that the report could be misinterpreted because the two scenarios presented in chapter 5 do not represent two extremes of the spectrum, rather they both suggest that the supervision for investment companies will prevail. OCC believes that functional regulation can best be achieved through product deregulation. Under product deregulation securities firms would establish affiliated trust companies operating commingled investment funds subject to bank regulation, while banks would establish securities affiliates to operate investment companies under securities laws.

We agree that the functional regulatory concept could be achieved through product deregulation as suggested by OCC. We do not agree with OCC, however, that our report will bias the reader because of the scenarios that we used to illustrate different ways of implementing the concept of functional regulation.

Because of the vagueness of the functional regulatory concept as it might apply to similar products, we believe some discussion is needed in the report of applying functional regulation within the framework of actual, specific proposals. We, therefore, developed two scenarios for inclusion in the report based largely on specific proposals. One proposal was advocated by the banking industry and actively considered by a congressional committee and the other proposal was advanced by SEC. The report clearly states the limitations on using the two scenarios. On page 13 we state that we are not recommending any particular mode of regulation. On page 62, we state that the two scenarios are neither designed to predict what will or should happen in the future nor to portray the most likely alternatives.

Nature of Pooled Investment Funds and the Institutions That Offer Them

Although both mutual funds and collective investment funds involve the pooling of funds and the management of investments for the benefit of others, important differences between them exist. A principal difference is that mutual fund shares can be made available to any segment of investors while collective investment funds are only available for the investment of trust assets; collective investment funds were created to more effectively manage the assets of trust department clients.

Both participants of collective investment funds and investors in mutual funds seek professional management of their assets. Because investors in a mutual fund are its shareholders, they may be called upon to vote on certain fundamental matters affecting the mutual fund's operation. Conversely, clients seeking trust services of the bank may rely more fully on the professional asset management function of the bank since in many cases investment discretion is vested with the institution.

Differences also exist between the two types of collective investment funds examined in this case study, common trust funds and commingled investment funds. Specifically, commingled investment funds are typically more similar to mutual funds than are common trust funds. The main reason for this is that commingled investment funds are dominated by employee benefit plan accounts which have a right to withdraw from the commingled investment fund similar to the right of investors to redeem their shares of a mutual fund. Each of the accounts participating in common trust funds, however, has established a traditional fiduciary relationship with the bank, a relationship which is presumed to be longer in term than the more tenuous investor type of relationship. These differences in relationships cause differences in the institutions' responsibilities as defined through the body of federal and state trust and securities laws and, as we shall discuss in chapter 3, differences in how the various types of funds are regulated.

Mutual Funds: Publicly Offered Securities Products

The mutual fund is a pooled investment fund with an organizational structure, normally incorporated under state law,[1] that

- receives money from shareholders in exchange for shares or units of beneficial interest;
- pools that money for investment in a portfolio of securities;

[1] A mutual fund may also be organized as a business trust (also referred to as a Massachusetts Trust) which is an unincorporated business association established by a declaration or deed of trust. Trustees act as directors and hold and manage the property for the benefit of the beneficial owners who are the shareholders.

- employs a professional investment adviser to manage the portfolio for a fee;
- seeks a return; and
- is required to pay shareholders on demand for the current value of their investment.

A mutual fund is an open-end management investment company, which means that (1) normally, it continuously issues and offers for sale redeemable securities which represent an undivided interest in the fund's assets and (2) management can buy and sell securities for the portfolio as long as such transactions are designed to meet the fund's investment objectives. This distinguishes a mutual fund from other investment companies that may have a fixed portfolio, a limited established life-span, or a finite number of non-redeemable shares predominantly issued through a one-time public offering and traded in the secondary market.

A mutual fund share is a highly liquid investment because of its sales and redemption features. Whenever a mutual fund sells or redeems its shares, it must compute both the market value of the securities held in its portfolio, and, based on this, the value of its outstanding shares—referred to as the net asset value of a share. When investors buy shares in a fund, they obtain them directly from the fund itself or from a broker at the net asset value plus any sales commission—referred to as a load. The mutual fund shareholders may at any time redeem their investments at the current net asset value of the fund's shares.

The proceeds from the sale of securities issued by a mutual fund are invested in its portfolio which is designed to meet the fund's stated investment policy. Some funds invest primarily in securities offering long-term growth, others in current income, still others in particular industries or classes of securities. Many funds offer various combinations of these objectives.

The mutual fund itself is not subject to federal income tax. Under the Internal Revenue Code, mutual funds generally are permitted to distribute investment income and capital gains to their shareholders without first paying a tax on them. Shareholders, however, are subject to taxation for their proportional share of income and capital gains realized by the fund. To maintain this tax treatment, mutual funds must meet the portfolio diversification requirements of subchapter M of the Internal Revenue Code.

Formation and Management of a Mutual Fund

Securities laws and regulations provide guidelines for the establishment and structure of a mutual fund. Any individual or group can form a mutual fund if the securities laws are followed but, typically, a securities firm or investment advisor will invest the initial capital—a minimum of $100,000—to form a new fund. As a corporation or business trust, the fund has a board of directors or trustees that act as directors and shareholders that hold equity ownership in the portfolio of securities. This portfolio represents the assets of the corporation or business trust.

Typically, a mutual fund has no employees. Instead, it contracts for all services including its management and shareholder servicing functions. Contracts are entered with an investment adviser, principal underwriter, custodian, transfer agent, and external auditor. The key agreement is made between a mutual fund and its investment adviser. This is critical because in most cases an advisory firm not only conducts securities research but also is responsible for the day-to-day operation of the fund itself. The adviser normally has the authority to execute portfolio transactions in accordance with the fund's overall investment objectives. The advisor's analysts conduct a constant appraisal of the fund's portfolio to determine the proper mix of securities. Additional duties of the advisor may vary among funds, so each contract must delineate the services the adviser will provide.

The principal underwriter's function is the distribution or sale of mutual fund shares to the public. The principal underwriter either purchases the securities issued by the fund for resale or acts as agent for the fund. For these functions the underwriter receives remuneration in the form of a commission equal to a percentage of total sales. In some cases, the mutual fund will act as its own distributor with no underwriter contract. In these cases, the transfer agent who maintains the fund's shareholder ownership records will process sale or redemption orders. The compensation received by the adviser and underwriter must be disclosed in the fund's prospectus. The contract that specifies the duties and compensation for the adviser and underwriter must be approved by a majority vote of the shareholders. If the contract is for more than two years, it must be approved annually by the board of directors or by a majority vote of the shareholders.

Other factors may influence the fees charged shareholders. Market forces will require that a fee be reasonable or the fund may lose customers. Two states have strict limitations on the expense ratio of mutual funds. The fees paid to the adviser or other service contractors are part of that ratio and this can temper their size. Further, section 36(b) of the Investment Company Act of 1940 (hereafter the 1940 Act) allows shareholders or the SEC to bring action through a civil suit against an investment advisor if they feel that the advisor's compensation is excessive in relation to the services provided.

The board of directors of a mutual fund has duties and responsibilities similar to those of directors of other corporations but enhanced in certain areas. Traditionally, a director oversees the interests of the corporation and its shareholders. The 1940 Act imposes a specific fiduciary duty on directors and advisors with respect to the level of compensation received under the advisory contract and attempts to protect shareholders by requiring at least 40 percent of a mutual fund's directors to be disinterested directors. Except under certain conditions, these minority directors must lack any relationship with those who comprise the management of the fund and affect its day-to-day operations such as the investment advisor, principal underwriter, or any broker/dealer. The 1940 Act imposes special responsibilities on these "non-interested" directors for the protection of shareholders which are in addition to those imposed by the act on all directors. Approval by a vote of a majority of the non-interested directors is required in the case of

- the making, renewal and performance of any investment advisory agreement,
- the making, renewal and performance of any agreement with a principal underwriter, and
- the selection of accountants.

Shareholders' Participation and Relationship to Fund

Before purchasing shares in a mutual fund, investors must make certain decisions for themselves on their investment goals and the risks they are willing to assume. Such investors may conduct their own research but are likely to rely on the recommendations of advisors, brokers, insurance salesmen, or bankers. Additionally, shareholders have the opportunity to vote on matters relating to the operation of the fund including the election of directors, approval of certain contracts, and any proposed changes to established fundamental fund policies or procedures. However, SEC staff observe that shareholder participation in the voting process is often minimal. If shareholders are dissatisfied with the performance or operation of the fund, they can redeem their shares rather than attempt to institute change by bringing questioned policies, procedures, or contracts to a vote of other shareholders.

Securities laws and regulation place certain fiduciary requirements on the management of mutual funds for the benefit and protection of shareholders. The mutual fund management is responsible for safe-keeping, handling, and investing shareholder assets in accordance with fund objectives and policies and securities law. The laws limit what fund managers can do and provide SEC with concrete rules to enforce. Furthermore, it can be inferred from section 1(b) of the 1940 Act that any conflict between managers of the mutual fund and the investor be resolved in favor of the investor.

Prior to the passage of the Investment Company Act of 1940, an extensive study[2] conducted by the SEC at the request of Congress revealed that certain relationships, practices, and transactions between investment companies and others adversely affected the interests of investors. Such relationships, practices, and transactions were either made illegal or were regulated by the 1940 Act. The 1940 Act's provisions, in particular sections 17 and 36, combined with requirements of other securities laws, set forth the fiduciary relationships that protect investors. Section 36(a) of the 1940 Act makes unlawful a "breach of fiduciary duty involving personal misconduct." Courts have described Section 36(a) as a "reservoir of fiduciary obligations imposed upon affiliated persons to prevent gross misconduct or gross abuse of trust not otherwise specifically dealt with in the Act."[3] Section 36(b) imposes a specific fiduciary duty upon the investment adviser of a registered company with respect to the fairness of compensation for services provided by the adviser. A breach of a fiduciary duty under section 36(b) may be enjoined by a court of law. In addition, section 36(b) provides a private right of action against the investment adviser or any persons enumerated in section 36(a) who have a fiduciary duty with respect to payments made to the

[2]The SEC submitted to Congress three reports in four parts: SEC, Report on the Study of Investment Trusts and Investment Companies: (1) The Nature, Classifications, and Origins of Investment Trusts and Investment Companies, H.R. Doc. No. 707, 75th Cong., 3d Sess. (1938); (2) Statistical Survey of Investment Trusts and Investment Companies, H.R. Doc. No. 70, 76th Cong., 1st Sess. (1939); (3) Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies, ch 1-6, H.R. Doc. No. 279, 76th Cong., 1st Sess. (1939-1940); ch 7, H.R. Doc. No. 136, 77th Cong., 1st Sess. (1941); (4) Control and Influence over Industry and Economic Significance of Investment Companies, H.R. Doc. No. 246, 77th Cong., 1st Cong. Sess. (1941); and Conclusions and Recommendations H.R. Doc. No 246, 77th Cong., 1st Sess. (1941).

[3]Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981); Brown v. Bullock, 194 F. Supp. 207, 238-39 n.1 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961).

An officer, director, member of an advisory board, investment adviser or depositor of a registered investment company, and the principal underwriter of a registered company if it is an open-end company, unit investment trust or face-amount certificate company, are all covered by §36(a).

adviser. Section 36(a), in contrast, has no such express provision, although some courts have implied a private right of action.[4]

Fiduciary principles are also imposed on investment advisers, including advisers to mutual funds, by section 206 of the Investment Advisers Act of 1940 (hereafter referred to as the Advisers Act). An adviser is a fiduciary who owes a duty of undivided loyalty to all clients and must deal fairly and honestly with them.[5] The duty to deal fairly implies a duty to disclose all relevant information and to avoid, or obtain a client's prior consent to, any conflict of interest. Section 206 does not relieve an adviser from any higher stanoard imposed by any other applicable laws.[6] Further, a breach of an adviser's fiduciary duty can be the basis for removal from the industry.[7]

The anti-fraud sections of the Securities Exchange Act of 1934 (hereafter referred to as the 1934 Act), sections 10(b) and 15(c), are construed to impose significant obligations of fair-dealing on corporate insiders and broker dealers. Taken together, these obligations impose fiduciary duties upon an investment adviser to a mutual fund, officers and directors of a mutual fund, and broker-dealers with respect to the execution of portfolio transactions for a mutual fund. Because insiders, including officers and directors of an investment company, have a fiduciary obligation to their shareholders arising from state law as well as the laws discussed above, they are liable under section 10(b) to purchasers and sellers of securities in transactions where they have fraudulently withheld material information or misrepresented the facts.

Broker-dealers have an affirmative duty to disclose any facts relevant to a customer's investment decision.[8] This duty to disclose is applied to broker-dealers under two closely related theories - the "shingle" theory and a fiduciary theory. The shingle theory is that a broker-dealer, by "hanging out his or her shingle," makes an implied representation to all

[4] See, e.g., Brown v. Bullock, supra note 1; Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir.), cert. denied, 1134 U.S. 934 (1977); The Cambridge Fund, Inc. v. Abella, 501 F. Supp. 598 (S.D.N.Y. 1980).

[5] SEC v. Capital Gains Research Bureau, Inc., 375 U.S.. 180 (1963).

[6] Frankel, The Regulation of Money Managers, Vol. 2, Chapter XII at §3 (1978).

[7] Section 203(e) authorizes the SEC to revoke an adviser's registration, and section 209(e) authorizes both a civil action by the SEC for injunctive relief and a criminal action by the Attorney General. The Supreme Court has held, however, that private parties have only a limited right to sue to recover their fees in the case of a breach of section 206. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

[8] Wolfson, Phillips and Russo, Regulation of Brokers, Dealers and Securities Markets, §2.03 (1977)

customers, even those with whom there is no special relationship of trust and confidence, that the broker-dealer will deal with them fairly and in accordance with the ethical standards of the industry.[9] For example, broker-dealers that are members of the National Association of Securities Dealers (NASD) are subject to the NASD Rules of Fair Practice. These rules seek to prevent manipulative practices and to promote just and equitable principles of trade. They include rules regulating recommendations to customers (the "suitability" rule) and rules regarding fair prices and commissions.[10]

Broker-dealers have also been held to be fiduciaries whenever a relationship of trust and confidence is established with a customer. This fiduciary theory is invoked to impose a duty to disclose any facts that could materially affect a customer's decision.[11] Case law is therefore clear that broker-dealers have important obligations of fair-dealing, the details of which depend on the nature of the broker-dealer/customer relationship. It is also worth noting that a significant percentage of investment advisers to mutual funds are also broker-dealers or affiliated persons of broker-dealers.

In addition to the above, section 17 of the 1940 Act contains specific requirements which in effect regulate the actions of mutual fund fiduciaries and affiliated persons or associates of the fiduciaries. As a result, persons controlling 5 percent or more of the voting stock of the fund, any officer, director, promoter, or principal underwriter of the fund (and affiliated persons of such persons) are prohibited from self-dealing in a transaction to which the mutual fund is a party. For example, affiliated persons usually cannot sell any security or other property to their mutual fund, they cannot purchase securities or other property from their mutual fund unless the securities are issued by the mutual fund, and they cannot borrow money or other property from the fund without prior SEC approval. Further, affiliated persons are prohibited from receiving compensation when acting as agent for their mutual fund outside of their normal salaries with one major exception. Brokers who are affiliated persons and execute transactions for a mutual fund may

[9] 3 Loss, Securities Regulation 1483 (2d ed. 1961); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968) (citing text); Wolfson, Phillips and Russo, Regulation of Brokers, Dealers and Securities Markets, §2.03 (1977)

[10] NASD Manual, Rules of Fair Practice, Art. III, §§2, 4 (1976).

[11] Rolf v. Blyth, Eastman Dillon and Co., 570 F. 2d 38 (2nd (Cir.), cert. denied 439 U.S. 1039 (1978); Pachter v. Merrill Lynch, 444 F. Supp. 417 (E.D.N.Y. 1978).

receive a fee as long as that fee does not exceed the usual and customary broker's commission.

Shareholders are also protected by requirements specifying the maintenance of the fund's portfolio of securities. Every mutual fund must place and maintain its portfolio with a custodian who is different from those individuals making the day-to day decisions for the fund. While there are several options as to who the custodian might be, the most typical custodian is a bank. In addition, any officer or employee of the mutual fund must be bonded by a reputable fidelity insurance company against larceny and embezzlement.

Provisions of section 17 also prohibit any action that attempts to reduce the liability of fiduciaries or their affiliates. A mutual fund is prohibited from including in its charter, certificate of incorporation, or any other instrument of organization any provision which protects any director or officer against any liability to the mutual fund or its security holders to which the director or officer would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence, or reckless disregard of duties involved in the conduct of his office. Further, language in a contract or agreement in which any person acts as an investment adviser or principal underwriter which purports to protect such persons from the same liability as stated above is also prohibited.

Section 17 also makes it unlawful for any affiliated person of an investment adviser or principal underwriter to engage in acts or courses of business that are fraudulent, deceptive, or manipulative. As a device to aid in preventing such conduct, mutual fund investment advisers and principal underwriters are required to develop a written code of ethics for their employees and institute procedures to prevent violations of this code.

The SEC may accept applications for exemptions from the above provisions. However, the SEC may grant such applications only if the terms of the transaction are reasonable, consistent with the policies recited in the mutual fund's registration statement and reports, and the proposed transaction is consistent with the general purpose of the 1940 Act.

Collective Investment Funds: Bank-Sponsored Investment Products for Fiduciary Customers

Collective investment funds are operations of bank trust departments whose function is to provide a variety of fiduciary services. Banks and bank regulators maintain that these funds are an economical and efficient way of managing the investment of smaller accounts in these trust departments. By pooling the assets of these accounts the bank can achieve investment diversification and economically provide professional investment management services.

Each of the separate accounts invested in a collective investment fund requires some type of fiduciary service from the bank. The exact nature of that service is set forth in an agreement between the bank and its customer which is tailored to the needs of the customer's account. Investment of the account's assets in a collective investment fund can be made exclusively by the trustee bank or can be decided cooperatively by the bank and the person establishing or otherwise responsible for the account. In the case of employee benefit plans, regulation does not prevent trust customers from turning to the bank solely for investment in a specific commingled investment fund.

Formation and Management of Collective Investment Funds

A bank establishes its collective investment fund(s) to meet the investment requirements of its fiduciary clients. These investment needs might be met by a capital growth fund, an income fund, or a balanced growth and income fund, or might be met by more specific funds such as tax-exempt bond funds or industry-related funds. A small bank may only have one collective investment fund, if that. A large bank may have 20 or more funds. Fiduciary accounts may be totally invested in one collective investment fund, partially invested in a fund and partly individually managed, or split among several funds, depending on the type, size, and objectives of the account and the capabilities of the bank. Each collective investment fund is a separate entity. Investments in the fund are known as "units of participation" and each unit represents a proportionate interest in all assets of the fund's portfolio. Unlike a mutual fund, no shares are issued to participants in a collective investment fund as evidence of equity ownership in the bank's collective investment fund.

Management of collective investment funds is the responsibility of the bank. The bank's board of directors, which is responsible for the overall management of the bank, may assign management and oversight of the collective investment funds and, indeed, of all trust operations, to various bank officials or committees. In managing collective investment funds, the bank may conduct its own investment research or contract for research. However, a trust committee (or its equivalent) must review and approve the purchase and sale of fund assets to fulfill the requirement that the bank manage the fund. This trust committee may be identical to a committee overseeing other trust department activities or it may be constituted specifically to oversee the collective investment fund.

Trust fees charged to trust department clients will vary according to the amount of assets managed and the specific services rendered. Banks are limited with respect to the fees they can charge for collective investment fund participation. The total amount of fees which can be charged to fiduciary accounts which are invested in collective investment funds can be no more than the account would pay if it did not participate in the collective investment fund. Some trust departments set minimum limits on the size of accounts they admit, in order to charge a minimum trust fee. A major money center bank may establish a floor of $200,000 for the size of admitted accounts, while a small bank may have no minimum.

Clients' Relationship With Bank

The function of a trust department is to act for the exclusive benefit of its fiduciary clients in all matters subject to their fiduciary agreement. According to the FDIC examiners manual, a bank acts in a fiduciary capacity when the business it transacts, or the money or property it handles, is not its own or for its own benefit but belongs to another and is for the benefit of others.

Although there is a complex array of specific fiduciary relationships, for the purposes of this case study we categorized these relationships into two basic types—traditional and agent. When a bank acts in a traditional fiduciary capacity, it performs the previously mentioned functions of a trustee, executor, administrator, guardian, or custodian under a Uniform Gifts to Minors Act. This report refers to a traditional fiduciary capacity as a "trust relationship." In a trust relationship, ownership of and beneficial interest in the trust property are separated. The bank takes title to the trust property to manage it for the benefit of others. On the other hand, when a bank acts as an agent, this separation of beneficial interest in and ownership of a client's property is not present. The client retains legal ownership of the property and directs—to the extent specified in the agency agreement—the disposition of it.

The terms of trust or agency arrangements can bestow on the trustee or agent varying degrees of authority over the investment of trust or agency account assets. For example, an agency relationship might provide that an agent bank's investment activities be limited to making investment recommendations. Written approval would be required from the client before the agent bank could make any investment transactions or disbursements. On the other hand, agency agreements also can be written to give broad discretionary authority to the agent bank. Trust agreements can provide the trustee bank with a similar range of investment discretion. Despite the similarities in the range of discretion possible in both trust and agency relationships, granting complete investment discretion is a frequent characteristic of trust relationships but not of agency relationships.

Because a bank takes title to property in a trust relationship, this arrangement may continue beyond the death of a client or beyond the dissolution of a firm establishing a trust. It allows the bank as trustee to continue to manage the trust property for the benefit of others, such as heirs, or to dispose of the trust property in accordance with the terms of a trust instrument, will, or court order. In contrast, an agency relationship (bank as agent) would necessarily terminate upon death of or dissolution by the client, because the client never relinquishes legal ownership to the property.

In both trust and agency relationships, the bank's actions for its clients must be guided by the trust principles of loyalty and prudence. The principle of loyalty requires a fiduciary to act solely in the interests of his clients, excluding all self-interest, in performing fiduciary services. In so doing, the fiduciary should avoid potential conflict of interest situations which may prevent the exercise of independent and disinterested judgment on behalf of clients.

The principle of prudence pertains mainly to investment decisions of fiduciaries and is generally referred to in prudent man rules. Although there is no one, all-encompassing rule, in essence, this principle requires a fiduciary to invest assets in the same way that a prudent man would invest his own property in a similar situation. This duty of prudence in investment is a rule of conduct, not of performance. It stresses propriety and caution in fiduciary investment decisions: a cautious investment approach minimizes risk and, above all, emphasizes preservation of the principal assets of the trust.

It is difficult to describe loyalty and prudence in more specific terms. Various state laws and the Employee Retirement Income Security Act of

1974 (ERISA) contain prudent man rules. However, the principle of loyalty and prudence is most clearly enunciated on a case-by-case basis in state and federal court decisions. Loyalty and prudence are critical in fiduciary relationships because often a fiduciary owes an allegiance to someone beyond the individual who establishes the account, such as participants or their beneficiaries in personal trusts.

Depending upon the size and capabilities of the bank, trust department clients can range from individuals with small sums they wish to place in trust for a specific purpose, to giant corporations needing the bank's full range of skills and services to assist in a variety of matters. An individual may create a personal trust during his lifetime or through a will which becomes operational upon his death. The trust may be created to reduce taxes or for more personal reasons such as to provide for beneficiaries too young or otherwise incapable of managing their own affairs.

Additionally, employee benefit plans may seek the services of a bank's trust department. They may employ the bank as a trustee with multiple responsibilities; they may employ it as simply a custodian of cash and securities; or something in between the two. That is, the bank could merely have custody of some or all of a plan's assets or it could also be charged with one or more of the following responsibilities: providing investment advice, providing accounting services, administering the plan, or serving as the plan's trustee.

A key difference between a bank's fiduciary functions for employee benefit plan accounts and personal trust accounts is that the former fiduciary relationship can usually be changed in that banks may be replaced by other fiduciaries in any of their fiduciary functions for employee benefit plan accounts. Not all trust relationships involving personal trusts can be changed.

Whether a personal account or an employee benefit plan, any account participating in a bank-sponsored collective investment fund must have a trust relationship with the sponsoring bank[12] or, in the case of employee benefit accounts, some trustee other than the sponsoring bank. This trust requirement has to be met in order for collective investment funds to be tax-exempted under the Internal Revenue Code and exempted from registration requirements under securities law.

[12]Or an affiliate of the bank where permissible under state law.

Any account participating in a bank-sponsored common trust fund must have a trust relationship with the sponsoring bank for bona fide fiduciary purposes. A bona fide fiduciary purpose generally means that a trust relationship is created for a client to receive any of several traditional trust services (e.g. estate management, duties in the event of incapacity, or other discretionary duties), rather than strictly investment oriented trust services. At a minimum, bona fide fiduciary purposes require that the bank provide more than just investment services.

The requirement that common trust funds contain only accounts held in trust relationships by the sponsoring bank for bona fide fiduciary purposes rather than for only investment services was established in congressional and related regulatory actions during the period 1936-1940. In the Revenue Act of 1936, the Congress granted tax-exempt status to common trust funds maintained by a bank for accounts in which the sponsoring bank functioned in traditional fiduciary capacities. In 1937, the Federal Reserve Board authorized common trust funds maintained by banks only for the investment of accounts held for bona fide fiduciary purposes. The Investment Company Act of 1940 excluded collective investment funds from the definition of investment companies and exempted them from most provisions based in part upon the preceding legislative and regulatory actions.

The bona fide fiduciary purposes requirement and the requirement of a trust relationship are barriers preventing those seeking only investment management from participating in common trust funds. Actions by the SEC and the Supreme Court of the United States have affirmed that common trust funds can only be used for the administrative convenience of the bank in investing fiduciary account assets and not for any investment by the general public. To retain their exemptions from securities laws, common trust funds must be maintained by a bank for purposes other than or in addition to money management.[13] The Supreme Court's 1971 Investment Company Institute vs. Camp decision[14] held that a common trust fund maintained for investment—rather than bona fide fiduciary purposes—violated the Banking Act of 1933, commonly referred to as the Glass-Steagall Act.

In contrast to common trust funds, a trust relationship with the sponsoring bank for bona fide fiduciary purposes is not required for

[13]William P. Wade, Bank-Sponsored Collective Investment Funds: An Analysis of Applicable Federal Banking and Securities Laws, The Business Lawyer, volume 35, January 1980, page 390.

[14]Investment Company Institute v. Camp, 401 U.S. 617 (1971).

employee benefit plans invested in commingled investment funds. Bank-sponsored commingled investment funds are largely comprised of employee benefit plan assets. Although all participating assets must be held in trust, this trust relationship may be with any qualified trustee.[15] Thus, a bank may act as the trustee for employee benefit plans or as an agent for a trustee of other employee benefit plans participating in its commingled investment fund. Further, it is possible for employee benefit plans to select a bank-sponsored commingled investment fund solely for direct investment purposes. This is because the restriction on commingling fiduciary accounts seeking only investment services which applies to common trust funds has not been applied to commingled investment funds for employee benefit plan accounts either by bank regulators, by SEC in its interpretative rulings, by the Congress in providing its exemptions from security laws, or by the IRS in providing tax qualification under the Internal Revenue Code. It appears that the reason that no requirement exists for "bona fide fiduciary purposes" is that, as a group, corporate employee benefit plan sponsors are presumed to be more sophisticated investors than individual trust clients.[16]

The bank is responsible for all the trust services it offers, including collective investment funds, and for all of its actions as a fiduciary. Consequently, in sponsoring collective investment funds, the bank must exercise full or, at least, substantial investment discretion over all fund investments. Further, the bank's fiduciary responsibility for individual accounts does not end when those accounts are invested in a collective investment fund; it extends to all actions of the collective investment fund made on behalf of the accounts invested. When a bank is sued for any of its actions as a fiduciary, all capital assets of the bank are at risk and may be used to settle such lawsuits. While no separate insurance is required exclusively for a collective investment fund, sponsoring banks typically carry liability insurance to cover certain problems that may occur.

[15]The trustee may be a bank, other institution, an individual, or a group of individuals named in the documents governing the employee benefit plan.

[16]Wade, pages 379 and 403.

Regulation of Pooled Investment Funds

SEC is responsible for regulating mutual funds, while OCC regulates and other federal bank regulators supervise the regulation of collective investment funds. Both regulatory schemes are structurally similar in that they provide for a form of disclosure, periodic examinations, and enforcement measures. However, SEC's supervisory techniques are designed for investments while the bank regulators' techniques are designed for commercial and fiduciary bank activities. Other factors affecting the supervisory schemes include differences in the laws pertaining to fund operations and subtle differences in the regulators' objectives. These factors have resulted in a regulatory scheme for mutual funds which emphasizes disclosure of specific information to the public, whereas the regulatory scheme for collective investment funds relies heavily on examinations to ensure that prudential management is provided and that applicable laws and regulations are followed.

Regulation of Mutual Funds

Mutual funds are subject to the full range of securities laws which have helped shape SEC's regulatory objectives, policies, and procedures. An SEC official stated that his agency has three interrelated regulatory goals:

- Protection of investors.
- Maintenance of orderly markets.
- Encouragement of capital formation.

In discussing these goals as they relate to supervising mutual funds, one SEC official explained that his agency's goal is to protect investors by assuring the full and accurate disclosure of information on which investment decisions are made. This can be accomplished by enforcing the federal securities laws that require full and accurate disclosure of material information. The individual investor then makes the final judgment as to the worth of a security. SEC does not judge the merits of a security and cannot bar the sale of mutual fund shares even if its analysis of the disclosed data shows the shares to be of questionable value. This latter function has, however, been assumed by some states under their securities laws.

Federal and State Statutes

The Investment Company Act of 1940 is one of several federal statutes affecting mutual funds. It requires that the funds themselves be registered and contains specific prohibitions to assure that mutual funds are operated in the interest of security holders. The Act has provisions to discourage self-dealing by insiders as well as provisions to discourage managers of funds from profiting in a manner other than the method disclosed to, and approved by, shareholders.

The 1940 Act is described by SEC staff as having very specific requirements. It is designed to mitigate abuses that were identified prior to the act's passage. For example, section 13 places boundaries on changing a fund's investment policies without shareholder approval; section 15 controls the relationship between the investment adviser and mutual fund by specifying how the adviser may be compensated; section 17, as discussed earlier, prohibits conflict of interest transactions between the fund and specified affiliated persons, such as those controlling 5 percent or more of the voting stock of the fund or any officer or director of the fund; and section 18 limits the borrowing of a mutual fund by prohibiting the issuance of senior securities. Because the act is so specific, SEC also has the power to grant exemptions where warranted. Consequently, SEC has, in addition to its basic regulatory scheme, a process for examining applications for exemptions from some or all provisions of the 1940 Act.

Three additional federal statutes affect investment company activities. The Investment Advisers Act of 1940, enacted as a companion to the Investment Company Act, requires registration of all investment company advisers, prohibits fraudulent practices, and empowers SEC to discipline violators of the statute and of its rules. The Securities Act of 1933 is essentially a disclosure statute whose chief purpose is to provide investors with accurate information to make informed investment decisions. Disclosure is made by prospectus, which is filed with the SEC in the process of registration of the sale of securities by or on behalf of the issuer. Since open-end mutual funds constantly offer new shares, they must keep a prospectus continuously current.

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 prohibit fraud in the offer or sale (1933 Act) or the purchase or sale (1934 Act) of securities. These provisions apply to mutual fund disclosure documents and advertising. The Securities Exchange Act of 1934 also requires the registration of most brokers and dealers with the SEC and sets forth certain requirements for the solicitation of shareholder votes and proxies in connection with shareholder meetings.

Federal securities laws preserve the authority of states to regulate securities activities where such laws do not conflict with federal laws. Thus, for a mutual fund to offer its shares nationwide, it must meet divergent state securities laws commonly referred to as blue sky laws.

Not only are there various state registration requirements and fees, but certain states also impose differing expense limitations. A small number of states review offerings for merit or suitability, imposing investment restrictions that define what a mutual fund can hold in its portfolio. SEC, however, supervises mutual funds only with respect to federal law.

SEC's Supervisory Procedures

The federal securities laws to which mutual funds are subject contain detailed operational requirements as indicated in the prior section. SEC implements these laws through rulemaking and informal interpretations. It has basically two types of processes by which it assures that regulatory requirements are met: a review of disclosure documents and on-site examinations. Problems noted during reviews or examinations are often corrected by the fund voluntarily. If not corrected, the SEC may bring an enforcement action against the fund.

Disclosure

This element is the keystone of SEC's regulatory scheme. The registration statement is the primary vehicle through which disclosure is accomplished. One registration statement serves to register both the mutual fund under the 1940 Act and the securities it issues under the 1933 Act. This registration statement, as well as other disclosure documents, must be kept up-to-date.

The registration statement contains information such as:

- The method for investors to purchase and redeem shares;
- The investment objectives and policies of the fund;
- The names, addresses, positions, and responsibilities of all fund officers;
- The background, business connections, and services to be performed by the investment adviser;
- The identity of the underwriter;
- and certified financial statements by an independent auditor.

The registration statement consists of three parts. Part A serves as a disclosure document to the public and doubles as the prospectus (the fund must provide the prospectus to investors prior to or at the time they purchase shares). Parts B and C consist of information required by SEC to assure compliance with specific provisions of law or regulation. This information is available to the public upon request.

The initial registration statement is updated (amended) annually for three purposes: to keep material information current, to account for the shares of the fund that have been issued or redeemed, and to provide for the registration of any new shares. A mutual fund must issue financial or operating statements to stockholders and the SEC at least semiannually. Further, it must disclose information about pending legal proceedings by filing statements as required by SEC.

SEC selectively reviews registration statements because of a large and increasing volume of new statement filings. SEC staff concentrate their review on new registration statements but do not review all amendments.[1] During this review, SEC checks a registration statement for compliance with securities statutes and regulations. In so doing, SEC reviews the fund's disclosure about its operating plan, its management structure, and its financial condition. If technical problems are found, normally the mutual fund will change its registration statement in accordance with SEC's suggestion. When SEC is satisfied, it will declare the registration statement effective. While a mutual fund can begin selling shares 20 days after filing its initial statement with SEC, it typically waits until the registration statement is declared effective by the SEC rather than letting it become effective automatically without SEC action.

Examination

SEC's examiners perform on-site examinations in order to ascertain whether or not mutual fund activities are in compliance with the various federal securities laws and agency rules and regulations and whether the fund is operating in accordance with disclosure in its current prospectus. Examinations may be routine or for cause. A for cause examination results from complaints or other indications that a mutual fund may be operating in violation of federal securities laws or experiencing difficulties. The majority of examinations—about 85 to 90 percent—are routine. There is no specific cycle for routine examinations which are conducted without advance notice to the fund. These are surprise examinations which vary in scope and coverage. However, SEC reported the average time lapse between examinations for all investment companies in fiscal year 1984 as 4.3 years.

SEC has three variations of a routine examination. Although the scope of these examinations may vary they all utilize the basic procedures presented in table 3.1.

[1]Refer to criteria in 17 C.F.R. §230.485 (1985) for more complete criteria used in determining when a filing need not be reviewed.

One type of routine examination involves mutual funds which belong to "families." These families of funds normally have common investment advisers, bookkeeping systems, transfer agents, and depositories. Consequently, SEC has begun a program of examining an entire family at one time. Examiners test various common systems of several of the funds such as accounting systems, contractor services, or procedures that are designed to monitor or prevent conflict of interest situations of affiliated persons. If no problems are found, the SEC assumes these common systems are functioning properly for the remaining investment companies that comprise the entire family complex.

Additionally, SEC conducts full examinations of stand-alone funds (those that do not belong to a family). A full SEC examination probes four broad areas:

- Financial analysis.
- Investment activities.
- Management functions.
- Sales and liquidations of shares.

Examiners determine which matters warrant complete coverage and which may require only a partial review within these broad areas.

SEC has also developed a modified examination for a stand-alone mutual fund. The modified examination concentrates on the fund's accounting systems and devotes less time to its management activities and practices. This modified examination is used when the SEC is familiar with the mutual fund, when there have been no past problems with that fund, when SEC does not anticipate problems, and when there has been no substantial change in management.

Table 3.1: SEC Examination Scope

Areas of examination	Examples of tasks which may be performed
Financial analysis	Review accounting records of the mutual fund for currency and accuracy verifying certain accounts and payments.
	Select dates and verify the calculations of the fund's net asset value (the value of assets less liabilities).
Investment activities	Identify how portfolio decisions are made and implemented.
	Determine if any conflicts of interest are occurring wherein affiliated persons are benefiting in any way from portfolio transactions by (1) interviewing appropriate individuals; (2) reviewing the nature and cost of research services; (3) scheduling transactions, commissions, and names of brokers; and (4) reviewing the portfolio turnover rate to determine if the trading volume is commensurate with the fund's objectives. For example, a turnover of less than 50 percent could indicate capital appreciation through long-term investments and this should agree with the objectives in the prospectus.
Management functions	Determine if the proper number of disinterested directors exists and if the services contracted for by the fund are properly performed.
	Determine the type of custodianship that exists and whether the custodian/fund relationships as described in the contract are actually being followed in day-to-day operations.
	Check minutes of shareholders' meetings and directors' meetings to ensure the contracts are properly voted on and renewed.
	Review the personal security transactions of affiliated persons for evidence of possible conflict of interest violations; and review correspondence, bonding, and insurance.
Sales and liquidation of fund shares	Determine if the underwriter or broker-dealer complies with securities laws.
	Determine if the method for allocating advertising or distribution costs is proper and assess the status of the fund's registered shares, reconciling them to its financial statements.

In addition to the four areas of inquiry, the examiner can request and review advertising materials used during the period under examination to determine if SEC requirements are met. The prospectus is intended to be the primary selling document used to promote the sale of mutual fund securities. Therefore, advertising materials received by the public before they receive a prospectus are subject to legal restrictions. Examiners check to ensure that advertising complies with the general anti-fraud provisions of securities laws and the rules adopted pursuant to those laws.

Enforcement

If SEC finds violations of any federal securities laws, rules, or regulations, it has a number of administrative, civil, and criminal enforcement tools available to either obtain correction or punish violators. These range from discussing problems with mutual fund officials during an examination to referring criminal violations to the Department of Justice for prosecution. The severity and the repetitive nature of a violation and its impact on investors are major factors in determining which action is to be undertaken.

SEC considers public disclosure of violations a deterrent to future violations of securities laws and a valuable enforcement tool. While SEC's examination reports, deficiency letters that may be sent to a mutual fund because of findings during examinations, and investigations of violations are generally non-public, its administrative hearings and formal administrative proceedings are generally public, as are proceedings brought to a federal court. Administrative proceedings may result in such actions as temporarily or permanently prohibiting individuals from serving in certain capacities in a mutual fund, or the suspension or revocation of a mutual fund's registration statement.

Civil or criminal judicial proceedings may be instituted to enforce securities laws. The SEC's principal enforcement remedy is a federal court injunction prohibiting future violations of the securities laws. In addition to "obey the law" injunctions, courts frequently enter orders providing other equitable relief, including restitution, disgorgement of profits, or other appropriate relief. Also, under section 36 of the 1940 Act, the SEC may ask a court to find that a person associated with a fund or its advisor has breached a fiduciary duty with respect to advisory fees or in other respects. Evidence of criminal violations is referred by the SEC to the Department of Justice for possible prosecution.

Regulation of Collective Investment Funds

As operations of a bank's trust department, collective investment funds are included under the bank regulators' general supervision of the trust department. Operations of trust departments and, specifically, collective investment funds are affected by both federal and state laws and regulations. The federal regulatory objective is to assure that all of these various laws and regulations are being followed for two purposes: to maintain the safety and soundness of the bank and to protect the interests of trust customers. If a bank is operated in a safe and sound manner, the interests of trust customers would be protected; if the interests of customers are appropriately protected, the likelihood of a lawsuit that would threaten the bank is lessened. Indeed, according to regulatory officials, no collective investment fund or trust department has ever caused the failure of a bank.

The regulators' principal assurances concerning the operation of collective investment funds are derived from performing routine bank examinations. During these examinations, regulators ensure that required audits have been performed on both the trust department itself and the collective investment funds.

Federal Statutes

Although no federal banking laws pertain directly to the operation of collective investment funds, other federal laws and regulations are critically important to the administration of these funds. The Internal Revenue Code sets criteria for exempting collective investment funds and participating accounts from federal taxation, and ERISA applies to all commingled investment funds which contain assets of employee benefit plans that are subject to ERISA. Finally, securities laws contain anti-fraud provisions which apply to all types of collective investment funds.

Federal banking policies which affect collective investment funds are expressed through OCC's regulations contained in 12 C.F.R. 9.18.[2] These regulations were designed to protect the interests of fiduciary accounts invested in collective investment funds. They specifically provide for

- a distinction between common trust funds and commingled investment funds;
- a detailed operating plan for each fund;
- a valuation of fund assets at least every 3 months to permit entrance to and withdrawal from the collective investment fund;
- an audit and financial report of the fund;
- a prohibition against certain transactions between the bank and its funds;
- a limitation—for common trust funds only—on the percentage of the fund that one beneficiary or account can hold or that can be invested in the securities of one issuer; and
- a prohibition against issuing a certificate of interest in the fund.

[2]Compliance with 12 C.F.R. 9.18 is mandatory for all national and state-chartered banks which sponsor common trust funds in order for the fund to qualify for a federal tax exemption. All national banks which sponsor commingled investment funds are also required to comply with 12 C.F.R. 9.18. State-chartered banks, however, are not required by federal law or regulation to comply with 12 C.F.R. 9.18 in the operation of their commingled investment funds in order to receive their federal tax exemption status.

The Employee Retirement Income Security Act of 1974 (ERISA), for the purpose of protecting employee benefit rights, and the Internal Revenue Code of 1954 (IRC), in order to qualify employee benefit plans for federal tax exemption, require the service of a trustee or custodian for IRC section 401 corporate employee benefit plans, IRC section 401 Keogh Plans for self-employed individuals, and IRC section 408 Individual Retirement Accounts (IRAs). Corporate employee benefit plans are usually tax-exempt in accordance with IRC section 401(a) qualification requirements. Consequently, collective investment funds in which corporate employee benefit plan assets are placed are usually qualified by the IRS for federal tax-exemption based upon the requirements of Revenue Ruling 81-100. Employee benefit plan accounts tax-qualified under IRC section 401(a) are subject to ERISA requirements. Banks administering the collective investment funds in which these accounts participate are subject to compliance with ERISA. All nationally chartered banks which administer collective investment funds tax-exempt under Revenue Ruling 81-100 are also required to comply with the requirements of OCC Regulation 12 C.F.R. 9.18. Finally, collective investment funds tax-exempt under Revenue Ruling 81-100 requirements and the interests in these funds are usually exempt from the registration requirements of securities laws.

Some collective investment funds are unable to attain tax-exempt status under Revenue Ruling 81-100 requirements. If participating accounts are unable to meet the tax-qualification requirements of IRC section 401(a), a collective investment fund may still receive a federal tax exemption if it meets the requirements of IRC section 584. These funds may also contain accounts subject to ERISA requirements. All banks which offer these funds must administer them in accordance with OCC Regulation 12 C.F.R. 9.18. The funds and interests in the funds are usually exempt from the registration requirements of securities laws because these collective investment funds are comprised entirely of assets for which the bank has been appointed trustee, have met the tax-qualification requirements of IRC section 584, and are administered in compliance with OCC Regulation 12 C.F.R. 9.18.

Until 1974, the Internal Revenue Code of 1954 required banks with trust powers to serve as trustees for all tax-qualified, private employee benefit plans (corporate, Keogh Plan, and IRA). The enactment of ERISA amended the Internal Revenue Code to permit brokerage firms, investment advisers, insurance companies, and banks without trust powers, for example, to serve as custodians for IRS tax-qualified Keogh Plan and IRA employee benefit plans. A custodial Keogh Plan or IRA, however, is treated as a trust and the custodian of the plan or account is treated as a trustee for the purposes of Internal Revenue Code tax-qualification requirements. This simply means that the custodial account, as well as the trusteed account, has to meet the tax law requirements for qualification as a federally tax-exempt employee benefit plan. Therefore, any custodian or trustee would have to demonstrate to the Internal Revenue Service's satisfaction that it would administer the account consistent with tax law requirements.

The IRS qualifies individual Keogh Plans and IRAs for federal tax exemption under IRC section 401 and 408 criteria, respectively. Depending upon the basis used for their federal tax exemption and the types of participating accounts, collective investment funds which might include these employee benefit plan assets would be required to comply with Revenue Ruling 81-100, IRC section 584, ERISA, and/or OCC Regulation 12 C.F.R. 9.18. However, the applicability of federal securities laws to collective investment funds partially or wholly containing qualified Keogh Plan or IRA assets can vary.

For the purposes of this report, we have found that, where the applicability of federal securities laws may be concerned, banks either register their collective investment funds and/or interests in these funds with the SEC under securities laws or operate their collective investment funds on an intrastate or private offering basis, thereby relying on an exemption from securities laws under section 3(a)(11) or section 4(2) of the 1933 Act, respectively. Furthermore, the legality under Glass-Steagall of collectively investing IRA assets in collective investment funds exclusively for IRA assets is unclear following recent litigation.[3] Federal, state, and local government employee benefit plans, on the other hand, are not bound by the same requirements as exist for private employee benefit plans (corporate, Keogh, and IRA). Because these government or public employee benefit plans are exempt from ERISA coverage, they are not required to be held in trust or to meet the extensive federal reporting, disclosure, and funding requirements of ERISA Titles I and IV. Where these government employee benefit plans do participate in bank-

[3] Investment Company Institute v. Conover, No. C-84-0742-WWS (N.D. Calif., 8-28-84), and Investment Company Institute v. Conover, No. 83-0549 (D.D.C., 11-8-84). In these contradictory decisions, the D.C. District Court disagreed with the Northern District of California's holding that collective investment funds for IRA assets were essentially mutual funds which created arrangements that violated the Glass-Steagall Act prohibition on the marketing of securities by commercial banks. Also refer to Investment Company Institute v. Connecticut Bank and Trust Co., No. H-85-160-JAC (D. Conn 1-21-86), a recent decision upholding the OCC's approval of a bank-sponsored collective investment fund for IRA assets. The fund in question is registered as an investment company under the 1940 Act and its securities are registered under the Securities Act of 1933.

sponsored collective investment funds, they are treated by the IRS as IRC section 401 qualified plans. This means that these plans and the collective investment funds in which they participate must meet the group trust and other requirements of Revenue Ruling 81-100. Federal banking regulators say that only a small amount of government employee benefit plan assets have recently begun to participate in bank-sponsored collective investment funds.

All banks which offer collective investment funds for personal trust account assets must comply with OCC Regulation 12 C.F.R. 9.18. In order for these collective investment funds to receive a federal tax exemption, they must be administered in compliance with IRC section 584 requirements. Indeed, one of the requirements of IRC section 584 is that the bank will administer these funds in compliance with 12 C.F.R. 9.18. Moreover, if a fund contains any account assets subject to ERISA requirements, the bank is responsible under ERISA to comply with ERISA requirements in its actions for the ERISA covered accounts. Collective investment funds for personal trust account assets and the interests in these funds are usually exempt from the registration requirements of securities laws.

ERISA also contains a number of specific provisions pertaining to fiduciaries of covered employee benefit plans whether or not they are qualified by the IRS for federal tax exemption. For example, section 404(a)(1) of ERISA concerns fiduciary loyalty and prudence and applies to all fiduciaries of an employee benefit plan regardless of their specific duties and responsibilities. ERISA requires all fiduciaries to discharge their duties with respect to a plan solely in the interest of the participants and beneficiaries and to act

> "... with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

The ERISA prudent man standard applies to all plan-related actions of a fiduciary, not just investment decisions.

ERISA was designed to correct problems that existed at the time of its passage.[4] Consequently, it preempted any state laws or employee benefit plan provisions that conflict with it. According to both Department of

[4] According to Dan M. McGill in his book, Fundamentals of Private Pensions, the fiduciary laws of various states in theory applied to persons and institutions managing the assets of employee benefit plans, but the reach of these laws and the scope of their remedies were considered by most legal

Labor representatives who administer the Act and to bank regulatory officials, all investment actions of a collective investment fund containing ERISA-covered employee benefit fund assets are subject to ERISA. Under the provisions of ERISA, assets of an employee benefit plan held in or invested in a commingled investment fund result in the sponsor of such fund being a plan fiduciary and the underlying assets of such pooled fund being characterized as plan assets under ERISA.[5] In contrast, only the decision to invest employee benefit plan assets in a mutual fund is covered by ERISA's provisions, not the particular portfolio investments of the mutual fund. Thus, ERISA's provisions, such as those concerning prudence and loyalty, extend to all investment actions of a collective investment fund yet go no further than the decision to invest an employee benefit fund's assets in a mutual fund.[6]

The interrelationships among and between ERISA requirements, Internal Revenue Code (Code) requirements, various types of employee benefit plans, and bank-sponsored collective investment funds are broad and complex. Many types of employee benefit plans may be partially or totally exempted from certain ERISA provisions or may be granted simplified compliance procedures. An employee benefit plan can be subject to ERISA requirements whether or not it is qualified by the IRS for federal tax exemption. Every employee benefit plan subject to ERISA is required by ERISA to authorize participation in any collective investment fund operated by a bank. Moreover, a collective investment fund must comply with certain ERISA and Code requirements even if some of its participating accounts are neither subject to ERISA nor tax-qualified by the Code. However, federal bank regulators assert that the vast majority of employee benefit plans which are collective investment fund participants have been tax-exempted in accordance with IRC section 401(a) requirements and, therefore, are covered under ERISA. The collective investment funds in which these employee benefit plans typically participate have met the requirements for tax-qualification under Revenue Ruling 81-100.

For the purposes of this report, therefore, a predominant feature common to participants in bank-sponsored collective investment funds

experts to be inadequate for employee benefit plans, especially those operating across state boundaries. Prior to ERISA there was no single law or body of law designed to comprehensively regulate all employee benefit plans.

[5]29 U.S.C. 1101.

[6]The reason ERISA does not extend to the investment actions of mutual funds is that the protections of the 1940 Act apply to the management of mutual funds.

for employee benefit plan assets is that they are protected by requirements of ERISA and the Code. Banks which sponsor their own or administer other private employee benefit plans must comply with ERISA in all their actions on behalf of plan participants and beneficiaries. Again, for the purposes of this report, if a bank has been given the discretion to place the assets of employee benefit plans into any collective investment fund, the administration and operation of that collective investment fund must be in compliance with the bank's responsibilities under ERISA and the Code with regard to participating accounts.

Finally, federal securities laws exclude common trust funds and commingled investment funds from the definition of investment companies and specifically exempt them from most requirements. However, collective investment funds are not exempt from the anti-fraud provisions of the Securities Act of 1933 or the Securities Exchange Act of 1934. These provisions prohibit making any untrue statement of a material fact or engaging in any practice that deceives the "purchaser" in connection with the purchase or sale of "securities." Advertising is one of the areas in which these provisions apply. However, the bank regulators have established advertising rules which vary considerably according to the type of fund. Few advertising restrictions have been placed on banks with respect to commingled investment funds; advertising of common trust funds, on the other hand, is limited. Essentially, all references to the common trust fund may be made only as part of an advertisement for the bank's general trust services; promotion of a common trust fund alone is prohibited.

State Statutes

State law continues to be a primary force in directing trust operations, especially for operations involving trust accounts not subject to ERISA. All trust instruments are established in accordance with state law. Account assets cannot be invested collectively unless state statutes or the trust agreement so authorize. Even nationally chartered banks must obey state law on this point. Many provisions of OCC regulations refer to "local law" or laws of the state in which the national bank is located. State statutes codify the rules regarding fiduciary loyalty in matters such as self-dealing and other conflicts of interest. The duty of loyalty is still largely defined, applied, or enforced by state courts on a case-by-case basis.

The laws of prudent investment originated under state law. Today, at least three different types of prudent man statutes can be found among the various states which identify particular types of investments as suitable or unsuitable for trust assets—legal lists,[7] a uniform probate code,[8] and a model prudence rule.[9] When applied to personal trusts, state prudent man standards require that each item in the personal trust account's investment portfolio stand on its own merits and be capable of satisfying prudent man standards. Therefore, if a personal trust account's portfolio includes units of participation in a common trust fund, the common trust fund, as an investment suitable for trust assets, must be able to stand on its own merits and be capable of satisfying a state's prudent man standard. Some states even require common trust funds to periodically account to the courts of their respective states. In these accountings, each investment in a common trust fund's portfolio may be reviewed for fiduciary propriety.

However, as an operation of a commercial bank, a trust department and its collective investment funds must meet the requirements of only one state—that in which the bank is chartered. Once established, trust departments are not restricted to accepting accounts only from customers residing within the state in which the bank is chartered.

Federal Supervision of Collective Investment Funds

The regulatory scheme devised by the federal commercial bank regulators for trust departments consists of an approval process wherein the regulator authorizes the conduct of trust business; a regular cycle of on-site examinations to both update the regulator's information on the operation of the department and to test the soundness of operations; and a system for reviewing financial and other data submitted periodically by the banks. The offering of a new collective investment fund is initiated by the bank's drawing up an operating plan and investing fiduciary assets in the fund.[10] The collective investment fund is then supervised in conjunction with the trust department as a whole. In the event of a serious problem in trust operations, the regulators have available a

[7]State approved lists of prudent investments. The oldest form of state prudence statutes, legal lists can include such investment options as certain obligations issued or guaranteed by a state or the federal government and common stocks and bonds.

[8]Rather than specifying permissible investments, these state statutes dictate that a fiduciary shall invest as a prudent person would managing the property of another.

[9]Found in a majority of states, this rule requires the fiduciary to manage the property of another with the same prudence he would normally exercise in dealing with his own property. Such prudence should consider the probable income as well as the probable safety of their capital.

[10]All plans for common trust funds must be filed with the OCC regardless of the bank's trust charter. However, in the case of commingled investment funds, only nationally chartered banks are required to make this filing with OCC.

number of administrative and legal actions they can take to obtain compliance with sound fiduciary principles and applicable federal and state laws.

Disclosure

Although a bank is required to make certain disclosures concerning its collective investment funds, such disclosures are accomplished in several ways. Some information such as the identity and background of key persons operating the trust department—and responsible for any collective investment funds—will be disclosed to the regulator in the trust powers application and updated by the regulator during subsequent examinations. Information on such matters as the fund's investment policy and operating procedures will be contained in its operating plan. Actual investments made and operating results will be contained in periodic financial reports. A bank that desires to offer a collective investment fund must first have, or obtain, trust powers. OCC is the sole authority for granting national banks their trust powers. State-chartered banking institutions receive trust powers from their respective states; the Federal Reserve and FDIC consent to the exercise of these powers. All federal authorities require a letter of intent (application) indicating the proposed management of the trust department including information on the experience and training of proposed trust department officials. All authorities consider the business potential of the proposal and the general financial condition of the bank in making their decision.

Once a bank has trust powers, it develops an operating plan before offering common trust funds or commingled investment funds. OCC Regulation 12 C.F.R. 9.18 requires this operating plan to include the

- investment powers and general investment policy of the fund;
- method of allocating income, profits, and losses;
- terms and conditions governing the admission to or withdrawal from the fund;
- required auditing;
- basis, method, and minimum frequency for valuing assets in the fund, including specific criteria for each type of asset;
- period following each valuation date during which the actual valuation may be made (usually not exceeding 10 business days);
- basis for fund termination; and
- remaining matters that may be necessary to clearly define the rights of participants in the fund.

These requirements are applicable to all collective investment funds except commingled investment funds of state-chartered banks. Nevertheless, state-chartered banks may voluntarily follow these regulations in developing their commingled investment fund plans. Regardless of the regulator, all operating plans should be examined and approved by the bank's legal counsel and approved by the bank's board of directors. A copy of the plan must be available for inspection during banking hours at the principal office of the bank and must be furnished to any person requesting a copy. Once operating, the funds must issue periodic financial statements, the contents of which are not required to include disclosures of any personnel or procedural changes.

Plans for collective investment funds offered by national banks are filed with OCC's Washington office. Federal regulators of state-chartered banks do not require that a collective investment fund's plan be submitted before commencing fund operations. Normally, OCC reviews plans in its headquarters office whereas any review of these plans by the other regulators would not occur until the next examination of the bank's trust department. According to federal bank regulatory officials, once a bank has been granted permission to exercise full trust powers, the bank is free to engage in any trust business, including offering collective investment funds, without prior approval. In the past, OCC reviewed all collective investment fund plans, particularly since their regulations require all common trust fund plans to be filed with that agency. However, OCC now will make such a review only on request from nationally chartered banks. Plans filed with the OCC on behalf of state member banks, for example, may be forwarded to the Federal Reserve Board by the OCC. The Board then sends the plan documents to the appropriate Reserve Bank for their review. All plan documents are reviewed by examiners either upon pre-operation filing or during a regularly scheduled examination. Questions are referred to Board staff who, in turn, may consult with the OCC or seek formal interpretation.

Examination

The trust examination is conducted as part of the overall OCC and Federal Reserve commercial bank examination. FDIC may conduct a separate examination of banks with large trust departments, whereas smaller bank trust operations may be reviewed during a comprehensive examination of the entire institution. These on-site examinations are used by the three regulators to ensure banks are complying with appropriate federal and state laws, regulations, and fiduciary principles. These are usually not surprise examinations. However, like SEC, there are variations in the scope of some of these examinations and there is a wide latitude given the examiners in selecting examination steps and techniques.

The scope of an examination may depend on the condition of the bank or the trust department. While the Federal Reserve only performs full-scope examinations during which the entire trust department is examined, the other regulators have examinations of varying depth. For example, OCC conducts either comprehensive, targeted, or visitation examinations. A comprehensive examination covers the entire institution. A targeted examination covers a specific area and may or may not include the trust department. A visitation is a brief bank visit to monitor the progress of the bank in correcting major criticisms and deficiencies noted in a previous examination or to review the operations of a healthy bank. This visitation includes a discussion with bank officers intended to keep OCC up to date on any changes in the bank's management or performance.

As a result of their examinations, commercial and trust operations are given numerical ratings. Trust department ratings are based on evaluations of the following six critical areas

- organization and supervision;
- operations, controls and audits;
- asset administration;
- account administration;
- conflicts of interest; and
- earnings, volume trends, and prospects.

Table 3.2 contains examples of the steps used by bank regulators for trust examination. Depending on the scope of the examination and the examiner's judgment, these steps may be accomplished through interviewing bank personnel, reviewing bank records, and/or making observations or tests.

Table 3.2: Bank Regulators' Trust Examination Scope

Areas of examination	Examples of tasks which may be performed
Organization and supervision	Assure the bank has defined the duties and responsibilities of trust department personnel.
	Assure the bank has standards for hiring, training, supervising, and evaluating personnel.
Operations, controls and audits	Assure there is proper separation of duties.
	Assure there is proper control of assets and investment decisions.
	Assure there is a policy for investing or otherwise making cash productive within a reasonable time.
Asset administration	Determine the bank's investment policies.
	Determine whether the bank uses an approved list of securities, and whether such lists are updated periodically and followed.
	Determine whether the bank has a policy against loans to participants in commingled investment funds secured by units in those funds.
Account administration	Assure that account records are proper and complete.
	Assure the bank follows specific ERISA provisions and has controls for filing timely reports with the Department of Labor and Internal Revenue Service on employee benefit plans.
	Assure investments of collective investment funds comply with pertinent regulations.
	Assure that fees charged directly or indirectly to accounts participating in collective investment funds do not exceed the amount they would be charged if not participating.
Conflicts of interest and self-dealing	Determine if the bank has a code of ethics for its personnel.
	Determine if the bank has a policy for screening transactions to identify conflicts of interest or self-dealing.
	Determine if the bank has information on affiliations of bank directors or others with whom transacting business might involve a conflict of interest and self-dealing.
	Determine if the bank has policies preventing the trust department from purchasing assets which could involve a conflict of interest (specific instances).
Earnings, volume trends, and prospects	Assess management's attitude toward new business development.
	Assess unusual composition of business.
	Assess operating results and earnings.

The frequency of a federal regulator's routine examinations of a trust department may depend on the rating of the commercial bank, as well as the rating of the trust department and, perhaps, other factors. In general, this frequency varies from 12 to 36 months with each regulator requiring a comprehensive examination at least every 3 years.

Depending on the regulator, the examination may be performed by trust specialists or generalist examiners. The Federal Reserve and FDIC have developed alternate year and divided examination agreements, respectively, with some state bank examination agencies. Under these agreements, many of the banks whose commercial operations are rated satisfactory are examined by these two federal regulators in one period and state regulators the next.

Examiners must be concerned that trust departments not only meet their agency's rules and regulations but also meet pertinent ERISA provisions, Internal Revenue Code requirements, appropriate provisions of federal securities laws, and follow pertinent state laws. In determining the scope of examination, bank regulators may rely heavily on the results of internal and external audits. However, because of an examiner's discretion in the application of a particular examination step, i.e., the use of statistical or judgmental sampling techniques, there is no assurance that each collective investment fund will be examined during each trust department examination. When a collective investment fund is reviewed, the examiner may perform such steps as

- determining whether the fund's portfolio assets are valued periodically, as required;
- verifying such calculations or assuring that the bank's internal auditors are verifying these calculations;
- evaluating investments of the fund to determine whether they are consistent with the fund's plan and the bank's investment policy; and
- determining whether the bank has exclusive management of the collective investment fund by reviewing investment, administrative, and operational decisions.

In addition, there are specific examination steps for reviewing a bank's collective investment fund advertisements. For example, OCC looks for instances where banks improperly imply or guarantee a specific rate of return for their collective investment funds. However, excluding common trust funds which can only be advertised in conjunction with a bank's overall trust services, collective investment funds are subject to no other advertising restrictions than the anti-fraud provisions of securities laws.

Enforcement

If bank regulators find violations of any state or federal laws, rules or regulations, or any unsafe or unsound banking practices, they have a number of enforcement tools available. These include discussing problems with bank officials during an examination, detailing findings in the report of examination, and referring criminal violations to the Department of Justice.

Enforcement procedures are implemented through administrative, civil, and criminal proceedings. Administrative proceedings—which are not routinely disclosed to the public—are agency-directed enforcement actions, with the objective of correcting violations of law or regulations. An example of an informal administrative proceeding is a memorandum of understanding between a bank and its regulator. Before such a memorandum is drafted, violations or deficiencies are brought to the bank's attention for correction at examination exit conferences or upon the transmittal of the examination report. Formal administrative proceedings include such actions as written agreements or cease and desist orders.

If a bank fails to comply with a regulator's administrative action, the regulator may seek recourse through the federal courts. In these cases, the enforcement action escalates to a civil proceeding. On penalty of a contempt citation, the bank must then comply with the federal court enforcement action. All criminal violations are referred to the Department of Justice for prosecution.

Functional Regulation Requires Resolution of Regulatory Differences

Proponents of functional regulation have applied this concept in several contexts. On the one hand, functional regulation has been construed to mean subjecting the same activities to the same rules enforced by the same regulator. In this context, the terminology "same activities" refers to identical products. Therefore, if commingled investment funds and mutual funds were identical products, then under the functional regulation concept, they would be subject to the same rules enforced by the same regulator. However, we have shown in previous chapters that these two pooled investment products are not identical.

In another context, functional regulation has been construed to mean applying more similar rules to similar products that are presently subject to different regulation. In this chapter we give examples which illustrate a range of product similarities permissible under current regulation for commingled investment funds and mutual funds. We also give examples which illustrate regulatory differences between these two pooled investment products. Reducing or removing these differences is necessary in order to implement a functional regulatory scheme involving commingled investment funds and mutual funds.

Pooled Products Can Be Similar

Current regulation of mutual funds and commingled investment funds makes it possible for these pooled products to have the same investment objectives and the same investment portfolios. Although this is not always true, these funds may even serve the same customers.

With regard to investment objectives, federal securities requirements allow a mutual fund initially to adopt almost any objective as long as it is disclosed to potential investors. For example, investment objectives of mutual funds might include achieving long-term capital growth, income, or a balance by including bonds, preferred stock, and common stock within the portfolio.

Additionally, mutual fund managers are allowed to develop portfolios of securities with a wide range of risk positions. These risk positions may range from a portfolio that would be suitable for conservative investors to one that caters to investors who desire to take greater risks for a potentially higher return. For example, an aggressive and risky strategy may call for building a portfolio based on concentration within one industry or in venture capital firms that are considered by most analysts as "more hazardous" because of the difficulty in forecasting the potential success due to the absence of a track record.

Commingled investment funds can also include investment objectives such as long-term capital growth, income, or a balanced approach. Moreover, a commingled investment fund for employee benefit plan participants can have a risk posture not typically associated with investments for other types of trust customers. Under the portfolio theory of ERISA,[1] a fiduciary is judged on the performance of an entire investment portfolio rather than the risk of specific items in the portfolio. That is, the requirements of prudence will be satisfied if the fiduciary has given appropriate consideration to all relevant facts and circumstances and the role that the investment or investment course of action plays in the plan's investment portfolio.

Finally, general public investors and trust investors can meet their investment needs with mutual funds or commingled investment funds. However, commingled investment fund participation is limited solely to assets held in trust. Mutual funds can serve both general public and trust customers.

Regulatory Requirements Are Different

Fundamental to many of the regulatory differences between mutual funds and commingled investment funds is the fact that the former pooled funds are treated as securities products and the latter are not. As securities products, mutual funds are required to comply with federal securities laws governing investment companies. Federal securities laws exclude bank-sponsored commingled investment funds from the definition of investment companies and specifically exempt them from most securities requirements.

Commingled investment funds are treated as trust products for regulatory purposes. As trust products, they are subject to fiduciary laws and regulations specific to trust products. While ERISA, the Internal Revenue Code, and common law prescribe requirements for a variety of trust relationships, the operations of commingled investment funds are regulated principally by OCC requirements specified in 12 C.F.R. 9.18.

Securities laws requirements for mutual funds differ from regulatory requirements for commingled investment funds in comparable operational areas. Although not a comprehensive list, the following comparisons illustrate some basic regulatory differences.

[1] Refer to 44 Federal Register, 37221-37225, June 26, 1979.

Customer Base

While either mutual funds or commingled investment funds can be suitable for the investment of trust and general public customers, federal regulation prevents non-trust customers from participating in commingled investment funds. OCC Regulation 12 C.F.R. 9.18(a)(1) and (a)(2) collective investment fund definitions limit respective fund customers to trusts. Even in cases where a bank sponsoring a commingled investment fund acts in an agent capacity for a particular employee benefit plan customer, that customer must be a trustee of the participating employee benefit plan. In short, a trust relationship must be present between all participating accounts in a commingled investment fund and some trustee. The presence of a trust relationship distinguishes trust customers of commingled investment funds from the public-at-large.

Participant Roles in Fund Management

The 1940 Act requires that investors have a voice in the management of a mutual fund. This is quite different from the regulation of commingled investment fund operations. Mutual funds are required to submit to a shareholder vote the election of directors, approval of the advisory contract with the mutual fund's investment advisor, and any change in fundamental policies. This shareholder voting is required even though participation is often minimal. Nonetheless, the requirements to make full disclosure and to obtain shareholder votes is intended to act as a deterrent to overreaching on the part of management.

In contrast, OCC regulations and common law trust principles require a bank to exercise exclusive management control over its commingled investment funds. Moreover, the bank has complete responsibility for all management decisions or investment actions it makes. No regulatory provisions exist to allow others—employee benefit plan trustees, named fiduciaries, or beneficiaries—to participate in such management decisions as selecting the bank's board of directors, deciding upon changes to the commingled fund's investment objective, or selecting the trust committee to manage the commingled investment fund's portfolio. In fact, when a bank acts as a trustee with investment discretion over employee benefit plan assets, the employee benefit plan's sponsor or other trustees have made a conscious decision to select the bank for this fiduciary responsibility and to prescribe the limits of the bank's authority over plan assets including investment in the bank's commingled investment fund.

Liquidity

OCC Regulation 12 C.F.R. 9.18(b)(4) requires a bank which sponsors a commingled investment fund to determine the value of assets in the fund at least quarterly. A bank may admit accounts to participate in the fund or withdraw participating accounts from the fund only on this valuation date.[2] In addition, regulations permit banks to establish a prior notice requirement for admission to or withdrawal from commingled funds. Such a notice, if used by banks, cannot exceed 5 days before the valuation date.

In contrast, a mutual fund by definition stands ready to sell or redeem shares whenever the public desires. As a result, the net asset value of a mutual fund share is usually determined daily.

The liquidity of a pooled fund's portfolio is also treated differently by its respective regulators. The SEC requires that an open-end investment company invest no more than 10 percent of its assets in illiquid securities, that is, restricted securities or securities for which there is no established market.[3] In contrast, although OCC regulation does not specify portfolio liquidity requirements for commingled investment funds, fiduciary duty imposed by common law (law of trusts) requires that proper liquidity be maintained consistently with the particular needs and purposes of a fund. OCC regulation requires that a commingled investment fund's portfolio contain such percentage of assets as is necessary to provide adequately for the liquidity needs of the fund and to prevent inequities among fund participants.[4]

Portfolio Diversification

While mutual funds and commingled investment funds may have identical investment objectives, the composition of the respective fund portfolios are subject to different regulatory requirements. OCC regulations prescribe general diversification requirements for the investment portfolios of common trust funds but exempt commingled investment funds from these requirements.[5] An OCC trust official stated that a commingled investment fund's portfolio diversification should be prudent as determined by the bank. In making judgments on prudence the bank is subject to the ERISA prudent man standard, details contained in the governing trust instruments of participating accounts, and/or instructions in the plan documents for participating employee benefit plan accounts.

[2]The bank may adopt a more frequent valuation date than quarterly and some banks have chosen a monthly valuation cycle for their collective investment funds.

[3]Investment Company Act Release Number 7221 (June 9, 1972).

[4]12 C.F.R. 9.18(b)(9)(iii).

[5]12 C.F.R. 9.18(b)(9).

In contrast, the 1940 Act limits the percentage of assets of any one issuer of securities that a diversified mutual fund may include in its portfolio. Section 5(b)(1) of the 1940 Act generally prohibits a diversified company from investing more than 5 percent of its assets in securities of one issuer. This prohibition applies only to 75 percent of the assets of the investment company. Therefore, theoretically a fund could concentrate the unrestricted 25 percent of its assets in a single issuer, and could invest up to an additional 5 percent of its assets in the same issuer, consistent with the requirement. Mutual funds also must comply with the diversification requirements of subchapter M of the Internal Revenue Code in order to qualify for tax flow-through treatment, an absolute necessity to be able to compete in the industry.

Registration Fees

While both mutual funds and commingled investment funds must track or monitor the relative percentage of fund assets held by respective fund participants, different requirements exist concerning the registration fees paid to the respective regulators of these funds. Commingled investment funds account for units of participation held by each participating account and recalculate each account's proportionate share at each valuation period. However, no fee is paid by the bank to either state or federal regulators specifically for its fund operation.

In contrast, a mutual fund must not only register the shares it sells with the SEC under provisions of the 1933 Securities Act but must also register as an investment company under the 1940 Act. As discussed in chapter 3, a mutual fund continuously comes into contact with the 1933 Act because it stands ready to sell or redeem shares daily. As a result, the mutual fund is subject to registration fees established by the 1933 Act and through rules adopted by the SEC.

Most mutual funds take advantage of an SEC rule that allows them to register an indefinite number of shares with SEC. Under this rule, a fee of one-fiftieth of 1 percent of the sale price of the number of shares sold less the redemption price of the shares redeemed is charged. The SEC must be notified of this net figure within 2 months of the end of the mutual fund's fiscal year or the fee is determined without a deduction for the redemption price of the number of shares redeemed.

In addition, states may charge fees for registering mutual fund shares. Forty-four states require securities registration before a mutual fund may market shares to customers within their borders. These fees vary but typically they are based upon a percentage of total shares offered.

Sometimes a minimum or maximum dollar amount is attached to this percentage fee.

Advertising

The SEC and bank regulators have adopted different approaches toward regulating advertisements of mutual funds and commingled investment funds. SEC has adopted four specific rules that apply to mutual funds and also relies on the National Association of Securities Dealers (NASD) to set guidelines and review mutual fund advertisements for compliance with those guidelines. The Comptroller of the Currency has not developed specific regulations for commingled investment fund advertising but does advise banks to conform to standards set by SEC and NASD.

SEC's four rules are discussed first. Rule 156[6] identifies areas of investment company advertising that traditionally have been susceptible to misleading statements. This rule suggests that, in considering whether or not a statement of material fact is misleading, weight should be given to a number of factors. For example, information may be misleading if statements are incomplete, if statements imply future performance of the fund, or if discussions of possible benefits do not give equal prominence to risks or limitations.

Rule 134[7] defines what is known as a "tombstone advertisement." This advertisement is designed to give potential investors fundamental information about a particular security which will assist them in deciding whether or not to request a prospectus. Tombstone advertisements are not included within the Securities Act of 1933 definition of a prospectus and are not subject to the statutory liability under section 11 of that act. As a result, Rule 134 specifically restricts the information that can be included in this type of advertisement. Mutual funds, however, may make use of an expanded tombstone rule. Without restating all provisions of this rule, it basically permits a description of the mutual fund, the offering, and how a statutory prospectus may be obtained, but it does not permit performance figures.

The third rule, Rule 135a[8] of the Securities Act, permits a generic advertisement. Like a tombstone advertisement it is not by definition a prospectus, so the information allowed in this type of advertisement is

[6] 17 C.F.R. 230.156.

[7] 17 C.F.R.. 230.134.

[8] 17 C.F.R.. 230.135a.

restricted to only general information about investment companies. It also invites investor inquiries for further information.

The fourth rule defines what is referred to as an "omitting prospectus"[9] advertisement. Under this rule, a mutual fund advertisement may contain only information found in the statutory prospectus (section 10(a) of the Securities Act of 1933). However, precise use of the language in the prospectus is not required. This rule allows an omitting prospectus advertisement to be used before a mutual fund's registration statement becomes effective if disclosure is made of the pre-effective status. Significantly, if a Rule 482 advertisement is misleading in some manner, perhaps because of an omission of material information, the SEC may issue an order preventing or suspending its use until it is corrected. In addition, a person who has purchased the security by means of the advertisement could seek to rescind the purchase even if the advertisement was not intentionally misleading, but misleading only as a result of negligence. If an advertisement purporting to be a Rule 482 advertisement does not comply with the requirements of the rule, the SEC may initiate a proceeding to enjoin the violation of section 5 (1933 Act)[10] that results from the use of such advertisement. Moreover, if the information in a Rule 482 advertisement that is false or misleading is derived from false or misleading information in the section 10(a) prospectus, the fund might be subject to strict liability under section 11 of the 1933 Act in addition to the liabilities associated with the general antifraud provisions of the Securities laws.

In addition to SEC rules, mutual fund advertising by brokers or dealers must comply with NASD guidelines pursuant to provisions of the Securities Exchange Act of 1934. Principal underwriters of mutual funds, who are members of NASD, are required to file any advertising material with the NASD within 10 days of its use. NASD staff review the advertising material and can ask its members to make corrections to advertisements when the guidelines as set forth in NASD's Rules of Fair Practice are not met. Further, NASD may require that a member file all advertising with the Association's Advertising Department 10 days prior to its use for up to a 1-year period if the member has departed from the association's guidelines. As a result, mutual fund advertising, although not always reviewed by SEC, is regularly monitored by NASD.

[9]17 C.F.R. 230.482.

[10]Refer to section 5(b)(1).

It is clear that SEC intends the section 10(a) prospectus to be the primary selling document used to promote mutual fund securities. Advertisements that are not deemed to be such a prospectus are restricted in their content. The omitting prospectus advertisement can allow greater promotion of a mutual fund than the other types of advertisements because its contents can include any information given in the section 10(a) prospectus. Thus, for example, past yield statistics may appear in this type of advertisement if such information is found in the section 10(a) prospectus.

In contrast, OCC Regulation 12 C.F.R. 9.18 contains no advertising restrictions for commingled investment funds. Further, these bank funds are exempt from securities laws which require a prospectus and the requirements and liabilities that apply directly to it. Commingled funds are subject to the antifraud provisions of the securities laws[11] and the Comptroller of the Currency advises banks to conform to advertising standards set by SEC and NASD to avoid violation of these provisions.[12] Further, bank examiners are instructed to review collective fund advertisements for compliance with the antifraud provisions of securities laws during trust department examinations. However, banks are not members of the NASD and do not submit advertising for the same procedural review that mutual fund advertisements must receive.

In summary, a bank fund has no strict liability under Section 11 of the 1933 Act as a result of a misleading section 10(a) prospectus. Further, a bank is not required to restrict its advertisements to tombstone type advertisements or to information contained in a section 10(a) prospectus, is not subject to rescission for failing to comply with such restrictions or for unintentionally misleading statements in advertisements made by reason of negligence, and does not submit its advertisements for review by the NASD.

Conclusion

If the proposed concept of functional regulation is to be applied to two existing similar products, the current regulation of one or both products must be changed in some way. For example:

[11]Section 17 of the Securities Act of 1933 and section 10 of the Securities Exchange Act of 1934, but not, unless the bank is a broker or dealer, Section 15c(1) of the 1934 Act.

[12]Comptroller's Handbook for National Trust Examiners, July 1984, section 1101.6, paragraph 9.5118.

- Is it necessary to completely remove the current regulatory scheme for one of these products and replace it with the other in order to achieve functional regulation, or
- Would it be sufficient to change some of the current regulation attached to one or both of these products to achieve functional regulation?

In the case of the former question, implementing functional regulation would most likely mean replacing bank-sponsored commingled investment funds with mutual funds regulated in accordance with securities laws. In order for this change to occur, Glass-Steagall Act prohibitions against commercial banks underwriting mutual funds would have to be removed. In the case of the latter question, decisions would be required as to which regulation would be removed, which would be altered, and which would be retained intact. In any case, the extent of change required to implement functional regulation for mutual funds and commingled investment funds would have to be determined by the Congress.

Functionally Regulating Pooled Investment Funds: Implications of Two Approaches

Because it is unclear what the concept of functional regulation would mean for mutual funds and commingled investment funds, we constructed two scenarios. These scenarios are meant to offer a hypothetical framework for applying functional regulation to pooled products offered by investment companies and commercial banks. In our first scenario, we explore the ramifications of one regulatory change in which banks would be granted additional authority to engage in securities activities. These activities would be transferred to an affiliate(s) of bank holding companies. This transfer could result in a bank product which would be the same as a mutual fund currently offered by securities firms. Because the concept of functional regulation can be interpreted so broadly, however, we also construct a second scenario to illustrate the ramifications of regulating a certain type of mutual fund similar to a commingled investment fund. In this second scenario, mutual funds and commingled investment funds would remain as they are, but a new class of investment company would be created. The regulation of this new securities product would more closely resemble the current regulations of a bank-sponsored commingled investment fund.

These two scenarios are neither designed to be predictions of what will or should happen in the future, nor to portray the most likely alternatives. Rather, they illustrate the interaction of certain variables under specific assumptions; there could be many other variables and assumptions.

Scenario One: Regulating Commingled Investment Funds Like Mutual Funds

As discussed in chapter 1, legislative proposals have been introduced in the Congress that would grant banks some securities powers they do not now have. Some of these proposals would permit the creation of a securities affiliate for bank holding companies. This affiliate, referred to as a DISA (depository institution securities affiliate), would conduct most bank securities activities and, under one proposal, the DISA would sponsor mutual funds and would be regulated by SEC under securities laws.

Therefore, it is possible to conceptualize a situation in which the DISA-managed commingled investment fund would, in effect, become a mutual fund. This would create a situation where products performing the same function are regulated in the same way by a common regulator. In this scenario, the commingled fund would be replaced by the DISA fund. This DISA fund would cease to be a separate fund for employee benefit plan trust assets and would become a mutual fund open to investment by anyone with the minimum to invest. The bank trust department would simply use this DISA-managed fund as one more investment alternative for the employee benefit plans it manages as a fiduciary.

When analyzing this situation, several factors should be considered. First, some participants in a commingled investment fund employ the bank as trustee with the knowledge that the fiduciary principles of ERISA will apply to the investment decisions regarding the participant's assets. These principles will be affected to varying degrees under this scenario. Second, although the DISA is an affiliate, there continues to be a close relationship between its activities and a commercial bank, perpetuating the possibilities for conflicts of interest. Thus, SEC, as the DISA regulator, may need clear access to information on commercial clients of the bank to directly assess such possibilities. Next, the regulators' objectives and their ability to meet these objectives could be hampered and, lastly, existing federal and state laws would pose barriers to such a change. Each of these implications is discussed in turn.

Implications for Fiduciary Principles

If commingled investment funds were transferred out of bank trust departments into mutual funds managed by a DISA, the bank's fiduciary responsibilities would not be diminished. The trust principles of loyalty and prudence would still apply, and trust officers would be obliged to maintain fiduciary standards discussed in earlier chapters. However, if the bank's trust department was separated from the new form of commingled investment fund and this new fund is the only pooled fund available for the investment of employee benefit plan assets trusteed by the bank, the bank might have some difficulty in complying with the loyalty trust principle.

According to the basic trust principle of loyalty, a trustee bank must conduct itself solely in the interest of its fiduciary clients. As currently applied to banks, this principle prevents trust officers from, among other things, investing trust assets in bank pooled funds that would not be in the best interests of their clients, particularly if such investments generate income for the bank beyond reasonable trust management fees. Further, federal bank regulators allow banks to charge a management fee for accounts where the bank is the trustee, but restrict banks from charging an additional fee for participating these assets in its commingled funds.

If a bank is selected as a trustee or named fiduciary for an employee benefit plan and the bank elects to place plan assets in its affiliated DISA mutual fund, then it would be necessary to ensure that the plan is not charged a double fee. The double fee would result if the employee benefit plan pays both a trust management fee to the bank (which might include investment management) and pays the mutual fund management fee to the bank affiliate's (DISA) mutual fund like all other fund investors. Such a double fee situation might violate the trust principle of loyalty if the bank has an incentive to place trust accounts in its affiliated DISA mutual fund to take advantage of this additional source of income. The double fee can be avoided if guidelines are adopted to reduce or proportionately offset the trust fee by the amount of the mutual fund's management fee. However, OCC regulatory officials believe improper incentives may exist even if the above fee adjustment is made. These officials maintain that it is improper to place a fiduciary in the position of promoting such an affiliated fund in any manner. Basically, the concern is whether a fiduciary can truly act in the best interest of trust clients where the investment of clients' assets under its supervision could be helpful to the prosperity of its own enterprise—the DISA-managed fund.

The principle of prudence may also be affected, although to a lesser extent, under this proposed scenario. If the bank is the trustee of an employee benefit plan, then trust department officers would still be required to determine if the DISA-managed fund was a prudent investment for the trust account. Because some existing mutual funds could be suitable for employee benefit plan investment, this should not be a formidable obstacle. However, because of the close association between the trustee bank and its affiliated fund, some guidelines may be needed to identify conditions under which the DISA-managed fund is a prudent investment, or, when it is no longer a prudent investment when compared to the safety and rate of return offered by competitors.

In cases where the bank does not act as the employee benefit plan's trustee but serves in an agent capacity when accepting such plan assets, the situation changes. If the only pooled fund available within a bank holding company structure is the DISA-managed mutual fund, employee benefit plan trustees seeking only investment management would likely deal directly with the securities affiliate, totally bypassing the trust department. In this case, the double fee problem and other concerns would be non-existent.

Implications for the New Structure

Conducting securities activities through a DISA would seem to place even more distance between trust activities and commercial banking activities than is possible through a set of operating policies. Nevertheless, the

DISA and mutual funds managed by it are still affiliates of a bank. The possible impact of this affiliation must be considered.

Requiring the placement of bank securities activities in an affiliate of the holding company rather than directly with the bank or bank subsidiary is a design to separate securities activities from traditional bank activities, to the greatest extent possible, when giving the banking industry new securities powers. The rationale for this structure is that such an affiliate, which is to be separately capitalized, will reduce potential risks that any securities activity may pose to the holding company's traditional bank subsidiaries.

Some banking experts, however, have raised questions concerning just how independent any bank holding company affiliate can be from the total holding company structure. If a significant amount of affiliated banks' fiduciary accounts are invested in the DISA-managed mutual fund, the desired degree of independence may be diminished. Specifically, banks may be less willing or able to remain independent from a troubled securities affiliate which holds large sums of their fiduciary assets.

This separation of the bank from the DISA-managed mutual fund has a second ramification. Some employee benefit plans seek bank-sponsored commingled investment funds as suitable investments for their plan assets precisely because banks have corporate assets to extract in the event of fiduciary violations. This feature could be eliminated if all commingled investment funds operated within the bank's trust department were abolished to achieve functional regulation.

Implications for Existing Laws and Regulators' Objectives

This scenario is developed based on the premise that the Congress might empower banks to conduct an expanded range of securities activities and decide to regulate commingled investment funds as mutual funds. Such a move would require change to the Glass-Steagall provisions of the Banking Act of 1933 which prohibit banks from being "affiliated in any manner . . . with any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of stocks . . . or other securities." This act separated commercial banking from most securities activities, including offering mutual funds. The intention of the Congress to permit such activities would need to be explicit because it would constitute an important change to our current regulatory system.

Further, certain federal securities laws would also have to be clarified. For example, section 3(c)(11) of the Investment Company Act of 1940 gives bank-sponsored commingled investment funds certain exemptions from securities laws and may need to be altered if the funds are to be regulated identically. Also, other provisions, such as section 3(a)(2) of the Securities Act of 1933, which exempts any securities issued by banking institutions, may need to be altered to give SEC clear jurisdiction over the new DISA-managed mutual funds.

The regulatory framework developed by bank regulators gives them oversight responsibility over all bank operations including trust and commercial activities. However, GAO[1] has demonstrated in the past that fragmented supervision over the holding company can lead to regulatory problems affecting bank supervision. Bank holding companies are regulated by the Federal Reserve. Affiliated banks, however, may be regulated by different bank regulators depending on their charters and membership in the Federal Reserve. Our report listed examples of poor coordination and sometimes contradictory enforcement actions that were taken against holding company bank affiliates even though the agencies have similar safety and soundness objectives.

With the introduction of a securities affiliate, the need for cooperation among regulators may extend to SEC as well, especially if trust accounts are collectively invested in a DISA-managed mutual fund. In such a structure, the bank and the respective bank regulators will have relinquished their former direct responsibility over the operation of the former collective investment funds. That responsibility would then rest with the securities affiliate and the SEC. Nevertheless, the conflict of interest concerns discussed earlier would remain. Both the SEC and the bank regulators may need to ensure that procedures are in place to prevent the flow of information or the use of the DISA-managed mutual fund's assets to promote the commercial interests of the bank. Further, these procedures might need to be tested during examinations by a regulator with an overview of both banking and DISA activities.

Such SEC-bank regulator coordination may be complicated by differences in their respective regulatory objectives and techniques. The three bank regulators' safety and soundness concerns sometimes result in regulatory actions only disclosed between the bank and the appropriate regulator. While SEC's examination reports are confidential, regulatory action

[1] Federal Supervision of Bank Holding Companies Needs Better, More Formalized Coordination (GGD-80-20, Feb. 12, 1980).

may take the form of public disclosure during hearings or court action. The situation may arise where bank regulators would prefer to take confidential action but SEC would insist on public hearings. This, in turn, could lead to a loss of confidence in the banking operation of the holding company. This possibility would have to be addressed by the regulators and agreements reached on the nature of disclosures associated with a troubled securities affiliate of a bank holding company.

Intergovernmental Implications

As chapter 3 indicated, states have some authority to impose their own unique statutory and regulatory requirements on commingled investment funds and mutual funds. For mutual funds, states have their own registration, blue-sky, and expense limitation requirements. For commingled investment funds, states can prescribe conditions under which individual trust accounts may be collectively invested. In addition, the Department of Labor's enforcement of ERISA could impact on the proposal to place trust accounts in a DISA-managed mutual fund. State laws and ERISA must be considered when contemplating changes to the current structures of pooled products.

In this scenario, the DISA-managed mutual fund would be subject to the same state requirements as any other mutual fund. The fund would have to register, pay the appropriate registration and amendment fees, comply with blue-sky requirements, and adhere to state expense limitations. The fund will have to do this not for a single state but for all states in which it is marketed. Thus, a DISA-managed fund with assets from an employee benefit plan for participants and beneficiaries in several states likely would have to comply with each of those states' securities requirements. Under this arrangement, it is possible that the expenses associated with multiple state registrations could be passed on in the form of fees that could exceed those associated with commingled investment funds which are subject only to the fiduciary requirements of the state in which their bank is chartered.

ERISA contains provisions that also restrict the investment authority of the fiduciary of an employee benefit plan. If the bank acts as a trustee with investment authority for employee benefit plan assets, then the bank might be restricted from investing plan assets in its own DISA-managed mutual fund. Section 406(a)(1)(A) of ERISA states that:

> "A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect sale or exchange . . . of any property between the plan and a party in interest."

Further, section 406(b)(1) states that "A fiduciary with respect to a [employee benefit] plan shall not deal with the assets of the plan in his own interest or for his own account."

ERISA section 408(b)(8) exempts section 406 transactions between an employee benefit plan and a bank or trust company's current commingled investment fund but is naturally silent regarding products of our hypothetical holding company securities affiliate. When queried about this matter, a Department of Labor representative suggested that a situation in which both the bank trust department and its securities affiliate both charged a management fee would be a violation of ERISA absent the bank obtaining an administrative class exemption.[2] Further, this representative indicated that one of the conditions of such an exemption would preclude the bank and its affiliate from both charging a management fee for their handling of the same employee benefit plan assets.

Scenario Two: Regulating Mutual Funds Like Commingled Investment Funds

Another scenario for achieving a degree of functional regulation would require the creation of a new class of investment company that could be offered by securities firms or even banks to employee benefit plans. This second scenario is based in part on a 1982 SEC concept release (I.C. 12888) to authorize a new type of investment company.

This new investment company would not require investor voting on management issues or require independent members on its board of directors. Extending this proposal even further for the purpose of achieving regulation more similar to that of commingled investment funds, the Congress could create a new class of investment company to compete with bank commingled investment funds by

- restricting participation to only qualified employee benefit plans;
- allowing national distribution, yet subjecting the new fund only to federal regulation and the regulation of the state in which the fund is established;
- requiring a quarterly rather than daily valuation to permit entry or redemption;
- removing shareholder voting requirements;
- removing board of director requirements; and
- treating shares of the new fund as exempted securities not subject to filing a prospectus.

[2] 42 Federal Register, 18732-18734, April 8, 1977.

By restricting entry to qualified employee benefit plans, the new class of investment company might take on several commingled investment fund characteristics that could reduce the new investment company's operating costs and perhaps make it more competitive with the bank funds. For example, compliance with various state registration fees and other blue sky requirements adds to the cost of a mutual fund's operations. Subjecting a new class of investment company to only the requirements of the state in which it is formed rather than the requirements of all states in which the fund is marketed could reduce legal and administrative costs. Such a change would mirror the situation of bank funds which are subject only to their respective state fiduciary requirements. Even though states have implemented these blue-sky laws to protect investors, if the investors are all employee benefit plans they may not need the protection of these state securities laws, particularly when ERISA covers most employee benefit plan operations. In addition, employee benefit plans may not require the degree of liquidity provided by daily entry and redemption; and, therefore, a monthly or quarterly process may be adequate for the new security.

A new class of investment company limited to employee benefit plans might alter another regulatory requirement under current securities law. If only employee benefit plans are allowed to participate in such a new investment company, then it may not be necessary to issue shares subject to the registration requirements of the Securities Act of 1933. However, the new investment company itself would still have to register with the SEC under section 8 of the 1940 Investment Company Act to attain status for regulatory purposes and perhaps might have to pay an annual registration fee based on a percentage of assets to help offset SEC's oversight expenses.

Shares or units of participation of this new fund could be treated as exempt securities. In such a case, the new fund would not have to file a prospectus.[3] Instead, this new fund could be required to file an operating plan much like the plan described in OCC Regulation 9.18, and SEC could control the content of the plan by regulation. Notably, the new fund would still be subject to the anti-fraud provisions of federal securities laws[4] just like the current bank funds. The operating plan, coupled with a requirement for a contractual agreement (as described next), would

[3] As required by the Securities Act of 1933, section 10.

[4] Securities Act of 1933, section 17 and Securities and Exchange Act of 1934, section 10.

perhaps provide the proper degree of investor protection for this class of investor.

Additionally, in designing this new fund, some decision would have to be made concerning the applicability of ERISA. The coverage of ERISA could be limited as it currently is with mutual funds to the initial decision to invest in the fund; or the coverage of ERISA could apply to investment managers' everyday actions in making portfolio decisions as it does currently with commingled investment funds.

Finally, the new class of investment company would have no requirements concerning shareholder voting or disinterested members on its board of directors to specifically oversee its operations. SEC recognized the possibilities of this type of adjustment in its 1982 concept release. At that time, SEC requested comments on whether the Commission should propose rules or recommend legislation "to enable all or certain types of registered open-end investment companies to be organized and operated without shareholder voting, or without either shareholder voting or boards of directors." This concept release was made "to reduce the expenses of fund operations without sacrificing investor protections."

This SEC concept release discussed the possibility of removing completely the board of directors as well as shareholder voting requirements to form a new fund referred to as a unitary investment fund. The legal relationship between the fund manager and investors would be established in a contract which would contain terms regarding investment objectives, management fees, and charges to shareholder accounts. If such a fund was available exclusively to employee benefit plans, the contract might also need to address the fiduciary standards required by the Department of Labor. In fact, this new fund's management and portfolio transactions could be made subject to ERISA provisions in a manner similar to commingled investment funds. Also, the new fund's contract would be amendable by the securities firm only after appropriate notice is given to investors so they could exercise their redemption option.

Shareholder voting on management issues is not available to customers of commingled investment funds and may not be an appropriate technique for managing employee benefit funds. It would not seem appropriate for managers of one employee benefit plan to be able to affect the investment of assets of another such plan through shareholder voting in pooled funds. However, to replace the protections afforded by voting, employee benefit plan investment managers would have to be adequately informed of proposed changes and afforded adequate redemption opportunity before their implementation.

Some or all of the above changes could allow a new class of investment company to compete more equally with commingled investment funds. Operating costs may be less for such a fund because the new fund would not have to pay director salaries, conduct proxy solicitations, be subject to multiple state fee expenses, or be subject to the various costs associated with producing and distributing a prospectus. Employee benefit plans could benefit from such a new product if the new fund is able to reduce its operating costs and pass these savings on to employee benefit plan customers. Indeed, some new form of investment company could be an attractive alternative in those cases where employee benefit plans seek only investment management.

Summary

In this chapter we have explored two contrasting scenarios that could lead to more equal competition among pooled funds offered by investment companies and commercial banks. The different scenarios suggest that a range of approaches may exist to achieve the goal of functionally regulating these two pooled products. Further, several important decisions will be necessary depending upon the course of action that is chosen. In the first scenario such public policy issues would have to be addressed as deciding to give banks expanded securities powers; altering key conflict-of-interest principles, particularly when the bank acts as trustee for employee benefit plans and assets; and determining what role states should play in this regulatory scheme.

In the second scenario an entirely different method is employed to achieve functional regulation. The Investment Company Act could be amended to create a new class of investment company. Commingled investment funds and mutual funds would still exist and operate; however, this new investment company would give securities firms a product that could compete more directly with commingled investment funds for that market segment consisting of employee benefit plans seeking only investment services.

Elements Evaluated by GAO in Comparing Pooled Investment Funds

Product Characteristics

Purpose of fund
Nature of ownership
Institution/client relationship
Investment objectives
Investment risk
Entry/exit (liquidity)
Protections offered
Clients/investors (pooling)
Taxation

Institutional Characteristics

Purpose of institution (bank or investment company)
Nature of the institution
Relation of fund to institution

Operations
Management (including investment decisions)
Investment advice
Other operations (bookkeeping, custodian, etc.)

Regulatory Characteristics

Overall objectives

Disclosure

Objective of regulator
Information submitted to regulator
Operating information and procedures
Updating operating information and procedures
Dissemination of operating information and procedures

Examination

Objectives
Advance notice
Frequency
Discretion of examiners
Scope of examination
Examination elements
Examination of records and accounts
Calculation of value of assets

Operations
Payments to clients/shareholders
Portfolio transactions
Composition and actions of Board of Directors
Contracts
Correspondence
Fidelity coverage
Activities of affiliated persons
Entry and exit from fund
Conflict of interest and self-dealing

Enforcement

Moral suasion
Deficiency letter/memorandum of understanding
Written agreements
Letter of caution or warning
Hearings
Censure
Limitation on activities
Suspension
Injunction
Cease and desist order
Termination of powers

Other

Restitution
Civil money penalties
Other penalties
Referral to Department of Justice for criminal proceedings

Other Characteristics

Applicable federal laws and regulations
Applicable state laws and regulations

Advance Comments From the Board of Governors of the Federal Reserve System

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

March 11, 1986

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This is in response to your letter of February 7th to Chairman Volcker enclosing for our review and comment a draft report entitled "Functional Regulation of Financial Products: An Analysis of its Applicability to Two Types of Pooled Investment Funds". Our staff subsequently conveyed some suggestions for editorial and technical changes to your staff in oral discussions and we understand that these changes will be incorporated in the final report. Except for these suggestions for language changes, the staff found the report to be satisfactory.

If you have any further questions with respect to this matter, please call Robert S. Plotkin, Assistant Director, 452-2782.

Very truly yours,

Welford S. Farmer
Deputy Director

Enclosure

Advance Comments From the Comptroller of the Currency

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

March 14, 1986

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Anderson:

This is in reply to your request for our review and comment on your draft report entitled "Functional Regulation of Financial Products: An Analysis of its Applicability to Two Types of Pooled Investment Funds."

We believe our written comments to be an appropriate culmination to the time and attention we have given this project and its resultant report over the last three years. We commend your staff on its achievements in becoming knowledgeable and conversant in a complicated and technical subject. However, we believe the proposed report contains one significant deficiency.

Our criticism of the draft report deals with its final chapter, where two scenarios are constructed to describe means by which a measure of functional regulation of the contrasted pooled vehicles could be achieved. Here, we see a failure to make truly parallel comparisons, resulting in an impression of bias to the reader. This is because both scenarios contemplate circumstances wherein the system of supervision designated for investment companies will prevail. In the first scenario, the report explores making bank commingled investment funds into investment companies, so that banks would be required to operate any such pooled investment devices as investment companies through a securities affiliate. This obviously represents one extreme end of the spectrum of possibilities. One would expect that the second scenario would provide the opposite side of the spectrum, that is, where securities firms are able to operate pooled investment devices under the banking laws. Instead, however, what is presented is a variation of the first scenario, whereby securities firms would be permitted to establish new types of investment companies which would have some operating characteristics similar to those applicable to bank collective investment funds. This new investment company would be subject to the supervisory system applicable to conventional investment companies.

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In choosing to present these two scenarios, we believe that the report has taken an extremely unrealistic approach. Scenario one would in effect force out of banks their largest segment of collective investment fund activity. It would require that a significant amount of funds--well over $100 billion--be operated as investment companies through affiliates. This would be a very drastic measure; one which can only be justified through a most extreme and fundamentalist theory of functional equivalency. The fact that bank commingled investment funds compete in some degree and have some characteristics in common with investment companies is not, we believe, sufficient justification for causing their discontinuance in favor of investment company vehicles.

We submit that true functional regulation can best be achieved, and indeed is being achieved, through a scenario which is not included in the report--product deregulation. Securities firms have established affiliated trust companies which can and will operate commingled investment funds. These funds are subject to banking regulations in every respect identical to such funds operated by trust departments of banks. This avenue should be opened to all securities dealers. To a less parallel extent, banks have established affiliates which are engaging in the securities business, subject to the supervision of the SEC and the other securities regulators. Complete parallel regulation would be achieved for banks if they were permitted through affiliates to operate investment companies, as this office has repeatedly recommended. This unwritten scenario would thus achieve functional regulation in a manner which would not be revolutionary, but rather, would constitute a logical progression of trends which are already taking place. It would be achieved without disrupting private decision-making and without causing a drastic restructuring of the types of investment vehicles which financial institutions can operate for their fiduciary accounts.

We have discussed these and other issues and comments with your staff, and would be pleased to provide additional information.

Thank you for the opportunity to comment.

Sincerely,

Richard V. Fitzgerald

Richard V. Fitzgerald
Chief Counsel

Advance Comments From the Federal Deposit Insurance Corporation

NOTE: GAO comments supplementing those in the report text appear at the end of this appendix.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF DIRECTOR - DIVISION OF BANK SUPERVISION

March 7, 1986

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

Thank you for the opportunity to review and comment on the draft report entitled "Functional Regulation of Financial Products: An Analysis of its Applicability to Two Types of Pooled Investment Funds."

You have identified mutual funds and bank-sponsored trust department collective investment funds as "suitable for functional regulation" because they share certain product characteristics and can be marketed to the same potential customers. We agree that they have many common characteristics but, as your report indicates, there are also noteworthy differences.

This is but one of many such overlaps/inconsistencies in a complex regulatory framework for financial services products. It is for Congress to address the broader issue of "functional regulation." While we agree that bank-sponsored trust department collective investment funds as well as other areas may be appropriate for consideration, should Congress mandate a major realignment of regulatory responsibilities, we would prefer not to pursue this issue on a piecemeal approach at this time. In this regard, we feel it appropriate that your draft report does not make any recommendations to shift responsibility for oversight of collective investment funds from the banking agencies to the Securities and Exchange Commission.

We believe it should be pointed out that, through omission, there is an implication in the draft report that collective investment funds are not subject to fiduciary responsibilities and standards, whereas mutual funds are. This tends to be misleading, as both the collective investment funds and the fiduciary accounts which use them are subject to State or Federal fiduciary laws and regulations.

It should also be noted that the differences that exist in operational requirements and application of fiduciary standards between mutual funds and collective investment funds are due to the different customer base for each. Mutual

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funds are offered to the general public. Collective investment funds may only be used by preexisting bona fide trust department accounts, and are prohibited from being offered to the general public. This very restricted availability of collective investment funds has long been recognized in the Federal securities laws, which exclude them from the registration requirements needed to offer a security such as a mutual fund to the general public.

Two other points should also be made concerning certain parts of the draft report.

See comment 1.

- Statements are made that the bank regulators emphasize protecting bank customers through assuring the safety and soundness of banks. This may be interpreted as indicating there is no protection afforded trust beneficiaries and participants in collective investment funds which is certainly incorrect. In reviewing trust department management and operations, both for individual and collective investment trust funds, FDIC emphasizes the manner in which the bank's fiduciary responsibilities are being carried out so as to preclude events which would adversely impact on the trust account customers and beneficiaries as well as the bank itself.

See comment 2.

- In Chapter 3, "Regulation of Pooled Investment Funds," a statement is made that the regulatory scheme for collective investment funds relies heavily on examinations to obtain information chiefly for the regulators. The purpose of the examinations is not only to obtain information for the banking agencies. It is also to ensure that prudent and lawful management is provided to the trust accounts, collective investment funds, and the trust department itself, and to see that any deficiencies are reported to management for corrective action.

I understand that a member of my staff has contacted Mr. Staiger to offer a few suggestions aimed at correcting other minor technical deficiencies in the draft report.

Sincerely,

Robert V. Shumway

Robert V. Shumway
Director

The following are GAO's comments on the Federal Deposit Insurance Corporation's letter dated March 7, 1986.

GAO Comments

1. We believe the use of the term "emphasize" in the text does not indicate that no other protections are afforded trust participants in collective investment funds. In fact, these protections are discussed in chapter 3.

2. We revised this report to reflect this observation.

Appendix V Advance Comments From the Securities Exchange Commission

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

March 12, 1986

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

Thank you for the opportunity to review the GAO draft report entitled "Functional Regulation of Financial Products: An Analysis of its Applicability to Two Types of Pooled Investment Funds". The enclosed memorandum to Chairman Shad, prepared by the Commission's staff, provides comments on the report.

If you have any questions, please feel free to contact me at 272-2750.

Sincerely,

Kathryn B. McGrath

Kathryn B. McGrath
Director

Enclosure

See comment 1.

M E M O R A N D U M

TO: Chairman Shad

FROM: Kathryn B. McGrath Kathryn B. McGrath

SUBJECT: GAO Draft Report on "Functional Regulation of Financial Products: An Analysis of its Applicability to Two Types of Pooled Investment Funds"

DATE: March 7, 1986

The staff of this Division and the Office of the General Counsel have reviewed the above-referenced GAO draft report. We have no major problems with its content. We believe, however, that the attached suggested changes would improve the final report.

Carol Martin (272-3031), Angela Hall (272-2799) and I (272-2750) will be happy to answer any questions you or the GAO might have about this.

Attachment

The following are GAO's comments on the Securities Exchange Commission's March 12, 1986 letter.

GAO Comments

1. Because of the technical nature and length of the attached comments, they were not reprinted in the report. Many of the suggestions made by SEC however, have been incorporated in the report.

Glossary[1]

Administration
A fiduciary capacity of a trust institution appointed by a court to settle the estate of a person who dies without a valid will. This fiduciary functions in accordance with the intestacy laws of a state.

Bank Holding Company
A bank holding company is a form of bank ownership by which individuals own a company that controls one or more banks, other companies engaged in activities closely related to banking, or another bank holding company.

Blue Sky Laws
State statutes which attempt to insure that the terms of securities offerings are fair, just, and equitable and meet minimum standards of investment quality. Blue sky laws impose requirements which are unique to securities offerings in a particular state.

Collective Investment Fund
A pool of investments managed by a bank according to a written plan on behalf of several individual fiduciary accounts whose assets are lawfully contributed to the fund. Participation in these funds is available only to fiduciary assets held in trust by a bank or other lawful trustee.

Commingled Investment Fund
A major type of collective investment fund consisting solely of assets of retirement, pension, profit sharing, stock bonus or other trusts which are exempt from federal income taxation under the Internal Revenue Code.

Common Trust Fund
A major type of collective investment fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as trustee, executor, administrator, guardian, or custodian under a Uniform Gifts to Minors Act.

Custodian
The organization (usually a bank) which holds in custody and safekeeping the securities and other assets of a mutual fund or trust.

[1] This Glossary briefly defines terms as they are used in the text of this report.

Custodian Under a Uniform Gifts to Minors Act	A fiduciary capacity of a trust institution imposed under state law. This fiduciary functions as a custodian of property with responsibilities substantially equivalent to those of a guardian and/or trustee.
Employee Benefit Plan	ERISA defines employee benefit plans as plans which provide retirement income to employees or result in deferred employee income for a period extending to the termination of covered employment or beyond. Although some exemptions exist, ERISA requires that the assets of employee benefit plans be held in trust.
Employee Retirement Income Security Act	A federal statute administered by the Department of Labor, Internal Revenue Service, and Pension Benefit Guaranty Corporation which regulates the conduct of those charged with administering and investing assets of privately sponsored employee benefit plans. This Act amended the Internal Revenue Code provisions governing the tax deferral nature of such plans.
Executor	A fiduciary capacity of a trust institution nominated in a will by the maker of the will to carry out the provisions of the will. In order to preclude legal conflict, this fiduciary must have the will accepted by a court of competent jurisdiction as the valid and final will of the deceased. It must then receive written authority from that court to serve as executor.
Fiduciary	A person(s) acting alone or jointly with others primarily for the benefit of another in all matters connected with its actions. The principal function of a fiduciary is the management of property for others.
Guardian	A fiduciary capacity of a trust institution appointed by a court to care for the property or the person (or both) of a minor or incompetent, for example. The duties and responsibilities of this fiduciary are governed by state statutory provisions and court interpretations.
Investment Adviser	The organization which is employed by a mutual fund to give professional advice on its investments and the mangement of its assets.

Investment Company

A corporation, trust, or partnership in which investors pool their money to obtain professional management and diversification of their investments. Mutual funds are the most popular type of investment company.

Mutual Fund

An investment company which ordinarily stands ready to buy back (redeem) its shares at their current net asset value; the value of the shares depends on the market value of the fund's portfolio securities at a given time. Also, most mutual funds continuously offer new shares to investors.

Pooled Investment Funds

A term used in this report to refer to both mutual funds and collective investment funds.

Portfolio

Holdings of securities by an individual or institution.

Prospectus

The official booklet which describes the mutual fund and offers its shares for sale. It contains information as required by the Securities and Exchange Commission on such subjects as the fund's investment objectives and policies, services, investment restrictions, officers and directors, how shares can be bought and redeemed, its charges, and its financial statements.

Prudent Man Rule

An investment standard for fiduciary assets. This standard generally requires that fiduciary assets be invested in a manner similar to that which would be selected by a prudent person of discretion and intelligence who is seeking a reasonable income and preservation of assets.

Transfer Agent

The organization under contract to a mutual fund to prepare and maintain records relating to the accounts of its shareholders.

Trustee

A fiduciary capacity of an individual or institution holding title to and managing trust property on behalf of another or others.

Underwriter The organization which acts as the distributor of a mutual fund's shares to brokers-dealers and the public.