INVESTMENT COMPANY INSTITUTE

MEMO# 2649

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ADMINISTRATION BILL ON FINANCIAL SERVICES RESTRUCTURING

-1- March 28, 1991 TO: BOARD OF GOVERNORS NO. 20-91 MEMBERS - ONE PER COMPLEX NO. 15-91 RE: ADMINISTRATION BILL ON FINANCIAL SERVICES RESTRUCTURING ____ The Bush Administration has released its bill to reform the deposit insurance system and to restructure the financial services industry. The bill has been introduced in both Houses of Congress. A copy of the bill and the accompanying section-by-section analysis is attached. Set forth below is a brief summary of the bill's provisions, focusing on investment company and other securities powers. Please note that the summary is based on preliminary review by the Institute staff and does not cover all provisions in the bill. Provisions Concerning Securities Powers General. Under the bill, banks would be permitted, through separate affiliates or subsidiaries, to engage in various securities activities, including investment company activities. Specifically, the bill would repeal Sections 20 and 32 of the Glass-Steagall Act, which prohibit banks from being affiliated with firms "engaged principally" in securities activities and limit common directors, officers and employees between commercial and investment banks. (Section 221 of the bill) Under the bill, banks could be affiliated with securities firms, as well as insurance companies and other companies engaged in financial activities, under common "financial services holding companies" (or "FSHCs"), which would replace bank holding companies. Most securities activities, including investment company activities, would be required to be carried out in a separate securities affiliate of the FSHC, subject to full SEC regulation (Sections 201 and 203). In this regard, the bill adopts the general framework endorsed by the Institute. Banks not affiliated with separate securities affiliates would be permitted to sell investment company securities through a subsidiary of the bank (rather than a separate holding company affiliate); however, bank subsidiaries would be barred from -2- sponsoring, organizing or controlling registered investment companies. Generally, only FSHCs that fall within the highest of five "zones" established with respect to capitalization ("Zone 1") or that meet other capital standards would be permitted to own securities affiliates; however, existing "Section 20 affiliates" would be grandfathered for a three year period. Securities affiliates would be required to make certain disclosures to customers and receive written acknowledgments of the disclosures from customers. The required disclosures include that the affiliates are not insured institutions and that the securities they offer are not federally insured. The SEC would be authorized to adopt regulations governing these required disclosures. In addition, the appropriate federal banking agency would be authorized to adopt certain "firewalls" governing activities such as disclosure by a bank of nonpublic customer information to its affiliates and credit support by a bank for its securities affiliate. (Section 203) The types of transactions subject to restrictions under Sections 23A and 23B of the Federal Reserve Act also would be expanded. (Section 223) Ownership by Commercial Firms. The bill would allow commercial firms to acquire FSHCs, but only if the FSHC falls within Zone 1. These firms would be considered "diversified holding companies". Additional firewalls would be applied to transactions between the insured institution and the diversified holding company and its affiliates. Most importantly, a bank could not loan money to an affiliated diversified holding company or any of its affiliates. (Section 204) In this way, the bill provides for a full "two way street", and adopts the position endorsed by the Institute. Reporting and Other Obligations. FSHCs would be required to maintain certain records and make certain reports to the appropriate federal banking regulator. Diversified holding companies also would be required to make similar reports. The bill would direct banking agencies to "consult with and, to the extent possible, use reports obtained by" the "functional regulator" of the diversified holding company, FSHC or affiliate (which, in the case of a securities affiliate, would be the SEC) to obtain the needed information. Similarly, banking agencies could conduct examinations of holding companies but would be required to consult with or make use of reports obtained by the SEC in the case of securities affiliates. The SEC would be given reciprocal access to reports and would be permitted to make reciprocal examinations of insured depository institutions with respect to activities that could have a material impact on a securities affiliate. (Section 205) Banking regulators would be permitted to issue cease-and- desist orders against holding companies and, under certain -3- circumstances, order divestment in response to activities constituting a serious risk to a depository institution. (Section 205) Amendments to the Securities Laws. The bill would repeal the exemptions in the Securities Act for securities issued or guaranteed by bank and thrifts (other than certain traditional bank instruments such as deposits, letters of credit, etc.) (Section 241) The Securities Exchange Act would be amended to require that bank brokerage activities generally be carried out by a subsidiary or affiliate of the bank and not by the bank itself. Banks could engage in certain specified brokerage activities directly, including transactions in commercial paper and other exempted securities, trust activities (unless the bank receives incentive compensation and publicly solicits brokerage business), "sweep accounts", transactions for employee benefit accounts, and private placements. In addition, banks without broker-dealer subsidiaries or affiliates could engage in up to 1,000 securities transactions a year. Similarly, banks could generally engage in dealer activities only through separate subsidiaries or affiliates. (Section 242) The bill would impose additional restrictions on the offer and sale of securities on bank premises. In general, securities issued by a bank or any affiliate could not be offered or sold to the public in any part of the bank "commonly accessible to the general public for the purpose of accepting deposits" (i.e., bank lobbies). However, this restriction would not apply to shares of an affiliated investment company, provided that the sales are effected by a registered broker-dealer. (Section 242) 1940 Act and Advisers Act Amendments. The Investment Company Act would be amended to add certain "firewalls" between a bank and an affiliated fund. Specifically, the SEC would be authorized to adopt regulations governing banks acting as custodians for affiliated management investment companies or as trustees for affiliated unit trusts. The definition of "interested person" would be broadened to include persons affiliated with custodians, transfer agents, or entities that execute transactions for, engage in principal transactions with, or loan money to an investment company or any investment company with the same adviser, principal underwriter, sponsor or promoter. (This would include both banks that engage in such activities as well as foreign broker-dealers not registered under the Securities Exchange Act within the scope of the definition.) Section 10(c) of the 1940 Act would be amended to extend the current prohibition on the majority of a fund's board consisting of directors, officers and employees of a single bank to directors, officers and employees of a single bank and its affiliates. (Section 243) -4- In addition, the bill would give the SEC rulemaking authority with respect to "loans, purchases or sales of assets, and other transactions involving a bank, an affiliated person and an affiliated registered investment company". The section-by- section analysis states that this provision is intended to give the SEC authority to address conflict-of-interest transactions involving banks and affiliated funds (similar to the current prohibitions under Section 17). (Section 243) This provision differs from the Institute's consistent position, which has been to urge the adoption of statutory firewalls which would prohibit specified transactions (subject to SEC exemptive authority) such as a bank (1) "dumping" trust assets into an affiliated fund, (2) loaning money to an affiliated fund, (3) causing an affiliated fund to purchase securities issued by a borrower from the bank, and (4) loaning money to a company whose securities are held by an affiliated fund. The bill also contains a provision that would allow the SEC to adopt regulations requiring prominent disclosure that shares of an investment company affiliated with, or with a name similar to, a bank, are not bank obligations and are not FDIC insured. The SEC also would be permitted to issue orders that the use by a fund of a name similar to a bank is deceptive and misleading. (Section 243) The Institute has recommended that similar names or logos be barred for a specified time period following enactment of legislation granting banks mutual fund powers. The bill does not contain special 1940 Act firewalls governing cross- marketing, shared offices and the like, which have been recommended by the Institute. The Institute has consistently stated that, as part of any legislation granting banks mutual fund powers, the current exemptions from the 1933 and 1940 Acts for bank common trust funds and bank collective funds for retirement plans should be repealed. The Treasury bill would substantially narrow the exemption for common trust funds by limiting it to those funds not advertised or publicly offered, used only for fiduciary purposes and not assessed a separate management fee. (In essence this would codify current SEC interpretations of the scope of the exemption.) Common trust funds would be permitted to convert to registered investment companies on a tax-free basis. (Section 245) With respect to collective funds for retirement plans, the bill directs the SEC to conduct a study of their regulation (as well as the regulation of common trust funds and insurance company separate accounts for retirement plans) and to report legislative and administrative recommendations to the Congress within 6 months. The section-by-section analysis states that the purpose of this study "is to adopt a regulatory scheme that protects investors in pooled investment funds on an equal basis, regardless of whether the funds are pooled by investment companies, banks or insurance companies". (Section 246) -5- The bill also requires banks that serve as investment advisers to investment companies to be registered under the Investment Advisers Act (a position endorsed by the Institute). A bank itself could serve as adviser by establishing an identifiable division or department to perform the function, which would be subject to SEC regulation. The SEC would be required to notify the appropriate banking regulator before any inspection or enforcement action against any FSHC, bank or bank department or division registered under the Advisers Act, unless the protection of investors requires inadequate action. (Section 244) Non-Securities Powers Provisions Interstate Banking. The bill would allow FSHCs to acquire banks on a nationwide basis and would permit full interstate branching by both national and state banks three years after its effective date. (Sections 261-264) (The Institute has consistently called for nationwide banking so that securities firms affiliated with banks could offer both securities and banking products on a nationwide basis.) Deposit Insurance Reform. The bill would reduce, to some extent, the current scope of federal insurance for deposits. As under current law, each depositor would be insured up to $100,000 per institution. In addition, a depositor could be insured up to an aggregate of $100,000 per institution for deposits made in connection with IRAs, Keoghs and other self-directed defined contribution plans. (Section 101) Deposits obtained through a "deposit broker" (as defined) would no longer be insured. In addition, BICs would no longer be eligible for deposit insurance. "Pass through" of deposit insurance to pension plan beneficiaries would be eliminated, except for self-directed defined contribution plans (and pension plans of state and local governments). The above amendments would take effect two years after the date of enactment (except with respect to certain grandfathered time deposits). The FDIC is also directed to conduct a study on the feasibility of reducing deposit insurance coverage to a $100,000 limit per depositor (as opposed to per institution). Other provisions would (1) restrict solicitation of deposits by institutions with low capital, (2) require the FDIC to use "least cost resolution" in assisting troubled institutions, (3) require the FDIC to establish a risk-based deposit insurance premium system, (4) restrict risky activities by state banks that are federally insured, (5) require the SEC and banking regulators to develop regulations requiring supplemental disclosure of the market value of assets and -6- liabilities of banks, to be included in financial statements and reports, and (6) require the FDIC to undertake a project to determine whether a private reinsurance system would be feasible. (Sections 102-109, 116) Regulatory Reform. A new Office of Depository Institutions Supervision, a bureau within the Treasury Department, would be established. It would replace the OCC and the Office of Thrift Supervision and would regulate national banks and thrifts. The Federal Reserve Board would regulate state banks. Holding companies would be regulated by the agency regulating the principal bank subsidiary of the holding company. The FDIC would remain responsible for deposit insurance and resolution of failed institutions. (Sections 301-361) BIF Recapitalization. The bill would recapitalize the Bank Insurance Fund by granting the FDIC authority to borrow up to $25 billion from the Federal Reserve Banks. (Repayments would be made out of increased premiums.) The bill also would impose an aggregate ceiling on premiums of 30 basis points. (However, if risk based premiums are adopted, individual institutions may be assessed greater premiums.) (Section 401) We will keep you informed of developments regarding this and related legislation. Craig S. Tyle Associate General Counsel Attachment

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