January 1983

Remarks on Mutual Fund Underwriting by Banks

Stephen J. Friedman
Pace Law School

REMARKS

STEPHEN J. FRIEDMAN
Member, Debevoise & Plimpton, New York City
Former Commissioner, Securities and Exchange Commission

First, I think it is important to begin with the question of the relevance of history to the particular activity we're talking about. Secondly, it is very important to understand the forces that are driving banks into a particular activity because whether they're merely competitive forces or fundamental economic forces has an important impact on your ability to deal with them. It is also necessary to understand how viable the current state of affairs is — whether we're in effect in equilibrium. Next, one must examine the effect of proposed changes on bank safety and soundness, on bank power, and critically, on the capital raising process. One has to look in a very detailed way at the question of competitive equality and the level playing field.

The question of conflict of interest, which has received much attention, is critical. It seems to me the basic question is the extent to which relatively conventional tools in our regulatory system can deal with those conflicts. Some conflicts have to be prohibited; other conflicts can be regulated. Whether or not the *existing system* is adequate to deal with them is really beside the point. The Congress is legislating in this area and it can authorize new tools to deal with new problems.

There are two final questions. One is the relevance of the growth of unregulated financial intermediaries; the second is the relevance of recent experience.

THE PROCESS OF CHANGE

Before going through these issues, I want to make one general comment. In the case of deregulation in the financial markets, the

answer one finds at the end of the analytical train is very much a function of how one approaches the issue to start with. The New York Times had an editorial a few days ago dealing with these issues and one of the recommendations of the editorial writer was "When in doubt, choose competition." It's very clear that is not the approach Congress uses, and my personal judgment is that it is probably not a sensible approach for most policy makers. That doesn't mean you don't end up with a pro-competitive choice. But the existence of markets, the shape of the markets, the nature of the intermediaries and their relationships with people are largely a function of the regulatory system that has been in place for the past half a century. A decision to choose a step which would result in increased competition, which would remove a barrier, may change in a very fundamental way the economic ground rules under which all those competitors and all those institutions are functioning.

The final results of the adjustment process are highly uncertain, and every senator and every congressman is very sensitive to this uncertainty. That doesn't mean that changes ought not to be made, but it does mean that changes ought not to be made unless you have a good reason. One ought to be able to identify an evil or a substantial inefficiency in the way the markets are functioning or a clear benefit to be gained. There is no better example than the steps that Congress has taken to deregulate deposit interest rate control. The markets had run circles around, and are still running circles around, the controls on deposit interest rates. The inefficiencies in the functioning of the markets are clear and the need for change is clear.

THE RELEVANCE OF HISTORY

Let me start my framework of questions with the question of the relevance of history in its application to investment management. It is true that the study that was prepared by the SEC [Securities and Exchange Commission] in 1939 that gave rise to the Investment Company Act revealed many abuses in the management of investment trusts. Many of those trusts were managed by banks. Nevertheless, it seems to me very clear that the fundamental response to that problem, which was essentially viewed as an abuse of a fiduciary position, was not the Glass-Steagall Act, but the Investment Compa-

ny Act of 1940. Congress responded to the abuses with sections 17(a) and 17(d) of the 1940 Act,[1] which basically prohibits most conflict situations without prior approval of the Commission.

Although the Supreme Court has decided that bank sponsorship of open-end funds is a violation of the Glass-Steagall Act, that kind of distribution activity hardly strikes at the core of what Congress was concerned about in 1933, when it adopted the prohibitions in sections 16,[2] 20,[3] and 21 [4] of the National Banking Act. As for the promoter's interests with which the Court was so concerned in the *Camp* case,[5] it seems to me that the promoter's interest is equally applicable to bank management of individual agency accounts and certainly bank management of commingled trust accounts of various sorts. In sum, commingled retail investment management does not introduce any substantial new dangers.

MARKET FORCES AND REGULATORY CHANGE

Secondly, consider market forces. It is very clear that any regulatory scheme has to be consistent with fundamental economic trends. It ought not and cannot in the end respond to abstract notions of the way a market "ought to look." Inevitably any law that tends to segregate markets in a way that is inconsistent with basic economic trends will be doomed to failure. The effect of the economic conditions in the late sixties and the seventies on the market structure decisions that were made in the thirties have created the dissonance between the regulatory system and what people are actually doing that we see all around us today.

Accordingly, I think we have to ask ourselves in this context why it is that banks want to offer retail commingled investment management services. I think there are three basic reasons. The first is that the squeeze on the profitability of traditional lending activities that has come from the volatility of interest rates has clearly driven banks

---

[1] 15 U.S.C. § 80a-17(a)(d)(1976).
[2] 12 U.S.C. § 24 (seventh)(1976).
[3] 12 U.S.C. § 377 (1976).
[4] 12 U.S.C. § 378 (1976).
[5] Investment Co. Inst. v. Camp, 401 U.S. 617 (1971).

to seek fee income, and fee income from investment management is an obvious choice. That is a perfectly good reason for banks to seek that end, but not a compelling policy reason to change the law.

The second reason, which is stronger from the public policy point of view, has to do with efficiency with which banks use their existing resources. As I'm sure you all know, banks are now the largest single manager, as a group, of investment funds in the United States today. They manage in excess of $400 billion in private pension funds alone. Having created that capability, there is strong pressure for it to be used as efficiently and in as broad a range of situations as possible. Again, while efficiency argues for an extension of bank power, Congress could certainly take into account countervailing policies.

The third reason is more urgent, and that has to do with the recent offering by various kinds of financial institutions of integrated financial services to consumers. There is a powerful incentive for banks to put themselves on the same basis as Merrill Lynch. On the other hand, one can say that the same modern technology that has permitted Merrill Lynch to tie together investment management services offered by it with banking services offered by a bank would permit a bank to tie together banking services offered by it with securities services offered by a securities firm — without integrating the institution itself. That is, the final product offered to the consumer is not necessarily a function of the powers of the dominant institution. We see this pattern developing today in a funny way with the growth of so-called "proprietary bank money market funds," in which the bank is an advisor to the money market fund. Funds are swept out of either demand deposit accounts or trust accounts into a bank-advised money market fund and a securities firm is inserted (sometimes in quite an awkward way) between the bank and its own customers as a distributor — and often the investment manager as well. This structure is proliferating at a fantastic rate all around us today, again in an attempt to offer an integrated package of services.

Thirdly, we have to ask ourselves whether the regulatory world, as it exists today in the financial markets or in investment management, presents a viable equilibrium or whether the internal strains in the system are bound to break down and change is inevitable. Using the proprietary bank money market fund as an example, it seems to

me that if banks are permitted to continue to act as advisors to open-end funds which must be distributed by securities firms to the bank's own customers, then that situation is so unreal and so fraught with unnecessary transaction costs, that it simply cannot be maintained over time. Indeed, I would go so far as to say that if institutionalization of savings continues and if banks continue to be the largest single factor in the investment management business in this country, then the logic of prohibiting them from rendering those services to individuals will become increasingly more elusive.

SAFETY AND SOUNDNESS ISSUES

Certainly the central inquiry in each of these Glass-Steagall areas is the effect of the extension of bank securities activities on bank safety and soundness, on power, and on capital raising. The safety and soundness concern, more than any other element in this whole package, requires a contemporary review — a fresh look. The quality of bank regulation has changed drastically since 1933. In spite of the difficulty we've had in controlling the money supply, the degree of control of the monetary system that is actually exercised today by the Federal Reserve is drastically different than it was in 1933. The control over margin credit, which was totally out of hand in 1929, and the linkage between securities firms getting into trouble because of the crash and banks getting into trouble because of the extension of margin loans is under much greater control. Surely the quality of bank supervision has vastly increased. Moreover, if one were to look at the principal threats to bank stability today, the areas of greatest risk would be found in what I think most people would concede are clear banking activities: the trading of U.S. Treasury securities in a highly volatile interest rates environment is a risky business and the swings of losses and profits are very great. The trading of foreign currencies, which is an essential activity for an international bank, also offers special risks, as does lending to the governments of lesser developed countries. These activities involve risks that dwarf the kind of risk that is involved in the distribution of mutual fund securities.

As Dave Silver is quick to point out, when one thinks about this issue, one has to examine the REIT [Real Estate Investment Trust]

experience of the early 1970's. I would ask the question differently than he would. It seems to me the question is not what happened then, but what would have happened if a regulatory regime like the Investment Company Act [6] had been applicable to the relationship of banks to their associated REIT's. My guess is that the Congress is perfectly capable of creating a regulatory scheme that would deal with the bank-mutual fund relationship.

The question of bank power is one which is not terribly relevant to the investment management issue. The institutionalization of savings has been so great that bank control over savings in the form of pension funds dwarfs the amount of additional funds that would be managed by banks if they were able to manage mutual funds (excluding money market funds). That is, the amount of assets held in non-money market mutual funds is small compared to the assets that are currently managed by the banks. I would exclude from that equation the funds currently held in money market funds. Money market funds are part of the deposit base. They exist only because of deposit interest rate controls. In countries which have no deposit interest rate controls, there are virtually no money market funds. Although many would disagree with me, I believe that if deposit interest rate controls were eliminated, money market funds would eventually dry up.

BANK INVESTMENT MANAGEMENT AND THE "LEVEL PLAYING FIELD"

Next, is the question of the impact of bank investment management on the capital raising process. Although that question is very critical when one considers bank underwriting of corporate securities or revenue bonds, it is much less important when discussing investment management.

It is worth mentioning in passing that because money market funds are used by consumers as alternative deposit instruments, the whole question of bank management of money market funds raises a series of banking questions that are really quite unrelated to the

---

[6] 15 U.S.C. §§ 80a-1–80a-52 (1976).

Glass-Steagall Act. Regulation Q[7] imposes deposit interest rate controls. What sense does it make to have a regime that controls deposit interest rate controls on one hand and on the other hand, permit uncontrolled money market funds that are associated with bank deposit accounts? What of the impact of sweep arrangements on Regulation D and the efforts of the Fed to control the level of reserves?

Let me say just a word about the level playing field problem. It is very important to keep firmly in mind that there are really two aspects to it. One has to do with equal *regulation* and the other has to do with equality of *function*. On the regulatory side, it will very often be the case that a regulatory regime applied to the securities industry is transferrable virtually *in toto* to banks. That's certainly the case with application of the Investment Company Act to mutual fund management by banks. It may not be quite as easily applied as banks start to use the mutual fund structure as a substitution for collective investment funds and common trust funds. I'm not sure the shareholder democracy provisions fit the pension fund model.

When the notion of equality is extended to function, then it starts to break down at the edges. Banks use the goal of competitive equality as an argument for interstate banking. They say, "we're competing with securities firms, they have offices all over the country and we ought to too." Securities firms use it as an argument for deposits. I think that kind of argument is quite misguided.

Each type of institution in our financial market has its own advantages and disadvantages. Insurance companies, securities firms, banks, retailers, all attract the consumer dollar in a very different way. The resulting mosaic is one in which each institution functions in a niche in the market where the others have weaknesses; it is an enormous strength in our economy and we ought to take great steps to try and preserve that pattern. Competition does not require homogeneity. Each kind of institution ought to be in a position to compete for the same consumer dollar, but with its own strengths.

I won't say anything more about conflict of interests. It has been, and will continue to be, the source of detailed discussion by others. I think it should be perfectly possible to design a regulatory system which will deal with any conflicts of interest. Sometimes that system

[7] 12 C.F.R. Part 217 (1982).

might, as does the Investment Company Act, prohibit self-dealing, or dealing between a bank and an associated fund.

THE GROWTH OF FINANCIAL INTERMEDIARIES

The last two points I want to make have to do with the relevance and experience and with the growth of unrelated intermediaries. One of the characteristics of all deregulation debates is a highly abstract quality. On the one hand, we have people who are in favor of "competition," and on the other hand we have people who are against "abuse and overreaching" of depositors. If the Congress is actually going to go forward with legislation, it is important to bring that highly abstract debate down to a factual level. There is a wealth of real-world experience to inform the judgments. In the investment management area, we have the REIT experience, and we have the experience of bank management of a variety of individual accounts and commingled accounts. That ought to be examined and we ought to ask the question, "Have there been any substantial abuses and are they the kind of abuses that the law can deal with?" In the revenue bond area, banks have not only been underwriting municipal bonds (general obligation bonds) since 1933, but have participated very substantially in the revenue bond market — housing bonds recently, and others before that. That experience ought to be examined. We ought not have generalized debates about potential abuses. We ought to look at whether abuses have occurred.

Finally, there is the question of the significance of the growth of unregulated financial institutions. The Sears money market fund is probably the most pointed example. I don't begin to know the long-term significance of that step and it may be that the Congress may have to make decisions before it is known, but that ought to be a focus of inquiry. It may be fruitless to say that banks can't do certain things if everyone else can and is doing them. One also has to ask about the relevance of insurance company activity to bank powers. Insurance companies are major providers of long-term credit in our society.

In closing I want to make one comment on the way legislative change occurs in the financial markets area. Our Congress, and I think it's a strength of our political system, does not take radical steps. That means that congressional action is most likely to occur in

those areas where the markets have really overtaken the old system. That has occurred in investment management, into which banks have moved very heavily. If you want to see where the Congress is going, I think you'll have to look at where the market has gone.