Statement of Henry Harfield

before the

House Committee on Interstate and Foreign Commerce

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My name is Henry Harfield. I am legal counsel to the First National City Bank of New York, and appear here today on its behalf to testify in support of H. R. 8499 and H.R. 9410. These bills are identical in content and I shall refer to them hereafter as if they were a single bill.

I am grateful to the Committee for this opportunity to present my views and those of the Bank which I represent. This bill is important legislation and it is greatly needed. It deals primarily with the regulation of the collective investment by banks of money entrusted to the banks by individuals. The collective investment by banks of funds held by them as fiduciaries is important because it involves great amounts of money and great numbers of people. Banks have been providing fiduciary services for more than 150 years and for more than forty years they have employed the device of collective investment in order to bring to the public the resulting economies in operation. According to February 1964 statistics of the American Bankers Association, there are at present over 600 traditional common trust funds operated by banks located in every state of the Union except Alaska, Idaho and Wyoming. Nearly 300 collective funds for employee-benefit trusts are operated by banks located in 39 states. The amount of money and the number of people affected by this activity underscores its importance.

Nevertheless, there are only about a dozen collective funds for Smathers-Keogh trusts in the whole country, and I am aware of none for managing agency accounts. The demand for these facilities is being frustrated.

The bill represents needed legislation because the wholesome development of this fiduciary business, and indeed its present stability, is at present threatened by unnecessary confusion and conflict among Government agencies. From 1937 until 1963 Federal regulation of common trust funds was carried out by the Federal Reserve Board. The Federal Reserve Board issued Regulation F, which remained substantially unchanged during that quarter of a century. It was extremely restrictive. It did not in any way call in question the propriety of administration by banks of collective funds but it limited the availability of such bank services so as in effect to make it impossible for banks to offer the economies of collective investment to persons of modest means who desired investment advice. In 1962, Congress transferred jurisdiction over the fiduciary activities of national banks and common trust funds operated by all banks from the Federal Reserve Board to the Comptroller of the Currency. The Comptroller, after extensive study, promulgated Regulation 9 which, by streamlining certain procedures and stripping away various legal myths, allowed the banks an opportunity to reduce the price of their fiduciary services through collective investment of small discretionary agency accounts whose owners theretofore had been denied the opportunity to obtain such services at a reasonable price. At this point, the Securities and Exchange Commission asserted jurisdiction over the fiduciary activities of banks if such activities were conducted on a collective basis. Further, question was raised as to whether the tax treatment of the classic form of common trust fund would be available to managing agency funds operated under the new regulation or whether the contention by the SEC that the historical exemptions from the securities laws were no longer applicable, would result in discriminatory taxation of these plans.

The bill now before you would resolve these doubts. The bill recognizes the utility of expanded availability of collective investment by banks of funds held by them as fiduciary. It provides standards for the regulation of such funds and their investment plans in the public interest. It provides unequivocally that these banking activities shall be supervised by Federal bank authorities. It exempts such funds or plans from the securities laws in a manner which should be sufficiently unmistakable to entitle managing agency funds to the same tax treatment as the traditional funds which already have an express exemption from the securities laws.

There are a great many misconceptions, both of fact and of law, about the operation of bank collective investment funds. With the permission of the Committee, I should like to review for the record exactly what is the nature of the business which this bill would regulate.

The management and investment of other people's money is a fundamental part of the banking business. Both on a national and on a state level, legislation affirmatively recognizes the public utility of having banks act as managers of the savings and investments of the people.

In so doing, banks act as fiduciaries, not as businessmen bargaining at arm's length with their customers. As fiduciaries, banks are required to and do assume an unusually high standard of care, skill and fidelity: the law holds them to this high standard. Historically, special rules and special forms of regulation and procedure have been applied to fiduciary activities. Banking is itself a highly regulated industry, but within the framework of that regulation there is and historically has been a special supervision of trust departments by specially trained and qualified examiners.

The kind of management which a bank provides for its fiduciary accounts is necessarily expensive. The average man, even of some means, can't afford to have a bank as fiduciary on full-time basis unless the collective investment technique is used. Even people who ride in taxis can't always afford a chauffeur.

As a result, there is a great, unfulfilled demand for professional management of money and investments. The more affluent the society, the greater is this demand.

Banks set about providing service to meet this demand more than forty years ago. They did it by bringing to their fiduciary customers the economies of collective investment. Instead of maintaining total separation of every aspect of each trust, executorship, guardianship or agency, they commingled assets and pooled the expenses of investment analysis and research; they used the economies of large-lot buying and achieved a degree of safety through diversification impossible for any but the largest individual accounts.

There are, in my judgment, two reasons why the development of bank collective investment techniques in the 1920s did not have the natural growth merited by the continuing demand for it.

First, there was a devastating tax problem. Almost as soon as banks began to use the technique of collective investment, the tax authorities moved in for added revenue. They claimed that the aggregate of the fiduciary investments should pay a tax in addition to the tax payable by the individual estates on accounts whose assets were collectively invested. They made this claim stick in the courts, and Congress had to act to restore a decent balance. After the tax authorities had successfully claimed that bank collective funds were independently taxable, Congress amended the Internal Revenue Code so as to exempt these funds, so as to eliminate what is in effect double taxation.

And let me make a particular point here. Congress consistently followed this policy a few years later, when the Investment Company Act of 1940 was passed. Investment companies are given tax treatment equivalent to bank collective investment funds. The references are in sections 851 and 584 of the Internal Revenue Code.

Now, this brings us to the second impediment to development of bank services. Until 1962, the only federal regulation of bank collective investments was by the Federal Reserve Board, which in 1937 promulgated Regulation F for that purpose. Although this regulation applied to national banks, the tax advantages of common trust funds, whether operated by national or state banks, were keyed to and dependent on conformity with this Regulation. Thus, all bank collective funds designed for the individual were, in effect, subject to Regulation F, either directly or in order to avoid tax disadvantages.

The Federal Reserve Board was also engaged in administering the laws intended to separate commercial banking from the securities business. These laws had nothing whatever to do with the regulation of the fiduciary activities of banks, as I shall point out in just a moment. Nevertheless, a curious (and I believe unwholesome) osmosis took place, with the result that Regulation F became a blend heavily flavored with the bitter taste of tax concepts mingled with the Bank Holiday of 1933. The Internal Revenue Code was supposed to follow Regulation F; instead, Regulation F leaned on the exemptive provisions of the Internal Revenue Code. The impression created was that there was something wrong in having banks operate collective funds, and that Regulation F was intended to keep sin within bounds.

As a matter of fact there has never been any suggestion that banks should refrain from dealing with securities on behalf of their customers. In the early 1930s, banks were restricted in respect of the underwriting and distribution of securities, but Congress carefully noted that this in no way inhibited the right and ability of banks to deal in securities for account of their customers. This is explicit in R.S. Section 5136 and inherent in the legal grant of fiduciary powers.

Similarly, there has never been any suggestion that it is improper for banks to invest fiduciary funds collectively. Moreover, the fact that a bank commingles the funds of Trust A and Trust B does not in the slightest alter the fiduciary responsibility of the bank in respect of either trust.

Regulation F permitted collective investment, in the form of common trust funds or similar funds, but it very severely circumscribed the form of the participating accounts. In this state of affairs, there was universal acceptance of the propriety of bank collective investment, of its tax status and of the fact that it was not the securities business and should be supervised by banking authorities rather than securities authorities.

The present regulation, by the Comptroller, makes no change in the basic concepts, but it does adopt as a standard the <u>substance</u> of the participating accounts, instead of the <u>form</u> of those accounts. In effect, it says that any account the bank holds as a true fiduciary may enjoy the benefits of collective investment,--not just the formal trusts and guardianships. The phrase used by the Federal Reserve Board was "true fiduciary <u>purpose</u>", which was something less than precise and involved subjective terms. The test used by the Comptroller is "true fiduciary <u>relationship</u>", which is both precise and objective. A <u>relationship</u> can be determined as a matter of law; a purpose is a state of mind. The test used under Regulation 9 is the obligation the bank undertakes to its customer. If that obligation is the responsibility of a fiduciary, the high standard of fidelity and freedom from self-dealing, then the form is not important. The customer, the public, is entitled to the economies of collective investment.

Unfortunately, when the Comptroller amended Regulation 9, the attention of its critics was focused on the mechanics rather than the design. Collective investment is merely a mechanical device. The use of this device doesn't change the basic relationship or design. The relationship of an investor to the company in which he buys a share is one thing. The relationship of an investor to his fiduciary, --trustee, executor, or agent, is another. These are separate things. They are not made the same because they use some of the same mechanics. The suggestion that if a fiduciary commingles the assets of several accounts, those assets become an entity is absurd. The absurdity is best indicated by noting that the fiduciary does not thus eliminate or reduce his special fiduciary responsibility.

Fiduciary funds collectively invested by a bank do not become an investment company.

The great virtues of the present bill are:

1. It gives effect to substance by recognizing the specific character of collective investment funds maintained by banks in their fiduciary capacity.

2. It imposes on bank supervisory authorities the responsibility of seeing that this distinction is maintained and respected. They are the experts in this field.

3. It eliminates the confusion which has existed for years with respect to the availability to the general public of bank management of their funds.

4. By eliminating confusion and preventing jurisdictional disputes, it permits the public to have free and economical access to the regulated bank services which are so much in demand.

It is very important to note one last point. The banking industry does not oppose regulation. It is accustomed to regulation. What it wants, and badly needs, is simply a clear statement as to who does the regulating.