SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

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Final - minor changes made 7/31/81 to reflect Dan G.'s comments

Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Garn:

In your letter of June 19, 1981, you posed fifteen questions dealing with matters which have been the subject of hearings before the Committee on Banking, Housing and Urban Affairs. The Commission's responses to each of your questions are set forth below.

1. You have agreed that money market mutual funds create a significant shift in the way funds are invested, primarily by shifting local funds to large corporations and money center banks, as well as foreign countries. You have also stated that the Commission has given "no-action" letters to facilitate investment by such funds in smaller institutions. Could you suggest any other means — which either the Commission could implement or could be proposed as legislation — which might help prevent such funds from drying up sources of local credit for mortgages, small business investment and consumer credit?

As you note in your question, the Commission's staff has acted to remove unnecessary impediments to the efforts of those funds that desire to invest their assets in certificates of deposit issued by small banks. However, any effort by the Commission to encourage money market funds either to invest or not to invest their assets in particular types of money market instruments would be outside the Commission's traditional interpretation of its statutory mandate to protect the integrity of this nation's securities markets, and to ensure that the individual investor has sufficient information to be able to make an informed investment decision. Therefore, the Commission does not plan to take any direct action to shift investments by money market funds away from large corporations, large banks and foreign countries.

The Commission believes that free market forces provide the most efficient means of determining how investment capital, including money market fund assets, should be allocated. Thus, with respect to possible legislative action the Commission would be concerned with any measure that would unduly interfere with the natural allocation of capital. Of course, Congress might reasonably determine that meeting particular credit needs, such as mortgages, small business investment or consumer credit, is so important to the health of the nation's economy that investment capital should be encouraged to flow into those uses at the expense of other sectors of the economy. Incentives to invest in certain sectors of the economy could be provided by various means, such as tax preferences or federal guarantees.

2. With regard to required reserves on deposits, it has been pointed out to the Committee that sterile reserves reduce the maximum possible yield on invested funds, thus putting financial institutions which are required to maintain these reserves at a competitive disadvantage with money market mutual funds. Please comment.

It is true that requiring reserves of uninvested assets reduces the return that can be paid to depositors or investors. However, for the most part the limitations on interest available from depository institutions are not caused by such reserve requirements, but rather are due to legal restictions. Moreover, it is important to note that reserve requirements on the assets of money market funds would have a different effect on such funds than they do on depository institutions. The return that a depositor will get from a bank is guaranteed and set at the time a deposit is made. However, a money market fund shareholder receives only a proportionate share of the return on his investment after expenses. Because the investor is entitled only to a proportionate share of the total assets of the fund, not to any specific return on his investment, and because a money market fund normally confines itself to relatively low-risk investments, the Commission believes that imposing reserve requirements on money market funds would not be justified by any increased safety provided to investors. Such requirements would, however, produce a lower yield to investors. For this reason the Commission believes, as I stated in my testimony before your Committee on May 13, 1981, that the existing framework of regulation applicable to money market funds provides appropriate investor protection, and that imposing additional, bank-type regulation, including reserve requirements, on those funds would harm the interests of investors without corresponding benefits to them.

3. Please report on any plans you have to alter requirements and/or oversee existing requirements regarding advertisement of money market mutual funds, especially on the matter of:

   A. Such funds being investments, not deposits;

   B. There being no Federal Deposit Insurance Corporation or Federal Savings and Loan Insurance Corporation insurance on such funds;

   C. The advertised annual yield being historical only and not guaranteed for the future; and

   D. The use of misleading words or acronyms.

The Commission has no plans to alter requirements or our oversight of existing requirements regarding advertisement of money market mutual funds. It is our view that inclusion of misrepresentations or misleading statements concerning the matters you refer to in money market fund advertising has not been a significant problem. Nor have we received complaints or other information from investors or the public that would lead us to believe that advertisements by money market funds have resulted in misconceptions by investors. In this regard, the Commission believes it is extremely important to ensure that money market fund advertising is not false or misleading, and has made strong efforts towards this goal. In doing so, however, it has been sensitive to the need to avoid unnecessary burdens on honest businessmen which can be caused by overly detailed and vigorous requirements. For the reasons set forth below the Commission has no present plans to alter its requirements with respect to advertisements by money market funds in any of the four areas you have mentioned. As I stated in my testimony of May 13, 1981, before your Committee, the Securities Act of 1933 and Commission rules thereunder significantly limit investment company advertising. For example, the content of investment company advertising and sales literature, including advertising by money market funds, is subject to the antifraud provisions of section 17(a) of the 1933 Act and rule 10b-5 under the Securities Exchange Act of 1934.

The Commission has determined that it is most appropriate to regulate investment company advertising by means of a general anti-fraud standard, rather than attempting to regulate the specific content of all types of investment company advertisements. Until March 8, 1979, the content of all written advertising and sales literature used by money market funds and other investment companies was in effect regulated by the Commission's Statement of Policy on Investment Company Sales Literature ("Statement"). That document provided examples of representations which the Commission considered permissible and examples of representations which the Commission believed might violate the anti-fraud provisions of the federal securities laws. The Statement was withdrawn in March, 1979, as part of the ongoing effort of the Commission prudently to reduce the regulatory burden on those entities under its jurisdiction. While in recent years the Commission has adopted several rules to permit investment companies to convey a wider variety of information to investors in their advertisements, an investor must still receive a full, statutory prospectus prior to, or with confirmation of his share purchase. The Commission believes that the responsibility for determining that a particular advertisement by a money market fund gives an accurate, nonmisleading picture of the fund should be on fund management, not on the Commission.

However, the Commission has acted diligently to prevent abuses in specific areas where the absence of direct regulation of money market fund advertising could result in investors being misled. For example, the Commission amended rule 434d under the 1933 Act on September 30, 1980, to require that any yield quotations in money market fund advertisements be computed according to a standardized method. I might note that when the Commission adopted this amendment it specifically considered requiring money market funds to state in their advertisements that the advertised yield could not be guaranteed for the future, or that such funds were not insured by any agency of the federal government. The Commission determined that, in light of its general policy not to establish specific standards with respect to investment company sales literature except to the extent that it is demonstrably necessary, it should leave with fund management responsibility for deciding what disclosure is needed in order to make a particular advertisement not misleading within the meaning of the federal securities laws.

On the other hand, written advertising and sales literature utilized by investment companies is filed with the Commission under section 24(b) of the Investment Company Act of 1940, and the Commission's staff periodically reviews these materials to make certain they are not misleading. Where appropriate, the staff advises the company to make revisions in such materials, and the staff has generally found investment companies receptive to its comments. While the staff has not found it necessary to recommend commencing a formal enforcement action against any money market fund to date on account of misleading advertising, the Commission would not hesitate to bring such enforcement action if it found that a money market fund was using misleading advertisements, such as advertisements stating that the legal relationship and safety obtainable from owning a share of a money market fund was equivalent to the legal relationship and safety obtainable from the deposit of money in a bank, and formal enforcement action appeared to be the appropriate remedy. In sum, the Commission believes that the system now in place to regulate investment company advertising adequately protects investors, while allowing the investment company industry the necessary freedom to inform the public of the many different types of products available for its consideration.

4. What adverse effects would, in your opinion, result if money market mutual funds were:

   A. Forbidden to provide third-party instruments for withdrawals; and

   B. Required to allow five days for redemption, as is the usual length of time with stock sales?

Forbidding third-party instruments for withdrawal would reduce investors' access to their assets in money market funds. In addition, the third-party instrument method of redemption allows the investor to earn interest on his investment in a money market fund until his money is actually available for his use. Requiring a five day mandatory delay in processing of redemption requests submitted by shareholders of money market funds would inconvenience shareholders in such funds by depriving them of access to their money for that period of time, without any apparent benefit to justify the inconvenience. These expedited means of redemption appear to be benefits without any counterbalancing disadvantages to the investor, and if they were restricted the investor would be unnecessarily deprived of those benefits. Institutional investors in particular find the expedited forms of redemption and investment offered by money market funds to be important means of earning the highest possible amount of interest on their investments.

In the written statement I submitted to your Committee on May 13, 1981, I noted that money market funds which offer features such as third-party instrument privileges are not essentially different than traditional mutual funds. These privileges are merely alternative methods of effecting fund redemptions. Unless special provisions are made, redeeming one's investment in a mutual fund can be a cumbersome procedure. Most money market funds have sought to avoid unnecessary delays in processing redemption requests by their shareholders, as well as effecting new purchases of fund shares, by establishing expedited means of effecting redemptions and investments. Accordingly, most money market funds provide privileges whereby a fund shareholder can direct that some of the money in his account be sent to a third party. In addition, a majority of money market funds provide that shareholders may receive payment for redeemed shares and credit for money invested on the same day by wiring federal funds through the banking system. In order to effect transactions through wired federal funds the shareholder must have a previously established account at a commercial bank.

5. The U.S. League of Savings and Loan Associations testified that a money market fund named Instiutional Liquid Assets had to be "propped up." Please comment on this and on any dangers you perceive for such funds.

The statement by the U.S. League of Savings and Loan Associations that Institutional Liquid Assets ("ILA"), a money market fund registered with the Commission as an open-end, diversified, management investment company under the Investment Company Act of 1940, had to be "propped up" may be somewhat misleading to the extent that it gives the impression that the fund was in danger of becoming insolvent. This was not the case. Rather, as explained in detail below, because of the valuation method used by ILA its shareholders might have suffered a decline of seven-tenths of one percent in net asset value. To avoid this, Salomon Brothers, ILA's principal underwriter, purchased securities from the fund for more than their market value to make up the discrepancy.

The problem to which the League was apparently referring occurred in the Fall of 1980 when ILA, which offers its units exclusively to institutional investors, experienced some problems with the method it was using to value the money market instruments in its Government Portfolio (one of two security portfolios comprising the fund). Such problems were analyzed on Page 18 of the Report of the Staff of the Division of Investment Management of the Securities and Exchange Commission ("Staff Report"), which accompanied my testimony before your Committee on May 13, 1981. Pursuant to an exemptive order obtained from the Commission, ILA, like many other money market funds, uses the amortized cost method of valuation to enhance its ability to maintain a stable per unit net asset value. Under this valuation method, rather than valuing portfolio securities at their current market value, IIA is permitted to value its portfolio securities for purposes of determining the per unit net asset value on the basis of their cost on the date of purchase (plus or minus any discount or premium).

The amortized cost valuation method helps a money market fund maintain a stable per share net asset value by allowing the fund to utilize the cost of its portfolio securities as the basis for determining its net asset value irrespective of fluctuations which may occur in its market-based net asset value per share. Money market funds are permitted to use this method of valuation based on the premise that, subject to appropriate limitations, a fund can value its securities at their amortized cost and maintain a stable net asset value per share without creating material dilution or other unfair results to shareholders. This premise is based on the theory that if portfolio securities are held to maturity they will be worth their amortized cost value and that during the period preceding maturity there is little deviation between the current market value and the amortized cost value of high quality securities with very short maturity periods. However, because a money market fund can never conclude with certainty that it will hold a particular security until maturity, and thus be assured of receiving an amount equal to the amortized cost value of such security, the Commission permits a money market fund to use amortized cost pricing only when no material deviation exists between the fund's net asset value as determined under amortized cost pricing and the market-based net asset value. Accordingly, any money market fund using the amortized cost valuation method pursuant to a Commission order is subject to certain conditions, including restrictions on the type of portfolio securities which may be purchased, designed to ensure that: (1) the fund's amortized cost net asset value will fairly reflect the actual net asset value of the fund; and (2) the fund will be able to continuously maintain a stable net asset value.

Pursuant to the conditions of its amortized cost order, IIA's Board of Trustees was obligated to establish precedures designed to ensure that the net asset value per unit of IIA's portfolio was stabilized at $1.00. In addition, the Trustees were obligated to monitor the net asset value per unit of each of its portfolios using the current market values of the securities comprising such portfolios, and to compare such market-based net asset value with the amortized cost net asset value. In the event that the deviation between the market-based net asset value per unit and the amortized cost net asset value per unit exceeded one-half of one percent, or if the Trustees concluded that material dilution or other unfair results to investors could occur from continued use of the amortized cost net asset value, IIA's order required the Trustees to take action to eliminate such unfair results and to stabilize the net asset value per unit at $1.00. In response to these conditions, ILA's Trustees directed its investment adviser, The First National Bank of Chicago ("Bank"), to determine the extent of any deviation in ILA's net asset value under the market and amortized cost valuation methods at least quarterly, and at other times as prescribed, and to report its findings to them.

On October 2, 1980, the Bank's regular quarterly report of the deviation in ILA's net asset value, as determined under the above two valuation methods, for the period ending September 30, 1980, reflected the fact that the value of a unit of ILA's Government Portfolio, using market values for all assets, was $.9928. On October 3, 1980, the Bank advised ILA that, in its view, the good faith valuation of its Government Portfolio required the use of market values rather than amortized cost values for computing the net asset value per unit. If this advice had been followed, on October 3, 1980, ILA would have had to price it units for purposes of sale and redemption at $.993 rather than the previous price of $1.00.

Rather than allow unitholders to suffer a reduction in the value of their units from $1.00 to $.993, ILA, the Bank, and ILA's principal underwriter, Salomon Brothers ("Salomon"), instituted a program, with the consent of the Commission, designed to raise the market-based per unit net asset value of ILA's Government Portfolio in order to enable the fund to continue to use the amortized cost valuation method, and maintain the value of its shares at $1.00. This program was accomplished primarily through the repurchase of portfolio securities by Salomon at their amortized cost value rather than their current market value. It should be noted that this action was taken not because of any problem with the creditworthiness of the securities making up ILA's Government Portfolio, but in order to allow such Portfolio to continue to use the amortized cost valuation method and thus avoid a temporary reduction in net asset value. The action which Salomon took removed from ILA's Government Portfolio those securities whose current market value most deviated from their amortized cost value, and by so doing reduced the above deviation of the net asset value of its Government Portfolio below one-half of one percent, thereby allowing ILA to maintain a $1.00 net asset value.

The conditions which the Commission has placed on the use of the amortized cost valuation method by money market funds are designed to ensure that, if those conditions are adhered to, a fund will be able to continuously maintain a stable per share net asset value without creating material dilution or other unfair results to shareholders. Money market funds have taken the position that use of the amortized cost valuation method, subject to the conditions imposed by the Commission, benefits their shareholders by allowing them to maintain a stable net asset value under all but the most unexpected circumstances. While those conditions do not guarantee that every money market fund will be able to maintain a stable per share net asset value at all times, and the Commission would not permit any money market fund to claim otherwise, the experience of the fund industry as a whole indicates that such conditions do provide appropriate protection for investors.

6. Do you favor allowing banks, thrifts and credit unions to underwrite and sell commingled agency accounts, to compete with money market mutual funds?

I am unable to respond to this question on behalf of the Commission at this time. We are currently developing a Commission position in order to repond to your letter of July 13, 1981, to Chairman Shad asking for our comments on S. 1424, which would permit banks, thrifts, and credit unions to underwrite and sell commingled agency accounts.

7. The American Bankers Association suggests that the Commission's authority with regard to banks' collective investment trusts be preempted, citing two difficulties:

   A. Keogh accounts may not now be aggregated in one trust unless all participants are from the same state; and

   B. Other kinds of trusts may not be aggregated with each other, making it particularly difficult for small banks whose trusts of any one kind are often not large enough for successful collective investment.

   Please comment.

With respect to the first part of your question, it should be noted that the securities laws do not prohibit interstate aggregation of Keogh accounts, rather registration under the Securities Act of 1933 would be required. Congress apparently determined to treat Keogh accounts like other non-exempt securities under the 1933 Act "because of their fairly complex nature as an equity investment and because of the likelihood that they could be sold to self-employed persons, unsophisticated in the securities field." 1/ In this regard, the Investment Company Amendments Act of 1970 amended section 3(a)(2) of the Securities Act of 1933 ("1933 Act") to exempt from the registration requirements of the 1933 Act interests or participations issued by bank collective trust funds or insurance company separate accounts in connection with corporate pension or profit-sharing plans which meet the requirements for qualification under section 401(a) of the Internal Revenue Code of 1954 ("Code"). Congress did not, however, exempt interests or participations issued by bank collective trust funds or insurance company separate accounts in connection with such plans (known as Keogh or H.R. 10 plans) which cover employees, some or all of whom are employees within the meaning of section 401(c)(1) of the Code. 2/ Such funds or separate accounts are, however, excepted from the definition of "investment company" under section 3(c)(11) of the Investment Company Act of 1940. In sum, registration under the 1933 Act is required, absent some other exemption, such as the intrastate exemption. The intrastate exemption, however, is available only when all plan participants reside in the state where the issuer is organized and conducts the bulk of its business. 3/

Concerning the second part of your question, the securities laws do not prohibit the aggregation and collective investment management of trust assets which are not under section 401 of the Code, but do require compliance with

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1/ S. Rep. No. 194, 91st Cong., 2d Sess. 27-28 (1970); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 44 (1970).

2/ See H.R. No. 1382, 91st Cong., 2d Sess. 43 (1970). Plans of partnerships are generally Keogh plans because partners are self-employed persons within the meaning of section 401(c)(1).

3/ Section 3(a)(11) of the 1933 Act, the so-called "intrastate exemption," exempts

> Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such securiy is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.

the registration and other provisions of the securities laws where such trusts are offered to investors as vehicles for collective investment management. However, such direct or indirect offers by banks of interests in collective investment funds managed by them may raise questions under the Glass-Steagall Act. See Investment Company Institute v. Camp, 401 U.S. 617 (1970).

Section 3(c)(3) of the 1940 Act excepts from the definition of "investment company"

> any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian (emphasis added).

Corresponding exemptions from registration for any interest or participation in such a fund are contained in section 3(a)(2) of the Act and section 3(a)(12) of the Securities Exchange Act of 1934. Whether these provisions apply to a bank fund containing assets of various trusts of which the bank is a trustee depends on whether the trusts have been created for bona fide fiduciary purposes and not to serve as mere conduits for investment in the fund. 4/ We believe

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4/ A bank is not a trustee for purposes of the common trust fund exception simply because the instrument under which it acts designates it a trustee or co-trustee. Genesee Merchants Bank & Trust, available January 8, 1979, Howard Savings Bank, available August 13, 1979, William C. Connelly, available May 1, 1980, Merchanics Bank, available January 5, 1981 (trustee for standardized, revocable, mini-trusts); National Boulevard Bank of Chicago, available October 18, 1974 (trustee for section 401 trusts). For a fund containing moneys held by a bank in trust to come within the common trust fund exception, the moneys must be those of trusts created for the true fiduciary purposes and not to serve as mere conduits for investment in the fund. Howard Savings Bank, supra. See 24 Fed. Reserve Bull. 4 (1938), 26 Fed. Reserve Bull. 393-394 (1940); Hearings on Common Trust Funds — Overlapping Responsibility and Conflict in Regulation Before a Subcommittee of the House Committee on Government Operations, 88th Cong., 1st Sess. 4 (1963) (statement of William L. Cary); S. Rep. No. 184, 91st Cong., 1st Sess. 27 (1969).

that this view is in accordance with the intent of the Congress, as reflected in the following analysis concerning the 1933 Act exemption for interests in common trust funds.

> The proposed amendment would exempt from the registration provisions of the Act interests and participations in the traditional common trust funds maintained by banks as investment vehicles for the assets held by the bank in a bona fide fiduciary capacity. This is identical to the exemption for a 'common trust fund or similar fund' in section 3(c)(3) of the Investment Company Act. This exemption is limited to interest or participations in common trust funds maintained by a bank for the collective investment of assets held by it in a bona fide fiduciary capacity and incident to a bank's traditional trust department activities; it would not exempt interests or participations in bank funds maintained as vehicles for direct investment by individual members of the public. 5/

Section 3(c)(11) of the 1940 Act, as stated before, excepts from the definition of "investment company" a bank collective trust fund, consisting solely of assets of trusts qualified under section 401 of the Code. The section 3(c)(11) exception is, therefore, not available to a bank fund which contains moneys other than those of section 401 trusts. Moreover, as previously indicated, the section 3(c)(3) exception is not available to a bank fund which contains moneys of trusts that have been created as vehicles for investment in the fund and have no true fiduciary purposes. Such trusts which are ineligible for a section 3(c)(3) fund may include section 401 trusts even though they also serve a tax-deferral purpose. As a result, banks may not be able to mix section 401 moneys with other moneys in a trust for collective management that would be entitled to the section 3(c)(3) exception. Rather, the section 401 moneys could be collectively managed by a bank only in a section 3(c)(11) fund and, as noted above, such funds must consist solely of section 401 moneys. The Commission would not necessarily object if Congress determined to amend section 3(c)(3) or section 3(c)(11) to permit banks to aggregate section 401 moneys with moneys that may be invested in a common trust fund. The Congress, however, before making such an amendment, may wish to consider whether the tax-qualified status of investors is a significant factor in the management of their moneys and, if so, whether it would be appropriate, in effect, to authorize banks to manage together assets of tax-qualified trusts and of trusts that are not tax-qualified.

5/ H.R. No. 1382, 91st Cong., 2d Sess. 43 (1970).

8. If banks and other financial institutions were permitted to arrange private placements, underwrite and sell revenue bonds, or perform services of a security nature, do you perceive any problem in charging the several financial institution supervisory agencies with the responsibility of licensing and supervising these activities, much as they now enforce the securities laws with regard to banks and financial institutions?

In 1977, three reports on bank sponsored securities services were transmitted by the Commission to Congress. 6/ The Commission reported on problems relating to prevalent bank securities activities including involvement in private placements, dividend reinvestment plans, employee stock purchase plans, automatic customer purchase plans, customer transaction services and investment advisory services. It was the Commission's conclusion that some changes should be made in the regulatory structure of such activities to assure adequate investor protection. 7/ Moreover, the Commission stated that the need for uniformity in the regulation of functionally similar securities activities is a continuing one. As the functions of financial institutions become increasingly more similar, Congress may wish to evaluate the existing regulatory framework in order to assure fair competition and effective regulation of securities activities. While we have not developed any detailed conclusions with respect to the manner in which all such activities could best be regulated, we believe that considerable study would be required before concluding that financial institution supervisory agencies should assume full responsibility for licensing and supervising securities activities of banks and financial institutions. For purposes of clarification, it should be noted that the Securities and Exchange Commission currently has enforcement authority with respect to bank and other financial institution securities activities.

With respect to certain proposed activities, such as bank underwriting of revenue bonds, it might be appropriate to apply existing regulatory mechanisms, which provide for the involvement of the bank regulatory agencies and the

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6/ Reports on Bank Securities Activities of the Securities and Exchange Commission, Committee Print, Senate Committee on Banking, Housing, and Urban Affairs, 95th Cong., 1st Sess. (August, 1977).

7/ Id. at 305.

Commission. As you know, the regulatory system for municipal securities professionals includes a self-regulatory organization composed of industry representatives — the Municipal Securities Rulemaking Board (the "MSRB") — as the primary rulemaking authority for municipal securities professionals, in addition to requirements for registration with the Commission. There is also Commission authority to develop rules concerning recordkeeping, prevention of fraud, and, for non-bank market participants, financial responsibility rules. The Commission, in conjunction with the bank regulators and the National Association of Securities Dealers, Inc. (the "NASD"), is responsible for the examination of municipal securities brokers and dealers and for the enforcement of the federal securities laws and Commission and MSRB rules. The regulatory system for municipal securities professionals is designed to recognize the interests of concerned regulatory authorities, including the federal bank regulators, the NASD, and the Commission.

While a regulatory structure exists for bank participation in the municipal securities markets, further consideration may be required with respect to other securities-related activities. In that regard, reliance on a number of individual regulatory agencies with diverse constituencies and mandates may present a special challenge to achieving the regulatory goals of fair competition and investor protection.

In addition, if increased activity in the securities markets by financial institutions were not to result in a dilution of the investor protections currently provided in those markets, the financial institution supervisory agencies would be required to assume new roles. Those supervisory agencies have traditionally focused their efforts on areas such as depositor protection and concern for institutional solvency and safety. As financial institutions move into new areas, the supervisory agencies may find that new concerns, including customer protections such as disclosure and qualification requirements for securities professionals as well as public and private issuer access to capital, grow in significance. Responding to such concerns could pose significant challenges, particularly in light of those agencies' continuing need to monitor the fiscal health of the financial institutions which they regulate.

9. The Securities Industry Association predicts that an alteration or repeal of Glass-Steagall will have an adverse effect on smaller securities firms. Can you provide any data helpful in evaluating this prediction?

The Commission has not undertaken a thorough study of the possible effects on the securities industry of a repeal of the Glass-Steagall Act. Nevertheless, in 1979 the Commission's Directorate of Economic Policy and Analysis prepared a Study entitled "Bank Participation in Municipal Revenue Bond Underwriting: Impact on Securities Industry Revenues" (October 19, 1979), which was designed to examine patterns of bank and broker-dealer municipal securities underwriting in an effort to estimate the potential impact on securities industry revenues if banks were permitted to underwrite municipal revenue bonds. The Study estimated, based on 1978 figures, that if commercial banks were allowed to underwrite municipal revenue bonds and obtained either the same underwriting share which they held at that time in those municipal revenue bonds they were eligible to underwrite, or their share in general obligation bonds, the revenues lost to the securities industry could be between $65,000,000 and $116,000,000 per year (or 7.0 to 12.4% of total underwriting and selling group concessions). The Study also indicated that, although such a revenue loss may not be deemed a major portion of securities industry revenues, the impact of bank entry and the consequent revenue loss could be disproportionately large for certain small firms with gross annual receipts under $10 million, suggested that, if such a revenue loss resulted in a substantial decline in the number of these smaller firms, that result could have an impact on the ability of smaller municipalities to meet their financing needs, as well as adverse implications for the corporate capital formation process, particularly for small businesses. While the potential for such a result would appear to lessen the benefits which might be expected from increased competition, any decision to be made by the Congress in this area would require a weighing of the magnitude of competitive benefits which might still be expected. 8/

10. The Securities Industry Association also advances as an argument for retaining Glass-Steagall the fact that banks enjoy tax advantages not available to broker-dealers. Would you comment on which tax provisions would have to be altered in order to put the industry on a basis of competitive equality with regard to underwritings of revenue bonds, commercial paper, and commingled agency accounts?

As your Committee is aware, the Commission is not charged with responsibility for interpreting the tax laws. The Commission does understand, however, that at least part of the "tax advantage" referred to by the Securities Industry

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8/ A copy of the Study is enclosed.

Association in its testimony before your Committee is that banks may deduct from taxable income interest paid to borrow funds used to finance positions in tax-exempt securities. Under Section 265(2) of the Internal Revenue Code, interest paid on borrowing to purchase or carry tax-exempt securities is not deductible. The Commissioner of Internal Revenue has interpreted this provision as not applying either to interest paid by banks on customer deposits or to interest paid by banks pursuant to various short term borrowing arrangements necessary for day-to-day operations. 9/ The effect of that policy is to allow banks to carry tax-exempt revenue securities with borrowed funds while at the same time deducting the interest paid on those borrowings from their taxable revenue. The Commissioner of Internal Revenue and the courts have repeatedly held, however, that non-bank dealers in tax-exempt securities are not entitled to similar relief under Section 265(2). 10/

As a matter of policy, in a reevaluation of the Glass-Steagall Act restrictions, existing advantages, tax and otherwise, of all competitors should be carefully considered.

11. The Comptroller of the Currency testified that the sale of commercial paper has increased significantly as a substitute for regular bank borrowing and that, therefore, new thought ought to be given to permitting banks to underwrite and sell commercial paper. Please comment.

As your Committee is aware, bank underwriting of commercial paper is the subject of pending litigation. The Commission has taken the position that, in view of the inclusion of commercial paper within the definition of a security in the Securities Act of 1933, commercial paper is a security under the Glass-Steagall Act since the two statutes were considered by the same congressional committees, were enacted contemporaneously, and were designed to achieve a comprehensive regulatory framework for the nation's financial markets. If this

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9/ See Rev. Pro. 70-20, 1970-2 C.B. 499.

10/ Denman v. Slayton, 282 U.S. 514 (1931); Wynn v. U.S., 288 F. Supp. 797 (E.D. Pa. 1968), aff'd, 411 F.2d 614 (3d Cir. 1969); Leslie v. Commissioner of Internal Revenue, 50 T.C. 11, rev'd, 413 F.2d 636 (2d Cir. 1969); Paul P. Prudden, 2 B.T.A. 14 (1925).

interpretation is followed, underwriting by banks of third-party commercial paper would be prohibited under Glass-Steagall. The Commission has filed an _amicus curiae_ brief in the U.S. District Court for the District of Columbia supporting two challenges to a decision by the Board of Governors of the Federal Reserve System that takes a contrary view. In our brief we took the position that any revision in the roles to be played by banks, broker-dealers, and other financial institutions raises complex issues concerning not only the conflicts of interest and abusive practices identified and addressed by the Glass-Steagall Act but also the concentration of economic power among financial institutions, the efficiency of the capital raising system, and the appropriate competitive balance to be struck within, as well as across, industry lines. It is always appropriate to consider altering past regulatory decisions but only Congress is equipped to evaluate and balance the complex policy considerations such a revision would entail. On July 28, 1981, the District Court held that the Board was erroneous in its conclusion that commercial paper was not a security for purposes of the Glass-Steagall Act, but did not decide whether, in the particular case before it, the bank's activities constituted underwriting within the meaning of Glass-Steagall. The Court also agreed that the policy questions concerning expansion of bank activities into the securities field, including the underwriting of commercial paper were matters for Congress to resolve, not the courts or bank regulators. 11/

12. Advocates of the authority for banks to underwrite and sell revenue bonds point out that general obligation bonds (which banks may underwrite and sell) have decreased in significance since the passage of Glass-Steagall, while the significance of revenue bonds has greatly increased. In your view, what are the differences between the two as regards:

    A. The potential effect on the safety and soundness of a bank underwriting the bonds;

As you know, the Commission does not have responsibility for the safety and soundness of banks. That responsibility has traditionally rested with the federal bank regulatory agencies which have broad supervisory powers that can be used to limit or condition the extent to which banks can engage in activities which those agencies believe raise concerns relating to bank

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11/ A.G. Becker Incorporated v. Board of Governors of the Federal Reserve System Civil Action No. 80-2614 (D.C.D.C., July 28, 1981).

safety and soundness. Accordingly, we are not in a position to evalute the potential effect on bank safety and soundness of bank underwriting of municipal revenue, as opposed to general obligation, bonds.

B. The potential for conflicts of interest on the part of a bank underwriting the bonds; and

The potential for conflicts of interest on the part of banks underwriting revenue bonds would appear to be similar to the conflicts that exist with respect to the underwriting of general obligation bonds. For the most part, the potential for conflicts of interest on the part of bank underwriters would appear to arise as a result of their ability to place the underwritten securities in accounts managed by the bank itself and the ability to make bank loans to the issuer of the underwritten securities. In addition, banks may be in a position to use their banking relationships with certain persons (e.g., correspondent banks, borrowers and prospective borrowers) to facilitate their underwriting activities.

C. The potential for unfair competition by a bank underwriting the bonds.

The potential for unfair competition as a result of bank underwriting of revenue bonds would depend to some degree on the extent of any authority granted and any restrictions applied to such activity. If banks were permitted to expand their current underwriting activities to include municipal revenue bonds they would, as you indicate, gain access to a much larger -- and increasing -- share of the market for municipal securities. This access could improve their competitive position by altering the balance in the relative market positions of banks and broker-dealers. In view of the significant concerns relating to the current fairness of competition between banks and broker-dealers, any move to expand the types of securities eligible for bank underwriting must take account of the degree to which competitive advantages (such as preferential tax treatment) which banks now possess are mitigated by their inability to offer a full line of municipal securities. The enlargement of the product line available to banks could enhance their ability to compete effectively in the underwriting of general obligation bonds, as well as making an increased number of municipal securities available to them.

13. Do you agree with Secretary Regan that ultimately all financial institutions should have the same powers?

It is my understanding that the above question was based on the statement which Secretary of the Treasury Donald Regan presented to your Committee on April 28, 1981, in which he said:

> The Depository Institutions Deregulation and Monetary Control Act of 1980 expanded the concept of putting all depository institutions—commercial banks, savings and loan associations, mutual savings banks and credit unions--on an equal competitive footing. We believe this is a desirable objective. It seems that at some point all the institutions must have the same powers to perform the same types of business. The current problems facing thrift institutions are largely the result of prior government attempts to structure an industry by statute in ways that are not economically feasible. We believe all depository institutions should have equal powers and should be free to choose whatever specialization they wish, based on their individual competitive skills and goals.

At the end of his statement Secretary Regan said:

> The recent legislation we are examining focuses on the relationships among depository institutions. It does not deal very much with the broader issues concerning the relationship of these institutions to other non-depository financial organizations. Yet, mergers in the securities industry in recent weeks suggest the financial markets are doing a lot of structuring of their own that will have implications for depository institutions. At some time, this Committee should broaden its examination of financial markets to look at how depository and nondepository financial businesses relate. I have some very strong personal convictions about the need to reduce legal barriers that separate the activities of all financial institutions in addition to those that enforce or encourage specialization among just depository institutions, but the Administration is not yet prepared with a policy on this broader issue.

In light of the foregoing excerpts from Secretary Regan's statement before your Committee, it appears appropriate in responding to your inquiry to make a distinction between the question of whether all <u>depository</u> institutions should ultimately have the same powers and the question of whether the legal barriers that separate the activities of <u>depository and nondepository financial businesses</u> should be reduced. The former question raises issues that are not within the Commission's purview. However, the broader question Secretary Regan posed as to the relative powers of depository and non-depository financial institutions involves many general policy issues that are of concern to the Commission. The Commission agrees with Secretary Regan that the legal barriers that now separate the activities of all financial institutions need to be re-examined to see if they continue to be justified. Where such barriers can be reduced without adversely affecting the interests of investors or depositors, the

Commission would not oppose such action. However, the Commission's position with respect to a particular proposal to reduce the legal barriers that now separate the activities of all financial institutions would depend on the specific provisions of such proposal.

14. One argument against interstate banking is the claim that large nation-wide banks will either buy up local banks or put them out of business. Do you have any data or information regarding the effect of nation-wide securities firms on local or regional firms that might shed light on this question, particularly since negotiated rates were mandated in 1975?

We wish to note at the outset that differences between the two industries make it difficult to determine the relevance of the developments in the securities industry to the banking industry.

During the last decade, the largest broker-dealers in the industry have grown, principally through mergers and acquisitions, faster than the rest of the industry. As indicated in Exhibit 1, the ten largest firms have increased their share of aggregate industry revenues from 28% in 1971 to 44% in 1980. Their share of securities commissions has increased at a slightly slower pace from 28% to 40%. The top ten firms in the securities industry also increased their share of aggregate industry equity capital at year-end, from 26% to 36% during the 1971-1980 period.

While there is ample evidence of increasing concentration of aggregate securities industry revenues, there is also evidence that smaller firms have successfully carved out profitable niches in the securities business. For example, the larger regional firms continue to be extremely profitable. Regional NYSE member firms as a group posted a 56% return on equity in 1980, and the introducing firms among this group -- that is, those generally smaller firms which do not execute and clear their own customer transactions -- realized a 58% return. This compares with a 49% average return for all NYSE member firms doing a public business. Another example is provided by the discount brokerage firms, which offer primarily execution services and do not attempt to compete along the full spectrum of brokerage services. These firms are among the fastest growing segment of the industry. Discount brokers' estimated share of retail brokerage commissions on securities transactions has grown from 3.5% in 1977 to 5.6% in 1980. During the same period, the number of such firms has increased from 90 to 125.

Although consolidations within the securities industry, thus, do not appear to have threatened seriously the ability of smaller firms to compete, we do not have any data or information concerning whether, if interstate banking is permitted, the banking industry would evolve in a manner similar to the securities industry.

15. Chairman Pratt of the Federal Home Loan Bank Board has suggested as one option to help thrifts, that they form partnerships to sell long-term, low yielding mortgages, transferred to them by the participating thrifts. Do you perceive any securities law problems with this idea? If so, how may such problems be most expeditiously resolved?

In his testimony before your Committee, Chairman Pratt said, "One proposal being reviewed carefully would involve participations by savings and loan associations in partnerships to which they would transfer their low yielding mortgages. The partnership would sell the low yielding mortgages and reinvest the proceeds in higher yielding new mortgages. Other proposals, resulting in the transfer of low yielding mortgages without recognition of losses for accounting purposes by the savings and loan associations, do not require S & L investments in partnerships." 12/

Chairman Pratt did not state whether it is contemplated that interests in the partnerships would be sold to the public. If the partnerships would, for example sell limited partnership interests in them to the public, those interests would be securities, and, absent a statutory exemption, they would have to be registered under the Securities Act of 1933. A partnership would not have to register as a broker-dealer under the Securities Exchange Act of 1934 so long as

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12/ Statement of Richard T. Pratt, Chairman, Federal Home Loan Bank Board Before the Banking, Housing and Urban Affairs Committee of the United States Senate, Hearings on Financial Institutions Oversight, April 28, 1981, page 12.

every mortgage it sold was a "mortgage security," as defined in 17 CFR 240.3a12-4, was not in default, and had an unpaid principal amount of at least $50,000. 13/

So long as a partnership is not engaged in the business of issuing redeemable securities, 14/ face-amount certificates of the installment type 15/ or

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13/ A "mortgage security" is defined in 17 CFR 240.3a12-4 to mean "a whole loan mortgage, an aggregated whole loan mortgage, a participation interest, or a commitment." These terms are defined as follows:

(1) The term "whole loan mortgage" means an evidence of indebtedness secured by mortgage, deed of trust, or other lien upon real estate or upon leasehold interests therein where the entire mortgage, deed or other lien is transferred with the entire evidence of indebtedness.

(2) The term "aggregated whole loan mortgage" means two or more whole loan mortgages that are grouped together and sold to one person in one transaction.

(3) The term "participation interest" means an undivided interest representing one of only two such interests in a whole loan mortgage or in an aggregated whole loan mortgage, provided that the other interest is retained by the originator of such participation interest.

(4) The term "commitment" means a contract to purchase a whole loan mortgage, an aggregated whole loan mortgage or a participation interest which by its terms requires that the contract be fully executed within 2 years.

14/ "Redeemable security" means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof. Section 2(a)(32) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(32).

15/ "Face-amount certificate" means any certificate, investment contract, or other security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or

Footnote continued

periodic payment plan certificates, 16/ it would appear that, as a person engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate, it would be excepted from the definition of an investment company pursuant to section 3(c)(5)(C) of the Investment Company Act of 1940.

I hope you find these responses to be of assistance. If you have any further questions, or if I can provide you with any additional information, please let me know.

Sincerely yours,

John R. Evans
Commissioner

Enclosure

15/ cont.

dates more than twenty-four months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount (which security shall be known as a face-amount certificate of the 'installment type'); or any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum (which security shall be known as a "fully paid" face-amount certificate). Section 2(a)(15) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(15).

16/ "Periodic payment plan certificate" means (A) any certificate, investment contract, or other security providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments and (B) any security the issuer of which is also issuing securities of the character described in clause (A) and the holder of which has substantially the same rights and privileges as those which holders of securities of the character described in clause (A) have upon completing the periodic payments for which such securities provide. Section 2(a)(27) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(27).

EXHIBIT I

CONCENTRATION LEVELS WITHIN THE BROKER-DEALER INDUSTRY
1971-1980

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Percent of Aggregate Industry Revenues Accounted for by:										
Top 10 Firms	28.1%	28.1%	32.2%	35.1%	34.6%	34.2%	34.6%	38.5%	39.6%	43.9%
Next 15 Firms	15.9	16.0	17.0	18.4	17.8	18.4	21.2	21.3	19.5	17.2
Top 25 Firms	44.0	44.1	49.2	53.5	52.4	52.6	55.8	59.8	59.1	61.1
Percent of Aggregate Industry Securities Commission Income Accounted for by:										
Top 10 Firms	27.8%	27.4%	28.8%	32.1%	34.9%	36.1%	37.3%	41.5%	37.4%	39.8%
Next 15 Firms	16.1	16.3	17.4	17.2	17.1	17.0	18.8	17.5	17.6	16.2
Top 25 Firms	43.9	43.7	46.2	49.3	52.0	53.1	56.1	59.0	55.0	56.0
Percent of Aggregate Industry Underwriting Profits Accounted for by:										
Top 10 Firms	29.3%	29.9%	34.5%	42.3%	44.2%	41.3%	44.3%	43.9%	43.3%	47.2%
Next 15 Firms	22.8	21.3	21.7	22.5	22.5	22.1	21.7	21.8	22.9	20.3
Top 25 Firms	52.1	51.2	56.2	64.8	66.7	63.4	66.0	65.7	66.2	67.5
Percent of Aggregate Industry Equity Capital at Year End Accounted for by:										
Top 10 Firms	30.8%	29.7%	32.8%	36.8%	31.3%	32.1%	26.4%	31.1%	32.4%	33.3%
Next 15 Firms	13.3	15.5	15.4	14.5	14.6	13.7	17.5	16.3	16.5	15.7
Top 25 Firms	44.1	45.2	48.2	51.3	45.9	45.8	43.9	47.4	48.9	49.0

Note: The periods 1971-1974, 1975-1976 and 1977-1980 are not completely comparable because of changes in the requirements for filing the reports on which this data is based.

Source: Form X-17A-10 and Schedule II of the FOCUS Report
Directorate of Economic and Policy Analysis
Securities and Exchange Commission