STUDY BY THE STAFF OF THE U.S.

General Accounting Office

Survey Of Investor Protection And The Regulation Of Financial Intermediaries

Traditionally, various types of financial institutions offered specific types of products and services. Market forces, however, have recently undermined these traditional barriers. As a result, financial institutions and the services and products they provide are undergoing rapid change; more alternative investment opportunities are available today then ever before. This report provides an overview of investment opportunities, the degree of risk to which they are exposed, and the type of protection and regulation available.

This report identifies variations among the different forms of financial intermediary regulation and investor protection and also describes reviews GAO plans to undertake in these areas.

GAO/GGD-83-30
JULY 13, 1983

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
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FOREWORD

Changes in the investment product markets may be creating gaps or overlaps in protections for depositors and investors. A variety of competing investment opportunities are now being offered which can confuse consumers, especially small depositors, who have a variety of investment motives. Also, there are sometimes subtle but confusing differences in the protections covering these products.

Regulators employ different types of investor protections--onsite examinations, disclosure of information, and insurance--for the depository, securities, and commodities industries. Included in the differences in regulation are (1) the degree to which regulators manage intermediaries' risk exposure through geographic and product line or asset and liability restrictions, (2) the policy of direct supervision of intermediaries versus reliance on self-regulatory organizations for this function, (3) the amount and types of information required to be disclosed to the investing public, and (4) the extent to which regulators impose restrictions on or establish criteria for advertisement of intermediary services.

Financial industry regulators have also adopted different approaches to protect investors from loss. Depository institution regulators are primarily concerned with the safety and soundness of the institutions they regulate and generally protect investors by providing account insurance. Commercial bank trust departments are supervised by the appropriate Federal and/or State regulator primarily to determine whether fiduciary standards are being observed for the purpose of protecting the customer and the institution. Trust assets are not insured unless the funds are invested in insured deposit accounts.

Securities and commodities industry regulators provide protection through such methods as public disclosure and maintaining orderly markets. Securities industry investors are protected against losses not related to market conditions when a brokerage house enters into insolvency. There is no insurance of commodity investors' accounts.

The primary objective of our study was to identify and describe differences in Federal regulation of financial intermediaries; therefore, we excluded the insurance and pension fund industries because they are almost exclusively regulated by the States. However, these industries will be covered in future GAO work.

W. J. Anderson

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Director

STUDY BY THE STAFF OF THE UNITED STATES GENERAL ACCOUNTING OFFICE

SURVEY OF INVESTOR PROTECTION AND THE REGULATION OF FINANCIAL INTERMEDIARIES

D I G E S T

Financial intermediaries act as mediators between investors and the investment positions they are attempting to achieve. These investment opportunities may vary in the degree of risk to which the investment is exposed; the types and extent of investor protection provided by Federal, State, or industry regulation and insurance; and the yield to investors. In the past, intermediaries have provided essentially distinct investment opportunities, but recent changes have resulted in a blurring of these distinctions. More investment options are available than ever before, and some of these options are a blend of investment opportunities that were previously exclusive to only one type of intermediary.

Differences, in a broad sense, do exist in the protections afforded investors and in the manner in which the financial intermediaries serving these investors are regulated. This is the result of traditional, economic, and legal viewpoints which have evolved over the years to result in differences in regulatory philosophies and laws. Corresponding to these differences is a variation in the manner in which investors are perceived by financial intermediaries. (See pp. 49 to 61.)

GAO undertook this staff study to identify the variations which exist among different forms of financial intermediary regulation and investor protection. This study presents an overview of what an investor may encounter when attempting to select investment opportunities. In this regard, GAO discusses the various types of financial intermediaries, how the intermediaries are regulated, and what forms of protection are provided to investors. (See pp. 3 to 6.)

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GAO obtained comments on a draft of this staff study from the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve System, the Federal Home Loan Bank Board, the National Credit Union Administration, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Securities Investor Protection Corporation. Most comments received involved suggestions to expand or clarify matters presented in the report, and where appropriate, the study was changed. Also, there were some comments with which GAO does not concur. These comments together with GAO's evaluations, are discussed in the text of the staff study. A complete set of the agencies' comments are included in appendixes VIII through XV.

DIFFERENCES IN REGULATION

GAO found that differences in regulation exist in (1) the degree to which regulators manage intermediaries' risk exposure through geographic and product line or asset and liability power restrictions, (2) the policy of direct supervision of intermediaries versus reliance on self-regulatory organizations for this function, (3) the amount and types of information required to be disclosed to the investing public, and (4) the extent to which regulators impose restrictions on or establish criteria for advertisement of intermediary services.

Five Federal financial institution regulatory agencies primarily supervise and regulate depository institutions. The five agencies approve or deny a variety of applications including those for charters, branches, mergers, insurance, and conversions from State to national status; issue rules and regulations regarding corporate structure and practices; and perform onsite examinations. State-chartered depository institutions are also regulated and examined by State authorities. Commercial bank trust services are regulated and examined by the bank's Federal regulator and any applicable State regulator. (See pp. 16 to 19.)

The Securities and Exchange Commission (SEC) has broad authority to regulate the securities markets. Securities regulation focuses on registration of securities traders, disclosure, compliance with rules on such things as capital adequacy, and onsite examinations. The authority vested in SEC is exercised through a combination of reporting requirements, oversight by self-regulatory bodies, and direct supervision. (See pp. 19 to 25.)

The Commodity Futures Trading Commission is responsible for regulating commodity futures trading on the organized commodity exchanges. In conjunction with self-regulatory organizations, the Commission requires registration of commodity professionals, establishes trading rules, conducts market surveillance, and performs limited on-site examinations. (See pp. 25 to 29.)

DIFFERENCES IN INVESTOR PROTECTION

Financial intermediary regulators have adopted different approaches to protect investors from loss. Depository institution regulators are primarily concerned with the safety and soundness of the institutions they regulate and generally protect investors by providing account insurance. Commercial bank trust departments are supervised by the appropriate Federal and/or State regulator primarily to determine whether fiduciary standards are being observed for the purpose of protecting the customer and the institution. Trust assets are not insured unless the funds are invested in insured deposit accounts or held in bank accounts as uninvested trust funds. These accounts are, however, subject to the same insurance limitations as all other accounts. (See pp. 30 to 37.)

Securities and Commodities industry regulators provide protection through such methods as public disclosure and maintaining orderly markets. Securities industry investors are protected against losses when a brokerage house enters into insolvency. There is no insurance of commodity investors' accounts. (See pp. 30 and 40 to 42.)

An investor who feels that an intermediary has improperly handled his/her account may seek reparations against the intermediary in varying ways dependent upon the type of intermediary involved and the intermediary's regulators. (See pp. 45 to 48.)

Variances exist between Federal insurance programs for depository institutions and the Securities Investor Protection Corporation protection for securities investors. Foremost, deposit insurance covers all losses up to $100,000 related to an institution's insolvency. Securities investors are only protected against the loss of cash and securities held by the brokerage house should it fail or become insolvent. This protection extends only to the return of cash and securities to customers and not to losses incurred from market transactions. Federal deposit insurers also have broader regulatory and supervisory powers than the Corporation and thus are in a better position to reduce the risk to their insurance reserves and assist troubled institutions.

In comparing Federal and State deposit insurance programs GAO found several significant variances. Federal deposit insurance programs are larger than State programs and they have a larger number of member institutions over which to help spread the impact of a failure. Unlike State programs, Federal deposit insurance programs have available lines of credit with the U.S. Treasury and a greater availability of funds to provide member institutions with temporary financial assistance. (See pp. 55 to 59.)

GAO PLANS FUTURE WORK IN INVESTOR PROTECTION AREA

GAO is undertaking a series of reviews to evaluate the implications of the rapid changes taking place in the financial services industry. GAO will also consider in its work the insurance industry, which is basically regulated by State agencies. This work will seek to describe the evolving markets and customers' needs and how the current structure of investor protection could be affected. Further, GAO will assess the historical and current arguments for establishing and maintaining the various product-line, risk, and geographic distinctions that created today's variances in protection. Finally, GAO will evaluate the various methods of protection (mix of disclosure, supervision, and insurance), the structure of regulation, and the type of competitive environment that might be fostered in the future. (See p. 6.)

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ABBREVIATIONS

CFTC	Commodity Futures Trading Commission
CLF	National Credit Union Administration Central Liquidity Facility
FBI	Federal Bureau of Investigation
FCM	Futures Commission Merchant
FDIC	Federal Deposit Insurance Corporation
FHLBB	Federal Home Loan Bank Board
FRS	Federal Reserve System
FSLIC	Federal Savings and Loan Insurance Corporation
GNMA	Government National Mortgage Association
GAO	General Accounting Office
IRA	Individual Retirement Account
NASD	National Association of Securities Dealers
NCUA	National Credit Union Administration
NFA	National Futures Association
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
PDIC	Pennsylvania Deposit Insurance Corporation
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation

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CHAPTER 1

INTRODUCTION

Financial intermediaries provide investment opportunities which vary in the degree of risk to which the investment is exposed; the types and extent of investor protection provided by Federal, State, or industry regulation and insurance; and the yield to investors. In the past, intermediaries have provided essentially distinct investment opportunities, but recent economic changes have resulted in a blurring of these distinctions. More investment options are available than ever before, and some of these options are a blend of investment opportunities that were previously exclusive to only one type of intermediary. For example, securities brokers now offer money market funds which combine an investment company's ability to pool individual resources and maintain a diversified high yield investment portfolio with liquidity and check writing features--services once limited only to depository institutions.

Our approach to this staff study was to develop an overview of what an investor may encounter when attempting to select investment opportunities. In this regard, we attempted to identify in a general sense what options are available to the investor and what forms of regulation and/or insurance may have an influence on the investor's selection. We did not attempt to evaluate the effectiveness of the regulation or insurance which is now in place. In doing this, we attempted to portray the investment opportunities and how they are regulated in a general sense. We did not intend to cover all possible options or all the exceptions and variations which exist in the investor protection and financial intermediary regulation activities we discuss.

DEFINITIONS

For the purposes of this staff study we employed the following definitions:

--Financial intermediaries--Those who act as mediators between investors and the investment positions which they are attempting to achieve.

--Financial intermediary regulators--Those who are responsible for overseeing the operations of the intermediaries and the markets in which they operate.

--Investor protection--That method which is used to assure investors that they will not be penalized by improper actions or failures of intermediaries. Protection mechanisms include Federal, State, and private deposit insurance; regulator onsite examinations; requirements for information disclosure; and customer reparations.

We have also defined four broad categories of financial intermediaries:

--Depository institutions--Institutions which accept funds from depositors and make loans to eligible borrowers. These institutions--commercial banks, mutual savings banks, savings and loan associations, and credit unions--are chartered and supervised by one of five Federal regulators or a State regulator or both. Investments (deposits) in these institutions are for the most part insured. 1/

--Trust services--A trust is a fiduciary relationship in which one person (the trustee) is the holder of legal title to property subject to an equitable obligation to keep or use the property for the benefit of another person (the beneficiary). Commercial bank trust departments offer trust services to individuals in the form of personal or retirement trusts. Trust accounts can be comprised of either discretionary assets over which the bank has power to make investment decisions, nondiscretionary assets over which the bank has no investment power, or a combination of the two. Trust services provided by commercial banks are regulated and supervised by the banks' Federal and/or State regulators. Savings and loans were recently given trust powers similar to those of banks but, to date, few savings and loans have offered trust services. Trust services may also be provided by an entity, which is not a depository institution, commonly referred to as a non-deposit trust company. Non-deposit trust companies which are chartered by a depository institution regulator are regulated by the same regulator and those chartered by a State are solely regulated by that State. However, State chartered non-deposit trust companies which are subsidiaries of bank holding companies are also supervised by the Federal Reserve.

Trust services may also be provided by an entity which is not a depository institution nor regulated by a Federal or

1/Except for depositor-owned organizations wherein ownership interests and deposits are synonymous, ownership interests--i.e., stock--are not insured.

State banking authority. This type of trust company offers shares to the public in its own name and is regulated by the Securities and Exchange Commission (SEC) as an investment company. Those who do not offer shares to the public in their own names are regulated solely by State authorities.

--Brokerage houses--Brokerage houses facilitate the buying and selling of corporate securities and futures contracts by performing the actual trading between customers. Stock brokers are regulated by self-regulatory bodies 1/ such as the securities exchanges and the National Association of Securities Dealers (NASD), which are subject to SEC oversight. Commodity brokers are regulated by the commodity exchanges with oversight provided by the Commodity Futures Trading Commission (CFTC). The newly formed National Futures Association (NFA) will play a role with respect to commodity brokerage firms and their employees similar to that function now performed by NASD in the securities area.

--Investment companies--An investment company is one which engages in the business of investing, reinvesting, or trading in securities. Investment companies can take several forms, but all such companies pool investor cash and invest it in corporate or other types of securities. Their incomes are derived from the yield on their funds' investment portfolios less advisory and administrative expenses. Money market funds are a very popular type of investment company. Many brokerage houses sponsor money market funds for their clients. Investment companies are regulated by the SEC.

DEPOSITORY INSTITUTIONS CONTROL LARGEST SHARE OF INVESTMENT FUNDS

The following table provides the most recently available data on the assets of financial intermediaries discussed in this study. Commercial banks control almost $2.4 trillion in assets either in the form of deposits or discretionary trust funds. From 1980 to 1982, money market funds were the fastest growing category,

1/Self-regulatory bodies are groups of industry professionals equipped with quasi-governmental powers to adopt and enforce standards of member conduct. Their regulation, as planned by the Congress, is carried out under Government supervision.

increasing in size by almost 200 percent. Financial intermediaries are discussed in more detail in chapter 2 of this study.

Assets Of Financial Intermediaries

	1980	1981	1982
	--(billions)--		
Commercial banks	$1,703.7	$1,808.7	(a)
Discretionary trust funds (note b)	571.2	585.8	(a)
Savings and loan associations	629.7	663.8	706.0
Mutual savings banks	171.6	175.6	174.7
Domestic finance companies (note c)	150.1	172.3	(a)
Money market funds	75.8	184.9	220.6
Broker-dealers	111.1	132.2	(a)
Credit unions	71.7	77.7	87.2
Investment companies (not including money market funds)	58.4	55.2	76.7

a/Data was not available as of March 1, 1983.

b/Asset values were not available for nondiscretionary funds.

c/Any institution operating within the United States, other than a depository institution, that makes loans to businesses or individuals.

INTERMEDIARY REGULATION PROVIDES INVESTOR PROTECTION

Depository institutions are highly regulated by both Federal and State authorities. The Federal regulators of depository institutions are the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (FRS), and the Federal Deposit Insurance Corporation (FDIC) for banks; the Federal Home Loan Bank Board (FHLBB) for savings and loans; and the National Credit Union Administration (NCUA) for credit unions. Each State has one or more regulatory authorities for depository institutions. The State's degree of involvement is primarily a function of State law, the State regulator's funding level, and agreements reached with Federal regulators on sharing examination duties.

Activities of depository institution regulators include approving or denying applications to form or merge institutions, issuing rules and regulations regarding corporate structure and practice, insuring deposits, and examining and supervising institutions.

SEC has the primary responsibility for regulation of securities activities, including securities exchanges, brokers, dealers, and investment companies. The authority vested in SEC is exercised through a two-tier system of (1) direct examination and reporting requirements and (2) oversight of self-regulatory bodies. The two largest self-regulatory bodies are the New York Stock Exchange (NYSE) and NASD. SEC also oversees the Securities Investor Protection Corporation (SIPC) through approval of its rules and bylaws. SIPC protects investor cash and securities held by registered broker-dealers against loss in the event the broker becomes insolvent. This protection extends only to the return of the customer's cash and securities, and not market losses.

CFTC regulates futures trading of agricultural products, precious metals, and financial instruments with the objective of protecting both the rights of customers and the financial and economic integrity of the commodity markets. CFTC performs its regulatory function through registration, examination, and reporting requirements; conducting general market surveillance, reviewing the enforcement of exchange rules, and overseeing a reparations program for evaluating the grievances of commodity futures traders. CFTC also oversees the commodity exchanges and the newly formed NFA.

The regulation of financial intermediaries is discussed in greater detail in chapter 3 of this study. A summary of variances in the regulation of financial intermediaries and the protections afforded investors is provided as appendix I.

PROTECTION VARIES BY TYPE OF INVESTMENT

Federal and State regulators of financial intermediaries have adopted various approaches to protect depositors and investors from loss. Financial intermediary regulators provide investor protection by

--providing insurance for investors' accounts against losses caused by the failure of financial depository institutions and brokerage firms,

--overseeing the operations of industry self-regulatory bodies,

--performing onsite examinations of financial intermediaries,

--establishing rules and regulations for reporting and disclosing information necessary for the monitoring and evaluation of investment objectives,

--requiring compliance with established trading rules, and

--requiring compliance with the regulatory framework with which investment companies and investment advisers must operate.

Should an investor feel that a loss has been sustained as a result of an inappropriate action on the part of a financial intermediary, the investor may seek reparations through methods ranging from the filing of consumer complaints to civil lawsuits for damages and restitution of profit.

It is important to realize that the protection afforded depends, in large part, on the type of investment. Investor protection is discussed in more detail in chapter 4 of this study.

We are undertaking future work in the investor protection area to evaluate the implications of the rapid changes taking place in the financial services industry. We will also consider in this work the insurance industry, which is basically regulated by State agencies. This work will seek to describe the evolving markets and customers' needs and how the current structure of investor protection could be affected. Further, we will assess the historical and current arguments for establishing and maintaining the various product-line, risk, and geographic distinctions that created today's variances in protection. Finally, we will evaluate the various methods of protection (mix of disclosure, supervision, and insurance), the structure of regulation, and the type of competitive environment that might be fostered in the future.

OBJECTIVES, SCOPE, AND METHODOLOGY

We undertook this study because we noted that an ever increasing and sometimes confusing number of investment opportunities were being offered to individuals. Also, we noted that these various opportunities were bringing about large shifts in the growth of various types of investments. The objective of this assignment was to identify and discuss variations which exist among different forms of financial intermediary regulation and investor protection related to these investment opportunities. These variations are discussed in chapter 5 of this study. We pursued this objective by performing work in three areas--depository institutions, securities trading, and commodity futures trading. In each area we reviewed prior General Accounting Office (GAO) work related to these subjects. This review was conducted in accordance with generally accepted government auditing standards.

The administration is responding to these changes in the financial services industry by having the Vice President head a study of the problems in the existing system of Federal regulation of this industry. The justification for this study included the need to evaluate (1) the regulation of the current system of highly complex services and (2) the type and nature of the various regulatory requirements which exist among different types of institutions and the products they may offer.

We focused on financial intermediaries that receive investment funds from individuals and are regulated and/or insured primarily by Federal agencies. Our scope did not include insurance companies and pension funds because they are almost exclusively regulated by State agencies. Both FDIC and NCUA stated that the omission of the insurance and pension fund industries in our study was an important shortcoming. Our planned omission of pension and insurance funds was the result of the perspective from which our study was intended to be viewed. We agree that insurance and pension plans are important financial decisions for an individual and often provide investment options similar to financial institutions, trusts, brokerage firms, and commodities dealers. The insurance and pension fund industries are almost exclusively regulated by the States. The primary objective of our review was to identify and describe differences in Federal regulation of financial intermediaries, including an overview of (1) the nature of the investment opportunities available, (2) what type of insurance and/or protection is available, (3) how the intermediary is regulated, and (4) what means an investor has to pursue relief if he or she feels that their account has been improperly handled. Also, in certain ways, much of insurance and pension fund activity is of an investment nature and may be conducted through the financial intermediaries we discuss in detail in this study. Finally, we do not discuss investment opportunities which individuals may enter into directly, such as the direct purchase of real estate, business interests, or commodities (precious metals, collectibles, government securities, etc.).

We developed information on the Federal depository institutions by reviewing information gathered during prior GAO assignments. In addition, we reviewed the latest annual reports of the FDIC, OCC, FRS, FHLBB, and NCUA; held discussions with agency staff; and reviewed various agency reports, publications, and studies.

We also acquired information on State depository institution regulation primarily through direct contacts with industry organizations, such as the Conference of State Bank Supervisors and the National League of Savings and Loans. We made an extensive effort to identify and analyze State depository institution insurance programs. This effort included a meeting with senior officers of six State insurance programs, and structured telephone interviews with officials representing a total of eight State insurance funds. (See app. IV for a list of the State insurance funds.) In addition, we reviewed their annual reports and other financial and organizational information.

We reviewed SEC background material gathered during previous assignments. We also reviewed SEC annual reports and program information and interviewed SEC staff concerning such things as SEC's philosophy, its method of regulation, and the industry self-regulation structure. At NASD and NYSE, we interviewed senior officials to obtain an understanding of each entity's regulatory philosophy and the programs available to their membership. Also, we reviewed self-regulatory organization documents, such as annual reports, background information booklets, and public information brochures. We interviewed SIPC officials and reviewed various documents relating to the objectives and method of insuring investors.

We reviewed background material on CFTC's major customer protection program and the regulation of commodity futures trading. We spoke to officials of CFTC's Division of Trading and Markets, Division of Enforcement, and the Office of the Executive Director. We discussed the registration program for commodity professionals, the review of commodity brokers and commodity exchanges, the enforcement of futures trading rules, and the programs for handling consumer complaints and customer reparations. We also reviewed program information, such as policy and procedure manuals, and other documents provided by CFTC officials.

We obtained comments on our study from the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve System, the Federal Home Loan Bank Board, the National Credit Union Administration, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Securities Investor Protection Corporation. Most comments received involve suggestions to expand or clarify matters presented in the study, and we made changes to the study where appropriate. Also, there were some comments with which we do not concur. These comments, together with our evaluations, are discussed in the text of the study. A complete set of the agencies' comments are included in appendixes VIII through XV.

CHAPTER 2

FINANCIAL INTERMEDIARIES

PROVIDE INVESTMENT SERVICES

Financial intermediaries serving investors can be divided into four broad categories--depository institutions, commercial bank trust departments, brokerage houses, and investment companies. Each intermediary provides investment opportunities which vary in (1) the degree of risk to which the investment is exposed; (2) the types and extent of investor protection provided by Federal, State, or industry regulation and insurance; and (3) the yield to investors.

DEPOSITORY INSTITUTIONS OFFER SECURITY

Depository institutions accept funds from depositors and in turn make loans to eligible borrowers. These institutions--commercial banks, mutual savings banks, savings and loan associations, and credit unions--are chartered and supervised by Federal regulators, State regulators, or both. Investments (deposit accounts) in these institutions are insured up to certain limits. Depository institutions are vested with a high public trust and are one of the principal components of the national economy and as such are highly regulated and closely supervised. They are custodians of the deposits that form the bulk of the Nation's money supply and are the principal sources of credit for commercial, agricultural, and consumer lending. The rates they pay have historically been regulated, but under the Garn-St Germain Depository Institutions Act of 1982, they have been given authority to offer accounts with a competitive rate of return.

However, depository institutions are generally prohibited from engaging in the business of issuing, selling, underwriting, or distributing securities, except for United States Government obligations and the general obligations of the States and their political subdivisions. Also, there are some limitations on the extent to which they may make investments in securities on their own behalf.

Commercial banks are stockholder-owned corporations. They have the broadest business powers of the regulated depository institutions. They accept both consumer and commercial deposits and make loans to commercial enterprises, individuals, and Federal, State, or local governments.

FDIC questioned the inclusion of banks in our discussion of financial intermediaries. It believes that our definition does not apply to the manner in which banks most commonly intermediate funds because a depositor cannot be said to be looking to a bank as a conduit to achieve for the depositor a particular ultimate investment position. We believe that the FDIC's position on the role of financial institutions as intermediaries may have been valid many years ago when all rates were fixed and stable. However, recent volatility in interest rates has made the financial institution a very important intermediary to an investor's strategy. It provides the investor not only with an opportunity to obtain high market rates with the maximum amount of flexibility and safety for a short period of time, but also longer term competitive investment rates for use in holding funds for periods of time extending up to one's retirement (IRA and Keough accounts).

Savings and loans may be either stockholder- or depositor-owned. They have been the Nation's largest source of credit for residential mortgage loans. The Garn-St Germain Depository Institutions Act of 1982 gave savings and loans more bank-like powers. Mutual savings banks have characteristics of both commercial banks and savings and loans. They are depositor-owned and are major investors in residential loans, but they traditionally have had wider business powers than savings and loans.

Credit unions are depositor-owned organizations whose investors (owners/members) share a common bond of occupation, association, or residence. The objectives of a credit union are to promote thrift among its members and to provide them with a source of credit at reasonable rates of interest. After expenses and legal reserve requirements have been met, the earnings of credit unions are paid to members in the form of dividends.

Within the last 5 years, expanded powers have been granted to Federal credit unions. These powers include being permitted to lend a greater percentage of their assets for mortgage loans and being able to offer share drafts (a checking account). Also, in 1982, the maximum dividend rate is being phased out for Federal credit unions.

TRUST SERVICES PROVIDED BY COMMERCIAL BANKS OFFER INVESTMENT ALTERNATIVES

Commercial bank trust departments offer individuals investment alternatives in the form of trust services. A trust is a fiduciary relationship in which one party holds legal title to property subject to an obligation to keep or use the property for the benefit of another. Trust assets held by commercial banks are not insured unless they are invested in insured deposit accounts or held in bank accounts as uninvested trust funds. The appropriate bank regulator supervises commercial bank trust services to determine the impact these services might have on the overall financial condition of the bank and to maintain a high degree of compliance with laws and regulations. The regulators' main concern for trust accounts is that they are handled properly because the beneficiaries and courts could hold the bank accountable for losses which occur because of a breach of fiduciary duty or violation of law or regulation.

Trust services offered by commercial banks to individual investors generally fall into the categories of personal or retirement trusts. Personal trusts can be created to generate income and/or manage funds for an individual or his/her heirs. Personal trusts are commonly used to distribute property in a decedent's estate, to divide property in cases of divorce, or to provide for the administration of assets where the court has declared an individual incompetent. Retirement trusts differ from personal trusts in that the individual creating the trust is unable to access the funds in the account until he or she reaches a legally specified retirement age. Common examples of retirement trusts are Individual Retirement Accounts (IRAs) and Keogh accounts. Trust account assets placed in insured deposit accounts are protected up to $100,000 per account, the same as any other insured deposits. Trust assets such as stock or other nondeposit investments are not insured by Federal or State deposit insurance programs.

Trust accounts can be comprised of either nondiscretionary assets, such as a particular stock which the bank has been directed not to sell or trade; discretionary assets, such as cash or stock which the bank has been given the power to invest or sell as it sees fit; or a combination of the two. The bank's trust department decides where discretionary assets should be invested to meet the needs of the trust. Banks must avoid conflicts of interest; that is, they must consider the needs of the beneficiary and not the bank or its officers when making investment decisions. State and Federal laws, the courts, the trust agreements, and their responsibility to the trust beneficiary require bank officers to exercise prudent judgment and act in a cautious manner when investing discretionary trust assets.

BROKERAGE HOUSES PROVIDE ALTERNATIVES WITH POTENTIALLY HIGHER RETURNS

Brokerage houses act as intermediaries for investors who wish to buy or sell securities, trade commodities, or purchase shares in brokerage-related mutual funds. Trading in the securities and commodity markets is generally conducted through organized exchanges which facilitate the conversion of investor funds into securities and the trading of commodity futures contracts between buyers and sellers. The securities and commodity sections of a firm's business are separate and distinct both in protection provided and method and source of regulation. Brokerage houses often have investment company affiliates which sponsor money market funds providing an investment opportunity for customer cash. Investment companies are discussed in greater detail later in this chapter.

Brokers act either as agents for their customers in bringing buyers and sellers together in the securities markets, or they act as dealers in a trade, by buying for or selling to their customers investments from their own inventory. These services may be commonly provided by the same individual or firm.

Brokerage houses may also act as investment bankers by underwriting the introduction of corporate, State, and municipal securities into investment markets. They function as middlemen between business and government issuers of securities and individuals and institutions that have money to invest. A new issue of securities may be underwritten through direct negotiation or competitive bidding. This is usually done through a purchase agreement made between the issuer and a particular investment banking firm or syndicate of firms to market the issue. The purchase agreement covers (a) the proceeds of the sale for which the investment bankers are accountable to the issuer and (b) the liability of the investment bankers to purchase unsold securities from the issuer. In either case, investment bankers may be liable for damages if they do not exercise the diligence of a prudent man in assuring that issuer representations are accurate.

The difference between the price investment bankers pay for securities and the price at which they sell to investors represents their compensation. Investment bankers arrive at a purchase price by attempting to estimate what price investors will pay for a security. During the distribution, investment bankers may also stabilize the market price. Stabilization occurs when the investment banker makes market purchases of the security to prevent or retard a price decline during the distribution period. This action helps limit the loss that an investor can incur and provides assurance of liquidity while the distribution period is effective. SEC regulations govern stabilizing practices.

Securities trading

Securities are financial instruments, such as stocks or bonds, issued by private or public entities. Issuers must be able to sell their securities to investors in order to raise capital, and investors must have a place to dispose of or exchange their investments in securities. The needs of issuers and investors are satisfied by securities brokers whose services make efficient securities trading possible.

Full-service brokers integrate several businesses that the securities laws consider to be separate. The services, which are all subject to regulation by the SEC, are: broker, dealer, and investment adviser. Securities brokers act as agents for their customers--facilitating transactions by bringing buyers and sellers together. Dealers, on the other hand, generally act as principals to a trade by maintaining an inventory of securities for the purpose of buying or selling for themselves or their customers. Investment advisers provide expert advice to individuals and institutions, but commonly give investment advice in conjunction with broker or dealer services. Some broker-dealers charge separate fees for advisory services and some investment advisors are not affiliated with any broker-dealer.

Securities brokers conduct business on organized markets which facilitate trade in securities. Securities transactions are considered either primary or secondary and the securities markets specialize accordingly. The primary market is used to facilitate the sale of new issues of securities to investors. A secondary market enables investors to buy, sell, or trade securities subsequent to their initial sale. Most initial securities distributions are made on the "over-the-counter market" which also does a large volume of secondary trading in those securities which are not listed on "exchanges." Exchanges are secondary markets where the most actively traded securities are bought and sold. They are highly organized markets where traders physically meet to match bids to buy or sell. In the over-the-counter market, by contrast, traders negotiate primarily by telephone.

Commodities trading

The most common intermediary in the commodity futures market is the futures commission merchant. These individuals or groups of individuals solicit and accept orders to purchase or sell commodities for future delivery. A futures contract is a commitment at an agreed upon price to receive or deliver a specified quantity and grade of a commodity at a future date. The contract price is established in an open auction and is constantly updated. Commodity futures activities are regulated by CFTC, and trading is conducted on designated commodity futures exchanges. Futures markets are designed to provide wide participation to keep individuals or groups from gaining control of the markets.

Futures contracts are standardized with respect to quantity, quality, and location so buyers and sellers are only concerned with price. Those who buy and sell futures contracts can be classified as: hedgers, who want to minimize risk; and speculators, who are willing to assume risk. Individuals or firms who utilize a specific commodity buy and sell commodity futures contracts related to their business as a means of (1) protecting against potential losses resulting from price changes, (2) protecting inventory values, and (3) establishing firm prices for their products. The commercial use of futures markets for business purposes is known as hedging. The commercial hedger is a market participant who uses the futures market as a means of minimizing the risk of price changes found in business operations by shifting the risk to speculators. A speculator is a market participant who trades futures contracts, thereby accepting market risks in hope of making a profit from price changes. The speculator plays an important role in assuring that commodities are fairly priced.

INVESTMENT COMPANIES OFFER LIQUIDITY AND DIVERSIFICATION

The definition of an investment company includes most companies engaged in the business of investing, reinvesting, or trading in securities. A brokerage firm's usual primary income source is the commission charged to customers for the buying and selling of stocks and bonds. An investment company's primary income represents the total return on its portfolio less advisory and administrative expenses. It must file a registration statement for its securities and register the company with the SEC. Investment companies are regulated and registered by the SEC to insure full and fair disclosure to the investing public.

Investment companies can take several forms, but all such companies pool investor cash and invest it in corporate or other types of securities. These companies raise money by offering their own shares to the general public. The pooling of funds can provide small investors with opportunities which might not otherwise be available to them. Unlike other Federal securities laws, which emphasize disclosure, the Investment Company Act provides a regulatory framework within which investment companies must operate. Among other things, the act: (1) prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval; (2) protects against management self-dealing, embezzlement or abuse of trust; (3) provides specific controls to eliminate or mitigate inequitable capital structures; (4) requires that an investment company disclose its financial condition and investment policies; (5) provides that management contracts be submitted to shareholders for approval and that provision be made for the safekeeping of assets; and (6) sets controls to protect against unfair transactions between an investment company and its affiliates.

A money market fund is a prominent type of investment company that specializes in holding financial instruments sold in the money markets. The money markets consist of securities which generally mature in less than 1 year and include such items as Treasury bills, certificates of deposit, bankers acceptances, and short-term corporate notes. Money market funds are organized and regulated primarily under the Investment Company Act of 1940, and their shares are sold to the public subject to the disclosure and antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Like all investment companies, a money market fund obtains funds by sales of shares in its own name and stands ready to redeem these shares at the investor's request. Money market funds provide expedited means for effecting redemptions of their shares. Money market funds are subject to disclosure laws, particularly with respect to such matters as the diversification of portfolio risk. Investors in money market funds obtain their profits from dividends paid by the fund.

CHAPTER 3

REGULATION OF FINANCIAL INTERMEDIARIES

VARIES BY INVESTMENT SERVICES PROVIDED

Regulation of financial intermediaries by Federal, State, and industry self-regulatory organizations takes varying forms. Depository institutions and trusts can be regulated by Federal regulators, State regulators, or both. Federal depository regulators emphasize limited entry, regulation of asset and liability powers, onsite examinations, reporting for surveillance purposes, and insurance of customers' deposits. State depository regulation is similar to Federal regulation. However, most State-chartered institutions are federally insured. Regulation of brokerage houses, investment advisors, and investment companies includes such things as requiring registration; establishing accounting, reporting, disclosure, and antifraud requirements; and setting trading rules.

DEPOSITORY INSTITUTION AND TRUST REGULATION

The United States has a dual bank regulatory system in which banks and bank trust departments are subject to State or Federal supervision and often are subject to both. Other types of depository institutions such as savings and loans and credit unions may also be subject to both Federal and State regulation. Supervisory authority depends on the institution's charter and its source of deposit insurance. All federally chartered institutions must have Federal deposit insurance and are supervised by Federal authorities. Most State-chartered institutions are also federally insured and are subject to State and Federal supervision. Some State-chartered institutions are not federally insured and are subject only to State supervision. They may or may not be insured.

Federal responsibility for depository institutions

There are five Federal agencies which supervise and regulate depository institutions. OCC charters and supervises national banks, FRS supervises its member State banks, and FDIC supervises federally insured State banks that are not FRS members. FDIC also supervises and insures Federal- and State-chartered mutual savings banks which elect Federal deposit insurance. FHLBB charters Federal savings and loans and supervises all federally insured savings and loans and federally chartered mutual savings banks. NCUA charters Federal credit unions and oversees all federally insured credit unions.

The five Federal financial institution regulatory agencies have a wide range of responsibilities for regulation (the process of interpreting legislation and issuing rules and regulations for depository institutions) and supervision (the process of monitoring, examining, and insuring compliance with safe and sound practices and applicable laws). Federal depository institution regulators approve or deny applications to form or merge institutions, issue rules and regulations regarding corporate structure and practices, approve or deny applications for Federal deposit insurance, and examine and supervise institutions.

Banks

The three Federal bank regulatory agencies affect the structure and operation of commercial banks by granting national bank charters, FRS memberships, FDIC insurance, and by approving applications to establish bank holding companies, new branches, mergers, and other bank structural changes. Regulations governing permissible banking activities and the conduct of bank business are based on a combination of State and Federal laws.

The Federal banking agencies conduct several different types of bank examinations. Separate examinations are made of banks' commercial departments, compliance with consumer protection laws and regulations, electronic data processing systems, trust departments, international branch operations, bank holding companies, affiliates, and subsidiaries. Most of the agencies' resources are devoted to examining commercial departments of banks, primarily to determine the soundness of the banks and their compliance with applicable laws and regulations.

FDIC provides the deposit insurance for most commercial banks. FDIC administers the insurance fund, offers financial assistance to banks, and liquidates failed institutions.

Savings and loans

The FHLBB formulates policies for and supervises the operation of the 12 Federal Home Loan banks, the system of Federal savings and loan associations, the Federal Savings and Loan Insurance Corporation (FSLIC), and the Federal Home Loan Mortgage Corporation. FHLBB's responsibilities include chartering, merging, and supervising Federal savings and loan associations and supervising FSLIC-insured State savings and loan associations. The FHLBB also has responsibilities with respect to savings and loan holding companies and their subsidiaries, consumer credit protection, and security measures.

Another responsibility of the FHLBB is supervising the operations of FSLIC. Most savings and loan associations are insured by FSLIC, which is responsible for administering the insurance funds for member savings and loan associations and liquidating closed insured savings and loan associations.

Credit unions

NCUA was created to regulate and to provide insurance for Federal credit unions and qualifying State-chartered credit unions. NCUA's responsibilities include chartering Federal credit unions, supervising Federal and NCUA-insured State-chartered credit unions, providing special assistance to member credit unions, and administering and operating the National Credit Union Administration Central Liquidity Facility (CLF). The purpose of the CLF is to improve general financial stability by functioning as the lender of last resort for credit unions. Membership in the CLF is voluntary and open to all credit unions.

NCUA also administers the National Credit Union Share Insurance Fund which provides insurance to credit union shareholders. NCUA also liquidates the holdings of member credit unions which are placed in involuntary liquidation.

State responsibility for depository institutions

State-chartered depository institutions are regulated by State authorities. In addition, most are regulated in some way by Federal regulators. The degree to which the State regulators are involved is primarily a function of State law, the State regulator's funding level and agreements reached with Federal regulators on sharing examination responsibilities. Some State-chartered depository institutions are insured by depository-institution-owned insurance companies. However, the States are generally not obligated to provide these insurance companies with any direct financial assistance.

Every State has regulatory authorities for commercial banks and savings and loan associations. All but three States charter and supervise credit unions. State depository institution regulators may grant charters, approve or deny applications for branches and other structural changes, prescribe permissible activities and geographic boundaries, and supervise institutions through onsite examinations and financial reporting.

Regulation of commercial bank trust services

Commercial bank trust services are regulated and supervised by the bank's Federal and/or State regulator. Bank regulators have established application and approval criteria for granting trust powers to banks, including an assessment of bank management. The regulatory agencies can grant full trust powers or limit the bank's powers to specific activities. Commercial bank trust departments are subject to examination by the regulatory agencies and must abide by the applicable Federal and State laws regarding trust activity.

SEC RESPONSIBILITY FOR THE SECURITIES MARKETS

SEC was created by the Securities Exchange Act of 1934. It has broad authority to require financial disclosure by publicly held companies; prescribe regulations to prevent manipulations of security prices; regulate practices of stock exchanges, brokers, and dealers; and regulate certain practices of investment companies. The authority vested in SEC is exercised through a combination of reporting requirements; oversight of self-regulatory bodies, such as NASD; and direct examination.

SEC carries out its responsibilities in conjunction with a group of self-regulatory organizations which, while subject to SEC oversight, are responsible for making rules and for direct supervision of their broker-dealer members. SEC applies the governing laws and, with the self-regulatory organizations, provides the rules and regulations which are used to oversee the financial intermediaries in the securities industry. It regulates under these laws by (1) overseeing the accounting, auditing, and financial reporting of publicly held companies; (2) requiring the registration of securities sold in interstate commerce; (3) assuring itself that the self-regulatory organizations are enforcing rules and regulations; (4) conducting investigations of fraud and insider trading; and (5) carrying out selected audits of intermediaries. Because of recent growth and volatility, SEC has concentrated its investment company examination efforts on money market funds.

Segments of the securities markets are exempt from general regulation and supervision by SEC and the securities industry self-regulatory organizations. For example, broker-dealers trading only in Federal Government securities or involved only in intrastate trading of securities are not required to be registered with SEC. However, these broker-dealers are still subject to certain provisions of the Federal securities laws, such as the anti-fraud provisions. SEC can take enforcement action against a broker-dealer for violations of applicable Federal securities laws. These broker-dealers are also generally subject to State securities laws and regulations. The recent collapse of a Government securities dealer has caused concern in the financial markets. The Federal Reserve Bank of New York, as a result, appointed a new surveillance chief to police Government-securities trading.

Securities laws require disclosure and trading rules

The laws administered by SEC relate in general to securities and finance. The principal laws are the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Each act contains powers enabling SEC to control and maintain the integrity of the investment security markets.

The Securities Act of 1933 is mainly concerned with the initial sale of securities from issuers to investors. The act requires the filing of a registration statement for securities to be sold through any instrumentality of interstate commerce and prescribes the content and form of both the registration statement and the prospectus. The act emphasizes full and fair disclosure by requiring that securities offered for public sale be registered and that sufficient financial and other information be made available to the public so that informed and intelligent investment decisions can be made.

The Securities Exchange Act of 1934 deals with the organized secondary markets where securities are traded among investors. Under the act, SEC registers, regulates, and prescribes records and reports to be made by national securities exchanges, securities brokers and dealers, national securities associations, and municipal securities dealers. SEC also prescribes regulations to prevent fraud and manipulation of security prices and to assure a fair and efficient securities market. SEC can suspend any security traded on a national securities exchange or in the over-the-counter market.

The act provides for supervision of the exchanges and requires the broker-dealers who are members to develop a system of self-regulation. Each exchange under SEC oversight is responsible for its own broker-dealer members. The act limits the extension of credit to investors in securities--called margin purchasing. 1/ The act also has antifraud

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1/Although SEC enforces the limits on margin purchasing, it is the Federal Reserve Board that has the authority to set the limits.

sections prohibiting manipulative or deceptive practices in connection with the purchase or sale of securities.

The Trust Indenture Act of 1939 applies to bonds and other debt securities issued to the public under a trust relationship. Even though securities have been registered under the Securities Act, they may not be sold unless the trust agreement is designed to safeguard the rights and interests of investors. Major provisions of the act impose high standards of conduct and responsibility on the trustee, require that the trustee be free of conflicting interests which might interfere with its duties to investors, and provide for reports and notices by the trustee to investors.

The Investment Company Act of 1940 applies to financial intermediaries who use funds invested in them to invest in the securities of other entities. These companies must also register with SEC, and there is an extensive body of regulation requiring disclosure of specific information concerning financial and investment policy, as well as regulation of the composition of boards of directors and capital structure and prohibition of insider self-dealing. Investment companies are not part of the securities industry's self-regulatory system. SEC is therefore directly responsible for monitoring this industry's financial condition and compliance with Federal laws and regulations. Examinations of other investment companies are conducted less frequently.

The Investment Advisers Act of 1940 requires investment advisers to furnish in their registration statements, a written disclosure statement with certain specified information regarding their backgrounds, business practices, and investment policies. By regulation, SEC requires similar information to be disclosed to existing and prospective clients. This disclosure requirement was imposed because of concern about the adequacy of information provided to clients regarding the advisers' backgrounds and business practices. The act also requires the filing of periodic reports.

SEC is empowered by the Securities Investor Protection Act of 1970 to approve SIPC by-laws or rules. The act requires the SEC or any self-regulatory organization to notify SIPC of any broker-dealer subject to their regulation that is in or approaching financial difficulty. SIPC is a non-federally funded, quasi-governmental organization which was created to provide insurance-like protection to customers of member brokers and dealers who are unable to meet financial obligations to their customers.

Also, SEC coordinates its activities with State securities commissions. All States and the District of Columbia have laws regulating securities. The Congress recognized State securities laws, commonly referred to as "blue sky laws," when it passed the Securities Act of 1933. This act preserved certain of the States' rights to regulate securities. As a result, many securities must be registered at the Federal and State levels. State laws are not identical, but most have provisions covering (1) fraud in the sale of securities, (2) registration of securities dealers and brokers, and (3) registration of securities. However, the purposes of Federal and State laws often differ markedly. Federal laws require full disclosure without considering the merits of the investment. Many State laws function as licensing processes. Complete disclosure, while important, does not automatically permit securities to be sold in a State because registration may be denied if the State commission finds that the investment lacks merit or is considered too speculative. The North American Securities Administrators Association is a leading proponent of efforts to develop uniform State securities laws.

Self-regulatory organizations directly supervise securities trading

The Securities Exchange Act of 1934 established a system of self-regulation which is subject to SEC oversight. In principle, each self-regulatory organization is responsible for supervising its member broker-dealers. Broker-dealers who are not members of an organized market are registered with and supervised directly by SEC. The self-regulatory organizations maintain the integrity of the securities markets through surveillance and disciplinary actions against member broker-dealers.

As of September 30, 1981, there were 10 securities exchanges and the over-the-counter market. Many of the large broker-dealers are members of a number of these markets. In 1975, amendments to the securities laws shifted to SEC the authority for designation of a principal examination authority for those broker-dealers who were members of more than one market. One of the principal responsibilities of the designated examining authority is monitoring the financial condition of its supervised institutions.

The largest and most important of the self-regulatory organizations are the NASD and NYSE.

National Association of Securities Dealers

NASD, the self-regulatory organization responsible for regulating the over-the-counter securities market, was established under authority granted by the 1938 Maloney Act amendments to the Securities Exchange Act of 1934. The act allows for the registration of more than one national securities association to supervise the over-the-counter market. To date, only NASD has registered to do so. Virtually all exchange member firms that deal with the public are members of NASD. As of October 31, 1981, NASD's membership totaled 3,196 main and 8,320 branch offices of member firms. To accomplish its purposes, NASD has established a code of ethical conduct known as the "Rules of Fair Practice."

NASD performs its self-regulatory functions by:

--Conducting a nationwide field inspection program for the purpose of insuring that member firms and persons associated with such firms are complying with SEC and NASD rules, Federal Reserve Board regulations, 1/ and directives of the Municipal Securities Rulemaking Board. 2/

1/The Securities Exchange Act of 1934 authorizes the Board of Governors to regulate the use of credit for purchasing or carrying securities. In exercising this responsibility the Board imposes limitations on the amount of such credit that may be provided by brokers and dealers, banks, and other lenders. In order to prevent borrowers from obtaining more credit abroad than lenders are permitted to supply in this country, as well as to improve compliance generally, all U.S. persons who use securities credit are required to comply with the Board's margin regulation. Regulatory limitations apply to corporate stocks registered on national exchanges or designated as over-the-counter margin stocks.

2/The Municipal Securities Rulemaking Board was designed to function as an independent, self-regulatory organization charged with primary rulemaking authority for the municipal industry. Its 15 members are divided into three categories--securities firm representatives, bank dealer representatives, and public members, each category having equal representation on the Board. In the public category, at least one member must be representative of issuers of municipal securities and one representative of investors. In recognition of the existing regulatory structure for banks and securities firms, the Board does not have inspection or enforcement authority. Instead, under the Securities Acts Amendments the SEC, NASD, and the three Federal bank regulatory agencies are charged with inspection responsibility and enforcement of the Board's rules, which have the force of law under the legislation.

--Administering qualification examinations to those wishing to enter the securities business to help assure that they are aware of their obligations under the Federal securities laws and are aware of the ethical requirements of NASD rules. All sales personnel, whether part-time or full-time, and managers must pass at least one of several NASD examinations in order to qualify as registered representatives entitled to transact business on behalf of the public.

--Preventing the use of advertising or other promotional materials which are false or misleading.

--Regulating members, over-the-counter market activities, and trading practices. NASD facilitates trading activity through the use of a computerized communication system which stores up-to-the-second price quotations from a nationwide network of dealers for more than 3,600 over-the-counter securities. In addition to providing accurate and timely quotations, the system is used by the NASD in the surveillance of trading activity in the over-the-counter market.

--Reviewing the underwriting arrangements for new securities offerings. New securities offerings involving members must be filed with the NASD.

NASD is authorized under the Maloney Act to take disciplinary action against those who violate the established bylaws and rules. Discipline may involve censure, fine, suspension, registration revocation, barring of an individual from association with a member, or expulsion of a member from NASD. All decisions rendered by NASD's business districts are reviewed by the SEC and are subject to a right of appeal to the SEC and subsequent appeal to the courts.

New York Stock Exchange

The NYSE is responsible for overseeing the operation of its exchange marketplace and monitoring its member firms. Its regulatory programs are similar to those of NASD. For example, NYSE oversees the operation of the exchange marketplace and administers detailed rules and regulations related to the maintenance of orderly markets and the standards of professional competence. Sanctions for violation include disciplinary actions such as censures, fines, suspensions, and bars to employment in any member organization. Like NASD, NYSE monitors the market by an on-line price surveillance program called "Stock Watch."

NYSE is also responsible for supervising the retail member firms of the NYSE that deal with the public. Like NASD, it monitors the adequacy of securities education and training of registered representatives, the quality of sales supervision, and the financial strength and operational efficiency of member firms that deal directly with the public. This is done by professional staff who prepare tests of broker training; review the firm's advertising and market letters; investigate customer complaints; and conduct annual field examinations of the capital sufficiency, sales practices, financial and other record-keeping efficiency, and supervisory diligence of each firm's management.

CFTC RESPONSIBILITY FOR THE COMMODITY MARKETS

CFTC is responsible for regulating commodity futures trading conducted on the organized commodity exchanges. It carries out this responsibility in conjunction with self-regulatory organizations which, subject to CFTC oversight, directly supervise their members. CFTC implements the governing laws and develops the rules and regulations which are used to oversee the financial intermediaries in the commodity futures industry. The methods of regulation include efforts to (1) assure that the self-regulatory organizations are carrying out their self-regulatory responsibilities and are enforcing the rules and regulations under which they operate and (2) carry out daily market surveillance and selected audits of intermediaries. Also, CFTC advocates that the maintenance of a competitive market is in itself an important factor in an effective regulatory program.

CFTC requires fair and orderly trading

CFTC's authority is derived primarily from the Commodity Exchange Act of 1936, as amended by the Commodity Futures Trading Commission Act of 1974, and the Futures Trading Commission Acts of 1978 and 1982. The acts generally authorize CFTC to control and maintain the integrity of the commodity markets and provide CFTC with jurisdiction over commodity transactions for future delivery. The CFTC approves contracts for commodities the exchanges wish to trade on the basis of its determination of those contracts' usefulness to businesses in managing risks of commodity ownership.

An important aspect of the acts is the audit and financial surveillance authority they grant to the CFTC. Generally, the Commission monitors exchange activity, but it may directly audit commodity professionals at its own discretion. Commodity futures exchanges are required to impose Commission-approved rules on their members, with CFTC supervision and enforcement of exchange rules through a rule enforcement review program. The Commission is also authorized to conduct market surveillance programs to identify adverse market situations and prevent them from disrupting futures markets. The CFTC act requires certain persons who deal in commodities to register with the Commission and authorizes the Commission to deny registration to any applicant found to be unfit.

How CFTC regulates

CFTC regulates futures trading in agricultural commodities, petroleum and related products, precious metals, and financial instruments to prevent price manipulation, market corners, dissemination of false or misleading information, and mishandling of traders' margin money and equity. Before a new contract can be traded, CFTC must review and approve it, with approval contingent upon the contract's potential usefulness in establishing cash prices and/or providing an opportunity to hedge the risk of commodity ownership. Once trading commences, CFTC, along with the self-regulatory organizations, maintains market surveillance programs to detect manipulation or other harmful activities.

CFTC's regulatory and enforcement efforts are intended to ensure that the futures trading process is fair, protects the rights of customers, and maintains the financial and economic integrity of the marketplace. Regulation of the commodity markets is provided through a dual system of direct CFTC regulation and industry self-regulation. CFTC approves the rules under which exchanges operate and monitors exchange enforcement of those rules. In addition, CFTC reviews the terms of proposed contracts, registers firms and individuals who handle customer funds or give trading advice, and periodically audits member and nonmember futures commission merchants (FCMs) as well as commodity pool operators.

CFTC also mandates risk disclosure requirements for FCMs and other participants in the Commodities Futures Markets. Regulations require that potential investors receive pro forma risk disclosure statements about their investment, as well as information about the individual and organization with which they are dealing. The risk disclosure statements inform potential investors that, among other things, (1) trading commodity futures contracts can quickly lead to large losses as well as gains, (2) in some cases the total loss may exceed the initial investment, and (3) under certain conditions, it may be difficult or impossible to liquidate a position.

Registration

The Commodity Exchange Act of 1922, as amended, requires certain parties active in the commodity futures market to register with CFTC. The registration program helps CFTC maintain a record of commodity industry participants and helps keep unfit persons from participating. CFTC uses a fitness screening process consisting of checking an applicant's name and other pertinent information in his/her application against the Federal Bureau of Investigation (FBI) and SEC files. The FBI checks to see if the applicant has a criminal record or if there is other information relevant to an individual's qualification. The SEC checks to see if the applicant has committed any securities-related crime or violation. If the screening process reveals information indicating possible grounds for denial, CFTC can initiate an investigation of the individual. These investigations are conducted by CFTC staff or done under contract by the Office of Personnel Management. If no grounds for denial are found, CFTC grants registration.

CFTC registrations are valid for 1 to 2 years, after which registrants must reapply. Upon reregistration, CFTC does not make fitness checks against FBI or SEC files, but relies on the applicants to disclose in their applications whether they engaged in any potentially disqualifying activities since their last registration. As of July 1, 1982, CFTC implemented new registration rules and procedures which apply only to associated persons (commodity sales personnel). These new rules and procedures provide for FCM sponsorship of associated persons, as well as the above mentioned security checks. However, the associated person's registration will last as long as the individual registrant remains in the employment of the sponsoring FCM.

Audit and financial surveillance

Another aspect of CFTC regulation is the audit and financial surveillance program. CFTC carries out its program through periodic monitoring and auditing of FCMs and through oversight of exchange activities. Two principal types of audits are performed--full financial audits and segregation audits. Full financial audits examine all aspects of an FCM's financial operation. Segregation audits are performed to verify an FCM's compliance with CFTC's segregation requirements on maintaining a customer's funds in a separate account. In addition to these principal types of audits, CFTC conducts onsite trade practice investigations to assess particular segments of a firm's operations and direct audits of exchanges' financial surveillance programs as well as overseeing such audits as conducted by the exchanges.

Information disclosure

In April 1980, CFTC formed a Front Office Audit Unit to enhance customer protection by providing greater assurance that full disclosure of risks is being made to customers. The unit examines the methods by which firms involved in the commodity markets solicit prospective customers. Front Office auditors are expected to recognize indications of unacceptable marketing practices, violations of the Commodity Exchange Act, and violations of CFTC's regulations.

Self-regulatory organizations directly supervise commodity futures trading

Commodity industry self-regulation is primarily the responsibility of the organized commodity exchanges. The Commodity Exchange Act requires the exchanges to establish and enforce rules to govern futures trading. CFTC reviews exchange activities and records and works in conjunction with the exchanges to establish and enforce the financial requirements of exchange members. The exchanges have primary responsibility for reviewing members' financial conditions and maintaining market surveillance. A new self-regulatory organization, the National Futures Association (NFA), was created in 1981 to extend self-regulation to non-exchange members and promote greater consistency in dealings with customers.

Commodity futures exchanges

Each commodity exchange is responsible for establishing and enforcing FCM compliance with established minimum financial and related reporting requirements. All the exchanges' rules must be approved by CFTC, and all exchanges must have financial and related reporting requirements identical to or more stringent than those of CFTC. CFTC oversees the exchanges' audit and financial surveillance programs, while the exchanges perform the periodic audits and daily financial surveillance of member FCMs.

Each commodity exchange is required to perform the following:

--Surveillance of market activity to detect and prevent situations conducive to price distortion.

--Surveillance of trading practices to detect and prevent trading abuses.

--Investigation of rule violations and customer complaints.

--Examination of members' books and records.

National Futures Association

NFA was approved by CFTC in September 1981 to become a commodity industry self-regulatory organization. NFA has the authority to establish ethical standards against fraud, manipulative practices, and other abuses, and to impose financial requirements and uniform customer relations rules. NFA will be responsible for developing a full-scale disciplinary system and a procedure for dealing with its members' financial problems.

Various developments in the commodity industry led to the creation of NFA, including fraudulent industry practices, changing rate structures, and a desire for more consistent industry regulation. The commodities options scandal of the 1970s, which took place outside the regulated markets, showed that the industry's image could be seriously damaged by fraudulent practices which the industry was unable to prevent. Another development was the elimination of fixed commission rates on the exchanges; for decades the exchanges offered lower commissions to firms joining the exchanges than to nonmembers. The commission rate structure was replaced by rate bargaining, which offered the firms an opportunity to get low rates without joining the exchanges. Because exchanges can only regulate their members, they lost control over both the ethics and solvency of the nonmember firms. Another development was the proliferation of rules on the various exchanges governing the same activity. In some cases, the rules of one exchange were not consistent with the rules of other exchanges. The firms wanted more uniformity, especially when dealing in the customer relations area.

CFTC points out that NFA was designed to address many of the problems above, but NFA lacks the authority to deal with fraudulent operators who are not NFA members. CFTC believes NFA will be able to incorporate a pool of legitimate commodity firms, from which a customer should be able to select a reliable firm confident that he or she will be treated fairly Since the program is not yet operational, we are unable to comment on NFA's effectiveness.

CHAPTER 4

INVESTOR PROTECTION TAKES SEVERAL FORMS

Depository institution regulators generally provide investors protection by providing account insurance. SIPC protects investor cash and securities held by registered broker-dealers. This protection extends only to the return of the customer's cash and securities, and not market losses. Account insurance is paid by Federal insurers of depository institutions and SIPC only when an intermediary enters into insolvency or liquidation. There is no insurance of investors' commodity and trust accounts. However, trust account assets are not includable in the estate of the depository institution should bankruptcy occur and are protected by blanket bond insurance. Losses sustained by individual account holders, but not coinciding with financial difficulty for the intermediary, are not insured but are addressed through customer reparations programs or through formal civil lawsuits.

Also, Federal and State regulators of depository institutions perform extensive examinations and establish mandatory reporting requirements, all of which are based on specific safety and soundness criteria. The securities and commodities industries are primarily supervised by self-regulatory organizations and State securities commissions. In addition, securities and commodities industry regulators require information disclosure to investors, establish rules of operation, and perform some onsite examinations.

FEDERAL INSURANCE PROTECTS MOST DEPOSITORS

Deposits at most commercial banks, mutual savings banks, savings and loans, and credit unions are insured by one of three Federal agencies, although some State-chartered institutions have State as well as Federal insurance. FDIC insures commercial banks and State-chartered mutual savings banks under the Banking Act of 1933. FSLIC insures savings and loans and federally chartered mutual savings banks under the National Housing Act of 1934. NCUA insures credit unions under the amendments to the Federal Credit Union Act of 1934. Each act establishes an insurance fund financed by the institutions principally through assessments based on their volume of deposits. (See app. II.)

The statutory provisions governing Federal insurance of accounts are comparable for the three agencies, so the following remarks generally apply to all federally insured institutions. These institutions can be identified by their insuring agency's symbol which institutions are required to prominently display.

Accounts are insured for up to $100,000. Insurable accounts are any deposits received by an institution in its usual course of business. Examples are checking deposits, savings deposits, certificates of deposit, certified checks, and cashiers checks.

Ownership interests determine the maximum amount of deposits an individual can place in a single institution and receive insurance coverage. An individual depositor can increase his or her coverage by having accounts in more than one institution. Also, by establishing many different types of accounts, an individual depositor can increase his or her coverage above $100,000 at the same institution.

Each of the following accounts has a total insured value of up to $100,000 per individual per type of account:

--Accounts in the depositor's own name.

--The depositor's interests in joint accounts. 1/

--IRA and Keogh accounts.

--Testamentary trusts, trusts which become effective upon the depositor's death, where the beneficiary is a spouse, child, or grandchild of the depositor. ($100,000 for each beneficiary.)

--Irrevocable trusts. ($100,000 for each beneficiary.)

Although most consumer transactions with insured depository institutions are insured, there are exceptions. An increasing number of financial institutions are publicly offering retail repurchase agreements. These generally involve the "sale" of an interest in government securities, in a denomination of less than $100,000 and for a term of less than 90 days, subject to an

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1/No joint account shall in any case be entitled to insurance coverage in excess of $100,000. The insurance protection on joint accounts is not increased by rearranging the names of the owners, changing the style of the names, or by establishing more than one joint account for the same combination of owners in the same insured institution. The individual's insurable interests in each joint account owned by different combinations of individuals are added together and the total is insured up to the $100,000 maximum.

agreement by the institution to "repurchase" the interest. Although this instrument has many of the advantages of a deposit, it is not considered a deposit and is not insured.

How Federal deposit insurance programs operate

Congress authorized a deposit insurance program for banks and savings and loans in the 1930s and extended insurance coverage to credit unions in 1970. All federally chartered depository institutions are required by law to have Federal deposit insurance and most State-chartered institutions have Federal insurance, some voluntarily and the remainder because of State law. Of all State-chartered institutions, 96 percent of banks, 98 percent of savings and loans, and 81 percent of credit unions are federally insured. A major function of Federal deposit insurance is to stabilize the financial industry by creating public confidence in depository institutions.

The three Federal deposit insurance funds receive no appropriated funds but generate income from annual assessments of insured institutions. The assessment is made at a rate of 1/12 of 1 percent of the adjusted total deposits held in the insured institution. The insurance funds are composed of assessments which are invested in Government securities, the FDIC's interest in other assets, and assets obtained through acts of financial assistance. Each fund has built up a reserve (app. III) consisting of assessments and retained interest income from its investment portfolio. Along with its reserves, each agency has the authority to borrow from the U.S. Treasury as follows; FDIC, $3.0 billion; FSLIC, $750 million; and NCUA, $100 million. To date, the agencies have never had to draw on these funds.

Financial stability

Since the insurance programs were initiated, over 1,700 insured institutions have entered liquidation. The insurance funds have been sufficient to pay all depositors the full insured amount, and 99 percent of the total deposits in all liquidated institutions have been recovered. Trust assets are not subject to such liquidation. Losses do not occur to trust assets except possibly to the extent they are invested, above the insured limits, as deposits in the failed institution.

Through supervision and examination, the regulatory agencies attempt to identify institutions in financial difficulty as early as possible. When an institution gets into serious financial trouble, its Federal regulator will try to arrange for the institution to merge with a healthier one thus avoiding a bank failure. If a merger cannot be arranged, FDIC generally pays other banks to assume the deposits and other liabilities of the troubled bank, including uninsured deposits, thus avoiding any loss to depositors. In some cases, however, these actions cannot be accomplished and the bank fails. In these cases a receiver is appointed and the assets and liabilities of the bank are liquidated, and some loss may result to uninsured depositors in the process.

In addition to the insurance funds used to pay depositors of failed institutions, Federal regulators have other funds available to help assure the financial stability of their institutions. These funds can be lent to insured institutions with the Federal treasury acting as lender of last resort. The largest of these lenders is the FRS. It requires depository institutions to maintain a certain percentage of their deposits on deposit with the FRS as reserves. The Federal Home Loan banks require their member savings and loan associations to contribute to a comparable fund by purchasing Federal Home Loan bank stock in amounts equal to a fixed percentage of the association's deposits. The CLF acts as a comparable lender to its member credit unions. Membership or access to the CLF does not depend on insurance status.

STATE DEPOSIT INSURANCE PROGRAMS VARY IN MEMBERSHIP AND ORGANIZATION

The vast majority of State-chartered depository institutions are federally insured, but many State-chartered institutions carry other forms of insurance or are not insured at all. These latter institutions are all chartered by States with laws that do not require participation in Federal insurance programs. These institutions include commercial banks, mutual savings banks, savings and loans, domestic branches of foreign banks, and credit unions. Some of these institutions are insured by State-sponsored member-supported insurance funds, while others, to the best of our knowledge, are uninsured.

State laws governing deposit insurance coverage for State-chartered institutions vary from State to State and among types of depository institutions within a State. No comprehensive data exists on deposit insurance for all State-chartered institutions. However, the following chart provides the best available data about the number of nonfederally insured depository institutions by institution type.

Institutions Not Federally Insured (note a)

Type of institution	Number of institutions
Credit unions	4,115
Savings and loans	541
Domestic branches of foreign banks	172
Mutual savings banks	110
Other domestic banks (note b)	205
Total	c/5,143

a/The number of uninsured institutions is based on reports dated January 1981 to May 1982.

b/These institutions vary in their organization and principal businesses. The practice common to all of them is the regular acceptance of deposits. The largest group is 149 industrial banks (deposit taking finance companies) located in Colorado.

c/Included in this total are a number of totally uninsured institutions, the exact number of which we were unable to determine.

The industrial bank is an example of an institution which may not be federally insured. Industrial bank is a term for variously named institutions chartered by States to extend installment credit to consumers and to accept certain forms of deposits. The definition excludes finance companies which may sell certificates of investment under general securities law. Twenty-three States are known to have statutes permitting industrial banks, and at least 9 of these States have provided for deposit insurance. Data for industrial banks is available only on a State-by-State basis, and there is little uniformity or consistency in the availability or detail of information from one State to another.

There are three primary reasons why a State-chartered depository institution might not have Federal deposit insurance:

--Some institutions do not meet Federal deposit insurance program requirements for minimum size or organizational structure. Being unqualified for Federal deposit insurance programs, these institutions provide protection to their depositors by joining State insurance programs.

--A smaller group of institutions choose State insurance over Federal insurance to avoid the dual regulatory environment in which federally insured institutions operate.

--Other institutions may be required by State law to participate in the appropriate State deposit insurance fund. For example, Massachusetts requires all savings and loans and mutual savings banks to join the appropriate State insurance funds. Some institutions in Massachusetts, however, participate in both State and Federal insurance programs.

State deposit insurance programs

There are eight insurance funds in six States which insured from 4 to 158 institutions each and had insurance reserves ranging from $118,000 to $291 million each. These funds 1/ provide insurance to savings and loans, commercial banks, and mutual savings banks. Two of the eight funds insure credit unions along with other types of depository institutions. In addition, there may be as many as 17 State insurance funds which insure only credit unions. We did not gather information on those 17 funds. Appendix IV provides detailed information on the eight State insurance funds we reviewed. The State insurance programs vary greatly in the number and kind of institutions they insure.

State laws governing State-chartered savings and loan institutions vary from State to State:

--Twenty-five States allow only federally insured savings and loan associations.

--Twenty-five States allow nonfederally insured savings and loans; but only 1 of these requires State insurance, 4 others provide insurance funds, and 20 have no insurance funds.

For commercial banks:

--Twenty-three States require Federal insurance for commercial banks.

--Two States offer optional State insurance programs for banks.

1/Organized as private corporations.

--Twenty-five have no insurance requirements or insurance funds for banks.

Credit union deposit insurance is a recent phenomenon. Except for Wisconsin, which has long insured credit union accounts, there was no credit union deposit insurance until the National Credit Union Share Insurance Fund was organized in 1970. Currently, 41 States require State-chartered credit unions to participate in a deposit insurance program:

--Eleven States require participation in the Federal insurance program.

--Three States require participation in the State insurance program.

--Twelve States provide credit unions the option of participating in either the Federal insurance program or their State insurance programs.

--Fifteen States give the option of participation in the Federal insurance program or any other insurance program approved by the States' credit union authorities.

Of the remaining nine States, three do not charter credit unions, and six do not require deposit insurance.

Financial stability

All eight State-chartered deposit insurance companies are private, depository-institution-owned entities established by State laws that subject them to different limits on their authority. No State is obligated to financially assist any of the companies in meeting its insurance obligations, and only one company has a line of credit from its State's Treasury [Pennsylvania Deposit Insurance Corporation (PDIC), for $10 million]. Direct oversight by State supervisory authorities varies. Four of the six States examine their State's deposit insurance companies; two do not.

The companies are not uniform in their abilities to control insurance risk. We were advised that three of the eight funds do not have the authority to approve or discontinue an institution's membership in the fund. Those companies must rely on State supervision of their membership to anticipate or resolve problems involving financial risks to the insurance fund. We were informed that only four of the eight companies have authority to examine their members. Of these, only two perform examinations regularly enough to maintain a staff of examiners.

With the exception of the PDIC, which insures banks not insured by FDIC, State deposit insurance companies have the ability to minimize costs to the insurance fund by selecting the least costly solution when dealing with a problem institution. These options include arranging mergers, making loans, purchasing assets, or operating a failed institution as trustee. In addition, both Massachusetts insurance funds and the Maryland insurance company have separately maintained liquidity funds to provide loans to their memberships.

Appendix V provides the insurance reserve figures for the State deposit insurance programs we reviewed. With the exception of PDIC, which is very new, the State-chartered deposit insurance companies' reserves-to-insured-deposits ratios compare favorably to those of the Federal deposit insurance companies. However, unlike the Federal deposit insurance funds, these programs do not have a large membership over which to spread the financial impact of a failure.

SIPC PROVIDES PROTECTION FOR SECURITIES INVESTORS

In December 1970, the Congress passed the Securities Investor Protection Act which created SIPC. Prior to 1970, there was no uniform investor protection policy in the securities industry. Some exchanges provided protection while others did not. The coverages were not uniform, and payment of claims was at the discretion of the exchange. SIPC expanded protection to all customers with funds and securities held by broker-dealers. This protection includes most securities--notes, stocks, bonds, debentures, and certificates of deposit--but not unregistered investment contracts or any interests in commodity contracts or commodity options.

SIPC coverage provides investors with protection when a brokerage house enters into insolvency because of problems such as brokerage house mismanagement. Mismanagement would generally include losses from such business activities as brokerage house losses on bad management decisions concerning the type of stock to purchase for their inventory, firm overextension in buying of a certain asset for inventory, lost stock certificates, and other management decisions which would cause solvency problems for the firm. This protection extends only to the return of cash and securities to the customers; not to other losses in the value of shares which were caused by an underlying fraudulent transaction for a customer's account. Investment companies, including money market funds, are not protected by federally sponsored insurance but are required to obtain private insurance for protection against employee fraud or mismanagement.

SIPC is a nonprofit, membership corporation which is to remain in existence until the Congress acts to dissolve it and is not an agency or establishment of the United States Government. SIPC activities are subject to SEC and congressional oversight. To avoid regulatory overlap, SIPC was not given regulatory power over the general operation of broker-dealers and is primarily dependent on SEC and the self-regulatory organizations to monitor broker-dealers. The Securities Investor Protection Act requires the SEC and self-regulatory organizations to advise SIPC of firms in or approaching financial difficulty.

SIPC's functions include initiating the steps leading to the liquidation of a member; advising the trustee, his counsel, and accountants; reviewing claims; auditing distributions of property; and, where assets in the trustee's hands are insufficient, providing the funds necessary to satisfy customer claims and to carry out the liquidation proceeding. If the court appoints SIPC or a SIPC employee as trustee in a liquidation, or if SIPC initiates a direct payment proceeding, the staff becomes responsible for all facets of operation. This ranges from taking control of customers' and members' assets to satisfying valid customer claims and accounting for the handling of all assets and liabilities to the court having jurisdiction.

SIPC is required to notify SEC of all proposed bylaw and rule changes. If SEC determines that the bylaw involves a matter of significant public interest, it will be published. After publication, SEC either approves or orders proceedings to determine whether the proposed changes should be disapproved. SEC may require SIPC to adopt, amend, or repeal any SIPC bylaw or rule. SEC may examine and inspect SIPC or require reports and records. SIPC files an annual report with SEC covering its activities during the year as well as financial statements which have been examined and reported on by independent public accountants.

Membership in SIPC is mandatory for broker-dealers

Membership in SIPC is required for all persons registered as brokers or dealers under the Securities Exchange Act of 1934 and all members of a national securities exchange except:

1. Those brokers whose principal business, as determined by SIPC, subject to SEC review, is conducted outside the United States, its possessions, and territories.

2. Broker-dealers whose businesses consist exclusively of:

   a) the distribution of shares of registered open end investment companies or unit investment trusts,

   b) the sale of variable annuities,

   c) the business of insurance, or

   d) the business of rendering investment advisory services to registered investment companies or insurance companies.

It should be pointed out that SIPC does not cover those broker-dealers who deal exclusively in registered open-end investment companies. SIPC coverage is effective only when a SIPC member holds customer securities or cash.

All security brokers or dealers registered with SEC are required to be insured. SIPC does not have the authority to deny membership to a firm even if SIPC feels that the firm is a high risk. If a firm is delinquent in paying its assessment and such delinquency is not cured within five days after receipt by the firm of a notice of delinquency, it is unlawful for the firm, unless specifically authorized by the SEC, to continue to engage in business as a broker or dealer. Nevertheless, if the firm subsequently goes out of business, it is still a member of SIPC and its customers are entitled to the protections provided under the Securities Investor Protection Act.

The statute creating SIPC required that, through assessments, it establish an insurance fund of at least $150 million. An assessment of .5 percent of gross revenues was implemented to attain the $150 million fund level. The minimum was reached in 1977, and in 1978 the assessment was reduced to .25 percent of gross revenues. In 1979 the assessment was reduced to $25 per year, where it has remained primarily to enable SIPC to maintain the collection system and keep track of its more than 7,000 members. The balance in the insurance fund as of March 1982 was about $167 million. The assets of SIPC's insurance fund are invested in U.S. Government securities with varying maturities to maintain liquidity. Since 1978 earnings from these investments have been SIPC's principal source of revenue.

The Securities Investor Protection Act allows SIPC to borrow from banks or other financial institutions pursuant to lines of credit or other written agreements. In addition, SIPC may borrow, through SEC, up to $1 billion from the U.S. Treasury.

Liquidation procedures exist to return investor funds

SEC and self-regulatory organizations are required to notify SIPC whenever they find a broker-dealer in financial difficulty. SIPC acts only as a liquidator and has no other alternative for dealing with problem firms. A liquidation by SIPC is initiated when, it is determined a firm has failed or is in danger of failing to meet its obligations to its customers and, among other things, is insolvent within the meaning of the Bankruptcy Code.

Once the conditions for liquidation exist, SIPC will, except in very small cases, go to a Federal district court and ask the court to begin a liquidation proceeding. The court then appoints SIPC or a person designated by SIPC as trustee to liquidate the firm and settle the claims against it. In certain small cases SIPC can initiate a "direct payment procedure" without court intervention. SIPC itself then carries out the customer protection tasks normally carried out by a court-appointed trustee. The trustee satisfies customer claims first by returning to the appropriate customers the securities which are on hand and registered in their names; second, by dividing among the customer claimants all customers' securities and cash received, acquired, or held by the firm for the accounts of customers; and finally by utilizing funds provided by SIPC. The trustee will replace missing securities as long as he can purchase the replacements in a fair and orderly market. SIPC can advance up to $500,000 per customer account to cover a customer's claim for cash and securities, but no more than $100,000 can be for that portion of the claim which is for cash. The purpose of the SIPC advance is to protect the customer as to the difference between what he is owed and the distribution he will receive from the trustee of customer related property in the trustee's possession. The liquidation process is explained in more detail in appendix VI.

SIPC has conducted 161 liquidations through the end of 1982. Approximately 120 of those liquidations have been closed out. SIPC has handled approximately 140,000 customer claims. Only 246 customers were not fully reimbursed because their accounts exceeded the insurance limits in effect at the time of liquidation. It is SIPC's intent to compensate customers as quickly as possible so they can continue conducting their securities activities. However, SIPC does not cover lost profits during litigation or financial losses incurred as a result of investor inability to trade securities.

In commenting on our draft study, SIPC stated that it was important that the nature and perception of the protection afforded under the Securities Investor Protection Act of 1970 be clearly understood. It asked that we try to avoid using the term "insurance" when discussing SIPC coverage because it might imply greater protection than is actually provided. In our draft study we use the term "insurance" in a very general sense to include the different types of financial protections available to investors. In each case we attempted to clarify, for each of the programs discussed, the extent and nature of the insurance and/or protection provided. However, we agree that it is very important that the exact nature of the coverage afforded by the insurance be understood. Therefore, we have modified the extent to which we use the term insurance when referring to the securities coverage and expanded our discussion of the coverage.

INVESTOR PROTECTION IS PROVIDED BY SUPERVISION AND REGULATION

In chapter 3 we discussed how financial intermediary regulators vary in their scope and philosophy of regulation. Depository institutions are supervised directly by Federal and State regulators. Securities and commodity futures industry intermediaries are supervised primarily by self-regulatory organizations and State securities commissions. Regardless of regulatory structure, however, all financial intermediary regulators require information disclosure to investors, establish rules of operation, and perform at least some examinations.

Information disclosure allows investors to make informed decisions

Financial intermediary regulators provide a measure of investor or depositor protection through information disclosure requirements. Federal and State regulators have established information disclosure requirements for depository institutions including such things as the nature and extent of deposit insurance and the requirement that depositors be made aware of the terms of interest paid. Some reports depository institutions make to their regulators are available to the public, including reports of financial information (call reports) and reports on insider activity. However, the results of the regulators' safety and soundness examinations and their opinion of an institution, as expressed by its assigned supervisory rating, are not disclosed.

Information disclosure does not insure securities investors against loss, nor does the SEC have authority to disapprove securities for lack of merit. The primary standard which must be met in the registration of securities is that of an adequate and accurate disclosure of the material facts concerning the company and the securities it proposes to sell. Assuming proper disclosure, SEC cannot deny registration or otherwise bar the securities from public sale whether or not the price or other terms of the securities are fair or the issuing company offers reasonable prospect of success. This contrasts with some State securities laws which allow for disapproval of an issuance based on merit. Once the investor has been given the opportunity to make an informed decision, he or she assumes whatever risks may be involved.

Also, SEC is a primary reviewer of bank holding company registration statements filed under the Securities Act of 1933 and all forms filed under the Securities Exchange Act of 1934. SEC issues guidelines for the preparation of financial statements which must be informative and provide substantial and specific disclosure. These financial statements are required to provide full disclosure of, among other things, goodwill, cost and market values of investment securities, loan loss reserves, anticipated major losses, and any changes in the risk characteristics of the loan portfolio. The appropriate Federal bank regulator is primarily responsible for reviewing securities disclosure statements by banks registered under the Securities and Exchange Act of 1934.

Established trading rules assure a fair market

The execution of an investor's order is accomplished in the market place. Self-regulatory organizations are responsible for protecting investors and the public interest by administering the markets on which these transactions take place. SEC oversees and examines the self-regulatory organizations which, in general, are responsible for

--designing rules to prevent fraudulent and manipulative acts and practices;

--promoting just and equitable principles of trade; and

--fostering cooperation and coordination with persons engaged in regulation, clearing, settling, processing information with respect to, and facilitating transactions in securities.

In addition, there are a number of suitability standards for professionals in the securities industry. These standards are directed toward insuring that they maintain their financial and professional integrity. The primary financial standard deals with net capital considerations. Broker-dealers in the industry must have a minimum net capital to meet contingencies requiring immediate cash infusions. For example, brokers must maintain a minimum net capital in order to make timely payments for securities if customers fail to pay for the securities. Net capital requirements also reduce SIPC's risk of brokerage failures. SEC and the self-regulatory organizations monitor net capital compliance through periodic reports filed by registrants and by onsite examinations. In addition, independent public accountants must review and compute net capital compliance in audits of financial statements filed by registrants.

Background checks are made to determine if an individual or firm applying for registration as a professional securities dealer meets various standards. Other SEC standards deal with the professionals' relationships with clients. For example, there are conflict of interest standards that prohibit professionals from recommending investments in companies in which they have an undisclosed economic interest. Also, investor advisors and brokers are prohibited from recommending investments not suited to their clients' financial status. An advisor, for example, would be prohibited from recommending a tax shelter to a widow living on a tax-exempt annuity.

CFTC approval is required for each futures contract an exchange wants to trade. The exchange must submit to CFTC a standardized contract, which includes

--the quantity and deliverable grades of the commodity,

--alternate grades which may be delivered at a premium or discount, and

--the delivery location.

A properly drafted contract can reduce the potential for market manipulation.

Market surveillance is conducted by both CFTC and the commodity futures exchanges. Surveillance is conducted by collecting, analyzing, and comparing, on a daily basis, supply and demand data to show whether a trader is attaining a dominant position in the market. Another of CFTC's responsibilities is to review the exchanges' efforts in rule enforcement. The Commodity Exchange Act requires the exchanges to establish and enforce commodity futures trading rules. The exchanges and CFTC conduct financial reviews of commodity futures brokers and review trading practices to assess compliance with relevant laws and regulations.

Onsite examinations assess compliance with laws and regulations

Onsite examinations of financial intermediaries by Federal regulators and industry self-regulatory organizations are conducted to assess each industry's financial condition and compliance with laws and regulations. The regulators believe this technique is effective in deterring institution misconduct. Accordingly, routine onsite examinations have always been fundamental to depository institution regulation and are conducted routinely and on an exception basis throughout the securities and commodities industries.

Onsite examination is the primary method by which depository institution regulators evaluate the financial conditions of institutions and their compliance with applicable laws and regulations. Each regulator establishes its own examination policies and procedures on the basis of what it perceives is necessary to insure soundness and compliance. Factors that influence these policies are the number and size of institutions the regulator supervises, the regulator's concept of examination, and the regulator's personnel resources. Depository institution regulators conduct several different types of examinations generally every 1 to 2 years. In some cases, troubled institutions may be examined as often as every 6 months. Generally, separate examinations are made of banks' commercial loan departments, compliance with consumer protection laws and regulations, electronic data processing systems, international branch operations, holding companies, affiliates, and subsidiaries.

Depository institution regulators also perform trust examinations. Regulators check to see that accounts are being administered in accordance with the relevant trust instruments and that the trust department is acting in the best interest of the beneficiaries. In assessing the trust department's administrative proficiency, the examiners review the handling of responsibilities, such as: protecting and preserving trust property, making property productive and converting unsuitable assets, keeping and rendering accounts, and maintaining loyalty to the beneficiaries. Another essential element is the assessment of internal controls and investment policy.

The SEC routinely examines investment companies, investment advisers, and a small number of broker-dealers which are not members of a self-regulatory organization, to monitor financial condition and compliance with laws and regulations. Because money market funds are a new investment opportunity and have been so overwhelmingly accepted by the public, SEC examinations in this area are concentrated on this type of investment company; other forms of investment companies are being examined less frequently.

SEC and CFTC perform periodic examinations of industry self-regulatory organizations and exception-basis examinations of securities and commodities intermediaries. These financial intermediary regulators examine self-regulatory bodies, such as the securities and commodity exchanges, to insure the organizations monitor and enforce fair trade and customer practices. In addition, SEC and CFTC examine a broker if financial and market surveillance indicates an unsound condition, violation of law, or violation of established trading rules.

Self-regulatory organizations in the securities and commodities industries routinely conduct onsite examinations to assess the financial condition of their members and to test their compliance with Federal and self-regulatory business practice rules and regulations. These examinations attempt to insure that members comply with various requirements such as the maintenance of sufficient capital balances. Also, examinations can, under certain circumstances, be of a limited scope.

CUSTOMER REPARATIONS PROVIDE REDRESS FOR IMPROPER PRACTICES

Should an investor feel that an intermediary has improperly handled his/her account, the investor may seek reparations against the intermediary. The administrative method of pursuing relief and the basis for such pursuit is dependent upon the type of intermediary involved and the intermediary's regulators.

Depository institution consumer complaint process

The Federal Trade Commission Improvement Act of 1975 requires the banking regulators to maintain a complaints handling system. Savings and loans were included in 1979; credit unions are not required to provide such a service, but do so on agency initiative. The five regulators process approximately 22,000 complaints per year.

When a person has a problem with or complaint against a depository institution, he or she can file a complaint with the institution's regulator. Complaints are handled in a similar manner by all regulators. They may be phoned into the regulator, with a followup letter detailing the situation, or written by the individual. They are generally accepted and investigated by the regulator's regional or field office.

Once a complaint has been reviewed by the regulatory agency and found to be valid, the regulatory agency contacts the depository institution concerning the complaint. Within the framework of this administrative process, there are generally two ways in which reparation can be made:

--When the amount can be determined and the method of reparation is specified by law, the regulators must enforce the specified remedy.

--When the method of reparation is not specified by law, the regulator can use its supervisory powers to encourage the institution to initiate corrective action. If corrective action is not taken, the regulator can initiate action, the most severe of which is the termination of insurance.

Securities investors can recover losses through legal and administrative actions

The SEC's primary enforcement tool has been the filing of civil suits against securities violators to permanently enjoin them from repeating violations of the securities laws. In these suits, SEC may ask the court for ancillary relief such as the disgorgement of any illegal profits or a full and complete accounting of all investor funds. These suits are often settled through the acceptance of a consent decree. The settling of a suit by consent decree involves negotiations, and, as a condition to settlement, SEC may seek an agreement from the defendant not to repeat the violative conduct and require the return of investor funds or other actions beneficial to the investor.

A secondary tool that the SEC has available is an administrative proceeding which is generally applied to professionals and registered members of the securities industry. An administrative proceeding may result in suspensions, censure, or even barring professionals from practicing before the SEC or from associating with other members in the securities industry. Another tool is a criminal referral to the Department of Justice. If an investigation finds criminal violations, the SEC may make a reference to the Department of Justice. If Justice prosecutes, the violators may be assessed fines, imprisoned, or both. SEC may provide Federal and State prosecutors access to its civil investigative records.

In addition to formal SEC enforcement actions or individual private suits, investors may attempt to resolve their disputes through a more informal mechanism. For this purpose, SEC operates a consumer complaint handling system similar to that of the Federal financial institution regulators. SEC views investor complaints as an important source of information for the detection of securities laws violations. In 1980, the SEC received about 19,000 written and telephone complaints.

SEC does not formally adjudicate disputes between private parties. However, SEC responds to all consumer complaints, with more serious complaints being forwarded for comment to the entity involved. A dispute with a broker-dealer may also be submitted for arbitration to a self-regulatory organization.

In addition to SEC actions, investors may, under certain circumstances, sue in Federal and State courts to recover their funds. Investors may use the information SEC has presented in court as evidence of wrongdoing. Investors may also seek redress informally through an arbitration procedure established by the self-regulatory organizations. In addition, the self-regulatory authorities may direct offending members to make restitution or pay damages as "fitting sanctions" in their disciplinary proceedings.

Commodities investors may recover losses through legal and administrative actions

The Commodity Exchange Act provides a broad range of tools to ensure that contract markets and other industry participants fulfill their self-regulatory or statutory responsibilities. CFTC may suspend (for a period of up to 6 months) or revoke the designation of any exchange as a contract market for failure to enforce its rules or for other violations of the act or CFTC regulations, after a hearing on the record and subject to judicial review. CFTC may also seek redress against other market participants, in both the Federal district court and through the administrative process. CFTC is one of the few regulatory agencies with the authority to assess a civil penalty of up to $100,000 for each violation of the act. In addition to CFTC enforcement actions, customers in the futures markets may assert claims in Federal district court based on implied rights of action for violation of several of the act's key provisions.

In 1974 Congress amended the Commodity Exchange Act to establish a reparations program--an adjudicatory process to resolve disputes between commodity customers and industry professionals concerning such things as excessive trading, unauthorized trading, and fraud. The objective of the reparations program is to provide an alternative grievance procedure midway in complexity and expense between the traditional remedies of arbitration and civil litigation. However, criminal remedies for such matters as fraud remain applicable.

The reparations process begins with the receipt of complaints from commodities customers. To have a valid claim, the claimant must substantiate that the named firm violated the Commodity Exchange Act in some manner and that the claimant suffered monetary loss as a result of the firm's acts. If the claim cannot be settled prior to reaching the adjudicatory stage, and the amount of damages sought is greater than $5,000, the claim is scheduled for a formal hearing before an administrative law judge. If the amount of damages claimed is $5,000 or less, the hearing is held before a hearing officer. If one party is dissatisfied with the results of the hearings, he or she can appeal by filing an application for review with CFTC. There is a further right of appeal from CFTC's findings to the U.S Court of Appeals. This process is described in detail in appendix VII.

In FY 1981, CFTC concluded work on 601 complaints, either by hearings, settlement by the parties, default, or dismissal for cause. The number of complaints filed has increased annually and may be based on the following factors:

--An increase in the number of individuals trading in commodity markets.

--An increase in customer awareness of the existence of the reparations process.

--A greater willingness by customers to utilize the reparations process.

CFTC has been aware of problems with the reparations process and has been evaluating its reparations program. In February 1982, GAO testified that the reparations program was not meeting its objectives. Statistics indicated that a complaint took an average of 3 years to resolve; complainants had difficulty understanding the program; and reparations were expensive--commodity attorneys charge fees ranging from $1,000 to $10,000. To improve the reparations program, GAO recommended that CFTC (1) improve program management, (2) make the program's operation clearer to participants, and (3) develop arbitration as a more effective alternative to reparations. CFTC believes that the Futures Trading Act of 1982, dated January 11, 1983, provides CFTC with the opportunity to simplify and streamline the reparations process.

CHAPTER 5

VARIATIONS IN REGULATION

AND INVESTOR PROTECTION

When viewed in a broad sense, the "protections" afforded "investors" using financial intermediaries differ among the various intermediaries. These differences are a result of traditional, economic, and legal viewpoints with regard to risk, regulatory philosophies consonant with law, and risk management or insurance. Within these contexts, the investor protection differences we discuss below are not necessarily inequities. We are, however, planning investor protection related reviews which include the examination of the Federal regulation in such areas as advertising, information disclosure, and insurance. Also, we plan to review the erosion of the barriers which used to separate the products offered by various investment intermediaries.

DIFFERENCES IN THE PERCEPTION AND TREATMENT OF INVESTORS

In our discussion of investor protection, we define investors as all individuals placing funds in depository institutions, trust accounts, securities, investment companies, and commodity futures contracts. However, the perception of what an investor is varies among the financial intermediaries. The following provides an overview of what investors are perceived to be and how they are treated in the depository institution, securities, and commodity futures industries.

An individual who puts funds in a depository institution is more commonly referred to as a depositor. A depositor, in the vast majority of depository institutions, has the knowledge that his or her initial investment or deposit is insured for up to $100,000 by an agency of the Federal and/or State government and that the institution is highly regulated and supervised to maintain financial soundness. The governing laws assure the investor that there is little risk of losing his or her initial investment. The return on investment has traditionally been regulated and, consequently, was less when compared to that paid on many other types of investments.

In contrast to a depositor, an individual who puts funds into securities is considered to be an investor. The investment goal may include capital appreciation on the initial investment, a higher current return on investment, or the prospect of future increases in the return. This type of investor takes a certain amount of risk in an attempt to achieve his/her investment goal. The securities investor is protected against the loss of cash and securities held by the brokerage house in the amount of $500,000 ($100,000 in cash) but has no protection from market losses. Investments in securities can range from being relatively safe purchases of securities in large stable corporations to very high risk investments in venture capital. Therefore, a primary purpose of Federal securities laws has been to require full disclosure of financial and other information so investors can make informed decisions on the merits of securities and thus exercise judgment in deciding whether to purchase them. In addition, investors are generally protected by regulation from misrepresentation, deceit, and other fraudulent practices in the sale of securities.

Investors in the commodity futures market can be classified as: hedgers, who want to minimize risk; and speculators, who are willing to assume risk. Individuals or firms who utilize a specific commodity buy and sell commodity futures contracts related to their business as a means of (1) protecting against potential losses resulting from price changes, (2) protecting inventory values, and (3) establishing firm prices for their products. The commercial use of futures markets for business purposes is known as hedging. The commercial hedger is a market participant who uses the futures market as a means of minimizing the risk of price changes found in business operations by shifting the risk to speculators. A speculator is a market participant who trades futures contracts, thereby accepting market risks in hope of making a profit from price changes. However, the potential for significant gain is probably greater than for any other type of investment. CFTC regulates the commodity futures market through registration of intermediaries, surveillance, auditing (especially of exchanges), and efforts to maintain an orderly market.

NCUA found our study to be "of little use in offering .tner perspective on past financial developments or in analyzing current problems and issues." It states that our belief that a person called an "investor" actually exists is hypothetical, misleading, extremely theoretical, and unrelated to its experience of how individuals manage their funds and understand the institutions with which they elect to do business. Finally, it finds our presentation lacking an understanding about the topics discussed and our findings misleading and possibly factually incorrect.

There are many investors, big and small, who are responsible for the over $3.8 trillion of 1981 funds which we show on page 4 of our study. An example of individuals managing their funds as investors can be seen by the sudden growth of money market funds. This type of investment, which offers a high rate of return and liquidity, grew by over $109 billion in 1981 alone. A further illustration of investor management was demonstrated by the introduction of insured money fund accounts at financial institutions. These funds, offering rates competitive with money market funds and Federal deposit insurance, grew partly at the expense of money market funds to $111 billion after being in existence for less than 1 month. As might be deduced from this example, individuals who are investors give careful consideration to decisions, such as where to place their funds, how the funds will be protected, and who will protect their best interests. Finally, concerning its anxiety about our ability to conduct this study and its reliability, the comments of the others who have reviewed our study were generally positive.

REGULATORY DIFFERENCES

Our survey indicates that regulatory differences exist in the approaches Federal, State, and self-regulatory organizations take in dealing with financial intermediaries. Four significant differences are

--the degree to which regulators manage intermediaries' risk exposure through geographic and product line or asset and liability power restrictions,

--whether regulators choose to directly supervise intermediaries or rely on self-regulatory organizations for this function,

--the regulatory requirements placed on intermediaries regarding the extent of disclosure of information to the investing public, and

--the extent to which regulators impose restrictions on or establish criteria for advertisement of intermediary services.

Risk management

Federal and State authorities strictly regulate the activities of depository institutions in order to reduce the business risks to which they are exposed. Depository institution regulators place restrictions on the geographic area in which some institutions can compete and the types of services that can be offered to the public. Historically, the asset and liability powers of depository institutions have been regulated to minimize the business risks to which these institutions are exposed. In contrast, the securities and commodity futures industries are regulated primarily to maintain fair and orderly markets, not to restrict the business risks to which they are exposed. An investment banking firm, for example, can underwrite speculative security issues, and may even specialize in risky issues to generate a large discount.

Direct supervision or self-regulatory oversight

Federal and State regulators of depository institutions directly supervise the institutions for which they are responsible, including the performance of routine onsite examinations of all important aspects of the depository institutions' operations. Commercial bank trust departments are also routinely examined directly by Federal and State regulators.

SEC and CFTC rely extensively on self-regulatory organizations to directly supervise the securities and commodity futures traders for which they are responsible. These self-regulatory organizations perform routine examinations of brokerage firms and maintain constant surveillance of the securities and commodity futures markets. SEC and CFTC conduct periodic audits of the self-regulatory bodies to insure that they are emphasizing the proper issues when conducting their examinations.

Disclosure is greater for securities than for depository institutions

Information disclosure rules are intended to insure that investors can make informed decisions. The information disclosure requirements for investors at depository institutions are less when compared to the requirements established by SEC. This variance can be noticed when comparing the disclosure requirements of investment companies to those of trust departments, and securities investors with financial institution depositors.

Disclosure requirements are greater for investment companies than for depository institution trust departments

The disclosure requirements depository institution regulators place on trust departments provide less information to investors than the requirements placed on investment companies by SEC. Depository institution trust departments are regulated by the same agency which regulates the commercial side of the bank. Therefore, OCC, FDIC, and FRB regulate commercial bank trust departments, and FHLBB is responsible for the few savings and loans offering trust services. No Federal legislation exists requiring depository institution trust departments to provide information to trust beneficiaries disclosing trust account activity.

The establishment of trust department disclosure requirements generally has been left to OCC for national banks and State banking authorities for State-chartered banks, except in the case of court supervised accounts, including guardianships and executorships. In these situations, the court decides on the frequency of reports disclosing the status of an account. The only continuing disclosure requirement for bank trust departments is OCC's regulation applying to bank collective investment funds. This requires the bank to prepare, once every 12 months, a financial report for its collective investment funds. The report need not be audited by independent public accountants and need not even be distributed to fund investors except upon specific request.

It is sometimes up to the individual, trustee, or beneficiary of a trust to request information regarding his or her account in a depository institution's trust department. Generally, trust departments provide account information if requested by the individual, trustee, or beneficiary of a trust, unless the disclosure is specifically prohibited by the trust instrument.

In contrast, investment companies are subject to extensive disclosure requirements under Federal securities laws. According to the Securities Act of 1933 and the Investment Company Act of 1940, an investment company must provide investors with a prospectus which discloses all material facts of the offer. The two primary objectives of such disclosure are

--to provide investors with material information concerning the securities offered for public sale and

--to prevent misrepresentation, deceit, and other fraudulent acts and practices regarding securities sales.

The investment company shareholders have the right to elect the directors of the investment company. In addition, shareholders' approval must be obtained for fundamental changes in investment policy, changes in the terms of investment advisory contracts, and the appointment of independent accountants. An investment company must send to its shareholders, at least semi-annually, reports showing changes in the company's investment policy and other information. An annual report, containing financial statements audited by independent certified public accountants, must be sent to shareholders each year.

OCC stated that our comparison of the disclosure requirements between investment companies and bank trust departments is not valid primarily because trust departments act in a fiduciary capacity and do not in any meaningful sense sell investments to individuals. While trust departments, acting in a fiduciary capacity, often function in a manner much different from that of an investment company, we included trust departments in our comparisons because they often provide personal services which are intended to generate income for an individual or his/her heirs. These services are often performed by pooling the assets of the individuals and investing them, often within certain guidelines, at the discretion of the institution. This is a function much like that of an investment company. It is in these cases where variations in regulation exist. Financial institution regulators provide little guidance, if any, to trust departments while SEC provides very strict regulatory guidelines for investment companies.

Securities investors have access to more information than depositors

A variance exists in the publicly available information useful to securities investors and depositors. When contemplating an investment decision, a securities investor can obtain extensive information on the securities to be purchased or the issuing company. For example, the securities laws require a company issuing securities to file a prospectus with the SEC. The prospectus provides detailed information on the financial condition of the company, including its financial statements certified by independent public accountants; a description of the security being offered and its relationship to the company's other capital securities; information about company management; and a description of the company's properties and business.

A depositor has less information available upon which to make his/her investment decision, except for about 570 bank holding companies which are registered with SEC and about 650 banks which are required to register with their bank regulators. Registered depository institutions are generally required to comply with the antifraud and certain other provisions of the securities laws as would any nondepository entity, although the disclosure requirements for registered depository institutions are administered by the depository institution regulators, not SEC. For nonregistered depository institutions, a depositor can generally obtain, financial statements (although not necessarily audited) from the bank regulator or through publication in a local newspaper. A depositor also can generally get, from the bank regulator, reports disclosing stock held by and loans made to principal shareholders and officers. A depositor or purchaser of bank securities does not have access to the institution's Federal and/or State examination reports or the regulator's supervisory rating assigned to the institution.

Advertising restrictions in the securities laws

Securities traders' advertisements are subject to statutory requirements. Additional requirements are imposed by the rules and regulations of the SEC, self-regulatory organizations, and

SIPC. For example, under the Federal securities laws, investment companies are limited in publishing advertisements containing yield information.

Bank advertising is not subject to restrictions comparable to the advertising provisions in the securities laws. Recently, depository institutions have advertised in a variety of ways which would not be permitted under the securities laws. An example would be some of the advertisements of bank "money market accounts" or collective investment funds.

OCC expressed concern that our study implies that banks have engaged in deceptive advertising since they are not subject to restrictions comparable to those of other financial intermediaries that are subject to securities law. We did not in any way intend to portray bank advertising as deceptive. The point of our comparison was to identify the variations in the standards which have been established for advertising like investment opportunities in two different industries.

INSURANCE DIFFERENCES

The existence of insurance for investor assets varies by type of investment. Funds placed in depository institutions are insured against all losses within insurance limits. Investments in securities are not insured, although money and securities in the custody of a brokerage will be replaced if a brokerage firm goes out of business and becomes the subject of a liquidation or direct payment proceeding. No aspect of commodity futures trading is insured.

Federal deposit and securities industry insurance programs vary

Several variances exist between Federal insurance programs for depository institutions and SIPC insurance for securities investors. These variances are:

- --Federal deposit insurers have extensive regulatory and supervisory authority over insured depository institutions, whereas SIPC has no similar authority with which it can reduce or control the risk brokerages pose to its insurance reserves.

- --Federal deposit insurers have broad authority to assist depository institutions in financial difficulty, whereas SIPC is dependent on SEC and the self-regulatory organizations to regulate and supervise securities brokers.

--Federally insured depository institutions prominently advertise the existence of insurance coverage, whereas securities brokerages have not been as aggressive in informing their customers of the existence of SIPC insurance.

--SIPC protects against nonmarket losses on securities or cash held in the brokerage firm name for up to $500,000, ($100,000 in cash) whereas losses at federally insured depository institutions are covered up to a maximum of $100,000 per insured account.

SIPC has no regulatory authority with which it can reduce or control risk. Federal deposit insurance programs have regulatory and supervisory authority over the institutions they insure. They can choose not to insure an institution they consider to be a bad risk and work to reduce risk in an insured institution through supervision and examination. SIPC has no regulatory or supervisory authority over its insured institutions and cannot deny insurance to any brokerage firm, even if it feels the firm is a high risk. As a result of the above, there is a difference in industry coverage by SIPC and deposit insurance. Although nearly all securities brokerage houses are automatically members of SIPC, all depository institutions are not required to be members of Federal insurers.

Federal deposit insurers have the authority to financially assist troubled institutions or merge them with financially strong institutions. Through supervision and examination, depository institution insurers attempt to identify institutions in financial difficulty as early as possible. The Federal insurance programs then have several means of dealing with institutions experiencing financial difficulty, including increased supervision, financial assistance, and merger before they place the institution in receivership. In contrast, SIPC is informed by SEC or the self-regulatory organizations about a brokerage firm's financial condition, but has no authority to assist the brokerage firm financially and can only act when the financial condition warrants initiating liquidation proceedings.

Depository institutions participating in a Federal deposit insurance program prominently display the name and symbol of the insurance program covering depositors at that institution. For example, federally insured banks prominently display FDIC's name and symbol. The purpose of this is to foster a sense of safety in dealing with depository institutions. In contrast, individuals who open a trading account with securities brokers are less likely to be informed about the insurance protection provided by SIPC in the event of the brokerage's failure. However, SIPC by-laws require members to indicate at their offices and in advertising that they are SIPC members.

Federal deposit insurance covers an investor's original principal and interest on deposit against all market as well as nonmarket losses up to $100,000 per insured account. Joint accounts or those funds held in a trust capacity are separately insured. Should a brokerage firm fail, SIPC protection covers funds invested against losses for up to $500,000, with no more than $100,000 of that being in cash. This coverage is in addition to the securities the brokerage held in the customer's name. Customer name securities are returned without a limit on their value. In paying an insurance claim, SIPC attempts to return like shares to the customer, purchasing the securities on the open market if necessary. If a fair and orderly market does not exist, SIPC will pay the balance of a claim in cash. However, SIPC does not insure against general market losses or losses to a customer's account which were the result of any underlying fraudulent transactions.

Variances between Federal and State deposit insurance

There are several significant variances between the three Federal deposit insurance programs and the eight State insurance programs we reviewed. The principal advantages the Federal insurance programs hold over State insurance programs is the size of the Federal insurance fund and the fact that the impact of a failure can be spread among thousands of member institutions. The Federal insurance fund also is administered by agencies of the Federal Government. In contrast, the State insurance funds we reviewed were all depository-institution-owned private corporations ranging in size from 4 to 158 member institutions. As a result, it appears that the Federal insurance programs would be better equipped to manage a large member failure.

These weaknesses in the State deposit insurance system surfaced in 1976, when the American Savings Insurance Co., a private deposit insurance company insuring savings and loans in Mississippi and Tennessee, failed. The failure was caused by the collapse of Bankers Trust Savings and Loan, the insurance fund's largest insured institution. At the time of failure, Bankers Trust's total deposits were 20 times the insurance company's assets. In addition, Bankers Trust owned over 45 percent of the insurance company's stock based on its proportional share of insured deposits. The failure precipitated a run on other State-insured institutions. Eventually, Mississippi's governor declared a banking holiday for all State-chartered savings and loans so that the hardest pressed institutions could close until the financial environment became more orderly.

Other variances we noted between the Federal deposit insurance programs and the eight State deposit insurance programs we reviewed include the following:

--The Federal insurance programs have established lines of credit with the U.S. Treasury ranging from $100 million to $3 billion, while only one State insurance program has a line of credit with its State Treasury, for $10 million.

--The Federal insurance programs are funded entirely by annual member assessments, while in five State programs, insurance reserves are partially composed of member deposits which belong to the members and would be returned if a member left the insurance fund.

--All federally insured depository institutions are subject to Federal regulator supervision, while only four of the State programs have the authority to examine member institutions.

--All Federal insurance programs have a liquidity fund to provide financial assistance to member institutions, while only two State funds have liquidity funds to assist members in financial difficulty.

Commodity futures accounts are not insured

The securities and commodity futures industries handle the issue of insurance protection differently because of differences which existed between the industries when the issue of CFTC insurance was first discussed. In the early 1970s, the securities industry had a much higher public participation level than did the commodities industry. However, in recent years, the public has become more involved in the commodity futures market, both from the perspective of the number of contracts traded and in the number of groups which are active in the market.

When the Congress created SIPC, it did so because it felt a need for uniform investor protection for the large number of investors in the securities industry. In contrast, the Congress did not include an insurance provision in the Commodity Futures Trading Act of 1974. Instead, the Congress instructed CFTC to advise it if the need for commodity futures account insurance legislation ever arose. CFTC has studied the insurance issue and prepared a report, dated November 1, 1976, which concluded that the need for insurance was low because (1) public confidence in the safety of customer funds on deposit with FCMs appeared to be relatively high, and (2) insurance would not be cost-effective. The Congress has considered CFTC's recommendations and has not adopted legislation concerning insurance.

OTHER DIFFERENCES

During our survey we identified other differences which exist because Federal regulation of financial intermediaries is structured by type of intermediary rather than by type of service provided. Two significant differences are the competitive advantage money market funds have over deposit accounts and the potential jurisdictional overlaps between SEC and CFTC.

Money market funds have historically had advantages over deposit accounts

The rate of return on an investment varies by type of investment, level of risk, and whether or not regulatory ceilings on the rate of return have been mandated. Historically, commercial banks and savings and loans have paid interest at a specified rate, which varies with the type of account. Except for the new accounts discussed below, the maximum rate of return on funds placed in a depository institution is established by Federal law. When an individual opens an account he or she is told what the rate of return will be. However, credit unions pay quarterly dividends based on the earnings for that period. When an individual opens a credit union account, he or she is told the prevailing dividend rate at that time or what the rules governing changes in the rate of return will be. If the credit union's earnings are high, the dividend rate can rise; if earnings are low, the dividend rate could fall. Most deposits in depository institutions are insured up to $100,000, which virtually eliminates losses for most individual depositors.

Investments made through other financial intermediaries have rates of return which are generally free from Government regulation. For securities investments, the rate of return is often related to the riskiness of the venture and conditions in the securities markets. The rate of return from an investment company depends on the yield of the company's portfolio and its management fees. The yield on investments held in the portfolio is subject to market conditions.

In the early 1980's depository institutions experienced a large decline in their share of the savings market, to the significant benefit of money market funds, as a result of a disparity in financial intermediary regulation. Money market funds increased by almost $109 billion in 1981 alone, and it is generally believed that much of this money came from depository institutions. Unlike most depository institutions, money market funds are not required to hold reserves, nor are their yields subject to any established interest rate ceilings. As a result, money market funds offered a higher investment yield than most deposit accounts.

The objectives of a money market fund are to preserve shareholder capital, maintain liquidity, and, consistent with these objectives, achieve the highest possible current income from the short-term money market securities in which the fund invests. These funds provide several benefits to investors, including a higher potential yield from the pooling of funds, liquidity similar to a checking account, diversification of investments among different types of securities with varying maturities, and professional portfolio management.

While money market funds offered investors rates higher than those offered by depository institutions, the increased rate of return available through this type of investment was accompanied by a higher level of risk. Money market funds are not protected by Federal, State, or SIPC insurance. If a security in which a money market fund has invested were to be defaulted on, that default would represent a loss to the fund and to its shareholders. Another difference is that as interest rates fluctuate, dividends payable on all money market fund shares change, precluding investor certainty in a particular rate of return.

Newly introduced market rate deposit accounts are designed to assist depository institutions in competing more directly with investments in money market funds. The Garn-St Germain Depository Institutions Act of 1982 required the Depository Institutions Deregulation Committee to authorize a new deposit account, free of interest rate ceilings, directly equivalent to and competitive with money market funds. Depository institutions began offering this account on December 14, 1982, and as of January 5, 1983, new money market deposit accounts in the amount of $111 billion have been opened. In addition, depository institutions began offering "Super Now" accounts on January 4, 1983. The interest rate paid on these accounts fluctuates weekly. While these new instruments significantly close the yield gap between these two investment alternatives, there may still be more restrictions on an investor's access to his or her funds.

<u>SEC/CFTC agreement on jurisdictional boundaries</u>

In the early and mid-1970s, a number of new options and futures contracts were developed by the securities and commodities exchanges which related to such financial instruments as debt securities and foreign currency. These new trading instruments in some instances transcended the traditional distinctions which had been established between securities and commodities and raised questions concerning whether the SEC or CFTC had regulatory responsibility for oversight of these new trading instruments. The lack of certainty in this area created considerable confusion in the markets and in certain instances litigation. To correct this situation the SEC and CFTC determined to work together in an effort to resolve these jurisdictional issues. Following several months of discussions, in December 1981 the agencies announced an agreement regarding what they believed was appropriate allocation of jurisdiction between them. Both agencies prepared and submitted to the Congress proposed legislation that would codify this accord by amending both the securities and commodities laws. The amendments to the securities laws were enacted in October 1982. The amendments to the commodities laws were passed by the Congress in December and signed by the President in January 1983.

Generally, the amendments provide that SEC will have authority to regulate options on any security or certificate of deposit, including any group or index of securities or certificates of deposit. The CFTC will have exclusive authority to regulate futures on exempted securities 1/ (other than municipal securities) and on broad-based securities groups and indices, as well as options on such futures. Neither agency could approve futures trading on individual stocks or municipal securities. The SEC has jurisdiction over trading in foreign currency options on national securities exchanges, and the CFTC has jurisdiction over trading in such options on commodity markets.

Because changing economic conditions may result in the emergence of other new financial instruments, it is possible that the accord is not the final resolution of all potential jurisdictional issues. However, it does provide a point of reference for resolving future jurisdictional questions between SEC and CFTC and may serve as a model for new legislation.

1/Securities which are specifically exempted from coverage under the Securities Act of 1933 and the Securities Exchange Act of 1934.

SUMMARY OF VARIANCES IN REGULATION AND INVESTOR PROTECTION

TYPE OF INSTITUTION	Insurance coverage	Who insures	Insurance backed by	Regulator responsible for	Entities involved in establishing rules and regulations	Investor protection primarily provided by	Types of services provided	Rate of return	Advertising
Depository institutions:									
--Banks --Saving and loans --Credit unions	$100,000 per account	Federal insurance programs, and State sponsored insurance programs	Federal insurance programs--full faith and credit of U.S. Government (note a) State sponsored insurance programs--no one (note b)	Banks-FRS, FDIC, OCC, State authorities S&Ls-FHLBB, State authorities Credit unions-NCUA, State authorities	Federal and State depository institution regulators	Onsite examination and account insurance	Deposit accounts, checking accounts, commercial and personal loans	variable	Subject to regulatory requirements
Securities brokers	$500,000 ($100,000 cash) per account	SIPC (note c)	U.S. Dept. of Treasury (note d)	SEC	SEC and securities industry self-regulatory organizations	Information disclosure requirements, SRO onsite examinations, and market surveillance	Securities trading	variable	Subject to strict legal and regulatory requirements
Investment companies	None	Not insured	N/A	SEC	SEC	Information disclosure requirements and onsite examinations	Investment services	variable	Subject to strict legal and regulatory requirements
Commodities brokers	None	Not insured	N/A	CFTC	CFTC and commodity futures industry self-regulatory organizations	Information disclosure, SRO onsite examinations, and market surveillance	Commodities trading	variable	Subject to regulatory requirements
Commercial bank trust departments	Only funds on deposit in insured accounts	Not directly insured	N/A	OCC, FDIC, FRS	Federal and State banking authorities	Onsite examinations	Personal investment, corporate trust pensions	variable	Not strictly regulated

a/Federal insurance programs have lines of credit with the U.S. Treasury as follows: FDIC $3 billion, FSLIC $750 million, and NCUA $100 million.

b/The Pennsylvania Deposit Insurance Corporation has a $10 million line of credit with the Pennsylvania State Treasury.

c/SIPC insures securities investors against nonmarket losses only.

d/SIPC has a $1 billion line of credit with the U.S. Treasury.

APPENDIX I

CHARACTERISTICS OF FEDERAL DEPOSIT INSURANCE PROGRAMS

AS OF DECEMBER 31, 1981

Insurance Fund	Year organized	Type of institutions insured	Number of insured institutions
Federal Deposit Insurance Corporation	1933	commercial banks	14,441
		mutual savings banks (note a)	331
Federal Savings and Loan Insurance Corporation	1934	savings and loans	3,779
		mutual savings banks (note a)	6
National Credit Union Share Insurance Fund	1970	credit unions	17,155

a/In addition to insuring State-chartered mutual savings banks, FDIC will also insure mutual savings banks which convert to a Federal charter under the option granted by the Garn-St Germain Depository Institutions Act of 1982. FSLIC insures those mutual savings banks which converted to a Federal charter under the option granted by the Depository Institutions Deregulation and Monetary Control Act of 1980.

FEDERAL DEPOSIT INSURANCE PROGRAM RESERVES

AS OF JUNE 30, 1982

Insurance Fund	Insurance reserves (note a)	Total deposits of insured institutions	Insurance reserves as a percent of total deposits
	-------(millions)-------		
Federal Deposit Insurance Corporation	$12,385	$1,446,974	0.86
Federal Savings and Loan Insurance Corporation	6,420	553,900	1.16
National Credit Union Share Insurance Fund	179	64,264	0.29

a/Insurance reserves primarily consist of revenues from insurance premiums and interest on investments.

CHARACTERISTICS OF STATE DEPOSIT INSURANCE PROGRAMS

FOR REPORTING PERIODS ENDING JANUARY-April 1982

Insurance Fund	Year organized	Type of institutions insured	Number of insured institutions	Basic insurance coverage
Pennsylvania Deposit Insurance Corporation	1979	private banks (note b)	4	c/$100,000
Mutual Savings Central Fund Inc. (Massachusetts)	1932	mutual savings banks	d/158	100%
Maryland Savings-Share Insurance Corporation	1962	savings and loans	105	$100,000 per account
Ohio Deposit Guarantee Fund	1956	savings and loans	80	100%
The Co-operative Central Bank (Massachusetts)	1932	savings and loans	120	100%
Pennsylvania Savings Association Insurance Corporation	1979	savings and loans	82	$100,000 per account
North Carolina Savings Guaranty Corporation (note a)	1967	savings and loans credit unions	42 24	c/$100,000
Rhode Island Share and Deposit Indemnity Corporation (note a)	1969	commercial banks credit unions loan and investment companies (note e)	1 60 11	c/$100,000

a/As many as 17 other States have insurance programs for State-chartered credit unions and 9 States for State-chartered industrial banks. Because of time restraints, we were unable to research these programs for inclusion in our presentation.

b/These private banks' capital structures consist of partnership shares that can be limited as well as general. There is one other private bank that is not insured because it has elected, in accordance with Pennsylvania law, to pledge sufficient assets to guarantee its deposits. In Pennsylvania a private bank has the same powers as a commercial bank.

c/Insurance coverage intended to be similar in nature to that provided by Federal insurance funds.

d/Includes 48 mutual savings banks also insured by FDIC. If one of these institutions were to fail, the first $100,000 of a depositor's money would be insured by the FDIC, and the balance would be insured by the fund.

e/Loan and investment companies are Rhode Island-chartered industrial banks that, except for trust services, have the same deposit and investment powers as commercial banks.

STATE DEPOSIT INSURANCE PROGRAM RESERVES (note a)

Insurance Fund (note b)	Insurance reserves (note b)	Total deposits of insured institutions (note c)	Insurance reserves as a percent of total deposits
	------(thousands)-------		
Mutual Savings Central Fund Inc. (Massachusetts)	$291,174	$ d/11,393,237	2.56
The Co-operative Central Bank (Massachusetts)	98,306	4,169,225	2.36
Maryland Savings-Share Insurance Corporation	55,610	2,454,912	2.27
North Carolina Savings Guaranty Corporation	27,116	2,067,387	1.31
Ohio Deposit Guarantee Fund	53,452	1,984,530	2.69
Rhode Island Share and Deposit Indemnity Corporation	11,992	904,944	1.33
Pennsylvania Savings Association Insurance Corporation	2,095	96,865	2.16
Pennsylvania Deposit Insurance Corporation	118	90,000	0.13

a/The figures below are from the latest available State documents, covering a period from June 1981 to February 1982.

b/Insurance reserves can consist of two principal components: (1) retained earnings from primary revenues of insurance premiums and interest on investments, and (2) deposits made by insured members based on a percentage of the members' insurable deposits. Insurance funds in the following States have reserves partially composed of members' deposits: Maryland, Ohio, Pennsylvania (savings and loan fund only), North Carolina, and Rhode Island. Although these deposits are for insurance purposes, deposits remain the property of the member.

c/Total deposits exceed the level of insurance coverage provided due to maximum limits imposed by law, except for programs in Massachusetts and Ohio where all deposits are insured without limit.

d/Does not include the deposits of 48 mutual savings banks also insured by FDIC.

SIPC LIQUIDATION PROCESS

Customer claims are satisfied by the trustee in the following order. First, customer name securities, i.e., those securities which are on hand and registered in the name of the customer or were in the process of being transferred to the customer's name pursuant to customer instructions at the filing date, are distributed. There is no limit on the value of customer name securities which SIPC or the trustee will return.

Second, the customer's net equity is computed for those whose claims were not fully satisfied by the distribution of customer name securities. Net equity is defined as the filing date value of securities and cash the broker owes the customer less any amount the customer owes the broker. Net equity claims are satisfied, to the extent possible, by allocating customer property to claimants. Customer property is defined as cash and securities (except customer name securities) received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer. If available securities are insufficient to satisfy customer property claims, the trustee is obliged to purchase the missing shares as long as a fair and orderly market exists. If the shares cannot be obtained, the trustee allocates the available shares on a pro rata basis and pays the customer cash for the difference. The amount to be paid is based on the securities' value at filing date.

Third, if the customer's remaining net equity reflects a long securities position and/or a credit balance, the trustee is obliged to cover any losses occurring from this point on. SIPC protection for all of the above is limited to $500,000; cash losses of up to $100,000 are included in the $500,000 insurance total. The $100,000 cash limit was implemented to be on par with the financial institutions' level of insurance.

The ability to transfer all or some of a failed broker's accounts in bulk to another brokerage house helps SIPC to keep liquidation costs down and speeds up the process of making securities available to the claimant. SIPC is not required to obtain customer consent for the transfer of accounts to another brokerage house, but once the transfer has occurred, the customer can change firms if he or she does not like SIPC's choice. However, a bulk transfer frequently cannot be arranged, because SIPC is sometimes unable to find a firm both willing and able to take on the accounts or because of problems with the failed broker's records.

CFTC REPARATIONS PROCESS

Complaints from customers are screened to eliminate those containing information insufficient to constitute a valid claim. To qualify as a claim that will be considered, the complaint must include information that the named firm violated the Commodity Exchange Act in some manner and that the claimant suffered monetary loss as a result of the firm's acts. Furthermore, a claimant is required to file a complaint within 2 years of the alleged wrongdoing. Given the complexity of statutory and regulatory language, CFTC often helps claimants to add to or revise their complaints so that they comply with filing requirements.

When a complaint is filed, a copy is sent to the firm named in the complaint (the respondent). The maximum reply period available to the respondent is 45 days, and failure to reply may result in a default judgment against him and a determination of damages. The respondent may admit to liability for a portion of the claim without prejudicing his right to dispute liability for the remainder. Furthermore, both parties may choose to settle the claim prior to its reaching the adjudicatory stage.

If the claim cannot be settled and the amount of damages sought is greater than $5,000, the claim is scheduled for a formal hearing before an administrative law judge. Procedures available at this stage may vary and parties may expedite the hearings process by attending prehearing conferences to clarify issues, obtaining stipulations of facts, and limiting the number of witnesses. The parties may also utilize such processes as the production of documents, depositions on written interrogatories, and admissions.

If the amount of damages claimed is $5,000 or less, the parties are not granted an oral hearing except in special circumstances. Discovery techniques are similar to those available to the parties in claims above $5,000, but the hearing differs in that

--it is held before a hearing officer instead of an administrative law judge, and

--the procedures in the hearing are not as complex.

If one party is dissatisfied with the results of the hearing, he or she can appeal by filing an application for review. A party opposing the application can file a response before CFTC decides whether or not to review the initial decision. If CFTC acts favorably on the application, both parties file briefs, but oral argument of the issues is permitted before the Commission only at CFTC's discretion. If, after the initial decision in favor of the complainant, the respondent fails either to pay the amount of the award or to appeal the decision within 15 days from the expiration of the period allowed for compliance with the order, the respondent, if registered with CFTC, is prohibited by statute from trading on contract markets and is suspended until he or she pays the amount of the award with interest. There is a further right of appeal from CFTC's findings to the U.S. Court of Appeals.

 APPENDIX VIII

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

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

January 11, 1983

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

Dear Mr. Anderson:

This is in response to your letter dated November 30, 19 requesting comments with respect to a draft report entitled "Investor Protection and the Regulation of Financial Intermediaries."

A few language changes, pertaining mainly to supervision of fiduciary activities of banks and nondeposit trust companies, were furnished by Robert S. Plotkin, Assistant Director, Division of Banking Supervision and Regulation, to Mr. Douglas Nosik of your staff on December 23, 1982 and were satisfactorily resolved. Mr. Plotkin also suggested that you may wish to consider an expanded description of the role of the Municipal Securities Rulemaking Board and Federal Reserve Board margin regulations, which are presently mentioned only very indirectly on page 21 of the exposure draft in connection with a description of the activities of the NASD. Board staff does not have any other comments on the draft report at this time.

We appreciate the opportunity to comment. If you have any further questions, please call Mr. Plotkin, 452-2782.

Sincerely yours,

William W. Wiles

William W. Wiles
Secretary of the Board

Comptroller of the Currency
Administrator of National Banks

Washington, D.C 20219

January 5, 1983

Mr. William J. Anderson
Director
General Government Division
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Anderson:

We appreciate the opportunity to comment on the General Accounting Office's (GAO) draft report entitled "Investor Protection and the Regulation of Financial Intermediaries." Though the report is informational and contains no recommendations, the Office of the Comptroller of the Currency (OCC) would like to highlight two areas concerning commercial bank trust departments, services and activities.

The draft report discusses information disclosure requirements and attempts to draw comparisons between security dealers, investment companies and bank trust departments. We feel this is not a valid comparison because trust departments act in a fiduciary capacity and do not in any meaningful sense sell investments to individuals.

The frequency with which bank trust departments prepare account statements and distribute them is not determined by the OCC or State banking authorities. Such matters are determinea by local law, the courts, the trust instruments, and trust beneficiaries.

The draft report also refers to advertising collective investment funds. The discussion appears to imply that banks have engaged in deceptive advertising since they are not subject to restrictions comparable under securities laws. The OCC would like to note that 12 CFR 9.18 and supporting Precedents and Opinions in the Comptroller's Handbook prohibit advertisement of collective funds consisting of assets contributed by personal trusts and estates. Reference to such funds are permitted only as part of an advertisement for a bank's general trust services. Banks may advertise collective investment funds consisting of assets contributed by retirement, pension, profit sharing and similar tax exempt trusts. In regard to such advertisements, the OCC does monitor them for violations of the anti-fraud provisions of the securities laws.

Several minor technical questions and matters have been discussed directly by staff of this Office with Mr. Douglas Nosik of your staff. We are pleased to have been able to handle these matters in an informal but highly effective manner and believe that they have been resolved to our mutual satisfaction. We, of course, would be happy to elaborate on any of our comments with you or your staff.

Sincerely,

C. T. Conover

C. T. Conover
Comptroller of the Currency

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington D C 20429

OFFICE OF DIRECTOR - DIVISION OF BANK SUPERVISION

December 30, 1982

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

Dear Mr. Anderson:

Chairman Isaac asked me to reply to your request for comments on your draft report entitled "Investor Protection and the Regulation of Financial Intermediaries." We have reviewed the draft with interest. Your report does not offer recommendations on the subject; rather it is a compendium of relevant facts. We appreciate having the opportunity, at this draft stage, to extend our comments.

The draft, on pages i and 1, defines financial intermediaries as those who act as mediators between investors and the investment positions which they are attempting to achieve. This definition does not apply to the manner in which banks most commonly intermediate funds. The depositor cannot be said to be looking to the bank as a conduit to achieve for the depositor a particular ultimate investment position. Further, the report's treatment of all deposits as investments is not an entirely accurate characterization.

An important shortcoming is the omission from the report of significant intermediaries. Neither the insurance nor the pension fund industries are analyzed, although we are inclined to believe that there may well be readily available information sufficient to present the kind of overview done on the intermediaries involved in this report. We note that as of a recent date, aggregate assets of these industries were $666 billion and $729 billion, respectively. Mortgage bankers and acceptance companies (GMAC and the like) are not discussed although they represent a sizable segment of financial intermediation activity. The report also fails to quantify the huge share of financial intermediation carried on by brokers and dealers. Because of the omission of these major participants, the presentation on pages 3 and 4 depicting the relative share of intermediation carried on by banks is misleading. The page 4 table suggests that asset size is an indicator of share of intermediation. In fact, much intermediation (as that term is used in the report) is not reflected as assets of the intermediator. Examples are the intermediation activities of brokers, dealers, investment bankers and mortgage bankers.

The references to insurance coverage are generally accurate. We usually object to the use of the term "insured accounts," but that term is used by FSLIC and NCUA. It is probably less confusing in this context than trying to describe what is meant by "insured deposits." Note however that, strictly speaking, various references to FDIC insurance of "accounts . . . for up to $100,000" or "$100,000 per account" are incorrect since accounts, as such, are not separately insured. The general rule is that funds held by a depositor in the same right and capacity are insured up to $100,000. Funds held in different rights and capacities are insured separately up to $100,000.

We suggest revisions to certain texts, as follows, to enhance accuracy or completeness.

-- Page iii, top paragraph, at end of the last sentence: Add , or held as uninvested trust funds.

-- Page 4, penultimate paragraph, last sentence: After "a function of" insert State law, . . .

-- Page 8, third paragraph: We suggest that this discussion of the issuing, selling, underwriting and distributing of securities by depository institutions be expanded. You might wish to include a reference to our Bank Letter 47-82 dated September 24, 1982 (copy enclosed) on the advance notice of proposed rulemaking on securities activities of nonmember banks. Although banks generally are not permitted to deal in and underwrite securities (with the exception of Federal Government debt, investment general obligation bonds and certain revenue obligations), nonmember banks may become involved in the near future, through bona fide subsidiaries, in some of the underwriting activities prohibited for banks under the Glass-Steagall Act.

-- Page 9, third paragraph, third sentence: Insert at end of sentence , or held as uninvested trust funds.

-- Page 11, first paragraph: Unless the price of initial distributions of stock only are stabilized through market purchases, the reference to "stock market purchases" is overlimiting and the word "stock" probably should be deleted.

-- Page 14, last paragraph: It may also be worth mentioning that the FDIC now may insure federally chartered mutual savings banks.

-- Page 16, fourth paragraph, third sentence: After "of" insert State law, the State regulator's . . .

-- Page 27, third paragraph: The reference to the FDIC insuring banks under the "Federal Reserve Act of 1933" should instead cite the "Banking Act of 1933."

-- Page 29, first full paragraph: The reference to "other assets obtained during liquidations" as part of the insurance fund is not entirely accurate. Such assets are held in a fiduciary capacity. The FDIC is entitled to recover from them only to the extent of its outlays; other creditors and stockholders may have an interest in the assets as well. We suggest you qualify the reference by alluding to "the FDIC's interest in other assets."

-- Page 29, last full paragraph: The insurance funds are also used to protect depositors in the form of loans, purchase and assumption transactions, etc. In the first sentence, delete "pay" and insert "protect."

-- Page 30, list of "Institutions Not Federally Insured": The item "Domestic commercial banks" includes (per the note) industrial banks in Colorado. These institutions are not commercial banks. The item should be changed to read "Other domestic banks."

-- Page 35: The report omits quantification of the total exposure to risk of the Securities Investor Protection Corporation (SIPC). This precludes calculation of the ratio of the SIPC fund to its total exposure. We would expect that the fund balance of $166 million would produce a low ratio to insured risk compared to the similar ratio for deposit insurance, however, we recognize the significant difference in the character of risk coverage afforded.

-- Page 37, first full paragraph: The reference to the truth-in-lending law as an information disclosure requirement protecting investors or depositors is incorrect. The truth-in-lending law is designed to protect consumer borrowers.

-- Page 37, last sentence: The allusion to Federal regulators reviewing disclosure statements by banks "registered with SEC" is incorrect. The phrase should read "registered under the Securities Exchange Act of 1934."

-- Page 41, third paragraph, last sentence: FDIC could take action more severe than issuing a cease-and-desist order; it could terminate insurance.

-- Page 45: Discussion of the nature of commodity futures investors should cover hedgers, a major segment of investors.

-- Pages 45 and 46, bottom paragraph of page 45, second sentence: Change "an institution" to read "some institutions." Not all institutions have restrictions on the geographic areas in which they compete.

-- Page 48, second full paragraph: The draft omits consideration of the large number of banks reflected in bank holding company filings with the Securities and Exchange Commission. In addition, there are about 600 banks registered under the Securities Exchange Act of 1934 with Federal bank regulators.

-- Page 53 omits discussion of the so-called "Super NOW Accounts" scheduled to go into effect in January 1983.

-- Page 56: The last two columns of the line for depository institutions should be revised: (1) Depository institutions offer not only fixed but also variable rates of return. (2) Advertising is regulated; FDIC regulation section 329.8 covers advertising by banks that FDIC regulates. Also, "note d" is omitted from this page.

-- Page 57: "Note a" -- under the Garn-St Germain Act, FDIC will continue to insure State-chartered mutual savings banks which convert to a Federal charter. Thus, federally chartered mutual savings banks will be FDIC insured or FSLIC insured, depending on the time of their conversion. "Note a" should be revised to reflect this change in the law.

We appreciate the opportunity to review this draft report. Please do not hesitate to contact me should you have any questions regarding our comments.

Sincerely,

James L. Sexton

James L. Sexton
Director

Enclosure

APPENDIX XI

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

RICHARD T. PRATT
CHAIRMAN

DEC 29 1982

Mr. William J. Anderson
Director, General Government Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Anderson:

We have reviewed your November 30, 1982 draft report entitled "Investor Protection and Regulation of Financial Intermediaries" and have no comments or additional information to offer.

We, however, appreciate the opportunity to respond to the report and if you have questions or need further information, please contact me.

Sincerely,

Richard T. Pratt

Richard T. Pratt
Chairman

NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

December 30, 1982

Mr. William J. Anderson
Director
General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson.

This is in response to your November 30 1982 letter in which you requested our comments on GAO's draft report entitled, "Investor Protection and the Regulation of Financial Intermediaries".

In your methodology description we note that the Report:

> "focused on financial intermediaries that recieve investment funds from individuals and that are regulated and/or insured to some extent by Federal and/or State agencies. For intermediaries primarily regulated or insured by State authorities our access to information was limited and our data collection efforts were restricted because the required data is not centrally located. Our scope did not include insurance companies and pension funds because of limitations in data availability... Also we did not discuss investment opportunities which individuals may enter into directly..."

The primary source of data was information "gathered during prior GAO assignments " from reviewing "the latest annual reports of the FDIC, OCC, FRS, FHLBB and NCUA; from holding "discussions with agency staff", and "reviewing various" agency reports, publications and statistics". The occasion for the study is your perception that, "In the past intermediaries have provided essentially distinct investment opportunities, but recent economic changes have resulted in a blurring of these distinctions;" and therefore the objective was "to identify and discuss variations and disparties which exist among different forms of financial intermediary regulation and investor protection."

As a result of this approach we found the study of little use in offering either perspective on past financial developments or in analyzing current problems and issues. Major segments of the financial industry are not included; for example, the first two "investments" normally considered and made by an individual are personal insurance protection and some type of pension planning (voluntarily or through employee enrollment . These industries, as you state, were omitted from consideration. In addition the whole arena of State-chartered and State regulated institutions are ignored or covered only in summary listings. There is thus a bias toward federal data, perceptions, and practices when much of the history suggests that innovation and change originates from the diverse operating and regulatory environments found in the states. Moreover,

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

the study presents a hypothetical person called an "investor" faced with "more investment options than ever before" and attempts to develop an "overview of what an investor may encounter when attempting to select investment opportunities." We find this premise not only misleading, but extremely theoretical and unrelated to our experience of how individuals manage their funds and understand the institutions with which they elect to do business. The mythical "investor" of your Report does not exist, and the marketplace as well as at times, your own Report recognizes the various activities engaged in by individuals as "depositors", or as "savers", or as "shareholders", or as "investors", or as "speculators", or as "arbitragers", or as "traders", etc. This premise of an investor doing comparative shopping among completely different financial activities is then used to try to develop a comparison of regulatory oversight among allegedly similar financial options. In reality, there is no such uniformity in activity. We therefore believe that the use of terms such as "blurring" "disparities" "inequities", "variances" in a conclusionary manner does not describe regulatory imbalances, but rather the authors' own perceptions, attitudes, as well as a lack of understanding about the topics discussed.

As a result we find the purported findings to be misleading (for example, "securities investors have access to more information than depositors") and possibly, factually incorrect, and revealing an insensitivity to the way individuals and various markets interact and how the various financial industries have developed.

Recently Vice President Bush asked the financial regulators to participate on a task force to develop recommendations regarding possible regulatory efficiencies and industry relief from burdensome or unnecessary regulation. We believe that this effort using the expertise, experience and knowledge of people who know the industries is the most effective way to proceed in evaluating issues about the direction of financial regulation, and the public's participation in the financial industries of today and the future.

Sincerely,

E. F. Callahan

E. F. CALLAHAN
Chairman

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

December 30, 1982

Mr. W.D. Campbell, Acting Director
Accounting and Financial Management
Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Campbell:

Chairman Shad has asked me to thank you for giving us the opportunity to review your draft report entitled, "Investor Protection And The Regulation of Financial Intermediaries." It is generally accurate and will serve as a helpful summary of applicable law and regulations in this area.

We have, however, a number of suggested corrections and clarifications which we have indicated on the enclosed copy of the draft. We believe that these changes are all self-explanatory, but if you have any questions about them or need any further assistance in this matter, please call Alan Rosenblat, Assistant General Counsel, at 272-2428.

Sincerely,

Russell B. Stevenson, Jr.
Deputy General Counsel

SIPC

SECURITIES INVESTOR PROTECTION CORPORATION
900 SEVENTEENTH STREET N.W. SUITE 800
WASHINGTON, D.C. 20006
202-223-8400

OFFICE OF GENERAL COUNSEL

December 29, 1982

Mr. W. D. Campbell
Acting Director
Accounting and Financial
Management Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Campbell:

This is in reply to your letter of November 30, 1982, addressed to our chairman, James G. Stearns. Since Mr. Stearns is out of town, I am responding on his behalf.

We have reviewed your draft report entitled "Investor Protection and the Regulation of Financial Intermediaries." Attached hereto is a memorandum of comments on that draft report. There are, however, two principal areas in which the draft report causes us some concern and I will comment on them here.

Throughout the report, the protections provided by this corporation to securities customers of stockbrokerage firms are referred to as "insurance." We have always tried to avoid using this term, since it can be read as implying protection greater than is afforded under the Securities Investor Protection Act of 1970 ("SIPA"). For example, some customers might assume that their investments are "insured" against market loss. This, of course, is not true.

Of much greater concern to us are the statements throughout the report to the effect that SIPC "insurance" provides protection against a broker-dealer's "fraud and mismanagement." For example, on page iii of the digest to the report, it is stated that "... deposit insurance covers all losses up to $100,000 related to an institution's insolvency, whereas securities investors are only insured against fraud and mismanagement on the part of their brokerage house." We believe statements such as this to be highly misleading. There is no protection against fraud or mismanagement per se. The purpose of SIPA is to provide for the return to customers, within certain limits, of the cash and securities owed to them by the stockbroker when their stockbroker goes out of business and becomes the subject of a liquidation proceeding or direct payment proceeding under SIPA. Certainly fraud and mismanagement are two, but not the only, underlying causes for the demise of brokerage houses being liquidated under SIPA. But the protections of the statute extend only to the return of the cash and securities to the customers; not to other damages which may have been caused by the underlying fraud or mismanagement. For example, one of the most common types of fraud in the securities business is the inducement of customers to purchase certain securities on the basis of fraudulent representations as to the present or future value of those securities. Thus, a customer

Mr. W. D. Campbell
Page 2
December 29, 1982

might be induced to purchase shares of xyz stock for $25 per share. When the brokerage firm goes under, the customer discovers that the stock was worth only $1 per share and that the stockbroker had been manipulating the market for that stock. SIPC will protect the customer by returning to him the actual shares of the xyz stock which he purchased, or if that is not possible, giving him the actual market value of that stock on the date the liquidation proceeding was initiated. As to the actual damages suffered by the customer, i.e. the difference between the $1 per share value of the stock and the $25 per share which he paid, the customer is, at best, a general creditor of the stockbroker and receives no protection from SIPC.

I hope that the comments in this letter and the enclosed memorandum will be helpful to you. If you have any further questions or if we can be of additional assistance, please do not hesitate to get in touch with me.

Very truly yours,

Theodore H. Focht by mep

Theodore H. Focht
General Counsel

THF:rm

Enclosure *

*GAO Note: We did not reproduce the enclosure.

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W.
Washington, D.C. 20581

January 19, 1983

HAND DELIVERED

Mr. J. Dexter Peach
Resources, Community and Economic
Development Division
General Accounting Office
Washington, D.C. 20548

Re: Draft of a Proposed Report: Investor Protection and the Regulation of Financial Intermediaries.

Dear Mr. Peach:

Thank you for providing copies of the above-referenced draft report ("Report") being prepared for Congress. We understand the purpose of this Report to be a narrative overview of the regulatory schemes in effect with respect to financial intermediaries. In keeping with this approach, our comments briefly supplement or clarify certain descriptions or inadvertent omissions relating to the regulatory scheme under the Commodity Exchange Act ("CEA"). Among other things, the Report appears to overlook the Commission's strong enforcement authority and critical facets of the customer protections provided by the CEA and Commission regulations.

For your convenience we have commented on a chapter by chapter basis. However, as you know, the subject matter in one chapter often has a bearing upon or applies to the topics of other chapters as well.

With respect to Chapter One, the description of the Commission's regulatory function appears to neglect any reference to the Commission rules which the Commission enforces for the protection of participants in the futures markets. The Commission's statutory authority and actual practice in this area are extensive. See, e.g., 7 U.S.C. §§6f through 6i, 6m, 7, 7a (1976 and Supp. IV 1981).

For example, all customer funds must be segregated and separately accounted for by FCMs. Further, the Commission routinely monitors the financial strength of commodities firms. In this regard, the Commission has comprehensive net capital rules to require futures commission merchants to maintain minimum net capital equal to the highest of: (1) $50,000 (in the case of member firms) and $100,000 (in the case of non-member firms),

Mr. J. Dexter Peach
Page 2

(2) 4% of the funds required to be segregated pursuant to the Act and the regulations, or (3) for futures commission merchants which are also securities broker-dealers, the minimum net capital requirement established by the Securities and Exchange Commission. See 17 C.F.R. § 1.17 (1982). Generally, any firm which fails to comply with these requirements must transfer all customer accounts and cease doing business unless otherwise directed by the Commission.

The discussion of the mechanics of futures trading in Chapter Two is succinct. However, certain technical terms are worth noting. Under the CEA, as amended, contract markets or futures exchanges are "designated" as opposed to authorized. See 7 U.S.C. § 7 (1976). Futures markets encourage broad participation so that the prices of commodities are determined in a free and competitive environment. As noted below, participants classified as "hedgers" use the markets to shift their risk of price changes to others; while speculators seek to maximize profit and are essential for assuring market liquidity in addition to fair prices. Moreover, any futures contract application suitable merely for speculative purposes would not be permitted to trade under the CEA.

This chapter also mentions the disclosure laws to which securities investment companies and money market funds are subject. It omits, however, any mention of the Commission's risk disclosure requirements for FCMs, CPOs and CTAs, as well as options transaction disclosure rules. See, e.g., 17 C.F.R. §§ 1.55, 4.21, 4.31 (1982).

The end of Chapter Three focuses on the Commission's responsibility for the commodity markets and the role of the organized futures exchanges and other self-regulatory organizations in enforcing compliance with the CEA, Commission regulations and contract market rules. The Commission's authority is more correctly stated as deriving from the Commodity Exchange Act of 1936, as amended by the Commodity Futures Trading Commission Act of 1974, the Futures Trading Act of 1978 and the Futures Trading Act of 1982, P. L. 97-444.1/ In exercising this authority, the Commission routinely conducts market surveillance to identify and prevent adverse market conditions, reviews contract market rules and rule changes to determine whether Commission approval is appropriate, and reviews contract market rule enforcement programs.

The Commission also registers categories of industry participants. Each registrant is fingerprinted for all categories of registrants. See 17 C.F.R. §§ 3.10-3.14 (1982). Also, all associated persons must be "sponsored" by an FCM. Sponsorship of APs requires that FCMs must screen each AP application, verify information relating to the applicant's educational and employment background, and certify in writing that the application is accurate and complete to the best of the FCM's knowledge. See 17 C.F.R. § 3.12(c) (1982).

1/ The predecessor of the Commodity Exchange Act is the Grain Futures Act of 1922, Pub. L. 67-331, 42 Stat. 998 (1922).

Mr. J. Dexter Peach
Page 3

Beyond these regulatory activities, the Commission, from time to time, conducts onsite trade practice investigations and direct audits of exchanges' financial surveillance programs as well as overseeing such audits as conducted by the exchanges.

In addition to the self-regulatory functions of the exchanges discussed in the Report, we would note that a clearing organization connected to an exchange would assume, within certain limitations, the legal responsibility for the opposite side of a futures or options contract. Thus, the clearing organization guarantees performance of a contract.

The Report further discusses the function of the recently-established National Futures Association. The Commission views the creation of NFA as a vital supplement to Commission regulation of the commodities industry. The NFA is charged with the responsibility to "establish and maintain a customer protection program." This program will supplement the Commission's current regulatory scheme. 17 C.F.R. § 170.5 (1982). The Commission is concerned, however, by the Report's statement that "NFA lacks the means to deal with fraudulent operators who are not exchange members." Report at 26. To the extent that it implies that NFA is without authority over nonmembers of an exchange, it overlooks the fact that NFA's authority derives from the CEA and its authority to discipline NFA members is not dependent upon exchange-membership. If, however, the phrase refers to a lack of resources, we would merely note that it is too early to assess that at this time.

Chapter Four summarizes the responsibilities of securities self-regulatory organizations. These responsibilities also apply to the commodities self-regulatory organizations. Moreover, unique to commodities regulation is the imposition of speculative position limits which restrict the size of large traders' holdings. These limits have been set by Commission regulation for certain agricultural commodities and must be adopted by contract markets with respect to all other designated commodity contracts. See 17 C.F.R. § 1.61 (1982). Such limits are intended to protect the market from adverse consequences associated with extraordinarily large speculative positions. As a consequence, speculative position limits provide additional customer protection as well.

Chapter Four also discusses opportunities for redressing customer complaints, but appears to omit entirely a discussion of the civil enforcement authority vested in the Commission. The CEA provides a broad range of potent tools to ensure that contract markets and other industry participants fulfill their self-regulatory or statutory responsibilities. The Commission may suspend (for a period of up to six months) or revoke the designation of any exchange as a contract market for failure to enforce its rules or for other violations of the Act or Commission regulations, after a hearing on the record and subject to judicial review. 7 U.S.C. §§ 7b, 8(a) (1976). Alternatively, the Commission may issue a cease and desist order and is one of the few

Mr. J. Dexter Peach
Page 4

regulatory agencies with the authority to assess a civil penalty of up to $100,000 for each violation of the CEA. In fiscal year 1981, nearly $2,000,000 in these penalties were assessed by the Commission. Failure to comply with such an order is a misdemeanor under the Act and may result in fines of up to $100,000 and/or imprisonment for up to one year. 7 U.S.C. § 13a (Supp. IV 1981). Additionally, the Commission may seek injunctive relief against a contract market or any other person in federal district court to enjoin any violation of the Act or Commission regulations or to enforce compliance. 7 U.S.C. § 13a-1 (1976).

In addition to Commission enforcement actions, customers in the futures markets may assert claims in federal district court based on implied rights of action for violation of several of the Act's key provisions. See Merrill Lynch, Pierce, Fenner & Smith v. Curran, 102 S. Ct. 1825 (1982). Under the most recently enacted amendments to the CEA, this remedy will be available against any person other than a contract market, clearing organization or registered futures association. See P. L. 97-444, Section 235 (1982).

The Report provides a detailed discussion of the reparations procedure. This procedure was established as an auxiliary forum, a form of small claims court for customer grievances. In recognition of various difficulties in this area, the 1982 amendments simplify and streamline the reparations procedure. See P. L. 97-444, Section 231. In addition, this legislation will encourage reliance on an additional forum, arbitration, by eliminating the statutory $15,000 limit on claims submitted for arbitration and by requiring registered futures associations such as NFA to provide an arbitration-type procedure. See, id., Section 217.

The final chapter of the Report briefly compares and contrasts various regulatory protections and market practice restrictions. First, it must be understood that commodity futures customers are market participants, not investors in the traditional sense of the term. As noted above, one is either a hedger or a speculator. Speculators are concerned with maximizing profits and hedgers are intent upon shifting risk. Neither category of futures participants in the market is concerned with investment as a means of return on capital invested in an enterprise. Nonetheless, futures participants are protected under the CEA from fraud and other illegal practices in the sale of futures contracts. See, e.g., 7 U.S.C. §§ 6b, 6c, 6o (1976 and Supp. IV 1981).

Moreover, especially stringent sales practices and promotional restrictions have been adopted for options trading. High pressure sales tactics are expressly prohibited in options transactions and each contract market designated for options trading must establish procedures for, and conduct sales practice audits of, its members. 17 C.F.R. § 33.4(b)(10) and (c) (1982). Exchanges are further required to review promotional material used by their members in marketing options and FCMs must promptly submit such materials to the exchanges for review. 17 C.F.R. § 33.4(b)(8) (1982).

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Similarly, Commission rules and guidelines prevent an FCM or any other person from making false or misleading representations relating to futures contracts. Further FCMs are explicitly prohibited from representing that an FCM will guarantee against or limit a loss. Other rules require the strict segregation of customer funds or address potential trade practice abuses. 17 C.F.R. §§ 1.50 through 1.56 (1982) and Guideline No. 2, Comm. Fut. L. Rep. (CCH) ¶6430.

The Report also describes in several chapters the differences in various federal insurance programs for investors. In so doing, the Report notes that futures trading is not federally insured. In 1974, Congress considered commodity account insurance, but rejected the idea and ultimately decided to direct the Commission to study the issue and to submit a report to Congress containing the Commission's recommendations on this matter. See Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 417, 88 Stat. 1415 (1974). The Commission prepared a report, dated November 1, 1976, and concluded that the need for insurance was low because (1) public confidence in the safety of customer funds on deposit with FCMs appeared to be relatively high; and (2) insurance would not be cost-effective. Congress has apparently endorsed the Commission's recommendations and has not found it necessary since that time to adopt legislation concerning insurance.

The Commission does, however, continue to monitor commodity firm insolvencies and changing circumstances in the commodity markets to determine if a different conclusion on the subject of insurance is warranted. In this regard, the Commission has found that the amount of commodity customer losses has been very small in contrast to the losses of securities customers. For example, between 1938 and 1981, a total of only $7,786,103 in regulated commodity customer money was lost. This is less than the average annual amount paid by SIPC and far less than the total of $109 million which SIPC has paid out to reimburse securities customer losses in just over 10 years since its creation in 1971.

These comments represent the bulk of the Commission's concerns relating to the Report. With the understanding that the Report is primarily a descriptive overview of the varying regulatory schemes, we have provided a cursory description of the CEA and Commission regulations. If, however, we can be of any further assistance in this matter, please contact me.

Once again, the Commission appreciates this opportunity to comment on the Report.

Very truly yours,

Jane K. Stuckey

Jane K. Stuckey
Secretary of the Commission
For the Commodity Futures
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