United States General Accounting Office

GAO

Report to Congressional Requesters

September 1995

BANK MUTUAL FUNDS

Sales Practices and Regulatory Issues

GAO/GGD-95-210

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-259882

September 27, 1995

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

The Honorable Henry B. Gonzalez
Ranking Minority Member
Committee on Banking and
Financial Services
House of Representatives

This report presents the results of our review of bank and thrift sales of mutual funds. You requested that we report on the extent to which banks and thrifts have expanded into mutual fund activities. You also asked us determine the disclosure and sales practices of banks and thrifts with respect to mutual funds, and to evaluate the framework for regulation and oversight of bank and thrift mutual fund operations. This report recommends that the banking and securities regulators develop a common approach for conducting examinations of bank and thrift mutual fund activities.

As agreed with you, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will provide copies to interested members of Congress, appropriate committees, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Association of Securities Dealers, the Securities and Exchange Commission, other interested parties, and the public.

Major contributors to this report are listed in appendix X. If you have any questions, please call me at (202) 512-8678.

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

At one time, restrictions in the 1933 Glass-Steagall Act were viewed as barring banking institutions from most aspects of the mutual fund business. However, since the early 1980s a series of decisions by banking regulators and court rulings has allowed banks and thrifts to engage in a wide variety of mutual fund activities, including selling mutual funds to retail customers and serving as a fund's investment adviser. As a result, banks and thrifts have become a major force in the mutual fund industry. As the influence of banking institutions on the mutual fund industry has grown, Congress and federal regulators have become concerned whether the current regulatory framework and oversight mechanisms, which date from the 1930s, still address today's realities. Particularly, they are concerned about whether the existing regulatory framework adequately protects investors who purchase mutual funds at a bank or thrift and whether these investors are properly informed of the risks of mutual fund investments compared to insured deposits.

In separate requests, the former Chairman of the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce and the former Chairman of the House Committee on Banking, Finance and Urban Affairs asked GAO to (1) determine the extent and nature of bank and thrift involvement in mutual fund sales, (2) collect and analyze data on the sales practices used by banks and thrifts in selling mutual funds and use the data to evaluate whether adequate disclosures of the risks of investing in mutual funds are being made to customers by salespersons in certain banks and thrifts, and (3) assess the adequacy of the existing regulatory framework for overseeing bank and thrift sales of mutual funds.

Background

The mutual fund activities of banks and thrifts are subject to a variety of securities and banking laws and regulations. The Securities Act of 1933 requires that all mutual fund shares be registered with the Securities and Exchange Commission (SEC). SEC regulates and supervises the operations of all mutual funds under the Investment Company Act of 1940, and regulates and supervises the activities of mutual fund investment advisers under a companion law, the Investment Advisers Act of 1940. The Securities Exchange Act of 1934 requires that a person who sells shares in mutual funds must be registered as a broker-dealer with, and regulated by, SEC and be a member of the industry's self-regulatory organization for broker-dealers, the National Association of Securities Dealers (NASD). Banks who sell shares in mutual funds are exempt from these requirements. As a result, banks may choose to sell mutual funds directly

to the public without being subject to some aspects of the federal securities laws. Similarly, banks that provide advisory services are exempt from the definition of investment adviser under the Investment Advisers Act of 1940. They may choose to provide investment advice to mutual funds without being subject to SEC regulation under the Advisers Act. Banks that operate their own mutual funds are, however, required to register these funds with SEC, and these funds are regulated by SEC.

The mutual fund activities of banks are also subject to the regulation and supervision of bank regulators. Depending on the type of bank and the way it has organized its mutual fund operations, this is done by one of three agencies: the Office of the Comptroller of the Currency (OCC) for national banks; the Federal Reserve Board for state-chartered banks that are members of the Federal Reserve System and for bank holding companies; or the Federal Deposit Insurance Corporation (FDIC) for federally insured state-chartered banks that are not members of the Federal Reserve System. The Office of Thrift Supervision (OTS) regulates thrifts, which do not have the broker-dealer exemption that banks have. Therefore, mutual fund sales by thrifts can not be done directly by the institution, but must be done through a registered broker-dealer.

To collect information on the extent to which banks and thrifts sell mutual funds and the sales practices they follow, GAO sent a questionnaire to a random statistical sample of 3,460 banks and thrifts nationwide. GAO also visited a random sample of 89 banks and thrifts in 12 metropolitan areas posing as customers interested in purchasing mutual funds to test whether the sales practices being followed provided adequate disclosures to bank customers of the risks of investing in mutual funds. GAO obtained data on the size of the mutual fund market and the level of bank and thrift participation in it from a well-known source of data on the mutual funds industry (Lipper Analytical Services, Inc.). Also, GAO interviewed banking and securities regulators, officials of bank and thrift institutions, and industry representatives; and reviewed relevant literature, testimony, studies, laws, and regulations.

Results in Brief

In the last few years, many banks and thrifts have entered the mutual fund business to retain customers, increase fee income, and diversify their operations. As of the end of 1993, about 114 banking institutions had established their own (proprietary) families of mutual funds with assets

valued at over $219 billion.[1] In addition, banks and thrifts have also become major sales outlets for other companies' (nonproprietary) funds. GAO estimates that about 2,300, or nearly 17 percent, of about 13,500 banks and thrifts in the United States were offering mutual funds for sale to their customers at the end of 1993.

The rapid growth of bank mutual fund sales over the last 5 years has raised concerns that bank customers may not fully understand the risks of investing in mutual funds compared to insured bank products. In February 1994, the four banking regulators responded to these concerns by issuing guidelines to banks and thrifts on the policies and procedures that these institutions are to follow in selling nondeposit investment products, such as mutual funds. During visits to a sample of banks and thrifts in 12 metropolitan areas in March and April 1994, GAO found that many institutions were not following the guidelines. About one-third of the institutions visited made all the risk disclosures called for by the guidelines, and about one-third did not clearly distinguish their mutual fund sales area from the deposit-taking area of the bank as required by the guidelines. The banking regulators have stated that they are including steps in their examinations to determine how well institutions are following the guidelines.

The current regulatory framework allows banks to choose how to structure their mutual fund sales and advisory activities and, depending on that structure, how they are regulated. As a result, banks can choose to sell mutual funds directly to their customers and be subject to oversight by the banking regulators, but not by securities regulators. However, most banks that sell mutual funds choose to do so through affiliates that are subject to the oversight of the securities regulators. Bank regulators also have issued guidance to banks that sell mutual funds through these affiliates. This creates a potential for different regulatory treatment of the same activity and a potential for conflict and inconsistency among different regulators. Similar concerns arise for banks that can carry out mutual fund investment adviser activities either in the bank or in a separate affiliate, although—in this case—most banks carry out such activities in the bank rather than in an affiliate. While the banking and securities regulators have been taking steps to better coordinate their efforts, additional coordination could help alleviate differences in

[1] As of the end of 1994, the total value of bank proprietary funds was almost $306 billion. This amount includes the Dreyfus funds, which were acquired by Mellon Bank in 1994. If the Dreyfus funds had been included in the value of bank proprietary funds at the end of 1993, the comparable figure would have been about $294 billion.

regulatory treatment meant to protect customers that buy mutual funds from banks.

Principal Findings

Banks and Thrifts Have Rapidly Expanded Their Participation in the Mutual Fund Industry

As of year-end 1993, 114 bank and thrift companies had established their own proprietary mutual funds. The value of assets managed by bank proprietary funds has grown from $46 billion at the end of 1988 to over $219 billion at the end of 1993. This represents a near doubling of banks' share of the market, from 6 percent to 11 percent in 5 years. During the same time frame, the total number of bank proprietary funds rose from 317, or 13 percent of the industry, to 1,415, or 24 percent. Banks and thrifts have also become major sellers of nonproprietary mutual funds. According to an industry estimate, in 1993 banks and thrifts sold about $67.5 billion in fixed-income (bond) and equity (stock) funds, of which slightly more than half were sales of nonproprietary funds. Nearly 1,800 nonproprietary funds were available through banks and thrifts at the end of 1993, a 62-percent increase from the 1,100 funds available at the end of 1991. GAO estimates that about 2,300, or 17 percent, of the approximately 13,500 banks and thrifts in the United States sold either proprietary or nonproprietary funds at the end of 1993. The main reasons given by banks and thrifts for offering mutual funds were retention of customers and fee income.

Inadequate Compliance With Sales Guidelines

GAO's visits to banks and thrifts in 12 metropolitan areas disclosed that many institutions did not adequately inform potential investors of the risks of investing in mutual funds. Disclosure of these risks—that mutual funds are not insured by FDIC, are not deposits, are not guaranteed by the institution, and could involve loss of principal—is called for by the February 1994 interagency guidance issued by the banking regulators. Compliance with the guidance is important to ensure that bank customers fully understand the differences between these investments and traditional bank products. Salespersons at only an estimated 32 percent of the institutions in the 12 areas mentioned all 4 risks during their sales presentations, and salespersons at an estimated 19 percent of the institutions failed to mention any of the four risks.

GAO also estimates that about 34 percent of the banks did not clearly separate the mutual fund sales area from the deposit-taking area as called

for by the guidelines. However, most employees, such as tellers, who were not designated salespersons were adhering to restrictions on discussing mutual fund investments with customers. GAO's review of mutual fund sales literature obtained during the visits showed that it generally included the required disclosures, but some documents did not present the disclosures clearly and conspicuously as required by the guidance.

Although the interagency guidance does not have the same authority as a regulation, each of the banking regulators has developed additional examination procedures to evaluate bank and thrift compliance with the guidelines. Banking regulators told us that these procedures are being used during regularly scheduled safety and soundness examinations. They also said that they are requiring the banks and thrifts to correct any deficiencies identified as a result of the examinations.

Expanded Role of Banks in Mutual Funds Raises Regulatory Issues

As banks have taken on a larger role in selling and managing mutual funds, the securities regulators have become concerned that the laws and regulations that govern banks' securities activities may need to be changed. SEC testified that banks' exemptions from registering as broker-dealers and investment advisers, which allow bank employees to sell mutual funds and banks to provide investment advice to mutual funds without SEC's oversight, should be eliminated because they could result in inadequate protection for investors who purchase mutual funds through banks and could impede SEC's ability to fully enforce the securities laws. SEC's position is that all bank mutual fund activities should be subject to oversight by the securities regulators, who have a direct mandate for investor protection. By contrast, banking regulators have argued that measures they have taken to strengthen their oversight of mutual fund activities provide adequate protection to individuals who choose to invest in mutual funds through banks. In addition, they argue that removing the exemptions would make it difficult to avoid regulatory overlap or to ensure comprehensive and integrated risk management of supervised institutions.

Eliminating banks' exemption from registration as broker-dealers, as advocated by SEC, would affect relatively few banks. On the basis of questionnaire responses, GAO estimated that only about 180, or 8 percent, of the 2,300 banks that sold mutual funds did so directly by using their own employees. The other banks and all thrifts conduct their sales

through SEC-registered broker-dealers.[2] These sales activities are already subject to the oversight of the securities regulators and to the banking regulators as well—a situation that can result in duplication of effort, inconsistency, and conflict among regulators.

Because banks are exempt from SEC investment adviser regulation, SEC does not have the authority to fully examine the records of bank investment advisers to detect potential securities law violations and conflicts of interest when it examines the related mutual fund. As of September 1993, 78 of 114 banks (68 percent) that provided investment advice to mutual funds did so directly, rather than through an SEC-registered subsidiary or affiliate. For these 78 banks, SEC can examine investment adviser activity, but only as it applies to the related mutual fund. Any other investment advisory activity, such as advising bank trust funds, is overseen by bank regulators. Bank regulators may also examine mutual fund advisory activity, but not primarily to detect securities law violations. Those cases that involve both SEC and bank regulators create the potential for duplication of effort, inconsistency, and conflict among regulators.

The potential for overlap and conflict among regulators would continue to exist even if the banks' exemptions from the securities laws were eliminated, because bank regulators would still have a continuing responsibility to examine the potential effects of bank mutual fund activities on bank safety and soundness. Regulators have begun to take steps to better coordinate their efforts. For example, in January 1995, NASD and the banking regulators agreed to coordinate their examinations of broker-dealers selling mutual funds and other nondeposit investment products on bank premises. However, bank regulators and SEC have no similar agreement to coordinate their oversight of investment advisers.

Recommendations

GAO recommends that SEC, the Federal Reserve, FDIC, OCC, and OTS work together to develop and approve a common approach for conducting examinations of banks' mutual fund activities to provide effective investor protection, while ensuring bank safety and soundness.

[2]Because thrifts do not have the bank exemptions, all securities sales personnel in thrifts must be registered representatives of a broker-dealer.

Matter for Congressional Consideration

Since GAO's visits, the banking regulators said they have adopted additional examination procedures to help ensure that banks provide customers accurate and complete information about the risks of mutual funds. Therefore, GAO is not recommending changes to the regulators' oversight practices at this time. After the interagency guidelines have been in place long enough to produce sufficient data for trend analysis, Congress may wish to consider requiring that the banking regulators report on the results of their efforts to improve banks' compliance with the interagency guidance.

Agency Comments

GAO obtained written comments on a draft of this report from FDIC, the Federal Reserve, OCC, OTS, NASD, and SEC. These comments are presented and evaluated in chapters 3 and 4. All the organizations supported GAO's recommendation, and several cited efforts to work closely together that were underway or recently completed. OCC commented that in its view this report overemphasizes the potential for contradictory and inconsistent regulation, but SEC commented that the report does not take into account sufficiently the regulatory overlap created by duplicative examinations of broker-dealers. Nevertheless, OCC and SEC each reported that in June 1995, they reached an agreement on a framework for conducting joint examinations of bank advisers to mutual funds. The agencies expect that the agreement will result in greater coordination and more efficient oversight of bank mutual fund activities. According to SEC, preliminary meetings have been held with FDIC staff to discuss entering into a similar agreement with that agency.

The Federal Reserve, OCC, and OTS commented that the lack of banking institutions' compliance with the interagency guidelines may have been attributable to the fact that GAO's on-site visits occurred during the first 2 months after the guidelines were issued. The Federal Reserve and OCC indicated that bank practices are now generally in compliance with the guidelines. Although GAO's visits were made shortly after the interagency guidance was released, most of the principles contained in this guidance were quite similar to those contained in guidance issued by the banking regulators during 1993. Consequently, GAO believes that the interagency guidelines were a valid basis for evaluating mutual fund sales practices on the premises of banks and thrifts at the time of its visits.

However, GAO also realizes that the institutions' activities may change over time as the regulators implement their new examination procedures to ensure that the institutions comply with the interagency guidelines. GAO

believes that Congress may find it useful in exercising its oversight responsibilities to receive information on the banks' compliance with the interagency guidelines after the banks and banking regulators have had sufficient time to fully implement their changes. Accordingly, GAO added a matter for congressional consideration suggesting that after an appropriate implementation period, Congress may wish to consider requesting the regulators to provide status reports on the results of their examination efforts.

Contents

Executive Summary 2

Chapter 1 Introduction 14
Background 14
Regulation of Bank and Thrift Mutual Fund Activities 16
Objectives, Scope, and Methodology 19

Chapter 2 Banks and Thrifts Have Rapidly Expanded Their Participation in the Mutual Fund Industry 22
Growth of Proprietary Funds Has Outpaced the Industry as a Whole 22
Banks and Thrifts Have Become Major Retailers of Nonproprietary Funds 24
Larger Institutions More Likely to Have Fund Sales, but Smaller Institutions Are Increasingly Entering the Market 25
Customer Retention and Fee Income Are the Main Reasons Banks and Thrifts Said They Sell Mutual Funds 26

Chapter 3 Inadequate Disclosure of Risks Associated With Mutual Fund Investing 27
Concerns About Bank Sales of Mutual Funds 27
Federal Banking Regulators Have Issued Guidance on How Mutual Fund Sales Are to Be Conducted 28
Some Institutions Did Not Adequately Disclose the Risks of Mutual Fund Investing 29
Distinction Between Mutual Fund Sales Areas and Deposit-Taking Areas Was Not Always Clear 34
Roles and Responsibilities of Employees in Deposit-Taking Areas Generally Complied With Regulatory Guidance 35
Proprietary Fund Sales Literature Generally Contained Key Disclosures but Presentation Was Not Always Clear 37
Some Institutions Provided Incentives for Selling Proprietary Funds 40
Customer Account Information Was Widely Used to Market Mutual Funds 41
Banking Regulators Have Developed Additional Examination Procedures 43
Conclusions 45
Matter for Congressional Consideration 45
Agency Comments and Our Evaluation 46

Chapter 4 Expanded Role of Banks and Thrifts in the Mutual Fund Industry Raises Regulatory Issues

49
Increase in Bank Mutual Fund Activities Has Raised Concerns About Adequacy of Current Regulatory Structure 49
Most Banks Choose to Sell Funds Through SEC-Registered Broker-Dealers 51
Regulatory Framework for Mutual Fund Sales in Banks Can Cause Conflict and Overlap Among the Regulators 54
Both SEC and Banking Regulators Have Responsibility for Bank Fund Investment Advisers 57
Eliminating Banks' Exemptions Would Not Resolve All Problems 59
Scope and Frequency of SEC's Inspections Has Been Limited, but Resources May Be Increasing 61
Potential Conflicts of Interest May Arise When Banks Manage Mutual Funds 64
The Prohibition on Sponsorship and Underwriting of Mutual Funds by Banks May Increase Banks' Costs 68
Conclusions 69
Recommendation 71
Agency Comments and Our Evaluation 71

Appendixes

Appendix I: Objectives, Scope, and Methodology Survey of Banks and Thrifts 72
Appendix II: Questionnaire 81
Appendix III: Data Collection Instruments for Shoppers' Visits 96
Appendix IV: Comments From the Federal Deposit Insurance Corporation 113
Appendix V: Comments From the Federal Reserve System 115
Appendix VI: Comments From the National Association of Securities Dealers 118
Appendix VII: Comments From the Comptroller of the Currency 127
Appendix VIII: Comments From the Office of Thrift Supervision 134
Appendix IX: Comments From the Securities and Exchange Commission 138
Appendix X: Major Contributors to This Report 147

Tables

Table 2.1: Increase in Net Assets Managed by Bank Proprietary Funds Compared to Nonproprietary Funds 23
Table 2.2: Total Net Assets by Fund Type 24
Table 4.1: How Mutual Funds Are Sold by Banks by Asset Size and Method of Sale 53

Table I.1: Survey Dispositions of Sampled Banks and Thrifts 74
Table I.2: Geographical Distribution of Shopper Visit Sample 78
Table I.3: Source and Disposition of Shopper Visit Sample 78

Figure

Figure 3.1: Risk Disclosures of Mutual Fund by All Sales Representatives. 31

Abbreviations

FDIC	Federal Deposit Insurance Corporation
FRS	Federal Reserve System
ICI	Investment Company Institute
NASD	National Association of Securities Dealers
NAV	net asset value
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation

Introduction

The mutual fund industry's growth in the last decade has been phenomenal. At the end of 1984, mutual funds managed assets totaling about $371 billion. By 1990 managed assets had grown to over $1 trillion, and by December 1994 this figure had doubled to about $2.2 trillion, second only to the $2.4 trillion in total deposits held in U.S. commercial banks.

According to the Investment Company Institute (ICI), the national trade association of the mutual fund industry, there are a number of reasons for the industry's growth. These include appreciation in the value of assets held by the mutual funds; additional purchases by existing shareholders; the introduction of new types of products and services; the growth of the retirement plan market; increased investment by institutional investors; the introduction of new distribution channels—such as banks; and a shift by individual investors from direct investments in stocks, bonds, and other securities to investment in securities through mutual funds. Also, in recent years investors have shifted to mutual funds in an attempt to obtain a better investment return than has been available through alternative investments, such as certificates of deposit.

Background

A mutual fund, formally known as an open-end investment company, pools the money of many investors.[1] These investors, which can be either individuals or institutions, have similar investment objectives, such as maximizing income or having their investment capital appreciate in value. Their money is invested by a professional manager in a variety of securities to help the investors in the fund reach their objectives. By investing in a mutual fund, investors are able to obtain the benefits of owning a diversified portfolio of securities rather than a limited number of securities. This can lessen the risks of ownership. In addition, investors gain access to professional money managers, whose services they might otherwise be unable to obtain or afford.

Each dollar that an investor puts into a mutual fund represents some portion of ownership in that fund. Funds must calculate their share price on days on which purchase or redemption requests have been made based on the market value of the assets in the fund's portfolio, after expenses, divided by the number of shares outstanding. This leads to a figure known as the net asset value (NAV). Per-share values change as the value of the

[1]The term "open-end" refers to the fact that shareholders may redeem shares issued by the fund on any day on which it is open for business. Other types of investment companies include "closed-end" funds, unit investment trusts, and separate accounts of insurance companies issuing variable annuities. This report does not discuss these other types of investment companies.

assets in the fund's portfolio changes. Investors can sell their shares back to the fund at any time at the current NAV. Many newspapers carry the purchase and redemption prices for mutual funds on a daily basis.

A mutual fund is owned by its hundreds or thousands of shareholders. A board of directors is responsible for overseeing the fund's investment policies and objectives. The board generally does not do the work of the fund itself, but instead contracts with third parties to provide the necessary services. The Investment Company Act of 1940 requires that at least 40 percent of the board of directors be independent of the fund, its adviser, and underwriter. One of the functions of the board is to approve the mutual fund's contracts with its investment adviser. The investment adviser plays a key role in the operation of a mutual fund. The investment adviser manages the fund's investment portfolio by deciding what securities to buy and sell in accordance with the fund's stated investment objectives. Other functions of the board include choosing the administrator, who generally acts as the fund's manager by keeping the books and records, filing necessary reports with the Securities and Exchange Commission (SEC), and calculating NAV; the distributor or "underwriter," who either sells the fund's shares directly to the public or enters into agreements with broker-dealers or banks that will in turn sell them to retail customers; the transfer agent, who keeps track of fund shareholders and maintains information about the number of shares owned by investors; and the custodian, who is responsible for safeguarding the cash and securities assets of the fund, paying for securities when they are purchased by the fund, and collecting the income due when securities are sold.

Mutual funds are sold to the public in two basic ways: directly to the public or through a sales force, such as a broker. With direct marketing, funds often solicit customers through newspaper, television, and magazine advertising or direct mail. These funds typically have low or no sales fees, or "loads." Funds that are marketed primarily through a sales force are usually available through a variety of channels, including brokers, financial planners, banks, and insurance agents. These sales people may be compensated through a load, which is included in the price at which the fund's shares are offered; through a distribution fee paid by the fund; or both.

Regulation of Bank and Thrift Mutual Fund Activities

The mutual fund activities of banks and thrifts are subject to a number of federal and state securities and banking laws and regulations—and to the shared oversight of a variety of federal and state securities and banking regulators. In general, the mandate of securities laws is to protect investors through full and timely disclosures, while many banking laws are geared to protecting depositors and ensuring bank safety and soundness.

Federal Securities Laws Apply to Mutual Fund Activities

The principal securities laws that apply to mutual funds are the Investment Company Act of 1940; a companion law, the Investment Advisers Act of 1940; and the Securities Act of 1933. These laws are intended to foster full disclosure of the risks involved in buying mutual funds and to protect investors.

The Investment Company Act requires all mutual funds to register with SEC. The act contains numerous requirements relating to the operation of funds, including rules on the composition and election of boards of directors, disclosure of investment objectives and policies, approval of investment advisory and underwriting contracts, limitations on transactions with affiliates, permissible capital structures, custodial arrangements, reports to shareholders, and corporate reorganizations.

Investment advisers to mutual funds, except banks, are subject to the Investment Advisers Act, which requires that any firm in the business of advising others as to the value of securities register with SEC. The Advisers Act also imposes reporting requirements on registered investment advisers and subjects them to restrictions against fraudulent, deceptive, or manipulative acts or practices.

The Securities Act of 1933 requires that all publicly offered shares of any issuer, including mutual funds, be registered with SEC. In addition, SEC has adopted rules under that act to require extensive disclosures in a fund's prospectus, including information about the fund's investment objectives and policies, investment risks, and all fees and expenses. The act also regulates mutual fund advertising.

In addition to the above laws, another securities law, the Securities Exchange Act of 1934, regulates how shares in mutual funds are sold. This act requires that persons distributing shares or executing purchase or sale

transactions in mutual fund shares be registered with SEC as securities broker-dealers.[2]

SEC oversees the regulation of mutual funds and their investment advisers under the Investment Company Act and the Investment Advisers Act. SEC reviews disclosure documents, such as prospectuses, and inspects mutual fund operations. It also registers and inspects investment advisers. Broker-dealers who sell mutual funds are regulated and examined by SEC and the National Association of Securities Dealers (NASD). NASD was established pursuant to the Securities Exchange Act of 1934 as a self-regulatory organization for brokerage firms, including those that engage in mutual fund distribution, and is itself subject to SEC's oversight. SEC and NASD regulate broker-dealers by regularly examining broker-dealer operations on-site and investigating customer complaints. NASD has also established Rules of Fair Practice, which govern standards for advertising and sales literature, including filing requirements, review procedures, approval and recordkeeping obligations, and general standards. In addition, NASD tests individuals to certify their qualifications as registered representatives[3] and has primary responsibility for regulating advertising and sales literature used to solicit and sell mutual funds to investors.

Banks Are Exempt From Requirements to Register as Broker-Dealers and Investment Advisers

The Securities Exchange Act of 1934 exempts banks from its broker-dealer registration requirements. As a result, banks may choose to have their own employees sell mutual funds and other nondeposit investment instruments without the need to be associated with an SEC-registered broker-dealer or subject to NASD oversight.[4] In those instances, the banking regulators, instead of NASD, are responsible for overseeing the sales activities of bank employees.

Banks are also exempt from being defined as investment advisers under the Investment Advisers Act. As a result, banks may serve as investment

[2]Broker-dealers combine the functions of brokers and dealers. Brokers are agents who handle public orders to buy and sell securities. Dealers are principals who buy and sell stocks and bonds for their own accounts and at their own risk.

[3]A registered representative is a person associated with a broker-dealer who must acquire a background in the securities business and pass relevant qualifications examinations administered for the industry by NASD. The broker-dealer must be registered as such with SEC and be a member of a self-regulatory organization, such as NASD or a stock exchange.

[4]Thrifts are not exempt from the definitions of “broker” and “dealer” in the Securities Exchange Act of 1934; therefore, all securities sales personnel in thrifts must be registered representatives of a broker-dealer. Thrifts similarly are not exempt from the Investment Advisers Act of 1940, as are banks. Therefore, thrifts that provide investment advice to mutual funds must do so through an SEC-registered subsidiary.

advisers to mutual funds without registering with SEC. However, some banking organizations place their advisory activities in a nonbank subsidiary of a bank holding company. In these cases, the subsidiary is required to register as an investment adviser and is subject to SEC oversight under the Investment Advisers Act.

Federal Banking Laws and Regulation

In addition to the oversight provided by securities regulators, a number of banking laws apply to banking organizations' mutual fund activities. One such law is the Glass-Steagall Act, which was enacted in 1933. The Glass-Steagall Act was designed to curb perceived securities abuses and speculative investments by banks that were thought to have contributed to the collapse of commercial banking in the early 1930s. The act prohibits certain securities activities by banks and their affiliates. For example, the act generally prohibits all banks from underwriting (publicly distributing new issues of securities) and dealing (trading for its own account) in certain securities directly. It also prohibits Federal Reserve System member banks from purchasing certain securities for the bank's own account and from having interlocking management relationships with firms that are engaged primarily or principally in underwriting securities.[5] Until the early 1980s, Glass-Steagall was viewed as prohibiting banks from engaging in most mutual fund activities. Since then, a series of federal banking agency decisions and court rulings have eroded the Glass-Steagall restrictions and allowed banks to engage in a wide variety of mutual fund activities that had not been permitted previously. These include serving as the investment adviser to a mutual fund, selling mutual funds to retail and institutional customers, and offering various administrative services, such as recordkeeping and custodial functions. Essentially, banks can now do everything but underwrite a mutual fund.[6]

While the Glass-Steagall Act restricts banks' mutual fund activities, the actual powers granted banks to engage in these activities and the framework for their regulation and oversight are found in other laws. The powers of national banks to engage in mutual fund activities are contained

[5]The act allows banks and companies affiliated with a bank to underwrite and deal in certain types of securities known as bank-eligible securities. These include U.S. government securities, general obligation bonds of states and municipalities, and securities issued by specified government agencies or instrumentalities.

[6]Even so, a subsidiary of a state nonmember bank (if it does not have a member bank affiliate) may provide these services, as may an affiliate of a savings association (if it does not have a member bank affiliate). Under an Office of the Comptroller of the Currency proposal, subsidiaries of national banks could also be given permission to engage in securities activities that are not currently allowed, such as underwriting securities. OCC plans to consider and decide applications from banks on a case-by-case basis.

in the National Bank Act, which is administered by the Office of the Comptroller of the Currency (OCC). State-chartered banks derive their powers from the state laws under which they are chartered, subject to restrictions imposed by the Federal Reserve Act if they are members of the Federal Reserve System. State-chartered banks that are members of the Federal Reserve System are supervised by the Federal Reserve Board as well as by state-level banking authorities. Federally insured state-chartered banks that are not Federal Reserve members are subject to regulation and oversight by the Federal Deposit Insurance Corporation (FDIC) under the Federal Deposit Insurance Act and state banking authorities. The powers of bank holding companies are found in the Bank Holding Company Act of 1956, which is administered by the Federal Reserve Board. The authority for thrifts and their affiliates to engage in mutual fund activities is contained in federal and state laws applicable to savings and loan associations, particularly the Home Owners' Loan Act and the Federal Deposit Insurance Act. Thrifts are supervised by the Office of Thrift Supervision (OTS).

Objectives, Scope, and Methodology

This report was prepared in response to requests from the former Chairmen of the House Committee on Banking, Finance, and Urban Affairs and the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce that we examine the disclosure and sales practices of banks with respect to mutual funds. Our objectives were to (1) determine the extent and nature of bank and thrift involvement in mutual fund sales, (2) assess whether the sales practices followed by banks and thrifts provide bank customers adequate disclosures of the risks of investing in mutual funds, and (3) analyze whether the existing framework for regulation and oversight of bank and thrift mutual fund sales practices and proprietary fund operations adequately protects investors.

To determine the extent and nature of bank and thrift involvement in mutual fund sales, we gathered and analyzed information on the size of the mutual fund market, the level of bank and thrift participation in it, and the methods by which banks and thrifts market mutual funds to their customers. To do this, we obtained data from Lipper Analytical Services, Incorporated, a well-known source of data on the mutual fund industry. Lipper maintains a database of information on bank-related mutual funds and publishes a semiannual report, "Lipper Bank-Related Fund Analysis," which we used as a source for some of the information in this report. We also used other information accumulated by Lipper on the mutual fund

industry as a whole. We did not verify the data we obtained from Lipper; however, we asked Lipper to provide us a detailed description of the methods it uses to accumulate data and the internal controls it employs to ensure its accuracy. We used the description to determine that these methods and controls would provide reasonable assurance that the information supplied by Lipper was accurate. In addition, we determined that Lipper's mutual fund data are widely used in the financial services industry and are considered reliable by those who use it. Because Lipper's database does not cover the extent to which nonproprietary funds are sold through banks, we also surveyed a random sample of 2,610 banks and 850 thrifts to obtain comprehensive data on which of these institutions offer mutual funds for sale, the types of funds they sold, and their recent sales data. In addition, to obtain additional information on the characteristics of mutual fund sales through banks and thrifts, we reviewed pertinent regulatory and industry studies, particularly a survey of mutual funds that was released by ICI in November 1994.

To determine whether the sales practices followed by banks and thrifts provide bank customers adequate disclosures of the risks of investing in mutual funds, we developed and mailed a questionnaire to a random sample of banks and thrifts asking these institutions to provide information concerning how and by whom mutual funds are sold to retail customers, how sales personnel are compensated, whether written policies and procedures have been established, and the types of disclosures that are made to retail customers. Posing as bank customers interested in a mutual fund investment, we also visited a randomly selected sample of 89 central offices of banks and thrifts in 12 cities. The purpose of these visits was to observe and document the sales practices of institutions selling mutual funds and to test whether salespersons were following the federal banking regulators' guidance concerning mutual fund sales programs. A detailed explanation of the methodology we used in our survey questionnaire and in our visits to banks and thrifts is contained in appendix I.

To gain an understanding of how the existing regulatory framework for overseeing bank sales of mutual funds protects investors, we (1) interviewed selected bank and thrift regulators, securities regulators, bank and thrift officials, and industry representatives in Washington, D.C.; New York, New York; Boston, Massachusetts; Philadelphia, Pennsylvania; San Francisco, California; and Chicago, Illinois; (2) reviewed relevant literature, congressional testimony, studies, regulations, and laws; and

(3) reviewed and analyzed financial regulators' examination policies, procedures, reports, and workpapers.

We did our work between May 1993 and December 1994 in accordance with generally accepted government auditing standards.

We provided a draft of this report to FDIC, the Federal Reserve, NASD, OCC, OTS, and SEC for comment. Their comments are presented and evaluated in Chapters 3 and 4, and their letters are reprinted in full in appendixes IV through IX, along with our additional comments. The organizations also suggested several technical changes to clarify or improve the accuracy of the report. We considered these suggestions and made changes where appropriate.

Banks and Thrifts Have Rapidly Expanded Their Participation in the Mutual Fund Industry

Since restrictions on banks' mutual fund activities were liberalized in the 1980s, banks and thrifts have rapidly expanded their participation in the mutual fund industry. Many institutions have established their own families of mutual funds, called proprietary funds, and the sales of these funds as a percentage of total industry sales have grown sharply. Banks and thrifts have also become major sales outlets for nonproprietary mutual funds. Institutions with assets greater than $1 billion are more likely to sell mutual funds than are those with less assets, but most of the institutions that have begun selling mutual funds since the end of 1991 are the smaller ones. Most banks and thrifts reported that they sell mutual funds for two reasons: to keep their customers and to increase their fee income.

Growth of Proprietary Funds Has Outpaced the Industry as a Whole

As of December 31, 1993, about 114 bank and thrift companies had established proprietary mutual funds. These are funds for which a bank or one of its subsidiaries or affiliates acts as the investment adviser and that are marketed primarily through the bank. Most of these have been established by very large banking organizations; of the 114 companies that had proprietary funds as of December 31, 1993, 79 were among the top 100 bank holding companies in the United States.

During the 5 years between the end of 1988 and the end of 1993, the growth of bank proprietary funds in terms of the value of assets managed by the funds has been much greater than the growth of the industry as a whole. As shown in table 2.1, between December 31, 1988, and December 31, 1993, the value of assets managed by bank proprietary funds grew from about $46 billion, or 6 percent of the industry total, to about $219 billion, or 11 percent of the industry total. Although banks greatly increased their sales of mutual funds to retail customers during the 5 years, the increase in their sales to institutional customers was even greater.[7] Retail sales grew by 324 percent, and institutional sales grew by 443 percent. Nearly $119 billion of the $219 billion (54 percent) of the assets in bank proprietary funds at year-end 1993 were in funds marketed primarily to institutional customers. In contrast, only about 10 percent of the assets in nonproprietary funds were marketed primarily to institutional customers.

[7]Retail funds are primarily offered to bank customers who are investing on their own behalf. Institutional funds are primarily offered to clients of bank trust departments, commercial banks, thrifts, trust companies, or similar institutions.

Table 2.1: Increase in Net Assets Managed by Bank Proprietary Funds Compared to Nonproprietary Funds

Dollars in billions

	Net assets as of 12/31/88	Net assets as of 12/31/93	Percentage change
Proprietary Funds			
Retail	$23.7	$100.5	324%
Institutional	21.9	118.9	443
Subtotal	**45.7**	**219.4**	**380**
Percent of total	6	11	
Nonproprietary Funds			
Retail	668.5	1,591.6	138
Institutional	88.3	182.0	106
Subtotal	**756.8**	**1,773.6**	**134**
Percent of total	94	89	
Total	**$802.4**	**$1,993.0**	

Source: Lipper Analytical Services, Inc., and GAO analysis.

The number of proprietary funds offered by banks also grew faster than the industry as a whole. As shown in table 2.2, as of December 31, 1988, there were 317 bank proprietary funds, representing about 13 percent of the 2,372 total mutual funds in existence at that time. By December 31, 1993, banks offered 1,415 proprietary mutual funds, or 24 percent of the industry total of 5,851 funds. Table 2.2 also shows that, while more than one-half of the assets in bank funds were in money market funds, the greatest growth, both in the number of funds offered and assets managed, was in taxable fixed-income (bond) funds, followed by equity funds.

Table 2.2: Total Net Assets by Fund Type

Dollars in billions

	12/31/88		12/31/93		Percent change	
	Number of funds	Assets	Number of funds	Assets	Number of funds	Assets
Proprietary Funds						
Fixed income	46	$1.7	305	$30.4	563%	1,688%
Equity	89	3.9	432	43.2	385	1,008
Money market	103	29.6	461	133.8	348	352
Municipal debt	79	10.4	217	11.9	175	14
Subtotal	**317**	**45.7**	**1,415**	**219.3**	**346**	**380**
Percent of total	13%	6%	24%	11%		
Nonproprietary Funds						
Fixed income	368	$164.9	946	$346.7	157%	110%
Equity	926	207.7	1,877	732.9	103	253
Money market	255	240.7	692	448.1	171	86
Municipal debt	506	143.4	921	245.9	82	71
Subtotal	**2,055**	**756.7**	**4,436**	**1,773.6**	**116**	**134**
Percent of total	87%	94%	76%	89%		
Total	**2,372**	**$802.4**	**5,851**	**$1,992.9**	**147%**	**148%**

Note: Fixed-income funds include those funds that invest primarily in fixed-income issues, such as money market instruments, bonds, and preferred stocks; equity funds include funds that invest primarily in common stocks, as opposed to bonds; money market funds are funds that invest in financial instruments with average maturities of less than 90 days; and municipal debt funds are funds that invest primarily in municipal debt issues.

Source: Lipper Analytical Services, Inc., and GAO analysis.

Banks and Thrifts Have Become Major Retailers of Nonproprietary Funds

In addition to sales of proprietary funds, banks and thrifts also have become major sales outlets for nonproprietary funds. These are funds managed by an independent fund company and sold by the bank or bank affiliate. Nonproprietary funds are also available to investors outside the bank through an unaffiliated broker-dealer. According to data compiled by ICI, 1,780 nonproprietary funds were available through the bank channel (banks and thrifts) at the end of 1993. This represents a 62-percent increase from the 1,100 funds available as of the end of 1991.

ICI's data also show that new sales of fixed-income and equity funds through the bank channel rose from $28.1 billion in 1991 to $67.5 billion in 1993. However, because sales of fixed-income and equity funds through

nonbank channels also rose considerably, the percentage of sales through the bank channel to total sales increased only slightly, from 13 percent in 1991 to 14 percent in 1993. In addition, ICI found that about 55 percent of banks' sales of fixed-income and equity funds in 1991 was attributable to sales of nonproprietary funds. This figure rose to 59 percent in 1992, then dropped to 51 percent in 1993. An ICI official told us that the increase in bank sales of nonproprietary funds in 1992 was caused by a strong demand for equity funds—a segment of the market in which bank proprietary funds were not as well represented as were nonproprietary funds. In 1993, there was a surge in demand for fixed-income funds, a segment in which bank funds were well represented. Also, by 1993 banks had introduced more equity funds. As a result, bank sales of proprietary funds increased in 1993 compared to their sales of nonproprietary funds.

ICI's data show that, as of the end of 1993, the assets of funds attributable to bank sales were about $298 billion, or 14.2 percent of the $2.1 trillion in total mutual fund assets. This figure includes both proprietary and nonproprietary funds sold through banks and thrifts. In 1991, the comparable percentage was 11.6 percent, and in 1992, 13.8 percent. In breaking down the total between money market funds and long-term funds (fixed-income and equity funds), ICI found that in 1993, nearly 29 percent of all money market fund assets were attributable to bank and thrift sales. Less than 9 percent of long-term fund assets were attributable to bank and thrift sales, indicating the relatively strong presence of banking institutions in the money market fund area. However, the 9 percent of long-term fund assets attributable to bank and thrift sales at year-end 1993 represents a near doubling of the comparable figure at year-end 1991.

Larger Institutions More Likely to Have Fund Sales, but Smaller Institutions Are Increasingly Entering the Market

On the basis of the responses to the questionnaire we sent to a nationwide sample of banks and thrifts, we estimate that nearly 17 percent, or about 2,300 of the approximately 13,500 banks and thrifts in the United States, were offering mutual funds for sale as of the end of 1993. The results also indicated that the larger the size of the institution, the greater the likelihood that it had a mutual fund sales program. About 74 percent of the banks with $1 billion or more in assets had mutual fund sales programs, but only 11 percent of the banks with assets less than $150 million sold mutual funds. Similarly, about 60 percent of thrifts with assets of $1 billion or more had sales programs, but only about 3 percent of thrifts with assets less than $100 million sold mutual funds.

Our data also show that while larger institutions are more likely to sell mutual funds, smaller institutions are increasingly introducing mutual fund sales programs. We estimate that about 49 percent of all banks and thrifts that had mutual fund sales programs began selling funds within the last 2 years. About 74 percent of those banks entering the mutual fund sales arena over the previous 2 years had assets of less than $250 million.

Customer Retention and Fee Income Are the Main Reasons Banks and Thrifts Said They Sell Mutual Funds

About 94 percent of the banks and thrifts responding to our questionnaire cited retention of customers as of great or very great importance in their decisions to begin selling mutual funds to their retail customers, and about 49 percent reported that fee income was of great or very great importance in their decisions. However, fee income may become more important after sales begin.

Discussions we had with bank officials showed that once the mutual fund sales program is established, the objectives of the program may broaden to include the generation of fee income. For example, an official of one very large bank with a large and widely marketed family of proprietary funds told us that initially the bank began offering uninsured investments, including mutual funds, as a defensive measure to retain customers. The bank now offers a full line of investment products and recognizes this as a key customer service and revenue-generator. A July 1994 survey by Dalbar Financial Services, Inc., of Boston, Massachusetts, a mutual funds research and consulting firm, confirmed that fee income becomes more important as a mutual fund sales program matures. Dalbar's survey of over 200 bank executives indicated that while almost half of the respondents said they got into the business to retain customers, only 36 percent said that was still their top priority. In contrast, about 30 percent of the bankers said that they were now in the business to increase fee income, up from 19 percent who said that was the reason they got into the business in the first place.

Inadequate Disclosure of Risks Associated With Mutual Fund Investing

In response to the rapid growth of sales of mutual funds by banks and concerns that bank customers may be confused or ill-informed about the differences between mutual funds and traditional bank products, the federal banking regulators have increased their regulatory and supervisory oversight of banks' mutual fund sales activities. Our visits to banking institutions demonstrated the need for this increased emphasis as well as for continued vigilance by regulators. We estimate that about one-third of the institutions that sold mutual funds in the 12 metropolitan areas we sampled fully complied with the bank regulators' guidance on disclosing the risks of investing in mutual funds.[8] Further, about one-third of the institutions did not clearly distinguish their mutual fund sales area from the deposit-taking areas of the bank as stated in the guidance. Many banking institutions paid employees in the deposit-taking areas to refer customers to mutual fund sales representatives. During our visits to the institutions we found that these employees complied with statements in the guidance about not providing investment advice. However, some of the sales literature we were provided did not clearly and conspicuously disclose the risks of investing in mutual funds.

Concerns About Bank Sales of Mutual Funds

As banking institutions have become major retailers of mutual funds, regulators, Congress, and the public have become increasingly concerned that investors who are likely to purchase mutual funds through a bank or thrift may not fully understand the differences between these investments and traditional bank savings products, such as certificates of deposit and money market deposit accounts. In particular, there is concern that sales of mutual funds in a bank lobby or through bank employees may mislead customers into believing that mutual funds are federally insured. Further, bank customers may not understand that even mutual funds that appear to be conservative investments, such as government bond funds, may be subject to fluctuations in value and could involve loss of principal.

In November 1993, SEC released the results of a survey taken to determine the degree to which investors understand the risks associated with mutual funds. The survey was limited to 1,000 randomly selected households, 47 percent of which reported that they owned shares of mutual funds. The survey results indicated that confusion about the risks of investing in mutual funds was not limited to those who purchased mutual funds

[8] At the 95-percent level of confidence, the sampling error is plus or minus 17 percent. The estimates in the text relating to risk disclosures are based on weighted data obtained in our actual visits to 89 institutions (banks and thrifts) in 12 metropolitan areas and are generalized to the entire universe of 552 institutions in those cities. See appendix I for a detailed discussion of our sampling and testing methodology.

through a bank. For example, 66 percent of the investors in the survey who bought money market mutual funds through a bank and 41 percent of all holders of mutual funds incorrectly believed that these funds are federally insured. In addition, 39 percent of all mutual fund holders and 49 percent of those who purchased a mutual fund through a bank incorrectly believed that mutual funds purchased from a stockbroker are federally insured.

Federal Banking Regulators Have Issued Guidance on How Mutual Fund Sales Are to Be Conducted

Between June and October 1993, each of the four banking regulators—OCC, FRS, FDIC, and OTS—issued guidance to the institutions they regulate concerning how sales of mutual funds and other nondeposit investment products should be conducted. In February 1994, the four regulators jointly issued the "Interagency Statement on Retail Sales of Nondeposit Investment Products." This new guidance superseded the guidelines previously issued and unified the guidance to banks and thrifts on the policies and procedures that they should follow in selling mutual funds and other nondeposit investment products.

The interagency statement contains guidelines on disclosures and advertising, the physical setting and circumstances for bank sales of investment products, qualifications and training of sales personnel, suitability and sales practices, compensation practices, and internal control systems. In particular, it emphasizes that banking institutions are to ensure that bank customers are made aware that the products (1) are not FDIC-insured; (2) are not deposits or other obligations of the institution; (3) are not guaranteed by the institution; and (4) involve investment risks, including possible loss of principal. The statement applies to bank employees as well as employees of either an affiliated or unaffiliated third-party broker-dealer when the sales activity occurs on the premises of the institution. It also applies to sales resulting from a referral of retail customers by the institution to a third party when the institution receives a benefit from the referral. With regard to qualifications and training of sales personnel, the guidance states that if bank personnel sell or recommend securities, the training they receive should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives under the securities laws.

Some Institutions Did Not Adequately Disclose the Risks of Mutual Fund Investing

Oral disclosure of the risks of mutual fund investing is very important in making sure that customers fully understand the nature of these investments. On the basis of our visits to 89 banking institutions in 12 metropolitan areas, we estimate that about 32 percent of the institutions in these areas that sell mutual funds completely disclosed the risks associated with investing in mutual funds in accordance with the banking regulators' guidance.[9] In addition, disclosure of the risks of investing in bond funds was inadequate, when compared to the guidance, at about 31 percent of the institutions. However, there were no misleading references to Securities Investor Protection Corporation (SIPC) insurance during our visits.[10]

Sales Personnel at Many Institutions Did Not Orally Disclose the Risks Associated With Investing in Mutual Funds

The most important difference between a bank's mutual fund investments and deposits is the risk to the investor. Bank depositors' accounts are insured up to $100,000 by FDIC. Mutual funds are not insured against market loss and, consequently, are more risky to the investor. The guidance issued by the banking regulators states that retail customers must be clearly and fully informed about the nature and risks associated with nondeposit investment products. Specifically, when nondeposit investment products are either recommended or sold to retail customers, the disclosures must specify that the product is (1) not insured by FDIC; (2) not a deposit or other obligation of the institution; (3) not guaranteed by the institution; and (4) subject to investment risks, including possible loss of the principal amount invested.

The interagency guidance states that these disclosures should be provided to the customer orally during any sales presentation, orally when investment advice concerning nondeposit investment products is provided, orally and in writing prior to or at the time an investment account is opened to purchase these products, and in advertisements and other promotional materials. In addition, guidance issued by NASD in December 1993 stated that its bank-affiliated members must develop procedures that require registered sales persons to reiterate to customers,

[9]At the 95-percent level of confidence, the sampling error is plus or minus 17 percent.

[10]SIPC is a nonprofit membership corporation, established by Congress under the Securities Investor Protection Act of 1970, to insure the securities and cash in customer accounts of member brokerage firms against the financial failure of those firms. All brokers and dealers, with some exceptions, that are registered with the Securities and Exchange Commission are required to be members of SIPC. SIPC insures individual brokerage accounts to an overall maximum of $500,000 per customer, with a limit of $100,000 on cash. SIPC provides coverage only if a brokerage firm goes bankrupt and does not have sufficient assets to settle its customer accounts. It does not protect investors against market risk or against losses due to poor performance of investments. Unlike FDIC, SIPC is neither an agency of the U.S. government nor a regulatory authority.

in all oral and written communications, the material differences between insured depository instruments and investments in securities that carry risk to principal. The NASD guidance specifically noted that advertising and sales presentations should disclose that mutual funds purchased through banks are not deposits of, or guaranteed by, the bank and are not federally insured or otherwise guaranteed by the federal government.

The interagency guidance emphasizes that bank customers should clearly and fully understand the risks of investing in mutual funds. Therefore, we tested whether the sales representative made the disclosures called for in the interagency guidance without our prompting.

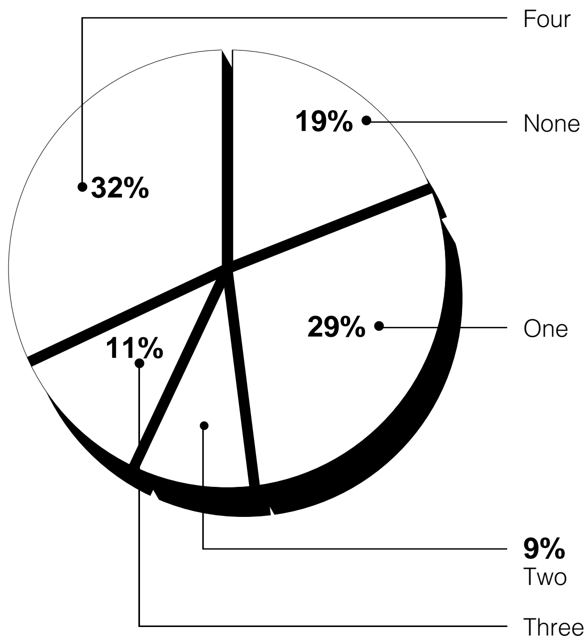
We found that sales personnel at many of the institutions we visited in our survey of bank sales practices did not fully comply with the disclosure requirements. As shown in figure 3.1, sales personnel at an estimated 32 percent[11] of the banks and thrifts we visited disclosed all four of the critical facts concerning the nature and risks associated with mutual fund investments during their sales presentations, and less than half (43 percent)[12] disclosed at least three of the four risks. At the other end of the disclosure spectrum, sales personnel at 19 percent[13] of the institutions did not mention any of the four risks.

[11]At the 95-percent level of confidence, the sampling error is plus or minus 17 percent.

[12]At a 95-percent level of confidence, the sampling errors for this estimate is 19 percent.

[13]At a 95-percent level of confidence, the sampling error for this estimate is plus or minus 16 percent.

Figure 3.1: Risk Disclosures of Mutual Fund by All Sales Representatives.



Note: Full disclosure is communicating all four risks of investing in mutual funds.

Source: GAO analysis.

Neither Bank Employees Nor Broker-Dealer Employees Adequately Disclosed Risks

Because of the small size of our sample, none of the differences in performance between bank and broker-dealer employees that could be identified are statistically significant. Less than half of each group made all the disclosures called for in the guidance. For example, an estimated 44 percent of bank employees disclosed all four risks, as compared to 32 percent who were employees of broker-dealers.[14] Similarly, about 6 percent of bank employees failed to make any of the disclosures called for in the guidance, and 18 percent of the broker-dealers made no disclosures.

[14]Of the total sales personnel, we identified 21 percent as bank employees and 62 percent as broker-dealer employees. We could not identify the employee affiliation for the remaining 17 percent. About 18.5 percent of the group of salespersons that we could not positively identify as either bank or broker-dealer employees made all four disclosures. Similarly, 41 percent of this group failed to make any disclosures. Because these figures are not included in this analysis, the percentages differ from figure 3.1, which includes all sales personnel.

Disclosure of Bond Fund Risks Was Inadequate at Over 30 Percent of the Institutions

Investors who purchase mutual funds through a bank or thrift are likely to be more conservative than those who purchase mutual funds elsewhere and to be more interested in purchasing a bond fund because they believe these funds are relatively safe. However, the prices of bonds and bond mutual funds are affected by changes—or the expectations of changes—in interest rates. In general, the value of bonds and bond mutual funds moves in the opposite direction of interest rates. If interest rates rise on new bonds, the prices of older ones decline. Thus, investors who own shares of bond mutual funds could find that the value of their investment is worth less than they paid for it if interest rates go up after they purchased the funds.

NASD has recognized that investors with deposits, such as maturing certificates of deposit, may be interested in purchasing bond mutual funds because of their higher yields, but they may not be aware of the risks posed by these investments. In December 1993, NASD told its members that they "...have a significant obligation in their oral as well as their written communications to provide customers, seeking non-depository alternatives to depository accounts, with full and fair disclosure of the material differences between the products, especially the greater degree of risk to capital that the customer may experience." With regard to bond funds, NASD stated that investors should receive clear disclosures that although such funds may pay higher rates than certificates of deposit, their NAVs are sensitive to interest rate movement, and a rise in interest rates can result in a decline in the value of the customer's investment.

In our visits, we wanted to determine whether the salesperson fully explained the effect of interest rate fluctuations—either up or down—on the value of the underlying bonds in a bond mutual fund and, consequently, the value of the fund shares. We estimated that at 66 percent of the institutions sales personnel explained the effect of interest rate movement on the value of the underlying bonds in the fund and the value of the fund shares. At 31 percent of the institutions the explanations were either nonexistent or unclear to us.[15] About 3 percent of the institutions visited did not sell bond funds.

Listed below are several representative examples found during our visits of what we believed was adequate disclosure:

"He explained that although bond funds are more conservative, they are still exposed to risk, especially as interest rates rise, prices of bond funds decline. He stressed that before

[15]The sampling error is plus or minus 15 percent at the 95-percent level of confidence.

recommending any particular fund he would need to discuss our personal financial information."

"Early in his presentation, the representative discussed in general terms the impact of the movement of interest rates on bond values. When asked about the safety of bonds, he provided more detail on the relationship of bond values and changes in interest rates. He used an example that clearly illustrated the relationship along with discussing the impact of the recent decision by the Federal Reserve to raise interest rates on current bond values."

"The sales representative did a very good job of explaining the effect of interest rate fluctuations on the value of bonds. The representative put no particular emphasis on either stock or bond funds. She clearly explained the difference in terms of risk and discussed the effect of interest rate fluctuations on bond funds early on."

Following are examples of inadequate disclosure:

"He said a lot about bond funds, but was very unclear. If he made this relationship, I missed it. He said bonds had higher yield, but were more volatile. He also said that they were FDIC insured 'like CDs'."

"The salesperson provided very little information on bond funds other than they are "safe" relative to stocks. She stressed that all of the bank's funds are safe because they are relatively conservative funds."

There Were No Misleading References to SIPC Insurance

A critical part of the disclosure issue is the use of potentially misleading or confusing information concerning FDIC insurance coverage for mutual fund investments. The banking regulators' guidance statement states that when any sales presentations involve reference to insurance coverage by any entity other than FDIC, such as SIPC, a state insurance fund, or a private insurance company, the customer must be provided with clear and accurate explanations to minimize any possible confusion with FDIC insurance. Further, the guidance states that such representations should not suggest or imply that any alternative insurance coverage is the same as or similar to FDIC insurance. In our visits, we did not observe any instances of inadequate or confusing or misleading references to SIPC during the sales presentations.

Distinction Between Mutual Fund Sales Areas and Deposit-Taking Areas Was Not Always Clear

Selling or recommending mutual funds or other nondeposit investment products on the premises of a depository institution may give the impression that the products are FDIC-insured or are obligations of the depository institution. To minimize confusion, the guidance states that sales or recommendations of nondeposit investment products on the premises of the institution should be conducted in a physical location distinct from the retail deposit-taking area. In situations where physical considerations prevent sales of nondeposit products from being conducted in a distinct area, the institution has a responsibility to ensure that appropriate measures are in place to minimize customer confusion.

In our visits to banking institutions, we evaluated what measures had been taken to clearly separate their retail deposit-taking areas, such as teller windows and new account desks where accounts and deposits could be taken, from the area where nondeposit investment products were sold. As part of our visits, we observed the physical layout of the bank to ascertain whether the bank clearly distinguished its mutual funds/investment services sales area from its traditional banking activities area. In some cases, we were directed to separate offices located in another building, where we also evaluated the physical layout of those offices. We looked for such things as partitions, roping, separate cubicles, floor space, and glass walls. We also looked for signs and other means of visible communications to differentiate the area from the traditional banking activities. At the end of the visit, we evaluated the extent to which the facilities appeared to clearly separate the areas for mutual funds sales activities from traditional banking activities.

On the basis of our subjective evaluations, we estimate that about 34 percent of the institutions had little or no success in clearly distinguishing the area in which mutual funds were sold from the deposit-taking area.[16] In addition, 79 percent of the institutions with on-site sales areas or desks did not have a sign indicating that products sold there were not insured by FDIC.[17] Following are some observations made during our visits:

"There was no separation of mutual funds and banking activities. The sales representative sat at an unmarked desk in the middle of the bank floor. There were no signs present. However, her business cards were on the desk. All brochures of mutual fund activities were in her desk drawer. No signs indicating non-FDIC insured, non-bank product or potential loss of principal."

[16]At a 95-percent level of confidence, the sampling error is plus or minus 11 percent.

[17]At a 95-percent level of confidence, the sampling error is plus or minus 9 percent.

"There was nothing at all to indicate mutual fund sales. No signs, no posters, no brochures, nothing. In fact, we thought the sales area would be in the adjacent loan section, where we were told to enter. But there were no signs there. The only clue was a sign on the person's desk saying that he was a registered representative for a company. For the entire time we were in the bank until we met with him, we could not have known that they sold mutual funds. The mutual fund sales desk was co-located in an area offering traditional banking activities such as new accounts and customer service. The mutual fund sales desk did not contain any signs or displays to distinguish it from other banking activities. In fact, the mutual fund sales desk was located next to the main bank reception desk near the front door of the bank. (All desks were separated by 3-foot partitions)."

However, we also observed examples of clear separation:

"The bank floor space was extremely limited. Desks were fairly close together—all bank activities were in close proximity to one another. Although the space was limited, there was a hanging sign clearly marked "Investment Services." There was one sign on the desk approximately 10" x 12" displaying the proprietary fund which stated non-FDIC insured and not guaranteed by the bank. This information was at the bottom of the sign and readable, the size of the print was fine. A kiosk next to the desk also identified the same information. Overall, disclosure was fairly clear to a new customer."

"Two desks were located at the far end of the lobby approximately 25 feet from the teller windows. They were the only 2 desks in that space—one desk belonged to the mutual fund sales representative and the other to his assistant. Both desks faced the lobby with the representative's desk on the right if one were looking at the mutual fund area. To the right of the representative's desk was a very large (3'x 5'), lighted sign indicating the sale of mutual funds. A rack of mutual fund brochures was to the right of the sign. No other bank activities were near the mutual fund area."

Roles and Responsibilities of Employees in Deposit-Taking Areas Generally Complied With Regulatory Guidance

The banking regulators' guidance states that "in no case" should tellers and other employees, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited. However, tellers and other employees who are not authorized to sell nondeposit investment products may refer customers to individuals who are specifically designated and trained to assist customers interested in the purchase of such products.

Most of the banks and thrifts that sold mutual funds indicated in their responses to our questionnaire that they limited their employees—tellers,

other branch employees, and bank and branch managers—to referring customers to designated nondeposit investment sales personnel. The activities of bank tellers were the most restricted—only about 3 percent were permitted to do anything other than refer customers to designated investment sales personnel. Other bank branch employees who were not licensed to sell securities, such as those who open new accounts and process loan applications, and branch managers were less restricted—about 13 percent of bank branch employees and 18 percent of branch managers were allowed to perform sales activities other than refer customers to designated sales representatives.

With regard to the specific activities that bank and thrift employees are allowed to perform, about 1 percent of the banks and thrifts that sold mutual funds reported that they allowed tellers to discuss the investment needs of the customer and noninsured products available through the institution; about 8 percent of other branch employees and 12 percent of branch managers were permitted to perform this function. Almost none of the institutions reported that they permitted tellers or other branch employees to suggest that a customer should invest in a specific investment product. Less than 2 percent reported that they allowed branch managers to offer specific investment advice to customers. NASD noted that if these activities were permitted to occur in the deposit-taking area of the bank they would appear to violate the interagency guidance. In addition, if a bank broker-dealer is involved and the bank employees performing these activities are unregistered, current NASD rules, which prohibit unregistered persons from providing investment advice, would also appear to be violated.

In our visits to banks in 12 metropolitan areas, we found that most banks and thrifts were limiting the activities of personnel in the deposit-taking area of the bank. We found that only 1 percent of bank tellers we met discussed investment needs in general or noninsured products available through the bank. None of these discussions related to specific investments.

The guidance permits institutions to pay tellers and other bank employees who are not authorized to sell investment products nominal, one-time, fixed dollar fees for each referral to a sales representative whether or not a transaction takes place. SEC, however, has taken the position that referral fees to financial institution personnel who are not qualified to sell investment products should be eliminated. According to SEC, because investors who purchase securities on the premises of a financial institution

may not be aware that the securities are not guaranteed by that institution or by the federal government, the payment of referral fees creates an inappropriate incentive for unqualified bank employees to offer unauthorized investment advice to their customers. In addition, in December 1994, NASD issued a notice requesting comment on proposed amendments to its rules governing broker-dealers operating on the premises of financial institutions. Under these proposed rules changes, broker-dealers would be prohibited from making any payments, including referral fees, to individuals employed with the financial institution who are not registered representatives of the broker-dealer. As of June 1995, NASD had completed its review of 284 comment letters received on its proposal, and the letters were being considered by NASD's bank broker-dealer committee.

About 43 percent of the institutions that responded to our questionnaire indicated that they compensated at least one of the following groups with referral payments: tellers, other unlicensed branch employees, and bank and branch managers. According to officials of several banking institutions, these payments are typically for $5 or $10 and not contingent on whether a sale is actually made.

Proprietary Fund Sales Literature Generally Contained Key Disclosures but Presentation Was Not Always Clear

Our evaluation of proprietary fund sales literature obtained from the banks we visited showed that the great majority of documents contained disclosures of the risks of investing in mutual funds. However, in some cases the disclosures were not clear and conspicuous.

Under SEC rules, fund advertisements and sales literature may not be materially misleading. Money market funds, in particular, must disclose prominently that their shares are not insured or guaranteed by the U.S. Government, and that there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share. In addition, SEC requires disclosure by bank-sold and bank-advised funds that their shares are not deposits or guaranteed by the bank or insured by any U.S. government agency. Mutual fund advertisements and sales literature are required to be filed with NASD (if the fund's shares are sold by an NASD member) or with SEC. According to SEC, as a practical matter, most fund ads and sales literature are filed with NASD rather than with SEC. NASD's advertising department is to review advertisements and sales literature for compliance with both SEC's rules and the NASD Rules of Fair Practice.

In addition to the requirements of the securities regulators, the banking regulators' guidance states that advertisements and other promotional and sales material about nondeposit investment products sold to retail customers of depository institutions should conspicuously disclose that these products are not insured by FDIC; are not a deposit or other obligation of, or guaranteed by, the institution; and are subject to investment risks, including possible loss of principal. When we visited banks, we obtained sales literature for proprietary funds, which we analyzed to determine if it contained the required disclosures. In total, we analyzed 26 documents that we obtained at 15 banks.[18] All of the documents we reviewed stated that the funds are not insured by FDIC and not guaranteed by the bank. All but three documents cautioned that mutual fund investments are subject to investment risks, including loss of principal, and all but four disclosed that mutual fund investments are not bank deposits.

We also reviewed the literature to determine whether it complied with the interagency guidance instructions that the risks be presented in a conspicuous, clear, and concise manner. We did this by looking at the placement of the disclosures, the size of the print used, the segregation of information in the literature as it pertains to FDIC-insured and noninsured products, and by making judgments about whether any obviously misleading or confusing information was presented.[19] We were particularly concerned with whether any of the sales or marketing brochures suggested or conveyed any inaccurate or misleading impressions that the mutual funds were insured products or guaranteed. In our subjective evaluation, nearly half of the sales literature had disclosures that were conspicuous and readable to a great or very great extent. However, we characterized about 15 percent of the literature as having little or no success in achieving this objective. None of the advertising and sales brochures describing mutual fund products that we reviewed had the FDIC-insured logo or "Member FDIC" imprinted on them.

Following are examples of what we classified as confusing, misleading, or inadequate disclosure:

[18]Of the 89 banks visited, 21 sold proprietary funds. However, we were not able to obtain proprietary fund literature at six of these institutions.

[19]The interagency guidance does not define the term "conspicuous" nor does it address the issue of where in the literature disclosures should be made. In February 1994, OCC issued additional guidance to its examiners that states: "Advertisements and brochures should...feature these disclosures at least as large as the text describing the bank's nondeposit investment products. The OCC believes that these disclosures are conspicuous when they appear on the cover of a brochure or on the first part of relevant written text. A bank's disclosures could also be considered conspicuous if it prints the required disclosures in a box or by displaying them in bold type or with bullet points."

"The disclosure information on risks is located at the bottom of the back page in very small print. It is very difficult to locate and read. In general, I do not believe the brochure gives proper emphasis to the fact that these funds are not insured by FDIC and may mislead someone into thinking that these funds are backed or guaranteed by the bank. All four brochures have the disclosure statement in small print on the back cover. There is no further discussion of those points in the literature and, in my opinion, the point could be easily overlooked."

"The brochure we received on behalf of the bank itself was an introductory booklet with application materials. This material all contained the required disclosures basically, although the disclosures do not state lack of FDIC insurance specifically, and disclosures are very small and are placed at the very back, bottom of the page. Very poor job of disclosing risks and uninsured nature. Also, much information is given in the brochure that would give the impression of a very safe, almost guaranteed investment, and very high returns. "

"One possible misleading or confusing statement is that the bank's name is used on the cover [of the brochure] without clearly identifying it as an investment instrument of the securities firm, and not the bank. Another piece of literature in the packet states that the funds are managed by investment professionals at the bank. Finally, the one page disclosure form is covered by other material and is the last item on the right-hand side. However, the disclosure form does have a section for the investor's signature. The disclosure form is very effective, but it was the last item placed in the information packet. Nowhere in the first five plus pages was there any mention of the four required elements. A smaller brochure within the information packet included a statement on the back cover in very small print."

In September 1994, OCC released the results of a review it did of materials used by national banks in the sale of mutual funds and annuities. The review included about 8,500 documents that were voluntarily submitted by over 700 banks. The review identified many documents that were not consistent with the interagency statement. Problems uncovered by OCC, together with OCC's advice on how the problems should be corrected, included the following:

- Conspicuousness: Not all documents met OCC's standards—disclosures in type at least as large as the predominant type and boxed, bolded, or bulleted if they appear other than on the cover or at the beginning of the relevant portion of a document. As a result of its review, OCC determined that disclosures on the back of documents were not conspicuous. Also, OCC now encourages banks to make the key disclosures in type that is larger and bolder than the predominant type in the document.

- Key disclosures: OCC found that some documents did not include the disclosures that the product was not FDIC-insured, was not a deposit or obligation of the bank, was not guaranteed by the bank, and could result in the possible loss of principal. In some cases, the agency told the affected banks that they could correct the problem by adding stickers that conspicuously provided the disclosure. In other cases, such as when the document contained qualifying remarks that limited the effectiveness of the disclosure, banks were advised to stop distributing the documents in question.
- Fees: Some documents did not disclose applicable fees, penalties, or surrender charges. OCC counseled banks to make sure that fees were disclosed to customers and suggested that banks develop suitable written acknowledgement forms.
- SIPC insurance: Some documents contained incomplete or confusing references to SIPC insurance. OCC told banks that they could correct these problems by using printed supplements that provide a more detailed description of SIPC coverage.
- Relationships: Some documents did not disclose an advisory or other material relationship between the bank or an affiliate of the bank and the mutual fund whose shares were the subject of the document. Banks were reminded that such relationships should be disclosed.
- Out-of-date forms: Some banks were using documents supplied by third-party vendors that were not the most current version provided by that vendor and did not contain all of the disclosure messages required by the interagency statement. OCC advised banks to remove and replace outdated forms and establish systems for controlling documents.

In commenting on a draft of this report, OCC stated that it is now reviewing sales-related documents as part of its regular on-site examinations and that it is finding that banks have improved their materials.

Some Institutions Provided Incentives for Selling Proprietary Funds

According to the banking regulators' guidance, personnel who are authorized to sell nondeposit investment products may receive incentive compensation, including commissions. The guidance cautions that incentive programs should not result in unsuitable recommendations or sales to customers. It makes clear that sales personnel in banks should obtain directly from the customer certain minimum information, such as his or her financial and tax status and investment objectives, upon which to base their investment recommendations. However, banks are not prohibited from providing sales personnel greater compensation for

selling proprietary, as compared to nonproprietary, funds, nor are they required to disclose any such arrangement to the customer.

In response to congressional interest in the extent to which incentives exist for sales personnel on bank premises to sell proprietary funds versus nonproprietary funds, our questionnaire asked banks and thrifts to describe their sales compensation policies. We also discussed the issue with a senior NASD official, who told us that it is a common and well-established practice in the industry for a sales representative to receive greater compensation, or a "better payout," for selling the firm's proprietary fund over third-party funds.[20]

Eleven percent of the banks and thrifts that sold proprietary funds stated that sales personnel in their institutions received greater compensation or special incentives for selling proprietary funds than for selling nonproprietary funds. Of the banks that described their sales compensation policies, most stated that proprietary funds rewarded the salesperson with a greater payout or additional revenue. For example, one bank told us that both proprietary and nonproprietary funds pay a commission of 3.2 percent, but an extra 15 percent is added to the amount of the commission for a proprietary fund. We also asked the banks and thrifts that received our questionnaire to indicate whether or not sales personnel were expected to meet quotas or targets for the sale of proprietary funds. Eighteen percent of the banks that sold proprietary funds responded that sales personnel were expected to meet sales quotas or targets for proprietary fund sales. Most of the institutions that answered this question indicated that they expected proprietary fund sales to be a certain percentage of all mutual fund or bank product sales, or a specific dollar amount each month.

Customer Account Information Was Widely Used to Market Mutual Funds

The interagency guidance does not prohibit banks and thrifts from providing confidential financial information to mutual fund sales representatives. However, the guidance states that the institution's written policies and procedures should include the permissible uses of customer information, but the guidance does not suggest what would or would not be permissible uses. Whether banking institutions should be allowed to

[20]In commenting on a draft of this report, NASD stated that there are sales practices, suitability, and investor protection issues that are considered by NASD when proprietary products with a higher payout are sold. NASD also stated that in the recent past there have been major changes in the way broker-dealers compensate their sales representatives, and that most major firms now provide the same payout for both proprietary and outside products. We did not verify the accuracy of this statement.

share financial information on their customers with broker-dealers is a controversial issue. In March 1994, the North American Securities Administrators Association testified in favor of placing a prohibition on banks' sharing confidential customer information with any affiliated securities operations. Also, NASD's December 1994 proposed rule governing broker-dealers operating on bank premises included a provision that would prohibit its members from using confidential financial information maintained by the financial institution to solicit customers for its broker-dealer services. As of March 1995, NASD was still evaluating comments on its proposal. However, reports in banking industry journals indicated that many banks and banking regulators were strongly opposed to the rule. They characterize the rule as being unfair because (1) nonbank brokerages are permitted to supply their brokers with information about their customers' use of bank-like services, such as certificates of deposit; and (2) the rule does not clearly define what is meant by confidential customer information. The latter issue could prove to be particularly difficult to resolve. For example, in commenting on a draft of this report, FDIC stated that it knows of no reliable definition of what customer information is confidential and what information is public. FDIC noted that, while banks must comply with laws concerning confidentiality of customer information, it did not want to prohibit the use of information that is otherwise available publicly or among a bank's affiliates.

To obtain information on the extent to which banks and thrifts were using customer information in their mutual fund sales programs, we asked the institutions that received our questionnaire (1) whether they had written policies and procedures that covered the permissible uses of customer account information; and (2) to describe how they marketed their mutual funds and, if applicable, what customer information was used. About 68 percent of the institutions that responded to the question stated that they had written policies or procedures that described how customer account information is to be used. About 40 percent of the institutions that sold mutual funds stated that they provided customer information, such as account balances or CD maturity dates, to mutual fund sales personnel. Almost half of these (49 percent) said they provided sales personnel CD maturity lists; others said their sales personnel had access to all customer data (24 percent), and a minority (15 percent) provided customer account balances to their sales personnel. With regard to the use of other marketing techniques that are likely to make use of customer account information, 65 percent of our respondents used telephone calls to market their mutual funds; 63 percent targeted mailings to existing bank

customers, such as holders of CDs; and 59 percent used inserts in monthly account statements.

Banking Regulators Have Developed Additional Examination Procedures

Although technically the interagency guidance does not have the same authority as a regulation, each of the banking regulators has developed additional examination procedures to evaluate bank and thrift compliance with the guidelines. In February 1994, about a week after the interagency guidance was issued, OCC issued examination procedures and an internal control questionnaire that specifically address sales of retail nondeposit investment products. OCC officials told us that these examination procedures are being used during the scheduled safety and soundness examination for each bank, which is either once every 12 months for large national banks, or once every 18 months for smaller national banks. The first examinations are to be a complete review of each bank's mutual fund operations. OCC expected to complete these "benchmark" reviews by the end of 1995. Subsequent examinations could be less exhaustive depending on the results of the initial examinations. However, certain components of each review are mandatory, including separation of mutual fund sales activities, compliance with disclosure requirements, and review of suitability determinations. OCC officials told us that as of May 1995, their examinations have not shown any systemic problems with bank mutual fund sales programs. They have identified problems at individual banks, including failure to properly document suitability determinations and uncertainty about responsibilities for overseeing third-party broker-dealers, which they said these banks corrected. They also said that OCC has taken no formal enforcement actions against any bank as a result of the bank's mutual fund sales program.

FDIC issued examination procedures for state nonmember banks participating in the sales of nondeposit investment products on April 28, 1994. According to an FDIC official, these procedures are being applied during the regularly scheduled safety and soundness examinations. FDIC's procedures require that its examiners complete a questionnaire at each examination or visit in which the bank's sale of nondeposit investment products is reviewed. The questionnaire includes a variety of questions on whether the bank is complying with various provisions of the interagency guidance. Copies of the completed questionnaires are to be forwarded to the responsible FDIC regional office, and significant deficiencies found during examinations are to be commented on in the examination report together with the recommended corrective action. An FDIC official told us that as of May 1995 FDIC had not taken enforcement actions against any

bank with regard to the operation of the bank's mutual fund sales program. However, FDIC examiners have found that written agreements between banks and third-party broker-dealers have, in some cases, not been complete. In addition, the examiners have found instances in which banks' written policies governing their mutual fund programs needed to be more precise. An FDIC official said that FDIC has required banks to correct these problems. He also said that FDIC is conducting its own shopper visits to banks to test bank compliance with the interagency guidance. FDIC expects to complete these visits in late summer 1995 and expects to share the results of these visits with the other banking regulators.[21]

On May 26, 1994, the Federal Reserve issued examination procedures for retail sales of nondeposit investment products. The procedures were to be used during examinations of state banks that are members of the Federal Reserve System as well as during inspections of nonbank subsidiaries that engage in securities sales on bank premises. According to Federal Reserve officials, the examination procedures were being used during annual safety and soundness examinations. All state-chartered banks that are members of the Federal Reserve System are to be examined using the new procedures by the end of 1995. Federal Reserve officials said that no material abuses have been found, but in some cases better recordkeeping and training of employees were needed. With regard to training of bank employees, Federal Reserve examiners have found some instances in which untrained bank employees were performing duties, such as gathering detailed financial information from customers, that are reserved to either licensed broker-dealers or to bank employees with training equivalent to licensed broker-dealers. The official said the Federal Reserve has been emphasizing to banks that employees who are not licensed by NASD are limited in the activities they can perform and has required banks to either appropriately train these employees or take measures to restrict their activities.

In addition to the additional procedures incorporated into the annual safety and soundness examinations, the Federal Reserve conducted an in-depth review of three large banks' mutual fund programs. Federal Reserve officials told us that they have also developed consumer education seminars for elderly investors that are to be provided at the 12 Federal Reserve banks. Further, they said they are conducting banker education conferences at the 12 Federal Reserve banks to promote banks'

[21]In commenting on a draft of this report, OCC cited its own efforts to organize an interagency mystery shopping initiative. SEC and the Federal Reserve declined to participate, and OCC did not continue the effort. OCC said it is cooperating with FDIC on this initiative.

understanding of and conformance with the Federal Reserve's requirements for mutual fund sales.

In April 1994, OTS issued guidelines for examining the securities brokerage activities of thrifts, including mutual fund sales. OTS' guidelines focus on determining the adequacy of internal controls in containing the level of risk presented to the thrift and minimizing potential customer confusion between FDIC-insured and non-FDIC-insured investment products. The procedures call for the examiners to review advertising and promotional material, disclosure policies, procedures on the use of customer information, compensation policies, referral fees and practices, training and qualification policies and procedures, and systems for ensuring that investment recommendations are suitable for a particular customer. OTS officials told us that no systemic problems have been found in its examinations of thrifts' mutual fund programs as of May 1995.

Conclusions

At the time of our review, many bank and thrift institutions did not fully comply with the guidance issued by the banking regulators. As a result, customers of those banks and thrifts may not have had accurate and complete information about the risks of investing in mutual funds. In addition, institutions that were not following the guidance opened themselves to the possibility of private lawsuits, particularly under the securities laws, that could affect the safety and soundness of the institution.

The banking regulators have recognized the importance of closely monitoring institutions' mutual fund sales programs and have adopted procedures to be included in periodic safety and soundness examinations, which they are currently implementing.

Matter for Congressional Consideration

Because the banking regulators have adopted additional examination procedures to help ensure that banks provide customers accurate and complete information about the risks of mutual funds since the completion of our field work, we are not recommending changes to the regulators' oversight practices at this time. However, after the interagency guidelines have been in place long enough to provide data for trend analysis, Congress may wish to consider requiring that the banking regulators report on the results of their efforts to improve banks' compliance with the interagency guidance.

Agency Comments and Our Evaluation

In commenting on a draft of this report, OCC, OTS, and the Federal Reserve noted that we visited banks less than a month after the bank regulatory agencies issued the interagency guidance. These banking agencies indicated that the deficiencies we noted may have been attributable to the fact that during this time the institutions were in the process of implementing new procedures, and the agencies had not yet implemented related examination procedures. OCC commented that it believes that bank practices have changed significantly since we completed our visits. OCC also commented that the conclusions, captions, and discussion in this chapter did not adequately distinguish between the adequacy of banks' oral and written disclosures. OCC believed that our conclusion that disclosure was inadequate appears to refer to the oral disclosure requirements, and the description of banks' written disclosure efforts did not support a conclusion of inadequate overall compliance.

The Federal Reserve commented that since May 1994 its examiners have been confirming that state member banks are aware of, and making efforts to ensure that their sales programs are in conformance with, the guidelines. According to the Federal Reserve in those few cases where its examiners have discovered deficiencies, the banks in question have taken voluntary corrective action to address the problems.

Our visits to banks were made in March and April 1994. The timing of these visits was dictated by our desire to respond promptly to the Committees' requests for information on the actual practices being followed by banks and thrifts in the sale of mutual funds. As noted in the report, these requests were driven by concern that customers of banking institutions were confused about how mutual funds differ from insured deposit products. Although our visits occurred shortly after the interagency guidance was issued, each regulator had issued guidance in 1993 that banking institutions should have been following. This guidance largely paralleled the February 1994 interagency guidance. For example, on July 19, 1993, OCC released guidance to national banks that covered many of the same areas that were included, and strengthened, in the February 1994 guidance. The July 1993 OCC guidance called for banks to take steps to separate, as much as possible, retail deposit-taking and retail nondeposit sales functions. It noted that disclosure of the differences between investment products and insured bank deposits needs to be made conspicuously in all written or oral sales presentations, advertising and promotional materials, and statements that included information on both deposit and nondeposit products. Further, it recommended that banks ensure that their sales personnel are properly qualified and adequately

trained to sell investment products. Similar guidelines were issued by the Federal Reserve in June 1993, by OTS in September 1993, and by FDIC in October 1993.

While we believe that the results of our shoppers visits to banks and thrifts accurately portray those banks' mutual fund sales activities at the time of our visits, we also realize that the institutions' activities may change over time as the regulators implement their new examination procedures to ensure that the institutions comply with the interagency guidelines. We also believe that compliance with the guidelines is essential to ensure that investors obtain accurate and complete information about mutual fund risks. Thus, we believe that Congress may find it useful in exercising its oversight responsibilities to receive information on the banks' compliance with the interagency guidelines after the banks and banking regulators have had sufficient time to fully implement their changes. Accordingly, we added a matter for congressional consideration suggesting that once the interagency guidelines have been in place long enough to provide sufficient data for trend analysis, Congress may wish to consider requesting the regulators to provide status reports on the results of their examination efforts. Such reports, for example, could be made a part of congressional oversight hearings.

We disagree with OCC's comment that the report captions do not clearly distinguish between oral and written risk disclosures. (See pp. 29 and 37, for example). Further, we tested the extent of oral disclosures because of the importance placed on these disclosures by the interagency guidance. We believe that this is an appropriate emphasis because customers are highly influenced by what they hear during sales presentations. Further, although we found that most sales literature contained the required disclosures, the disclosures were not always clear and conspicuous. This paralleled OCC's own findings in its September 1994 review of national banks that sold mutual funds. (See pp. 39 and 40.)

SEC commented that our testing of compliance with the interagency guidelines and discussion of the banking agencies examination procedures, as opposed to compliance with the federal securities laws and rules, appeared to place undue emphasis on the guidelines as a source of consumer protection in this area. SEC summarized the various means by which it and NASD regulate and oversee mutual fund sales practices of broker-dealers, including those operating on bank premises. SEC also outlined the ways in which it and NASD regulate and oversee mutual fund disclosure documents, including registrations, prospectuses, advertising,

and sales literature. SEC stated that although the banking regulators' guidelines are useful, the federal securities laws remain the most important set of investor protection criteria applicable to mutual funds and sales practices of broker-dealers. NASD made similar comments, noting that although the interagency guidelines are directly enforceable over banks and bank employees, they do not provide the bank regulators with direct and equal regulatory authority over SEC-registered NASD member broker-dealers, including the authority to bring enforcement actions for serious violations.

By using the interagency guidance as criteria to assess the sales practices being followed by banks and thrifts, we did not intend to minimize the importance of securities laws and regulations. Rather, we used the interagency guidance because it provided guidelines that applied to all mutual fund sales on bank premises, including indirectly to broker-dealers working under a contractual arrangement with a bank, and it contained bank-specific requirements that we wanted to test. In addition, we noted that the guidelines are similar in many respects to securities rules.

Expanded Role of Banks and Thrifts in the Mutual Fund Industry Raises Regulatory Issues

The current regulatory framework allows banking institutions to choose how to structure their mutual fund sales and advisory activities and, depending on that structure, how they are regulated. For example, banks can choose to sell mutual funds directly and be subject to oversight by the banking regulators, but not by securities regulators. However, most banks that sell mutual funds choose to do so through affiliates that are subject to the oversight of the securities regulators. Banking regulators also have issued guidance to banks that sell mutual funds through these affiliates. This creates a potential for different regulatory treatment of the same activity and a potential for conflict and inconsistency among banking and securities regulators. Similar concerns arise for banks and thrifts that can carry out investment adviser activities either in the bank or thrift or in a separate affiliate, although—in this case—most institutions carry out such activities directly rather than in an affiliate. While the banking and securities regulators have been taking steps to better coordinate their efforts, additional coordination could help alleviate differences in regulatory treatment meant to protect customers who buy mutual funds from banks and thrifts.

Increase in Bank Mutual Fund Activities Has Raised Concerns About Adequacy of Current Regulatory Structure

When the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 were enacted, the 1933 Glass-Steagall Act barred banks from engaging in most securities activities and limited bank securities activities to (1) underwriting and dealing in government securities, which were exempt from Glass-Steagall Act restrictions; and (2) providing brokerage services solely for customer accounts.[22] Because banks were already subject to federal banking regulation, the securities laws exempted banks from the regulatory scheme provided for brokers and dealers and for investment advisers. However, over the last 2 decades the federal banking regulators and the courts have interpreted the Glass-Steagall Act in ways that allow banks to provide a wide range of brokerage, advisory, and other securities activities comparable to services offered by SEC-registered broker-dealers and investment advisers. Consequently, banks have rapidly expanded their presence in the mutual funds industry.

Because of the rapid increase in banks' mutual fund activities, some Members of Congress and the securities regulators have expressed concern that the current regulatory framework and oversight and enforcement mechanisms have not kept up with changes in the market

[22]Underwriting is the public distribution of new issues of securities; dealing refers to the business of holding oneself out to the public as being willing to make a secondary market in a security by offering to buy and sell securities as principal.

and may no longer be adequate to protect the interests of investors who purchase mutual funds through a bank. SEC has testified that eliminating the banks' exemptions from registering as broker-dealers and investment advisers would result in better investor protection and allow uniform regulation of securities activities regardless of industry classifications. SEC contends that when banks sell mutual funds directly using their own employees, customers are not afforded the same level of protection as customers who make their purchases through a broker-dealer. Specifically, SEC makes the following arguments:

- Guidelines issued by the banking regulators concerning retail sales of mutual funds are not regulations. Therefore, SEC believes they are not legally enforceable by the bank regulators or customers; are too general; do not contain sufficient provisions for training bank personnel, especially with regard to making suitability determinations; and raise potential problems of regulatory overlap and conflict with respect to registered broker-dealers that assist banks in the sale of securities products.[23]
- The banking regulators' primary focus is not investor protection, but the safety and soundness of the institution. As a result, SEC believes bank regulators minimize their disclosure of enforcement actions to protect the bank from adverse customer reactions in contrast to securities regulators, who make their enforcement actions a matter of public record to get maximum deterrent effect. SEC also argues that the securities regulators are better trained and have more expertise in assessing suitability determinations; that is, ensuring that customers make investments that are compatible with their income, assets, and investment goals.

SEC also testified that banks' exemption from the Investment Advisers Act should be repealed for banks that advise mutual funds and that SEC should have the authority to regulate and inspect the mutual fund advisory and sales activities of banks. In addition, SEC has testified that when banks manage proprietary funds, there may be potential conflicts of interest between the funds and the bank's other clients—conflicts that SEC may be unable to detect because of its lack of jurisdiction over bank investment advisers.

In response to criticisms that their guidelines are inadequate, the banking regulators have argued that, in some cases, their guidance exceeds SEC and

[23]In commenting on a draft of this report, NASD stated that while the interagency guidelines are directly enforceable over banks and bank employees, they are not directly enforceable over broker-dealers and their associated persons. Conversely, rules currently being proposed by NASD to govern the conduct of bank broker-dealers would not apply to banks that sell mutual funds directly through their own employees. (See pg 54.)

NASD requirements for nonbank mutual fund companies[24]. For example, they say the guidance requires banks to disclose orally and in writing to potential customers that their mutual fund investments are not FDIC-insured and are subject to market fluctuations in value. Banks are required to ensure that customers sign written statements acknowledging that they understand the risks associated with mutual fund investments. By contrast, nonbank mutual fund customers are not required to sign written statements acknowledging the risks associated with mutual funds.

Bank regulatory officials also reject the argument that the guidelines represent a less enforceable standard than SEC regulations. The bank regulators have informed banks that the adequacy of their mutual fund operations will be assessed on the basis of the new guidelines during the next scheduled safety and soundness exam. According to the regulators, they will bring any identified deficiencies in bank mutual fund operations to the attention of senior bank managers and directors. The managers and directors will be required to correct these deficiencies within a specified period of time. Failure to make needed improvements could result in a variety of enforcement actions, such as cease and desist orders or civil money penalties. Because of such possible sanctions, the regulators believe that bank managers will establish mutual fund sales operations that comply with the interagency guidelines.

Most Banks Choose to Sell Funds Through SEC-Registered Broker-Dealers

Under current laws and regulations, sales of mutual funds in banks can be made either by employees of the bank; by employees of an affiliate, subsidiary, or third-party broker working on behalf of the bank; or by "dual employees"—individuals who work for both the bank and a broker.[25] If the salesperson is an employee of a broker or is a dual employee, he or she must be registered with NASD and is subject to SEC and NASD oversight. However, because the 1934 act exempts banks from being defined as a "broker" or a "dealer," a bank can choose to use its own employees to sell mutual funds or other securities. These employees may do so without

[24]In its comments on a draft of this report, NASD disagreed that the interagency guidance exceeds SEC and NASD requirements.

[25]Dual employees who perform brokerage activities must register as representatives of the broker and pass the appropriate examinations. Although dual employees are not employees of the broker in the normal meaning of the term, as they are frequently not paid directly by the broker, they are supervised by the broker and work on the broker's behalf.

registering with NASD or being subject to SEC and NASD rules and oversight.[26]

Banks that use their own employees to broker securities are not subject to SEC regulation and oversight. However, responses to our questionnaire showed that the vast majority of banks that sell mutual funds on their premises choose to do so through SEC-registered broker-dealers, either affiliates or subsidiaries of banks or third-party broker-dealers, rather than directly by unlicensed bank employees.

As shown by table 4.1, only about 8 percent of banking institutions that responded to our questionnaire reported that only their own employees directly sold mutual funds to retail customers.[27] On the basis of these responses, we estimate that about 180 of the 2,300 banking institutions that were selling mutual funds to their retail customers at the end of 1993 did so directly using only their own employees. About 43 percent reported sales by "dual employees" of the bank or thrift (or its affiliate or subsidiary) and a registered broker-dealer, 29 percent through an affiliated or subsidiary broker-dealer organization, and 38 percent through a networking or leasing arrangement with a registered third-party broker-dealer. When we analyzed these results by bank size, we found that small banks were least likely to sell mutual funds directly with their own employees. Only 7 percent of banks with assets less than $150 million reported selling mutual funds exclusively with their own employees. In contrast, about 14 percent of banks with assets between $250 million and $1 billion responded that their own employees, rather than broker-dealers, sold funds at their banks.

[26]Thrifts are not exempt from the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934. Therefore, sales of mutual funds by thrifts must be made through a registered broker-dealer.

[27]Another 5 percent of the banks reported that they sold mutual funds using their own employees and sold funds either by using dual employees or an affiliated or third-party brokerage. When we combine these institutions with the 8 percent of banks that sold funds only through their own employees, and after we weight for differences in bank size, we estimate that about 12 percent of banks in the 12 metropolitan areas use their own employees to sell mutual funds.

Table 4.1: How Mutual Funds Are Sold by Banks by Asset Size and Method of Sale

	Method of sale			
Banks (by asset size)	Directly by bank employees only (percent)	Through dual employees (percent)	Through affiliate or subsidiary (percent)	Through third party (percent)
<$150M	7	43	17	46
$150-$250M	12	50	29	27
$250M-$1bn	14	41	31	34
$1bn and up	4	39	68	27
Total for all banks	**8**	**43**	**29**	**38**

Note: Totals do not equal 100 percent because, other than the "directly by bank employees only" category, the methods of sale are not mutually exclusive. For example, when a bank sells funds using dual employees, the employee works for both the bank and the bank's subsidiary broker-dealer. In such cases, the respondent might have checked both the dual employee and subsidiary/affiliate boxes.

Source: GAO analysis of questionnaire data.

According to the American Bankers Association, banks that choose to offer brokerage services directly through the bank do so because they do not yet have sufficient business to justify the expense of employing a registered broker-dealer. As a result, some in the banking industry have asserted that eliminating banks' exemption from registering as broker-dealers would unfairly penalize banks that had a small volume of brokerage transactions. To gather information on this issue, we contacted about 80 percent of the banks that reported selling mutual funds through their own employees to find out why they sold funds directly, rather than through a broker-dealer. They cited three reasons for selling funds directly through their own employees: (1) they wanted to maintain control over their relationship with their customers, rather than turn it over to a broker-dealer; (2) they did not do enough business to justify establishing an arrangement with a broker-dealer or setting up their own affiliate; and (3) they sold funds mainly as a convenience to their customers. Three of the banks we contacted sold proprietary funds, although one of these has since switched to selling funds through a third-party broker-dealer.

Regulatory Framework for Mutual Fund Sales in Banks Can Cause Conflict and Overlap Among the Regulators

Under the current regulatory framework, broker-dealers that operate on the premises of banks and thrifts are subject to regulation by SEC and indirectly to oversight by banking regulators. This can cause conflict over what rules these broker-dealers are to follow in conducting their mutual fund sales programs and can also cause duplication of effort and an unnecessary burden on the broker-dealer when the regulators carry out examinations of these activities.

For example, in December 1994, NASD released for comment proposed rules governing broker-dealers operating on the premises of banking institutions. According to NASD, these rules are designed to fill a regulatory void by specifically governing the activities of NASD member bank broker-dealers who conduct a securities business on the premises of a financial institution.[28] They differ from the banking regulators' interagency guidance in several respects. First, the proposed NASD rules prohibit the payment of referral fees by the broker-dealer to employees of the financial institution. The interagency guidance permits payment of these fees. Second, the proposed rules place restrictions on brokers' use of the bank's or thrift's customer lists that are stricter than the interagency guidance. Specifically, the proposed NASD rules state that confidential financial information maintained by the financial institution can not be used to solicit customers for the brokerage. This appears to rule out the use of information such as certificate of deposit maturity dates and balances. The interagency guidance requires only that the banking institution's policies and procedures include procedures for the use of information regarding the institution's customers in connection with the retail sale of nondeposit investment products. Third, the proposed NASD rules appear to place limits on the use of bank or thrift logos in advertising materials. For example, the proposed rules state that advertising and other sales materials that are issued by the broker-dealer must indicate prominently that the broker-dealer services are being provided by the broker-dealer, not the banking institution. Further, the financial institution may only be referenced in a nonprominent manner in advertising or promotional materials solely for the purpose of identifying the location where broker-dealer services are available. In contrast, the interagency guidance requires only that advertising or promotional material clearly identify the

[28]In commenting on a draft of this report, FDIC stated that it is not necessary that the interagency guidance and NASD rules be exactly the same. However, the interagency guidance applies not only to sales of investment products on bank premises done directly by employees of the bank, but also to sales by employees of third-parties, such as broker-dealers. Inconsistencies between the guidance and NASD rules, which also apply to broker-dealer employees, may lead to confusion and disparities in how bank mutual fund customers are treated.

company selling the nondeposit investment product and not suggest that the banking institution is the seller.

NASD's proposal has generated controversy in the banking industry. According to the financial press, some bankers have complained that the proposed NASD rules hold bank brokerages to standards that are higher than for nonbank brokerages. They point out, for example, that, unlike bank brokerages, nonbank brokerages are not required to disclose that mutual funds are not federally insured. In response, an NASD official said that when a customer deals with a brokerage in a bank, that brokerage has a higher responsibility to ensure that the customer understands the risk involved in investing in securities as compared to savings accounts or certificates of deposit.

Another area of concern is the potential for overlapping examinations or examinations that may result in conflicting guidance. Under the current regulatory framework, a broker-dealer in a bank could be examined periodically by NASD to determine if it is in compliance with securities rules, by SEC if it is doing an oversight inspection of NASD or is doing an inspection for "cause," and also by the banking regulators to determine if the bank is complying with the interagency guidance.[29] Although we found that a number of steps have been taken to avoid overlapping and conflicting activities, some problems have not been resolved.

For example, SEC is concerned that the banking regulators, particularly OCC, have begun to examine registered broker-dealers that sell securities in banks and has plans to examine mutual funds advised by banks. SEC testified that because registered broker-dealers and mutual funds are already subject to regulation by SEC and NASD under the federal securities laws, imposing an additional layer of banking regulator examination and oversight is unnecessary and may result in firms receiving inconsistent guidance on compliance issues.

Because of SEC's concern, we reviewed examination guidelines issued by OCC, the Federal Reserve, and FDIC to determine the degree to which they required examiners to review broker-dealer records, especially third-party broker-dealers. OCC's February 1994 guidelines for examination of retail nondeposit investment sales require that contracts between banks and broker-dealers provide bank examiners access to the records of

[29]SEC evaluates the quality of NASD oversight in enforcing member compliance with federal securities laws in part by examining a sample of broker-dealer firms that NASD previously examined to assess the quality of NASD examinations. See Securities Industry: Strengthening Sales Practice Oversight (GAO/GGD-91-52, April 25, 1991).

third-party vendors (broker-dealers). However, the emphasis of the guidelines is on determining whether the bank has exercised the proper management control over the third-party vendor, rather than on a specific examination of the vendor's operations. For example, the guidelines state that when (1) preliminary examination findings clearly show that bank management has properly discharged its responsibility to oversee the third party's operations, (2) only a few complaints have been filed against the vendor, and (3) the vendor's reports to the bank are timely and properly prepared, examiner access to third-party records should generally be limited to reports furnished to bank management by the vendor. The guidelines are not clear, however, as to what actions examiners are to take if these conditions are not met, stating only that "After making a judgment about the effectiveness of the oversight of third party vendor sales, complete any other examination procedures that appear appropriate."

According to an OCC official, before OCC examiners do a bank inspection, they typically ask the bank to provide the results of the broker-dealer's last NASD inspection. The NASD inspection report is to be reviewed to determine if it addresses any concerns about the bank's mutual fund program. If the OCC examiners have concerns about the bank's mutual fund program, they may do a limited inspection of the broker-dealer's books and records. OCC may also direct the bank to hire an accounting firm to audit the broker-dealer if the limited OCC inspection identifies problems. This official said that OCC's inspection approach is designed to avoid duplication by placing on the bank the responsibility for controlling and overseeing the broker-dealer's operations. During its inspections, OCC is to check the adequacy of these controls and the bank's oversight of broker-dealer compliance. According to the OCC official, OCC inspections of the broker-dealer should be a rare event if the bank exercises adequate oversight. In commenting on a draft of this report, OCC reiterated that any inspections of third-party broker-dealers would be limited to pertinent books and records and would not be complete examinations.

The Federal Reserve's examination guidelines do not contain provisions that imply its examiners will review the operations of a third party in detail. The guidelines state that the examination procedures have been tailored to avoid duplication of examination efforts by relying on the most recent examination results or sales practice review conducted by NASD and provided to the third party. For example, the guidelines state that in making determinations about suitability and sales practices involving registered broker dealers, Federal Reserve examiners should rely on

NASD's review of sales practices or its examination to assess the organization's compliance with suitability requirements.

The emphasis of FDIC's examination guidelines is similar to the Federal Reserve's. The guidelines state that examinations of banks that have contracts with a third party should focus on the agreement with the third party and the bank's methods for determining the vendor's compliance with bank policies and with provisions of the interagency statement.

Banking and securities regulators have begun to take steps to better coordinate their efforts. In January 1995, NASD and the four banking regulators signed an agreement in principle to coordinate their examinations of broker-dealers selling mutual funds and other nondeposit investment products on bank premises. The agreement calls for the agencies to share examination schedules, NASD to share its examination findings with the banking regulators, referral of any violations of banking or securities laws to the appropriate agencies, and other matters. Also in January 1995, NASD agreed to establish a new committee for bank-affiliated brokerages. This committee is to join 32 other standing NASD committees that represent specific interests; it is to recommend to the NASD board of governors rules and procedures for bank-affiliated brokerages and third-party brokerages that are doing business on bank premises.

Both SEC and Banking Regulators Have Responsibility for Bank Fund Investment Advisers

Many banks now provide investment advice to their own mutual fund families. Because the Investment Advisers Act of 1940 exempts banks from being defined as investment advisers, bank advisers do not have to register with SEC and are not subject to SEC regulations and oversight. As a result, when SEC inspects the records of a bank-advised fund, it does not have the authority to review certain records of the investment adviser that may be pertinent to an examination of the fund's portfolio transactions.

According to SEC officials, when a bank serves as the investment adviser to a mutual fund and is not registered with SEC, SEC is limited to reviewing only the activities of the adviser as the activities relate to the mutual fund. If, for example, the bank serves as the investment adviser to a mutual fund, a pension fund, and private trust funds, SEC can look at the bank's activities only with respect to the mutual fund. SEC can not review the records of the other funds or accounts to determine if conflicts of interest exist or if the mutual fund was disadvantaged in some manner in relation to the other funds the bank is advising by the decisions of the investment adviser.

Banks nevertheless may establish a separate SEC-registered subsidiary or affiliate to provide investment advice to a mutual fund, or they may provide such advice directly. While some banks have established SEC-registered subsidiaries or affiliates in which to conduct their mutual fund investment advisory activities, most provide such advice directly. According to SEC's records, 78 of the 114 (68 percent) banking organizations that provided investment advisory services to mutual funds as of September 1993 did so directly rather than through SEC-registered subsidiaries or affiliates. If the bank chooses to conduct its mutual fund investment advisory activities directly, these activities are overseen principally by the banking regulator responsible for supervising and examining that bank and by SEC to the extent bank advisory activities relate to mutual funds subject to the Investment Company Act.

Banks that provide investment advice to their proprietary mutual funds are subject to examinations of these activities by the banking regulators. These examinations are carried out regardless of whether the investment advisory function is also subject to inspection by SEC. While the banking regulators' examinations have traditionally focused on safety and soundness issues, rather than enforcement of securities laws, OCC is drafting guidelines for examination of mutual fund activities that indicate OCC examiners may attempt to determine whether bank and fund practices comply with the Investment Company Act of 1940. This concerns SEC because it believes such guidelines raise potential problems of conflict and overlap among the regulators.

OCC officials told us that although the agency has been doing examinations of investment advisers for years as part of the trust examination process, the new examination guidelines will focus examiners' attention more directly on potential conflicts of interest that can arise when banks advise mutual funds. These potential conflicts of interest may violate securities laws and could enrich fund advisers at the expense of fund investors.

The Federal Reserve also examines investment advisers in state-chartered member banks and in subsidiaries of bank holding companies. If the investment adviser is the trust department of a state member bank, the examination is to be carried out as part of its examination of trust activities. If the investment adviser is a subsidiary of a bank holding company, on-site inspections are to be conducted as an integral part of bank holding company inspections. Although investment advisory subsidiaries of bank holding companies are required to register with SEC and are subject to SEC supervision and examination, the Federal Reserve's

guidelines note that such examinations are infrequent. Therefore, examinations by Federal Reserve Bank examiners are to be undertaken whenever they consider the investment adviser activities to be significant. Among the factors Federal Reserve examiners are to consider in deciding whether to schedule an examination of an investment advisory subsidiary of a bank holding company are volume and type of activity, date and results of previous Federal Reserve Bank and/or SEC inspections, and the extent of services provided to affiliated banks or trust companies.

The Federal Reserve's guidelines for inspections of investment advisory subsidiaries of bank holding companies state that these inspections are primarily focused on safety and soundness considerations and not on compliance with securities laws. The objectives of these inspections are to (1) determine whether the adviser's organizational structure and management qualifications are satisfactory; (2) evaluate the adequacy of the adviser's financial condition and internal controls; (3) review the appropriateness of the adviser's investment practices; (4) determine whether the institution has adequate policies and procedures to prevent self-dealing and similar improper conflicts; and (5) evaluate compliance with bank holding company laws, regulations, and interpretations.

According to an FDIC official, if an FDIC-regulated bank has an affiliate that provides investment advisory services to a proprietary mutual fund, that entity would be supervised and inspected by the Federal Reserve under the holding company inspection system. In addition, a small number of state nonmember banks provide investment advisory services to mutual funds through their trust departments. FDIC examiners are to inspect these advisers as part of FDIC's overall trust and compliance examination program. The trust examination guidelines address a number of areas involving the investment advisers' activities. Specifically, the guidelines focus on the advisers' supervision and organization, operations controls and audits, asset administration, account administration, and conflicts of interest and self-dealing.

Eliminating Banks' Exemptions Would Not Resolve All Problems

Under the current regulatory framework, many banks' securities activities are subject to review by both the securities and banking regulators. As shown by the responses to our questionnaire, over 90 percent of institutions that sell mutual funds do so through SEC-registered and supervised broker-dealers. These broker-dealers are subject to review by NASD and SEC, who attempt to ensure investor protection through enforcement of the securities laws; and by the banking regulators, who,

among other things, attempt to ensure that the institution is operating its mutual fund program in a safe and sound manner and in compliance with the interagency guidance. A similar situation exists in the regulation of investment advisers. We noted, for example, that even when the bank conducts its mutual fund advisory functions in a separate subsidiary, the Federal Reserve continues to conduct its own inspections of these subsidiaries. In addition, OCC is drafting examination guidelines that will call for assessing banks' compliance with various provisions of the Investment Company Act of 1940. To the extent that these examinations would be carried out at entities already subject to SEC oversight, banks and their affiliates may be subject to having the same activities examined by two sets of regulators.

The securities regulators have proposed that the regulatory framework could be simplified if a system of functional regulation were adopted. Under a "pure" functional regulation system—regulation according to function and not according to entity performing the function—SEC and the other securities regulators would be responsible for ensuring that banks comply with the securities laws. The securities activities of banks would be conducted in separate subsidiaries and affiliates, and banking regulators would be precluded from conducting examinations of the securities subsidiaries and affiliates of banks, which would eliminate duplicative regulation and oversight. However, the Comptroller of the Currency has testified that under this framework, the banking examiners would be unable to properly assess whether the securities activities were affecting the safety and soundness of the bank because they would have to rely on reports from the functional regulator that could be too infrequent, insufficiently detailed, or insufficiently comprehensive to allow the examiners to make a determination.

Eliminating banks' exemptions from the securities laws would expand SEC's authority to oversee banks' securities activities and would appear to address SEC's concerns that (1) investors are not adequately protected by the securities laws when retail securities sales are made directly by bank employees, and (2) it can not fully examine the transactions of mutual fund investment advisers when the adviser is a bank. However, just eliminating the exemptions does not remove the potential for duplication and conflict between the banking and securities regulators because each group will continue to be involved in supervising banks' securities activities.

Scope and Frequency of SEC's Inspections Has Been Limited, but Resources May Be Increasing

In the past, SEC has had trouble keeping up with its existing workload because the size of its inspection staff has not kept pace with the explosive growth in the size and complexity of the mutual fund industry. As a result, the agency was forced to reduce the scope and frequency of its inspections over the past decade. The size of SEC's mutual fund company inspection staff began to increase in fiscal year 1994, and the agency believes that with the additional staff it is adding in fiscal year 1995 and has requested for fiscal year 1996, it will be able to examine mutual fund companies and their advisers with reasonable frequency. However, if these additional resources are not approved or if the financial services industry continues to expand as it has in recent years, SEC may continue to face challenges meeting its responsibility to oversee mutual funds and their advisers.

SEC's inspections of investment companies and their related investment advisers are to be carried out by staff in SEC's regional and district offices in accordance with general examination objectives that are established by SEC's Office of Compliance Inspections and Examinations[30] at the beginning of each new fiscal year. Each region is responsible for preparing an annual inspection plan that responds to these overall objectives.

Fiscal Years 1991 to 1993

SEC's objective for inspecting investment companies and investment advisers during fiscal years 1991 through 1993 was to get the greatest dollar coverage with the limited staff available. With this in mind, SEC had a program for inspecting investment companies during this period that called for inspecting funds in the 100 largest fund families and all money market funds. To the extent that time was available after SEC completed inspections of the 100 largest fund families and money market funds, SEC's 1993 program called for its regions and districts to also inspect smaller fund families, with priority to be placed on inspecting families that had never been inspected. Moreover, SEC testified that its investment company inspections were limited in scope, focusing primarily on portfolio management to determine whether fund activities were consistent with the information given investors and whether funds accurately valued their shares. SEC stated, for example, that it rarely scrutinized important activities, such as fund marketing and shareholder services. Inspections of

[30]This office was established effective May 1, 1995, to centralize SEC's inspection program for investment companies, investment advisers, broker-dealers, and self-regulatory organizations. The new office is intended to enhance SEC's inspection efforts and promote a more effective use of its examination resources. Prior to the reorganization, the Division of Investment Management oversaw investment company and investment adviser inspections, and the Division of Market Regulation oversaw broker-dealer inspections.

money market funds focused on compliance with a 1940 act rule that specifies the quality and maturity of permissible instruments that may be held for money market funds and the requirements for portfolio diversification.

According to SEC officials, SEC staff review the activities of advisers to investment companies concurrent with their examination of the investment company. In addition, between 1991 and 1993, SEC's inspection programs called for inspecting all investment advisers with $1 billion or more in assets under management, with about one-third to be done in each of the 3 years. If time permitted, the regions and districts were also to inspect some advisers with less than $1 billion under management that had custody or discretionary management authority over client assets or conducted their business in a way that regional or district office staff believed needed review.

Fiscal Year 1994

For fiscal year 1994, SEC changed its inspection approach to (1) reintroduce an element of surprise into the inspections, and (2) allow the staff to focus on investment companies and advisers that they considered more likely to have problems. To accomplish these objectives, SEC headquarters informed SEC's regions and districts that they were to inspect all medium and small fund families that had not been examined since 1990 and all new fund families formed during the year. SEC estimated that 350 families had not been inspected since 1990; and many of them, especially those connected with banks, had never been reviewed. As in preceding years, the guidance stated that, except for families that had never been inspected, inspections should be limited in scope with an emphasis on portfolio management activities. For families connected with banks, staff were to closely review advertising and the procedures by which shares were distributed to shareholders. According to SEC, during fiscal year 1994, its staff conducted inspections of 303 small and medium fund families, including 225 money market portfolios within those families. The staff inspected funds in the 100 largest fund families only when a cause inspection was necessary.

With respect to inspections of investment advisers in fiscal year 1994, SEC headquarters instructed SEC's regions and districts to focus on potentially higher risk small and medium size advisers with discretionary management authority that had not been inspected in the prior 4 years, with no particular emphasis on large entities. SEC reported that as a result of the shift to inspections of smaller, higher risk investment advisers, the

assets under management of inspected advisers decreased from $1.7 trillion in 1993 to $520 billion in 1994. However, the number of deficiencies identified increased by 57 percent, from 5,523 to 8,672.

Size of Inspection Staff Is Increasing, but Challenges Remain

Until recently, SEC believed that it did not have enough staff to properly oversee the mutual fund industry. For example, in November 1993 SEC testified that despite efforts to use its resources more effectively, such as by obtaining data in electronic format and beginning development of a risk assessment program for investment companies, it needed more and better trained people to deal with the mutual fund industry. An SEC official told us that SEC needs a total of 300 examiners to inspect investment companies and 210 examiners to inspect investment advisers. At the end of fiscal year 1994, SEC had about 200 staff assigned to inspections of investment companies and about 50 to inspections of investment advisers.

In December 1993, the Office of Management and Budget approved the hiring of 150 additional investment company examiners (50 each year beginning in fiscal year 1994 through 1996). With the additional staff, SEC plans to perform comprehensive inspections of the 50 largest mutual fund families over a 2-year period. Funds in the other families would be inspected comprehensively about once every 4 years. With respect to investment adviser examiners, in its fiscal year 1996 budget SEC is requesting an additional 193 staff years for the investment adviser inspection activity. If it receives the additional staff, SEC estimates that it will be able to inspect advisers much more frequently than it has in the past. Currently, about 21,000 investment advisers are registered with SEC, but only about 7,000 to 8,000 actually exercise discretion over client assets. According to SEC, it allocates more of its inspection resources to the advisers with discretionary authority and expects to examine these advisers every 6 to 8 years. An SEC official told us that if SEC were required to oversee bank-related investment advisers that are not currently registered with the Commission, it would have little or no effect on their resources because this would add relatively few (fewer than 100) advisers to their total inventory of advisers. Further, SEC staff already examine the activities of many of these advisers during their inspections of the related investment companies.

Even if SEC acquires additional inspection staff, it will face major challenges in adhering to its planned inspection schedule. There have been time lags in hiring new examiners, and they need to be trained over a period of several months. In addition, though there has been a slowdown

recently, the number of new mutual funds continues to increase. Also, such issues as the mutual funds' use of derivatives and personal trading by fund managers have come to the forefront.

Potential Conflicts of Interest May Arise When Banks Manage Mutual Funds

The increase in the number of banks that manage their own proprietary funds has caused the securities regulators and some in Congress to be concerned as to whether the banking and securities regulations are adequate to prevent certain conflicts of interest when banks operate proprietary mutual funds. Specific concerns are whether, or under what circumstances, (1) banks should be permitted to serve as custodians for their own mutual funds, (2) banks should be permitted to loan money to their mutual funds, (3) bank funds should be permitted to purchase securities issued by a borrower of the bank when the proceeds are used to pay off a loan to the bank, (4) banks should be permitted to extend credit to customers to purchase shares of bank funds, and (5) limits should exist on interlocking management relationships between banks and their mutual funds.

Banks May Act as Custodians of Their Own Mutual Funds

The Investment Company Act of 1940 (the 1940 act) does not prohibit a bank from acting as both the advisor and the custodian for the same mutual fund. This has caused concern among securities regulators that a bank could cause its affiliated (proprietary) mutual fund to select the bank as fund custodian, thereby depriving the fund of an independent custodian and creating the potential for abuse and self-dealing.

The fund custodian holds all securities and other fund assets on behalf of the fund. The 1940 act requires a mutual fund to place and maintain its securities and similar investments in the custody of a bank with aggregate capital and surplus and undivided profits of not less than $500,000; a company that is a member of a national securities exchange; or the fund itself. In practice, the fund custodian is almost always a bank.

Although the 1940 act does not prohibit a bank from acting as both adviser and custodian for a mutual fund, SEC's position is that such banks are subject to its self-custody rule. That rule requires that securities and investments of a mutual fund maintained in the custody of the fund must be verified by actual examination by an independent public accountant at least three times a year, two of which must be without prior notice. These requirements, among others, must be satisfied when a bank acts as adviser (or is affiliated with the adviser) and as custodian or subcustodian of a

fund. In addition, SEC has advocated changing the 1940 act to subject affiliated bank custodianships to specific SEC rule-making authority.[31]

Our analysis of the data provided by Lipper showed that as of September 30, 1993, 53 of 114 banks that advised funds also acted as custodians of those funds. According to the SEC official in charge of SEC's inspections of mutual funds, auditors must file a certificate reflecting securities verification, which SEC examiners typically review when examining the mutual funds. This official noted, however, that the SEC rule requiring verifications three times a year was written when securities were issued in physical form, such as stock certificates. Today, securities are issued in book-entry form rather than in physical form, requiring more elaborate verification procedures. Independent auditors now evaluate the process and controls used by the custodian to make a daily reconciliation of statements of securities held by the mutual fund with the Depository Trust Company (DTC).[32] However, physical examination of pertinent records is still required to review the custodian's reconciliations. The SEC official also told us that there have been no specific examples of abuses relating to the custody of securities that have occurred when banks also acted as the funds' investment advisor.

Some Bank Loans to Affiliated Funds Are Permitted

The 1940 act allows a mutual fund to borrow up to one-third of its net asset value from any bank. Because the act does not expressly prohibit a mutual fund from borrowing money from an affiliated bank, securities regulators are concerned that the lack of such a prohibition creates the potential for overreaching by a bank in a loan transaction with an affiliated investment company.

Several banking laws, however, restrict banks' ability to make loans to affiliated mutual funds. For example, section 23A of the Federal Reserve Act prohibits a member bank from lending more than 10 percent of its total capital (capital stock and surplus) to a mutual fund that is advised by the bank or its affiliates and 20 percent to all affiliates (a mutual fund advised by the bank is defined as an affiliate). Section 23B of the Federal Reserve Act states that all such lending must be on an arm's length basis.

[31]In commenting on a draft of this report, OCC pointed out that bank custodial activities are also reviewed and supervised by federal bank regulators. OCC stated that because both the securities and banking laws apply to bank custodial activities, these activities may be subject to more intensive oversight than those of custodians that are not banks.

[32]DTC is a central securities repository where stock and bond certificates are exchanged. Most of these exchanges now take place electronically, and few paper certificates actually change hands. DTC is a member of the Federal Reserve System and is owned by most of the brokerage houses on Wall Street and the New York Stock Exchange.

The Federal Deposit Insurance Act applies Sections 23A and B restrictions to all federally insured nonmember banks. Under Regulation Y, the Federal Reserve prohibited banking organizations (bank holding companies and their bank and nonbank subsidiaries) from extending credit to any mutual fund company advised by a bank within the organization or its affiliates. In addition, a rule adopted by FDIC permits nonmember state banks to extend credit to an affiliated mutual fund subject to the Sections 23A and B restrictions. These must be stand-alone banks and not holding companies. Holding companies must comply with Regulation Y.

The Federal Reserve's bank holding company supervision manual contains detailed guidelines for examining for compliance with Sections 23A and B. The chief examiners in three Federal Reserve district offices told us these examinations are conducted regularly. According to the Federal Reserve official responsible for overseeing enforcement actions, the Federal Reserve has never taken any enforcement actions charging that bank holding companies or member banks had violated Sections 23A or B provisions relating to proprietary mutual funds.

Mutual Funds Are Not Prohibited From Purchasing Securities Issued by Borrowers From Affiliated Banks

The 1940 act does not expressly prohibit a mutual fund from purchasing the securities of companies that have borrowed money from an affiliated bank, but it does prohibit most transactions between a fund and its affiliates. In addition, Sections 23A and 23B of the Federal Reserve Act, which prohibit banks from engaging in certain transactions with affiliates, do not impose restrictions on the ability of proprietary funds to purchase the securities of companies that are borrowers from an affiliated bank. As a result, securities regulators believe that there is a risk that a bank may use its affiliated mutual fund to purchase securities of a financially troubled borrower of the bank. The indebtedness to the bank would be repaid, but the mutual fund may be left with risky or potentially overvalued assets.

A Federal Reserve Board attorney told us that while Sections 23A and 23B do not specifically prohibit proprietary funds from purchasing securities from a borrower of the affiliated bank, such activities are generally violations of state conflict-of-interest laws if the participants intend to prop up a weak bank borrower. This official said that the Federal Reserve enforces these laws as part of its examination and compliance process as do state regulators. This official also told us that bank commercial lending departments are prohibited from sharing sensitive loan information with

trust departments. However, if a fund purchases the securities of a bank borrower, such an action would not necessarily be considered a violation of the restrictions. Illegality would depend upon the intent of the participants, that is, an intent to rescue a failing corporate borrower. Similarly, a bank intentionally causing an affiliated fund to acquire the securities of a troubled borrower to shore up the borrower's finances may be in violation of the affiliated transaction provision of the 1940 act, and the bank would be violating its fiduciary obligations as an adviser to the fund.[33]

Officials of two very large banks that we visited told us that it was possible, even likely, that their proprietary funds would make investments in entities to which the bank had loaned money. For example, a bank official told us that if one were to examine his bank's loan portfolio, it would not be inconceivable to find IBM as a borrower and, likewise, IBM would probably turn up as one of the stocks held by that bank's mutual fund family. Even so, this would be coincidental rather than the result of any planned activity, as many of the Fortune 500 companies are likely to be customers of his bank and others like it. Officials at both banks stressed that the lending and investment advising activities are quite separate and that their controls for separating these activities precluded any abuses.

Management Interlocks Between Some Banks and Mutual Funds Could Occur

To eliminate potential conflicts of interest between securities firms (including mutual funds) and banks, Section 32 of the Glass-Steagall Act and regulations of the Federal Reserve Board prohibit interlocks among officers, directors, and employees of these entities. However, because of interpretations by the Federal Reserve Board and FDIC, there are opportunities for interlocks to occur between banking organizations and mutual funds. Whether these interlocks have resulted in actual problems is uncertain; regulators told us that no cases have been reported.

Section 32 of the Glass-Steagall Act, as interpreted by the Federal Reserve Board, prohibits employee, officer, and director interlocks between banks that are members of the Federal Reserve System and mutual funds. The Board has applied Section 32 to bank holding companies; consequently, a bank holding company with member bank subsidiaries may not have an interlock with a mutual fund. However, the Board has indicated that interlocks between nonbanking subsidiaries of bank holding companies

[33]Banking law may also impose a fiduciary duty on the bank adviser in certain cases, such as when a bank is investing trust assets.

and securities firms are not subject to Section 32. Therefore, a nonbanking subsidiary of a holding company could have an interlock with a mutual fund.

Section 32 does not apply to banks that are not members of the Federal Reserve. Thus, a nonmember state bank could maintain an interlock with a mutual fund. In addition, FDIC's regulations do not prohibit interlocks between a state nonmember bank and a mutual fund for which it acts as an investment adviser. However, a nonmember bank with a bona fide subsidiary or securities affiliate that engages in mutual fund activities impermissible for the bank itself (such as acting as the fund's underwriter) would be subject to restrictions. The bona fide subsidiary or securities affiliate may not have common officers with the bank and would be required to have a majority of independent directors.

The 1940 act does not prohibit interlocks between banks and investment companies. However, Section 10(c) of the act prohibits a registered investment company from having a majority of its board consist of officers, directors, or employees of any one bank. The act defines the term "bank" to include a member bank of the Federal Reserve System. In addition, section 10(a) requires that at least 40 percent of a fund's board members be "disinterested persons." These are persons who are not to be affiliated with a fund's adviser, including a bank adviser, or with the fund's principal underwriter.

The Prohibition on Sponsorship and Underwriting of Mutual Funds by Banks May Increase Banks' Costs

A bank may serve as the investment adviser to a mutual fund; act as an agent in purchasing mutual funds for customers (i.e., provide discount brokerage services); provide full brokerage services to customers, including investment advice concerning mutual funds; provide administrative services to mutual funds; and serve as the custodian and transfer agent to mutual funds. However, the Glass-Steagall Act prohibits banks that are members of the Federal Reserve System and bank holding companies from sponsoring mutual funds or underwriting and distributing the shares of mutual funds.[34] These restrictions also apply to affiliates of

[34]Under securities laws the sponsor must invest a minimum of $100,000 seed capital in the mutual fund by purchasing $100,000 worth of shares in the company. The sponsor often is the mutual fund's investment adviser or underwriter. The distributor or underwriter contracts with the mutual fund to market the fund's shares to the public. The distributor may sell the fund directly, by mail, or through its employees or may contract with other broker-dealers or banks to sell the fund to retail customers. Retail brokers and banks purchase and redeem mutual fund shares for their customers typically by forwarding orders to the distributor. These retail brokers typically are compensated by receiving a portion of the sales load and/or 12b-1 marketing fee from the distributor. In some cases the roles of sponsor and underwriter may be shared.

banks that are members of the Federal Reserve System and to nonmember banks. They do not apply, however, to subsidiaries or affiliates of state banks that are not members of the Federal Reserve System. So, a subsidiary of a state nonmember bank (if it does not have a member bank affiliate) may provide these services, as may an affiliate of a savings association (if it does not have a member bank affiliate).

Most parties seem to agree that the restrictions on sponsoring, underwriting, and distributing mutual funds are insignificant in practical terms. Shares of mutual funds are not "underwritten" in the traditional sense, whereby an underwriter commits as principal to purchase large blocks of securities for resale to the public or agrees to use its "best efforts" to sell securities to the public. Instead, investors generally purchase shares of mutual funds either directly from a fund or from securities firms, financial planners, life insurance organizations, or depository institutions. An official of one bank we visited said that he did not regard the Glass-Steagall prohibitions on sponsorship and underwriting as a necessary guard against conflicts of interest. In his opinion, the original (1933) concern about a bank exposing itself to risk by acting as principal in the underwriting of securities does not apply to the issue of bank sales of mutual funds because the bank sells mutual funds on an agency basis; since it does not act as principal, it does not expose its capital to risk.

The major cost of the Glass-Steagall restrictions to banks is that they must contract with unaffiliated distributors that perform underwriting functions in return for fees. One banker told us that the elimination of the Glass-Steagall provisions that prevent commercial banks from underwriting securities would eliminate the banks' need to hire such organizations and pay such fees. He also said that without Glass-Steagall restrictions, the banks might be able to operate more efficiently.

Conclusions

Eliminating banks' exemption from the Securities Exchange Act of 1934 and requiring that all mutual fund sales by banks be conducted through broker-dealers, as suggested by SEC, currently would affect less than 10 percent of all banks. Banks that sell mutual funds directly through their own employees rather than a broker-dealer generally do so either because they want to maintain control of their customer relationship or they do not have a sufficient volume of business to justify establishing a relationship with a broker-dealer. Eliminating the exemption would allow SEC and self-regulatory organizations, such as NASD, to enforce the securities laws

uniformly in connection with the sale of mutual funds. However, the fact that SEC does not now have oversight of direct retail sales by bank employees does not mean that these banks are free to conduct these sales without any supervision. The bank regulators' interagency guidance applies to all sales activities on the premises of the banking institution, regardless of whether they are done through a broker-dealer or directly by a bank employee, and the banking regulators have taken steps in their examinations to increase their scrutiny of banks' compliance with the guidance.

Similarly, removing the exemption from the definition of investment adviser under the Investment Advisers Act of 1940 for banks that advise funds, as suggested by SEC, would allow SEC to more fully inspect previously unregistered advisers to determine that the adviser is carrying out securities transactions in a way that is fair to all of its clients, including the mutual fund. However, removing the exemption may also permit SEC to make limited inspections of bank activities that have been solely within the domain of the banking regulators, such as transactions involving trust accounts. These activities are regularly examined by the banking regulators. The banking regulators' examinations, however, focus principally on safety and soundness considerations, rather than on compliance with the securities laws.

Although removing the exemptions would allow the securities regulators to extend their oversight of banks' mutual fund activities, this action would not, by itself, resolve conflict and overlap among the regulators. This is because the banking regulators in their role of overseeing the safety and soundness of banks would continue to be involved in conducting examinations and issuing rules and guidance on banks' securities activities. Although the regulators have taken some actions to work more closely together, as in the January 1995 agreement between NASD and the banking regulators on coordinating their examinations, there are areas in which additional coordination would be desirable. For example, although NASD's December 1994 proposed rules governing securities broker-dealers operating on bank premises paralleled the interagency guidance in many respects, they have caused controversy because they contain provisions that differ from the banking regulators' interagency guidance. NASD officials commenting on this report said these differences are purposeful and provide a more explicit, well-defined, and enforceable approach to regulating these NASD members. In addition, the banking regulators and SEC do not currently have an agreement to coordinate their oversight of investment advisers similar to the one between NASD and the banking

regulators for sales practice examinations. SEC is concerned that OCC examiners will be attempting to enforce securities laws as part of their examinations of investment advisers, and it would appear that development of such an agreement, to include a common approach for conducting and coordinating these examinations, would help eliminate overlapping examinations and conflicting guidance.

Recommendation

We recommend that SEC, the Federal Reserve, FDIC, OTS, and OCC work together to develop and approve a common approach for conducting examinations of banks' mutual fund activities to avoid duplication of effort and conflict, while providing efficient and effective investor protection and ensuring bank safety and soundness.

Agency Comments and Our Evaluation

Each of the organizations (SEC, NASD, OCC, FDIC, the Federal Reserve, and OTS) that provided comments on a draft of this report supported our recommendation. Several agencies cited efforts that have been recently completed or are currently under way to work closely together, including implementing the January 1995 agreement between the banking regulators, SEC, and NASD to coordinate examinations. However, OCC believed the report overemphasized the potential for inconsistent or contradictory regulation.

In addition, SEC and OCC stated that in June 1995 they reached agreement on a framework for conducting joint examinations of mutual funds and advisory entities in which both agencies have regulatory interests. Their comments indicated that they expect this agreement to result in increased coordination and result in more efficient oversight of bank mutual fund activities. According to SEC, its staff and OCC staff have informally discussed examination procedures and are beginning to schedule joint examinations. SEC also stated that its staff has met preliminarily with the staff of FDIC to discuss entering into a similar arrangement.

Objectives, Scope, and Methodology Survey of Banks and Thrifts

Congress asked us to determine the extent of bank and thrift involvement in the mutual fund industry and to assess mutual fund sales practices followed by those banks and thrifts. To respond to this request, we developed and mailed questionnaires to a random sample of 2,610 banks and 850 thrifts. The results of that survey are representative of the entire bank and thrift industry.

Our questionnaire gathered data on the number and type of funds offered for sale and also on the dollar amount of sales in 1992 and 1993. We also asked questions about bank and thrift policies and procedures for the sale of mutual funds. The fieldwork for the survey was conducted from February through June of 1994.

Survey Sample Plan

We developed the survey frame (a listing, without duplicates or omissions, of each element in the population of U.S. banks and thrifts) from a file containing the June 1993 Call Report data. This database listed 13,360 banks. After removing International Banking Associations and New York Investment Companies (which we felt were mostly commercial institutions unlikely to have retail mutual fund sales programs), our frame contained 11,769 banks. To that we added the 1,841 thrifts in another part of the June 1993 Call Report database, for a total population, or universe, of 13,610 banks and thrifts.

From this frame, we randomly sampled 3,460 banks and thrifts. We divided the institutions in the frame into 20 strata (see table I.1), and we distributed our sample across those strata so that survey estimates from each stratum would be likely to have sampling errors for the most important questions of no more than ± 5% at the 95-percent level of confidence. Unless otherwise noted, the survey statistics in this report have sampling errors within that range.

Because we surveyed only one of a large number of possible samples of the bank and thrift population to develop the statistics used in this report, each of the estimates made from this sample has a sampling error, which is a measure of the precision with which the estimate approximates the population value. The sampling error is the maximum amount by which estimates derived from our sample could differ from estimates from any other sample of the same size and design and is stated at a certain confidence level, usually 95 percent. This means that if all possible samples were selected, the interval defined by their sampling errors would include the true population value 95 percent of the time. In addition to

sampling error, all sample surveys may also be subject to error from a number of other sources, as described in the section on survey error and data quality below.

Questionnaire Design and Administration

We developed our questionnaire in consultation with experts in the finance industry and at regulatory agencies, and we conducted six pretests with banks that represented a range of sizes and regulators. We made revisions to the questionnaire on the basis of the comments we received. See appendix II for a complete copy of the questionnaire.

We addressed each questionnaire to the office of the President or CEO at each institution, using the mailing address information listed in the Call Report file.

We mailed questionnaires to all 3,460 sampled banks and thrifts in early February of 1994. To the 1,453 institutions not responding to our survey by the end of March 1994, we sent a follow-up questionnaire on April 1, 1994. We ended the fieldwork for this survey on June 16, 1994, discarding any questionnaire returned after that date.

Survey Response

By the end of the survey fieldwork period, we had received 2,519 completed questionnaires, accounting for 74 percent of the banks and thrifts in our sample. Table I.1 displays, by strata, the dispositions of the questionnaires we sent out. Because banks and thrifts in different strata were sampled at different rates, and because institutions responded at different rates across the strata, the survey estimates made in this report were weighted, or statistically adjusted, so that the answers given by institutions in different strata were represented in proportion to their actual numbers in the entire population.

There was a tendency for the smaller institutions (in terms of asset size) to respond at higher rates than larger institutions. Also, those responding early in the survey period tended to be the banks and thrifts not selling mutual funds (such questionnaires required little work on the part of our respondents, making it easier to fill out the questionnaire.) While we have no reason to believe that these patterns of response had any impact on the accuracy of the survey estimates, we conducted no follow-up contacts with any of the nonrespondents to determine if their answers were significantly different from those who did respond.

Table I.1: Survey Dispositions of Sampled Banks and Thrifts

Strata (institution type and asset size)	Original population[a]
FRS national banks up to $150 million	2,514
$150-$250 million	348
$250 MM-$1 billion	388
$1 billion and up	202
FRS state banks up to $150 million	749
$150-$250 million	76
$250 MM-$1 billion	84
$1 billion and up	63
FDIC banks up to $150 million	5,900
$150-$250 million	428
$250 MM-$1 billion	350
$1 billion and up	108
Mutual savings banks up to $150 million	272
$150-$250 million	100
$250 MM-$1 billion	140
$1 billion and up	47
Thrifts up to $50 million	486
$50-$100 million	440
$100 MM-$1 billion	778
$1 billion and up	137
Totals	**13,610**

Questionnaires mailed out			Questionnaires received			
Initial sample	Ineligible[b] from sample	Adjusted sample[c]	Returned undeliverable by Post Office[d]	Returned unusable questionnaire[e]	Returned usable questionnaire	Response rate[f]
350	2	348	12	2	265	76%
174	4	170	6	0	122	72
194	5	189	10	0	98	52
150	4	146	4	2	75	51
270	1	269	8	1	207	77
76	2	74	4	0	47	64
84	0	84	3	0	55	65
63	1	62	5	0	33	53
375	4	371	9	2	284	77
214	2	212	7	0	143	67
175	4	171	13	1	120	70
108	2	106	10	1	59	56
150	4	146	1	0	123	84
80	0	80	0	0	69	86
100	1	99	1	0	85	86
47	0	47	1	0	34	72
243	1	242	1	0	208	86
220	3	217	1	0	191	88
250	3	247	2	2	196	79
137	0	137	2	0	105	77
3,460	**43**	**3,417**	**100**	**11**	**2,519**	**74**

[a]All banks and thrifts identified in the June 1993 Call Report, except International Bank Associations and New York Investment Companies.

[b]Sampled elements outside the survey population due to no existing address, merger, receivership, or other cessation of operations as a depository institution.

[c]Number in original sample minus number ineligible.

[d]Sampled elements in the survey population, but questionnaire returned undeliverable due to insufficient address or unknown address and forwarding order expiration.

[e]Blank, incomplete, or refused questionnaire returned, or returned after cutoff date.

[f]Response rate calculated as the number of banks and thrifts completing usable questionnaires divided by the number of eligible banks and thrifts in the adjusted sample.

Survey Error and Data Quality

In addition to the presence of sampling errors, as discussed above, the practical difficulties of conducting any survey may introduce other types

of errors, commonly referred to as nonsampling errors. For example, differences in how a particular question is interpreted, in the sources of information that are available to respondents, or in the types of people who do not respond can introduce unwanted variability into the survey results.

We included steps in both the data collection and data analysis stages for the purpose of minimizing such nonsampling errors. We selected our sample from the most complete and up-to-date listing of banks and thrifts available, and we attempted to increase the response rate by conducting a follow-up mailing accompanied by cover letters stressing the importance of the survey. To minimize errors in measurement, we pretested the questionnaire thoroughly and obtained reviews from industry experts and agency officials.

To ensure data processing integrity, all data were double-keyed and verified during data entry. Computer analyses were performed to identify inconsistencies or other indication of errors, and all computer analyses were checked by a second independent analyst. Finally, we performed limited validation of a number of returned questionnaires through contacts with respondents or review of other agency records.

Bank Shopper Survey/Bank Shopper Visits/Shopper Audit

To help determine what sales and disclosure practices are being followed by banks selling mutual funds, we visited branches of 89 randomly selected banks and thrift sellers of mutual funds in 12 metropolitan areas. GAO evaluators posing as retail customers shopping for mutual fund investment opportunities received sales presentations and assessed the physical characteristics of the sales area, the roles played by bank and broker personnel they made contact with, the risk disclosures made by sales personnel, and the written information provided as part of the sales presentations.

The results of the visits are statistically generalizable to the larger population of institutions offering mutual funds for sale across the 12 metropolitan areas. While the results can be projected to that banking community in the aggregate, they cannot be used to definitively assess any one bank's practices, due to the potential variability in a bank's practices, because we met with only one salesperson, at one branch, on one day. The fieldwork was conducted between March 25, 1994, and April 13, 1994.

Visit Sample Plan

Banks and thrifts were selected in 12 metropolitan areas only where GAO had field offices (see table I.2). Only banks and thrifts in the Metropolitan Statistical Area[35] surrounding these cities were considered.

Banks and thrifts were selected primarily from the sample frame of the mail questionnaire survey (see table I.3). A list was developed of those banks that had returned questionnaires and identified themselves as mutual fund sellers and of those not yet returning the questionnaire, some of which could be mutual fund sellers. Banks and thrifts responding that they did not sell mutual funds were automatically excluded from the sample. In addition, a number of FDIC and FRS national banks with assets under $150 million were selected into the sample directly from the Call Report database even though they were not included in the mail questionnaire survey frame, because this group was initially underrepresented in the shopper's visit sample.

All banks and thrifts in the sample were screened through telephone calls to their main branch, headquarters office, or customer services department to discover or confirm that they sold mutual funds, without the identity of the caller as a GAO evaluator being disclosed. Only those banks and thrifts selling mutual funds remained candidates for a visit. During this call, we also determined the branch or office location that was to be visited.

In choosing which location to visit within a bank or thrift, we attempted to locate the main branch, headquarters office, "model" branch, or largest location that sold mutual funds. If no such single location existed, or if mutual funds were sold only by appointment with a sales representative at any location, we attempted to visit the largest location that was most convenient for the shopper team to visit. We visited only one location for each sampled bank.

[35]A Metropolitan Statistical Area is a relatively free-standing metropolitan area centered around a large population nucleus, and it includes adjacent communities that have a high degree of economic and social integration with that nucleus. It is a standard geographical designation used by the Bureau of the Census.

Table I.2: Geographical Distribution of Shopper Visit Sample

Metropolitan statistical area	Visits completed
Atlanta	4
Boston	12
Chicago	13
Cincinnati	3
Dallas	6
Denver	6
Los Angeles	10
New York	16
Philadelphia	5
St. Louis	3
San Francisco	7
Seattle	4
Total	**89**

Table I.3: Source and Disposition of Shopper Visit Sample

		Sample		
Category	Population in 12 cities	Unscreened (sellers and nonsellers)	Screened (sellers only)	Complete visits
Banks in mail survey frame				
Found to NOT sell mutual funds	376	0	0	0
Found to sell mutual funds	94	44	44	32
No response to questionnaire	410	248	103	55
Banks outside mail survey frame				
Small Banks	509	37	3	2
All Others	839	0	0	0
Total	**2,228**	**329**	**150**	**89**

Design and Implementation of Visit Methods

GAO evaluators, posing as prospective mutual fund investors, were trained to follow a scripted visit to each sampled bank or thrift. Most of the visits were conducted by pairs of GAO testers. Throughout their contacts with bank and thrift personnel, they presented themselves as investors with $5,000 to $10,000 in expiring Certificate of Deposit funds, trying to obtain information on mutual funds in which to invest. Without revealing their identities as GAO evaluators, they were to observe the layout of the sales on that occasion and to note the statements made by the sales representative

and other personnel they contacted in the bank or thrift. See appendix III for a copy of the questionnaire filled out by the shopper teams after each visit.

The general plan of the visits consisted of four parts: an initial observation of the lobby and platform area of the branch office; direct contact with personnel at the teller window to inquire about mutual fund investments; the sales presentation; and collection of brochures and other written documents for proprietary mutual funds, if any.

In the first part of the visit, shopper teams assessed the degree of separation between the mutual funds sales area and the platform areas where more traditional bank products were sold. In addition to physical separation, the shopper teams recorded their observations of how the bank or thrift designated the mutual fund sales area, perhaps through signs or banners. At the teller window, the shoppers were to state: “I have a CD maturing soon. What kinds of mutual funds do you sell here? Can you recommend one?” The teller’s response and subsequent actions were also recorded on the questionnaire. Upon contacting the sales representative in the third stage of the visit, the evaluators repeated their query and offered only the limited biographical information about their financial situations described above. After the sales presentation, shoppers asked for proprietary mutual fund brochures to review later.

After leaving the bank or thrift, both testers (for visits with two testers assigned) filled out the questionnaire on their own and then resolved any disagreements in their questionnaires while completing a third questionnaire together with the final data.

Analysis and Statistical Significance

Because of the limited scope of our investigation into the sales practices of each of the 89 banking institutions, we cannot make definitive statements about each institution’s operations. However, analyzing the shoppers’ data in the aggregate, we can make overall assessments of the approximately 552 banks that we project sell mutual funds in the 12 metropolitan areas that we studied.

The results of the shoppers’ visits are weighted to represent the entire population of mutual fund-selling banks. The precision of the data is subject to sampling and nonsampling error, as with the mail questionnaire survey (see page 72). The sampling errors associated with the shoppers’ visits are disclosed in various footnotes in chapter 3 of this report. To

reduce the presence of such errors, we pilot-tested the data collection protocol in 27 visits before finalizing it. Also, by having pairs of testers fill out the questionnaires separately before completing a consensus version for their final answers, we were able to gauge the reliability of the measures we were using.

Questionnaire

United States General Accounting Office

Survey of Banks and Thrifts on Mutual Fund and Securities Activities

INSTRUCTIONS

This questionnaire asks whether any retail mutual fund or other securities sales or services are taking place at this bank or thrift, and requests basic information about any such activities. It can be completed by the president or CEO, or by another officer familiar with the financial products and services made available by this bank or thrift.

Please answer all questions in terms of retail mutual fund and securities sales activities carried out on the premises of this bank or thrift, or in any of its offices, branches, or subsidiaries.

If you have any questions, please call Ms. Dorothy LaValle at (212) 264-6468, or Mr. Jeffrey Shapiro at (212) 264-9314. Please return the completed questionnaire in the enclosed envelope within 5 working days of receipt. In the event the envelope is misplaced, the return address is:

U.S. General Accounting Office
Mr. Frank J. Philippi
441 G Street, NW, Room 3126
Washington, D.C. 20548

Thank you for your help.

BACKGROUND

1. Please provide the following information so that we can contact you if we need to clarify an answer.

Name of Primary Respondent: ______________________

Title: ______________________

Institution: ______________________

Address: ______________________

____

Phone: (   ) ______________________

PRODUCTS AND SERVICES OFFERED

2. Does this bank or thrift currently make available for sale any of the following products or services to its retail customers? *(Check "Yes" or "No" for each row.)*

	Yes	No
Mutual funds? (stock or bond funds, money market mutual funds, etc.)		
Any other retail securities brokerage services or products? (for example: stocks, bonds, financial planning or investment advice, etc.)		

IMPORTANT INSTRUCTIONS:

If you answered "NO" in both rows of Question 2, check below, and STOP:

☐ NO MUTUAL FUND OR SECURITIES ACTIVITIES

Thank you for your time and care in filling out this questionnaire; please return it in the envelope provided, or mail it to the address found on this page.

If you answered "YES" in any row in Question 2, CONTINUE:

This survey contains one section on mutual fund sales and a second section on other securities brokerage activities. Some banks or thrifts will complete only one of these sections; others will complete both.

Please turn the page and follow the directions to complete the section(s) applicable to your bank or thrift.

The following section contains questions about mutual fund sales. If your bank or thrift makes available any mutual funds to its retail customers, please CONTINUE with question 3. If your bank or thrift does NOT make any mutual funds available for sale, please check the box below and turn to page 14.

☐ NO MUTUAL FUND SALES --------> *(Skip to page 14.)*

MUTUAL FUNDS

3. When did your bank or thrift begin selling mutual funds to retail customers? *(Check only one box.)*

1. ☐ Less than two years ago
2. ☐ 2 to 3 years ago
3. ☐ 4 to 5 years ago
4. ☐ 6 to 7 years ago
5. ☐ More than 7 years ago

----

6. ☐ Do not know

4. Of how much importance were the following factors in your bank or thrift's decision to begin selling mutual funds to its retail customers? *(Check only one box in each row.)*

	Very great importance	Great importance	Moderate importance	Some importance	Little or no importance	Do not know
Retention of customers						
Fee income						
Other: *(please describe)*						

5. How many of the following types of mutual funds were available for sale to retail customers as of December 31, 1993?

(Enter number of individual funds offered in each category, or "0" if none. Estimate where necessary, and indicate your answer as such. By "proprietary," we mean a fund for which your bank or thrift acts as an investment advisor and which is marketed primarily to your customers.)

	Proprietary (bank-advised)	Non-proprietary
Money Market Funds	No.	No.
Equity Funds	No.	No.
Fixed Income Funds	No.	No.
Balanced Funds (mix of bonds and equities)	No.	No.

6. What were the total dollar amounts of money market mutual fund sales to retail customers in calendar years 1992 and 1993?
(Enter dollar figures of all sales in each category -- initial as well as subsequent purchases -- or "0" if none. Estimate where necessary, and indicate your answer as such.)

Money Market Funds	Proprietary (bank-advised)	Non-proprietary
Total retail sales -- 1992	$	$
Total retail sales -- 1993	$	$

7. What were the total dollar amounts of any equity, fixed income and balanced mutual fund sales to retail customers in calendar years 1992 and 1993?
(Enter dollar figures of all sales in each category -- initial as well as subsequent purchases -- or "0" if none. Estimate where necessary, and indicate your answer as such.)

Equity, Fixed Income & Balanced Funds	Proprietary (bank-advised)	Non-proprietary
Total retail sales -- 1992	$	$
Total retail sales -- 1993	$	$

8. How does this bank or thrift sell <u>money market mutual funds</u> to its retail customers?
(Check either "Yes" or "No" for each row, or leave table blank if no such funds sold.)

Money Market Funds	Yes	No
Directly by employees of this bank or thrift		
By dual employees of this bank or thrift (or its affiliate/subsidiary) and a registered broker-dealer		
Through an affiliate or subsidiary organization		
Through a networking or leasing arrangement with a registered broker-dealer (or other third party)		
Other sales arrangement: *(please describe)*		

9. How does this bank or thrift sell <u>equity, fixed income and balanced mutual funds</u> to its retail customers?
(Check either "Yes" or "No" for each row, or leave table blank if no such funds sold.)

Equity, Fixed Income & Balanced Funds	Yes	No
Directly by employees of this bank or thrift		
By dual employees of this bank or thrift (or its affiliate/subsidiary) and a registered broker-dealer		
Through an affiliate or subsidiary organization		
Through a networking or leasing arrangement with a registered broker-dealer (or other third party)		
Other sales arrangement: *(please describe)*		

10. Where may retail customers open money market mutual fund accounts on the premises of your bank or thrift? *(Check either "Yes" or "No" for each row. Leave table blank if no such funds.)*

Money Market Funds	Yes	No
At teller windows		
In areas where customers open insured deposit accounts (i.e., platform areas)		
In designated and physically separated areas		
At designated desks (e.g., by signs or at kiosks) in lobbies or platform areas (not physically separated)		
Onsite to obtain applications, but thereafter by telephone with broker-dealer		
Off-site locations		
Other location: *(please describe)*		

11. Where may retail customers open equity, fixed income and balanced mutual fund accounts on the premises of your bank or thrift? *(Check either "Yes" or "No" for each row. Leave table blank if no such funds.)*

Equity, Fixed Income & Balanced Funds	Yes	No
At teller windows		
In areas where customers open insured deposit accounts (i.e., platform areas)		
In designated and physically separated areas		
At designated desks (e.g., by signs or at kiosks) in lobbies or platform areas (not physically separated)		
Onsite to obtain applications, but thereafter by telephone with broker-dealer		
Off-site locations		
Other location: *(please describe)*		

12. Does this bank or thrift permit customers to make some kinds of mutual fund transactions through an ATM system? *(Check only one box.)*

1. ☐ Yes *(Continue with question 13.)*
2. ☐ No *(Skip to question 15.)*

----

3. ☐ Not applicable - no ATM system *(Skip to question 15.)*
4. ☐ Do not know *(Skip to question 15.)*

13. IF ATM TRANSACTIONS PERMITTED:
Which of the following types of <u>money market mutual fund</u> transactions may be made through an ATM system? *(Check either "Yes" or "No" for each row. Leave table blank if no such funds.)*

Money Market Funds	Yes	No
Purchase additional shares in existing funds		
Sell shares		
Transfer shares among fund portfolios		
Other transactions: *(please describe)*		

14. IF ATM TRANSACTIONS PERMITTED:
Which of the following types of <u>equity, fixed income and balanced mutual fund</u> transactions may be made through an ATM system? *(Check either "Yes" or "No" for each row. Leave table blank if no such funds.)*

Equity, Fixed Income & Balanced Funds	Yes	No
Purchase additional shares in existing funds		
Sell shares		
Transfer shares among fund portfolios		
Other transactions: *(please describe)*		

15. Which of the following functions, if any, may your bank or thrift's personnel perform in your mutual fund sales program? *(Check all boxes that apply -- if a particular personnel type may perform a particular function, check the box corresponding to that combination, otherwise leave that box blank. Write "N/A" in boxes corresponding to personnel types that do not exist at your bank or thrift.)*

Functions:	Personnel: Tellers	Platform personnel (without securities licenses)	Dual employees of the bank or thrift and broker-dealer	Bank and branch managers
Discuss investment needs of customer and non-insured products available through your bank or thrift				
Suggest that a customer should invest in a specific investment product instead of another				
Hand out brochures or prospectuses for specific mutual funds or fund families				
Refer customers to an investment specialist or registered representative				
Accept investment orders or payments from customers				

16. Does your bank or thrift have written policies or written procedures regarding any of the following issues pertaining to mutual fund sales? *(Check either "Yes" or "No" for each row.)*

	Yes	No	Don't know
Functions of the bank or thrift's employees in mutual fund sales program			
Function and responsibilities of third party entities engaged in mutual fund sales program			
Types of mutual fund products to be made available for sale			
Permissible use of customer account information (e.g., marketing)			
Training of the bank or thrift's sales personnel regarding the mutual fund sales program			
System to detect sales abuses			
System to monitor customer complaints			
Guidelines for bank or thrift's management personnel regarding customer protection procedures and customer complaints at branch level			
Disclosures that must be made to retail customers			

17. IF ANY MUTUAL FUNDS SOLD DIRECTLY BY EMPLOYEES OF THIS BANK OR THRIFT (Refer to Qns. 8 and 9): Which of the following qualifications, if any, does your bank or thrift require for its personnel who sell mutual funds? *(Check either "Yes" or "No" for each row. Leave blank if no funds are sold directly by your employees.)*

	Yes	No	Don't know
NASD Series 6 equivalent training			
NASD Series 7 equivalent training			
Securities industry experience			
Other qualifications: *(please describe)*			

18. Which of the following types of compensation do personnel involved in mutual fund referrals or sales at your bank or thrift receive?
(Check all boxes that apply -- if a particular personnel type, who is in any way involved with the sale of mutual funds, receives a particular form of compensation, check the box corresponding to that combination, otherwise leave that box blank. Write "N/A" in boxes corresponding to personnel types that are in no way involved in your mutual fund sales program.)

	Personnel:				
Compensation:	Tellers	Platform personnel (without securities licenses)	Dual employees of the bank or thrift and broker-dealer	Registered representatives of broker-dealers	Bank and branch managers
Straight salary only					
Commission only					
Salary and commission					
Referral payments					
Bonus payments					
Gifts, travel, or payments as part of an incentive program					
Other compensation: *(please describe)*					

19. Do sales personnel receive greater compensation or special incentives for selling proprietary funds than for selling non-proprietary funds? *(Check only one box.)*

1. ☐ Yes *(Continue with next question.)*
2. ☐ No *(Skip to question 21.)*

----

3. ☐ Not applicable - do not sell both types of funds *(Skip to question 21.)*
4. ☐ Do not know *(Skip to question 21.)*

20. IF YES:
Please describe how compensation or incentives differ between sales of proprietary and non-proprietary funds:

____

____

____

21. Are sales personnel expected to meet quotas or targets for the sale of proprietary funds? *(Check only one box.)*

1. ☐ Yes *(Continue with next question.)*
2. ☐ No *(Skip to question 23.)*

----

3. ☐ Not applicable - do not sell proprietary funds *(Skip to question 23.)*
4. ☐ Do not know *(Skip to question 23.)*

22. IF YES:
Please describe these sales quotas or targets for proprietary funds:

____

____

____

23. Does your bank or thrift provide sales personnel with an approved, or preferred list of mutual funds to recommend for sale? *(Check only one box.)*

1. ☐ Yes *(Continue with next question)*
2. ☐ No *(Skip to question 25.)*

---

3. ☐ Do not know *(Skip to question 25.)*

24. Of how much importance are each of the following factors in the selection of the non-proprietary mutual funds or fund families that are on the approved/preferred list for sale to retail customers?
(Check only one box in each row. Leave table blank if no non-proprietary funds sold.)

	Very great importance	Great importance	Moderate importance	Some importance	Little or no importance	Do not know
Knowledge/experience of fund adviser						
Performance over specific time period (i.e., total return)						
Performance in up and down markets						
Performance as rated by nationally-recognized organization such as Lipper or Morningstar						
Customer service reputation						
Mix of funds available within a family						
Name recognition						
Customer/market demand						
Potential fee income						
Other: *(please describe)*						

25. Are there any types of mutual funds (e.g., junk bond funds) that your bank or thrift will not recommend for sale to any of your retail customers? *(Check only one box.)*

1. ☐ Yes -----> *Please describe that policy:*

____

____

____

2. ☐ No

3. ☐ Do not know

26. How does your bank or thrift (or any third party provider) market the mutual funds it makes available for sale? *(Check either "Yes" or "No" for each row.)*

	Yes	No	Don't know
Displays and advertisements for mutual funds in bank or thrift's lobby			
Inserts in monthly account statements			
Newspaper advertisements			
Radio or television commercials			
Targeted mailings to non-bank customers			
Targeted mailings to existing bank customers (e.g., holders of CD's)			
Telephone calls			
Investment seminars			
Other: *(please describe)*			

27. Does your bank or thrift provide information, such as customer account balances or CD maturity dates, to mutual fund sales personnel? *(Check only one box)*

1. ☐ Yes -----> *Please briefly identify the personnel and the information provided:*

   ____

   ____

   ____

2. ☐ No

----

3. ☐ Do not know

28. Are mutual fund sales personnel required to disclose any of the following?
(Check either "Yes" or "No" for each row. If "Yes," please indicate whether this disclosure is required to be acknowledged in writing.)

	Disclosure required?		IF YES: Are customers required to acknowledge this disclosure in writing?	
	No	Yes	No	Yes
Relationship of sales personnel to bank or thrift (e.g., bank or thrift employee, third party affiliate, etc.)				
Mutual fund is not a bank deposit				
Mutual fund is not FDIC insured				
Mutual fund is not guaranteed and could involve loss of principal				
Differences between insured deposits and investment in mutual fund				
Fund expenses (i.e., management fees and sales charges)				
Potential costs of switching to another mutual fund				
Breakpoints for reduced sales charge options				
Mutual fund performance information				
Other: *(please describe)*				

29. In which of the following ways, if any, do any of the parties involved in your mutual fund program monitor mutual fund sales? *(For each row, check all columns that apply.)*

Monitoring:	Party performing monitoring:			
	None	Your Bank/Thrift	3rd Party/ Broker-Dealer	Don't know
Daily review of trades				
Monthly review of trades				
Visits by management to sales locations				
Internal audit department reviews				
Exception reporting system				
Customer complaints				
Secret shopper surveys				
Customer surveys				
Other: *(please describe)*				

30. Has this bank or thrift ever made loans to its proprietary funds, within the limits imposed by Section 23A of the Federal Reserve Act? *(Check only one box.)*

1. ☐ Yes
2. ☐ No

---

3. ☐ Not applicable - no proprietary funds
4. ☐ Do not know

The following questions refer to securities brokerage services and products, other than mutual funds. If your bank or thrift makes any such services or products available to its retail customers, please CONTINUE with question 31. If your bank or thrift DOES NOT make such services or products available, please check the box below and skip to the last page:

☐ NO SECURITIES BROKERAGE ACTIVITIES -----------> *(Skip to page 15.)*

SECURITIES BROKERAGE SERVICES

31. Which of the following best describes this bank or thrift's retail securities brokerage operations:
(Check only one box.)

1. ☐ Investment advice and/or buy and sell recommendations in conjunction with executing customer buy and sell orders (full service brokerage).
2. ☐ Acting solely as an agent in executing customer buy and sell orders (discount brokerage).
3. ☐ Placing buy and sell orders as a service only when requested by a customer or to facilitate other transactions (accommodation brokerage).

Please explain if necessary:

____

____

____

32. How are securities brokerage services made available for sale at this bank or thrift? *(Check one box in each row.)*

	Yes	No
Directly by employees of this institution		
By dual employees of this institution/affiliate/subsidiary and a registered broker-dealer		
Through affiliate or subsidiary broker dealer		
Through a networking or leasing arrangement with a registered broker-dealer (or third party)		
Other arrangement: *(please describe)*		

COMMENTS

33. If you have any comments on this questionnaire, or on the issues raised in it, please use the space provided below, and attach additional sheets if necessary.

Thank you for your time and care in filling out this questionnaire.
Please return it in the envelope provided, or mail it to the address on the front within 5 working days.

GGD/CR/1-94/233392

Data Collection Instruments for Shoppers' Visits

Attachment II: SHOPPER QUESTIONNAIRE b:\dci.321 3/1/94
Review of Mutual Fund Sales Through Banks (Job code: 600338)

BANK CONTACT SHEET ID#______________

I. BACKGROUND

Auditors' Name(s)____

Bank Name:____

City: ____

II. CONTACT DISPOSITION

Record numbers called, names of departments, offices and employees contacted or visited.

Location Visited or Person Contacted	Date/Time	Outcome*	Notes
1st contact (main office phone call):			
2nd contact:			
3rd contact:			
4th contact:			
5th contact:			

***Commonly Used Codes:** 1 = No mutual fund sales

2 = Visit location selected or appointment made
3 = Referred to other location/person
4 = Test complete
5 = Test cancelled/incomplete (describe)
6 = Other outcome (describe)

III. Final Visit Location

Record the following data about the location where you actually received the sales presentation.

Address of office visited: ______________________________

____

Type of office visited:

1. ____ Main bank office/headquarters branch

2. ____ Other bank branch

3. ____ Limited service/specialty bank branch (e.g., money center, etc.)

4. ____ Non-bank offices (e.g., broker dealer)

5. ____ Other office:

____

____

NOTE: If mutual funds NOT sold at this bank, just return completed contact sheet. If mutual funds sold, attach contact sheet to completed questionnaire.

SHOPPER QUESTIONNAIRE ID #________

The purpose of the shopper survey is to test whether salespersons are following regulatory guidance concerning mutual fund sales. The extent to which salespersons are discussing the risks involved in mutual fund investments to bank customers who are rolling over mature Certificates of Deposit is especially important. Two congressional committees are concerned that bank customers understand the risks and, most importantly, that **mutual funds are not insured, are not bank deposits, not an obligation of the bank, and that there could be loss to one's principal.**

The background material gives the regulatory criteria on mutual fund sales through banks from the bank and securities regulators. The background material also contains guidance for shoppers on what to expect if banks have implemented these guidelines.

Shopper Profile: **All shoppers have a certificate of deposit (CD) maturing soon at another bank or thrift. The return on CDs today is quite low and you are interested in the higher returns you have heard mutual funds offer. Therefore you are shopping, trying to obtain information on where to roll over your CD money into a mutual fund. Shoppers have not ever invested in mutual funds. You have $5,000 - 10,000 to invest.**

Shoppers should feel comfortable using their own name in the event there are introductions and it seems appropriate to introduce oneself. However, there should not be any need to give an address or telephone number. In the event a shopper is asked for this information, we suggest your response be "It's easier for me to call you as I'm hard to reach." Should the salesperson want personal financial data, we suggest shoppers respond that "At this point, I'm just getting information -- I'll call or come back if I want more information on what to buy. Thanks though."

Procedures: The shopping visit consists of four parts:

1) observation of the bank floor plan, specifically where mutual funds [and other investments] are sold;
2) a visit to the bank teller;
3) a discussion about mutual fund investments with a salesperson; and
4) an evaluation of the bank's brochures.

Some questions require shoppers to ask a specific question.

A questionnaire should be completed immediately after the visit by each shopper. Then the shopper pair should complete a third consensus questionnaire. All should be returned to Bryon Gordon.

PART ONE: PHYSICAL SETTING - WHERE MUTUAL FUNDS ARE SOLD

Instructions: As you know, banks and thrifts typically have a bank teller window area where one cashes checks, makes deposits and withdrawals to FDIC-insured savings accounts, etc. Typically also, there is an area of desks where bank customers may open new CD and other FDIC-insured accounts, apply for loans, etc. This is referred to as the platform area. In some banks, a platform desk or area may be used to sell investment products such as mutual funds. Or, the area/desks where mutual funds/investment services are provided may be in a separate office. See Attachment I for regulatory criteria on what banks should do should they sell mutual funds.

However, not all banks sell mutual funds on the bank's premises or have full-time sales staff. Using information obtained from telephone calls made before the visit or at the time of the visit, indicate where and how mutual funds are offered for sale. The telephone tips for determining which banks sell mutual funds and which locations to visit will help you answer this question.

1. Where and how are mutual funds offered for sale at this bank? (Check either yes or no for each row.)

		Yes	No
1.	Mutual funds are sold ON-SITE (bank branch or office) by a FULL-TIME sales representative		
2.	Mutual funds are sold ON-SITE by a PART-TIME representative, and/or by APPOINTMENT		
3.	Mutual funds are sold ON-SITE through a TELEPHONE connection with a sales representative		
4.	Mutual funds are sold at an OFF-SITE, NON-BANK location		
5.	Other, please explain:		

If ON SITE (responses 1,2, and 3), CONTINUE WITH questions 2-6a.

If OFF SITE (response 4), and not at a bank branch or office, SKIP TO question 6b.

Instructions: Look over bank lobby area during your visit so that you can briefly describe the layout of the bank, i.e. where mutual funds and other investments are sold. For example, a bank may have a hanging sign, a kiosk of brochures on a desk or other signs to tell customers that this is the investment services desk. The desk may be, however, in the general platform area among desks where traditional banking activities and transactions take place (e.g.opening new FDIC-insured deposit accounts). See Attachment I, page 5 for guidance on how banks may separate physically and through use of signs their noninsured investment services such as mutual fund sales desks, from insured, deposit-taking activities.

2. For ON-SITE locations only:
How was the area or desk(s) used to sell mutual funds physically separated from the area or desks where traditional insured banking activities take place?
(Check either Yes or No for each row.)

	Yes	No
1. Desk was separated from banking activity desks by potted plants, roping, low wall or other type of partition.		
2. Investment services desk was in a cubicle within the bank's lobby area		
3. Investment services desk area was separated (set apart) from banking activities area by space, i.e. aisles or actual floor space. Estimate of how much space in feet: ______ ft.		
4. Investment services desk was in a separate office off the lobby - either solid or glass walls		
6. Other type of separation, please describe:		

Instructions: Questions 3 and 4 ask about the use of signs by the bank to indicate the desk or area in the bank at which mutual funds are sold. Some banks may use the term "Investment Services" or the name of the broker-dealer, third party which is actually selling the mutual funds.

3. For ON-SITE locations only:
How, or in what ways did the bank designate the mutual fund sales desk or area from the desks or areas where its regular FDIC-insured banking activities are conducted.
(Check either Yes or No for each row.)

	Yes	No
1. Hanging sign over desk		
2. Sign on desk to designate desk as mutual fund sales area		
3. Sign[s] on door, wall or other place marking mutual fund/investment service area		
4. Kiosk or display rack of brochures separating desk area from regular banking activity desks		
6. Other designation, please describe:		

4. For ON-SITE locations only:
Did the desk have a sign indicating that the products sold here are NOT insured by the FDIC?
(Check only one.)

1. ____ Yes

2. ____ No

5. For ON-SITE locations only:
To what extent was the bank successful in clearly distinguishing its mutual fund/investment services desk/area from its traditional banking activities area? By this we mean from not only the bank's teller windows, but also its customer service and new account desks where accounts and deposits may be taken, and other traditional banking activities take place. Take into consideration both the physical layout and use of signs. (Check only one.)

1. ____ Little or no extent
2. ____ To some extent
3. ____ To a moderate extent
4. ____ To a great extent
5. ____ To a very great extent

----

6. ____ Do not know/No basis to judge

6a. For ON-SITE locations only:
Briefly explain your rating by describing the layout. Take into consideration not only the physical setting, but also the presence (or lack of) signs, display racks, etc. If there was a sign indicating that the products are non-FDIC insured, describe the sign, size of printing (large and readable; fine print, etc.) and placement of sign (on desk, on wall where sign was hard to read, etc.)

____
____
____
____
____
____

and sketch (optional):

SKIP TO PART TWO.

6b. For OFF-SITE, NON-BANK location only:

Describe the OFF-SITE, NON-BANK location.
(For example: The off-site location was an office of a broker-dealer across the street.)

____

____

____

____

____

____

____

____

and sketch (optional):

SKIP TO PART THREE.

PART TWO: THE BANK TELLER

Procedure: All shoppers are to go to a bank teller window and ask this specific question:

"I have a CD maturing soon, what kind of mutual funds do you sell here? Can you recommend one?"

We are interested in assessing what bank tellers do in this situation.

Contingency note: As it is important to test the bank teller's behavior, visiting a bank teller should be the shopper's objective in all banks. However, in some banks, a customer may be greeted by a customer service person or another bank employee. In those instances, please explain you want to see the bank teller. In some banks, you may be referred by the bank teller to another bank employee who will take you to the investment services desk. Use Question 7 to describe the situation.

7. What did the bank teller say and do in response to the question, "I have a CD maturing soon, what kind of mutual funds do you sell here? Can you recommend one?" (Check either Yes or No for each row.)

	Yes	No
1. Discuss your investment needs in general?		
2. Tell you about non-insured (such as mutual funds, annuities) products available through the bank?		
3. Discuss specific mutual fund[s]?		
4. Recommend a specific mutual fund?		
5. Give you a generic brochure about investment products sold on bank premises?		
6. Give you specific brochures or prospectuses for specific mutual funds or fund families?		
7. Give you a business card of the salesperson/registered rep and/or refer you to him/her? (No introduction)		
8. Give you a referral form?		
9. Offer to make an appointment for you with the salesperson/registered representative?		

	Yes	No
10. Introduce you to another bank employee or to the salesperson/registered representative?		
11. Refer you to a designated telephone so you could talk to a sales representative located elsewhere		
12. Other action, please explain:		

7a. In the event that you were unable to complete the bank teller stop, please explain:

____

____

____

Instructions: If, after your visit to the bank teller, another bank employee introduced you to a sales representative or talked to you about the bank's services, answer question 8. If known, indicate title of this other bank employee, for example, branch manager.

8. Did another bank employee[s] introduce you or take you to the area where mutual funds are sold? (Check only one.)

1. ____ Yes
2. ____ No

8a. IF YES: Describe discussion with this employee briefly, and record the employee's title, if known:

____

____

____

GO TO PART THREE AND COMPLETE VISIT.

PART THREE: DISCUSSION WITH MUTUAL FUND SALESPERSON

Procedure: In most instances, you should be directed to a salesperson/registered sales representative - sometimes called an investment specialist or consultant - for information about and purchase of mutual funds. When beginning your conversation with the sales rep, you can repeat the question that you asked of the teller: **"I have a CD maturing soon, what kind of mutual funds do you sell here? Can you recommend one?"**
In your discussion with this person, keep in mind that we are interested in what this salesperson 1) tells you about his or her relationship to the bank; 2) what he/she discloses to you about the risks of investing in mutual funds; and 3) what he discloses to you about the risks of investing in bond funds in particular.

Step One: Determining the relationship of the salesperson to the bank.

Instructions: Shoppers are not to take the initiative and ask the salesperson what his or her relationship to the bank is. Rather, shoppers are asked to listen to determine the salesperson's relationship to the bank. Shoppers are, however, to ask for a business card at an appropriate time during or at the end of the visit.

Questions 9, 10 and 11 record what the relationship of the mutual fund sales person/operation to the bank is and how you found out this information.

9. Did the person orally and voluntarily identify his or her relationship to the bank (i.e. as a bank employee or a registered representative of a broker-dealer)? This would include telling you his/her relationship when he/she gave you a business card. (Check only one.)

1. ____ Yes

2. ____ No

10. In what other ways, whether or not the sales representative told you about his/her relationship to the bank, did you obtain information about the sales representative's relationship to the bank? (Check either Yes or No for each row.)

		Yes	No
1.	Gave you a business card which identified his/her relationship to the bank.		
2.	Disclosed relationship to bank when I asked for a business card.		
3.	Wore a name tag which disclosed relationship to bank (name tag included whether he worked for a securities firm or other).		
4.	Sat at a desk which was marked by signs, displays, etc. which identified sales representative and mutual fund services' relationship to bank.		
5.	Relationship of representative and mutual fund services was noted on a brochure.		
6.	Other, please describe:		

11. What is the relationship of the mutual fund sales representative to the bank? (Check either Yes or No for each row.)

		Yes	No
1.	Sales representative is a bank employee		
2.	Sales representative works for a broker-dealer		
3.	Not clear		
4.	Other, please describe:		

Step Two: What did the salesperson/registered representative tell you about the risks of investing in mutual funds?

Procedure: For this step, shoppers should listen and mentally track whether the sales representative discloses the four facts about mutual fund investments listed in question 11. We also ask shoppers to be alert to the manner in which the facts are disclosed and to describe any variance from an unbiased disclosure (for example, "the sales representative told us the risks involved, but minimized them by emphasizing the return.")

12. Did sales representative voluntarily tell you that an investment in a mutual fund: (Check Yes or No for each row.)

	Yes	No
1. Is not a bank deposit		
2. Is not FDIC insured		
3. Is not guaranteed by the bank		
4. That you could lose some of the principal amount you're investing?		

12a. Comment on how discussed (at what point in the discussion were disclosures made; how disclosed -- clarity, emphasis, seriousness given to statements, etc.); also itemize which part of 12, for example, 12.2 "not FDIC insured," the salesperson "discussed in conjunction with SIPC," for example.)

____
____
____
____
____
____

Step Three: What did the salesperson/registered representative tell you about the risks involved in investing in a bond fund?

Instructions: If the sales representative does not volunteer to discuss or recommend a bond fund, ask about bond funds - taxable or nontaxable - in a way which indicates that you, the shopper, understand these funds to be safe. The shopper should say,

"What about bond funds? -- I understand they're pretty safe investments."

In this case, note whether the risks involved - compared to renewing your CD, say - were explained to you.

[Note: In a bond fund, should interest rates rise, the underlying market value of the bond fund shares decline so that the shares which one has purchased are worth less; ergo there is loss to one's principal investment. NASD has told its members that "NASD members must make known to their customers that while higher yields may be realized on a bond fund, they must be balanced by disclosure that the customer's capital is exposed to a risk not present in ownership of a CD."]

13. Did the salesperson/registered representative voluntarily explain the effect of interest rate fluctuations - up or down - on the value of the underlying bonds in the fund and, consequently, the value of the fund shares? (Check only one.)

1. ____ Yes
2. ____ No
3. _____ N/A - bank does not sell bond funds

13a. Comment on the discussion (clarity, emphasis on stock funds or bond funds, seriousness given to statements, etc.)

____
____
____
____

Ending the discussion: Thank the salesperson/registered representative for taking the time to discuss their mutual fund choices/investments to you. Please obtain a business card and general brochures about the bank's investment services and specific brochures on mutual funds they make available for sale to retail customers.

PART FOUR: EVALUATION OF BANK LITERATURE ON MUTUAL FUND PRODUCTS

Instructions: Please obtain brochures of mutual funds sold by each bank visited. Mark each brochure with the bank's ID number and return with completed questionnaires.

In this segment of the survey, we are evaluating mutual fund sales literature of one type of mutual fund only - proprietary mutual funds. These are mutual funds for which the bank serves as an investment advisor. (See glossary) At this point, we are not evaluating sales literature issued by non-proprietary funds such as Fidelity, Dreyfus, or Putnam. Should you have any question as to whether the bank offers proprietary funds, call Bryon Gordon. We ask that you evaluate at least 2 mutual fund brochures, preferably proprietary ones. Do not use a prospectus or annual reports.

Please note the guidance provided by the Interagency Statement pertaining to advertisements and other promotional and sales material. This statement requires that all such material should conspicuously include, at a minimum, the following disclosures:

- not insured by the FDIC
- not a deposit or other obligation of, or guaranteed by, the depository institution; and
- subject to investment risks, including possible loss of the principal amount invested

In addition, sales literature must not suggest or convey any inaccurate or misleading impression about the nature of the product or its lack of FDIC insurance.

14. Does this bank sell proprietary mutual funds? (Check one.)

1. _____ Yes
2. _____ No

15. How many brochures for proprietary and non-proprietary mutual funds did you receive? (Enter numbers.)

1. _____ Number of proprietary fund brochures
2. _____ Number of non-proprietary fund brochures

If there are NO PROPRIETARY FUND BROCHURES, your bank visit is complete; you may return completed questionnaire to Bryon Gordon.

Instructions: Please answer the following questions about the first two brochures for proprietary funds that you received from the bank.

16. Did the mutual fund sales literature contain each of the following disclosures: (Check either Yes or No for up to two brochures.)

	Brochure #1		Brochure #2	
	Yes	No	Yes	No
Is not a bank deposit				
Is not FDIC insured				
Is not guaranteed by the bank				
Subject to investment risks, potential loss of principal				

17. To what extent were any the above disclosures, if they were listed at all, concerning mutual fund investment risks clearly conspicuous and readable? (Check only one box for each row.)

	To little or no extent	To some extent	To a moderate extent	To a great extent	To a very great extent
Brochure #1					
Brochure #2					

18. Did the FDIC-insured logo or "Member FDIC" appear in any of the brochures describing mutual fund products? (Check either Yes or No for each row.)

	Yes	No
Brochure #1		
Brochure #2		

Instructions: For this question you should try to determine whether or not the written sales materials being evaluated clearly segregate information about FDIC-insured deposits or products from information about nondeposit, non-FDIC-insured products. Please provide us with any written comment if you find that the sales literature suggests or conveys any inaccurate or misleading impressions about the nature of the mutual fund products, i.e., that the products are "insured" or "guaranteed."

19. Comments

Please characterize each of the brochures in terms of:

- Placement of disclosure of risks (if any) associated with investment in mutual funds;
- Readability (i.e., size of print), placement, and accuracy of the disclosures;
- Segregation of information as it appears in the brochure concerning FDIC-insured products and non-FDIC-insured products
- Presence of or emphasis given to information which may be misleading or confusing (for example, emphasis on insured securities in fund).

____
____
____
____
____
____
____
____
____

Please return this DCI to Bryon Gordon, GAO, Albany, New York. Include all brochures and the cover sheet, with each attachment identified by the ID number.

Comments From the Federal Deposit Insurance Corporation

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Division of Supervision

June 12, 1995

James L. Bothwell, Director
Financial Institutions and Markets Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for the opportunity to review and comment on your report entitled Bank Mutual Funds: Sales Practices and Regulatory Issues. Mr. Geer has asked that I reply to you directly.

We agree with your recommendation concerning developing a common approach for conducting examinations of banks' mutual fund activities. As you note in your report, we have already reached agreement among the federal financial institution regulatory agencies and NASD concerning scheduling of examinations and sharing of examination information. Developing a common approach to these examinations is logical in order that the financial institution regulators can oversee safety and soundness and securities regulators can continue their program of investor protection.

See p. 29.

We also have a few brief comments relating to your report. On page 40 you state that bank deposits are insured against loss up to $100,000 by FDIC. That sentence should correctly read that depositors are insured up to $100,000 by FDIC.

See pp. 41 - 43.

On page 61, the report discusses customer account information being used to market mutual funds. In several places confidential customer information is discussed. We know of no reliable definition of what customer information is confidential and what information is public. The FDIC is concerned that marketing products to consumers not be misleading or create misunderstandings and customer complaints. Often these customers are risk averse and securities products are not suitable. However, while banks must always comply with laws concerning confidentiality of customer information, we do not wish to stifle economic innovation by prohibiting use of customer information which is otherwise available publicly or among a bank's affiliates.

Now on p. 54.

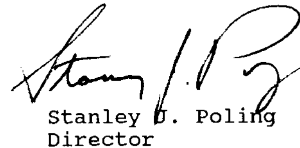
On page 77, you mention the proposed NASD rules governing broker-dealers operating on the premises of financial institutions. Because the FDIC supports the concept of functional regulation, we do not believe that a comparison of the NASD rules with the depository institution regulators' guidance is necessary. The interagency guidance sets the tone for depository institutions

2

engaged in the recommendation and sale of securities and the NASD rules establish the guidance for broker-dealers. It is not necessary that the two be exactly the same. A bank must abide by bank standards. A broker-dealer must abide by NASD standards.

If you have any further questions or comments, please do not hesitate to contact us.

Sincerely,



Stanley J. Poling
Director

Comments From the Federal Reserve System

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

DIVISION OF BANKING
SUPERVISION AND REGULATION

June 13, 1995

Mr. James L. Bothwell
Director, Financial Institutions
and Market Issues
United States General Accounting Office
Washington, DC 20548

Dear Mr. Bothwell:

This letter sets forth the Board staff's comments in response to the GAO's draft report entitled *Bank Mutual Fund Sales: Sales Practices and Regulatory Issues.* The draft report contains a detailed review of bank and thrift institution involvement in mutual fund sales and investment advisory activities and a discussion of the existing regulatory framework for overseeing these activities. The draft report also addresses sales practices of depository institutions pertaining to mutual funds and the adequacy of disclosure of the risks involved in such investments based on a survey conducted during the first half of 1994 and on a small number of on-site visits made during March - April 1994.

In general, the draft report describes the extent to which banks, thrifts and bank affiliated broker dealers are marketing mutual funds on depository institution premises. Although depository institutions' involvement with sales of nondeposit investment products has expanded in recent years, the GAO staff found that over 90 percent of bank-related mutual fund sales and investment advisory activities is occurring under SEC registration and supervision, and confirmed that the number of banks that act as investment advisers or sell mutual funds directly to customers is small. Notwithstanding these statistics, the draft report is correct in finding that the Federal Reserve is giving these activities close attention through the issuance of supervisory policies and on-site examinations designed to ensure that mutual fund sales and investment adviser programs are conducted in a manner that is consistent with principles of safety and soundness and customer protection. In addition, in October 1994 and March 1995 respectively, the 12 Federal Reserve Banks commenced offering investor education programs for bank customers and compliance education programs for banks. Both are attracting a great deal of interest and are being well attended.

GAO Recommendation on Interagency Coordination

We agree with the draft report's recommendation that the banking and securities agencies work together to develop a common approach to the examination of mutual fund activities occurring on depository institution premises. The banking and securities agencies have already accomplished much in this regard. As the draft report notes, in January 1995 the banking agencies concluded an Agreement in Principle with the NASD to coordinate the

scheduling and conduct of examinations of bank affiliated broker dealers selling mutual funds and other nondeposit investment products on depository institution premises. To date, Federal Reserve and NASD examiners have worked together on several examinations in a manner that promotes interagency cooperation and consistency. That agreement also calls for the referral of violations of bank and securities laws and regulations to the appropriate agency in order to improve the quality of supervision while minimizing burden on the industry and any duplication of efforts between the securities and banking regulators.

In a further effort to work together to promote consistency of supervision, the Federal Reserve provided guidance and comments to the NASD regarding its recent rule making proposal (Notice to Members 94-94) pertaining to certain sales practices of broker dealers and their affiliates. Our comments focused on the need to obtain consistency between the NASD's requirements and the banking agencies' February 15, 1994 Interagency Statement on the Retail Sales of Nondeposit Investment Products on bank premises (Interagency Statement).

Supervisory Activities of Federal Reserve and Securities Regulators

In discussing the overlapping supervisory jurisdictions of the banking and securities agencies, the draft report correctly recognizes that simply eliminating the banking industry's exemption from SEC registration for banks that act directly as investment advisers or brokers and, thus, requiring the activities to be conducted in a nonbank subsidiary, would not remove the potential for duplication of supervisory efforts between banking and securities agencies. Given the Federal Reserve's responsibility for supervising bank holding companies, it is necessary to review the nonbank activities of bank affiliated broker dealers and bank affiliated investment advisers for purposes of evaluating the overall soundness of the consolidated bank holding company. In this regard, the Board, following principles of functional regulation to the fullest extent practicable, has avoided duplicating the activities of the securities regulators and has confined its supervisory activities to those areas necessary to assure that an organization is financially sound, has adequate policies and internal controls, is adequately managed, and satisfies any special operating conditions set by the Board.

In those cases where the Federal Reserve is the sole federal regulator of a state member bank that acts directly as an investment adviser or a broker of mutual funds, its supervisory program includes elements that focus both on principles of preserving bank safety and soundness, as well as principles applicable to customer protection and sales practices in the securities markets. For example, after the SEC in a June 30, 1994 letter to the Investment Company Institute advised money market mutual funds that certain volatile market sensitive investments, such as structured notes, were not appropriate investments, the Federal Reserve issued related supervisory guidance to assist banking organizations in assessing comparable risks associated with investment advisory activities (SR 94-53(FIS), dated October 25, 1994). At that time, Federal Reserve examiners were instructed to intensify their examination of investment adviser activities to assure that these activities were properly managed by the banking organization and that they took into account an

investment's market risk in assessing the investment's suitability and consistency with the objectives of the advised fund.

Significantly, the draft report does not identify any areas in which there are serious gaps in the regulation of state member banks selling mutual funds or acting as investment advisers.

Other Matters

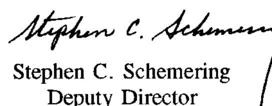
See pp. 45-48.

One of the specific findings contained in the GAO's draft report is that some depository institutions selling mutual funds were not in full compliance with the disclosure and separation guidelines issued by the banking agencies. The deficiencies noted by GAO staff are probably attributable to the fact that their on-site visitations occurred during the first weeks after issuance of the Interagency Statement while the document was still being circulated to examiners and depository institutions and before the Federal Reserve had implemented related examination procedures.

Since issuance of those procedures on May 31, 1994, Federal Reserve examiners have been confirming that state member banks are cognizant of the guidelines and are making serious efforts to ensure that their sales programs are in compliance with the disclosure and physical separation of investment sales provisions as well as with the other areas addressed by the Interagency Statement. In those few cases where Federal Reserve examiners have discovered deficiencies by state member banks or their affiliated broker dealers, the banks have taken voluntary corrective action to address the problems.

Thank you for the opportunity to comment on the draft report. Several technical comments and suggested clarifying changes to the GAO's draft report are contained in the attached Federal Reserve staff report. If you have any questions concerning this letter or the staff report, please contact either Howard Amer, Assistant Director, at (202) 452-2958 or Angela Desmond, Senior Counsel, at (202) 452-3497.

Sincerely,



Stephen C. Schemering
Deputy Director

Attachment

Comments From the National Association of Securities Dealers

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

John E. Pinto • Executive Vice President • Regulation • 1735 K Street, NW • Washington, D.C. 20006-1500 • (202) 728-8233

June 16, 1995

Mr. James L. Bothwell
Director, Financial Institutions
and Market Issues
General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

The National Association of Securities Dealers, Inc. (NASD or Association) appreciates this opportunity to comment on the draft of the General Accounting Office (GAO) report entitled Bank Mutual Funds: Sales Practices and Regulatory Issues.

As a general statement, the main focus of the GAO report relates to sales practices employed in the sale of mutual funds offered through banks, both directly and through broker-dealer affiliates or third party networkers, and the adequacy and comprehensiveness of the bank regulators' efforts to monitor these securities activities. Bank-direct securities activities occur at banks that sell directly through their own employees to provide securities brokerage services to retail customers rather than through broker dealers that are affiliated members or third party networkers. The GAO report also addresses the regulation of bank investment advisory activities in light of the bank exemption from Securities and Exchange Commission (SEC) registration or regulation under the Investment Advisers Act of 1940. Since NASD jurisdiction extends to those SEC-registered NASD member broker-dealers, our comments will address only those aspects of the draft report which relate to the securities activities of NASD members or individuals associated with those members.

Before addressing the specific recommendations, let me begin by emphasizing that the NASD is a strong advocate of functional regulation as the long-term solution to establishing an effective regulatory structure that spans the securities activities of banks and broker-dealers. NASD President and Chief Executive Officer Joseph R. Hardiman testified on April 14, 1994, before the House Subcommittee on Telecommunications and Finance on the proposed Securities Regulatory Equality Act, wherein he expressed the NASD's position that securities activities, regardless of the entity through which they are conducted, should be regulated under a single set of consistently applied rules. Under this structure, the SEC would be the sole federal regulator responsible for regulating and enforcing securities rules and activities, with the bank regulators having the federal authority to

National Association of Securities Dealers, Inc.

Mr. Bothwell
June 16, 1995
Page No. 2

regulate banking activities. In the meantime, the NASD is cooperating with the SEC and the bank regulators, working together to achieve the most effective regulatory programs possible under the current regulatory structure.

While acknowledging the significant coordination efforts among the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), SEC and NASD, the GAO has urged those organizations to continue to work together to implement an approach to regulating bank-direct and broker-dealer mutual fund sales practices by adopting consistent and effective standards for investor protection. Even though NASD regulatory jurisdiction does not extend to bank-direct securities activities, we are totally supportive of working closely with the bank regulators and SEC to develop uniform, consistent and comprehensive examination, advertising, and sales practice policies and procedures that subject banks and broker-dealers which sell securities on bank premises to similar standards. The GAO report correctly recognizes that the Agreement in Principle which the NASD signed along with the four bank regulators (OCC, FDIC, Federal Reserve and OTS), in January 1995, will be an important force in fulfilling the GAO's recommendations that bank and securities regulators work closely to coordinate examinations, share information, and provide consistent examinations and interpretations.

We believe the GAO should be aware of a number of other joint initiatives which are underway involving the NASD and bank regulators. For example:

- o meetings to develop a consistent approach to the review of advertising and sales literature, while avoiding duplication of effort;
- o agreement with the bank regulators to review the NASD's final rule proposal;
- o regional meetings held between NASD District Offices and bank regulators to coordinate sharing of information;
- o mutual participation in NASD/bank regulators' conferences, seminars and training programs; and,
- o on-going discussions to allow bank employees to take qualifications examinations and be subject to registration requirements.

These coordinated efforts will also serve an important investor protection role by focusing regulatory efforts by both securities and bank regulators on reducing customer confusion when securities are purchased on the premises of a bank. Given the long history which the NASD and SEC have in the regulation of mutual funds and securities activities in general, including strong emphasis on investor protection issues, sales practices, suitability, overall fair dealing and supervision, the NASD welcomes playing a primary role in this undertaking. Cooperative approaches among

Mr. Bothwell
June 16, 1995
Page No. 3

regulators, uniform application of law, and consistency of interpretations are particularly important because we must provide a level regulatory playing field for bank-direct and broker-dealer securities activities which fosters the highest degree of full disclosure and protection for the investing public, while also achieving a consistent and meaningful disciplinary response against banks and broker-dealers for serious misconduct.

As for specific comments on the draft report, they are as follows:

Now on p. 2.

a) Page 3, First Paragraph. To reflect a more accurate statement, we recommend the following language be substituted: "The Securities Exchange Act of 1934 requires that persons ~~broker-dealers~~ who sell shares in mutual funds must be registered as a broker-dealer with, and regulated by the SEC, and be a member of the industry's self-regulatory organization for mutual fund activities of broker-dealers, ~~such as~~ the National Association of Securities Dealers (NASD). However, national banks within the definition of Section 3(a)(6) of the 1934 Act who sell shares in mutual funds are exempt from these requirements" (New language underlined; deleted language is lined out).

Now on p. 14.

b) Page 13, Second Paragraph. We would suggest the report refer to the Investment Company Institute as a national trade association to insure a clear distinction from a self-regulatory organization.

Now on pp. 17 and 37.

c) Page 18, First Paragraph. While the GAO report mentions that the 1934 Act regulates mutual fund advertising, there is no reference at all to the significant role the NASD plays in regulating all member communications with the public, including having primary responsibility for regulating advertising and sales literature used to solicit and sell mutual funds to investors. NASD Rule of Fair Practice Article III, Section 35 is the industry's most comprehensive regulation governing standards for advertising and sales literature, encompassing for example, filing requirements, review procedures, approval and recordkeeping obligations, and general standards. Specifically with regard to investment company sales literature and advertising, the NASD rule requires filing with our Advertising Regulation Department within 10 days of first use or publication by any NASD member. Filing in advance of use is recommended. Each piece of sales literature and advertising filed with the NASD is closely reviewed to insure compliance with all aspects of the NASD's rules and those of the SEC, such as to insure that there are no exaggerated, unwarranted or misleading statements or claims, and that they are based on principles of fair dealing and made in good faith. To give the GAO an idea of the scope and magnitude of this important regulatory function performed by the NASD, in 1994, a total of 42,665 filings of advertisements and sales literature were reviewed by the NASD, of which 33,008 or 77% related to investment companies.

With this as background, it is important for the GAO to amend the draft report to properly reflect the critical role which the NASD plays in the regulation of mutual fund advertising and sales

Mr. Bothwell
June 16, 1995
Page No. 4

literature.

d) Page 18 Second Paragraph. Suggested language changes to more accurately reflect facts are: "Broker-dealers who sell mutual funds are regulated and routinely examined by the NASD. The NASD was established under authority granted by the 1938 Maloney Act amendments to the Securities Exchange Act of 1934, as a self-regulatory . . . ."

Now on p. 17 and 37.

Later in that same paragraph and continuing to the top of page 19, in addition to the areas cited in the report, the SEC and NASD regulate broker-dealers sales practices and fair dealings with customers. In fact, these are the main focus of our examination and enforcement efforts. In addition, and as described in detail in c) above, the NASD has also established rules of fair practice -- including a rule that specifically regulates the advertising of mutual funds -- in addition to its administering qualifications tests. Also, for accuracy, the NASD administers qualifications tests to individuals, not broker-dealers (p. 19)

Now on pp. 48, 50, and 54.

e) Page 38. We believe the report as currently drafted reflects the inaccurate conclusion that the guidelines established by the Interagency Statement provide the bank regulators with direct and equal regulatory authority over SEC-registered NASD member broker-dealers. They do not. While guidelines generally do not have the enforceability of rules, the Interagency Statement guidelines are directly enforceable over banks and bank employees, and not over broker-dealers or their associated persons. That distinction should clearly be made in the report, because it is this regulatory void that is the basis for the NASD's proposed rules to specifically govern the activities of NASD member bank broker-dealers who conduct a securities business on the premises of a financial institution.

See comment 1.

f) Page 39 - Footnote 8. The footnote is inaccurate as stated, and we suggest a complete rewrite. It should read: "A registered representative is a person associated with a broker-dealer who must acquire a background in the securities business, pass relevant qualifications examinations administered for the industry by the NASD, and be associated with a broker dealer which must be registered as such with the SEC and be a member of a self-regulatory organization such as the NASD and/or a stock exchange." The last sentence in the current report footnote must be deleted completely because it is not accurate.

g) Page 41. Specifically, the guidance praised by the GAO was provided in NASD Notice to Members 93-87 issued in December, 1993.

Now on p. 29.

See comment 2.

h) Page 42. The finding cited by the GAO report that 68% of sales personnel at banks do not adequately (or at all) disclose critical risk factors to investors gets to the heart of why the NASD has proposed its bank broker-dealer rules to regulate the conduct of broker-dealers who conduct business on the premises of a financial institution, backed by the full enforceability of rules. We believe this is critical for effective and meaningful regulation in this important investor protection

Mr. Bothwell
June 16, 1995
Page No. 5

area.

See comment 3.

i) Page 44. We suggest that the GAO delete the statement that ". . . bank employees tended to make the required disclosure more frequently than broker-dealer employees." This conclusion is misleading in light of the GAO's admission that because of the small sample size, ". . . none of the differences in performance between bank and broker dealers are statistically significant" (emphasis added). If the statements are not supportable with any degree of reliability, they should not be made.

Now on p. 36.

j) Page 52. The securities-related activities of non-registered bank employees referenced in the GAO report would appear to violate current NASD rules if an NASD bank broker-dealer is involved, and the Interagency Statement guidelines for bank-direct sales.

Now on p. 37.

k) Page 53. The last sentence on page 53 should be updated to state: "The NASD's review of the 284 comment letters received on its proposal has been completed, and they are currently under active consideration by its Bank Broker-Dealer Committee."

Now on p. 41.

l) Page 60. The reference on the top of page 60 citing an NASD official classifying payout differential as "common and well-established" gives the mistaken appearance of our condoning and supporting such a practice. In fact, there are clearly sales practices, suitability and investor protection issues that are considered by the NASD when proprietary products with higher payout are sold. Further, the GAO should be aware that there have been major changes over the recent past in the way broker-dealers compensate their sales representatives. Today, most major firms provide the same payout for both proprietary and outside products.

m) Page 70. We agree with the report in citing the Interagency Statement as establishing guidelines, not regulations, and believe it is important to have specific rules and regulations to govern the activities of NASD members which conduct a securities business on the premises of a financial institution that are clearly enforceable. That is why the NASD has proposed its bank broker-dealer rules. We also share the GAO's expressed concern for unnecessary regulatory overlap and conflict with regard to efforts by bank regulators to exercise authority over SEC-registered NASD member broker-dealers, and will continue to work with the bank regulators to prevent this from happening.

Now on pp. 50 and 51.

n) Page 71. We disagree with the assertion attributed to banking regulators that their guidelines "exceed SEC and NASD requirements"; further, these guidelines lack the force and authority of enforceable rules which are the cornerstone of NASD and SEC regulatory programs.

See comment 4.

o) Page 72. The example at the top of page 72 should be eliminated since customer confusion issues have not surfaced with respect to non-bank broker-dealer mutual fund customers. It is a poor example to use when implying that guidelines can be more meaningful than rules. They cannot.

Mr. Bothwell
June 16, 1995
Page No. 6

The second paragraph points out a major difference in the way securities regulators and banking regulators address violations and deficiencies, that is correction only as opposed to correction and disciplinary actions as deemed appropriate. This is a significant distinction that certainly adds to the concerns raised by the GAO about differences in regulatory treatment for the same activity that create conflict and inconsistency.

See comment 5.

p) Page 73 Footnote 22. The entire footnote should be rewritten to read: "Dual employees are individuals that are associated persons of the NASD member broker-dealer who have passed the appropriate qualifications tests, and who are also employees of the financial institution." The footnote as currently exists is inaccurate and confusing.

Now on p. 49.

q) Page 74. The first sentence on the page should be revised because it makes it appear as though the bank exemption from registration as a broker-dealer under Section 3(a)(6) of the 1934 Act depends upon brokerage activity, which it does not.

Last Paragraph

Now on p. 54.

r) Page 76 - 77. It is not the banks and thrifts that "are subject to regulation and oversight by both banking and securities regulators" as stated in the report, it is the broker-dealers selling on bank premises that could be the subject of conflicting, duplicative and burdensome regulation. The securities regulators do not exert or seek to exert any oversight authority over banks. We recognize our regulatory authority only extends to SEC-registered NASD members and their associated persons.

On the top of page 77, the GAO report refers to unnecessary burdens as applying to banks; instead it should refer to the unnecessary burdens and requirements that are thrust upon the NASD member broker-dealers who are exposed to examinations by bank regulators with no jurisdiction over them.

Now on p. 55.

See comment 6.

s) Page 77 - Last paragraph. The GAO's reference to reporting by the financial press of the NASD's bank/broker-dealer proposed rules requires a brief comment. The NASD is disturbed and frustrated by the inaccuracies and often inflammatory nature of the news coverage on the NASD rule proposal. While we expected some controversy, careless reporting has created confusion and concern well beyond the issues themselves. Simply stated, the NASD's proposed rules seek consistent treatment of affiliated and networking broker-dealers because the banking guidelines established by the Interagency Statement do not have the force and effect of law and cannot support disciplinary actions against broker-dealers. The proposed NASD rules will provide direction to NASD members as to what is expected of them when operating on the premises of a bank and establish clear authority to bring enforcement actions for serious violations. Since the NASD rules will not govern bank-direct securities business, they do not duplicate the guidelines established by the Interagency Statement issued by the bank regulators. To the contrary, they complement these

Mr. Bothwell
June 16, 1995
Page No. 7

guidelines. To the degree possible, the NASD proposed rules are consistent with the SEC's Chubb no-action letter and the bank regulators' Interagency Statement. There are some differences, such as the NASD's prohibition against broker dealers paying referral fees to tellers and other non-registered persons under the proposed rules. This position, however, is consistent with long-standing NASD policy prohibiting payments by NASD members to non-registered persons. There is no overlap or duplication created by the proposed NASD rules because our rules will govern the activities of broker-dealers, while the bank regulators' guidelines apply to the banks.

In recognition of the increased importance and rapid growth of our bank broker-dealer members, the NASD Board of Governors approved the creation of a Bank Broker-Dealer Committee as a standing committee of the Board. The new committee, which is comprised of twelve members representing various segments of the NASD bank broker-dealer membership, is responsible for making recommendations to the NASD Board on rules and procedures governing the securities activities of NASD member firms that are affiliated with financial institutions or that provide brokerage services and products on the premises of a financial institution. The first task for this Committee, which is already underway, is to review the 284 comment letters received by the NASD in response to its request for comments on the proposed bank broker-dealer rules and to thereafter make recommendations to the Board for any changes before filing the rules for SEC approval.

Now on p. 56.

t) Page 80. The description attributed to an OCC official about procedures employed prior to OCC conducting an examination of a bank call for obtaining a copy from the bank of the NASD's report of its latest examination. The NASD does not provide members with copies of its examination reports; we do, however, advise members of the results of our examinations. We also question the OCC practice of hiring an accounting firm to conduct examinations of an NASD member over whom the OCC has no regulatory authority or jurisdiction, resulting in obvious regulatory duplication and placing an unnecessary burden on the member. The Agreement in Principle would call for them to contact the NASD, and we believe that is the appropriate course of action to follow. We plan to contact OCC on both of these issues in order to clarify their practices and establish a more coordinated solution.

See comment 7.

We strongly object to the last sentence on page 80 which again cites an OCC official, this time stating that ". . . OCC examiners decided they could not rely on NASD's previous examination reports to satisfy their concerns". This is absolutely ridiculous. We have had numerous meetings and conversations with the staff of OCC, and they have never expressed any lack of confidence in the NASD's examinations. We are unaware of a single factual situation where the OCC has found any examination conducted by the NASD to be inadequate in any respect. We plan to contact the OCC to find out the genesis of this statement, but in the meantime, we request deletion of this offensive sentence.

See comment 8.
Now on p. 60.

u) Page 88. Again it seems the OCC officials cited in the report express reluctance to rely on any other regulator but themselves when they criticize the concept of functional regulation.

Mr. Bothwell
June 16, 1995
Page No. 8

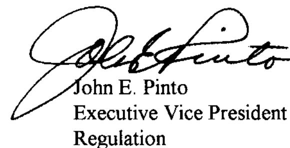
If this is an accurate reflection of their attitude, it is fertile ground for burdensome and unnecessary regulatory overlap and duplication.

Now on p. 70.

v) Page 106/107. We would suggest a qualifier be added to the last sentence on page 106 that continues on 107. The NASD's proposed bank broker-dealer rules provide for a more explicit, well-defined and enforceable approach to regulating this group of NASD members even though some aspects of the proposal may "have caused controversy". As stated under section (s) of this response, while the NASD tracked the Interagency Statement and SEC Chubb no-action letter wherever possible, certain provisions of our proposal differed purposely (such as prohibition on payment of referral fees to non-registered persons and use of confidential customer financial information).

The NASD appreciates this opportunity to comment on the draft report. The NASD is committed to protecting investors through the establishment of effective rules and regulations that address broker-dealer conduct when selling securities on bank premises, and in working closely with bank regulators and the SEC to coordinate consistent and uniform examination and enforcement policies and procedures.

Very truly yours,



John E. Pinto
Executive Vice President
Regulation

The following are GAO's comments on NASD's letter dated June 16, 1995.

GAO Comments

1. Revised to reflect NASD's concerns. Now on page 17.

2. While we do not have a position on the individual rules themselves, we applaud NASD's effort to regulate the conduct of broker-dealers who conduct business on the premises of a financial institution. Additional text has been added to the report to reflect the reason why NASD is proposing additional rules governing the conduct of broker-dealers operating on the premises of financial institutions.

3. We have modified this sentence so as not to draw a comparison between bank employees and broker-dealer employees.

4. We have deleted this example.

5. We believe that the footnote as written provides a more complete description of what a dual employee is than does the revision suggested by NASD. This definition was obtained from the publication, Mutual Fund Activities of Banks, by Melanie L. Fein, Victoria E. Schoenfeld, and David F. Freeman, Jr. (published by Prentice Hall Law and Business, 1993).

6. NASD's comments on press inaccuracies and the NASD proposed rules do not specifically address the points we discuss in the report. The 284 comment letters NASD received on its proposed rules indicate that others beside the press have concerns about the rules.

7. We have changed the text where appropriate and have deleted this last sentence from the final report.

8. This is an area of apparent disagreement between OCC and NASD that might be resolved by working more closely together as we recommend. For effective regulation of financial institutions whose activities are becoming more alike, regulators will have to work well together under any regulatory scheme with more than one regulator.

Comments From the Comptroller of the Currency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

July 5, 1995

Mr. James L. Bothwell
Director, Financial Institutions and Market Issues
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have reviewed your draft audit report titled BANK MUTUAL FUNDS: Sales Practices and Regulatory Issues. The report was prepared in response to Congressional requests that GAO determine the extent and nature of bank and thrift involvement in mutual fund sales, collect and analyze data on the sales practices used by banks and thrifts in selling mutual funds, use the data to evaluate whether adequate disclosures of the risks of investing in mutual funds are being made to customers by salespersons in certain banks and thrifts, and assess the adequacy of the existing regulatory framework for overseeing bank and thrift sales of mutual funds. The audit concluded that banks and thrifts have rapidly expanded their participation in the mutual funds industry, that compliance with sales guidelines is inadequate, and that the expanded role of banks in mutual funds raises regulatory issues. The draft recommends that SEC, the Federal Reserve, FDIC, OCC and OTS work together to develop and approve a common approach for conducting examinations of banks' mutual fund activities to provide effective investor protection, while ensuring bank safety and soundness.

See p. 45.

The OCC appreciates the attention of both the GAO and the Congress to this important issue. We regret that we must take exception to a number of points in the draft audit report. This letter details our concerns.

See comment 1.

In general, the OCC believes that the conclusions of the audit report are based on information that is dated and incomplete. GAO conducted the audit using survey techniques and on-site visitations less than a month after the bank regulatory agencies issued the Interagency Statement on Retail Sales of Nondeposit Investment Products (Interagency Statement) and the OCC issued examination guidelines in February 1994. It would be unrealistic to expect full compliance with newly issued guidance that required such things as reconfiguration of physical space, training of employees, publication of new sales materials, and responding to other changes in business practices. In any event, the audit is over a year old. We believe national bank practices have changed significantly. In addition, the GAO's mystery shoppers were specifically prohibited from providing financial

information when they visited banks to evaluate their compliance with the interagency guidelines, calling into question the completeness of the sales presentation the shoppers were given.

The OCC also believes that the GAO report overemphasizes the potential for inconsistent and contradictory regulation. There is no reason to presume most of the potential problems highlighted by the audit report will actually occur.

The comments that follow are intended to correct inaccuracies in the draft and to provide additional current information.

OCC Regulation and Supervision

See comment 2.

While not subject to federal securities laws, sales of mutual funds by national banks are subject to regulation and supervision by the OCC. The draft report throughout suggests that the Interagency Statement is the only regulatory guidance that applies to national banks' sales of mutual funds. In fact, the OCC has recordkeeping and confirmation rules parallelling the securities regulations at 12 C.F.R. 12, the fiduciary rules at 12 C.F.R. 9, and various other safety and soundness statutes and regulations. In addition, the anti-fraud provisions of the federal securities laws apply to national bank sales.

Now on p. 18.

Moreover, page 21 of the draft report misrepresents our proposed rulemaking governing corporate applications. The proposal is not intended to provide automatic approval or to grant authority for subsidiaries of national banks to engage in securities activities from which the bank is prohibited. Rather, the proposal only sets up a process for the OCC to consider applications from individual national banks to pursue new activities through operating subsidiaries. Applications would be considered and decided on a case-by-case basis.

Disclosure of Risks

See ch. 3.

The conclusions, captions and discussion throughout the disclosure section of the draft report fail to distinguish between the adequacy of banks' oral and written disclosures. It appears that the draft report's conclusion that disclosure is inadequate refers to the oral disclosure requirements. The description of banks' written disclosure efforts does not support a conclusion of inadequate overall compliance. The report should distinguish its evaluation of banks' compliance with the oral and written disclosure requirements. The distinction is important, since the proposal of the National Association of Securities Dealers (NASD) does not require any oral disclosure and the GAO obviously feels this is an important facet of sales practices.

Written Disclosures

Now on pp. 39 and 40.

The report inaccurately describes the 1994 OCC initiative to review national bank mutual fund sales materials for compliance with agency guidelines. The report (pages 57-59) does not mention that the testing was done voluntarily. Rather than portraying the event as evidence of national banks'

2

good faith in trying to develop accurate, non-misleading sales information, the report used OCC findings to support its contention that national banks failed to comply with acceptable sales practices.

As a result of our centralized review of over 8,000 national bank documents, we issued a letter to national banks in September 1994 to define further what is meant by clear and conspicuous disclosures. The OCC letter also detailed numerous concerns with national banks' advertising and promotional materials and provided instructions on how to bring the materials into compliance. We are now reviewing sales-related documents as part of our regular onsite examinations. We are finding that banks have improved their materials.

Oral Disclosures

Now on p. 44.

In connection with reviewing compliance for oral disclosures, the report should describe the Comptroller's efforts to organize interagency cooperation on a mystery shopping initiative. The proposal was rejected by the SEC and the Federal Reserve. The report also should expand the discussion of mystery shopping by FDIC to note that the OCC is cooperating with the FDIC on this initiative (pages 63-67).

Use of Customer Information

See comment 3.

The report suggests that the banking agencies have not provided guidance on appropriate uses of customer information. In fact, OCC examination procedures provide specific guidance on the policies and procedures that national banks should establish, emphasizing the need to avoid confusion when using depositor information to solicit for investment products (page 61).

Regulatory Issues

Sales programs involving bank customers, bank premises, and/or bank employees warrant bank regulator oversight to ensure the program is operating in a safe and sound manner. Bank regulators should not be excluded from appropriate involvement in oversight of any bank activity.

Referral Fees

See comment 4.

Now on p. 54.

In advancing the argument that the regulatory framework for mutual fund sales in banks causes conflict and duplication of effort, the draft report incorrectly characterizes the NASD proposal as banning referral fees. The NASD proposal, in fact, permits fees under limited circumstances similar to those permitted by the Interagency Statement. The NASD proposal requires the broker to pay the referral fees to the bank, rather than directly to the bank employee, and then permits the bank to transfer the fees to the employee. The report should note that the Interagency Statement was modelled on a longstanding SEC no-action position permitting referral fees (page 77).

3

Broker-dealers

Now on p. 56.

Statements made on page 80 of the draft report incorrectly describe the OCC's supervision of independent third party broker-dealers. The OCC does not examine independent third party broker-dealers. As noted in the beginning of the paragraph, we may inspect the books and records of an independent third party vendor as they pertain to that activity, but we do not conduct a complete examination as reported at the end of the paragraph.

Custodians

Now on p. 64.

The report fails to note that when a mutual fund chooses a bank as custodian, the bank's custodial activities are reviewed and supervised by federal bank regulators. Bank custodians are actually subject to regulation under both the federal securities laws and the banking laws. The report implies that bank custodial activities for mutual funds are somehow unregulated. Since both the securities and banking laws apply, such activities are in fact subject to more intensive oversight than those of other custodians (page 95).

Conflict of Interest

See comment 5.

Now on p. 67.

The discussion about situations in which conflicts of interest may arise is inadequate in two ways. First, it fails to note that similar conflicts could also arise for diversified securities firms that may be advising and brokering proprietary funds while also engaged in a variety of other relationships (including credit relationships) with an issuer whose securities are owned by the funds. Second, the discussion does not acknowledge safeguards that are already in place. For example, the SEC requires disclosure of the potential conflict of interest between bank advisory and lending activities. We are also aware that SEC staff has required funds advised by banks to disclose that the advisor may have lending relationships with issuers whose securities are recommended/purchased for the funds. The report also fails to note that under the Investment Company Act, the advisor is placed in a fiduciary relationship with the fund. Bank advisors may also be subject to the OCC's fiduciary regulations at 12 C.F.R. 9, including the conflict of interest provisions. The OCC's fiduciary examinations emphasize management of conflicts of interest as an integral part of safety and soundness in exercising trust powers (pages 99, 105).

Your Recommendation

The draft report recommends that the securities and banking regulators work together to develop a common approach to supervising bank mutual funds activities. In fact, agencies have been engaged in such cooperative efforts for some time. For example, in January 1995, we adopted and implemented an information sharing agreement with the NASD. The agreement provides for coordination of examinations where possible. In June, we also entered into an agreement with SEC to conduct joint examinations of national bank investment advisors to mutual funds. Going forward, we will continue to make further efforts to coordinate examination activities and information sharing where regulatory boundaries overlap.

4

Thank you for the opportunity to review and comment on the draft report.

Sincerely,

Judith A. Walter
Senior Deputy Comptroller for Administration

5

The following are GAO's comments on OCC's letter dated July 5, 1995.

GAO Comments

1. Although the shoppers were not to provide detailed financial information and were not able to follow through by making an actual purchase of a fund, the discussions with the sales representatives were of such length and substance that the sales representative should have orally disclosed the risks of investing in mutual funds, as recommended by the interagency guidance. While we agree that had the transaction actually been completed the disclosure rate may have been better, the interagency guidance requires that these disclosures be made orally during any sales presentation.

2. The report does not intend to suggest that the interagency guidance is the only regulatory guidance that applies to banks' mutual fund activities. However, this report focused on the interaction between the bank or its broker-dealer and the customer at the time of a sale. Recordkeeping, confirmation, and fiduciary requirements were not within the scope of our review, and we did not attempt to compare these requirements to those in the securities laws. With respect to the proposed rulemaking process, we have added a statement to the report on page 18 that OCC plans to consider and decide applications on a case-by-case basis.

3. The OCC examination procedures state that examiners are to determine whether policies governing the permissible uses of bank customer information address the steps to be taken to reduce possible confusion among depositors who are being solicited to purchase nondeposit investment products. However, there are no other examination steps, and it is up to the bank to determine the permissible uses of customer account information. Therefore, we do not agree that specific guidance has been provided to banks either directly or through application of examination steps. In commenting on this point, FDIC noted that there is no reliable definition of what customer information is confidential and what is public. FDIC stated that while banks must comply with laws concerning the confidentiality of customer information, it did not want to prohibit the use of customer information that is otherwise available publicly or among a bank's affiliates. (See app. VII.)

4. The NASD proposal states: "Employees of the financial institution who are not registered with the NASD member may not engage in any broker-dealer services on behalf of the member, nor receive any compensation from the member, cash or non-cash, in connection with but

not limited to the referral of customers of the financial institution to the member, or locating or introducing customers of the financial institution to the member." In June 1995, a NASD official told us that NASD does not have the power to affect a contractual relationship between a bank and a broker-dealer. Therefore, a bank could use money that it would earn as a result of this relationship the way it wants to. However, he said a direct transfer of fees from the broker to the bank, then to the employee, would be a violation of the proposed NASD rule. Therefore, we have not modified the report.

5. We were requested to study particular issues that arise when banking institutions advise mutual funds. Accordingly, the scope of our work did not include reviewing the activities of nonbank securities firms that have proprietary mutual funds. We are, therefore, unable to affirm the accuracy of OCC's statement that similar conflicts could arise for diversified securities firms that may be advising and brokering proprietary funds while also engaged in a variety of other relationships with an issuer whose securities are owned by the funds. With respect to the adviser's relationship with the fund, the report states on page 67 that the adviser has a fiduciary obligation to the fund under the Investment Company Act of 1940. In addition, we note that banking laws may impose additional fiduciary obligation in certain cases.

Comments From the Office of Thrift Supervision

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6000

June 23, 1995

Mr. James L. Bothwell
Director, Financial Institutions and Markets Issues
United States General Accounting Office
Washington, DC 20548

Dear Mr. Bothwell:

We have reviewed the draft report entitled Bank Mutual Funds: Sales Practices and Regulatory Issues. We concur with the GAO recommendation that the appropriate regulatory agencies continue working together to develop a common approach for conducting examinations of bank mutual fund activities to avoid duplication of effort and conflict. We have supported an interagency approach to this area since November 1993, when the Acting Director of OTS, Jonathan L. Fiechter, held a meeting with staff from each of the banking agencies to suggest a common approach for the regulation of nondeposit investment products sold in insured financial institutions. One of the major products of this initiative was the development of the Interagency Statement on Retail Sales of Nondeposit Investment Products.

We appreciate the opportunity to review the draft document and have the following comments.

See comment 1.

"Bank" References

Throughout the document there are references to "banks" without differentiating when the term is used to refer to both banks and thrifts, and when it is intended to apply solely to banks. For instance, Chapter 4 on page 68 begins with a discussion devoted exclusively to banks, then discusses both banks and thrifts (page 76) and then uses the term "bank" (page 77, first paragraph) in a context that refers to, or should refer to, both banks and thrifts. Chapter 4 ends with conclusions that refer to both thrifts and banks. Throughout the document it should be clear which type of institution is being discussed.

Examination Guidance

There are two references to that do not provide all the relevant details relating to the issuance of OTS examination guidance.

Page 2

See comment 2.

On Page 37, in the first paragraph, a statement is made that "Until mid-1993, none of the four banking regulators -- OCC, FRS, FDIC, and OTS -- had issued regulations or guidance to the institutions they supervise dealing specifically with retail sales of mutual funds or other nondeposit investment products."

Since 1982, every savings association that sold securities through a service corporation, (most sales of securities in the offices of savings associations occur through a service corporation) received a case-by-case approval that imposed conditions requiring that the activities comply with various operational safeguards. In 1989, OTS issued regulations, codified at 12 C.F.R. 545.74(c)(4), imposing the same safety and soundness provisions and consumer protection safeguards relating to the sale of mutual funds and other securities by service corporations. In addition, in June 1989, the OTS issued its Service Corporation Handbook. Section 800 of this handbook specifically addressed examination procedures for securities brokerage activities. In 1994, the Service Corporation Handbook was consolidated with the Thrift Activities Handbook and many of the original procedures were included in an expanded Section 640 dealing with securities brokerage.

Now on p. 45.

On page 66, in the second paragraph, a statement is made that "In January 1994, OTS issued guidelines for examining the securities brokerage activities of thrifts, including mutual fund sales." Actually, although dated January 1994, the guidelines were not issued until April 1994.

<u>Other Points</u>

See pp. 46 and 47.

It should be noted that the GAO conducted its survey and shopping visits very soon after the Interagency Statement was issued. During this time financial institutions were in the process of implementing the new procedures and not totally prepared to be tested on all the elements listed in the Interagency Statement.

See comment 3.

On page 45, the report refers to "trade journals". The source of this information is not further identified. It would be helpful to identify the source of the information.

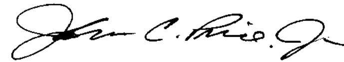
OTS has an ongoing commitment to ensuring that adequate controls are in place to contain the level of risk presented to thrifts in selling nondeposit investment products, including mutual funds, and to minimize potential customer confusion between FDIC insured and non-FDIC insured investment products.

Page 3

These issues are routinely addressed by our examiners during the regularly scheduled examinations of thrift institutions that offer nondeposit investment products. In addition, OTS's Quality Assurance Program is presently conducting studies to assess the effectiveness of our examiners' reviews of nondeposit investment sales programs. If these efforts disclose weaknesses in either an institution's sales program or in our regulatory approach, appropriate steps will be taken to correct the deficiencies.

Again, thank you for providing the opportunity to comment on this draft document. I hope these comments are of assistance to you and your staff.

Sincerely,



John C. Price, Jr.
Assistant Director
for Supervision Policy

Attachments

cc: Jonathan L. Fiechter
John F. Downey
Carolyn Buck
Tom Melo
Dwight Smith
Dean Shahinian
Robyn Dennis
Therese Monahan

The following are GAO's comments on the Office of Thrift Supervision's letter dated June 23, 1995.

GAO Comments

1. We have clarified the terminology where appropriate.

2. The sentence in the report was intended to draw attention to the fact that each of the regulators separately issued sales guidance in 1993. To avoid confusion, the sentence has been deleted from the report.

3. This reference has been deleted from the text.

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DIVISION OF
INVESTMENT MANAGEMENT

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

June 12, 1995

Mr. James L. Bothwell
Director, Financial Institutions
and Market Issues
General Government Division
General Accounting Office
Washington, D.C. 20548

Re: Draft Report on Bank Mutual Funds

Dear Mr. Bothwell:

We appreciate the opportunity to comment on the General Accounting Office's ("GAO") draft report entitled Bank Mutual Fund Activities: Sales Practices and Regulatory Issues. The draft report conveys valuable information about the extent of banks' entry into the mutual fund business -- data not readily available from government or private sources.

The draft report focuses on the participation by banks in two aspects of the mutual fund business: selling fund shares and acting as investment advisers to funds. As noted in the draft report, bank mutual fund sales are conducted either directly through the bank or through affiliated or unaffiliated registered broker-dealers operating on bank premises. GAO's data indicates that a small percentage of banks conduct securities sales directly. In contrast, the opposite appears to be true on the advisory side: most mutual fund investment advisory activity is conducted by the bank itself rather than through an affiliated entity registered as an investment adviser.

Bank involvement in securities businesses will likely continue to increase, especially if pending Glass-Steagall reforms become law. The Commission has, as we discuss below, worked with the federal banking regulators to keep pace with the increasing bank involvement in the securities business and intends to continue to cooperate with its regulatory counterparts.

Our comments address the following topics: 1) the Commission's efforts to improve coordination with the federal banking regulators, 2) some of the federal securities laws and rules applicable to sales practices and mutual fund advertising (a discussion that is largely absent from the draft report), 3) the resources available to the Commission for its mutual fund and investment adviser inspection programs, and 4) our thoughts on the role of functional regulation and ways to reduce regulatory duplication.

1. *SEC Agreement with OCC to Conduct Joint Inspections.*

GAO recommends that the Commission and the various bank regulators (the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision) work together to develop and approve a common approach for conducting examinations of bank

Mr. James L. Bothwell
June 12, 1995
Page 2

mutual fund activities. In fact, the Commission already is working to implement a program to achieve coordinated examinations.

Now on p. 71.

After several months of negotiation, the Commission and the Office of the Comptroller of the Currency ("OCC") recently agreed on a framework for conducting joint examinations of mutual funds and advisory entities in which both agencies have regulatory interests. We expect this agreement to result in increased coordination and communication between the Commission and the OCC and, as a result, more efficient oversight of bank mutual fund activities. The Commission and OCC staff have already informally discussed examination procedures and are beginning to schedule joint examinations.

The agreement between the OCC and the Commission describes areas of common interest that should be reviewed in the course of joint examinations. These areas include the bank's internal compliance and risk management systems as they relate to the funds, and the bank's management of conflicts of interest between it and the funds and between funds and other advisory clients. For example, this should permit the Commission to review trading records of other bank advisory clients to ensure that trades and investment opportunities are being allocated in an equitable manner.

The agreement provides for communication between the agencies before, during, and after each examination. To maintain flexibility, the agreement provides that the scope, staffing, and procedures for any particular joint examination will be determined on a case-by-case basis. 1/

2. Securities Laws Governing Mutual Fund Sales and Advertising

See pp. 47 and 48.

Commission Oversight of Broker-Dealer Sales Practices: A significant portion of the draft report is devoted to the Interagency Guidelines, adopted by the various banking regulators, that are designed to govern sales of mutual fund shares both by banks through in-house brokerage operations and by broker-dealers (bank-affiliated or independent) operating on bank premises. We are concerned that the report's focus on these guidelines and the extent of compliance with them may inadvertently convey the impression that the guidelines are the primary source of regulation of mutual fund sales practices even though, as the draft report acknowledges, they do not carry the force of law and even though the Commission and the SROs, and not the banking regulators, are responsible for overseeing broker-dealer sales practices. Furthermore, the guidelines do not establish precise standards of conduct, and banks have wide latitude to establish procedures to implement them. Finally, the guidelines may well contribute to regulatory confusion and duplication because they purport to apply to registered broker-dealers that sell securities in association with banks.

As the following paragraphs summarize, the Commission and the NASD actively regulate and oversee mutual fund sales practices of broker-dealers, including those affiliated with banks or operating on bank premises.

1/ Commission staff has met preliminarily with the staff of the Federal Deposit Insurance Corporation to discuss entering into a similar arrangement.

Mr. James L. Bothwell
June 12, 1995
Page 3

Regulation of Broker-Dealers: Mutual fund sales, whether conducted by banks or broker dealers, have historically been subject in varying degrees to the securities laws. 2/ The National Association of Securities Dealers ("NASD"), a self-regulatory organization ("SRO") created pursuant to statute, is responsible, subject to Commission oversight, for regulating the activities of its broker-dealer members. To the extent that they are viewed as applying to broker-dealers, rather than banks that engage directly in the sales of fund shares, the Interagency Guidelines contribute to duplicative regulation because the NASD is the primary regulator over member broker-dealers. 3/

Commission Inspections of Broker-Dealers: Sections 17 and 19 of the Securities Exchange Act of 1934 provide the Commission with the authority to inspect broker-dealers, and to review the regulatory and enforcement actions of self-regulatory organizations. The Commission seeks to ensure that this objective is fulfilled through its broker-dealer examination program. While the primary purpose of these examinations is to oversee the examination operations and capabilities of the various SROs, the Commission also conducts "cause" examinations of broker-dealer financial records or sales practices. In fiscal year 1994, the SEC's regional offices completed 680 broker-dealer exams of which 478 were oversight exams and 202 cause exams. Of the 680 total exams, thirty-two involved bank-affiliated broker-dealers or broker-dealers participating in bank network arrangements. In addition, the NASD conducted over 2,000 broker-dealer examinations in calendar year 1994.

Obligation of Broker-Dealers to Make Suitable Recommendations: Broker-dealers and their registered representatives have a general obligation to determine that a security is suitable for the customer when recommending the security. Although the Commission has not adopted a general suitability rule, the courts have enforced the suitability doctrine against broker-dealers through the application of Rule 10b-5 under the Securities Exchange Act of 1934 and other anti-fraud provisions of the federal securities laws. Moreover, the suitability requirements have been incorporated into the rules of the SROs. For example, the NASD's Rules of Fair Practice require that broker-dealers that recommend purchases, sales, or exchanges of securities to customers have reasonable grounds for believing that the recommendation is suitable for the customer on the basis of the facts disclosed by the customer. In addition, the NASD's suitability rules require a broker-dealer to make reasonable efforts to obtain information from non-institutional customers, other than with respect to transactions where a customer's investments are limited to money market funds,

---

2/ Although they may be exempt from broker-dealer registration and regulation, financial institutions selling mutual fund shares directly are still subject to the anti-fraud provisions of the securities laws.

3/ While the draft report mentions the NASD's proposed rules pertaining to broker-dealers operating on bank premises, it does not mention that this proposal would largely codify Commission requirements. In November 1993, the Commission staff issued a no-action letter to the Chubb Securities Corporation ("Chubb Letter") that describes the Commission's policy with respect to broker-dealers entering into networking arrangements with financial institutions. The Chubb Letter is the last in a long line of Commission staff no-action letters addressing such broker-dealer networking arrangements and requires broker-dealers operating on the premises of financial institutions to take certain actions with respect to the physical location, customer disclosure procedures, and promotional literature to clearly distinguish broker-dealer services from the banking function of the financial institution. A broker-dealer must stipulate that it will be solely responsible for all securities business conducted on the premises of the financial institution. The NASD's rule proposal is based in part on the Chubb Letter.

Mr. James L. Bothwell
June 12, 1995
Page 4

concerning the customer's financial status, tax status, investment objectives, and similar information. 4/

Now on pp. 17 and 37.

Commission and NASD Regulation of Mutual Fund Disclosure: In addition to the Commission's oversight of broker-dealer sales practices, all mutual fund sales and advertising are subject to the provisions of the Investment Company Act of 1940 ("1940 Act") and the Securities Act of 1933 ("1933 Act"). Mutual fund sales material distributed by NASD members is subject to review by the NASD under its Rules of Fair Practice. Following is a brief overview of these requirements:

Registration and Prospectus Delivery: Section 8 of the 1940 Act requires investment companies to register with the Commission under the 1940 Act. If the company is making a public offering, it must also file a registration statement that serves to register the company's securities under the 1933 Act and contains information about the company and its investment policies and attendant risks. The registration statement includes the fund's prospectus, the principal selling document that is required to be delivered to prospective investors. 5/

In addition to the specific information that a fund's prospectus and registration statement must disclose, these documents may not contain information that is materially misleading or omit information that is necessary to make the information included not misleading. In 1993, the Commission staff stated that bank-sold and bank-advised funds must include on the cover page of their prospectuses disclosure that their shares are not deposits of or guaranteed by the bank or insured by any U.S. government agency. 6/ Additionally, since 1991, money market funds have been required to include, on the cover page of their prospectuses and in any advertising or sales literature, a prominent statement that an investment in the fund is neither insured nor guaranteed by the U.S. government. 7/

Advertising: The Commission regulates fund advertising and sales literature pursuant to several rules under the securities laws: 8/

4/ NASD Rules of Fair Practice, Art. III, Sect. 2. The NASD has, on several occasions, reminded its broker-dealer members of their obligations with respect to mutual fund sales in particular. See NASD Notices to Members 94-94 (Dec. 1994), 94-16 (Mar. 1994), 93-87 (Dec. 1993), and 91-74 (Nov. 1991).

5/ The prospectus includes, among other things, condensed financial information showing income and capital changes for the last ten years and a fee table setting forth the various costs and expenses associated with investing in the fund.

6/ Section 35(a) of the 1940 Act makes it unlawful for funds and any persons selling fund shares to represent or imply that the fund's shares are guaranteed, sponsored, recommended, or approved by the United States or any agency or officer thereof.

7/ See Form N-1A, Item 1; Rule 482(a)(7) under the 1933 Act; Rule 34b-1(a) under the 1940 Act.

8/ Under the 1933 Act, a fund may not offer its shares for sale unless prospective investors receive a current prospectus meeting the requirements of that Act in advance of or at the time of sale. Prospectus is broadly defined to include any notice, circular, advertisement, or letter of communication (including radio or TV broadcasts) which offers any security for sale. Therefore, absent exemptions (continued...)

Mr. James L. Bothwell
June 12, 1995
Page 5

- *Omitting Prospectus*: Under Rule 482 of the 1933 Act, funds may publish advertisements containing a broad range of information, including performance data, as long as the substance of that information is included in the fund's prospectus. If an ad contains any performance information for the fund, the ad also must present the fund's total return, calculated under a formula specified by the Commission, for the last one, five, and ten years. Additionally, the ad must state that the performance figures represent past performance and that the investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original investment.

- *Tombstone Advertisements*: Rule 134 of the 1933 Act permits advertisements that contain certain limited information about the fund. These types of advertisements may not contain performance information, and must direct the reader to obtain a prospectus for further information.

- *Generic Advertisements*: Rule 135a under the 1933 Act permits generic advertisements that do not refer to the securities of any one fund.

- *Anti-Fraud Provisions*: All fund advertisements and sales literature are subject to the anti-fraud provisions of the federal securities laws. Rule 156 under 1933 Act identifies particular advertising practices that may be misleading, such as the use of implied promises of future performance.

- *Sales Literature*: Rule 34b-1 under the 1940 Act imposes certain requirements on fund sales literature, including certain of the disclosure requirements of Rule 482. 9/

8/(...continued)
from the prospectus delivery requirement, funds would be unable to advertise or distribute sales literature, as these documents would be considered prospectuses that do not comply with the 1933 Act.

See comment 1.

In light of these requirements, we point out that the draft report's statement (page 72) that "individuals can place orders for certain non-bank mutual funds over the phone or by responding to newspaper advertisements" does not accurately reflect the requirements of the securities laws, which effectively prevent investors from purchasing mutual fund shares directly from advertisements. As a matter of fact, mutual fund advertisements under Rule 482 must state that the investor should write or call for a prospectus and may not contain or be accompanied by an application through which an investor can buy fund shares. Similarly, advertisements under Rule 134 generally must inform readers how to obtain a prospectus and caution them to read it before investing. Of course, oral statements are not subject to any requirement for prior prospectus delivery. Therefore, if a broker sells fund shares based exclusively on oral statements, the investor typically will receive the fund's prospectus with the purchase confirmation.

9/ The Commission recently brought an action for remedial sanctions against a registered representative of a bank-affiliated broker-dealer involving the use of non-complying and misleading mutual fund sales literature. See In the Matter of Mulrooney, Admin. File No. 3-8522 (Oct. 13, 1994).

Mr. James L. Bothwell
June 12, 1995
Page 6

- *NASD Requirements*: Section 35 of Article III of the NASD's Rules of Fair Practice governs broker-dealer members communications with the public. The NASD also has issued its own Guidelines Regarding Communications with the Public about Investment Companies and Variable Contracts. These guidelines apply in addition to the Commission rules discussed above.

Mutual fund advertisements and sales literature are required to be filed with the NASD (if the fund's shares are sold by an NASD member) or with the Commission. As a practical matter, most fund ads and sales literature are filed with the NASD rather than with the Commission. The NASD's advertising department reviews advertisements and sales literature for compliance with both the Commission rules and the NASD Rules of Fair Practice, and generally provides written comments on the material filed.

As you can see from this discussion, the Commission and the NASD oversee a comprehensive regulatory structure regarding mutual fund sales practices that predates the adoption of the Interagency Guidelines by the federal banking regulators. The Commission and the NASD have clear authority (other than with respect to direct bank brokerage activities that are exempt from broker-dealer regulation) and expertise to regulate mutual fund sales practices. 10/ The Commission rules and the NASD guidelines provide important protections against fraud in the sale of mutual fund shares. We believe that the GAO's testing of compliance with the Interagency Guidelines and its focus on the examination procedures of the federal banking agencies, as opposed to compliance with the federal securities laws and rules, place undue emphasis on the guidelines as a source of consumer protection in this area. While the guidelines are useful, the federal securities laws remain the most important set of investor protection criteria applicable to mutual funds and sales practices of broker-dealers. By not discussing fully the requirements of the federal securities laws, the draft report can be read as minimizing the investor protection roles played by the Commission and the NASD and does not take into account sufficiently the regulatory overlap created by duplicative examinations of broker-dealers.

See pp. 47 and 48.

3. Commission and NASD Inspection Resources and Enforcement

The draft report indicates that the Commission's inspections resources are too limited to effectively inspect mutual funds and investment advisers. During 1994 and 1995, the Commission's investment company examination staff increased by 100. If the Commission's 1996 budget request for an additional 50 positions is approved, the Commission should be able to examine investment companies and their advisers with reasonable frequency. 11/ In addition, the NASD also inspects its member broker-dealers, focusing on sales practices and advertising, among other areas.

See comment 2.

10/ Even in the case of bank-sold funds, fund sales literature and advertising would still have to comply with Commission rules and would have to be filed with the Commission.

11/ Effective May 1, 1995 the Commission established the Office of Compliance Inspections and Examinations, effectively centralizing the Commission's inspection program for investment companies, investment advisers, broker-dealers, and SROs. The new office is intended to enhance the Commission's inspections efforts and promote a more effective use of its examination resources.

See comment 3.

Mr. James L. Bothwell
June 12, 1995
Page 7

While the Commission's inspection resources are limited, we believe that the effective use of enforcement actions by the Commission and the NASD serves to substantially improve industry compliance with the securities laws. The Commission's enforcement cases send strong signals to the industry that the Commission will not tolerate abusive practices. In the mutual fund area, the Commission has brought a number of enforcement cases, including cases involving misleading sales practices, 12/ abuses by a fund's adviser in allocating securities transactions to the fund in an unfavorable manner, 13/ and abuses by portfolio managers regarding their personal investments. 14/

4. Functional Regulation

The Commission has long supported a system of functional regulation because it would help reduce, if not eliminate, the duplicative and conflicting regulation alluded to in the draft report. We believe that proposals to institute functional regulation, such as repealing the exception from broker-dealer regulation for banks and the exception from investment adviser regulation for banks that advise mutual funds, would result in the securities-related activities of banks being monitored by the regulator that is the most knowledgeable and best equipped to address these activities. Such a system would significantly reduce regulatory overlap because each agency would oversee only those aspects of an entity's operations that come within its statutory purview and area of expertise. For the same reason, functional regulation also would eliminate regulatory gaps inherent in the present system. 15/

Absent Glass-Steagall reform or a system of functional regulation, the Commission is nevertheless committed to fostering cooperation with federal banking regulators to reduce the duplication inherent in the existing regulatory structure. The Commission and the federal banking regulators have different statutory mandates, and their staffs have differing areas of expertise. Their inspections, therefore, should focus on different aspects of an entity's operations. If federal regulators remain mindful of their respective missions and work to coordinate oversight when overlap exists, duplicative regulation that is costly to both the government and regulated entities can be avoided. 16/

12/ See Mulrooney, supra note 9.

13/ See Kemper Financial Services, Investment Advisers Act Release No. 1387 (Oct. 20, 1993).

14/ See United States v. Ostrander, 999 F.2d 27 (2d Cir. 1993); SEC v. Kaweski, U.S.D.C. Civ. Action No. 95-N-296 (D. Co. 1995).

15/ For example, as mentioned in the draft report, bank regulators do not review potential conflicts between a bank-advised fund and a bank's other advisory clients, and the Commission does not have authority to do so.

16/ In this regard, we agree with the GAO's assessment that the OCC's proposed examinations of banks for compliance with the provisions of the 1940 Act encourages duplicative and conflicting regulation (page 87 of draft report). The draft report also noted that the OCC has examined several broker-dealers that had already been examined by the NASD in the past several months. We note that it is unclear whether the OCC has the legal authority to conduct these examinations.

Mr. James L. Bothwell
June 12, 1995
Page 8

The Division appreciates the opportunity to comment on the draft report. I respectfully request that this letter be appended to the final report delivered to Congress.

Sincerely,

Barry P. Barbash
Director

The following are GAO's comments on the Securities and Exchange Commission's letter dated June 12, 1995.

GAO Comments

1. This statement has been deleted from the report.

2. We have revised the report to reflect that SEC believes it will be able to inspect investment companies and their advisers with reasonable frequency if its fiscal year 1996 request for 50 additional positions is approved. (See pp. 61 and 63.)

3. Our work was not intended to address the functional regulation issue.

Major Contributors to This Report

General Government Division, Washington, D.C.

Michael A. Burnett, Assistant Director, Financial Institutions and Markets Issues
Frank J. Philippi, Evaluator-in-Charge
Gloria Cano, Evaluator
Maia Greco, Bank Policies Analyst
Gillian M. Martin, Evaluator
Wesley M. Phillips, Evaluator
Barry L. Reed, Senior Social Science Analyst
Carl M. Ramirez, Senior Social Science Analyst

New York Regional Office

Dorothy T. LaValle, Senior Evaluator
Jeffrey Shapiro, Evaluator
Bryon S. Gordon, Evaluator

San Francisco Regional Office

Susan J. Kramer, Evaluator

Office of the General Counsel, Washington, D.C.

Lorna J. MacLeod, Attorney

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (301) 258-4097 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

PRINTED ON RECYCLED PAPER

United States
General Accounting Office
Washington, D.C. 20548-0001

Official Business
Penalty for Private Use $300

Address Correction Requested

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100