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COMMENTS

OF BANKS AND MUTUAL FUNDS:
THE COLLECTIVE INVESTMENT TRUST

by John Micheal Webb

I. Pre-1963: The Comparison

Banks have traditionally furnished investment advisory services to their customers by offering to hold and manage funds. Trust departments of national banks held assets of more than sixty-five billion dollars at the end of 1963 in accounts where they had investment responsibility. Generally this has been accomplished in the form of a so-called “managing agency account.” In such an arrangement the bank would undertake to hold and manage for the customer a portfolio of investments pursuant to a power of attorney giving the bank complete investment discretion. Because of the expenses involved in furnishing proper investment counsel, brokerage, and general management for such an account, only relatively large accounts were economically feasible for the banks to handle. A small account standing alone could not bear the expense and remain profitable. Therefore, banks could only furnish this service to small investors if they were allowed to pool a number of smaller accounts into a relatively large “commingled managing agency account” or collective trust. Prior to 1963, national banks, while authorized to commingle and invest trust funds held as trustee, executor, administrator or guardian, were not permitted to commingle regular managing agency accounts. In other words, a small investor could not, except within certain narrow restrictions, avail himself of a bank’s services in holding and managing his investment funds.

During the pre-1963 period, the operations and capabilities of the mutual fund industry were in sharp contrast to those of the banks.

1 Hearings on Collective Investment Funds, 88th Cong., 2d Sess. 27 (1964) (hereafter cited as Collective Funds Hearings).
2 So-called “common trust funds” were exempted from the Investment Company Act of 1940 by § 3(c)(2). Section 17 of the Federal Reserve Board’s Regulation F also permitted limited commingling.
3 The limited mechanism of the common trust fund was first permitted to national banks in 1937 through the promulgation by the Federal Reserve Board of an amendment to Regulation F, governing trust activities by national banks. Until 1962 the Board confined bank participation in common trust funds to situations in which banks were acting as trustees, executors, administrators, or guardians for “true fiduciary purposes.” This true purpose test was the primary road-block to commingled managing agency accounts, the sole purpose of which would be investment services.
Mutual investment funds have the character of cooperative enterprises. They are based on the theory that investors, individually capable of making only small or moderate sized purchases and lacking the qualifications or the services of professional investment managers, can, with advantage, pool their funds. If large accumulations can be so created, it should be possible to provide skilled supervision for the common portfolio and to minimize risks by making sufficiently broad diversification practicable. The mutual fund’s only business is investing. Capital is raised by the issuance of new shares to each shareholder joining the fund; and capital is returned to shareholders who wish to leave the fund by redeeming their shares. Typically a “sales load” of from seven and one-half per cent to eight and one-half per cent is charged to the investor. Although recently the subject of some criticism, this system has apparently proven successful, as the mutual funds now hold some thirty four billion dollars of the investing public’s assets and more than three million people participate as shareholders. In 1961 there were 330 such funds in operation.

At the close of 1962 the investment services provided by banks and mutual funds were not vastly dissimilar in nature. But the markets served by these two institutions were very different. The mutual funds, through a system of pooling, were able to serve the medium or small investor. The banks were forbidden to pool accounts other than those held for a “true fiduciary purpose” as trustee, guardian or administrator. Therefore, the bank-managed collective trusts were generally only available to widows, orphans and incompetents but not to ordinary investors. James J. Saxon, Comptroller of the Currency, pointed out another difference between bank’s collective trusts and mutual funds. In an appearance before a House subcommittee he stated, “Banks collectively invest with no extra charges therefor. This reflects the contrasts which are well known through various studies of the mutual funds industry of the abuses, the very

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5 The mutual fund is technically a diversified, open-end, management investment company pursuant to the classification of the Investment Company Act of 1940 § 5, 15 U.S.C. § 80a-5 (1958).
6 *Hearings on Common Trust Funds—Overlapping Responsibility and Conflict in Regulation*, 88th Cong., 1st Sess. 83 (1963) (hereafter cited as *Conflict in Regulation Hearings*).
9 *Wharton School Study*, supra note 7, at 37, 40.
10 Both mutual funds and bank-operated common trusts could pool funds and invest them.
grave abuses of the heavy loading charges that have been imposed on mutual funds. . . .

However, until recently the Federal Reserve Board's regulations have effectively precluded competition by the national banks with the mutual funds in the lucrative small investor market. Naturally, the banks desired and advocated a change in these regulations for many years. Charles Young, senior vice president of the City National Bank and Trust Company of Kansas City, in an address to the mid-winter Trust Conference of 1960 while speaking of this problem summarized the banks' attitude as follows:

For some inexplicable reason . . . a much different attitude seems to have existed at the Board with regard to the whole problem of collective trusts. Almost every effort made by this Association and its individual members to obtain a less rigid and more realistic, modern approach to the regulation of common trust funds has been rebuffed. Worse yet, the Board's action in these cases seemed to reflect the same attitude of reservation and doubt toward common trust funds and fear of their misuse, which existed 22 years ago with some justification but for which there is no longer justification today.

The banking industry's frustration was soon to end.

II. THE NEW ERA

In September, 1962, jurisdiction over trust powers of national banks was transferred by Congress from the Federal Reserve Board to the Comptroller of the Currency. Early in 1963, the Comptroller proposed a revision of regulations which for the first time would authorize national banks to maintain a collective trust fund for managing agency accounts, thus authorizing the banks to operate in substance an open-end investment company. Bankers seemed to believe that this proposed revision would allow them to enter the mutual fund market. The Comptroller's proposals were generally acclaimed by the banking industry as follows:

Commercial banks will have powers that will enable them to compete

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11 Collective Funds Hearings at 24.
12 Section 17 of the Federal Reserve Board's Regulation F.
14 Id. at 241.
16 Regulation F of the Federal Reserve Board was to be revised.
17 Open-end companies are companies in which there is no predetermined limit on size or membership and the stockholder or certificate holder has a right to compel the company to redeem his shares at their asset value. Closed-end companies have set limits and generally entrance can be gained only by purchasing from a present owner, and shareholders do not have the right to force the company to redeem shares at their asset value.
more effectively with mutual funds and other investment companies when new regulations proposed by Comptroller of the Currency James J. Saxon go into effect early in April. . . Under the proposed rule, banks will, in effect, be able to offer their investment services to individuals in competition with mutual funds, life insurance, closed-end investment companies, investment advisers and other investment media.18

As revised,19 regulation 9 permits the following three types of collective investment trusts:

(1) a common trust fund, in which the bank is permitted to place individual trusts held by the bank in the capacity of trustee, executor, administrator, or guardian into the common fund;20

(2) trusts consisting solely of assets from retirement, pension, profit sharing, stock bonus or other trusts which are themselves exempt under the Internal Revenue Code;21 and

(3) a type of collective trust fund which may contain funds held by the bank as fiduciary, other than trustee, executor, administrator or guardian.

It is the third type of collective trust that this comment is concerned with; this would be the so-called commingled managing agency account. Within regulation 9, sections 9.1 (g) and 9.18 (a) (3) are the crucial provisions for commingled managing agency accounts. Section 9.18 (a) (3) provides that where not in contravention of local law, funds held by a national bank as fiduciary may be invested collectively in a common trust fund, maintained by the bank exclusively for the collective investment and reinvestment of money contributed thereto by the bank in its capacity as managing agent under a managing agency agreement expressly providing that such money is received by the bank in trust. Section 9.1 (g) provides that “managing agent” means the fiduciary relationship assumed by the bank upon creation of an account so entitled (Managing Agency Account) which confers investment discretion on the bank and imposes upon it the fiduciary responsibilities imposed upon trustees under such instruments as wills and deeds.

Adoption of revised regulation 9 opened the doors for expansion of the banking industry into the area of management services to small investors, but it was far from the final resolution of all the banks' problems in the collective trust field. Two primary threats

20 This type of common trust fund is merely an extension of the powers that national banks previously had under Regulation F.
21 This type of trust is primarily intended for use in handling those retirement plans that became available upon passage of the Smathers-Reogh bill, the Self-Employed Individuals Tax Retirement Act of 1962.
remained. First, without a favorable ruling from the Internal Revenue Service, it was possible that such trusts would be "associations" and therefore taxed as corporations.\(^\text{22}\) Imposition of the corporate income tax upon commingled managing agency accounts would completely destroy their feasibility. Second, the Securities and Exchange Commission, immediately upon the passage of regulation 9, began to assert its jurisdiction as a regulatory agency. The SEC maintained that such trusts would be within the purview of both the Investment Company Act of 1940\(^\text{23}\) and the Securities Act of 1933. The specter of duplicate and burdensome regulation by the Comptroller and the SEC posed the greatest danger. To further complicate matters, the various investment associations and mutual funds began to voice their opposition to the banks intrusion.\(^\text{24}\)

### III. Tax Aspects

The same law that transferred trust authority from the Federal Reserve Board to the Comptroller also amended pertinent sections of the Internal Revenue Code.\(^\text{25}\) Section 384, the most important section to collective trusts, was amended to read as follows:

(a) Definitions.—For purposes of this subtitle, the term "common trust fund" means a fund maintained by a bank—

(1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and

(2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks.

(b) Taxation of Common Trust Funds.—A common trust fund shall not be subject to taxation under this chapter and for purposes of this chapter shall not be considered a corporation.\(^\text{26}\)

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\(^{22}\) Section 11(a) of the Internal Revenue Code of 1954 imposes a tax on the taxable income of "every corporation," but it does not define the term "corporation." The Code's definitional section at § 7701(a)(3) provides that "the term 'corporation' includes associations." The case law definition of "association" that has evolved is far from clear, but it is broad enough to include a collective investment trust which has the corporate features of separation of management from ownership and the division of ownership into "shares" or units of interest.

\(^{23}\) The Cole-Wagner Act (Pub. L. No. 768, approved August 22, 1940). Unlike the Securities Act of 1933 and the Securities Exchange Act of 1934 which compel issuers of securities to provide full and fair disclosure of information regarding their securities to prospective purchasers, the act, more on the order of the Public Utility Holding Act of 1935, provides not only for full disclosure of information regarding investment companies and their securities, but goes further and provides for the regulation of their activities.


On its face section 584 seems to provide complete protection for the commingled managing agency accounts if they qualify as "common trust funds." The danger to commingled managing agency accounts was created by income tax regulation section 1.584-1(b). This regulation provides that two conditions must be satisfied by a fund maintained by a bank before such fund may be designated a "common trust fund." The first condition is that such fund must be maintained by a bank exclusively for the collective investment of money contributed thereto by the bank acting solely in its capacity (i) as a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court; (ii) as an executor of the will of, or as an administrator of the estate of, a deceased person; or (iii) as a guardian of the estate of an infant, incompetent or absent person. The second condition is that the fund must be maintained in conformity with the rules and regulations of the Comptroller of the Currency, pertaining to the collective investment of trust funds by national banks, whether or not the bank maintaining such fund is a national bank or a member of the Federal Reserve System.

The second condition of regulation section 1.584-1 (b) and section 584 (a) (2) of the Internal Revenue Code clearly dictates that state banks must conform to the Comptroller's rules and standards. It is the first condition that was the basis of concern over whether the proposed commingled managing agency accounts would be within the term "common trust fund" and hence exempt from taxation as a corporation. This doubt was resolved in favor of the banks when the Internal Revenue Service on February 24, 1964 issued Rev. Rul. 64-59. This ruling in relevant part states:

[I]t is held that a fund maintained by a bank, exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank, in its capacity as managing agent, in accordance with sections 9.1(g) and 9.18 (a) (3) of title 12 of the Code of Federal Regulations, as amended, will qualify as a "common trust fund" within the meaning of section 584. . . . 27

This revenue ruling completely eliminated the threat posed by the corporate income tax. The second hurdle, regulation by the Securities and Exchange Commission, however, was not as easily cleared.

IV. THE JURISDICTIONAL SQUABBLE

The Securities and Exchange Commission took the position that the situation of all investors in managed commingled funds is the

27 Rev. Rul. 64-59 (1964).
same, whether the management or the adviser is a bank, a private investment counselor, a broker-dealer, an insurance company, or anyone else. The Comptroller of the Currency asserted that regulation by the Comptroller and the various banking agencies was sufficient protection for the public without any regulation or interference from the SEC. Two primary questions seemed to be posed:

(1) whether the newly-possible collective investment funds were sufficiently like mutual funds to warrant SEC regulation; and

(2) whether, if they were like mutual funds, regulatory action by one or more bank supervisory agencies would be as satisfactory as SEC regulation.

This jurisdictional dispute posed not only a question of duplicate regulation but also of the nature and adequacy of regulation.

William L. Cary, formerly Chairman of the Securities and Exchange Commission, emphasized that the inspection and regulation imposed by the banking agencies was not the equivalent of the "disclosure" that would be required by the securities laws. The SEC is oriented toward protection of shareholders by full disclosure; while the banking agencies are oriented toward protection of depositors by systematic inspection. According to former chairman Cary, the position of the holder of a unit of interest in a commingled managing agency account was exactly the same as a shareholder in a mutual fund. In an appearance before a House subcommittee Cary stated, "The disclosure requirements proposed by the Comptroller's regulation with respect to bank-sponsored mutual funds fall short of what Congress considers necessary for shareholders of mutual funds."

In addition to inadequate disclosure, Cary was concerned with possible conflicts of interest between the fund and other aspects of the bank's activities. The following four areas of potential conflict were specifically pointed out:

(1) Since the cash portion of the fund's portfolio may be deposited in the bank and used to make money for the bank, care must be taken to see that the question of how much of the portfolio should be kept in cash is decided on the proper grounds. Large amounts of cash should be kept uninvested only when it is beneficial to the collective trust and not for the benefit of the bank.

(2) The fund has brokerage business to direct. The usual system

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28 Collective Funds Hearings at 10.
29 "Full and fair disclosure" of all relevant information to enable the prospective investor to make an intelligent decision. This goal of disclosure is generally obtained by requiring "registration" of shares and by various reporting requirements. See 2 Loss, Securities Regulation, ch. 6 (1961).
30 Conflict in Regulation Hearings at 10.
31 Id. at 11, 12.
employed by banks of distributing brokerage according to a formula which rewards those brokers who keep balances in the bank or have other business relations with the bank, could lead to excessive portfolio turnover or to the fund's not receiving the maximum benefit from its brokerage business.

(3) Fund investments could be used to shore up bank investments. Should bank investments ever decline sharply while the fund investments maintained their position, the opportunity for switching investments would be present.

(4) Banks are underwriters and dealers in various kinds of government bonds, many of which might be a suitable class of investments for the mutual funds they sponsor.

The SEC maintained that it would be empowered to regulate the newly-created collective trusts under the Investment Company Act of 1940 and the Securities Act of 1933. Ordinarily, sections 3 (c) (3) and 3 (c) (7) of the Investment Company Act exclude banks from regulation by the SEC under the act.\(^3\) However, the Commission maintained that the operation of collective investment trusts by banks would fall under its jurisdiction without regard to those sections exempting banks. To bring these collective trusts within the purview of the Investment Company Act, the SEC subscribed to the theory that two entities would exist in the operation of these funds by banks—while the "bank entity" might be exempt, the "fund entity" clearly would not be. Former chairman Cary, in an appearance before a House subcommittee testified that, "we should separate out this pool of funds, or this fund from the bank as such. It is a totally separate organization."\(^3\) This separation would create a so-called "ectoplasmic investment company," a novel legal concept evolved by the Commission in two cases dealing with variable annuity contracts.\(^4\) The ectoplasmic theory or principle works to attribute legal

\(^3\) Section 3(c) (3) and (c) (7) in enumerating persons not considered to be investment companies provide as follows:

(3) Any bank . . . any common trust fund or similar fund of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian . . . if a majority of the units of beneficial interest in such fund . . . are held under instruments providing for payment of income to one or more persons and of principal to another or others.

(7) Any company primarily engaged, directly or through majority-owned subsidiaries, in one or more of the businesses described in paragraphs (3), (5), and (6), or in one or more of such businesses together with an additional business or businesses other than investing, reinvesting, owning, holding or trading in securities.

\(^4\) Conflict in Regulation Hearings at 16.

existence, as an entity, to one specific activity of a business otherwise exempt by describing as an investment company any amorphous group which is deemed to be functioning as an investment company. This separate ectoplasmic entity, the commingled managing agency account or collective trust, would not be a bank and therefore would not be entitled to the banking exemptions of the Investment Company Act.

The banks' operations would be brought within the ambit of the Securities Act of 1933 through the use of another, better known theory. According to the SEC, to make the operation of such funds economically feasible to banks, it would be necessary to obtain a large number of trusts and pool them. This, in the opinion of former chairman Cary, "inevitably means solicitation of the public to buy a security, that is the unit of interest in the pooled fund." Such a solicitation would amount to a public offering of a security by a non-exempt entity within the terms of the Securities Act. Securities issued or guaranteed by banks were classified as exempted securities by section 3 (a) (2) of the Securities Act. But Chairman Cary answered this problem with the statement, "it has been our interpreta-

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28 Conflict in Regulation Hearings at 6.
29 SEC v. Ralston Purina Co., 346 U.S. 119 (1953), is the case generally cited in defining the broadest extent of a public offering. In response to a question concerning what constitutes a public offering, former Chairman Cary, in the Conflict of Regulation Hearings, at 27, described the Ralston Purina case as follows:

It was a case, as I recall it, which involved the offering of a stock option, a stock purchase plan to the employees of the Ralston Purina Co. And the court, in that case, Mr. MacDonald, did not fix an exact number of offerees as the basis for a public offering, but it concluded that if an offering were to be made to a sufficient number of people to whom the information would not be intimately already available, mainly the inside officers, for example, of a company, then in that kind of a case, even the offering of a stock purchase plan to its own employees constituted a public offering.

It has been suggested that if the banks do not advertise the availability of participations in these collective trusts, no public offering will exist. However, it was pointed out in Conflict of Regulations Hearings, at 8, advertising is not the only way to solicit participation. Cary gave the following illustration: "The Bank of America with 738 branches and 25,700 employees in California, including branches in every community of modest size, can surely make the availability of the commingled managing agency account as an investment medium known in a highly effective fashion." Id. at 8.

The term "security" is broadly defined under both the Securities Act and the Investment Company Act to include certificates of interest or participations in profit-sharing agreements and investment contracts. There is no absolute protection to be found in the non-existence of a certificate or other paper, the mere existence of a bookkeeping notation evidencing a unit of interest in the collective trust would be sufficient to create a security.

30 Section 3 (a) (2) of the Securities Act of 1933 provides in relevant part as follows: the provisions . . . shall not apply to any of the following classes of securities . . . any security issued or guaranteed by any national bank, or by any banking institution organized under the laws of any State or Territory or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or Territorial banking commission or similar official; or any security issued by or representing an interest in or a direct obligation of a Federal Reserve Bank. . . .
tion that section 3 (a) (2) applies only to securities directly issued or guaranteed by a bank. The unit of interest in a commingled fund maintained by a bank does not represent an interest in, nor is it guaranteed by, a bank. The SEC's position could be summarized as asserting that the fund is a separate entity from the bank and that units of interest in it are securities.

The Comptroller of the Currency disagreed with the SEC's position on both of these jurisdictional theories. The Comptroller maintained that the regulations imposed by his agency completely precluded any public solicitation and that the ectoplasmic theory in this situation was invalid. Saxon, appearing before a House subcommittee, stated, "The fund is the bank—it is the board of directors that is responsible for its operation. There is no such distinction we see whereby the fund becomes a separate creature." He further contended that the ectoplasmic theory was logically unpalatable and violated clear congressional intent to exempt banks from the Investment Company Act by rendering section 3 (c) (3) and 3 (c) (7) nugatory. In the Comptroller's opinion, the unit of interest was not a security as defined by the Securities Act of 1933, and the exemption of section 3 (a) (2) of that act should control. Saxon strongly asserted that the inspection and regulation conducted by the banking agencies was more than adequate to protect investors, and he appeared to favor legislation, "eliminating the horrendous duplication which would obviously exist if both agencies were left in this field."

In discussing regulatory jurisdiction, it is important to remember that the Comptroller's statutory authority extends only to the trust functions of national banks. Despite the broadening effect of section 584 of the Internal Revenue Code, the banks chartered by the various states might in practice be comparatively free of the Comptroller's watchful eye. The Securities and Exchange Commission's jurisdiction would not be influenced by the characterization of a bank as "state"

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39 Conflict in Regulation Hearings at 4.
41 Conflict in Regulation Hearings, at 50.
42 The Securities Act of 1933 § 2 (1), defines the term "security" as follows:
   (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
43 See supra note 38.
44 Conflict in Regulation Hearings at 45.
or "national." In addition, section 9:18 (a) (3) of regulation 9 as previously discussed makes state law relevant. Looking briefly at the applicable state laws concerning collective investment trusts, they seem to fall into four broad categories. Sixteen states appear to expressly authorize such accounts,45 and twenty-three states seem to sanction such accounts inferentially.46 Seven states either expressly forbid such commingled managing agency accounts or place severe restrictions on them,47 and four states have no applicable statutes.48 Only two states, Missouri49 and New Hampshire,50 have developed any relevant case law.

In addition to the potential complexity caused by the wide variations in state laws, the jurisdictional dispute is further complicated by the intervention of the mutual fund industry. The Association of Mutual Fund Plan Sponsors, the Investment Company Institute and the National Association of Securities Dealers disagreed with the Comptroller and supported the SEC's jurisdictional claims. "They ... contended that the asserted protections to investors resulting from the Bank's fiduciary position and from banking regulations and supervision are inadequate substitutes for the protection of section 10 [of the Investment Company Act]."51 Section 10 would in effect completely frustrate banks in the operation of collective investment trusts, as it contains a prohibition of bank domination of mutual funds. Negotiated settlement of the jurisdictional squabble failed to materialize, and it seemed that congressional action would be necessary to resolve the dispute.52

V. ATTEMPTED LEGISLATION

As the result of this jurisdictional dispute, efforts were made to exempt bank-operated collective investment trusts from regulation under the securities laws by legislative action. Two bills were introduced during the second session of the Eighty-eighth Congress.53

45 Alabama, Connecticut, District of Columbia, Georgia, Hawaii, Indiana, Iowa, Kentucky, Louisiana, Michigan, Minnesota, Missouri, North Dakota, Rhode Island, South Carolina, and Vermont.

46 Alaska, Arkansas, Kansas, Maryland, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Washington, West Virginia, Wisconsin, and Wyoming.


48 Arizona, California, Colorado, and Idaho.

49 St. Louis Union Trust v. Toberman, 140 S.W.2d 68 (Mo. Ct. App. 1940).


52 See Collective Funds Hearings at 18.

53 By "two bills" is meant S. 2223 and the combination of H.R. 9410 and H.R. 8499 which are substantially identical.
The purpose of these bills was to provide for regulation by the Comptroller of the Currency rather than by the SEC of commingled managing agency accounts created and managed by banks. 44 Both bills received the active support of the banking industry and the Comptroller. 45 The National Association of Securities Dealers opposed passage of either bill. 46 Robert W. Haack, president of NASD, appearing before a House subcommittee stated, "while the association is mindful of the possible overlapping of jurisdiction and regrets that such dual jurisdiction often eventuates in a complex society, it believes that the protections afforded by the securities acts should be given to the customers of banks who participate in collective investment funds." 47 Neither bill ever got out of committee. 48

On October 22, 1965, just hours before the end of the first session of the Eighty-ninth Congress, Senator Thomas J. McIntyre introduced S. 2704, a bill "to provide for the regulation of collective investment funds maintained by banks, and for other purposes." In substance, the McIntyre bill would permit banks to operate collective investment funds resulting from a pooling of their managing agency accounts subject to regulations of the Comptroller of the Currency and exempt from the federal securities laws. While hearings were being conducted on this bill, the Securities and Exchange Commission handed down its decision on the application of the First City National Bank for certain exemptions from the Investment Company Act of 1940 in operating a commingled managing agency account. 49

On March 12, 1966, Comptroller of the Currency, James J. Saxon, a leading proponent of legislation to exempt collective trusts from the securities laws, suddenly reversed his position. 50 Saxon stated that, "We contend that the regulations of our office and those of the SEC are complimentary [sic] and we trust that they will be modified so as to eliminate duplicate reporting, and other unnecessary activities..." 51 He concluded that the McIntyre bill would not be needed. Shortly thereafter it was reported that, "in view of the strong opposition, coupled with the Comptroller of the Currency's withdrawal of support for the Bill, it is likely that the Bill is dead for the current session of Congress." 52 The SEC's treatment of the First National

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44 Collective Funds Hearings at 1.
45 Id. at 22, 72, 85.
46 Id. at 113.
47 Id. at 116.
49 SEC Release, supra note 11.
City Bank's application appears to be at least partially if not primarily responsible for the death of the McIntyre bill.

VI. The Citibank Decision

The First National City Bank (Citibank) had for many years offered an investment advisory service. This service consisted of holding and managing a portfolio of investments for individual customers. The smallest account that it was economically feasible for the Bank to handle was $200,000. Encouraged by the Comptroller's revision of regulation 9 and the favorable revenue ruling of the Internal Revenue Service, the Citibank took steps to enter the lucrative collective investment trust market. The bank proposed to allow customers to put up $10,000 or more for investment in securities through a commingled managing agency account. The plan would allow the bank, as investment adviser, to manage the investment program, determining what securities would be purchased or sold. No sales load or redemption charges would be imposed, and the operation of the account would be subject to the supervision of a seven man committee, the statutory equivalent of a board of directors. The initial units of interest in the account were to be sold pursuant to a private placement as exempted from the Securities Act of 1933.

Pursuant to his regulations, the Comptroller approved the arrangement proposed by the Citibank. In addition, the Federal Reserve System ruled that the proposed arrangement would not violate section 32 of the Banking Act of 1933. Section 32 prohibits any individual primarily engaged in, or associated with a corporation or partnership primarily engaged in, the “issue, flotation, underwriting, public sale or distribution . . . of . . . securities” from serving as an officer, director or employee of any member bank of the Federal Reserve System. Having obtained the approval of the Comptroller and the Federal Reserve Board, the Citibank approached the Securities and Exchange Commission.

The Bank filed an application to register as a diversified open-end management investment company under the Investment Company Act of 1940, and to be exempted from various provisions of that act. The principal exemptions sought for the account were from sections 10 (b) (3), 10 (c) and 10 (d) (2) of the act. Basically, the

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63 Rev. Rul. 64-59 (1964).
64 Securities Act of 1933 § 4(2).
67 Additional exemptions were requested from rules 17 C.F.R. 270.17f-2 and 17g-1, and temporary exemptions, until the first annual meeting of participants, from section 15(a), 16(a) and 32(a) (2).
exemptions were requested in order to permit all but one of the members of the supervisory committee to be affiliated with the bank. The mutual fund industry was quick to react to the Citibank's application. In a petition filed with the Securities and Exchange Commission the Investment Company Institute formally opposed the establishment of a commingled investment account and requested that a hearing be held. The National Association of Securities Dealers and the Association of Mutual Fund Plan Sponsors, Inc. both went on record against any SEC authorization for the Citibank's investment management plan and joined in the request for a hearing.

The Securities and Exchange Commission held a formal hearing on the Citibank's proposals. Acting under section 6 (c), the Commission, with one exception, granted the bank's requests for exemptions. Section 6 (c) provides that the SEC may exempt any person from any provision of the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and purposes fairly intended by the policy and provisions" of the Act. Relying upon this exemptive power, the SEC granted the Citibank exemptions from sections 10 (c) and 10 (b) (3) but refused to grant an exemption from section 10 (d) (2).

Section 10 (c) provides that a majority of the supervisory committee may not consist of persons who are officers or directors of a bank. The intervening representatives of the mutual fund industry maintained that this section reflects a deliberate policy of Congress in prohibiting the domination of mutual funds by banks. The mutual funds cited the areas of potential conflicts of interest that had previously been espoused by former chairman Cary as reason for the existence of this prohibition. The SEC overruled these contentions, pointing out that "a specific prohibition against bank domination of an investment company does not preclude an exemption pursuant to section 6 (c)." The Commission went on to say, "in our opinion, the Bank has shown that substantial safeguards are present here against conflicts of interest which could arise as a result of the Bank's commercial banking activities."

Under section 10 (b) (3) the supervisory committee may not have

70 SEC Release, supra note 51.
72 See text accompanying note 29 supra.
73 SEC Release, supra note 51, at 82,589.
74 Id. at 82,590. The safeguards referred to are the periodic examinations conducted by the various banking agencies.
a member who is affiliated with an investment banker unless a majority of the committee is not so affiliated. As the proposed account would be primarily a stock fund and the bank, as an investment banker, is limited to underwriting governmental debt securities, the SEC found that there was no basis for concern that the bank could abuse its position; therefore, the exemption was granted. However, the Commission did impose a condition that the account would not be permitted to buy any securities underwritten by the bank during the time any such securities remained unsold in the hands of the bank or any other underwriter.

Section 10 (d) would permit an investment company charging no sales load and meeting certain other requirements to have a supervisory committee with only one director who is not affiliated with its investment adviser. However, section 10 (d) (2) requires that the investment adviser be registered under the Investment Advisers Act of 1940, a condition that the Citibank could not meet because it would not be “engaged principally in the business of rendering investment supervisory services” as defined in the Advisers Act. The Commission denied an exemption from section 10 (d) (2) as being unnecessary to properly run the account. The SEC’s order permits up to sixty per cent of the committee members to be affiliated with the Bank, but it requires that forty per cent be unaffiliated.

The Commission approved the Citibank’s registration and the exemptions discussed above by a vote of four to one. Commissioner Hamer H. Budge dissented from the decision, stating that the specific ban by Congress against bank management should be repealed only by Congress itself, not by the Commission through the granting of exemptions under its general exemptive powers. The Commission’s decision is expected to be appealed to the courts by the Investment Company Institute and possibly by other elements of the mutual fund industry. The banking industry has continued to press for legislation exempting its operations in the collective trust field from the securities laws. However, the SEC’s Citibank decision and the Comptroller’s withdrawal of support for the McIntyre bill indicate that dual regulation will be the order of the day. But, this regulation will probably be in a modified form never seen before.

75 Section 202(a)(13) of the Advisers Act defines “investment supervisory services” as the “giving of continuous advice as to the investment of funds on the basis of the individual needs of each client.”
76 SEC Release, supra note 51, at 82,593.
VII. Conclusion

The SEC's Citibank decision eliminates the final barrier to the creation of bank managed collective investment trusts formed by pooling a number of comparatively small managing agency accounts. However, a number of problems remain to be resolved before banks can effectively compete with the mutual funds. The mutual funds presently have two primary advantages over the banks. First, they can sell interests in the fund for a very small monetary amount and, second, they can publicly solicit for purchasers of these interests. At the moment banks are unable to do either of these. The Citibank plan is keyed to "investments of $10,000 or more" per investor. That figure certainly precludes a very large proportion of the investing public; the investment is simply too big. Before banks can really enter the "mutual fund market," they must substantially reduce the size and price of the available investments.

Public solicitation of purchasers is the key problem that must be solved before the banks can sufficiently reduce their prices. While the mutual funds are presently able to solicit and advertise with comparative freedom, the Comptroller's regulation would apparently prohibit such solicitation by the banks. Arguments can be made to support the proposition that banks are already in such a favorable position to obtain investors that any prohibition of public solicitation would not greatly impede their competitive effectiveness. For example, the banks are already in relatively intimate contact with the best potential mutual fund customers, namely, their depositors. In addition, it is relatively common for potential investors to ask their local banker for investment advice, particularly in smaller communities. Such a request for advice would certainly lead to a discovery of the bank's commingled managing agency account or, if it is a small bank, the local banker could point out the existence of a collective investment trust managed by their correspondent bank in a neighboring city. The prevalence of branch banking in some states would also help alleviate the solicitation problem. But, even with the presently available methods of obtaining investors, if the banks desire to fully utilize all the potentialities of commingled managing agency accounts, they must be able to publicly solicit purchasers. Under the various securities laws the banks would be allowed to solicit purchasers for units of interest in the collective fund provided that the

19 See note 51 supra.
60 California's Bank of America with a branch in literally every moderate sized community in the state is the most striking example.
units were properly registered. The previously mentioned existence of dual regulation may help the banks reach a favorable solution to the solicitation problem if they can convince the Comptroller that the SEC's registration requirements will furnish adequate protection for all concerned. The past actions and attitudes evidenced by the Comptroller indicate that he will probably not be overly restrictive.

The Citibank decision poses another problem in relation to the governing body of the collective investment trust. Under that decision only sixty per cent of the trust's supervisory committee can be affiliated with the bank; the other forty per cent must be unaffiliated. Two questions are raised by this requirement. First, what will "affiliated" be construed to mean? Certainly the bank's officers and employees are affiliated. But what about depositors or the bank's legal counsel, are they affiliated? Second, presuming a broad definition of "affiliated," where will the unaffiliated forty per cent come from? Once the definition is arrived at, the majority of legal problems will be easy to solve, but the practical problems may prove unusually vexatious. Will the bank be willing to lose a large depositor to gain a committee member, or will they be willing to use a man who is a large depositor in a competing bank?

Mutual funds have recently been the subject of some rather severe criticism, particularly the Wharton Report. The development of a strong source of competition, represented by the banks, may prove very beneficial to the mutual fund industry by forcing reforms such as the reduction of sales loads. The emergence of bank-managed collective investment trusts will aid the prospective small investor to the extent that he will have a broader range of investment methods to choose from.

Will bank-operated mutual funds be detrimental or beneficial to the economy generally? Several views are available. Charles W. Buek, President of the U. S. Trust Company of New York has expressed the following opinion:

Is this trend desirable? I would say it is unquestionably desirable. Let's look at what it might do to the stock markets. We are so-called "professional traders." We should in theory have a stabilizing effect on the market. We are not omniscient, we don't walk on water, but we think we buy when stocks are cheap a little more often than a non-professional and sell when stocks are high priced a little more often. I should assume that we have some beneficial effect on the market.

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81 Securities Act of 1933 § 5.
82 See note 7 supra.
83 See note 6 supra and accompanying text.
84 Mundheim, Conference on Securities Regulation (1961); Buek, Trust Companies and Banks as Institutional Investors 149-50 (1963).
Conversely, there have been expressions of opinions to the effect that allowing the banks to enter the mutual fund field will cause a detrimental result. One line of argument maintains that the creation of another type of large institutional investor will tend to aggravate the economic dangers posed by the presently increasing trend toward larger investors.\textsuperscript{85} The single greatest threat that is cited is the concentration of corporate control in the hands of these investors. "The real concern with the potential influence or control of the institutional investor is not in the ownership of debt securities, but rather in the increase of holdings of common stock investment and, thus, corporate voting power."\textsuperscript{86} It has been asserted that this voting power is almost always exercised in favor of the current management, tending to perpetuate the status quo, frequently at the expense of sacrificing potentially beneficial changes.\textsuperscript{87} A controverting argument to this line of thought can be based upon the comparative sophistication of institutional investors. If the banks, as relatively knowledgeable investors, believe that a management change would improve the opportunities and potential returns from a corporation, they will be in a position to force such a change that might not otherwise occur. In addition, the degree of sophistication that banks reputedly have as investors will enable them to recognize faster than the average investor that such a change is desirable.

The effect, whether detrimental or beneficial, on the economy will probably not be known for several years after this industry has been in full scale operation.

What is important to recognize at this point in time is that the day of the bank-managed collective investment trust, available to small investors, has arrived. In the words of Leon T. Kendall, an economist with the New York Stock Exchange; "I fully expect in the next ten years to see a Chase Manhattan Mutual Fund or Bank of America Mutual Fund. I expect to find banks with demand deposit windows, savings deposit windows and mutual fund or common trust fund windows in each branch."\textsuperscript{88}

\textsuperscript{85} This view is elaborated in another article appearing in the Conference On Securities Regulation: Brown, \textit{The Institutional Investor as a Shareholder} 207 (1963).
\textsuperscript{86} Id. at 209.
\textsuperscript{87} Ibid.
\textsuperscript{88} This opinion was expressed in another article appearing in the Conference On Securities Regulation: Kendall, \textit{Relation of the Individual Investor to the Institutional Investor} 164, at 169 (1963).