Testimony of

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I am pleased to appear before the Financial Institutions Subcommittee today on behalf of the Federal Reserve Board to describe the actions the Board has taken to regulate bank sales of mutual funds and to present the Board's views on what additional regulatory or Congressional action is necessary.

Growth of Mutual Funds

Before describing the actions the Board has taken, I would like to make some observations about the recent growth in the mutual fund industry. Growth in mutual fund assets in recent years has been nothing short of explosive. Last year, the public bought a record $294 billion shares of mutual funds, nearly all of which was in stock and bond funds, bringing assets under management in the mutual fund industry to slightly over $2.0 trillion at year-end. As a consequence, mutual fund assets have surpassed the life insurance industry in size and, today, are exceeded only by commercial banks and pension funds. The strong inflows into mutual funds reflect their popularity among households. It is estimated that nearly a fifth of all households own shares in at least one mutual fund.

As mutual funds have become a significant competitor to depository institutions, these institutions have increased their participation in the mutual fund industry. The net assets of bank proprietary mutual funds are estimated to have increased from $44 billion at the end of 1988 to $220 billion at the end of 1993. Between 1988 and 1993, the market share of bank
proprietary funds doubled from 5 1/2 percent to over 10 percent of the total mutual fund industry assets.

The potential for customer confusion clearly exists when mutual funds are sold to the public by depository institutions, given their traditional insured deposit activities. The chief concern is that depositors may not understand that the mutual fund investments they buy from a depository institution are not deposits and are not covered by FDIC insurance. There is also the possibility that depository institution customers who buy mutual funds may receive less than adequate investment advice about mutual funds if sales personnel are not properly trained or their sales practices are not properly supervised.

This potential for customer confusion involving mutual fund sales could adversely affect the safety and soundness of a depository institution. If depositors suffer losses on investments they have purchased from a depository institution, the institution's reputation, and possibly its financial condition, could be adversely affected. More specifically, litigation risk and possible deposit withdrawals could affect a bank unfavorably.

**Board Actions Regarding Involvement by Banking Organizations with Mutual Funds**

The Board takes these concerns seriously. Over the years, the Board and its staff have issued a number of interpretive opinions, supervisory letters, and informal staff opinions addressing issues relating to bank sales of uninsured
investment products, including mutual funds. Many of these statements have been issued either in connection with the authorization of additional activities for bank holding companies or when the Board and its examiners have concluded that regulatory guidelines are necessary to address the manner in which an activity is being conducted. All of these statements reflect the Board’s longstanding policy that when banks sell uninsured investment products to their customers, they should do so in a manner that clearly distinguishes these products from insured deposits.

The first regulatory action that the Board took concerning mutual funds was a 1972 interpretive rule relating to conflicts that may arise when a bank holding company acts as an investment adviser to mutual funds. This rule authorized bank holding companies to act as investment advisers to mutual funds and, at the same time, created safeguards designed to assure a separation between the mutual fund being advised and the holding company’s subsidiary banks.

During the mid-80’s, as bank holding companies and banks received authorization to engage in discount and full service brokerage, the Board and its staff, through orders, opinion letters, and informal staff interpretations, adopted disclosure requirements that are applicable when these powers are used by banks and bank holding companies to sell mutual funds. Pursuant to these requirements, bank holding companies and banks are required to inform a customer that investments in a fund’s
shares are not obligations of a bank and are not insured by the FDIC. More recently, the Board revised its 1972 rule regarding investment advisory activities of bank holding companies to require that banks that sell or provide investment advice about mutual funds that are advised by an affiliate must disclose to customers the relationship between the affiliate and the fund.

**Interagency Guidelines**

In response to the rapidly growing involvement of depository institutions in the sales of mutual funds, the Board and the other bank regulatory agencies last month jointly issued a comprehensive set of guidelines governing the retail sale of mutual funds and other nondeposit investment products by depository institutions.

I would like today to focus on those aspects of the statement that are intended to address directly the question of potential customer confusion regarding the uninsured status of mutual funds and similar investment products, their nondeposit character, and the risks inherent in investing in such products. Assuring that customers are not confused about the products they are purchasing is not simply a matter of providing accurate disclosure. Experience has demonstrated that the "manner" in which products are sold -- the location of the sales, the experience and training of the personnel selling the products, and the conduct of sales programs -- all contribute to the customer's understanding of the nature and risk associated with their investments.
A. Disclosure

In developing the interagency guidelines, one of the goals of the agencies was to standardize the basic disclosures that banks provide customers about mutual funds and other uninsured investment products. The disclosures provided for by the interagency statement must, at the very minimum, indicate that the product is not insured by the FDIC, is not a deposit or other obligation of, or guaranteed by, the selling depository institution, and is subject to investment risks, including possible loss of the principal amount invested. These disclosures should be provided orally during any sales presentations or when investment advice is given; orally and in writing prior to or at the time an investment account is opened; and must be contained in all advertisements and other promotional materials. When the disclosures are provided in writing, they should be conspicuous and presented in a clear and concise manner. A depository institution also should disclose the existence of any advisory or other material relationship between the institution, or an affiliate of the institution, and a mutual fund whose shares are sold by the institution. Any other material relationship between the institution and an affiliate involved in providing the investment products should also be disclosed.

The agencies also provide for a disclosure concerning the Securities Investor Protection Corporation ("SIPC") and other forms of insurance when mutual funds are sold by broker-dealers
on bank premises. The interagency guidelines specifically state that if sales activities include any written or oral representations concerning insurance coverage provided by SIPC or any other insurance fund or company, then a clear and accurate explanation of the coverage must be provided. There should not be any suggestion or implication that an alternative form of insurance coverage is the same or similar to FDIC insurance of bank deposits.

The interagency guidelines also provide that advertisements and other promotional and sales materials conspicuously include at least the minimum disclosures and must not suggest or convey a misleading impression about the nature of the investment product or its lack of FDIC insurance. The minimum disclosures also should be emphasized in telemarketing contacts. Written materials that contain information about both FDIC-insured deposits and nondeposit investment products should clearly segregate the two types of information.

B. Location of Sales

In order to further minimize the potential for customer confusion, the interagency guidelines provide that, except in very limited situations where physical considerations prevent it, sales or recommendations relating to nondeposit investment products should be conducted in a physical location distinct from the area where retail deposits are taken.
C. Personnel

Another element that must be considered in minimizing the potential for customer confusion relates to the personnel who provide advice about, or sell, mutual funds or other nondeposit investment products. The interagency guidelines provide that tellers and other employees should not make general or specific investment recommendations or accept orders for nondeposit investment products, even if unsolicited, while located in the routine deposit taking area. Tellers and other employees who are not authorized to sell nondeposit investment products may only refer customers to individuals who are specifically trained to sell nondeposit investment products.

The interagency guidelines provide that depository institution personnel who sell, or provide investment advice about, nondeposit investment products should receive training that is the substantive equivalent of the type of training required for brokers licensed by the National Association of Securities Dealers ("NASD"). In addition, a depository institution should provide training to its employees who may have direct contact with customers to ensure a basic understanding of the institution's sales activities and the limits on their involvement in selling such nondeposit investment products.

D. Suitability

The guidelines also provide that depository institution personnel who recommend nondeposit investment products should have reasonable grounds for believing that a specific product is
suitable for the particular customer on the basis of information disclosed by the customer. Personnel should make reasonable efforts to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives, and other information that may be useful in making an investment recommendation. Personnel who are authorized to sell nondeposit investment products may receive incentive compensation for transactions entered into by customers; however, incentive compensation programs should not be structured in such a way as to result in unsuitable recommendations.

**Board Supervision of Mutual Fund Activities**

With regard to possible congressional action regarding mutual fund activities by banking organizations, the fact that the substantive provisions of H.R. 3306 are essentially mirrored in the agencies' guidelines reduces the need for legislative action at this time. If a depository institution or any of its employees do not follow the guidelines, the regulators have ample authority to address any unsafe and unsound practices regarding the sale of mutual funds by depository institutions and to sanction misconduct where appropriate.

The Federal Reserve is also augmenting its current examination procedures regarding sales of mutual funds by state member banks or affiliated broker-dealers to assure that the guidance contained in the recent interagency statement is being heeded. Sales of mutual funds by State member banks
traditionally have been supervised and examined by the Federal Reserve in the same manner as sales of other securities and nondeposit, uninsured financial instruments. Before the adoption of the interagency statement, the Board in June 1993 issued specific supervisory guidance for examiner use concerning proper disclosure and the separation of mutual fund sales from deposit taking activities on bank premises. Over the years, the Federal Reserve has developed product-specific examination procedures to ensure that these activities are carried out in a safe and sound manner. Further, the procedures are intended to address the Board’s commitment to adequate disclosure of the uninsured nature of these retail investment products. Federal Reserve examiners have been reviewing on a regular basis the sales practices associated with uninsured, nondeposit investment instruments for compliance with our policies.

Prior to the issuance of the interagency statement, the Board assembled an inter-district task force composed of senior examiners who have experience supervising and examining brokerage affiliates of banks and bank holding companies. That task force has been revising and expanding the Board’s existing securities examination procedures to incorporate specifically the interagency statement. Currently, the task force is field-testing and refining the expanded procedures at an examination of a large regional bank holding company and its securities affiliate that is actively involved in sales of mutual funds on the subsidiary banks’ premises. Upon completion of the
examination within the next several weeks, the task force will assemble in Washington, D.C. to finalize the revised mutual fund examination procedures and they will be implemented immediately thereafter.

To avoid unnecessary regulatory burden on banks and affiliated broker-dealers, and in recognition of the expertise developed by the securities self-regulatory organizations, the Board initiated discussions with the NASD pertaining to its examinations of bank affiliated broker-dealers. The NASD examines bank affiliated broker-dealers for compliance with its rules regarding sales practices, recordkeeping and other applicable customer protection requirements. Based on an informal survey of our Reserve Banks, we understand that about 85 percent of those State member banks that sell mutual funds do so through a registered broker-dealer selling on bank premises. About half of these registered broker-dealers are bank affiliated. All registered broker-dealers are subject to SEC oversight and to the additional requirements and rules adopted by their self-regulatory organizations.

Our discussions with the NASD have focused on cooperative efforts to minimize unnecessary duplication of examination efforts. These initiatives include examiner support and possible information sharing regarding bank affiliated broker-dealers. In this regard, an NASD examiner went on-site with our examiner task force in field testing our mutual fund examination procedures.
Aside from new examination initiatives, the Board is considering expanding the scope of the consumer education seminars now being offered by the Federal Reserve Banks around the country to address specifically consumer issues related to mutual funds.

**Conclusion**

The issues raised by this hearing today are of extreme importance to both consumers who are faced with increasingly complex choices about investments and savings, and to banks that must address their customers' need for access to a variety of investment and savings vehicles. Saving for a college education or for retirement is no longer as simple as depositing a set amount in a bank account each week. We believe that banks are in a unique position to help consumers understand the choices before them. But banks must recognize and affirmatively address the potential for customer confusion and the need to provide consumers with complete and accurate information. We intend to take all actions within our power to ensure that the depository institutions subject to the Board's jurisdiction do so. Selling mutual funds and other investment products in a manner that is not misleading and that provides customers with accurate and complete information is an important element of safe and sound banking which we intend to enforce.