

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 6216]
[September 19, 1968]

INTERPRETATIONS BY BOARD OF GOVERNORS
Regulation R—Relationships With Dealers in Securities Under Section 32
of the Banking Act of 1933

To All Member Banks in the Second Federal Reserve District:

Printed below are excerpts from the *Federal Register* of September 12 and 14, containing interpretations by the Board of Governors of the Federal Reserve System of its Regulation R, entitled "Relationships With Dealers in Securities Under Section 32 of the Banking Act of 1933."

Additional copies of this circular will be furnished upon request.

ALFRED HAYES,
President.

Title 12—BANKS AND BANKING

Chapter II—Federal Reserve System

**SUBCHAPTER A—BOARD OF GOVERNORS OF
THE FEDERAL RESERVE SYSTEM**

[Reg. R]

**PART 218—RELATIONS WITH DEALERS
IN SECURITIES UNDER SECTION
32, BANKING ACT OF 1933**

Variable Annuity Insurance Company

§ 218.112 Interlocking relationships between member bank and variable annuity insurance company.

(a) The Board has recently been asked to consider whether section 32 of the Banking Act of 1933 (12 U.S.C. 78) and this part prohibit interlocking service between member banks and (1) the board of managers of an accumulation fund, registered under the Investment Company Act of 1940 (15 U.S.C. 80), that sells variable annuities and (2) the board of directors of the insurance company, of which the accumulation fund is a "separate account," but as to which the insurance company is the sponsor, investment advisor, underwriter, and distributor. Briefly, a variable annuity is one providing for annuity payment varying in accordance with the changing values of a portfolio of securities.

(b) Section 32 provides in relevant part that: "No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve [at] the same time as an offi-

cer, director, or employee of any member bank * * *"

(c) For many years, the Board's position has been that an open-end investment company (or mutual fund) is "primarily engaged in the issue * * * public sale, or distribution, * * * of securities" since the issuance and sale of its stock is essential to the maintenance of the company's size and to the continuance of its operations without substantial contraction, and that section 32 of the Banking Act of 1933 prohibits an officer, director, or employee of any such company from serving at the same time as an officer, director, or employee of any member bank. (1951 Federal Reserve Bulletin 645; § 218.101.)

(d) For reasons similar to those stated by the U.S. Supreme Court in *Securities and Exchange Commission v. Variable Annuity Life Insurance Company of America*, 359 U.S. 65 (1959), the Board concluded that there is no meaningful basis for distinguishing a variable annuity interest from a mutual fund share for section 32 purposes and that, therefore, variable annuity interests should also be regarded as "other similar securities" within the prohibition of the statute and regulation.

(e) The Board concluded also that, since the accumulation fund, like a mutual fund, must continually issue and sell its investment units in order to avoid the inevitable contraction of its activities as it makes annuity payments or redeems variable annuity units, the accumulation fund, must continually issue and section 32 purposes. The Board further concluded that the insurance company was likewise "primarily engaged" for the purposes of the statute since it had no significant revenue producing operations other than as underwriter and distributor of the accumulation fund's units and

investment advisor to the fund.

(f) Although it was clear, therefore, that section 32 prohibits any officers, directors, and employees of member banks from serving in any such capacity with the insurance company or accumulation fund, the Board also considered whether members of the board of managers of the accumulation fund are "officers, directors, or employees" within such prohibition. The functions of the board of managers, who are elected by the variable annuity contract owners, are, with the approval of the variable annuity contract owners, to select annually an independent public accountant, execute annually an agreement providing for investment advisory services, and recommend any changes in the fundamental investment policy of the accumulation fund. In addition, the board of managers has sole authority to execute an agreement providing for sales and administrative services and to authorize all investments of the assets of the accumulation fund in accordance with its fundamental investment policy. In the opinion of the Board of Governors, the board of managers of the accumulation fund performs functions essentially the same as those performed by classes of persons as to whom the prohibition of section 32 was specifically directed and, accordingly, are within the prohibitions of the statute.

(12 U.S.C. 248(1). Interprets or applies 12 U.S.C. 78)

Dated at Washington, D.C., the 30th day of August 1968.

By order of the Board of Governors.

[SEAL] ROBERT P. FORRESTAL,
Assistant Secretary.

[F.R. Doc. 68-11004; Filed, Sept. 11, 1968;
8:52 a.m.]

Title 12—BANKS AND BANKING

Chapter II—Federal Reserve System

SUBCHAPTER A—BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. R]

PART 218—RELATIONS WITH DEALERS IN SECURITIES UNDER SECTION 32, BANKING ACT OF 1933

Insurance Company-Mutual Fund Complex

§ 218.113 Interlocking relationships between member bank and insurance company-mutual fund complex.

(a) The Board has been asked whether section 32 of the Banking Act of 1933 and this part prohibited interlocking service between member banks and (1) the advisory board of a newly organized open-end investment company (mutual fund), (2) the fund's incorporated investment manager-advisor, (3) the insurance company sponsoring and apparently controlling the fund.

(b) X Fund, Inc. ("Fund"), the mutual fund, was closely related to X Life Insurance Company ("Insurance Company"), as well as to the incorporated manager and investment advisor to Fund ("Advisors"), and the corporation serving as underwriter for Fund ("Underwriters"). The same persons served as principal officers and directors of Insurance Company, Fund, Advisors, and Underwriters. In addition, several directors of member banks served as directors of Insurance Company and of Advisors and as members of the Advisory Board of Fund, and additional directors of member banks had been named only as members of the Advisory Board. All outstanding shares of Advisors and of Underwriters were apparently owned by Insurance Company.

(c) Section 32 provides in relevant part that: "No officer, director, or employee of any corporation * * * primarily engaged in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve [at] the same time as an officer, director, or employee of any member bank * * *".

(d) The Board of Governors reaffirmed its earlier position that an open-end investment company is "primarily engaged" in activities described in section 32 "even though the shares are sold to the public through independent organizations with the result that the investment company does not derive any direct profit from the sales." (1951 Federal Reserve Bulletin 654, § 218.101.) Accordingly, the Board concluded that Fund must be regarded as so engaged, even though its shares were underwritten and distributed by Underwriters.

(e) As directors of the member banks involved in the inquiry were not officers, directors, or employees of either Fund or Underwriters, the relevant questions were whether (1) Advisors, and (2) Insurance Company, should be regarded as being functionally and structurally so closely

allied with Fund that they should be treated as one with it in determining the applicability of section 32. An additional question was whether members of the Advisory Board are "officers, directors, or employees" of Fund with the prohibition of the statute.

(f) Interlocking service with Advisory Board: The function of the Advisory Board was merely to make suggestions and to counsel with Fund's Board of Directors in regard to investment policy. The Advisory Board had no authority to make binding recommendations in any area, and it did not serve in any sense as a check on the authority of the Board of Directors. Indeed, the Fund's bylaws provided that the Advisory Board "shall have no power or authority to make any contract or incur any liability whatever or to take any action binding upon the Corporation, the Officers, the Board of Directors or the Stockholders." Members of the Advisory Board were appointed by the Board of Directors of Fund, which could remove any member of the Advisory Board at any time. None of the principal officers of Fund or of Underwriters were members of the Advisory Board; and the compensation of its members was expected to be nominal.

(g) The Board of Governors concluded that members of the Advisory Board need not be regarded as "officers, directors, or employees" of Fund or of Underwriters for purposes of section 32, and that the statute, therefore, did not prohibit officers, directors, or employees of member banks from serving as members of the Advisory Board.

(h) Interlocking service with Advisors: The principal officers and several of the directors of Advisors were identical with both those of Fund and of Underwriters. Entire management and investment responsibility for Fund had been placed, by contract, with Advisors, subject only to a review authority in the Board of Directors of Fund. Advisors also supplied office space for the conduct of Fund's affairs, and compensated members of the Advisory Board who are also officers or directors of Advisors. Moreover, it appeared that Advisors was created for the sole purpose of servicing Fund, and its activities were to be limited to that function.

(i) In the view of the Board of Governors, the structural and functional identity of Fund and Advisors was such that they were to be regarded as a single entity for purposes of section 32, and, accordingly, officers, directors, and employees of member banks were prohibited by section 32 from serving in any such capacity with such entity.

(j) Interlocking service with Insurance Company: It was clear that Insurance Company was not as yet "primarily engaged" in business of a kind described in section 32 with respect to the shares of the newly created Fund sponsored by Insurance Company, since the issue and sale of such shares had not yet commenced. Nor did it appear that Insurance Company would be so engaged in the preliminary stages of Fund's existence, when the disproportion between the insurance business of Insurance Com-

pany and the sale of Fund shares would be very great. However, it was also clear that if Fund was successfully launched, its activities would rather quickly reach a stage where a serious question would arise as to the applicability of the section 32 prohibition.

(k) An estimate supplied to the Board indicated that 100,000 shares of Fund might be sold annually to produce, based on then current values, annual gross sales receipts of over \$1 million. Insurance Company's total gross income for its last fiscal year was almost \$10 million. On this basis, about one-tenth of the annual gross income of the Insurance Company-Fund complex (more than one-tenth, if income from investments of Insurance Company was eliminated) would be derived from sales of Fund shares. Although total sales of shares of Fund during the first year might not approximate expectations, it was assumed that if the estimate or projection was correct, the annual rate of sale might well rise to that level before the end of the first year of operation.

(l) It appeared that net income of Insurance Company from Fund's operations would be minimal for the foreseeable future. However, it was understood that Insurance Company's chief reason for launching Fund was to provide salesmen for Insurance Company (who were to be the only sellers of shares of Fund, and most of whom, Insurance Company hoped, would qualify to sell those shares), with a "package" of mutual fund shares and life insurance policies that would provide increased competitive strength in a highly competitive field.

(m) The Board concluded that Insurance Company would be "primarily engaged" in issuing or distributing shares of Fund within the meaning of section 32 by not later than the time of realization of the aforementioned estimated annual rate of sale, and possibly before. As indicated in Board of Governors v. Agnew, 329 U.S. 441 at 446, the prohibition of the statute applies if the section 32 business involved is a "substantial" activity of the company.

(n) This, the Board observed, was not to suggest that officers, directors, or employees of Insurance Company who are also directors of member banks would be likely, as individuals, to use their positions with the banks to further sales of Fund's shares. However, as the Supreme Court pointed out in the Agnew case, section 32 is a "preventive or prophylactic measure." The fact that the individuals involved "have been scrupulous in their relationships" to the banks in question "is immaterial."

(12 U.S.C. 248(l). Interprets or applies 12 U.S.C. 78)

Dated at Washington, D.C., the 30th day of August 1968.

By order of the Board of Governors.

[SEAL]

ROBERT P. FORRESTAL,
Assistant Secretary.

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