FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **10553**
July 21, 1992]

INTERPRETATION OF REGULATION Y

Investment Advisory Activities of Bank Holding Companies

To All Bank Holding Companies, and Others Concerned, in the Second Federal Reserve District:

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has announced that it has amended its interpretive rule regarding investment advisory activities of bank holding companies.

The amendment is effective August 10, 1992.

The amendment expressly provides that a bank holding company and its nonbank subsidiaries may act as an agent for customers in the brokerage of shares of an investment company advised by the holding company or any of its subsidiaries.

The revised interpretive rule also provides that a bank holding company and its nonbank subsidiaries may provide investment advice to customers regarding the purchase and sale of shares of an investment company advised by a holding company affiliate.

The interpretive rule requires bank holding companies engaged in these activities to make appropriate disclosures to customers to address potential conflicts of interest or adverse effects.

Printed on the following pages is an excerpt from the *Federal Register* of July 9, containing the text of the Board's notice. Questions on this matter may be directed to Jay Bernstein, Staff Director of our Domestic Banking Applications Division (Tel. No. 212-720-5861).

E. GERALD CORRIGAN,
President.

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FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R-0698]

RIN 7100-AB13

Bank Holding Companies and Change in Bank Control Investment Advisory Activities

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board is revising its interpretive rule regarding investment advisory activities of bank holding companies to provide expressly that a bank holding company or its nonbank subsidiary may act as an agent for customers in the brokerage of shares of an investment company advised by the holding company or any of its subsidiaries. In addition, the revision will provide that a bank holding company or its nonbank subsidiary may provide investment advice to customers regarding the purchase or sale of shares of an investment company advised by a holding company affiliate. In both instances, the Board requires certain disclosures to be made to address potential conflicts of interests or adverse effects.

EFFECTIVE DATE: August 10, 1992.

FOR FURTHER INFORMATION CONTACT: Scott G. Alvarez, Associate General Counsel (202/452-3583), or Thomas M. Corsi, Senior Attorney (202/452-3275), Legal Division; or Robert S. Plotkin, Assistant Director (202/452-2782), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

In 1971, the U.S. Supreme Court held that the operation of a mutual fund by a national bank was prohibited by the Glass-Steagall Act because it involved the bank in prohibited securities underwriting and distributing activities.[1] Subsequent to the Court's decision, the Board amended its Regulation Y to permit a bank holding company to furnish investment advice to an open-end investment company (*i.e.*, a mutual fund) and to sponsor, organize, and advise closed-end investment companies. Concurrently the Board adopted an interpretive rule outlining the types of relationships the Board believed a bank holding company may have with a mutual fund and a closed-end investment company consistent with the Glass-Steagall Act. This interpretive rule (12 CFR 225.125) governs the manner in which a bank holding company that has obtained Board approval under section 4(c)(8) of the Bank Holding Company Act (BHC Act) to conduct investment advisory activities may conduct those activities. The Board's interpretive rule has been upheld by the U.S. Supreme Court.[2]

Paragraph (h) of the Board's interpretive rule regarding investment advisory activities states that a bank holding company may not engage in the "sale or distribution" of shares of an investment company advised by the bank holding company or one of its nonbank subsidiaries.[3]

Since the time the interpretive rule was issued, the Board has determined, and the Supreme Court has agreed, that a company or bank engaged in securities brokerage activities is not engaged in the "issue, flotation, underwriting, public sale, or distribution of securities" for purposes of the Glass-Steagall Act.[4] The Board has also determined, and the U.S. Court of Appeals has agreed, that the provision of the combination of investment advice and securities brokerage services to a customer by an affiliate of a member bank does not implicate the prohibition, contained in section 20 of the Glass-Steagall Act, of the "public sale" of securities.[5]

In June 1990, the Board requested public comment[6] on a proposal to revise its interpretive rule to indicate that the reference in paragraph (h) of that rule to "sale or distribution" of shares of investment companies advised by the bank holding company or its subsidiary does not prohibit a bank holding company or its nonbank subsidiary from acting solely as agent for the account of customers in the purchase or sale of shares of these investment companies. Acting by order on a specific application, the Board has already determined that the practices at which the prohibition against "sale or distribution" of shares of investment companies is directed are not present where the nonbank affiliate proposes to act only as agent for customers desiring to purchase or sell shares of an investment company advised by a bank affiliate. *Norwest Corporation*, 76 Federal Reserve Bulletin 79 (1990) (*Norwest*).

In its request for public comment, the Board also proposed to permit a bank holding company or its nonbank subsidiary to provide investment advice to customers regarding the purchase or sale of shares of an investment company advised by a holding company affiliate. In addition, the Board proposed to remove other restrictions in paragraph (h) of the interpretive rule, including restrictions on the ability of a bank holding company to make prospectuses available to customers.[7]

In order to address the potential for conflicts of interest or other adverse effects, the Board proposed that any bank holding company that provides advice or brokerage services to customers regarding an investment company advised by an affiliate shall disclose such dual roles to customers; shall caution customers to read the prospectus of an investment company before investing in the investment company; and shall advise customers in writing that the investment company's shares are not deposits, are not obligations of any bank, are not insured by the Federal Deposit Insurance Corporation (FDIC), and are not endorsed or guaranteed in any way by any bank (unless such is the case).

Proposal as Adopted

The Board has determined to adopt the revision substantially as proposed, with certain modifications made to address matters raised by the commenters. In order to address any potential adverse effects, the Board has determined that a bank holding company or nonbank subsidiary of the holding company must make the disclosures discussed above when the company or subsidiary provides a customer with securities brokerage or investment advisory services (either

[1] *Investment Company Institute* v. *Camp*, 401 U.S. 617 (1971).

[2] *Board of Governors* v. *Investment Company Institute*, 450 U.S. 46 (1981).

[3] 12 CFR 225.125(h).

[4] *BankAmerica Corporation*, 69 Federal Reserve Bulletin 105, 114 (1983), *aff'd*, *Securities Industry Association* v. *Board of Governors*, 468 U.S. 207 (1984).

[5] *National Westminster Bank PLC*, 72 Federal Reserve Bulletin 584 (1986), *aff'dd*, *Securities Industry Association* v. *Board of Governors*, 821 F. 2d 810, 811 (D.C. Cir. 1987), *cert. denied*, 108 S. Ct. 697 (1988).

[6] 55 FR 25849, June 25, 1990.

[7] The Board also requested comments on whether it was appropriate, as a general matter, to amend paragraph (g) of the interpretive rule, which limits transactions between a bank holding company or its subsidiaries and an investment company advised by the bank holding company. The Board received general comments on this matter. The Board has not determined to amend paragraph (g) at this time and will consider whether to amend paragraph (g) in a separate proceeding.

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separately or in combination) in connection with shares of any mutual fund or closed-end investment company advised by the bank holding company or any of its bank or nonbank subsidiaries.

The Board also believes that the officers and employees of a holding company bank that is permitted under relevant law and by its primary supervisor to provide advice or brokerage services to customers regarding the purchase of shares of an investment company advised by a nonbank affiliate of the bank should disclose the role of the nonbank affiliate and make the other types of disclosures required by the Board to be made by a bank holding company that provides these services. These disclosures are already required by the Office of the Comptroller of the Currency (OCC) for national banks. To the extent that a state-chartered bank owned by a bank holding company engages in providing advisory or brokerage services to bank customers in connection with an investment company advised by the bank holding company or a nonbank affiliate, but is not required by the bank's primary regulator to make disclosures comparable to the disclosures required to be made by a bank holding company providing such services, the Board believes that every bank holding company should require its subsidiary bank(s) to make the disclosures required by the Board to be made by the bank holding company.

Response to Public Comments

In response to its proposal, the Board received 29 comments from interested individuals and organizations, with 28 comments in favor and one opposed to the proposal. The principal issues raised by the comments are discussed below.

Authority to Make Proposed Revision

One commenter opposed the proposed revision to paragraph (h) of the interpretive rule. This commenter maintains that activities permitted under the proposal would constitute the public sale or distribution of securities in violation of section 20 of the Glass-Steagall Act (12 U.S.C. 377). The commenter also argued that the proposal would authorize activities that would not be a proper incident to banking for purposes of section 4(c)(8) of the BHC Act, because the adverse effects of engaging in the activities would outweigh public benefits.

The remaining 28 commenters favored adoption of the Board's proposal. Thirteen commenters argued that permitting bank holding companies to provide brokerage services and investment advice to customers regarding investment companies advised by holding company affiliates does not violate the Glass-Steagall Act as interpreted by the U.S. Supreme Court and other courts. These commenters also argue that significant public benefits would result from the proposal, including additional convenience to consumers, increased efficiency, and an increase in competition, and that potential adverse effects are adequately addressed through proper disclosures to customers and compliance with applicable securities laws.

The Board's interpretive rule indicates that the Board intends that a bank holding company that has received approval under section 4(c)(8) of the BHC Act to conduct investment advisory activities may exercise all functions permitted to be exercised by an "investment adviser" under the Investment Company Act of 1940, except to the extent limited by the Glass-Steagall Act. As explained above, the Supreme Court has determined that the kinds of activities authorized by the proposed revision do not represent the underwriting, public sale, or distribution of securities or any other activity prohibited by the Glass-Steagall Act for banks and their affiliates. In addition, the OCC has similarly determined that these activities are permissible for national banks under the National Bank Act. The OCC has also previously determined that the Glass-Steagall Act does not prohibit a national bank from providing investment advice to customers and conducting securities brokerage activities for customer purchases of an investment company advised by the national bank.[8] On this basis, the Board has determined that a bank holding company is not prohibited by the Glass-Steagall Act from providing brokerage and advisory services to customers regarding an investment company advised by the bank holding company or any of its bank or nonbank affiliates.

For the reasons explained in previous Board orders and suggested by commenters in connection with this proposal, the Board also believes that these activities are permissible under section 4(c)(8) of the BHC Act. The Board has previously determined that the provision of securities brokerage activities and investment advisory activities, separately or in combination, is closely related to banking under section 4(c)(8) of the BHC Act.

The Board also believes that compliance with applicable securities laws and the supplemental disclosures required by the Board address the potential adverse effects from these activities and that, on this basis, the public benefits of the brokerage and advisory activities permitted outweigh potential adverse effects. The Board has previously expressed concern regarding the potential that members of the public might be confused as to whether the securities they are purchasing are federally insured or are obligations of a bank, and the potential that the public might link the economic fortunes of a mutual fund with a bank. The Board believes that the disclosure requirements implemented in this revision adequately address these potential adverse effects. The Board believes that, with these disclosures, the revision will benefit the public by providing increased customer convenience for purchasers of mutual fund shares and increased efficiencies for bank holding companies.

Disclosure Requirements

The commenters generally supported the proposed disclosure and other requirements designed to address adverse effects that potentially could arise from the proposed activities. Several commenters, however, suggested modifications to these requirements. One commenter asserted that the Board should provide the bank holding company with discretion to determine the manner and timing of any required disclosures to customers, including by providing the disclosures in confirmations, in customer statements, or in a separate mailing, because the operations of bank holding companies may differ. Another commenter suggested that the Board not require employees of a bank holding company to advise customers to read an investment prospectus because regulations of the Securities and Exchange Commission already require a broker to direct customers, in writing, to read the prospectus before investing in an investment company, and the holding company employees may not have a meeting with the customer that would permit an oral caution.[9] A third

[8] *See, e.g.*, Letter, dated December 9, 1987, from J. Michael Shepherd, Senior Deputy Comptroller for Corporate and Economic Programs regarding First Union National Bank of North Carolina.

[9] Rules 134 and 482 of the Securities and Exchange Commission [15 CFR 230.134 and 230.482] provide that an investment company may advertise its availability, if the advertisement contains certain prescribed information and states that the potential investor should obtain a copy of the prospectus of the investment company and should read such prospectus before investing.

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commenter recommended providing an exception from the requirement that a bank holding company advise customers that the brokered investment company shares are not guaranteed, or supported by, any bank, or the FDIC, in situations in which the prospectus gives notice that the investment company is uninsured. Another commenter maintained that the Board should not require a bank holding company's subsidiaries to provide specific disclosure of the bank holding company's dual roles as broker and adviser because such a requirement is not imposed upon securities brokers that are not affiliated with a bank holding company.

The Board's proposal requires that a bank holding company advise its brokerage and advisory services customers of the dual role of the holding company as adviser to the investment company and broker or adviser to the customer, and that the investment company's shares are not deposits, are not an obligation of or endorsed or guaranteed by any bank, and are not insured by the FDIC. These disclosures must be made at least once before a customer invests in an investment company advised by a holding company affiliate.

The interpretive rule has been modified to indicate that these disclosures may be made orally so long as written disclosures are immediately provided to the customer. The specific manner and timing of these written disclosures has been otherwise left in the discretion of the bank holding company, subject to applicable securities laws.

The disclosures required in the Board's proposal are not more onerous than the replacement disclosures suggested by the commenter, but provide a more comprehensive explanation designed to assure that the customer understands the potential conflict of interest from the dual roles of the holding company and that the resources of the bank and the FDIC do not support the investment company. Similar disclosures are required by the OCC when a national bank provides brokerage or advisory services to customers regarding an investment company advised by the bank. These more comprehensive disclosures are particularly helpful because bank holding company customers may not be fully aware of the relationship of the bank holding company with the investment company as a result of a limitation on an affiliate-advised investment company having a name in common with, or similar to, the bank holding company.

As discussed above, in order to assure that the potential adverse effects at which the disclosure requirements are aimed do not occur when a bank affiliate provides advice on, or brokers shares of, an investment company for which the bank holding company provides investment advice, the Board believes that a holding company bank should disclose the advisory role of its affiliate and make the other disclosures required by the Board to be made by a bank holding company providing these services. The Board has amended its interpretive rule to include this requirement to the extent that a holding company bank providing brokerage or advisory services to its customers is not already required by its primary regulator to make such disclosures.

Other Comments

Two technical changes have been made to the proposed language to clarify another issue raised by commenters. The first change clarifies a phrase in the original proposal to indicate that the revisions of the interpretive rule to allow a bank holding company to conduct securities brokerage and investment advisory services presupposes that the bank holding company has received prior approval to engage in brokerage and/or investment advisory activities and does not eliminate the need for prior approval under section 4 of the BHC Act.

The second change makes clear that the Board's revision to its interpretive rule does not affect restrictions placed on the securities underwriting, public sale, or distribution activities of affiliates of banks that engage in these activities on a limited basis as permitted by the Board under section 20 of the Glass-Steagall Act and section 4(c)(8) of the BHC Act ("section 20 affiliate").[10] Moreover, this revision does not alter any other limitations or conditions imposed by Board order with respect to brokerage or investment advisory activities.

Administrative Procedure Act

One commenter contended that the Board failed to follow the requirements of the Administrative Procedure Act (5 U.S.C. 551, *et seq.*) (APA) in soliciting public comment on this proposal. The commenter contended that the Board's request for comment mischaracterizes the proposed revision as a clarification of the current interpretive rule. The commenter claimed that the proposal represents a rescission of a prior Board position. The commenter also argued that the Board has not provided an adequate basis for this change in position.

The Board believes that this commenter's arguments under the APA are misplaced. Even if the commenter were correct that the Board's proposal represents a change in a prior Board position, as explained above, the proposal is consistent with the Glass-Steagall Act as interpreted by the courts and with section 4(c)(8) of the BHC Act, and the Board has authority to adopt its current proposal.[11] The effect of the Board's proposal was fully explained in its request for comment, the legal authority for the proposed action was discussed, and a draft of the proposed revision to the interpretive rule was provided in order to permit all commenters a full opportunity to comment on the proposal. Moreover, in the Board's opinion, the APA requirement that an agency provide a reasoned justification for its actions is fulfilled by this Federal Register notice explaining the Board's action and its legal basis.[12]

[10] *See, e.g., J.P. Morgan & Co, Inc.*, 75 Federal Reserve Bulletin 192 (1989); *PNC Financial Corp*, 75 Federal Reserve Bulletin 396 (1989).

[11] The commenter urged that the Board, should it adopt this proposal as a final rule, restore the language previously used in the interpretive rule that prohibited the "sale or distribution" of shares of investment companies advised by a bank holding company or its subsidiaries, and clarify that this prohibition does not prevent a bank holding company or its nonbank subsidiaries from acting solely as agent for the account of customers in the purchase or sale of shares of such investment companies. The commenter is concerned that in eliminating the prohibition, the Board would be permitting bank holding companies to engage in activities that would violate the Bank Holding Company Act and the Glass-Steagall Act. The Board believes it has addressed this concern by adding a statement in the interpretive rule providing expressly that a bank holding company and its nonbank subsidiaries may not engage, directly or indirectly, in the underwriting, public sale or distribution of securities of any investment company for which the holding company or any nonbank subsidiary provides investment advice except in compliance with the terms of section 20 and only after obtaining the Board's approval under section 4 of the Bank Holding Company Act.

[12] This commenter also asserts that the Board, in finalizing the proposal, would be adopting an unsound policy, and should defer action until the issues raised by the proposal are addressed through the legislative process. However, the restrictions in the interpretive rule and the revisions thereof are appropriate under the provisions of existing law and the Board is not precluded from modifying these

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Effect on Bank Holding Companies Currently Conducting Investment Advisory and Securities Brokerage Activities

In connection with this final rule, the Board hereby grants relief to those bank holding companies who have previously committed that they would not broker and/or recommend shares of an investment company advised by an affiliate because of the previous interpretive rule. This relief is granted so that these bank holding companies may conduct the activity subject to the limitations and disclosure requirements adopted by the Board in this revision. This grant of relief does not alter any other commitments or restrictions accepted or imposed by the Board, including the limitations imposed or the disclosures required to be made by a section 20 affiliate. Moreover, bank holding companies that participate in a joint venture engaged in securities brokerage or advisory activities, and the joint ventures owned by such bank holding companies are not relieved from any limitations imposed on the ability of the company or joint venture to provide advice or brokerage services in connection with investment companies sponsored, advised, distributed or controlled by the joint venture partner.

Final Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 95-354, 5 U.S.C. 601 *et seq.*), the Board of Governors of the Federal Reserve System certifies that this final rule will not have a significant economic impact on a substantial number of small entities that would be subject to the regulation. This revision will not place additional burdens on any bank holding company. It will provide for all bank holding companies access to services the Board finds appropriate under section 4(c)(8) of the BHC Act and consistent with court holdings.

List of Subjects in 12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

restrictions to reflect recent developments. In this regard, the Board notes that this modification is consistent with the provisions of S.543 passed by the Senate last year, as well as the provisions of H.R.6 approved by the House Banking and Energy and Commerce Committees.

For the reasons set forth in this document, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1844(b)), the Board amends 12 CFR part 225 as follows:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1843(c)(8), 1844(b), 3106, 3108, 3907, 3909, 3310, and 3331-3351.

2. In § 225.125, paragraph (h) is revised to read as follows:

§ 225.125 Investment adviser activities.

* * * * *

(h) Under section 20 of the Glass-Steagall Act, a member bank is prohibited from being affiliated with a company that directly, or through a subsidiary, engages principally in the issue, flotation, underwriting, public sale, or distribution of securities. A bank holding company or its nonbank subsidiary may not engage, directly or indirectly, in the underwriting, public sale or distribution of securities of any investment company for which the holding company or any nonbank subsidiary provides investment advice except in compliance with the terms of section 20, and only after obtaining the Board's approval under section 4 of the Bank Holding Company Act and subject to the limitations and disclosures required by the Board in those cases. The Board has determined, however, that the conduct of securities brokerage activities by a bank holding company or its nonbank subsidiaries, when conducted individually or in combination with investment advisory activities, is not deemed to be the underwriting, public sale, or distribution of securities prohibited by the Glass-Steagall Act, and the U.S. Supreme Court has upheld that determination. *See Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 207 (1984); *see also Securities Industry Ass'n* v. *Board of Governors*, 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988). Accordingly, the Board believes that a bank holding company or any of its nonbank subsidiaries that has been authorized by the Board under the Bank Holding Company Act to conduct securities brokerage activities (either separately or in combination with investment advisory activities) may act as agent, upon the order and for the account of customers of the holding company or its nonbank subsidiary, to purchase or sell shares of an investment company for which the bank holding company or any of its subsidiaries acts as an investment adviser. In addition, a bank holding company or any of its nonbank subsidiaries that has been authorized by the Board under the Bank Holding Company Act to provide investment advice to third parties generally (either separately or in combination with securities brokerage services) may provide investment advice to customers with respect to the purchase or sale of shares of an investment company for which the holding company or any of its subsidiaries acts as an investment adviser. In the event that a bank holding company or any of its nonbank subsidiaries provides brokerage or investment advisory services (either separately or in combination) to customers in the situations described above, at the time the service is provided the bank holding company should instruct its officers and employees to caution customers to read the prospectus of the investment company before investing and must advise customers in writing that the investment company's shares are not insured by the Federal Deposit Insurance Corporation, and are not deposits, obligations of, or endorsed or guaranteed in any way by, any bank, unless that happens to be the case. The holding company or nonbank subsidiary must also disclose in writing to the customer the role of the company or affiliate as adviser to the investment company. These disclosures may be made orally so long as written disclosure is provided to the customer immediately thereafter. To the extent that a bank owned by a bank holding company engages in providing advisory or brokerage services to bank customers in connection with an investment company advised by the bank holding company or a nonbank affiliate, but is not required by the bank's primary regulator to make disclosures comparable to the disclosures required to be made by bank holding companies providing such services, the bank holding company should require its subsidiary bank to make the disclosures required in this paragraph to be made by a bank holding company that provides such advisory or brokerage services.

* * * * *

Board of Governors of the Federal Reserve System, July 2, 1992.

William W. Wiles,
Secretary of the Board.

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