STATE OF CONNECTICUT

DEPARTMENT OF BANKING

44 Capitol Avenue, Hartford, CT 06106

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COMMISSIONER

SECURITIES AND BUSINESS INVESTMENTS DIVISION
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BANKING COMMISSIONER'S COMMENTS

I am pleased to share with you some significant policy developments occurring in the Department of Banking.

Presently, the overriding issue before the department involves the implementation of the Advisory Interpretation issued by the department on February 7, 1985 regarding bank securities activities. In an effort to keep the industry well informed of recent developments in this area, this agency sponsored the first in a series of Guest Lectures on March 20th. The lectures were given by representatives of federal agencies and the banking industry. Pertinent parts of these lectures are contained in this edition of the bulletin. I believe that the lectures were and will continue to be mutually beneficial to regulators and the regulated industry.

A continuing concern of this agency involves the supervisory responsibilities of the securities industry. Included in this edition is an article pertaining to the ongoing responsibilities of brokerage firms in screening and supervising their personnel. I cannot emphasize too strongly that supervisory responsibility primarily rests with the firm and that the failure to exercise such responsibility may result in criminal, civil or administrative action. I urge the registrants of this department to read this article carefully and to take whatever steps are necessary to comply with supervisory requirements.

Currently, major efforts are under way to automate the operations of the Securities and Business Investments Division of the Department of Banking. The presence of a computer, a Lektriever system and the Central Registration Depository System (CRD) have greatly enhanced the overall efficiency of this agency. The anticipated enhancement of the CRD system is expected to have a favorable impact on the brokerage community. Your attention is directed to the notice contained in the Announcement section of this bulletin regarding Phase II of the CRD system. A more complete announcement concerning the installation and implementation of Phase II of CRD will be forthcoming shortly.

I welcome your comments and suggestions concerning the articles contained in this and prospective editions of the Bulletin.

HOWARD B. BROWN
BANKING COMMISSIONER

ANNOUNCEMENTS

New Banking Commissioner Appointed

On February 3, 1986, Howard B. Brown became Connecticut's new Banking Commissioner after serving as Acting Banking Commissioner. He joined the Department of Banking in June 1982 as Deputy Commissioner. Prior to joining the Department of Banking, he was associated from 1981 to 1982 with the reinsurance firm of Risk Administration Services, Inc., Greenwich, Connecticut. From 1978 to 1981 he was vice president of operations and administration and counsel to the chairman of O'Sullivan's Fuel Oil Inc., New Haven, Connecticut. From 1973 to 1978 he was employed as an attorney and later as associate counsel with the Hartford Insurance Group. He graduated from the University of Connecticut School of Law in 1973. In 1970, he received a B.A. from Morehouse College, Atlanta, Georgia.

Staff Changes

Cynthia E. Antanitis who is with the Legal Staff of the Department of Banking, was promoted to Senior Assistant Counsel, effective April 25, 1986.

William Bartol commenced employment with the Department of Banking, Securities and Business Investments Division, as a Connecticut Career Trainee on November 22, 1985. He was previously employed as a registered representative with First Investors Corporation. He holds a B.S. from Rensselaer Polytechnic Institute and an M.B.A. in finance from Boston College.

Salvatore Cannata commenced employment with the Securities and Business Investments Division as a Connecticut Career Trainee on November 22, 1985. He was previously employed as a registered representative with First Investors Corporation. He holds a B.S. from Fairfield University.

Kevin Atkins was hired by the Securities and Business Investments Division as Clerk Typist on November 29, 1985. He previously served as Administrative Clerk in the U.S. Air Force.

Sylvia Morgan, Examiner with the Securities and Business Investments Division, passed the CPA examination on February 8, 1986.

Louise E. Hanson was promoted to Staff Assistant on December 6, 1985.

Dorothy Jackson was promoted to Senior Secretary on March 14, 1986.

Appointment to the Banking Commissioner's Advisory Committee on Securities

On April 14, 1986, Commissioner Brown appointed Attorney Jody J. Cranmore, of the law firm of Updike, Kelley & Spellacy, P.C., Hartford, Connecticut, to the Banking Commissioner's Advisory Committee on the Connecticut Uniform Securities Act. Mr. Cranmore is a graduate of Catholic University Law School and holds an undergraduate degree from Bates College. He received an L.L.M. from Georgetown University Law School with a concentration in securities regulation. He was previously employed as an attorney with the Office of the Comptroller of the Currency in New York and Washington, DC. Presently, his practice encompasses new bank organizations and conversions, mergers and tender offers, fiduciary activities, consumer and commercial regulatory issues, branching and other market extension activities and regional interstate banking. He currently represents bank holding companies in public and private offerings and securities personnel such as broker-dealers, underwriters, transfer agents, and investment advisers.

CRD Phase II to Begin Shortly

The Central Registration Depository (CRD) of the National Association of Securities Dealers, Inc. (NASD) has facilitated broker-dealer agent registration through the implementation of Phase I of CRD. Broker-dealer registration will be greatly simplified through the implementation of Phase II of CRD.

In Connecticut, it is anticipated that the CRD Phase II program will begin in the very near future. Phase II will facilitate the registration of broker-dealers. Under Phase II, an applicant will file with the CRD 1) Form BD, 2) Form U-4 (to register one agent) and 3) a $300 fee ($250 for the firm and $50 for the agent).

The applicant will then file a copy of its supervisory procedures and a statement of financial condition with the State of Connecticut. The statement of financial condition must be less than 60 days old at the time of filing. A computation of net capital and aggregate indebtedness must also be included. An applicant who has been in business for more than one year must also submit its most recent and audited statement of financial condition. Each financial statement must be accompanied by a Registrant's Certificate.

Applicants will continue to be notified in writing by the State of Connecticut when their names have been entered in the Journal of Registrants. All amendments to Form BD will be filed with the CRD.

Connecticut's broker-dealer application packages are available upon request. The package includes an instruction sheet and one Registrant's Certificate. Any questions regarding broker-dealer registration, agent registration or Phase II of the CRD program may be directed to Norma Heckendorf at (203) 566-4560.

Department Publishes Investment Pamphlet

The Department of Banking has published a pamphlet for consumers entitled "What You Should Know Before You Invest". It tells how Connecticut regulates investment offerings and describes common investment frauds and how to avoid them. Copies are available to consumer groups and to financial institutions that wish to distribute them. They may be obtained from the Public Information Officer, Department of Banking, 44 Capitol Avenue, Hartford, CT 06106 (203) 566-4560, ext. 8388.

(Note: The pamphlet is in its second printing, and quantities may be limited).

INVESTOR ALERT: OIL AND GAS INVESTMENT FRAUDS*

OIL AND GAS INVESTMENT FRAUDS

State securities regulators around the country and the Council of Better Business Bureaus warn that oil and gas investment scams are alive and well, despite the recent industry downturn. Five states with significant amounts of oil and gas drilling and exploration operations reported a total of 850 investigations of unlawful oil and gas investment activity over the past two years. Illinois alone is investigating 17 major cases involving promoters who allegedly defrauded 1250 oil and gas securities investors of nearly $14 million.

Most oil and gas investment opportunities, while involving varying degrees of risks to the investor, are legitimate in their marketing and responsible in their operations. However, as in many other investment opportunities, it is not unusual for unscrupulous promoters to attempt to take advantage of investors by engaging in fraudulent practices.

Although some of the con artists have moved on to more lucrative fields since the oil boom ended in the early 1980s, many linger on in the oil patch. Kenneth Hooper, assistant director of the Texas State Securities Board says that "the incidence of oil fraud has hit the bottom and is starting back up."

The Leviticus Project was established in 1978 as a federally funded multistate law enforcement project designed for the investigation and prosecution of a variety of crimes relating to the coal industry. Because of the high incidence of oil investment fraud discovered over the past few years, the member states of the Leviticus Project have expanded their scope to include the investigation and prosecution of perpetrators of oil and gas investment fraud.

A recent survey by the North American Securities Administrators Association (NASAA) and the Council of Better Business Bureaus (CBBB) revealed a disturbing trend of increased oil and gas scams in the last two years. The survey uncovered these and numerous other examples of fraudulent oil and gas investment schemes in over 20 states:

*The Investor Alert is a quarterly release produced jointly by the Council of Better Business Bureaus (CBBB) and the North American Securities Administrators Association (NASAA), a national organization comprised of securities administrators from the fifty states and the Canadian provinces. The Investor Alert exposes investment frauds to the public and provides useful information on how to avoid the often sophisticated and unlawful schemes that are perpetrated on investors.

- In November 1985, a federal grand jury indicted an Illinois couple on 722 counts of securities, mail and wire fraud, conspiracy and selling unregistered securities. 300 investors in 20 states and several foreign countries had allegedly been bilked out of nearly $6.5 million through the sale of investments in southern Illinois oil wells. The indictment charged that the couple exaggerated the value and productivity of about 72 wells, retained the best wells for themselves and diverted investor funds to buy themselves Rolls Royces, a jet plane, a helicopter and other luxury items.

- Several states took action in 1985 against an oil development company that offered an investment scheme involving oil and gas exploration in Israel. Promotional material provided detailed explanation of how certain biblical interpretations pointed to the existence of oil in Israel. Information filed with the state securities agencies acknowledged that the company did not know of any gas or oil reserves in Israel and that it had no scientific basis to expect exploration to be fruitful. Promoters claimed to be guided by "religious and scriptural interpretation."

- Texas officials recently obtained a life sentence against a Dallas man who, claiming to be a millionaire petroleum engineer, raised $500,000 from Texas investors. It turned out that the man was a high school drop out with five theft-related felony convictions. Only a third of the money he collected was spent on drilling operations. What investigators could trace of the rest of the money was spent on such things as the purchase of a beauty parlor and a furniture store for the man's relatives.

- An investigation by the Alabama Securities Commission and the F.B.I. resulted in a July 1985 indictment of an Alabama promoter charged with defrauding 50 investors of over $6 million dollars. The indictment charged that the promoter misrepresented certain facts about his experience, the nature of the drilling venture and the prospects for success. He was also charged with converting more than $1 million of investor funds to his own use.

Other investigations revealed a case in which investors' funds were diverted from well drilling to pay for the promoter's European and Bahamian vacations leaving no money to pay for drilling wells. In another case, promoters solicited over $1.4 million from investors in eight states for the purchase of interests in oil and gas wells that had been permanently plugged and abandoned. Prospective limited partners in another instance were told that "scientific equipment" designed and built by the promoter would improve the prospects of striking oil or gas by 400%. Actually, no such equipment existed. Investors were led to believe that the promoter had engineering and business degrees as well as extensive oil field experience, when in fact, his most relevant prior experience was pumping gas at a service station.

What are Oil and Gas Partnerships?

Oil and gas investments take many forms, including limited partnership interests, ownership of fractional undivided interests in leases and general partnerships. Tax consequences and investor liability vary according to the type of program.

In a drilling limited partnership, an oil or gas company sells partnership units to investors and uses the money it raises to lease property and drill wells. In return for managing the project, the sponsor company usually takes an up-front fee that averages about 15-16% of one's investment, and shares in a percentage of any revenue generated. In return, the promoter offers the prospect of a substantial first year tax write-off and quarterly cash distributions from the sale of any oil and gas the partnership finds until the wells run dry.

Drilling partnerships have always been a gamble, and recently they have proven somewhat riskier than usual. Historically, about one in three haven't even returned the original investments. And, for partnerships formed since 1979 - which have suffered from the dramatic and largely unexpected fall in oil and gas prices - that level of failure has increased to 42%, one study estimates.

Fraudulent Sales Techniques

Fraudulent oil and gas deals are normally structured with the limited partnership (or other legal entity) in one state, the operation and physical presence of the field in a second state, and the offerings made to prospective investors in states other than the initial two states. Thus, there is less chance of an investor dropping by a well site or a nonexistent company headquarters. Such a structure also makes it difficult for law enforcement officials and victims to identify and expose the fraud.

Boiler Rooms

In order to attract the interest of potential investors, unprincipled promoters frequently use "boiler room" offices with banks of phones manned by salespersons with little or no background in energy exploration but plenty of experience in high-pressure sales. These techniques include repeated unsolicited phone calls to members of the public, hyping the profitability of the deal and promising extravagant tax advantages.

State securities regulators and Better Business Bureaus caution potential investors to beware of the following claims in a typical high-pressure sales pitch in an unsolicited telephone call:

- You will have an interest in a well that cannot miss;
- The risks are minimal;
- A geologist has given the salesperson a tip;

- The salesperson has personally invested in the venture;

- The promoter has "hit" on every well drilled so far;

- There has been a tremendous "discovery" in an adjacent field;

- A large, reputable oil company is operating or planning to operate in the area;

- Only a few interests remain to be sold and you should immediately send in your money in order to assure the purchase of an interest;

- This is a special private deal open only to a lucky chosen few investors.

How To Avoid Being Swindled

Most scam deals, say regulators, are devastatingly simple. "The game isn't really high-level fraud," says Royce Griffin, Colorado Securities Commissioner and president of NASAA. "It's usually more a total misuse of proceeds. Take the investors' money and buy yourself a Mercedes, things like that."

You can minimize the risk of being swindled if you resist pressures to make hurried, uninformed investment decisions. There are several steps you should take before parting with your money.

State securities regulators and Better Business Bureaus advise potential investors not to be afraid to ask the hard questions when solicited for oil and gas investment opportunities. Based on their own experience, regulators have devised a checklist of questions you should ask before investing.

1 Registration Requirements

Ask if the offering is filed with the office of the state securities commission in your state or the state in which the promoters are located. If so, contact that agency for any information it may be able to provide. If the promoter claims that the offering is exempt from registration requirements in the particular state in which the offers and sales are made, find out which of the exemptions is claimed and the terms of the exemption. Contact the state securities agency to confirm that the offering is indeed exempt.

2 Salespersons - Legitimate or con artist?

If it is a legitimate deal, the salesperson will not be reluctant to answer questions or provide written explanations to questions. Ask the name of the person offering you the security, where he is calling from and his background, particularly in other oil or gas ventures. Ask what commission and/or other compensation the salesperson will receive. Contact your state securities agency to find out if the promoter or salesperson has been sanctioned for previous violations of securities laws.

3 The Company - Be sure it is real

Ask the names of the principals of the company or the general partners offering the security, their backgrounds and experience in the oil and gas industry, and how long they have been associated with the company. Find out the history of the company, its capitalization, assets and retained earnings. What contingent liabilities does it have from other ventures? Does it have sufficient funds to cover unexpected costs?

Find out the company's or general partners' history in drilling operations. In particular, ask how long it has been in the oil and gas business, the number of wells drilled, the number of strikes and depth of the wells, and whether the company retained its interest in the wells it drilled. Determine if conflicts of interest involving the promoter are disclosed.

All the above information should be contained in a prospectus or "offering documents" that the promoter must furnish potential investors before they commit their funds.

4 The Investment - Avoid having your money used for a European vacation

Make sure funds raised are kept in a separate escrow account until used and that they won't be commingled with other funds. Also, be certain the funds will not be used for purposes other than those specified. Ask how much money is to be raised and the cost per fractional interest. Ask how much of the money will pay for advertising, salaries, drilling costs, legal fees, administrative expenses, sales commissions and any estimated profit to the company.

Assuming the well is completed, ask what the completion costs will be for each investor, including additional commissions to be paid (the purpose and amount), and whether investors may be obligated to pay in more money in the future.

Finally, evaluate the risk involved in making the investment. Is the well to be drilled a wildcat (drilled in territory not known to be productive) or is the drilling to be done in an area of proven oil reserves?

5 The lease

Secure a legal description of the property on which the program is to be drilled. How and when was it acquired? Is the principal selling the lease to the venture at the acquisition cost, and if not, how much profit is being made? Ask for a description of surrounding property, including local well completions and a geologist's report on the area. You will want to know if the lease is already in default and whether there is any overriding royalty or landowner's royalty being paid.

Ask for a disclosure of the person(s) selling the lease, the cost of the lease and any relationship between the lessor and the operator.

Secure a statement of the depth of the well to be drilled and an indication of when drilling is to begin. Insist on seeing a copy of the driller's contract with the promoter.

6 Additional questions to ask before investing

- Is a general statement made of all taxes that must be paid out of investors' share of any production?

- What is the location of available pipelines, or what method will be used to sell any production?

- What is the name and address of the operator? What are the terms of the agreement with him, including the compensation to be received and experience?

- How will the decision be made for completing the well or abandoning it? Who will make the decision? What is to become of funds received from the salvage value of equipment on the lease?

The checklist of questions to ask and information to obtain is a long one. It will take some time and perhaps even money invested in outside consultation before you feel comfortable risking your money in the investment. It is always advisable to seek the advice of a neutral expert before committing your funds to any investment deal.

For More Information

The Securities and Business Investments Division of the Department of Banking is responsible for the protection of investors and for ensuring that complete information is available for many types of investments. If you have questions about a possible oil and gas investment, contact the Division at (203) 566-4560. Your prompt action could save you money.

The Council of Better Business Bureaus and the Better Business Bureaus (BBB) of the U.S. and Canada answer inquiries on companies located in the areas they serve. Before putting money in an investment plan, it is a good idea to contact your local BBB for a reliability report on the company you intend to deal with.

OBSERVATIONS ON THE NETWORKING PROVISIONS OF SEC RULE 3b-9 AND CONNECTICUT'S ADVISORY INTERPRETATION ON BANK SECURITIES ACTIVITY

Rule 3b-9 requires banks to register as broker-dealers if they: (1) publicly solicit brokerage business for transaction related compensation or (2) receive transaction related compensation for providing brokerage services for trust, managing agency or other accounts to which they provide investment advice or (3) deal in or underwrite securities. There are several exceptions to the registration requirement, including the networking exception for banks which enter into a contractual arrangement with a registered broker-dealer which offers brokerage services on or off the bank's premises. In order to avail itself of the networking exception the bank must meet certain conditions. First, the broker-dealer must be clearly identified as the person performing the brokerage services, second, bank employees must perform only clerical and ministerial functions in connection with brokerage transactions unless they are qualified as registered representatives. For employees who perform more than clerical and ministerial functions, the rule contemplates dual employee status and supervision by the broker-dealer as "associated persons" under Section 3(a)(18) of the Securities Exchange Act of 1934. S.E.C. Release No. 34-22205; File No. 57-1000. Third, bank employees must not directly or indirectly receive compensation for brokerage services unless they are qualified as registered representatives. Finally, the broker-dealers must provide the services on a basis in which the customers are fully disclosed, i.e., all accounts are kept in the individual customer's name rather than in the bank's name.

On February 7, 1985, the Banking Commissioner issued an advisory interpretation concerning bank securities activities. The interpretation does not require banks to register as broker-dealers. It notes that banks are excluded from the definition of "broker-dealer" contained in Section 36-471(c) of the Connecticut General Statutes. The interpretation is narrower than Rule 3b-9 since it only deals with networking arrangements. Moreover, its scope is not coterminous with that of the Rule 3b-9 networking exception.

The interpretation construes the definition of "agent" contained in Section 36-471(b) of the Connecticut General Statutes as applied to certain employees of financial institutions which have entered into networking arrangements with registered broker-dealers. Briefly stated, individuals who are employees of either the participating bank or of the broker-dealer will be deemed agents of the broker-dealer and be subject to the registration requirements of Section 36-474(a) if they are involved in effecting or attempting to effect purchases or sales of securities. However, individuals merely engaged in clerical or ministerial functions will not be deemed agents.

Rule 3b-9 also makes a distinction between the performance by bank employees of clerical and ministerial functions in connection with brokerage transactions and functions which extend beyond the clerical and ministerial. The examples given by the SEC of activities which will be deemed clerical or ministerial and those which will not, while not as numerous as those specified in the interpretation, appear to be consistent with them, with one possible exception. Under Rule 3b-9 if bank employees handle customer orders, they are not performing a clerical or ministerial function, even if the orders are immediately forwarded to a broker-dealer for execution (S.E.C. Release No. 34-22205; File No. 57-1000). By contrast, the interpretation provides that the mere collection or verification of information for transmittal to and action by a registered agent or broker-dealer or the mere transmittal of order forms or like information for action by a registered agent or broker-dealer will be deemed a clerical or ministerial function. Thus, to the extent that "handling customer orders" encompasses collection and verification of information or the transmittal of order forms, Rule 3b-9 is more restrictive than the interpretation.

The interpretation also provides that if a broker-dealer occupies physical space within a financial institution and the space is directly accessible to customers of the financial institution, the broker-dealer will be deemed to be operating a "branch office" (as defined in Section 36-500-13(a)(4) of the Regulations) and will be subject to the record keeping and supervisory requirements of Section 36-500-13(a) of the Regulations. The interpretation requires that the space occupied by the broker-dealer be separated from the retail area of the participating bank, conspicuously identified as the place of business of the broker-dealer, readily distinguishable from the operations of the bank and staffed by persons whose affiliation with the bank is conspicuously identified. These requirements go beyond Rule 3b-9's networking exception in that the rule does not require the separation of the broker-dealer's office from the retail area of the bank. The rule, however, does require the broker-dealer to be clearly identified as the person performing the brokerage services.

The interpretation further provides that the broker-dealer must, in any advertising or promotional or sales literature and materials (including form letters and forms): (1) accurately represent its relationship with the participating bank; (2) indicate that the bank is not a registered broker-dealer, and (3) indicate that its existence and activities are separate from those of the bank. Such materials are required to be filed with the Commissioner and will become part of the broker-dealer's registration application or renewal. Under the SEC's interpretation of Rule 3b-9 (Release No. 34-22205; File No. 57-1000) advertising and other promotional literature must clearly specify that the broker-dealer rather than the bank will be performing the brokerage function. The literature will be deemed that of the broker-dealer and must be approved by the broker-dealer. However, it is permissible for the bank to work with the broker-dealer in developing the literature. The rule's provisions regarding literature may be narrower than those of the interpretation, if advertising and promotional literature is not deemed to include form letters and forms.

The interpretation imposes additional requirements on broker-dealers who enter into networking arrangements. First, broker-dealers who effect transactions in securities for the fiduciary accounts of banks must make full disclosure to the fiduciary customer of the relationship between the broker-dealer and the bank, and a failure to do so may constitute a dishonest or unethical practice under Section 36-484(a)(2)(H) of the Connecticut General Statutes. While the Rule 3b-9 networking exception does not contain a parallel provision, the disclosure requirement in the interpretation is consistent with the rule's disclosure policy as reflected in the requirement that the broker-dealer be identified as the person performing the brokerage services.

Finally, the interpretation provides that broker-dealers involved in networking arrangements keep their books and records separate from those of the bank. This requirement finds no parallel in Rule 3b-9.

ADVISORY INTERPRETATION ON THRIFT-RELATED SECURITIES ACTIVITIES

Facts

Corporation, a broker-dealer registered in this state, does business under the name X. X proposes to provide financial services to customers of Connecticut-based thrift institutions and to the general public through service centers to be located on the premises of the thrift institutions. Each participating thrift institution will enter into a Participating Association Agreement (the "Agreement") with X. Individuals performing services for or engaging in activities relating to X's business will generally fall into three categories. Financial Service Executives (dual employees) will be employees of both the participating financial institution and X and will divide their time between both entities. They may be registered representatives of X and will receive a salary from both X and the thrift. The thrift will recommend certain of its employees for dual employee status. Investment Executives will only be employees of X, and will be registered representatives of the brokerage firm. Employees who are neither dual employees nor Investment Executives will be employees of the participating thrift institution. Their activities will generally be confined to distributing promotional literature, directing persons to registered dual employees; and providing limited types of information and assistance. Only dual employees and Investment Executives will execute purchases and sales of securities. X may also retain a clearing broker to perform order execution, clearing and billing.

X will provide telephone services for its customers to use during off-hours and during New York Stock Exchange trading hours. Such telephone services will be provided from X's home office. The thrift may choose to have the X facilities open for business during additional hours, subject to X's approval. The X Center will be segregated from the rest of the branch premises via standard X furnishings and materials. The thrift will be obligated to maintain strict and total separation of its business from the business conducted at each Service Center, including the separation of records and physical facilities. In addition, the thrift will be obligated to conduct its business to avoid confusion between its business and that of X. With the exception of new certificates of deposit, retail repurchase agreements and other products and services currently offered by thrifts generally, the thrift will not offer securities or investment advisory services to customers except through the X program.

X will make revenue sharing payments to the thrift. Such payments will be based on a percentage of the origination fee (i.e., the charge to the customer for handling the securities transaction). The thrift will receive 10 percent on all origination fees over $50 due to the efforts of X Investment Executives and twelve to forty-four percent on all origination fees over $50 due to the efforts of dual employees . Your letter indicates that a percentage lease may be involved; however, this is not expressly required by the agreement. In addition, the thrift will pay a one-time participation fee per branch to X.

X will provide the thrift with standard finished advertising materials, point-to-sale displays and materials, stationery, calling cards, and direct mail materials. All advertisements and promotional materials will make it clear that all securities services will be provided by X. Subject to modification by the parties, the thrift is obligated to spend 15 percent of its annual advertising budget (or 15 percent of the national annual average advertising budget for institutions of equal size) on advertising the first year and 10 percent for subsequent years. X will also provide orientation materials to thrift employees not engaging in securities-related activities.

X supervisory personnel will have access to records maintained in connection with the securities related activities of X centers as well as access to Investment Executives, dual employees and other financial service executives of X.

Your letter raises three issues. The first is whether financial institutions organized under Connecticut law are authorized to participate in the X program. The second is whether those financial institutions would be deemed broker-dealers under Section 36-471(c) of the general statutes. The final issue is whether employees of participating financial institutions who engage in certain activities on behalf of their customers would be deemed "agents" within the meaning of Section 36-471(b) of the general statutes.

I. Ability of Thrift Institutions to Enter into Agreements with X

This Department is conducting an on-going review of the extent to which arrangements such as that contemplated by X should be deemed permissible for Connecticut-based thrift institutions. As you are undoubtedly aware, the homogenization of the financial services industry has promoted both uncertainty and litigation at the federal level. Similarly, Title 36 of the general statutes is less than clear on the issue of whether Connecticut savings banks and savings and loan associations may contract with broker-dealers for the provision of securities services to customers. This Department is not only concerned with the extent to which such arrangements would affect the safety and soundness of the financial institutions involved, but with potential conflicts of interest that may arise. Although Sections 20 and 32 of the Glass-Steagall Act, 12 U.S.C. 377, 78, apply only to "member banks", the division between commercial and investment banking that those sections attempted to preserve is an integral part of Title 36 of the general statutes.

This Department's opinion dated February 24, 1984 on the rental of office space to a stock brokerage firm does not cover many pertinent aspects of the X program. For example, the Participating Association Agreement, by its terms, is not clearly structured as a percentage lease. (A percentage lease is not objectionable as long as its terms are reasonably related to rent and are consistent with those of commercial leases in the immediate general geographical area.) In addition, the prior opinion did not contemplate a contractual relationship for services between a brokerage firm and the financial institution nor did it contemplate joint advertising between the two entities.

In effecting the desired ends of the agreement, the following conditions should be observed. If such conditions are satisfied, this Department would have no objection to X offering its program to thrift institutions in Connecticut. This Department reserves the right to change its position should circumstances or safety and soundness considerations so warrant.

1) An arms-length relationship must exist between X and the participating financial institution.

2) The area occupied by X must be sufficiently separated from the retail area of the participating thrift such that an individual referred to the X area of the participating thrift may leave the retail area and then choose whether to conduct securities business with X without feeling obligated to do so in the presence of officers and employees of the financial institution.

3) The signs or other labeling within the institution's building must not in any way imply or lead customers or the public to conclude that X's operations are a part of the institution.

4) Advertising must make it clear that X rather than the participating financial institution will be offering the securities services.

5) The participating thrift will not purchase securities from X for its own account.

6) No employee, officer or director of the participating financial institution may render investment advice without meeting the appropriate registration requirements.

The criteria mentioned above do not supplant or render ineffective the criteria contained in this department's Advisory Interpretation of February 7, 1985 concerning the regulatory ramifications of similar arrangements under chapter 662 of the Connecticut General Statutes, the Connecticut Uniform Securities Act.

II. Status of Participating Financial Institutions as Broker-Dealers Under Section 36-471(c) of the General Statutes

Section 36-471(c) of the general statutes provides that "unless the context otherwise requires" the term "broker-dealer" is defined to mean "any person engaged in the business of effecting transactions in securities for the account of others or for his own account." Excluded from the definition by virtue of Section 36-471(c)(3) of the definition is "a state bank and trust company, a national banking association, a credit union, a federal credit union, or [a] trust company." On February 7, 1985, this Department issued an advisory interpretation under Chapter 662 of the general statutes indicating that where a broker-dealer enters into a contractual arrangement with a financial institution, the participating financial institution would be excluded from the definition of "broker-dealer" under Section 36-471(c)(3) of the general

statutes. That interpretation has not been revised or superseded. This Department, however, is reviewing the interpretation in light of Rule 3b-9 which was recently promulgated by the Securities and Exchange Commission. Until such time as this Department's regulatory posture on the matter is modified, the advisory interpretation, including its determination that financial institutions would be excluded from the definition of "broker-dealer" and not required to register as such, remains intact.

III. Status of Employees of Participating Financial Institutions as "Agents" Under Section 36-471(b) of the General Statutes

Your correspondence indicates that most Dual Employees and Investment Executives will be registered representatives of X and therefore registered as agents under the Connecticut Uniform Securities Act. The question for consideration thus becomes whether those financial institution employees who are not registered dual employees must register as agents of X. In the February 7, 1985 advisory interpretation mentioned above, this Department indicated that employees of financial institutions would be required to register as agents if they engaged in one or more of the following functions: 1) opening customer accounts and/or making suitability determinations regarding the purchase or sale of securities, except for the mere collection or verification of information for transmittal to and action by another person registered as an agent or a broker-dealer under the Act; 2) rendering investment advice or making investment recommendations in connection with the purchase or sale of securities; 3) soliciting orders to purchase or sell securities; 4) processing orders to purchase or sell securities; 5) handling inquiries or engaging in the resolution of complaints regarding the purchase or sale of securities, and 6) directly or indirectly supervising sales personnel or assuming responsibility for the day-to-day operation of any place of business of a broker-dealer in Connecticut. Please be advised that as long as such financial institution employees do not engage in such activities, they would not be required to register as agents of X. The fact that non-dual employee activity would be confined to 1) informing potential X customers that X provides brokerage services; 2) distributing promotional materials,and 3) directing persons to registered dual employees or to a toll-free telephone would not appear to trigger the registration requirements. Caution should be exercised, however, to ensure that such employees do not engage in any solicitation activity.

With respect to dual employees who are not registered representatives of X, please be advised that the information provided indicates a strong probability that such persons would be required to register as agents. Registration should be effected to avoid possible compliance problems. By informing customers that X provides brokerage services and by distributing X promotional materials and brokerage account applications, for example, such employees may be involved in the solicitation of orders to purchase or sell securities. Similarly, in answering clerical and administrative questions (albeit exclusive of questions regarding customer brokerage accounts), it is not clear whether the unregistered dual employees would be precluded from expanding their answers to include matters involving the purchase or sale of securities. The receipt of completed brokerage account applications would not be considered an account opening function only if information is merely collected or verified for transmittal to and action by a registered agent; however your correspondence does not indicate whether the employee's function would be so limited. Consequently, it is the preliminary determination of this department that registration should be effected to promote compliance with the Act. This determination is subject to reconsideration if countervailing information is received by this department.

SECURITIES OFFERINGS INVOLVING SECOND MORTGAGES

It has come to the attention of the Department of Banking that some persons involved in the secondary mortgage loan business may be soliciting funds from the general public to finance the making of second mortgage loans. Such arrangements may involve the offer or sale of a "security" within the meaning of Section 36-471(m) of the Connecticut General Statutes and may require broker-dealer registration on the part of the participating secondary mortgage loan broker. Any person considering such an arrangement is advised to consult the securities laws of this state to ensure that he or she is in full compliance with those provisions. Following is the text of an advisory interpretation issued by this department illustrating how the securities laws of this state apply to one such arrangement. Transactions of a similar nature would be treated in the same manner. The department urges any person considering such arrangements to seek the advice of counsel before proceeding further.

Text of Advisory Interpretation

Facts

Associates ("X") is a secondary mortgage loan licensee in Connecticut. X is engaged in the business of investing in second mortgages on properties situated in this state. X proposes to enter into separate "trust agreements" with members of the public residing in Connecticut. Each trust agreement recites that X proposes to make its knowledge and expertise in locating suitable properties for investment available to the individual (the "Mortgage Owner") executing the agreement. Individuals wishing to participate in X's Trustee Mortgage Program (the "Program") must invest at least $5,500. That sum is payable to X at the time the trust agreement is executed and after X locates a suitable borrower and parcel. X will use the funds provided to make second mortgage loans. The sums will be deposited in X's trust account, without interest, before the closing. If the closing does not occur, X will return the funds, without interest, to the Mortgage Owner within 21 days following initial payment. (The Offering Circular, however, indicates a 20-day time period.) The trust agreement designates X as "trustee" for the Mortgage Owner in closing, servicing, and administering the second mortgage. (The Offering Circular, by contrast, places servicing and administering responsibility on the Mortgage Owner or his appointee.) X will take title to the mortgage as trustee for the Mortgage Owner who will receive beneficial ownership "for investment purposes" of the second mortgage. The Mortgage Owner's name will not appear on the land records without his prior approval and a letter of assignment. Although the agreement between X and the Mortgage Owner is called a "trust agreement" and thus purports to create a fiduciary relationship between the parties, the agreement specifically states that X will only be held to the standard of care it exercises in the conduct of its own second mortgage business and that its liability to the Mortgage Owner is limited to that set forth in the agreement.

The materials submitted do not indicate that Mortgage Owners will receive any receipt or certificate evidencing their beneficial interest, other than a copy of the trust agreement. You have indicated that X will not pool investor funds.

X will receive an origination fee consisting of a set number of points of the loan discount fee it charges the mortgagor. Any remaining balance of the loan discount fee would be payable to the Mortgage Owner. In addition, X will receive a servicing fee consisting of the difference between the interest rate charged to the mortgagor and the 14 percent annual interest rate received by the Mortgage Owner. The servicing fee will be deducted from payments of principal and interest remitted from X to the Mortgage Owner. While X will keep separate records of account for each Mortgage Owner, Mortgage Owners will not receive a statement of account for any period during which payment from the borrower is not received.

If there is any default in payment by the borrower, X will notify the Mortgage Owner of the default in writing within 30 days after the default occurs. Unless the Mortgage Owner requests action in writing, X will have no obligation to take action concerning default. If action is requested, the Mortgage Owner must indemnify X against anticipated out-of-pocket expenses or legal fees. If the Mortgage Owner ultimately acquires full title and wishes to sell the property, X retains the exclusive right to sell the property for six months thereafter; X will receive a 6 percent commission if the property is sold.

The trust agreement prohibits the Mortgage Owner from assigning his rights thereunder. In addition, the agreement gives X discretion to repurchase the Mortgage Owner's interest if the Mortgage Owner so requests in writing.

Discussion

Your correspondence raises the issue of whether the Program involves the offer or sale of a "security" within the meaning of Section 36-471(m) of the Act. Under Section 36-471(m) of the Act, the term "security" includes "any ... evidence of indebtedness ... [or] investment contract ...." Connecticut courts have adopted the construction of the term "evidence of indebtedness" set forth in United States v. Austin, 462 F.2d 724, 736 (10th Cir. 1972). See, e.g., State v. Farrah [1978-81 Transfer Binder] BLUE SKY L. REP. (CCH) para. 71,537 (Conn. Super. Ct. 1979). In United States v. Austin, the court stated that "[t]he term 'evidence of indebtedness' is not limited to a promissory note or other simple acknowledgement of a debt owing and is held to include all contractual obligations to pay in the future for consideration presently received." (emphasis added) The promise to pay need not be absolute but may be conditioned on the occurrence of a particular event. See, e.g., Curtis v. Johnson, 92 Ill. App. 141, 234 N.E.2d 566 (1968); Searsy v. Commercial Trading Corp., 560 S.W.2d 637 (Tex. 1977). The trust agreement obligates the Mortgage Owner to pay to X a designated sum which represents the principal amount of the mortgage to which X will take title as trustee for the Mortgage Owner. In return for such amount, X is obligated to pay to the Mortgage Owner the balance of the loan discount fee it charges to the mortgagor as well as a portion of the interest payments X receives from the mortgagor such that the Mortgage Owner will receive an effective rate of return of 14 percent per annum. The contractual agreement between X and the Mortgage Owner would thus appear to constitute an "evidence of indebtedness" and therefore a "security" under Section 36-471(m) of the Act.

It would also appear that the Program involves an "investment contract" within the meaning of Section 36-471(m) of the Act. Connecticut courts have employed the test for determining the existence of an investment contract set forth in S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946). See, e.g., Alvord v. Shearson Hayden Stone, Inc., FED. SEC. L. REP. (CCH) para. 97,339 (D. Conn. 1980). In Howey, the United States Supreme Court construed the term "investment contract" to mean "an investment of money in a common enterprise with profits to come solely from the efforts of others." An investment of money occurs where there is a parting of money in the hope of receiving profits through the efforts of another party. Alvord, supra, at p. 97,241. Your correspondence indicates that members of the public will be investing at least $5,500 with X in the hope of receiving a 14 percent return on their investment through X's expertise in making second mortgage loans.

The circuits have split in construing the "common enterprise" element of the Howey definition. One approach toward finding a common enterprise focuses on whether "vertical commonality" exists. Vertical commonality looks to the presence of a one-to-one relationship between an investor and an investment manager and does not require a pooling of monies from various investors. Vertical commonality has been acknowledged as the proper test in Connecticut. See Alvord v. Shearson Hayden Stone, Inc., FED. SEC. L. REP. (CCH) para. 97,339 (D. Conn. 1980). Vertical commonality, however, has been construed both broadly and narrowly. A broad test of vertical commonality examines whether the fortunes of all investors are inextricably tied to the efficacy of the promoter's efforts. Because the broad test of vertical commonality may duplicate the third prong of the Howey test (i.e., expectation of profit stemming solely from the efforts of the promoter), lower courts in the Second Circuit have frowned on its application. See, e.g., Michigian v. Art Capital Corp., FED. SEC. L. REP. (CCH) para. 92,261 (S.D.N.Y. 1985). The narrow test for vertical commonality examines whether there is a "direct relation between the success or failure of the promoter and that of his investors." Mordaunt v. Incomco, 686 F.2d at 817 (9th Cir. 1982), cert. denied, 105 S. Ct. 801 (1985). In the situation you describe, X's success or failure in locating a suitable borrower would affect not only the investor's return but the percentage of interest X shares with the investor. The profitability of the loans made by X has a direct impact on the return realized by both X and the members of the public with which it deals. Consequently, a common enterprise exists between X and the investor.

The final element of the Howey test is whether an expectation of profit is derived solely from the efforts of the promoter or a third party. Under the scenario you describe, the return realized by the investor depends very much on the efforts of X. X closes, services, and administers the loans. X evaluates the prospective borrower's ability to repay and selects suitable borrowers. X holds legal title to the mortgage for the benefit of the investor. X has control over the loan accounts. The investor may not sell any interest he may have in the property without X's assistance. X has discretion to repurchase the investor's interest. X negotiates the mortgage with the borrower, and investigates the borrower's payment of taxes and principal and interest. Although the Mortgage Owner has the right to examine the property subject

to the mortgage, it is unlikely that he will do so given the overriding responsibilities assumed by X. In addition, X's representations that "[p]articipants in our investment program will be earning 14 percent annual percentage rate on their investment" appears to be an implied guarantee that such a return will be realized, thus emphasizing the passive role to be played by the investor and the investment character of the arrangement. Many of the foregoing factors have been isolated by the Securities and Exchange Commission in examining whether public offerings providing for the acquisition, sale or servicing of mortgages or deeds of trust would be deemed investment contracts under the federal securities laws. See Release No. 33-3892, 17 C.F.R. 231.3892. Consequently, it would appear that the profits realized by the investor do, in fact, depend solely on the efforts of X such that the arrangement constitutes an "investment contract" within the meaning of Section 36-471(m) of the Act.

Absent an available exemption under Section 36-490 of the Act, the Program would have to be registered with this department pursuant to Section 36-485 of the Act. In addition, X may be deemed a "broker-dealer" within the meaning of Section 36-471(c) of the Act and required to register as such should it implement the Program as described.

BUSINESS BROKERS AND THE SECURITIES LAWS

The functions performed by business brokers vary. Generally speaking, however, a business broker is one who, for a fee, commission or other consideration, acts as an intermediary in the transfer of the business, including its assets, trademarks, goodwill and real and personal property. The business broker may act as an agent of either the seller or the buyer who plans to own or operate the business. Many times, a business broker merely lists going concerns for sale. Other times, the business broker may take an active role in negotiating the transfer or sale of the business.

An important issue is whether business brokers are required to register as broker-dealers under state securities laws. To be a broker-dealer under Section 36-471(c) of Chapter 662 of the Connecticut General Statutes, the Connecticut Uniform Securities Act, a person must be 1) engaged in the business 2) of effecting transactions 3) in securities 4) for the account of others or for his own account. This definition was patterned after Section 401(c) of the original Uniform Securities Act which was adopted by the National Conference of Commissioners on Uniform State Laws in 1956 and is substantially similar to the definition contained in the laws of other states adopting the Uniform Act. The third element of the definition is by far the most important since, if a security is not involved, the business broker would avoid not only broker-dealer registration but the antifraud provisions of the Connecticut act as well.

Transfers Involving Stock Sales

Some sales of businesses are accomplished, at least in part, by a stock transfer. In many jurisdictions, the "sale of business doctrine" historically relieved business brokers from complying with state and federal securities laws. The sale of business doctrine divides the transfer of a business into dominant and subsidiary parts. Essentially, the doctrine states that if a controlling interest in a business is transferred through the sale of stock, the dominant feature of the transaction is a sale of assets, with the stock passing as a mere indicia of ownership. Since the transfer of the business is perceived as an entrepreneurial rather than an investment transaction, the incidental sale of stock is not deemed to involve a "security." In recent years, the sale of business doctrine created a rift in the circuit courts of appeal, with the Seventh, Tenth and Eleventh Circuits adopting the doctrine and the Second, Fourth and Fifth Circuits rejecting it.

Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982) is representative of the position of the Second Circuit on the sale of business doctrine. That case concerned the transfer of a business by way of a sale of 100 percent of the outstanding shares, with the purchaser intending to manage the business directly. In rejecting the sale of business doctrine, the court noted that instruments ordinarily regarded as "stock" constituted a "security" for purposes of the federal securities laws, even though the underlying transaction involved a transfer of control. The court added that the concept of "control" underlying the doctrine was inherently elusive and that a distinction between commercial and investment transactions was of "most dubious value" where stock was concerned. In addition, the court stated that purchasers of a business regarded themselves as investors as well as managers.

Under the literalist approach adopted by the Second Circuit, a business broker would have been hard pressed to claim that the subject matter of the sale did not involve a "security." A constrasting impact of the doctrine on the activities of business brokers was illustrated in the following case. In Star Supply Company v. Jones, BLUE SKY L. REP. (CCH) para. 71,943 (1984), the Texas Court of Appeals scrutinized a fact situation concerning a business broker that entered into an exclusive listing agreement and agreed to find a buyer for the business. The contemplated transfer involved the purchase of all of the stock of the business as well as personal property, trade names, leases, franchises, accounts receivable, customer lists and good will. Stressing that it was required to look to the "economic reality" of the transaction, the court applied the test for determining the existence of a "security" set forth in SEC v. W.J. Howey, 328 U.S. 293 (1946). The Howey test, customarily used in determining the existence of an "investment contract," focuses on three elements: 1) an investment of money; 2) a common enterprise, and 3) profits derived solely from the efforts of others. The court found that since the goal of the purchaser was not an investment in reliance on the efforts of others but rather a desire to consume, use and acquire the thing purchased, the sale of securities was not involved. Consequently, the business broker was not required to be licensed as a securities broker under the Texas blue sky law to effectuate the sale of the corporation. Were Star Supply Company to be decided today, it is doubtful that the business broker would be able to avoid broker-dealer registration by arguing that a "security" was not involved for the United States Supreme Court effectively laid the sale of business doctrine to rest in Landreth Timber v. Landreth, 105 S. Ct. 2297 (1985).

Landreth Timber involved the sale of 100 percent of the outstanding stock of a closely held corporation. The question involved was whether the sale of business doctrine was to be applied. In rejecting the doctrine under the facts before it, the Supreme Court observed that how an instrument was labeled was not determinative. The characteristics of the instrument were also important. The Court went on to list several attributes of common stock:
1) the right to receive dividends contingent on an apportionment of profits; 2) negotiability; 3) the ability to be pledged or hypothecated; 4) the conferring of voting rights in proportion to the number of shares owned, and 5) the capacity to appreciate in value. If the instrument possessed the appropriate label and characteristics, the purchaser could justifiably assume that the federal securities laws applied. In a footnote, the Court added that preferred stock might have varying characteristics and still be covered by the federal securities laws. Remarking that the context of the transaction (i.e. the sale of stock in a corporation) was typical of the kind of context to which the federal securities acts applied, the court held that the plain meaning of the statutory definition of "security" mandated that the stock be treated as a security subject to statutory coverage. Following the Landreth Timber decision, it is unlikely that a business broker involved in the transfer of a business involving stock could claim that a security is not part of the subject matter of the purchase. Indeed, such a claim was rejected by the Securities and Exchange Commission where a broker-dealer agent introduced two of his clients to a concern and received a related "finder's fee." (In re Wamsganz, SEC, 9/16/85)

Of course, if a transaction is structured as a sale of assets for non-securities consideration, rather than, for example, a sale of stock, no security would be involved and the business broker would not be deemed a broker-dealer. Party choice in structuring the transaction thus assumes paramount importance.

Effecting Transactions in Securities

Even if a "security" is involved, determining whether the business broker is a broker-dealer would still depend on whether he is "engaged in the business of effecting transactions in securities for the account of others or for his own account."

Generally, effecting transactions in securities means making offers to sell or buy or making sales of securities. A business broker would not be effecting transactions in securities if he merely collects information on businesses, disseminates that information through publications (i.e. a listing arrangement) and passes the responses received on to the appropriate party. In such a situation, the business broker would only be performing a clearing-house function. Typically, information disseminated concerning the buyer would consist of a written description of the type of business or assets the buyer seeks to acquire and the manner and terms upon which the buyer seeks to acquire them. Information concerning the seller would include a description of the nature of the business, including its financial condition and past performance, and the manner and terms of its proposed acquisition.

If the business broker merely introduces the parties to a securities transaction and does not participate in negotiating or consummating the transaction, the business broker would not be effecting transactions in securities. Similarly, "matching up" buyers and sellers on the basis of general goals and resources or business experience would not constitute broker-dealer activity. Where, however, the business broker is in the business of engaging in advisory, evaluative, investigative or decision-making functions on behalf of a client with respect to the securities involved, he may not only be a broker-dealer, but an investment adviser as well if he receives compensation for rendering such advice. Such activity should be contrasted with non-securities analyses provided by a business broker on products, market conditions and competition. A business broker may be an investment adviser, for example, if he gives the buyer or seller advice on the value of the securities involved or issues evaluative reports regarding the securities aspects of the transaction. Rendering advice on effecting an acquisition through the purchase or sale of securities (versus other means) would be another example. If the business broker is a broker-dealer or an investment adviser, he would be required to become registered as such with the Banking Commissioner.

Also relevant in determining if a business broker is effecting securities transactions is whether he 1) is specifically employed to buy or sell securities; 2) holds or controls securities or securities-related funds; 3) receives a separate fee for his role in effecting a transfer of securities, and 4) holds himself out as being authorized to sell securities, having expertise in

securities or being engaged in the securities business. Each of these factors would be indicative of broker-dealer status. The factors listed, however, are not all-inclusive, and a case-by-case determination may be required.

Engaged in the Business

Even though a business broker may be effecting transactions in securities, he will not be a broker-dealer unless he is engaged in the business of doing so. While securities activity need not be the business broker's primary business, "engaged in the business" denotes a degree of frequency and regularity in effecting securities transactions and something more than a single isolated transaction. Many business brokers that effect securities transactions will be in the business of doing so.

Securities Registration Considerations

If the sale of a business involves securities, the seller must confront the issue of securities registration. This issue is separate from whether the business broker is required to register as a broker-dealer.

Since most business sales are publicized through newspapers and other media, this stage of the process will be explored first. Section 36-485 of the Connecticut Uniform Securities Act provides that "[n]o person shall offer or sell any security within this state unless (1) it is registered under this chapter or (2) the security or transaction is exempted under section 36-490." If the printed listing does not contain any reference to securities but merely describes such items as the nature of the business, its cost, property, equipment and fixtures, then the published information, in and of itself, does not involve an offer or "sale." If, however, securities are expressly mentioned, either generally or specifically, then an "offer" would be involved. If the offer is made in a Connecticut publication, the securities would have to be registered or an exemption found. It is noteworthy that the private placement exemption in Section 36-490(b)(9) of the Connecticut Uniform Securities Act would probably not apply inasmuch as the offering would involve an improper public solicitation.

Even if the publication does not refer to securities, if securities are transferred along with other assets of the business, the parties are still faced with the registration question. If the buyer is sufficiently sophisticated, the exemption contained in Section 36-490(b)(9)(A) of the Act for offerings made pursuant to Section 4(2) of the federal Securities Act of 1933 may be available. Reliance on the Section 4(2) exemption would necessitate a filing with the Department of Banking pursuant to Section 36-500-22(b)(9)(D) of the Regulations of Connecticut State Agencies and the payment of a $25 filing fee. Another alternative might be the exemption for offerings made pursuant to Rules 505 and 506 of federal Regulation D. Pursuant to Section 36-500-22(b)(9)(C) of the Regulations, a filing and the payment of a $25 filing fee would be required.

A third possibility is the exemption contained in Section 36-490(b)(14) of the Act. Several conditions must be satisfied to rely on this exemption. First, the offer and sale must be effectuated by the issuer. Thus if the business broker's activities are such that he is functioning as a broker-dealer, the seller would not be able to benefit from this exemption since the offering would be effected through a broker-dealer rather than through the issuer. Second, the total number of purchasers of all securities of the issuer cannot exceed 10. Third, no general solicitation is permitted in connection with the sale of the securities. Thus, if the media refers to an offering of securities, this exemption would not apply. Fourth, no commission, discount or other remuneration can be given directly or indirectly in connection with the offer and sale of the securities. If the business broker receives compensation for effecting offers or sales of securities, the exemption would not only be defeated but questions concerning the business broker's status as a broker-dealer would arise as well. Finally, the total expenses, excluding legal and accounting fees, in connection with the offer and sale of the securities may not exceed 1 percent of the sales price of the securities. Since the exemption contained in Section 36-490(b)(14) is self-executing, no filing other than a consent to service of process, would be required as long as all the conditions of the exemption are satisfied.

Regardless of whether an exemption from securities registration is available, the antifraud provisions of the Connecticut Uniform Securities Act would apply to the offer and sale of the securities.

Other Regulatory Provisions

Any business broker contemplating a sale of a business that involves the transfer of real property should contact the State of Connecticut Real Estate Commission concerning compliance with the real estate laws of this state.

In addition, the provisions of Chapter 662a of the Connecticut General Statutes, the Connecticut Business Opportunity Investment Act, may come into play where the seller represents that he will provide locations for certain equipment, purchase products, guarantee income, refund the price paid or supply a sales or marketing program. The Business Opportunity Investment Act, however, will not apply to the sale of an on-going business where the owner of the business sells and intends to sell only that one business opportunity. Thus, the business opportunity law should be reviewed by owners contemplating the sale of more than one business.

SCOPE OF MANUAL EXEMPTION

Section 36-490(b)(2)(A) of the Connecticut Uniform Securities Act exempts from registration "any nonissuer distribution of an outstanding security if ... a recognized securities manual contains the names of the issuer's officers and directors, a balance sheet of the issuer as of a date within eighteen months, and a profit and loss statement for either the fiscal year preceding that date or the most recent year of operations ...." Section 36-500-22(b)(2)(A) of the Regulations explains that the term:

> '[r]ecognized securities manual' as used in section 36-490(b)(2) of the Act includes Standard & Poors Standard Corporation Descriptions, Moody's Industrial Manual, Moody's Bank and Finance Manual, Moody's Transportation Manual, Moody's OTC Industrial Manual, Moody's Public Utility Manual, and Moody's International Manual exclusively. Supplements to said 'recognized, securities manuals are recognized, provided that the necessary information required by the Act is disclosed and the supplements are subsequently incorporated and published in the respective annual manual. If the manual contains the information required by section 36-490(b)(2)(A) of the Act only in abbreviated form, the securities are not exempt under that section. (emphasis supplied)

This department has been advised in writing by Standard & Poor's Corporation that Standard & Poor's Corporation Records is also known as Standard & Poor's Standard Corporation Descriptions. Consequently, since the publications are one and the same, the manual exemption would apply where the required information is published in Standard & Poor's Corporation Records.

SCREENING OF SECURITIES PERSONNEL

The Securities and Business Investments Division of the Department of Banking has observed that many broker-dealers submit for approval applications of agents that have had or have pending significant disciplinary history. The disciplinary history of securities personnel shown on Form U-5 may or may not constitute a basis to deny the application.

The Division is closely scrutinizing the activities of these agents and their sponsoring broker-dealers. The Division expects a broker-dealer to properly supervise all registered individuals and to assume front line responsibility for screening its personnel. Where the broker-dealer has a significant percentage of agents with a derogatory history as determined by the regulator, it will be necessary for the firm to establish adequate procedures to ensure compliance with the securities laws in order to detect and prevent the recurrence of securities violations.

A broker-dealer's duty to initially screen all applicants for employment is paramount. Closer scrutiny by the firm of the disciplinary history of prospective securities personnel will more likely than not facilitate regulatory compliance and enhance the integrity of securities personnel.

ENFORCEMENT

Cease and Desist Orders Issued

William C. Bates

On December 30, 1985, Commissioner Brown ordered William C. Bates of West Hartford, CT. to cease and desist from violations of the Connecticut Uniform Securities Act. An investigation disclosed that Mr. Bates misappropriated approximately $110,000 of customer funds on several occasions. The department also alleged that Mr. Bates engaged in a course of business that operated as a fraud and deceit upon investors. On December 30, 1985, Commissioner Brown also revoked Mr. Bates' agent registration. Mr. Bates was employed as an agent with Lowry Financial Services Corporation from October, 1983 to September, 1985. Lowry is registered as a broker-dealer in Connecticut and has its principal business office in North Palm Beach, Florida.

Atlantex Associates, et al.

On March 27, 1986, Commissioner Brown ordered Atlantex Associates; Ernest F. Lockamy, Managing General Partner; Dunn Petroleum, Inc.; Mike Sawyer,; and Dale Zopp, all of whom are located in North Miami Beach, Florida to cease and desist from offering or selling securities in or from Connecticut. An investigation by the Securities and Business Investments Division of the Department of Banking revealed that the respondents offered and sold unregistered securities and attempted to transact business without effecting a broker-dealer or agent registration.

Removatron International Corporation, et al.

On April 14, 1986, Commissioner Brown ordered Removatron International Corporation and its President, Frederick E. Goodman of Boston, Massachusetts to cease and desist from the offer and/or sale of business opportunities within or from Connecticut. It was alleged that the respondents sold unregistered business opportunities and failed to provide proper disclosures to purchaser-investors.

ADMINISTRATIVE SETTLEMENTS

E.F. Hutton & Co., Inc.

On February 13, 1986, Commissioner Brown announced the terms of a settlement agreement involving E. F. Hutton & Co., Inc. The settlement resulted from a Department of Banking hearing into whether Hutton's registration as a broker-dealer and investment adviser in Connecticut should be suspended or revoked based on the firm's conviction of 2,000 counts of federal mail and wire fraud.

The terms of the settlement were:

1. A one-year administrative probation period for E. F. Hutton & Co., Inc.

2. A $350,000 fine ($200,000 penalty plus $150,000 representing the costs of investigation and hearing).

3. Suspension for ten (10) business days (February 18 through March 3) from opening accounts or transacting business for new customers.

4. Letters of censure directed to certain operations and cash management personnel in the Northeast region reprimanding them for failure to exercise supervision over the Hartford office.

5. Notification to Connecticut employees that credit balances on customer accounts may be paid by a check drawn on a local bank at the customer's request.

6. Disqualification from using the private placement exemption from securities registration in Connecticut for six (6) months.

7. Institution and maintenance of a written system of procedures governing the responsibilities of supervisors in cash management, methods for evaluating their work, and specific measures to ensure regulatory compliance.

8. Filing of quarterly compliance reports with the Banking Commissioner while the firm is on administrative probation.

9. A requirement that directors, officers, agents and employees of Hutton comply with the terms of the company's plea agreement with the Department of Justice and the related permanent injunction.

10. A mandate that the recommendations of the Bell Report be implemented with respect to Hutton's illegal overdrafting activities.

The one year probation is contingent on Hutton not breaching any term or condition of the settlement agreement.

The monetary penalty agreed to by Hutton is the largest ever levied by the Department of Banking against a securities firm. It is also the largest penalty that any state has assessed Hutton to date as a result of the firm's excessive overdrafting.

Robert C. Clark, a former Hartford branch office manager of Hutton was the subject of a separate Department of Banking investigation and settlement order. Clark agreed to a six-month suspension of his registration as a broker-dealer agent and an investment adviser agent. The suspension began on February 13, 1986. Mr. Clark has since resigned from E.F. Hutton.

Garfield Securities, Inc.

A Greenwich, Connecticut brokerage firm was fined $1,000 and restricted from soliciting business for five days and from opening new accounts for Connecticut residents for ten days under the terms of an agreement with the Department of Banking. Garfield Securities, Inc. of 34 East Putnam Avenue, Greenwich, and its president, William Fred Ballou, agreed to the fine and restrictions after a Department of Banking investigation showed that the company had sold securities in up to nine other states without registering itself or its agents in those states.

Under the terms of the agreement, which was signed March 26, Garfield was prohibited from soliciting business from March 26 through April 2. It could not open new accounts for Connecticut residents during a ten-day period, from March 26 through April 2 and from April 24 through April 30. Within 30 days of the agreement, it was required to notify other regulatory authorities that it had sold securities in their respective jurisdictions without being properly registered. Garfield also had to pay a $1,000 fine and adhere to proper supervisory procedures. Garfield Securities was registered in Connecticut as a broker-dealer on April 5, 1982. It has an office in Greenwich and eight registered agents. The investigation of its activities, stemming from a routine examination of the firm by the department's Securities and Business Investments Division, found that it had sold securities without registering in Massachusetts, Rhode Island, Texas, New Hampshire, Vermont, Florida, Virginia, Maryland, and possibly California.

Civil Referrals

Lyle H. Kennedy

On January 28, 1986, Commissioner Brown requested Attorney General Joseph I. Lieberman to seek an injunction, the appointment of a receiver and an accounting of investor funds that were managed by Lyle H. Kennedy of 1159 Poquonnock Road, Groton, Connecticut, through the Kennedy Intervest Public Fund and the Kennedy Intervest Private Fund. Commencing in November, 1983, the Securities and Business Investments Division of the Department of Banking received several complaints from investors and ex-employees of the Public Fund.

Criminal Referrals

Peter Ranciato et al.

On January 23, 1986, Commissioner Brown requested Chief State's Attorney John J. Kelly to criminally prosecute Peter Ranciato d/b/a/ Statewide Consulting Co., a/k/a/ Taffy Project, and Roberta Spinnato, all of 26 Broadfield Road, Hamden, Connecticut, for violations of the Connecticut Uniform Securities Act.

On November 20, 1985, Mr. Ranciato and Ms. Spinnato were ordered to cease and desist from the offer and sale of securities in Connecticut. It was alleged that the respondents offered and sold unregistered securities, engaged in a course of business which acted as a fraud and deceit upon investors and failed to disclose to investors the unregistered status of the securities. At least two Connecticut investors invested $20,000 with Mr. Ranciato to purchase a limited partnership interest. Mr. Ranciato allegedly did not use these funds for the purposes outlined in the limited partnership agreement and in accordance with the representations made to investors. The Securities and Business Investments Division coordinated its investigation with other interested regulatory agencies.

Michael J. Creed

On February 28, 1986, Michael J. Creed of Southbury, Connecticut pleaded guilty in Connecticut Superior Court to two counts of failing to register as a broker-dealer. He is expected to be sentenced on June 27, 1986. The Office of the Chief State's Attorney will recommend that he receive two (2) years suspended sentence, four (4) years probation, a $4,000 fine and that he make restitution to investors of $20,000.

On July 2, 1985, the Department of Banking requested the office of the Chief State's Attorney to criminally prosecute Michael J. Creed for violation of the Connecticut Uniform Securities Act. On August 1, 1985, Chief State's Attorney, John J. Kelly commenced an investigation into this matter. On May 5, 1985, the Department of Banking ordered Mr. Creed to Cease and Desist from the offer and sale of securities within Connecticut. It was alleged that Mr. Creed sold unregistered securities in the form of limited partnership interests and failed to disclose the unregistered status of these securities. It was also alleged that Mr. Creed perpetrated a fraud and deceit upon Connecticut investors.

On June 29, 1984, the Department of Banking issued a subpoena to Mr. Creed. Mr. Creed failed to appear and produce records on July 12, 1984 as required by the subpoena. On September 10, 1984, a second subpoena was issued. On November 19, 1984, the Superior Court issued an order requiring Mr. Creed to appear before the Banking Commissioner on December 17, 1984. On December 17, 1984, Mr. Creed appeared, was sworn in and testified at an investigatory inquiry.

John Koropatkin

On March 31, 1986, John Koropatkin was convicted in Hartford Superior Court of selling unregistered securities in violation of the Connecticut Uniform Securities Act. He was sentenced to five years, execution suspended; five years probation with the condition that he make restitution of $60,000, $15,000 of which was paid on the date of sentencing and $1000 per month to be paid on each successive month.

Herbert M. Kirschner/HMK Management Corp.

On December 17, 1985, Commissioner Brown asked Chief State's Attorney John J. Kelly to criminally prosecute a Ridgefield man who defrauded investors of more than $2 million. The investigation found that Herbert M. Kirschner of Ridgefield, president of HMK Management Corp., also of Ridgefield, violated the state's securities laws by selling unregistered promissory notes. He violated the law's antifraud provisions by misrepresenting the investment. Kirshner's activities took place from 1982 to 1984. During that time, he raised at least $2 million, including some $600,000 from Connecticut residents, through the sale of unregistered promissory notes. HMK Management Corp. filed a voluntary petition in bankruptcy on October 26, 1984.

On January 28, 1985, the Banking Commissioner ordered HMK and Kirschner to cease and desist from offering or selling securities in or from Connecticut. Hearings on that order were held in March and April. The order was made final by Commissioner Brown on December 10 after receiving the report of the hearing officer. In referring the case to the Chief State's Attorney, it was recommended that restitution to investors be part of any sentence.

DEPARTMENT GUEST LECTURE SERIES

On March 20, 1986, the Department of Banking sponsored a series of Guest Lectures at the Summit Hotel in Hartford, Connecticut. Attorney Susan J. Walters of the Securities and Exchange Commission spoke on bank brokerage activities and Rule 3b-9. Attorney Thomas W. Lawless, Jr. of the Federal Deposit Insurance Corporation lectured on discount brokerage activities and the FDIC policies governing bank securities activities. Attorney Joan K. Willin discussed the Glass-Steagall Act, bank IRA collective investment funds and other bank mutual fund activities as well as placements of bank commercial paper. Participating in the ensuing panel discussion was Professor Robert Titus of Western New England School of Law.

Future lectures will address issues concerning bank holding companies, the role of the entrepreneur in the capital formation process, venture capital funds, the rules of corporate governance proposed by the American Law Institute and challenges and opportunities in the thrift industry. It is expected that these lectures will be given on a semi-annual basis. Transcriptions of the lectures will be made available at a cost of $35. For further information, contact Arthur Kleffke at (203) 566-4560, ext. 8386.

GUEST LECTURE SERIES EXCERPTS
March 20, 1986

Susan J. Walters*
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Banks are increasingly engaged in discount brokerage. Usually customers of these banks are not aware that there's a disparity in the regulatory system. They're not aware that the system set up to regulate banks by federal and state regulators usually is more concerned with the safety and soundness of the bank than with the investor's protection.

In 1983, the SEC proposed Rule 3b-9. In July 1985, Rule 3b-9 was adopted by the commission, and it was made effective on January 1st of this year. As adopted, the rule did change significantly from what was proposed. The SEC narrowed a great deal of the rule to accommodate concerns from the banks, from commentators and from the banking regulators themselves. Rule 3b-9 was adopted pursuant to Section 3 of the Securities Exchange Act. That section contains definitions for the Securities Act and the Exchange Act. It also gives the commission the authority to adopt new definitions or to interpret terms already in the Act.

*The views expressed by Ms. Walters do not necessarily represent those of the Securities and Exchange Commission or the State of Connecticut Department of Banking.

On that basis, the SEC proposed 3b-9. Basically it deals with the exclusion in 3(a)(4) and 3(a)(5), which are the sections of the Exchange Act that define broker and dealer. When they were drafted in 1934, they contained the caveat that a broker and dealer does not include a bank. 3b-9 revises that by saying that banks engaged in certain enumerated activities under the rule would be required to register with the commission as broker-dealers; that for purposes of 3(a)(4) and 3(a)(5), they would no longer be able to avail themselves of the bank exclusion.

As drafted, the rule has three prongs. Under the first prong, a bank that is engaged in publicly soliciting brokerage business for which it is receiving transaction-based compensation must conduct that activity as a registered broker-dealer. Under the second prong, a bank that is receiving transaction-based compensation for trust accounts for which it's also providing brokerage services must register with the commission, or that activity must be conducted by a registered entity. The third prong concerns a bank that is engaged in either dealing or underwriting securities other than exempt securities which are explicitly taken out by the '34 Act.

At this time, ... SEC interpretations ... on 3b-9 tend to center on the first and second prongs of the rule. However, given the expanding nature of the activities of banks, we believe that, in the future, the third prong, the dealing, underwriting prong of the rule, is going to take more precedence. However, at this time, since the first and second prongs seem to be the ones that raise the most issues, I will go into the most detail on those.

As drafted, the first prong and second prong both contain provisos that if a bank engages in those activities but does them under the proviso, it would not have to register. Under the first prong, the one that requires a bank receiving transaction-related compensation for publicly solicited securities brokerage, if the bank engages in what we call a networking relationship, the bank need not conduct that activity as a registered entity. It may use its bank employees to do some activities without having to register.

The Commission has always taken the position that a savings and loan is not a bank and, therefore, was never able to avail itself of the bank exclusion; consequently, any securities brokerage activity engaged in by a savings and loan had to be done by a registered entity, usually a service corporation of the S & L.

The networking letters basically said that -- and we have since put the idea of the networking letters into this proviso in the first prong -- if the bank has a contractual relationship with a registered broker-dealer... all the accounts introduced by the bank must be carried on a fully disclosed basis with the broker-dealer. That means that each individual's account is fully disclosed to the broker as opposed to an omnibus basis, which is where a broker sends in all of its orders only with the broker's name on it so that the clearing broker-dealer, the registered entity, has no idea who's actually making the trade...

Under the networking provisions, bank employees who are engaged in the securities business for the bank must perform only clerical and ministerial functions. They may not receive any transaction-related compensation unless they happen to be dual employees and registered reps, which is a status one obtains by taking certain exams that are offered by the NASD and the exchanges, and it also means that you have to register with the NASD or the exchange as a qualified person. This is what a registered rep actually means. If the bank employee is a dual employee, has taken the qualifying exams and has become a registered rep of the broker-dealer, the employee himself may receive transaction-based compensation.

In addition to this, the broker-dealer must be clearly identified as the person who is providing the brokerage service in order that the customer knows that it is the broker who is providing it and not the bank.

Finally, the networking proviso states that any transaction-related compensation can only go to bank employees who are registered reps. I might add that the bank can get transaction-related compensation, but the employee can only get it if he is a registered rep and a dual employee.

Under the second prong of the rule, the one dealing with advised accounts and the bundling of both advice and brokerage activities within one area, a bank providing services for these covered accounts, under the second prong, would have to register unless it meets three criteria that are in the rule in the second prong. These are that any advised account can independently choose the broker-dealer through which the execution of services for the securities will take place. It also means that transaction-related compensation or incentive compensation cannot be paid to bank personnel, though the bank, of course, can receive such compensation. And the accounts, again, must be carried on a fully disclosed basis.

The second prong generally applies where the services are bundled, that is, where you have both the investment advice and brokerage transactions, and where the customer is paying a transaction-related fee. It does not apply if the customer, in this case, the account, is paying a periodic fee. And that would be a periodic fee into which brokerage expenses are not built.

We've gotten a lot of questions on how accounts are set up, how you can tell whether or not it's a transaction-based fee as opposed to a periodic fee. It's really something that you have to examine with every account. You have to look at the account carefully to determine, in the fee arrangement, whether or not the part that is tied to the brokerage transaction can be separated out as directly related to those transactions. I can't give you any flat answer as to what a transaction based fee in an advised account is. All I can say is, if you have questions, you have to contact us directly, and we'll work it out with you.

We did, however, try to simplify this by putting in the rule that transaction-related compensation is monetary profit beyond cost recovery for brokerage services, and I realize that that definition isn't all that clear. So, as I say, if you have any situation where you're not sure if the compensation is transaction-related or not, you can give us a call, and we do try to straighten this out for people.

Questions also arise concerning the rule's applicability where the bank's activities are permissible under one prong of the rule, and where those activities are not clearly within the rule. Two things: First of all, we do answer questions. Second of all, the rule itself contains a proviso that the commission or the staff, in this case -- and we made sure it was the staff that had the ability, since we expect a lot of questions -- can specifically give an exemption if we look at the bank's activities and decide that on their face, they look like they are within the rule, since the rule was designed to cover them.

There are seven major exceptions to 3b-9. The exceptions mean that 3b-9 does not apply at all; therefore, the bank exclusion is available and you need not perform the activities through a registered entity. The first major exception is for what we call de minimis activities, that is, if the bank engages in less than a thousand securities transactions a year, the bank may effect those transactions without having to register as a broker-dealer. This includes all of the bank's securities activities with the exception of those covered by any of the other major exceptions in the rule or transactions, exempted by statute, such as transactions in municipal securities, government securities or any of the other exempt securities that are listed in Section 3(a)(12) of the Exchange Act.

We have gotten a lot of questions on the de minimus exception. Our preliminary view is that if the bank exceeds 1,000 transactions and then spins off its brokerage activities, we would not consider those first thousand transactions to have been exempt. You must have only a thousand transactions within the year, and you cannot work up to a thousand and then set up your broker. It has to have been done with a broker in the first place.

The third major exception is for transactions with affiliated companies. This basically says that a bank may continue to sell securities by itself for its investment portfolio, the investment portfolio of its affiliated companies and for the portfolios of its correspondent banks without having to face 3b-9's consequences. However, the exception does not include the bank's sale of its own securities or holding company securities. These sales must be done through a registered broker-dealer. I should add at this point that this prohibition does not apply to the certificates of deposit issued by banks since the Supreme Court decided in Marine Bank V. Weaver that certificates of deposits issued by a bank are not securities for purposes of the federal securities laws.

The fourth major exception to Rule 3b-9 is for sweep account arrangements. This refers to a deposit of funds into any no load open-end investment company registered under the Investment Company Act of 1940 that attempts to maintain a constant net asset value per share or has an investment policy calling for investment of at least 80 percent of its assets in debt securities maturing in four months or less. This basically encompasses money market funds. Deposit funds, which are the funds that are swept into the money market funds, are not limited to deposits as defined under the Federal Deposit Insurance Act. They would include funds treated as deposit funds by the bank, including any fund awaiting investment through affiliated brokers into some kind of money market fund.

The fifth major exception to Rule 3b-9 is for transactions in dividend reinvestment, stock option, pension, savings, or other types of employee and shareholder plans of issuers where the securities of the issuer or of the subsidiary of the issuer are involved. A bank can continue the activities that it traditionally has done in this area without having to register as a broker-dealer.

The sixth major exception is for what are called private placement activities. Traditionally banks have engaged in a great deal of private placements of securities. This area is not that clear. When adopting Rule 3b-9, the commission noted, in footnote 58 of the release that there may be circumstances under which a private placement would be considered to be a distribution for purposes of the securities laws regardless of whether it was considered a distribution for the purposes of Glass-Steagall or the banking laws, and the Fed the SEC and the comptroller recognize that we do treat private placements differently for purposes of the federal securities laws as opposed to federal banking laws. This area we have not gone into very much. We haven't gotten too many questions on it. So if you have some questions in this area, we're willing to discuss it but right now, there are situations or there could be situations where private placement, though we have exempted it, may, at some point, still be called a distribution.

The final major exception to 3b-9 is for so-called Section 15(e) companies. Section 15(e) of the Exchange Act was passed in 1975. It's exremely narrow. It applies to one bank. That bank was a member of the New York Stock Exchange before the definition of membership was changed in 1975. In 1975, Congress amended the Exchange Act to require both exchange members and non-exchange securities brokers and dealers to all register as broker-dealers. Prior to '75, exchange members did not have to register with the commission. They only had to be a member of their exchange. After '75, exchange-only members were required to register with us, but I assume through some kind of very strong lobbying, one bank was able to convince the Congress that it should be exempted from registration with the commission as long as it maintained its New York Stock Exchange seat. It, therefore, got 15(e) passed. 15(e) basically says that it need not register with us, but if we want, we can make it subject to all of the rules that we have written. I'm not sure anyone else comes under this except that one bank.

Since 3b-9 was adopted, we have come out with, at this point, seven public statements. One was issued by the commission. The other six have been what we call no-action letters. Now, the no-action process is crucial when the area is one of interpretation of the new rule. Traditionally, the staff has been granted the authority to take what we call a no-action position. The final paragraph of any letter will say that this is a staff position, we have stated that we would not recommend to enforcement that enforcement action be brought against you if you engage in the activities you have outlined in your letter without, in this case, registration as a broker-dealer.

No-action letters have to be read very strictly on their facts. They have to be read in their entirety and they have to be read basically as applying only to the person who requested the no-action letter. A no-action position is not a legal position. It's only saying that we wouldn't recommend enforcement to our own enforcement division.

But I must emphasize that, in these letters, you must read everything together. Sometimes something in there, one fact may look like something you think would be great, but it has to be read with all the facts of the letter, and if your situation is different from that letter, then you're better off coming in for a new letter than relying on the old letter. If, however, your situation is very similar to the one that was already granted, we usually leave it up to counsel for the bank to determine whether or not they will rely on the no-action position.

Given that caveat, so far we have issued three letters basically that dealt with the networking proviso in the first prong, and principally with the extent to which a bank employee may engage in securities activities without necessitating registration by the bank as a broker. This is the so-called clerical, ministerial activity.

Traditionally clerical and ministerial activity was limited to an unregistered entity, in this case, the bank employee, only assisting customers with applications. You could hand out an application. You could provide the broker-dealer with whom you had a networking agreement with customer credit information. You could, as a bank employee, assist customers in obtaining information about their accounts with the broker, but you could not provide any answers. You could not help them resolve any problems with the broker. Those questions would have to be handled directly by the broker. And the bank employee could also engage in electronic funds transfer for the customer.

On October 11 1985, the first letter on this issue was issued. It dealt with Wachovia Bank & Trust. To obtain these letters, usually you can get them from our office of public affairs, and you just give the name of the requesting entity and the date it's available; in this case, October 11, 1985.

In this letter, Wachovia Bank was setting up a separate broker-dealer subsidiary that would register with us and join the NASD. But the bank had a fairly extensive branching system, and didn't want all their branch banks to have to set up broker-dealer subsidiaries, so it requested a no-action position on branch networking arrangements pursuant to which its employees could handle customer securities and handle them in such a way that went beyond what we had previously said in our networking position.

In this case, bank employees were allowed to actually handle securities, which we've never allowed in the past, if they were expressly requested to do so by the customer, if the customer received a receipt from the bank employee for his securities, if the customer endorsed the stock certificates, and appointed the bank subsidiary (this would be the registered entity of Wachovia,) as the customer's attorney for transfer of the stock on the books of the issuer. It was also required that a copy of the receipt that was given to the customer would be kept by the bank and another copy would be given to the broker-dealer for its books and records. The bank could then deliver the certificates to the broker, but had to do so on the next business day after it received them, and it would be so noted in the customer's monthly statement of transactions. The bank was deemed to be responsible for safekeeping of the certificates until delivered to the broker, and bank employees were required to be fully bonded in order to cover theft or misappropriation. Bank employees also were given the authority to assist customers in placing orders. Again, this is something we had not allowed in the past. We've always considered the placement of orders as strictly a brokerage activity.

In this case, bank employees would help customers place orders for securities, but the customer had to first sign a written request for such assistance. The employee who placed the order had do so in the presence of the customer, and the bank employee had absolutely no discretion as to any aspect of transmittal of the securities order. The bank employee could only follow the customer's directions. And all orders placed by bank employees together could not exceed 1,000 a year.

The 1,000 exception that we allowed in Wachovia must be read in the context of everything in Wachovia. It is not a change from our original interpretation of the 1,000 transaction limitation that appears in Rule 3b-9.

In addition, Wachovia bank employees were not allowed to render any investment advice to customers. They could not solicit customers to effect transactions in brokerage accounts, and those bank employees that were assisting their customers in securities transactions could only be compensated on a salary basis.

We required Wachovia to make some further representations. The ability of a customer to avail himself of these services at Wachovia could not be advertised or otherwise solicited by the bank. In addition, the bank was considered to be an associated person of the broker-dealer and the bank employees who were engaged in this activity were also considered to be associated persons for purposes of Section 15b-(6) of the Exchange Act. Section 15b-(6) is that section of the Act that gives the commission authority to bar, suspend and otherwise discipline people for violations of the securities laws.

The second letter that we have done on the networking proviso was to Sovran Bank & Trust in Virginia. This went out on January 8, 1986. It was very similar to Wachovia but did expand a bit upon Wachovia. For example, it covered employees of all banks that had contractual agreements with Sovran Investment Corporation, or SIC, as they called themselves. SIC was the broker-dealer subsidiary of Sovran Bank. The letter encompassed employees not only of Sovran Bank and Sovran Bank's branches, but of banks that had correspondent relationships with Sovran or with SIC. So this letter was an extension of Wachovia which only dealt with Wachovia's own branches. The activities that bank employees could engage in were also expanded a bit.

In Sovran, we permitted employees to accept customer funds for payment of securities purchased through SIC, and to withdraw the purchase price from the customer's account with the bank. And I remind you, this involves a correspondent bank, not necessarily a branch of Sovran. The bank had to meet certain conditions if the employees were to engage in these activities. The bank had to promptly credit the purchase price to a SIC depository account with the bank, or with Sovran, if there was no account with the particular bank, within one business day. If the correspondent bank did not have a Sovran account , it had to credit within one business day to Sovran. Sovran had to then credit the customer purchase price within one more day to SIC.

Securities purchased through this program would be sent to customers by SIC directly, or on request, they could be held by SIC in accordance with industry practice. That basically means that the broker could hold the securities in what's known as "street name". Securities held in "street name" are held only in the name of the broker, and the broker's books and records indicate who actually owns the securities.

In no event were securities to be handled by the bank. They were either sent directly by SIC or held by SIC. Proceeds from the sale of securities could be remitted to customers by SIC directly, or a customer could, on request, have the proceeds credited to SIC's account with Sovran, following which Sovran was required to credit within one business day to the customer's account at Sovran, or if the customer did not have an account at Sovran, to the customer's account at whatever bank the customer has an account, and that bank would then credit to the customer within one business day.

The third letter dealing with networking went to Penn Bank, and its availability date is February 8, 1986. The major difference here was that, for the first time, we examined the ability of bank employees to get a per account bonus for their activities. My understanding is a bonus is given for opening checking accounts and other things, too. The employee who opens a brokerage account for a customer could get $2.50 per brokerage account opened. I think we felt that this wasn't going to make him ruin the securities market by soliciting all sorts of customers at $2.50 an opening, and the bonus was not tied to a number of transactions. A person would open an account and then never do a transaction. The clerk would get his $2.50.

Since I wrote this outline, two more letters have been made public, one of which was to Federated Securities Corporation, which was made available on February 6, 1986. The other letter was to Texas Commerce Bank, and it was available February 12, 1986.

The Federated Securities letter detailed conditions under which a bank could offer its own mutual funds to bank customers without running afoul of 3b-9. There were provisos in this letter that are very similar to those that we have in the first prong of the networking provisions.

The Texas Commerce letter reiterated what we had said in the adopting release for 3b-9 that sales of unit investment trusts must be done via a registered broker-dealer unless there is an express exemption to the rule or an interpretation is sought.

The final letter that we have issued on 3b-9 was actually the first one we issued, and it was a letter written by Richard Wessler, who is the associate director in our division, to James McLaughlin of the American Bankers Association. In that letter, we indicated a willingness to take a no-action position vis-a-vis any bank that could show a good faith effort to comply with Rule 3b-9 by January 1, 1986, but was unable to do so because of things beyond its control.

We thought good faith efforts existed where the bank applied, and filed its application with us before the 1st, but we hadn't acted on it. We have a 45-day period to act on any application, but we must act within 45 days. However, if a bank filed on December 31st, obviously we would not have acted on the application. If the bank had filed an application with the NASD prior to January 1st, we considered that a good faith effort. If the bank were contracting for a networking arrangement but your contract hadn't quite come through, or the bank was having disputes with the broker, or if you were negotiating before January 1, we would consider that a good faith effort. And finally, if the bank had filed a notice with its bank regulator, the Fed, or the Comptroller, for approval of a banking subsidiary before January 1, that would be a good faith effort.

Since this is March, these letters are not all that crucial now, but in December, we did issue 160 letters. At some point in mid December, we made a policy decision that instead of issuing no-action letters, we would issue exemption letters. Basically, an exemption letter is a little stronger than a no-action letter. It says that we will give you, in the case of networking, until April 1 to comply.

And a few final notes. Two topics that have come up quite frequently with respect to 3b-9 are with respect to 12b-1 plans and unit investment trusts. Rule 3b-9 was not intended to have any impact on a bank's arrangements under 12b-1 plans. However, if the compensation in those plans is transaction-related or if the plan appears in any way to involve dealing or underwriting of securities, then you really should have your bank counsel evaluate it and look at it carefully. We have not yet taken a position one way or the other.

With respect to unit investment trusts, (the Texas Commerce letter), we are very aware that there is a regulatory predicament here for banks. We have stated that unit investment trusts must be sold through a registered entity. The comptroller and the Fed have stated that the permissibility of conducting these activities in an operating sub, or a bank holding company subsidiary, is a de novo question; you must put a de novo application in to those regulators before you engage in unit investment trust activities in a sub. At that time, the Fed or the Comptroller will consider whether or not this is a permissible activity under Glass-Steagall.

Texas Commerce has an application in, a de novo application to have this activity done in its sub. It has not gotten a reply. We have given it until June 1 to continue operating out of the bank, as opposed to a sub. It is setting up a broker-dealer sub. That activity would have to be in the sub because of our reading of 3b-9.

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After discussing the Glass-Steagall Act itself and the debate surrounding that Act, I'd like to discuss four areas of commercial bank activity which raise Glass-Steagall issues: bank-sponsored IRA collective investment funds; bank mutual fund involvement; commercial paper placement; the most recent Bankers Trust decision, and bank brokerage services. First, I'd like to share some general observations, regarding advising banks on new product development in this area.

First, the Glass-Steagall Act analysis that regulators and courts apply is extremely factual and very precise, so it's important for your particular client to define very precisely and very clearly what activities the bank wants to engage in and how those activities are to be engaged in. You have to realize that courts follow a union of powers approach. Individual activities that are legal in and of themselves, may result in an illegality when combined with other activities. You'll find that there's often a lack of clear guidance from regulators and courts in this area, in part, because there's an overlap of statutes, and as a result, there's also some inconsistency. In addition, we're dealing with a statute that dates back to 1933, and so many interpretations regarding it may appear to be obsolete in face of today's realities.

The Glass-Steagall Act fosters intense competition. As a result, the major risk that you might find in involving yourself with some new product is not so much that your bank regulator will be suing you, but that your competitors will be, in fact, suing you. You can be engaging in an activity which your bank regulator tells you is legal and still find yourself having to defend an extremely costly suit brought by securities industry competitors. That's one reason why the cost of developing new products in this area is often very high.

Another reason making new products very expensive for the bank is the fact that they often require compliance with new areas of law, areas where bankers and their counsel have no expertise. For example, at CBT, we, in the last few years, have found that we have had to become experts in Investment Company Act law, Investment Advisers Act law and broker-dealer regulation. In addition, there's a need to set up intensive ongoing training of personnel because of the unfamiliarity with these new areas of law, and to develop systems for monitoring compliance to make sure that the employees understand the new products and the restrictions on handling these new products, and to make sure that there's legal compliance.

* The views expressed by Ms. Willin do not necessarily represent those of the Department of Banking.

And lastly, as I mentioned, you're going to have to risk litigation. This is not only very costly, but it leaves you in an uncertain position for many years. You're probably all familiar with the Camp case which involved an activity of Citibank which its regulator told it that it could do back in 1965. Then the Supreme Court, in 1971, said it's illegal. Bankers Trust began its disputed third-party commercial paper placement activities back in 1978, and now it has an April 15th deadline when an injunction might go into effect prohibiting it those activities.

New bank products often subject you to new regulators, and often these new regulators have a very different regulatory philosophy. The bank regulatory, safety and soundness philosophy, with its intent to protect depositors and keep the bank solvent, differs from the SEC's disclosure emphasis, which is intended to protect investors. The basic philosophies can lead the regulators in different directions in terms of their interpretations.

Lastly, I just wanted to mention that there's what you could call a mind-set problem when you want to offer new products. You find that if it's not a traditional bank product, it can be sometimes difficult for people to switch their mode of thinking to a new industry. Bankers sort of think like bankers; stockbrokers like stockbrokers. You try to get them to enter into the other area, and there's a psychological or cultural limit to that.

I'd like to discuss with you the policy debate surrounding Glass-Steagall at this time. As you are aware, there's intense disagreement about what Glass-Steagall was intended to mean and to what extent we should interpret it in a new manner because of the changes that have taken place in the past 53 years. As a result of changes in the financial and banking markets, many bankers are claiming that the Glass-Steagall Act is an anachronism, that its restrictions are no longer necessary in light of the changing marketplace and also the changing regulatory environment. This claim is based on the fact that bank regulators now have more intense examination, and enforcement powers and are more inclined to use those enforcement powers. There's also comprehensive conflict of interest legislation in place that deals with many of the concerns that prompted Congress to enact the Glass-Steagall Act. In fact, there are many bankers who say that the Glass-Steagall Act is not a tool of supervision at all; it's simply a method of dividing up the market, and that it is, in fact, for that reason, very often anticompetitive.

I think the anticompetitive aspect of it is evidenced by the names of the cases in this area. They're all the same. They're all either SIA v.Conover or SIA v. Federal Reserve Board or some variation of that, which makes it impossible to remember them. You just have to give them new labelings like I do, Bankers Trust case, whatever, just to keep your sanity. In other words, as one lawyer noted, "It's not the bank regulatory agencies who have been pressing for rigid enforcement of the Glass-Steagall Act; on the contrary, every one of the major cases that have come up during the last past two decades in which significant Glass-Steagall issues have been raised, have involved attack by some members of the securities industry on a decision by a federal bank regulator to permit banks to expand their securities-related activity.

Ironically, although the Glass-Steagall Act was intended to restore confidence in banks, it could have the effect of weakening them. For example, if you consider the commercial paper market and the effect that has had on bank lending, as more and more top corporations use commercial paper to satisfy their short-term borrowing, banks, of course, lose that business and also bank lending increases because of the selection of people who are then doing the borrowing. If banks are prohibited from entering into new areas, such as commercial paper placement, areas that are the equivalent of traditional lending, but a variation of that, and Glass-Steagall is used to prevent them from doing that, Glass-Steagall could, in fact, contribute to that difficulty.

George Gould, who is secretary for domestic finance, Treasury Department, spoke before the Senate Banking Committee a couple of weeks ago. He urged Congress to reconsider and clarify the services that banking organizations may offer to their customers, stating, "This is not just a matter of competitive equity, but one of competitive survival."

With that in mind, I'd like to discuss some new bank products that I've been involved with as counsel for CBT. One of them is bank-sponsored IRA collective investment funds. This is one product that has generated intense opposition from the mutual fund industry. The OCC has approved five banks' applications to offer IRA collective investment funds and each time, the ICI has brought a suit against the OCC and against the banks as well.

What is an IRA collective investment fund? It's a fund for commingled investment of IRA assets, of bank customers, in which you're tax-exempt under Section 408 of the Internal Revenue Code. As a commingled investment fund, it does resemble mutual funds, and it also resembles traditional bank common trust funds. However, unlike conventional mutual funds, the IRA collective investment fund is restricted to assets of bank customers who establish IRA trusts, and in addition, the interests in those trusts are nontransferable and subject to restrictions on withdrawal.

Central to an understanding of the litigation involving these funds is the Glass-Steagall Act. ICI v. Camp, the 1971 Supreme Court decision in which Citibank's commingled managing agency account was held to violate the Glass-Steagall Act. The commingled agency account at issue in the Camp case involved a situation where a bank customer could go into the bank, set up a managing agency account, invest from $10,000 to $500,000 and have that money commingled with other customers' managing agency accounts. Units in the fund were freely redeemable, and they could be transferred to anyone who executed a managing agency agreement with the bank. The fund was distinguishable from the IRA collective investment funds, because the funds were not held by the bank as a bona fide trustee. IRA collective investment funds are held by the bank as trustee of the individual's IRA trust account.

The Camp case is of particular importance in discussing the purposes of the Glass-Steagall Act. You'll find that the courts repeatedly refer to the eight so-called "subtle hazards." They're intended to prevent conflicts of interest where a bank is lending money to corporations, acting as the underwriter of securities of corporations and investing in the securities.

Moving from 1971 back to 1986, I wanted to just mention a few reasons why banks might be interested in these collective investment funds, inasmuch as they involve a great deal of legal work just to set up and to run. For example, you have to register the fund as an investment company, register the securities, and there's a lot of ongoing work that's involved in it, too.

Why are banks interested in these things anyway? It has to do with the growth in IRA assets. Interest in offering these type of funds increases as the individual customer's IRA grows especially since the passage of ERTA in 1981. By now, the average contributory IRA has grown to over $10,000. As they get larger and larger year by year, people are going to be looking at them as more than just a tax cut. They're going to want them to be an investment and to have a good yield.

Commingled funds offer the advantage of diversification and management. Unlike individually managed portfolios, they're affordable for amounts around $10,000. In addition, these funds become more attractive as interest rates on the deposit vehicles stabilize or even go down. And, of course, the banks are also concerned about the fact that, as people look to their IRA assets as investments, they're going to also be looking to bank competition, mutual funds, and so forth, as alternatives. Mutual funds and brokerage firms both doubled their IRA assets in 1985. So banks want to be able to provide a commingled fund that meets the customer's needs in order to protect the banks market share.

The collective investment fund is established by a bank to commingle only its bank customers' assets. It's established as a trust under state law, and it's registered with the SEC as an investment company. And the securities are registered under the '33 Act. In addition, blue sky registration will be required. The OCC approved the establishment of collective funds by Citibank in 1982, and, of course, the timing was crucial. It came the year after the passage of ERTA. That's why there was the economic incentive then to begin offering these funds to Wells Fargo and Bank of California in 1984 and to CBT in 1985.

In November of 1985, the OCC approved a fund for First Union National Bank, Charlotte, North Carolina. Each time, the ICI has claimed that this is a violation of the Glass-Steagall Act. The ICI's position is that, although a bank can commingle assets of a statutory retirement plan, you can't mass-market them to the public. The OCC's position is that the authority of the bank to offer these funds is confirmed by ERISA and that the bank was merely making the fact that it has these funds available known to the public.

There's a California case, and, of course, they all have the same name: ICI v. Conover, I and ICI v. Conover, II. We have a split in the district courts. In the California case, Judge Schwarzer held that the funds were illegal. He was very much influenced by the fact that they were competitive with mutual funds and, therefore, probably were mutual funds. Judge Richey held that they were bona fide fiduciary services--that's the way the banks (at least,

my bank) promote them as part of their IRA options -- and that the bank was not involved in any of the hazards that Camp was intended to prevent. Most recently, in Connecticut, Judge Cabranes ruled that the collective investment fund approved for CBT was permissible under the Glass-Steagall Act. He emphasized that it had all the indicia of a valid trust relationship. The assets were held by the bank as trustee of the customer. The bank was also the trustee of the fund and was subject to all of the fiduciary obligations under state trust law, the regulation of the OCC and ERISA. The bank was also subject to various marketing restrictions and had to promote the fund only as part of its overall IRA product, not as a separate general investment to the public.

Most recently, there was a suit brought against First Union National Bank and the OCC. Appeals from the three District Court decisions are all presently pending. The one in California, the one that went before the ICI, has been pending since July of 1984. The one that was decided in the D.C. District Court was argued in December. Our Second Circuit Court might just catch up with them all because we're in the process of briefing our appeal in the CBT case, and arguments are expected to be heard as early as the end of April. So it could be that we'll be the lucky ones to get to the Supreme Court first. We'll have to see how that goes.

I want to say a few words on the topic of bank mutual fund activities. These IRA collective funds are not, strictly speaking, mutual funds. They are fiduciary mutual account for statutory retirement plans. However, banks are interested in offering bona fide mutual funds to their customers through various arrangements. Susan has discussed 3b-9's impact on that and the various exemptions. I'd like to discuss OCC's position on banks offering tax-exempt mutual funds as well as the recent Federal Reserve Board pronouncement regarding conditions for bank holding company subsidiaries offering mutual funds, and the recent SEC no-action letter to Federated Securities Corporation.

In general, Glass-Steagall questions that come up on banks offering mutual funds are as follows: 1) Is the bank, by selecting certain mutual funds and making them available to the public, is the bank really giving implicit investment advice to its customers? 2) Is it endorsing these funds in some way and, therefore, acting as sort of an underwriter and also giving implicit investment advice? 3) To what degree can the bank become involved in promotion of funds? 4) What are the fee arrangements, and are there legal problems with them? and 5) Is the agency exception to Section 16 of the Glass-Steagall Act available to cover them?

Banks have been providing sweep programs involving mutual funds to customers since the mid-'70s, and recently banks have been interested in providing customers with tax-exempt mutual funds. For national banks, I recommend an OCC staff interpretive letter dated March 8, 1985, which contains a rather thorough Glass-Steagall Act analysis on the permissibility of that activity.

The OCC staff interpretive letter determined that there was no Glass-Steagall Act violation if a bank which provides this execution service to its customers observes certain conditions. First, the banks cannot be affiliated with the funds or their promoters or distributors. The bank's duties in providing the service can only be as an agent of its customer, never as an agent of the fund. The services the bank provides are limited to certain specified administrative services, which are detailed in that interpretive letter. The bank does not provide any investment advice regarding the funds nor does it make any recommendations to customers about the suitability of the funds. In addition, the bank must make specific disclosures to the customer that the funds are not FDIC insured, that they're not deposits or obligations of the bank, and that the bank does not endorse or recommend any of the funds.

There are also regulations regarding types of compensation and what the compensation can cover. Specifically, compensation can only constitute reimbursement for administrative expenses and must come way below what you would be getting if you were, in fact, acting as a distributor or underwriter. This is, to date and to my knowledge, the most complete word from the OCC on this type of arrangement. Largely, as a result of SEC Rule 3b-9, bank holding companies have been asking for permission from the Federal Reserve Board to transfer some of these mutual fund activities to their new discount brokerage subsidiaries. The Federal Reserve Board has indicated that it will not approve, on the basis of delegated authority, any applications where the subsidiary would be involved in brokering mutual funds or other investment company securities, including unit investment trusts, unless certain criteria are met. The word that I've gotten is that nobody has met these so far, so nobody is getting approved on this.

The applicant may not directly or indirectly receive any kind of compensation from the investment company. However, you may receive a normal brokerage fee from the customer. The applicant may not advertise or otherwise promote any specific security, although it may advertise the fact that it doesn't make mutual funds, in general, available. This is the one criterion that nobody seems to be able to meet. The applicant will stand ready to broker a large number of investment company securities, at least 30 funds, including funds from at least five different families of funds. This has got the mutual fund people very concerned because they don't want to be involved in an arrangement where they're wanted for a week. The basis for this is the Federal Reserve Board indication that if the bank is not offering a large number of funds then, by selecting a few, it is giving investment advice and endorsing a particular security and thus acting as an underwriter.

Based on conversations that we have had with the staff, they are very concerned about Bankers Trust and the implications of Judge Green's handling of the underwriting issue. Of course, that problem only arises if a bank is engaged in mutual fund activities which Rule 3b-9, requires a subsidiary to handle. There are many different types of mutual fund involvement that you can still keep within your bank, and Susan has alluded to several of these, including the networking arrangement, the sweep exemption, and the SEC no-action letter to Federated Securities Corporation, dated January 6, 1986. I heard that the SEC would be also issuing a future release covering some of these.

I'd also like to mention commercial paper placements. I think we're all aware of the drastic increase in the commercial paper market. In 1966, $22 billion dollars in commercial paper. In 1985, $303 billion dollars. From 1980 to 1985, commercial paper outstanding increased 143 percent as compared to a 51 percent increase in bank commercial loans. So, of course, banks have become very interested in alternatives to traditional bank lending. Many have even argued that if you want to reduce bank risk, and promote bank solvency, do third-party commercial paper placements; they are much safer than a lot of the loans.

In Bankers Trust (1978) the regulator determined that commercial paper is not a security for purposes of Glass-Steagall. The board saw commercial paper as the functional equivalent of a commercial loan because the paper consisted of short-term, large denominational notes with low default rates, and was sold to sophisticated purchasers, those purchasers you'd normally be selling participations to.

The case went through the federal court system. Bankers Trust lost at the Federal District Court level and won at the appellate level. In June of 1984, the Supreme Court ruled that commercial paper is, in fact, a security for purposes of Glass-Steagall, and it remanded the case for determination of the underwriting issue. So it didn't determine if there was any Glass-Steagall Act violation. It just said that commercial paper is a security.

The Federal Reserve Board subsequently issued a position, a ruling that this activity didn't constitute underwriting for purposes of Glass-Steagall, that it was, therefore, permissible. On February 4, 1986, Judge Green of the District Court, who had the case the first time, concluded that Bankers Trust was violating Glass-Steagall by offering this third-party commercial paper and that the Federal Reserve Board's ruling of June, 1985 was invalid. The case is on an expedited schedule. Argument is scheduled for April 1st, and an injunction that would prevent Bankers Trust from further engaging in this conduct is scheduled to go in effect on April 15th.

At the same time, Bankers Trust has submitted to the Federal Reserve Board an application to engage in commercial paper placement and various other ineligible activities through a subsidiary, ET Securities Corporation. It's a mirror image of the outstanding applications by Morgan and Citicorp.

What was Judge Green's reasoning, and what is the concern? Judge Green ruled that you can have underwriting without having any public offering. The fact that you're selling to a small number of sophisticated investors doesn't mean that you don't have underwriting for purpose of Glass-Steagall. He held that there was underwriting and that there was no Section 16 agency exception available.

Discount brokerage activity should be distinguished. In the Bankers Trust situation, you're not purchasing securities for

a customer. What you're doing is placing on the initial flotation commercial paper for your customer; your're acting as a seller for your customer on this initial market, and, therefore, unlike the discount broker, you have a promotional interest in the issue. You've earned your fees based on the success of placing the paper.

There's been a lot of concern expressed that the logic of Judge Green's decision will be fatal to other bank securities activities, specifically private placement activities. There's also a concern that it's going to have an effect on the Federal Reserve Board's treatment of the application for Citicorp and J. P. Morgan and, of course, Bankers Trust. There's also a more general concern. When Judge Green ruled on Section 16, she said that the agency exception was only intended to authorize very limited accommodation services that banks were engaged in back in 1933. Of course, this would wipe out a lot of other types of activities that banks have engaged in. As a result, there was some talk about bank regulators (e.g. OCC) submitting an amicus brief in that case.

You have to ask yourself whether Congress really intended to freeze banks at 1933 activities. It doesn't make too much sense. They were trying to cure certain abuses that were occurring at that time.

There's another problem in Judge Green's decision. She says that the activity is suspicious because banks haven't always been engaged in the activity. That's an argument that the ICI uses with collective investment funds. There are economic incentives to be involved in third-party commercial paper placement that weren't in existence in 1933.

I just wanted to say a few words on the legislative prospects. I've spoken to our legislature, and I've been following it in the press, and it certainly seems there's a drastic contrast between the rapid changes in banking and the incredible inaction on the part of Congress to face those changes or to do anything about them. There's no pending or anticipated legislation in this Congress that would revise Glass-Steagall or grant banks further powers in the securities area. So it's unlikely banks would begin to underwrite municipal revenue bonds, mutual funds, things we've been asking for, for years.

In fact, it's unlikely we'll get any significant federal banking legislation this year. The only chance I'm told is if there's a real emergency with FSLIC, and some moved to combine FSLIC and FDIC. If that occurs, maybe we can get commercial bank powers through the back door, but that doesn't seem the best setting in which to bring up the issue.

It has been said that SEC Rule 3b-9 is a charter for regulatory activism, and that the SEC is one agency that's not going to sit around and wait for Congress to act; it's going to act itself. In this regard, you have to wonder: What are bank regulators going to do if Congress continues to take no action in this area?

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FDIC Statement of Policy On The Applicability of the Glass-Steagall Act To Securities Activities of Subsidiaries Of Insured Nonmember Banks, Fed. Reg. 38984 (Sept. 3, 1982) (footnotes omitted).

"It is the opinion of the Board of Directors of the FDIC that . . . the Glass-Steagall Act . . . does not, by its terms, prohibit an insured non-member bank from establishing an affiliate relationship with, or organizing or acquiring, a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes or other securities. While the Glass-Steagall Act was intended to prohibit banks from certain of the risks inherent in particular securities activities it does not reach the securities activities of a bona fide subsidiary of an insured non-member bank."