March 8, 2000

To: Board of Governors

From: Staff[1]

Subject: Application of section 20 operating standards to financial holding companies

Action Requested: Approval of an interim rule that would continue for affiliations of securities firms with financial holding companies 2 of 8 operating standards that are currently imposed on bank holding companies that control section 20 affiliates. These two restrictions (1) require that intra-day extensions of credit to a securities firm from an affiliated bank or thrift or U.S. branch or agency of a foreign bank be on market terms consistent with section 23B of the Federal Reserve Act ("FRA"), and
(2) apply the limitations of sections 23A and 23B of the FRA to certain covered transactions between a U.S. branch or agency of a foreign bank and a U.S. securities affiliate.

Summary: Underwriting, dealing, and making a market in securities are financial activities permissible for financial holding companies under the Gramm-Leach-Bliley Act. Bank holding companies may currently engage in these activities only in a limited amount through so-called section 20 subsidiaries. Currently, section 20 subsidiaries are subject to 8 operating standards imposed by the Board in order to address certain potential risks and conflicts associated with the affiliation of a bank and a securities firm.

The issue presented by this memorandum is whether the Board should impose any of these 8 operating standards on financial holding

[1] Messrs. Mattingly, Alvarez and Corsi of the Legal Division, and Messrs. Martinson and Schoenfeld of the Division of Banking Supervision and Regulation.

companies that engage in full securities underwriting activities under the Gramm-Leach-Bliley Act. These restrictions would not apply to securities firms owned by financial holding companies unless the Board affirmatively acts to impose them.

For the reasons discussed below, staff recommends imposing only 2, a restriction requiring intra-day extensions of credit to a securities firm from an affiliated bank or thrift or U.S. branch or agency of a foreign bank to be on market terms, and a restriction which applies the limitations of sections 23A and 23B of the FRA to loans and other covered transactions between a U.S. branch or agency of a foreign bank and a securities affiliate.

The concerns addressed by the other six operating standards are, for the most part, addressed by the well capitalized and well managed criteria in the Gramm-Leach-Bliley Act and by rules established by the SEC and NASD on securities brokers and dealers. Several other areas will be addressed in the supervisory process or in the course of review of other policies currently underway. The operating standards would continue to apply to section 20 subsidiaries controlled by bank holding companies that do not qualify as financial holding companies. These bank holding companies are not otherwise required to remain well capitalized and well managed.

Summary of Operating Standards: The operating standards require that:

1. the bank holding company be well capitalized (or strongly capitalized in the case of a foreign bank);

2. the bank holding company adopt internal control policies to govern participation by depository institutions in transactions underwritten by section 20 affiliates;

3. interlocks between the bank and its section 20 affiliate at the board of directors and chief executive officer level be limited;

4. the section 20 subsidiary provide disclosures to retail customers regarding the uninsured nature of products purchased from the section 20 subsidiary and to inform the customer when a security recommended by a depository institution for purchase by the customer is being underwritten or dealt in by a section 20 subsidiary affiliated with the depository institution;

5. intra-day extensions of credit by a depository institution to an affiliated section 20 subsidiary be on market terms;

6. a depository institution not extend credit to a customer for the purpose of purchasing or secured by a security while the security is being underwritten by an affiliated section 20 subsidiary and for 30 days thereafter, with exceptions for preexisting lines of credit and credit for clearing purposes;

7. the section 20 subsidiary file with the Board certain reports prepared by the subsidiary for the SEC and the Board; and

8. a branch or agency of a foreign bank comply with the limitations in sections 23A and 23B of the FRA when extending credit to or purchasing assets from a section 20 subsidiary.

Discussion: The bills to repeal section 20 of the Glass-Steagall Act that were considered previously contained detailed firewalls between depository institutions and newly authorized securities affiliates. The Gramm-Leach-Bliley Act relies instead on requirements that each depository institution affiliated with a securities firm be and remain well capitalized and well managed. The Gramm-Leach-Bliley Act also relies on functional regulation of the securities firm by the SEC, full supervision of the depository institution by the appropriate federal banking agency, and umbrella supervision of the overall organization by the Board to identify and address potential risks to the

depository institution associated with the securities and other activities in the organization.

The Gramm-Leach-Bliley Act grants the Board authority to impose restrictions or requirements on relationships or transactions between a depository institution and any affiliate. The Board may impose a prudential limitation if the Board finds that the limitation is appropriate to avoid a significant risk to the safety and soundness of the depository institution or the Federal deposit insurance funds, to avoid other adverse effects or to prevent evasions of the banking laws. In determining whether to impose prudential limitations on affiliations with securities firms by financial holding companies, it is appropriate to begin with an analysis of the prudential limitations that the Board has imposed on section 20 affiliates.

A. Capital, Internal Controls, and Interlocks Requirements. The Gramm-Leach-Bliley Act imposes substantially the same requirement as operating standard 1 that all subsidiary banks and thrifts of financial holding companies, as well as foreign banks that are financial holding companies, be and remain well capitalized. The Gramm-Leach-Bliley Act also mandates that all subsidiary banks and thrifts of financial holding companies, as well as foreign banks that are financial holding companies, be and remain well managed. An important element of being a well managed institution is having in place policies capable of appropriately addressing any risks that may be raised by affiliation with a securities underwriter or dealer, and assuring corporate separation.[2]

[2] Because financial holding companies will not be required to seek approval prior to engaging in securities activities, the Board will not have the opportunity to conduct infrastructure reviews of securities subsidiaries prior to the acquisition of a securities firm.

It is expected that examination of the risk management systems and internal controls of a financial holding company will be conducted promptly after an affiliation between a securities firm and a financial holding company as appropriate. In view of this, it does not appear to be necessary to impose operating standards 1, 2, or 3 on financial holding companies at this time.

B. Disclosures to Customers. The greatest risk of customer confusion occurs when a securities firm is operating on the premises of a depository institution or through an employee that is also an employee of an affiliated depository institution, or is receiving a referral from an affiliated depository institution. In each of these situations, the disclosures required by operating standard 4 are required by the Interagency Statement on the Retail Sale of Nondeposit Investment Products. The Interagency Statement also requires that a bank or thrift disclose to a retail customer any material relationship between the institution and an affiliate involved in providing the nondeposit investment product.

Operating standard 4 extends these disclosure requirements to the section 20 affiliate even when it is not operating on the premises of a bank or through a bank employee or referral. The NASD and SEC have considered and determined not to impose these disclosure requirements on securities firms that are not operating on the premises of a depository institution.

Although staff is not recommending that the Board impose this limitation on financial holding companies at this time, the attached draft Federal Register notice states that the Board expects financial holding companies to ensure that their customers are not confused about the nature of

investment products being purchased. The notice further states that the Board reserves the right to establish disclosure requirements if abuses or customer confusion become apparent.

C. Intra-day Credit. Operating standard 5 requires that intra-day extensions of credit to a section 20 subsidiary by an affiliated bank or thrift, or U.S. branch or agency of a foreign bank be on market terms consistent with section 23B of the Federal Reserve Act. The Gramm-Leach-Bliley Act requires the Board, within the next 18 months, to address how the restrictions in section 23A apply to intra-day extensions of credit to all affiliates. That effort is underway, and provides the most comprehensive way to address issues related to intra-day credit. Until such time as that effort is complete, operating standard 5 remains important to ensure that intra-day extensions of credit by a depository institution to an affiliated securities firm for clearing or other purposes are not subsidizing the activities of the securities firm to the detriment of the depository institution affiliate. Accordingly, staff recommends that the Board apply the limitations in operating standard 5 to financial holding companies to cover intra-day extensions of credit between their subsidiary depository institutions and subsidiary securities firms at least until such time as the analysis regarding the application of section 23A to intra-day extensions of credit is complete.

D. Credit to Customers. Sections 23A and 23B of the FRA should protect depository institutions against risks related to credit extensions to customers to purchase securities underwritten by a securities affiliate. Staff is in the process of drafting a rule that would implement sections 23A and 23B, including the manner in which they apply to credit extended by a depository institution to customers of an affiliate.

E. Reporting Requirements. Operating standard 7 requires a section 20 subsidiary to file with the Board reports prepared for the SEC and reports enabling the Board to monitor compliance with the operating standards and with the 25 percent revenue test imposed by the Board under section 20 of the Glass-Steagall Act. Financial holding companies will no longer be required to comply with the 25 percent revenue test under the Gramm-Leach-Bliley Act. To the extent that it is necessary for the System to review the operations of a securities subsidiary of a financial holding company, the System may obtain reports relating to the securities affiliate without the operating standard.

F. Transactions with Branches and Agencies of Foreign Banks. Operating standard 8 requires that a U.S. branch or agency of a foreign bank comply with sections 23A and 23B of the FRA when extending credit to a U.S. securities affiliate, or when purchasing securities for which a section 20 affiliate is a principal underwriter. A branch or agency also may not advertise or suggest that it is responsible for the obligations of a section 20 affiliate.

The purpose of sections 23A and 23B of the FRA, which limits credit and other transactions between a bank and its affiliate, is to limit the possibility that the risks of activities conducted in a nonbank affiliate of a depository institution be transferred to the depository institution. The Board originally applied the restrictions in these sections to transactions between U.S. branches and agencies of a foreign bank and a section 20 affiliate as a prudential limitation, recognizing that U.S. branches and agencies are part of the U.S. financial structure. In addition, the Board adopted operating standard 8 because sections 23A and 23B apply to U.S. banks and thrifts, and the operating standard ensures competitive equity between foreign banks and

U.S. banking organizations in the funding of section 20 affiliates. These are the types of concerns that the Gramm-Leach-Bliley Act would require the Board to consider in imposing restrictions on foreign banks that become financial holding companies.

Under the Gramm-Leach-Bliley Act, foreign banks, as well as U.S. bank holding companies, that become financial holding companies will be able to engage in a broader range of securities activities than is permitted now. In view of this, the prudential and competitive equity concerns that led the Board to adopt operating standard 8 would justify applying that prudential limit in the case of a foreign bank that becomes a financial holding company. This restriction would apply only to transactions between a securities affiliate and a U.S. branch or agency of a foreign bank, and not to the foreign bank itself.

Recommendation: For the reasons discussed above, the staff recommends that the Board impose on financial holding companies only operating standard 5, which requires that intra-day extensions of credit to a securities firm from an affiliated bank or thrift or U.S. branch or agency of a foreign bank be on market terms consistent with section 23B of the FRA, and operating standard 8, which applies to certain transactions between U.S. branches and agencies of a foreign bank and an affiliated securities underwriter or dealer the same limitations as are applied to U.S. depository institutions.

Attachment

FEDERAL RESERVE SYSTEM

12 CFR PART 225

[Regulation Y; Docket No. R-]

Bank Holding Companies and Change in Bank Control; Securities Underwriting, Dealing, and Market-Making Activities of Financial Holding Companies

AGENCY: Board of Governors of the Federal Reserve System

ACTION: Interim rule with request for public comments.

SUMMARY: Underwriting, dealing in, and making a market in securities are financial activities permissible for financial holding companies under the Gramm-Leach-Bliley Act. Bank holding companies may currently engage in these activities only to a limited extent through so-called section 20 subsidiaries. Under the Board's current rules, section 20 subsidiaries are subject to 8 operating standards imposed by the Board in order to address certain potential risks and conflicts associated with the affiliation of a bank and a securities firm.

The Board is adopting this interim rule to impose two of these operating standards on financial holding companies engaged in securities underwriting, dealing or market-making activities. Under the interim rule, intra-day extensions of credit by a bank or thrift, or U.S. branch or agency of a foreign bank, to a securities affiliate engaged in securities underwriting, dealing, or market-making pursuant to section 4(k)(4)(E) of the Bank Holding Company (BHC Act) must be on market terms consistent with section 23B of the Federal Reserve Act (FRA). In addition, foreign banks that are financial

holding companies or that are treated as financial holding companies will be required to comply with the restrictions of sections 23A and 23B of the FRA with respect to lending and securities purchase transactions between a U.S. branch or agency of a foreign bank and a securities affiliate engaged in securities underwriting, dealing, or market-making pursuant to section 4(k)(4)(E) of the BHC Act.

DATES: The interim rule is effective on March 11, 2000. Comments must be received by May , 2000.

ADDRESSES: Comments, which should refer to docket number R- may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551 or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson also may be delivered to the Board's mail room between the hours of 8:45 a.m. and 5:15 p.m. and, outside of those hours, to the Board's security control room. Both the mail room and the security control room are accessible from the Eccles Building courtyard entrance, located on 20th Street between Constitution Avenue and C Street, N.W. Members of the public may inspect comments in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Thomas Corsi, Managing Senior Counsel, Legal Division (202) 452-3275; Michael J. Schoenfeld, Senior Supervisory Financial Analyst, Division of Banking Supervision and Regulation (202) 452-2836; for the hearing impaired only, Telecommunications Device for the Deaf (TDD), Janice Simms (202) 872-4984.

SUPPLEMENTARY INFORMATION:

The Gramm-Leach-Bliley Act differs from prior regulatory and statutory schemes in the manner that it addresses potential risks to a depository institution associated with securities and other activities conducted by affiliates. The current section 20 operating standards,[1] like the bills to repeal the Glass-Steagall Act that were considered in the late 1980s and early 1990s contain detailed restrictions on relationships and transactions between depository institutions and securities affiliates. The Gramm-Leach-Bliley Act relies instead on requirements that each depository institution affiliated with a securities firm be and remain well capitalized and well managed. The Gramm-Leach-Bliley Act also relies on functional regulation of the securities firm by the SEC, full supervision of the depository institution by the appropriate federal banking agency, and umbrella supervision of the overall organization by the Board to identify and address potential risks to the depository institution associated with the securities and other activities in the organization.

The Gramm-Leach-Bliley Act grants the Board authority to impose restrictions or requirements on relationships or transactions between a depository institution and any affiliate. The Board may impose a prudential limitation if the Board finds that the limitation is appropriate to avoid a significant risk to the safety and soundness of the depository institution or the

[1] 12 CFR 225.200. The operating standards would continue to apply to section 20 subsidiaries controlled by bank holding companies that do not qualify as financial holding companies.

Federal deposit insurance funds, to avoid other adverse effects or to prevent evasions of the banking laws.[2] The Board believes that most of the concerns that are raised by the affiliation of a securities firm with a financial holding company are addressed by the requirements of the Gramm-Leach-Bliley Act, other banking laws and regulations, and securities laws and regulations.

Two concerns that the Board believes are not addressed by current law or regulation relate to intra-day extensions of credit to a securities firm by an affiliated depository insitution, and to transactions between a U.S. branch or agency of a foreign bank that elects to become or be treated as a financial holding company, and an affiliated securities firm.

Intra-day extensions of credit. One operating standard applicable to section 20 subsidiaries ("operating standard 5") requires that intra-day extensions of credit to a section 20 subsidiary by an affiliated bank or thrift, or U.S. branch or agency of a foreign bank be on market terms consistent with section 23B of the Federal Reserve Act. In considering whether to apply this limitation to financial holding companies, the Board notes that the Gramm-Leach-Bliley Act requires the Board, within the next 18 months, to address how the restrictions in section 23A apply to intra-day extensions of credit to all affiliates. Until such time as that effort is complete, however, the Board believes that operating standard 5 remains important to ensure that intra-day extensions of credit by a depository institution to an affiliated securities firm for clearing or other purposes are not subsidizing the activities of the securities firm to the detriment of the depository institution affiliate. Accordingly, the Board is applying the limitations in operating

[2] Pub. L. No. 106-102, 113 Stat. 1338, 1369-71 (1999).

standard 5 to financial holding companies and foreign banks treated as financial holding companies to cover intra-day extensions of credit to their subsidiary securities firms from their subsidiary banks or thrifts or U.S. branches or agencies at least until such time as the analysis regarding the application of section 23A to intra-day extensions of credit is complete.

Transactions with U.S. branches and agencies of foreign banks. Another operating standard ("operating standard 8") applicable to section 20 subsidiaries requires that a U.S. branch or agency of a foreign bank comply with section 23A and 23B of the Federal Reserve Act[3] when extending credit to a section 20 affiliate, or when purchasing securities for which a section 20 affiliate is a principal underwriter.[4] A branch or agency also may not advertise or suggest that it is responsible for the obligations of a section 20 affiliate. Operating standard 8 permits a branch or agency of a foreign bank to engage in funding and securities purchase transactions with a section 20 affiliate subject to the same restrictions applicable to a U.S. depository institution.

The purpose of sections 23A and 23B of the Federal Reserve Act, which limits credit and other transactions between a bank and its affiliate, is to limit the possibility that the risks of activities conducted in a nonbank affiliate of a depository institution be transferred to the depository institution. The Board originally applied lending restrictions to transactions between U.S. branches and agencies of a foreign bank and a section 20 affiliate as a prudential limitation, recognizing that U.S. branches and

[3] 12 U.S.C. §§ 371c and 371c-1

[4] 12 CFR 225.200(b)(8).

agencies are part of the U.S. financial structure.[5] In addition, the Board adopted operating standard 8 because sections 23A and 23B apply to U.S. banks and thrifts, and the operating standard ensures competitive equity between foreign banks and U.S. banking organizations in the funding of section 20 affiliates. These are the types of concerns that section 114 of the Gramm-Leach-Bliley Act would require the Board to consider in imposing restrictions on foreign banks that become financial holding companies.

Under the Gramm-Leach-Bliley Act, foreign banks, as well as U.S. bank holding companies, that become financial holding companies will be able to engage in a broader range of securities activities than is permitted now. In view of this, the prudential and competitive equity concerns that led the Board to adopt operating standard 8 would justify applying that prudential limit in the case of a foreign bank that becomes a financial holding company. This restriction would apply only to transactions between a securities affiliate that underwrites, deals in, or makes a market in securities, and a U.S. branch or agency of a foreign bank, and not to the foreign bank itself.

Customer disclosures. The Board is not at this time imposing any customer disclosure requirements on financial holding companies with respect to the activities of a subsidiary securities firm engaged in securities underwriting, dealing, or market-making pursuant to section 4(k)(4)(E) of the BHC Act. To the extent that the securities firm makes a sale to a customer on the premises of a depository institution, or through a depository institution employee, or as a result of a referral by a depository institution, it will be

[5] See Canadian Imperial Bank of Commerce, et al., 76 Federal Reserve Bulletin 158, 163 (1990).

required to make the disclosures contained in the Interagency Statement on Retail Sales of Nondeposit Investment Products (Interagency Statement).

Whether or not the activities of subsidiary securities firms of financial holding companies are covered by the Interagency Statement, the Board expects financial holding companies to take all necessary steps to ensure that customers are not confused about the nature of investment products they are purchasing. If the Board becomes aware that customer confusion is occurring, or that action is necessary to prevent abuses, the Board may impose additional disclosure requirements on financial holding companies to address these issues.

Regulatory Flexibility Act

In accordance with the Regulatory Flexibility Act (5 U.S.C. 601-612), the Board must publish an initial regulatory flexibility analysis with this interim regulation. The purpose of the interim rule is to address concerns raised by the affiliation of a securities firm with a financial holding company that are not otherwise addressed by current law or regulation. The rule applies only to bank holding companies and foreign banks that voluntarily elect to become or be treated as financial holding companies under the Bank Holding Company Act as amended by the Gramm-Leach-Bliley Act, and also engage in certain securities activities. The interim rule applies to all financial holding companies regardless of size, and requires them to comply with certain restrictions that already apply to bank holding companies that control section 20 subsidiaries engaged in securities activities. The rule applies fewer restrictions to financial holding companies seeking to engage in securities activities than apply to bank holding companies that control section 20 subsidiaries and thus represents a reduction in the limitations on engaging in

certain securities underwriting and dealing activities. The Board specifically seeks comment on the likely burden this interim rule will impose on small business entities and financial holding companies that seek to engage in securities activities.

Administrative Procedure Act

The Board will make this interim rule effective on March 11, 2000 without first reviewing public comments. Pursuant to 5 U.S.C. 553, the Board finds that it is impracticable to review public comments prior to the effective date of the interim rule, and that there is good cause to make the interim rule effective on March 11, 2000, due to the fact that the rule sets forth a requirement relating to activities that financial holding companies will be able to engage in on March 11, 2000, due to statutory changes that become effective on that date. The Board is seeking public comment on the interim rule and will amend the rule as appropriate after reviewing the comments.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the interim rule under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in the interim rule.

List of subjects in 12 CFR Part 225

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

For the reasons set out in the preamble, the Board amends 12 CFR part 225 as follows:

PART 225 – BANK HOLDING COMPANY AND CHANGE IN BANK CONTROL (REGULATION Y)

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

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831(i), 1831p-1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. Section 225.4 is amended by adding paragraph (g) to read as follows:

(g) Requirements for financial holding companies engaged in securities underwriting, dealing, or market-making activities.

(1) Any intra-day extension of credit by a bank or thrift, or U.S. branch or agency of a foreign bank to an affiliated company engaged in underwriting, dealing in, or making a market in securities pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(E)) must be on market terms consistent with section 23B of the Federal Reserve Act.

(2) A foreign bank that is or is treated as a financial holding company under this part shall ensure that:

(i) Any extension of credit by any U.S. branch or agency of such foreign bank to an affiliated company engaged in underwriting, dealing in, or making a market in securities pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(E)), conforms to sections 23A and 23B of the Federal Reserve Act as if the branch or agency were a member bank;

(ii) Any purchase by any U.S. branch or agency of such foreign bank, as principal or fiduciary, of securities for which a securities affiliate described in paragraph (i) of this section is a principal underwriter conforms to sections 23A and 23B of the Federal Reserve Act as if the branch or agency were a member bank; and

(iii) Its U.S. branches and agencies not advertise or suggest that they are responsible for the obligations of a securities affiliate described in paragraph (i) of this section, consistent with section 23B(c) of the Federal Reserve Act as if the branch or agency were a member bank.