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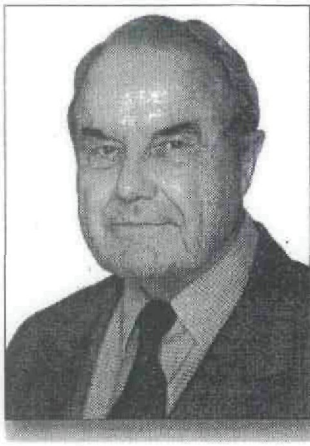
Anti-Tying Update



When we last discussed this subject on Nov. 19, 2003, the General Accountability Office (GAO) had released its Oct. 10, 2003 Report (GAO Report) to Chairman Michael G. Oxley and Ranking Member Barney Frank of the House Financial Services Committee and to Ranking Member John Dingell of the House Energy and Commerce Committee. This article will discuss the major developments that have occurred since then. Although almost two years have elapsed since the proposal (referred to below) was issued, and notwithstanding numerous statements from the Federal Reserve Board that a final revision of the Proposal was imminent, the banking industry remains in a type of "Neverland" as well as being left in a disadvantaged competitive position vis a vis non bank lenders (mainly, investment banks that are not subsidiaries of Financial Holding Companies.

Background

On Aug. 25, 2003, the Federal Reserve Board issued a Proposed Interpretation of the Anit-Tying Restrictions of Section 106 of the Bank Holding Company Act Amendments of 1970 (Anti-Tying Provisions) and Related Supervisory Guidance (Proposal) for review and comment by Sept. 30, 2003, after which time the Proposal was to have become final with whatever changes the Board decided to make. The Office of the Comptroller of the Currency (OCC) consulted with the Board in the preparation of the Proposal. As of Aug. 3, no final revision has been issued.

Pursuant to the Anti-Tying Provisions, banks are prohibited from granting or pricing credit (or some other product) conditioned on the borrower's obtaining another product from the bank (e.g. making a loan conditioned on the borrower appointing the bank as an underwriter of its securities) other than deposits, loans, discounts or trust services (traditional products).

The main difference in the financial services market from 1970 until now is the broader powers available to banks today under the Gramm-Leach-Bliley Financial Services Modernization Act (GLB) of 1999, particularly the power to underwrite corporate debt and equity securities generally without restriction.

Investigation

An outgrowth of the Enron and related hearings has been a concern that the commercial banking industry may not be complying with the Anti-Tying Provisions. In fact, Mr. Dingell asked the Board, the OCC and the GAO in July 2002 to look into this question. On Aug. 13, 2002, the Board and the OCC replied that they had found no evidence of illegal tying and answered each of his five questions in detail (see the March 19, 2003 article under this column), and advised that they were "conducting a special targeted review of the circumstances described in the press and referenced" in the Dingell letter.

The GAO's October 2003 report concluded that "The available evidence did not clearly support contentions that banks violated Section 106 and unlawfully tied credit availability or under priced credit to gain investment banking revenues."

Congressional Reaction

According to Mr. Oxley, "The GAO's findings and recommendations place this issue squarely where it belongs—within the power of the federal banking regulators who supervise institutions for compliance with anti-tying laws....At the same time, the study underscores the importance of continued vigilance to ensure that the availability of commercial credit is not unlawfully conditioned on the purchase of certain services." Mr. Frank "did not seem to think it dictated the need for legislative action" (Dow Jones Newswires, Oct. 21, 2003).

, Mr. Oxley also stated that "All indications would lead one to the conclusion that banks are successfully following current law and regulation under the supervision of the federal banking regulators." As can be expected, Mr. Dingell, obviously unhappy with the GAO report, said "Illegal tying is extortion, pure and simple" (Regulation & Law (10/21/03): GAO Says Bank Tying Claims Lack Evidence); but no such illegal tying was found!

The Proposal

The Proposal was developed by the Board and the OCC because, while they had found during their examinations that no evidence of unlawful tying existed, they also found variation among the banks in the interpretation of the Anti-Tying Provisions and related exemptions. The Proposal was designed in part to better inform the banks and their customers about the requirements of such provisions.

The Proposal provides a detailed explanation of the Anti-Tying Provisions and its exemptions, including the "traditional product" exemption and a newly proposed "mixed-product" exemption (which would occur where a bank offers a loan conditioned on the customer taking one of an offering of several other products that include one or more "meaningful" traditional products and one or more non-traditional (e.g. an underwriting) products. Some commentators believe that such a "meaningful option" concept is "impractical and unworkable." For an analysis of the Proposal, see the Oct. 15, 2003 article under this column.

The OCC's Position

The OCC, in a release on Sept. 25, 2003 entitled "Today's Credit Markets, Relationship Banking and Tying," stated that: "There is virtually no empirical evidence directly focusing on the tying of lending and underwriting activities by national banks. The indirect evidence available is consistent with permissible packaging of products by diversified banks, and product linkage at the behest of customers. Nor do banks appear to pos-

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sess market power in lending to larger commercial customers that are the most likely targets for tying." This paper has provided banks with support for their positions.

The Anti-Trust Division of the U.S. Department of Justice, on Nov. 7, 2003, submitted a comment letter to the Board in response to its Proposal. The division made comments and raised concerns (including its concern that "[Section 106] disadvantages banks as competitors in markets in which banks and nonbanks compete, thus lessening competition and harming consumers"). In essence, the division was of the opinion that the Anti-Tying Provisions should be interpreted and enforced in accordance with the antitrust laws generally (i.e. this should not be a per se violation, but rather should require that the bank accused of tying would only violate the provisions if it had the ability to control the market in the product involved, i.e. it controlled the loan or other similar market).

Basically, the letter states that the Board erred in applying a strict per se rule to tying arrangements, pointing out that the "Tying arrangements are per se illegal under the federal anti-trust laws only if the seller [i.e. a bank] has sufficient market power to make anti-competitive effects highly likely." In other words, the Proposal should only prohibit tying where the bank has dominant market power. The letter also mentions the division's concern that the Anti-Tying Provisions may be anti-competitive in that they do not apply to non-bank competitors.

The letter makes the point that "if the Board determines that Section 106 must remain broader than the antitrust laws, the Section's reach should be limited to those small businesses and consumers that were the original focus of the legislation." In other words, the Anti-Tying Provisions should not be made applicable to large corporate credits (as the writer has long maintained). Hopefully, the Board will adopt all (or, at least, some) of the division's suggestions.

Senators Sununu (Dec. 8, 2004), Dole (Feb. 23, 2005) and Crapo (May 27, 2005) have written Alan Greenspan encouraging the Board to follow the Justice Department's suggestions.

Per Se Violations

On Jan. 14, 2004, counsel for a group of commercial banks sent a letter to the general counsel of the Board which provided a presentation challenging the per se rule as it applies to the Anti-Tying Provisions and urging the Board to construct an interpretation of Section 106 "that is both correct and reflects economic reality."

The main thrust of their argument is that the judicial and legislative history supports the premises that: (i) the anti-tying provisions of the antitrust laws require that to have a per se violation there must be a dominant position in the "desired" product (i.e. bank loans); (ii) since Section 106 has been held not to require damages because its violation constitutes a per se violation, then a dominant position in the desired product is required; and (iii) therefore, there is no violation by a bank in a loan arrangement requiring some form of securities underwriting appointment where such bank has no dominant market power in the bank loan market.

Apparently, the Board has been concerned about its authority to take the "dominant market power" position suggested by the Justice Department because of the existence of certain contrary lower federal court decisions (i.e., these decisions go both ways and therefore there is no clear precedential authority).

However, this concern would seem to be moot in view of the June 27, 2005 U.S. Supreme Court decision (*National Cable & Telecommunications Association v. Brand X Internet Services,* 125 S. Ct. 2688 (2005), which held that a circuit court's construction of an "ambiguous" (which is clearly our situation with the Anti-Tying Provisions) statute did not bar the Federal Communications Commission from taking a contrary reasonable position under such statute. This basically should provide the

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Board with authority to issue a regulation (which would be accorded judicial deference) under an ambiguous statute that is consistent with certain lower court cases even though there exist other conflicting lower court cases.

Financial Professionals

The Association of Financial Professionals, based on its 2004 Credit Access Survey (Linking Corporate Credit to the Awarding of Other Financial Services) participated in by 370 corporate officers and treasurers, reported in June, 2004 that: "nearly two-thirds of financial professionals from large companies report that their commercial bank credit providers denied credit or changed the terms of credit after the company did not award other financial business..." The survey doesn't name either financial institutions or the customers involved, and its respondents "were promised anonymity." While the survey is interesting, its results are questionable without names, dates, etc. (i.e. it is totally "off the record").

Safe Harbor

In a November 2004 submission to the Board, the same bank group referred to above outlined its suggestion for a "large customer" exemption proposal (suggested in the Nov. 7 letter) which would provide a regulatory exemption under Section 106 for large credits to a large corporate customer which is concurrently negotiating a similar credit facility with one or more other financial institutions and which customer has one of the following attributes (each of which would be carefully defined): (i) outstanding debt of at least $100 million; (ii) minimum gross revenues for the most recent four quarters of at least $500 million; (iii) is rated investment grade by a nationally recognized statistical rating organization; or (iv) is managed or controlled by a financial sponsor that has at least $500 million of capital commitments and funded equity under management.

Basically, this would describe a type of borrower that most commentators agree would not be, based upon legislative history and judicial decisions, the intended beneficiaries of the Anti-Tying Provisions.

The concept here: since such large customers cannot, for obvious reasons, be "coerced" (which is an underlying concept of Section 106), then there is no violation.

Conclusion

The GAO report and the Nov. 7 letter certainly constitute a resounding plus for the banking industry and its regulators. Basically, the reviews by the Board and OCC mentioned above found no material violations of the Anti-Tying Provisions (other than the one violation by a foreign bank which resulted in a $3 million fine) by our banking industry, and the GAO Report confirmed the regulators' processes and findings. The Nov. 7 letter is extraordinary: how often does a regulatory agency have such unequivocal Justice Department support?

Based upon all of the foregoing, the Board should proceed in finalizing the Proposal (which has been outstanding for almost two years) along the lines described above for the following reasons:

- It seems clear there is no real problem here (probably a lack of understanding among large corporate borrowers or lobbying by nonbank lenders) since neither the federal bank regulators, the GAO nor the Justice Department have found any significant violations by banks of the Anti-Tying Provisions.
- It seems clear that, to be consistent with the anti-trust laws, Section 106 contemplates a per se violation and the bank involved must have a dominant market power in the desired product (i.e. the bank loan) in order to violate the provision. If for whatever reason the Board does not want to step up to this interpretation (although the Justice Department has already done so), then the Board should establish a safe-harbor exemption for large financial transactions with large corporations, since most commentators agree that Section 106 was designed to protect small businesses and individuals.
- Unless one of the alternatives described above is followed by the Board, the level playing field contemplated by Gramm-Leach-Bliley will not exist (because non-bank lenders will not be subject to Section 106) which may result in anti-competitive effects (as suggested by the Justice Department) that will be harmful to consumers in general.
- Lastly, the *Brand X* case referred to above clearly supports the Board's authority to require that the bank involved must have dominant market power in the desired product in order for the Anti-Tying Provisions to apply.