FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 83-99
August 29, 1983

REGULATION Y

BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

(Nonbanking Activities--Final Rule)

TO ALL MEMBER BANKS,
BANK HOLDING COMPANIES
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has adopted a final amendment to its Regulation Y, Bank Holding Companies and Change in Bank Control, to add discount securities brokerage and securities credit lending to the list of activities in which bank holding companies may engage. The request for comments concerning this matter was issued by Circular No. 83-33 dated March 4, 1983. The amendment will become effective on September 9, 1983.

A copy of the Board's press release and the notice as published in the Federal Register are printed on the following pages. The amendment in slip sheet form will be sent to you as soon as it is available.

Questions regarding the contents of this circular should be directed to David W. Dixon of the Holding Company Supervision Department, Extension 6182.

Additional copies of this circular will be furnished upon request to the Public Affairs Department, Extension 6289.

Sincerely yours,

William H. Wallace

William H. Wallace
First Vice President

FEDERAL RESERVE press release

For immediate release August 11, 1983

The Federal Reserve Board has amended its Regulation Y -- Bank Holding Companies -- to add securities brokerage and related margin lending to the list of activities generally permissible for bank holding companies. Individual applications will be considered on their own merits.

The action codifies a previous position taken by the Board in approving the acquisition by BankAmerica Corporation of Charles Schwab Corporation, a retail discount securities broker.

The Board acted after consideration of comment received on a proposal made in February to add these activities to the list of nonbanking activities in Regulation Y.

In its final ruling, as in its approval of the BankAmerica/Schwab application, the Board specified that the brokerage activities are to be restricted to buying and selling securities solely as agent for the account of customers, (and does not include securities underwriting or the provision of investment advice), and that margin lending on securities is to be conducted by a nonbank subsidiary of the bank holding company, according to the Board's Regulation T (Securities Credit by Brokers and Dealers).

The Board's notice in this matter is attached.

###

Attachment

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Docket No. R-0455]

Bank Holding Companies and Change in Bank Control; Regulation Y; Nonbanking Activity; Discount Securities Brokerage and Securities Credit Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: On January 7, 1983, the Board approved the application of BankAmerica Corporation to acquire Charles Schwab & Co., which engages in retail discount securities brokerage, securities credit lending, and certain incidental activities. In its order approving the application, the Board found that Schwab's brokerage and securities credit activities were closely related to banking for purposes of section 4(c)(8) of the Bank Holding Company Act ("BHC Act").

On February 22, 1983, the Board published for comment a proposal to add the activities engaged in by Schwab to the list in Regulation Y of nonbanking activities generally permissible for bank holding companies under section 4(c)(8) of the BHC Act. Approximately 73 comments were received in response to the Board's proposed rulemaking. Except for one comment, all of the comments supported adoption of the proposal. Some of the comments suggested additional revisions to the proposal. After considering all the comments, the Board has adopted the proposed rule, with minor revisions.

EFFECTIVE DATE: September 9, 1983.

FOR FURTHER INFORMATION CONTACT: Richard M. Ashton, Assistant General Counsel, 202/452-3750, or Richard M. Whiting, Senior Attorney, 202/452-3779, Legal Division, Board of Governors of the Federal Reserve System.

SUPPLEMENTARY INFORMATION: Section 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. 1843(c)(8) ("BHC Act"), states that bank holding companies may engage in those activities the Board has "determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." 12 U.S.C. 1843(c)(8). In determining whether the performance of nonbanking activities is

"closely related" to banking, the Board has generally taken into consideration the guidelines stated by the Court in *National Courier* v. *Board of Governors of the Federal Reserve System*, 516 F. 2d 1229 (D.C. Cir. 1975): (1) Banks generally have in fact provided the proposed services; (2) banks generally provide services that are operationally or functionally so similar to the proposed service as to equip them particularly well to provide the proposed services; (3) banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.

The Board's decision approving the acquisition by BankAmerica Corporation of Charles Schwab & Co., a discount securities broker, was preceded by a formal administrative hearing in which the Securities Industry Association ("SIA") and the Department of Justice participated.[1] Additionally, approximately 100 comments, most of which were favorable to the proposal, were filed with the Board. In its order approving the BankAmerica application, the Board noted that banks in fact have generally provided securities brokerage to some extent, and, in providing such brokerage services, have become particularly well equipped to perform the proposed securities brokerage activities. Moreover, the Board determined that, given the similarity between margin lending activities currently engaged in by banks and the proposed margin lending activities engaged in by Schwab, the proposed margin lending activities also are closely related to banking within the meaning of section 4(c)(8) of the BHC Act. The Board made similar findings in connection with its approval of the application of United Jersey Banks to acquire a discount broker.[2]

The Securities Industry Association requested judicial review of the Board's order approving the BankAmerica application. On July 15, 1983, the United States Court of Appeals for the Second Circuit denied SIA's petition and upheld the Board's order.[3] In particular, the Court discussed and supported the Board's conclusion that the proposed activities are "closely related" to banking. Additionally, the Court found that the proposed activities are not prohibited by the provisions of the Glass-Steagall Act, which generally separate commercial from investment banking.[4]

On February 22, 1983, the Board published for comment a proposal to add securities brokerage and margin lending to the list of nonbanking activities generally permissible for bank holding companies pursuant to section 4(c)(8) of the BHC Act. (48 FR 7746 (February 24, 1983)). A total of 73 comments, including those of all 12 Federal Reserve Banks, were received. Of these, 72 commenters generally favored adoption of the proposal and concluded that the proposed activities are "closely related" to banking and consistent with the Glass-Steagall Act. Many commenters specifically referenced the record and Board findings in the BankAmerica/Schwab matter. Other commenters noted that trust departments of banks have engaged in securities brokerage activities for some time, that banks and other financial institutions commonly provide securities brokerage services, and otherwise concluded that the proposed activities are permissible.

Lawfulness of the Proposal. The SIA was the only commenter opposing the proposal, reasserting objections it previously made in the BankAmerica/Schwab matter that the proposed activities violate the Glass-Steagall Act and the BHC Act. As described above, however, these arguments have been rejected by an administrative law judge, the Board, and the United States Court of Appeals for the Second Circuit. The remaining comments overwhelmingly supported the finding that the proposed activities are permissible. Accordingly, the Board finds that adoption of the proposed regulation would not contravene applicable law.

The SIA also states that in light of alleged undue risks to the bank holding company and the uncertainty created by the SIA's judicial challenge to the BankAmerica/Schwab order, the Board should proceed on a case-by-case basis rather than by promulgating the proposed regulation. However, the Board's issuance of a regulation adding a particular activity to the list of permissible nonbanking activities in Regulation Y means the proposed activity meets the first or "closely related to banking" test of section 4(c)(8). Bank holding companies wishing to engage in that activity must also comply with the "public benefits" test of the statute, which the Board applies on a case-by-case basis. The SIA's objections thus do not warrant a decision not to adopt the proposed regulation.

Incidental Activities. In its BankAmerica/Schwab decision, the Board found that a number of services offered by Schwab in connection with carrying accounts of its brokerage customers were permissible incidental activities. A number of commenters on the proposal recommended an express listing of such incidental activities, either in the regulation or in a separate interpretation.

In order to clarify that services incidental to brokerage services are permissible, the proposed rule has been modified to list permissible incidental services. In general, the list includes the permissible incidental services identified by the Board in the BankAmerica/Schwab decision: *i.e.*, custodial services, furnishing individual retirement accounts and cash management services. Cash management services are intended to include customer account-related functions such as paying interest on net free balances awaiting investment, providing arrangements under which free credit balances are automatically invested in money market mutual funds, and establishing arrangements under which access to such balances is provided by debit card or checking accounts.

The list of incidental activities in the regulation as adopted is not intended to be exhaustive. The Board believes that in order to compete effectively with other discount broker's, bank holding companies should have the flexibility to provide a full range of customer account and custodial services, provided such services meet the test for permissible incidental activities under section 4(c)(8). Whether certain types of services not listed in the regulation are permissible will be determined in individual instances.

Provision of Investment Advice. A number of commenters also supported eliminating the provision in the proposed regulation stating that permissible brokerage services may not include investment advice or research services. These commenters note that under § 225.4(a)(5)(ii) of Regulation Y, bank holding companies may furnish to any person investment advice concerning the purchase or sale of securities.

The Board has determined that elimination of this prohibition would not be appropriate at this time. The proposed rule was intended merely to incorporate into the regulation the Board's decision on the BankAmerica/Schwab application, which involved the acquisition of a discount securities broker that does not provide investment

[1] 69 Federal Reserve Bulletin 105 (1983).

[2] *United Jersey Banks/Richard Blackman & Co.*, 69 Federal Reserve Bulletin 565 (1983).

[3] *Securities Industry Assn.* v. *Board of Governors*, No. 83-4019 (2d Cir.).

[4] 12 U.S.C. 24 Seventh, 377, 378.

advice. The proposal did not comtemplate the authorization of significant other securities related activities since no record has been developed within which to assess the implications of providing securities brokerage and investment advice services together.

In this regard, the Board notes that the investment advisory services currently permitted pursuant to Regulation Y typically are furnished to sophisticated customers with substantial amounts of funds to invest. These services thus lack the high volume, retail orientation of many brokerage firms, whose investment advice tends to reach a wider segment of the public. More importantly, the investment advisory customers of banking organizations usually pay an explicit fee for investment advice, so that the adviser does not look to commissions for executing transactions as compensation for the advisory services, as full-line brokers typically do. Accordingly, in light of the narrow purpose of the proposed amendment the Board does not believe that it is appropriate at this time to remove the restriction in this proposal against providing investment advice.[5]

Modification of Restriction against Underwriting. In its comments on the proposed rule, the Antitrust Division of the Department of Justice, while supporting the proposal, recommends that the prohibition against underwriting in the proposed rule be modified to permit underwriting as a risk-free principal. The Department states that some legitimate activities of brokers may be considered underwriting and thus impermissible to holding company affiliates under the proposal.

In its *Schwab* decision, the Board found that Schwab's riskless principal transactions with respect to municipal securities appear to be consistent with permissible brokerage activities.[6] However, to adopt the Department's recommendations would appear to contemplate a significantly higher level of activity not within the Board's original proposal. Accordingly, the Board does not believe it appropriate to adopt the Department's recommendation.

Margin Credit Activities. Several commenters questioned whether under the proposal a bank or nonbank affiliate of the securities broker could extend credit for the purchase or carrying of securities to customers of that broker. The amendment contemplates that a bank holding company's or its nonbank subsidiary performing the permitted securities activities would be required to register as a broker/dealer with the Securities and Exchange Commission and that its margin credit activities would therefore be subject to the Board's Regulation T, which governs securities credit by broker/dealers (12 CFR Part 220). Regulation T, in turn, permits a broker to arrange credit for its customers but only upon the same terms and conditions upon which the broker itself could extend or maintain credit under Regulation T. A securities broker could, therefore, subject to the foregoing limitations, arrange for any bank to extend credit for the broker's customers under Regulation U, or any nonbank lender to extend credit to the broker's customers under Regulation G. However, the bank or nonbank lender may not extend any credit that the broker itself could not extend. The principal effect of this "arranging" provision is that the bank or nonbank lender may not extend credit to the broker's customers to purchase any securities on an unsecured basis, or to use any collateral other than securities traded on a national securities exchange or listed on the Board's List of OTC Stocks.

The rule also contemplates that the securities credit lending, as in the case of Schwab, would be carried out in connection with permissible brokerage services and credit would be extended only to brokerage customers. Thus, the proposed regulation would permit securities credit lending only on the condition that such lending be conducted in compliance with Regulation T. However, securities credit activities conducted independently of brokerage services might (although not within the scope of this proposal) also be closely related to banking under section 4(c)(8). Accordingly, while the Board's rule contemplates that securities credit lending would be conducted in accordance with Regulation T, this action is not intended to foreclose further consideration of other applications to conduct securities credit activities under other margin regulations.

Definition of "securities". One commenter asked that the term "securities" be defined in order to avoid ambiguity about the scope of permissible brokerage services and suggested the definition of "security" in the Securities Act of 1933 as an appropriate definition. The Board is aware, however, that, at least in questionable cases, whether a particular instrument is a security for purposes of the federal securities laws often poses difficult questions turning on the facts of each particular case and hence must be resolved on a case-by-case basis.[7] In addition, the Board believes that bank holding companies should have the flexibility to compete with nonbank-affiliated brokers and should thus be free, in individual cases, to execute orders to purchase or sell financial instruments that may not constitute securities for purposes of the federal securities law if nonbank-affiliated brokers execute orders for such instruments. Accordingly, in the Board's view, questions concerning whether particular types of interests may be bought or sold as agent for a customer under the amendment to Regulation Y are best resolved in the context of a particular case.[8]

Technical Modifications. The Board has considered various comments requesting technical modifications in the language of the proposal and believes that the proposal should be modified in certain respects. As suggested by several comments, deletion of the word "certain," which modifies "securities brokerage services," is warranted since the limitations implied by the word "certain" are made explicit elsewhere in the amendment and that word, therefore, is redundant. In addition, to avoid any ambiguity about the agency status of the permitted securities transactions, the restriction in the regulation against conducting securities underwriting is extended to include dealing in securities.

Applications Procedures. Several commenters, including three Federal Reserve Banks, request that all bank holding companies seeking to engage in permissible securities brokerage activities be required, regardless of the method by which the activities would be

[5] One commenter sought additional guidance with respect to what type of incidental activities fall within the prohibition against provision of investment advice. In the Board's view, these questions are best resolved in the context of particular circumstances.

[6] 69 Federal Reserve Bulletin (1983) at 116 n. 55. Similarly, "inadvertent principal" transactions, in which a broker holds securities for its own account as a result of a mistake in executing a customer's order, are not prohibited under the amendment's bar against conducting an underwriting business. *Id.*

[7] *See Marine Bank* v. *Weaver*, 455 U.S. 551, 560 n. 11 (1982). In defining "security" under the federal securities laws, "each transaction must be analyzed and evaluated on the basis of the content of the instrument in question, the purposes intended to be served, and the factual setting as a whole."

[8] The definition of securities in the Securities Act is employed in defining portfolio investment advice in § 225.4(a)(5)(ii) n. 1 of Regulation Y. The purpose of this definition is to prevent bank holding companies from becoming involved in speculative investment enterprises under the guise of providing investment advice. This danger does not appear to be present in connection with discount brokerage, the scope of which seems relatively well-defined in the industry.

initiated, to follow the application procedures applicable to the acquisition of a going concern. 12 CFR 225.4(b)(2). One Reserve Bank further states that applications to engage in these activities should not be approved by the Reserve Banks pursuant to delegated authority.

The Board believes that imposition of a general rule to govern all applications to engage in brokerage services would be undesirable and unduly burdensome. The implications of bank holding company provision of securities brokerage were examined in detail at a contested formal administrative hearing in connection with the BankAmerica/Schwab application and the Board determined that none of the objections raised against the proposal justified disapproval of the application. The majority of the Reserve Banks have not requested that special procedures be adopted for brokerage applications in all cases. The Reserve Banks have the authority to require necessary supplemental information in considering particular applications to offer brokerage services, including applications to commence such activities *de novo*. The Reserve Banks also may decline to exercise their delegated authority in cases that raise significant policy issues. The Board believes that the potential for conflicts of interest, which several comments cited as a reason for not permitting delegation of approval authority can best be considered under this procedure on a case-by-case basis.

Accordingly, with the revisions described above, the Board has adopted the proposal as a final rule. The Board has determined that securities brokerage and margin lending are "closely related" to banking, consistent with the Glass-Steagall Act, and, therefore, should be added to the list in Regulation Y of nonbanking activities that are generally permissible for bank holding companies.

For the purposes of 5 U.S.C. 605(b) (the Regulatory Flexibility Act), the Board certifies that this rule will not have a significant economic impact on a substantial number of small entities. Indeed, this rule should facilitate the application process for any company wishing to engage in the activity.

List of Subjects in 12 CFR Part 225

Banks, banking, Holding companies, Securities, Reporting and recordkeeping requirements.

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

This action is taken pursuant to the Board's authority under sections 4(c)(8) and 5(b) of the Bank Holding Company Act, 12 U.S.C. 1843(c)(8) and 1844(b). In order to implement this rule, 12 CFR 225.4 is amended by adding paragraph (a)(15) to read as follows:

§ 225.4 Nonbanking activities.

(a) * * *

(15) providing securities brokerage services, related securities credit activities pursuant to the Board's Regulation T (12 CFR Part 220), and incidental activities such as offering custodial services, individual retirement accounts, and cash management services, *provided* that the securities brokerage services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing or investment advice or research services.

* * * * *

By order of the Board of Governors of the Federal Reserve System, effective August 10, 1983.

William W. Wiles,

Secretary of the Board.

[FR Doc. 83-22303 Filed 8-15-83; 8:45 am]

BILLING CODE 6210-01-M