FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

DALLAS, TEXAS
75265-5906

August 7, 1996

Notice 96-77

TO: The Chief Executive Officer of each member bank and others concerned in the Eleventh Federal Reserve District

SUBJECT

Proposals to Modify Limitations on Section 20 Subsidiaries' Underwriting and Dealing in Securities

DETAILS

The Board of Governors of the Federal Reserve System has requested public comments on three proposals to modify the conditions under which section 20 subsidiaries of bank holding companies may underwrite and deal in securities.

The first proposal would increase the amount of revenue that a section 20 subsidiary may derive from underwriting and dealing in securities from 10 percent to 25 percent of its total revenue. The second proposal would amend or eliminate three of the prudential limitations, or firewalls, imposed on the operations of the section 20 subsidiaries. The third proposal would clarify that the Board will not consider interest income earned on securities that a member could hold for its own account toward a section 20 subsidiary's revenue limit.

The Board must receive comments on the first proposal by September 30, 1996. Comments on this proposal should refer to Docket No. R-0841. The Board must receive comments on the second and third proposals by September 3, 1996. Comments on these proposals should refer to Docket Nos. R-0701 and R-0932, respectively. Please address comments to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551.

ATTACHMENTS

Copies of the Board's notices (Federal Reserve System Docket Nos. R-0841, R-0701, and R-0932) are attached.

MORE INFORMATION

For more information, please contact Bobby Coberly at (214) 922-6209. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

FEDERAL RESERVE SYSTEM

[Docket No. R-0841]

Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice; Request for comments.

SUMMARY: The Board is proposing to increase from 10 percent to 25 percent the amount of total revenue that a nonbank subsidiary of a bank holding company (a so-called section 20 subsidiary) may derive from underwriting and dealing in securities that a member bank may not underwrite or deal in. The revenue limit is designed to ensure that section 20 subsidiaries will not be engaged principally in underwriting and dealing in such securities in violation of section 20 of the Glass-Steagall Act. Based on its experience supervising these subsidiaries and developments in the securities markets since a revenue limitation was adopted in 1987, the Board believes that a company earning 25 percent or less of its revenue from underwriting and dealing would not be engaged principally in that activity for purposes of section 20.

DATES: Comments must be received by September 30, 1996.

ADDRESSES: Comments, which should refer to Docket No. R-0841, may be mailed to the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551, to the attention of Mr. William Wiles, Secretary. Comments addressed to the attention of Mr. Wiles may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in room MP-500 between 9 a.m. and 5 p.m. weekdays, except as provided in section 261.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Gregory A. Baer, Managing Senior Counsel (202/452-3236), Thomas M. Corsi, Senior Attorney (202/452-3275), Legal Division; Michael J. Schoenfeld, Senior Securities

Regulation Analyst (202/452- 2781), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

Section 20 of the Glass-Steagall Act provides that a member bank may not be affiliated with a company that is "engaged principally" in underwriting and dealing in securities.[1/] In 1987, the Board first allowed bank affiliates to engage in underwriting and dealing in bank-ineligible securities -- that is, those securities that a member bank would not be permitted to underwrite or deal in -- when the Board approved an application by three bank holding companies to underwrite and deal in commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer-receivable-related securities.[2/] In 1989, the Board allowed five section 20 subsidiaries to underwrite and deal in all debt and equity securities, subject to more rigorous firewalls.[3/]

Currently, thirty-nine nonbank subsidiaries of bank holding companies are authorized to engage in underwriting and dealing activities that are not authorized for a member bank. Fourteen of these so-called section 20 subsidiaries have authority to underwrite and deal in commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer receivable

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[1/] 12 U.S.C. 377.

[2/] Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp., 73 Federal Reserve Bulletin 473 (1987), aff'd, Securities Industry Ass'n v. Board of Governors, 839 F.2d 47 (2d Cir.), cert. denied, 486 U.S. 1059 (1988) (hereafter "1987 Order").

[3/] J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp., 75 Federal Reserve Bulletin 192 (1989) (hereafter "1989 Order").

related securities. Twenty-two section 20 subsidiaries have authority to underwrite and deal in all debt and equity securities, and three may underwrite and deal in all debt securities. Over the past nine years, the Board has had substantial experience in supervising the activities and operations of those companies. In the Board's experience, the section 20 subsidiaries have operated in a safe and sound manner without adverse effects on their affiliated banks or the public, and have provided additional competition in the securities markets.

As a condition of its 1987 order approving underwriting and dealing in a section 20 subsidiary, the Board established a revenue test to ensure compliance with the "engaged principally" standard of section 20. The Board arrived at a revenue test through a series of interpretive steps. First, the Board determined that a bank affiliate would be "engaged principally" in underwriting and dealing only if underwriting and dealing were a "substantial line of business activity for the affiliate."[4/] The Board further found that the best measure of the underwriting and dealing activity of a section 20 subsidiary was the gross revenue derived from that activity.[5/] In terms of what revenue to consider, the Board ruled that securities that a member bank was authorized to underwrite under section 16 of the Glass-Steagall Act (for example, U.S. government securities) were not covered by the prohibition of section 20; accordingly, the Board decided that revenue derived from underwriting and dealing in such securities should not count in determining whether a section 20 subsidiary's level of underwriting and dealing activity was "substantial" for purposes of the statute. Rather, only revenue earned on "ineligible securities" -- those that a member bank could not underwrite or deal in -- was counted toward the section 20 limit.

Finally, the Board found that underwriting and dealing in ineligible securities would not be a "substantial" activity for a section 20 subsidiary if the gross revenue derived from that activity did not exceed 5 to 10 percent of the total gross revenues of the subsidiary. (As a prudential matter, the Board initially limited ineligible revenue to 5 percent of total revenue in order to gain

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[4/] Bankers Trust New York Corp., 73 Federal Reserve Bulletin 138, 142 (1987); 1987 Order at 481-483.

[5/] 1987 Order at 483-485.

experience in supervising such companies. In 1989, the Board raised the limit to 10 percent.)

No changes were made to the revenue test in subsequent orders until, in January 1993, the Board allowed section 20 subsidiaries to use an alternative revenue test that was indexed to account for changes in interest rates since 1989.[6] The Board found that historically unusual changes in the level and structure of interest rates had distorted the revenue test as a measure of the relative importance of ineligible securities activity in a manner that was not anticipated when the 10 percent limit was adopted in 1989. In particular, the Board found that because bank-eligible securities (such as U.S. government securities) tended to be shorter term than ineligible securities, an increase in the steepness of the yield curve had caused the revenue earned by at least some section 20 subsidiaries from holding eligible securities to decline in relation to ineligible revenue, even as the relative proportion of eligible and ineligible securities activities being conducted by these subsidiaries remained unchanged.[7] Five section 20 subsidiaries are currently operating under this indexed test.

At the same time it proposed the indexed revenue test, the Board sought comment on use of an asset-based measure as an alternative to the existing gross revenue measure, and in July 1994 sought comment on both the asset-based measure (for a second time) and a sales volume measure.[8] As the courts have recognized, "the relative significance of the firm's activities could

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[6] Order Approving Modifications to the Section 20 Orders, 79 Federal Reserve Bulletin 226 (1993) (hereafter, 1993 Modification Order).

[7] 1993 Modification Order at 228. Under the indexed revenue test, current interest and dividend revenues from eligible and ineligible activities for each quarter are increased or decreased by an adjustment factor provided by the Board. The adjustment factors, which are calculated for securities of varying durations, represent the ratio of interest rates on Treasury securities in the most recent quarter to those in September 1989. Section 20 subsidiaries use the adjustment factors to "index" actual interest and dividend revenues based upon the average duration of their eligible and ineligible securities portfolios.

[8] 59 FR 35,516 (1994).

be measured in various ways -- dollar volume, number of transactions, strategic significance, and so on."[9]

The Board has recently received petitions from trade groups and others urging the Board to increase the revenue limit to at least 25 percent of total revenue. Petitioners argue that the Board could justify a higher revenue limit either by reinterpreting "engaged principally" more consistently with the ordinary meaning of "principal" -- that is, to include only the largest or majority activity -- or by finding that a higher level of revenue does not yield a level of activity that is substantial.

Proposed Change to Revenue Limit

The Board is proposing to maintain the revenue test but increase the revenue limit from 10 percent of total revenue to 25 percent. The Board seeks comment on whether this amended revenue test would be an appropriate gauge of underwriting and dealing activity for purposes of section 20. The Board is concerned that a test based on assets or sales volume would not yield benefits -- in terms of greater accuracy, ease of administration, or immunity from manipulation -- that would justify the costs of converting compliance systems to a new test.

The Board is proposing to increase the revenue limit based on its supervision of the section 20 subsidiaries over a nine-year period. Based on this experience, the Board now believes that the limitation of 10 percent of total revenue it adopted in 1987, without benefit of this experience, unduly restricted the underwriting and dealing activity of section 20 subsidiaries to a level that fell short, and continues to fall short, of substantial activity and principal engagement for purposes of section 20.

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[9] Securities Industry Ass'n v. Board of Governors of the Federal Reserve System 847 F.2d 890, 894 (D.C. Cir. 1988). For example, the New York State Banking Department has interpreted its "little Glass-Steagall Act," which contains the same "engaged principally" language as section 20, to allow a securities affiliate of a bank to have up to 25 percent of its business activity consist of underwriting and dealing. New York originally measured activity using an asset test but has more recently employed a revenue test. See Letter from Deputy Superintendent Barrantes to Paul L. Lee (May 4, 1988).

Furthermore, the Board believes that changes in the product mix that section 20 subsidiaries are permitted to offer and developments in the securities markets have affected the relationship between revenue and activity. When the Board initially adopted a 5-10 percent of total revenue test for underwriting and dealing in investment-grade commercial paper, municipal revenue bonds, mortgage-backed securities and consumer receivable related securities, the Board concluded that a "substantial" level of engagement in those activities would generally yield revenues of greater than 10 percent of total revenue. Since initially establishing a revenue limit of 10 percent, the Board has expanded significantly the types of underwriting and dealing activities in which a section 20 subsidiary may engage, most notably in the 1989 Order allowing section 20 subsidiaries to underwrite all types of debt and equity securities. Nevertheless, the Board has not until now reexamined its assumption about what level of revenue corresponds to a substantial level of engagement in the types of ineligible securities activities permitted a section 20 subsidiary.

In fact, the Board's experience shows that the relationship between gross revenue and underwriting and dealing activity is not the same for corporate debt securities and other securities approved in the 1989 Order as it was for securities approved in the 1987 Order. A given level of activity in corporate debt and equity underwriting and dealing yields substantially higher revenue than an equivalent amount of activity in underwriting and dealing in investment-grade commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer receivable related securities. For example, bid/offer spreads on many corporate bonds and other securities authorized for dealing in the 1989 Order are significantly wider than the spreads on the securities authorized for dealing in the 1987 Order. Similarly, underwriting fees for those securities authorized in the 1987 Order are significantly smaller than fees for those securities authorized in the 1989 Order, particularly with respect to equity securities and non-investment grade debt securities.[10] Put another way, the Board believes that (all things being equal) a company that maintained a constant level of activity over the past nine years, but shifted its product mix from those authorized by the 1987 Order to those authorized by the 1989 Order, would have seen a significant increase in ineligible revenue.

[10] See, e.g., Investment Dealer's Digest 12 (Feb. 19, 1996); Investment Dealer's Digest 19 (February 15, 1988).

A converse trend appears to have developed with respect to eligible revenue, where market changes appear to have reduced the eligible revenue derived from a given level of activity. As noted above, to varying degrees over the years, prior interest rate changes have reduced eligible interest revenue relative to ineligible interest revenue for the majority of companies that have elected not to use the indexed revenue test. More importantly, with respect to eligible revenue derived from other sources, most notably brokerage services, increased competition has diminished revenue as a function of activity.[11/] Lower commissions have required companies to increase volume in order to maintain a given level of eligible revenue.

In sum, the Board believes that a section 20 subsidiary company that (1) maintained a steady level of both bank-eligible and ineligible securities activity since 1987, and (2) updated its product mix to include what the Board has interpreted the Bank Holding Company Act to allow, would have seen its the ratio of ineligible to total revenue more than double.

Finally, the Board believes that this increase in the revenue limit would not give rise to the potential dangers to commercial banks from general underwriting activities that motivated the Congress to enact the Glass-Steagall Act, or the more general dangers of affiliation that motivated the Congress to enact the Bank Holding Company Act. The Board has now had considerable experience supervising these companies, and believes that they have operated in a safe and sound manner. Particularly given the safeguards of the examination

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[11/] See, e.g., The Economist 9 (April 15, 1995) ("Commissions on listed securities as a percentage of the value of trade in these instruments have fallen from 70-90 basis points in the early 1980s to below 40 basis points. Even for over-the-counter trading . . . returns have fallen from 80-90 basis points to around 20 basis points.")

and reporting process and increased emphasis on internal risk management, the Board believes that allowing a section 20 subsidiary to increase to 25 percent the amount of revenue it derives from underwriting and dealing in ineligible securities would not pose significant risk to an affiliated bank.

By order of the Board of Governors of the Federal Reserve System, July 31, 1996.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board.

FEDERAL RESERVE SYSTEM

[Docket No. R-0701]

Review of Restrictions on Director and Employee Interlocks, Cross-Marketing Activities and the Purchase and Sale of Financial Assets

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice; Request for comment.

SUMMARY: The Board is providing a second opportunity for public comment on proposed revisions to three of the prudential limitations established in its decisions under the Bank Holding Company Act and section 20 of the Glass-Steagall Act permitting a nonbank subsidiary of a bank holding company to underwrite and deal in securities. The Board is proposing to ease or eliminate the following restrictions on these so-called section 20 subsidiaries: the prohibition on director, officer and employee interlocks between a section 20 subsidiary and its affiliated banks or thrifts (the interlocks restriction); the restriction on a bank or thrift acting as agent for, or engaging in marketing activities on behalf of, an affiliated section 20 subsidiary (the cross-marketing restriction); and the restriction on the purchase and sale of financial assets between a section 20 subsidiary and its affiliated bank or thrift (the financial assets restriction).

DATES: Comments should be received on or before September 3, 1996.

ADDRESSES: Comments should refer to Docket No. R-0701, and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. Comments also may be delivered to Room B-222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street, N.W.) at any time. Comments received will be available for inspection in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's rules regarding availability of information.

FOR FURTHER INFORMATION CONTACT: Gregory Baer, Managing Senior Counsel (202) 452-3236, Thomas Corsi, Senior Attorney (202) 452-3275, Legal Division; Michael J. Schoenfeld, Senior Securities Regulation Analyst (202) 452-2781, Division of Banking Supervision and Regulation; for the hearing impaired only, Telecommunications Device for the Deaf (TDD), Dorothea Thompson (202) 452-3544.

SUPPLEMENTARY INFORMATION:

Background

In its orders authorizing bank holding companies to operate section 20 subsidiaries, the Board has established a series of prudential restrictions (commonly referred to as firewalls) designed to prevent securities underwriting and dealing risk from being passed from a section 20 subsidiary to an affiliated insured depository institution, and thus to the federal safety net. The firewalls also mitigate the potential for conflicts of interest, unfair competition, and other adverse effects that may arise from the conduct of bank-ineligible securities activities. See, e.g., J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp., 75 Federal Reserve Bulletin 192, 202-03 (1989) (hereafter, 1989 Order); Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp., 73 Federal Reserve Bulletin 473, 492 (1987) (hereafter, 1987 Order).[1] In adopting these restrictions, the Board stated that it would continue to review their appropriateness in the light of its experience in supervising section 20 subsidiaries.

The Board originally sought comment on changes to the interlocks, cross-marketing and financial assets restrictions on July 10, 1990. 55 FR 28,295 (1990). The Board received forty responses to its notice, with comments coming from banks, securities firms, trade associations and other members of the public. However, because legislation affecting the section 20 firewalls was introduced shortly after the Board sought comment, and has been introduced intermittently in the years since, the Board has deferred further action.

Given the passage of time since the original notice, the Board has decided to reopen these three firewalls for comment. All comments received on the original notice will be considered by the Board before taking final action, but

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[1] The 1989 Order and the 1987 Order are referred to collectively as the "section 20 Orders."

commenters may wish to update their earlier submissions.

Proposed changes

Introduction

The interlocks and cross-marketing restrictions were intended to insulate a bank or thrift from the underwriting and dealing risks borne by an affiliated section 20 subsidiary by ensuring that each company is operated independently and is perceived as such by its customers. The Board is considering possible alternatives to these restrictions that would maintain the intended insulation while allowing each company to draw on management expertise at its affiliates, operate more efficiently, and serve its customers more effectively.

Similarly, the financial assets restriction was a prophylactic measure designed to insulate a bank or thrift from the risks of an affiliated section 20 subsidiary by limiting one means by which a bank or thrift could fund an affiliated section 20 subsidiary. The Board is now considering whether that restriction is overbroad to the extent that it covers purchases and sales where the bank or thrift assumes no credit or liquidity risk.

Interlocks

The interlocks restriction currently prohibits all director, officer, and employee interlocks between a section 20 subsidiary and its bank or thrift affiliates.[2] The restriction seeks to ensure that customers will not be confused about which company they are dealing with, and that in the event of troubles at the section 20 subsidiary, the two entities will continue to operate independently and be ruled to have done so in the event that creditors of the section 20 subsidiary attempt to recover against the bank or thrift.

By prohibiting bank or thrift employees from serving at the section 20

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[2] In specific cases, the Board has authorized limited officer or director interlocks between a section 20 subsidiary and its affiliated banks. See, e.g., National City Corporation, 80 Federal Reserve Bulletin 346, 348-9; Synovus Financial Corp., 77 Federal Reserve Bulletin 954, 955-56 (1991); Banc One Corporation, 76 Federal Reserve Bulletin 756, 758 (1990).

subsidiary, the interlocks restriction imposes considerable costs on bank holding companies operating a section 20 subsidiary and serves as a barrier to entry for those considering doing so. This cost may be prohibitive for some smaller bank holding companies that cannot afford to pay separate staffs to perform similar functions. Accordingly, the Board believes that this firewall should be reviewed in order to determine whether the burdens it imposes serve functions important to safety and soundness.

With respect to directors, the Board is seeking comment on whether to eliminate the current blanket prohibition entirely or instead to prohibit: (1) a majority of the board of directors of a section 20 subsidiary from being composed of directors, officers or employees of affiliated banks or thrifts, and (2) a majority of the board of directors of a bank or thrift from being composed of directors, officers or employees of an affiliated section 20 subsidiary. The Board believes that a prohibition on majority representation would help to ensure corporate separateness, while allowing personnel costs to be reduced and operating efficiencies to be exploited.

In addition, the Board originally requested comment on replacing the prohibition on officer and employee interlocks with a requirement that the section 20 subsidiary not be managed or controlled by its affiliated banks or thrifts and that there not be a substantial identity of personnel between the entities. Commenters strongly opposed this proposal as vague and impractical, and the Board agrees. The Board now seeks comment on whether the prohibition on officer and employee interlocks should be eliminated altogether or, alternatively, limited to only the senior executive officer or senior executive officers of the section 20 subsidiary.

The Board believes that if the restriction on officer and employee interlocks were eliminated or modified, existing firewalls and the Interagency Policy Statement on the Sale of Uninsured Investment Products would be sufficient to prevent customers from being confused about which company they are dealing with, and consequently whether any product they are obtaining is federally insured. For example, the Board's section 20 Orders require a section 20 subsidiary to provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its bank and thrift affiliates, and stating that securities sold, offered or recommended by the section 20 subsidiary are not deposits, not federally insured, not guaranteed by an affiliated bank or thrift, and not otherwise an obligation or responsibility of such bank or thrift. E.g. 1989 Order at 215. The Board seeks comment on whether existing disclosure requirements are sufficient to prevent customer confusion and potential liability of a bank or thrift.

The Board also seeks comment on whether concerns about corporate separateness, even given a restriction on director interlocks, warrant maintaining some restriction on officer interlocks. In particular, the Board seeks comment on whether it should generally allow such interlocks but prohibit (1) any senior executive officer of the section 20 subsidiary from serving as an officer or employee of an affiliated bank or thrift, and (2) any senior executive officer of a bank or thrift from serving as an officer or employee of an affiliated section 20 subsidiary.[3] Alternatively, the Board seeks comment on whether the officer or employee interlock should be limited only to the chief executive officer.

Cross-marketing

The Board's section 20 Orders also prohibit a bank or thrift affiliate of a section 20 subsidiary from acting as agent for, or engaging in marketing activities on behalf of, the section 20 subsidiary.[4] The Board is requesting

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[3] Under 12 CFR 225.71, a senior executive officer is defined to include a person who "without regard to title, exercises the authority of one or more of the following positions: chief executive officer, chief operating officer, chief financial officer, chief lending officer, or chief investment officer. Senior executive officer also includes any other person with significant influence over major policymaking decisions. . . ." The Board seeks comment on whether, if adopted, this definition should be amended to clarify its coverage of interlocks between U.S. branches and agencies of foreign banks and their affiliated section 20 subsidiaries.

[4] The cross-marketing restriction does not serve as a complete bar on marketing activities by a bank or thrift on behalf of an affiliated section 20 subsidiary. Pursuant to certain conditions, the Board has allowed a bank affiliate of a section 20 subsidiary to: (1) send materials describing the section 20 subsidiary and the section 20 subsidiary's services to retail and commercial customers directly or as a stuffer to bank statements; (2) have its officers and employees send materials and letters on bank letterhead describing the section 20

(continued...)

comment on whether to eliminate this restriction. As noted above, the Board believes that the disclosure requirements contained in the section 20 Orders and the Interagency Statement on Retail Sales of Nondeposit Investment Products may be a more narrowly tailored and less burdensome method of protecting against customer confusion as to whether the customer is dealing with a section 20 subsidiary or an affiliated bank or thrift.

The Board notes that the Glass-Steagall reform legislation passed at various times by the Senate and reported by the House Banking Committee has not prohibited cross-marketing and agency activities. That legislation would have relied instead on disclosures regarding the uninsured status of securities affiliates to prevent customer confusion.

Purchase of Financial Assets

The Board is also seeking comment on amending the financial assets restriction, which generally prohibits a bank or thrift from purchasing financial assets from, or selling such assets to, an affiliated section 20 subsidiary. An existing exception to this restriction allows the purchase or sale of U.S. Treasury securities or direct obligations of the Canadian federal government at market terms, provided that they are not subject to repurchase or reverse repurchase agreements between the underwriting subsidiary and its bank or thrift affiliates. See, e.g., 1989 Order at 216; Canadian Imperial Bank of Commerce, The Royal Bank of Canada, Barclays PLC and Barclays Bank PLC, 76 Federal Reserve Bulletin 158, 172 (1990).

In establishing the exception for U.S. Treasury securities, the Board cited the breadth and liquidity of the market for such instruments, which make

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[4](...continued)
subsidiary and the section 20 subsidiary's services to the bank's retail and commercial customers; (3) sponsor or co-sponsor with the section 20 subsidiary educational seminars to inform retail and commercial customers about investment opportunities, investment strategies, and the section 20 subsidiary's services; and (4) have its officers and employees send invitations on bank letterhead inviting their customers to attend the educational seminars sponsored or co-sponsored by the banks. Letter Interpreting Section 20 Orders, 81 Federal Reserve Bulletin 198 (1995).

evident the "market terms" on which the sale must be transacted and ensure that the bank will be able to resell any asset it purchases. In its 1990 Notice, the Board sought comment on extending this exception to include those U.S. Government agency securities and U.S. Government-sponsored agency securities for which there is a market with a breadth and liquidity comparable to that for U.S. Treasury securities.

The Board now seeks comment on whether it should expand this exception to include the purchase or sale of any assets with a sufficiently broad and liquid market to ensure that the transaction is on market terms and that the bank is not incurring credit or liquidity risk through the purchase of assets. The Board notes that the 1987 Order did not contain a financial assets firewall. In the Board's experience, banks and thrifts whose holding companies operate free of the financial assets restriction have not experienced adverse effects from purchasing assets from, or selling assets to, their affiliated section 20 subsidiaries.

The Board does intend to retain for now the financial assets restriction to the extent that it prohibits a purchase or sale of illiquid assets and any purchase or sale of assets subject to a repurchase or reverse repurchase agreement. The Board believes that any further changes to the financial assets restriction should be considered in conjunction with other funding firewalls, as part of a more comprehensive review of all the remaining firewalls between a section 20 subsidiary and its affiliated banks and thrifts.

By order of the Board of Governors of the Federal Reserve System, July 31, 1996.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board.

FEDERAL RESERVE SYSTEM

[Docket No. R-0932]

Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice; Request for comments.

SUMMARY: The Board is proposing for comment a change in the manner in which interest earned on securities authorized for investment by a member bank of the Federal Reserve System is treated in determining whether a company is engaged principally in underwriting and dealing in securities for purposes of section 20 of the Glass-Steagall Act. In order to ensure compliance with section 20, the Board required that the amount of revenue a company derived from underwriting and dealing in securities that a member bank may not underwrite or deal in (ineligible securities) not exceed 10 percent of the total revenue of the company. The Board is proposing to clarify that interest earned on the types of debt securities that a member bank may hold for its own account is not treated as revenue from underwriting or dealing for purposes of section 20.

DATES: Comments must be received by September 3, 1996.

ADDRESSES: Comments, which should refer to Docket No. R-0932, may be mailed to the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, D.C. 20551, to the attention of Mr. William Wiles, Secretary. Comments may also be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in section 261.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Richard M. Ashton, Associate General Counsel (202/452-3750), Thomas M. Corsi, Senior Attorney (202/452-3275), Legal Division; Michael J. Schoenfeld, Senior Securities Regulation Analyst (202/452-2781), Division of Banking Supervision and

Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, D.C.

SUPPLEMENTARY INFORMATION:

Background

Beginning with orders issued in 1987, the Board has authorized nonbank subsidiaries of bank holding companies, so-called section 20 subsidiaries, to underwrite and deal in ineligible securities.[1/] In order to assure compliance with section 20 of the Glass-Steagall Act,[2/] the Board provided as a condition of its orders that the gross revenue derived by the subsidiary from ineligible securities underwriting and dealing activities not exceed 10 percent of the total gross revenue of the subsidiary, when revenue is averaged over a rolling 8-quarter period.

For purposes of computing the 10 percent revenue limit section 20 subsidiaries currently report all interest earned on third-party ineligible debt securities held by the subsidiaries in an underwriting or dealing capacity as revenue derived from underwriting and dealing in securities.[3/] Questions have

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[1/] E.g., Citicorp, 73 Federal Reserve Bulletin 473 (1987), aff'd, Securities Industry Ass'n v. Board of Governors, 839 F.2d 47 (2d Cir.), cert. denied, 486 U.S. 1059 (1988).

[2/] Section 20 provides that a member bank may not be affiliated with a company that is "engaged principally" in underwriting and dealing in securities. 12 U.S.C. 377. Section 20 does not prohibit a bank affiliate from underwriting and dealing in securities that banks may underwrite and deal in directly (eligible securities).

[3/] Instructions for Preparation of the Financial Statements for a Bank Holding Company Subsidiary Engaged in Bank-Ineligible Securities Underwriting and Dealing, Form FR Y-20. Schedule SUD-I, Line Item 5 (December 1994)(FR Y-20 Instructions). See also "Structuring Bank-Eligible and Bank-Ineligible Transactions" in FR Y-20 Instructions.

been raised as to whether this treatment is appropriate for interest earned on debt securities that a member bank is authorized to hold. Under the Glass-Steagall Act, a member bank is expressly authorized to purchase and sell for its own account "investment securities," which generally include investment grade corporate debt and certain municipal revenue securities.[4] The Board is aware that pursuant to this authority many banks hold for their own account a significant amount of investment grade debt securities. In addition, many banks buy and sell these securities on a relatively frequent basis as part of managing their investment portfolio. In recognition of this activity, changes to accounting rules were made at the end of 1993 to establish separate accounting treatment for bank portfolio securities that are "available for sale" and not intended to be held to maturity.[5]

In view of the above, the Board is proposing to clarify that interest earned on the types of debt securities that a member bank may hold for its own account is not treated as revenue from underwriting or dealing in ineligible securities for purposes of section 20. The Board believes a distinction can be made between the interest earned by a section 20 subsidiary from holding these kinds of securities and the profit made from underwriting or reselling them. The profit or loss a section 20 subsidiary earns on the resale of investment grade ineligible debt securities the subsidiary holds in inventory more closely approximates the revenue that should be attributed to performing the functions of dealing in or underwriting securities, the critical element of which is the actual offering and sale of the instruments involved.[6]

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[4] 12 U.S.C. 24 Seventh, 335; 12 CFR 1.3. Member banks may not purchase any non-investment grade debt securities or equity securities for their own account.

[5] Statement of Financial Accounting Standards No. 115.

[6] For purposes of the section 20 revenue limitation, the Board has viewed "public sale" to include the activity of dealing in securities -- the process of buying and reselling to the public specific securities as part of an ongoing, regular business. E.g., Citicorp, supra, 73 Federal Reserve Bulletin at 506-08. The term "underwriting" generally refers to the process by which new issues of securities are offered and sold to the public. E.g., Securities Industry Ass'n v. Board of Governors, 807 F.2d 1052, 1062-66 (D.C. Cir. 1986), cert. denied, 483

On the other hand, the interest the subsidiary earns on investment grade ineligible debt securities while it holds them in inventory more closely represents the revenue that can be attributed to holding the securities as a member bank may do.[7] Thus, the Board believes that it is reasonable to conclude that interest revenue derived from holding the kinds of debt securities a member bank may hold should not be treated as revenue from underwriting or dealing in securities. The proposed clarification would apply only to interest derived from those types of debt securities that a member bank may hold for its own account, but not underwrite or deal in.

By order of the Board of Governors of the Federal Reserve System, July 31, 1996.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board.

U.S. 1005 (1987).

[7] This distinction is further reflected in the current reporting requirements for section 20 subsidiaries and in Generally Accepted Accounting Principles for bank holding companies, which prescribe that interest revenue be reported separately from gains or losses on securities owned. FR Y-20 Instructions, Statement of Income, Schedule SUD-I, Line Items 2, 5); Securities and Exchange Commission FOCUS Report (Form X-17A-5 Part II) and instructions thereto. Generally Accepted Accounting Principles incorporate the format of the FOCUS Report.