FEDERAL RESERVE BANK
OF DALLAS

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

DALLAS, TEXAS
75265-5906

February 7, 1997

Notice 97-13

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

SUBJECT

Request for Comment on Modifications to the Prudential Limitations

DETAILS

The Board of Governors of the Federal Reserve System is requesting public comment on removing the majority of the prudential limitations or firewalls that currently apply to bank holding companies engaged in securities underwriting and dealing activities through Section 20 subsidiaries. The Board is proposing to retain as operating standards for Section 20 subsidiaries a limited number of restrictions adapted from the current firewalls.

The Board must receive comments by March 10, 1997. 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. All comments should refer to Docket No. R-0958.

ATTACHMENT

A copy of the Board's notice as it appears on pages 2622-32, Vol. 62, No. 12, of the *Federal Register* dated January 17, 1997, is 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.

This publication was digitized and made available by the Federal Reserve Bank of Dallas' Historical Library (FedHistory@dal.frb.org)

Proposed Rules

Federal Register
Vol. 62, No. 12
Friday, January 17, 1997

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R–0958]

Bank Holding Companies and Change in Bank Control (Regulation Y); Review of Restrictions in the Board's Section 20 Orders

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed conditions to board orders.

SUMMARY: The Board has conducted a comprehensive review 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 seeking comment on modifications to these limitations that the Board believes will allow section 20 subsidiaries to operate more efficiently and serve their customers more effectively. These modifications would allow section 20 subsidiaries to operate more readily in conjunction with an affiliated bank, thereby maximizing synergies, enhancing services, and possibly reducing costs.

DATES: Comments should be received on or before March 10, 1997.

ADDRESSES: Comments, which should refer to Docket No. R–0958, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. Comments addressed to Mr. Wiles may also 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 the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, N.W. Comments may be inspected In room MP–500 between 9:00 a.m. and 5:00 p.m., except as provided in Section 261.8 of the Board's Rules Regarding the Availability of Information, 12 CFR 261.8.

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

Section 20 of the Glass-Steagall Act provides that a member bank of the Federal Reserve System may not be affiliated with a company that is "engaged principally" in underwriting and dealing in securities.[1] Beginning in 1987, the Board has issued a series of orders authorizing bank holding companies to establish "section 20 subsidiaries" to engage in underwriting and dealing in securities not eligible for underwriting and dealing by a member bank.[2] In those orders, the Board established a series of prudential restrictions as conditions for approval under the Bank Holding Company Act. The restrictions are 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, and to mitigate the potential for conflicts of interest, unfair competition, and other adverse effects that may arise from the conduct of bank-ineligible securities activities.

The Board's original section 20 order in 1987 contained twenty restrictions, and the Board's subsequent order in 1989 allowing underwriting and dealing in all debt and equity securities contained more stringent restrictions, numbering twenty-eight in all. The restrictions contained in these orders are not imposed on any nonbank subsidiary of a bank holding company other than a section 20 subsidiary.

Although the restrictions imposed in the Board's section 20 orders are commonly known as "firewalls," the term is something of a misnomer. While some of the most important restrictions are intended to prevent an outbreak of trouble at a section 20 subsidiary from spreading to an affiliated depository institution, many serve other purposes. For example, some of the "firewalls" are procedural, and others are directed towards consumer protection or preventing unfair competition.

Taken together, the section 20 firewalls are a very conservative regime designed to isolate a section 20 subsidiary from any affiliated depository institution or bank holding company. The firewalls have prevented bank holding companies from reaping possible synergy gains from the operation of an investment bank. The reasons the Board chose such a conservative regime are rooted in the time they were adopted.

First, when the Board approved establishment of the initial section 20 subsidiaries in 1987, it had little experience supervising investment banks in the United States. Because affiliation between banks and securities underwriters and dealers was long considered impractical or illegal, bank holding companies had not operated such entities since enactment of the Glass-Steagall Act in 1933. Moreover, pre-Glass-Steagall affiliations were considered, rightly or wrongly, to have caused losses to the banking industry and investors.[3] Thus, affiliation of banks and investment banks presented unknown risks that were considered substantial.

Second, although the Board recognized in 1987 that supervision and regulation of broker-dealers by the Securities and Exchange Commission provided significant protections, the Board had little experience with how

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

[2] *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 (1989) (hereafter, *1989 Order*); *Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp.*, 73 Federal Reserve Bulletin 473 (1987) (hereafter, *1987 Order*); *see also Canadian Imperial Bank of Commerce, The Royal Bank of Canada, Barclays PLC and Barclays Bank PLC*, 76 Federal Reserve Bulletin 158 (1990) (applying earlier orders to section 20 subsidiaries of foreign banks) (hereafter, *1990 Order*).

[3] Recent research indicates that this belief may have been inaccurate. *See, e.g.*, George J. Benston, The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered 41 (1990) ("The evidence from the pre-Glass-Steagall period is totally inconsistent with the belief that banks' securities activities or investments caused them to fail or caused the financial system to collapse.").

these protections operated in general or would operate within a bank holding company in particular.

Third, significant protections that currently exist with respect to section 20 subsidiaries were not present in 1987. Most significantly, section 23B of the Federal Reserve Act was under consideration but had not been adopted at the time of the Board's *1987 Order*. As noted below, many of the firewalls duplicate or overlap the restrictions of section 23B, which requires inter-affiliate transactions to be on arm's length terms, prohibits representing that a bank is responsible for a section 20 affiliate's obligations, and prohibits a bank from purchasing certain products from a section 20 affiliate. [4] Similarly, risk-based capital standards did not exist in 1987. Because those standards address some of the risks present in a bank's affiliation with an investment bank, they too overlap with some of the firewalls. Also, the Interagency Statement on Retail Sales of Nondeposit Investment Products was not adopted until 1994. The Interagency Statement is now the primary means by which the federal banking agencies seek to ensure that retail banking customers are not misled about the nature of the products that they are purchasing.

Introduction

In recognition that its concerns about affiliation could abate, the Board stated at the time it adopted the firewalls that it would continue to review their appropriateness in the light of its experience in supervising section 20 subsidiaries. The Board has now undertaken a comprehensive review of the restrictions imposed in its section 20 orders, and is proposing to eliminate most of them, and incorporate the rest in a statement of operating standards that the Board believes are appropriate for section 20 subsidiaries.

The risks of securities underwriting and dealing have in the Board's experience proven to be manageable in a bank holding company framework, and bank holding companies and banks have successfully undertaken and managed activities posing similar risks for which no firewalls were erected. Finally, many of the firewalls are duplicated, or at least addressed in some way, by other statutes or regulations that are more narrowly tailored to addressing the perceived risk or conflict. Thus, in many cases where the Board is proposing to eliminate a firewall, another restriction will remain.

The Board believes that the proposed changes will allow section 20 subsidiaries to operate more efficiently and serve their customers more effectively, consistent with the safety and soundness of affiliated banks. The most important changes being proposed by the Board address the firewalls regarding funding of a section 20 subsidiary by an affiliated bank, credit enhancements provided by a bank to issuers of securities underwritten by a section 20 affiliate, and loans provided by a bank to customers purchasing products of a section 20 affiliate. These changes would allow section 20 subsidiaries to operate more readily in conjunction with an affiliated bank, thereby maximizing synergies, enhancing services, and possibly reducing costs.

The Board is proposing to retain those restrictions that address issues of bank safety and soundness, significant conflicts of interest, or other concerns that are not addressed by other statutes or regulations. With respect to safety and soundness, the Board believes that it is essential that any bank holding company operating a section 20 subsidiary ensure that its subsidiary banks are well capitalized. Accordingly, the Board is proposing to reserve the discretion to reimpose the funding, credit extension, and credit enhancement firewalls in the event that an affiliated bank or thrift becomes less than well capitalized and the bank holding company does not promptly restore it to the well-capitalized level.

The Board proposes to incorporate in a statement of operating standards the practices that it believes a bank holding company and its section 20 subsidiary should follow in order to ensure safety and soundness and avoid conflicts of interest. For each of the existing firewalls, the Board seeks comment on whether that firewall, either alone or as part of a larger framework of restrictions, is necessary to ensure that underwriting and dealing in bank-ineligible securities is conducted in a safe and sound manner, and not subject to significant conflicts of interests, and should therefore be included as an operating standard.

The Board also seeks comment on whether adjustments to the proposed operating standards are necessary to address issues unique to foreign banks. In its *1990 Order*, the Board adopted a modified series of firewalls for foreign banks. The Board intends for the proposed operating standards to apply to both domestic and foreign banking organizations operating a section 20 subsidiary.

Discussion

Set forth below are: (1) each of the firewalls established in the Board's *1989 Order*, including any amendments subsequently made to that firewall; [5] (2) a description of whether the firewall was included in the *1987 Order* and the *1990 Order;* and (3) a request for comments on the firewall.

I. Capital Adequacy Conditions

Firewall 1(a) (Deduction of investment in Subsidiary From Bank Holding Company Capital)

Text of 1989 Order. In determining compliance with the Board's Capital Adequacy Guidelines, each Applicant shall deduct from its consolidated primary capital any investment it makes in the underwriting subsidiary that is treated as capital in the underwriting subsidiary. In accordance with the risk-based component of the Board's Capital Guidelines, Applicant shall deduct 50 percent of the amount of any investment in the underwriting subsidiary from Tier 1 capital and 50 percent from Tier 2 capital. In calculating primary capital and risk-based capital ratios, Applicant should also exclude the underwriting subsidiary's assets from the holding company's consolidated assets.

1987 and 1990 Order. The *1987 Order* provided for a similar capital deduction under an earlier set of capital standards. The *1990 Order* requires compliance with internationally accepted risk-based capital requirements after deduction of any investment in the section 20 subsidiary that is treated as capital in that subsidiary.

Request for Comment. The Board proposes to eliminate this restriction. The purpose of this firewall was to ensure that a bank holding company maintained sufficient resources to support its federally insured depository institutions and other banking operations by deducting any exposure to its section 20 subsidiary from its regulatory capital. The Board has viewed the deduction as reinforcement for the important requirement that any bank holding company that seeks to establish a section 20 subsidiary, and the insured depository institutions controlled by that bank holding company, be strongly capitalized.

In practice, however, the deconsolidation requirement has created regulatory burden without strengthening the capital of the organization. The deconsolidation requirement is inconsistent with GAAP and has therefore created confusion and imposed costs by requiring bank

[4] 12 U.S.C. 371c–1.

[5] Footnotes to the orders are omitted.

holding companies to prepare statements on two bases. Meanwhile, the deduction does not strengthen the capital of any insured depository institution affiliate of the section 20 subsidiary or the section 20 subsidiary itself, which is already subject to SEC-imposed capital requirements. Elimination of the deduction would not create or expose any incentive for a bank holding company to take capital necessary to support a depository institution and reinvest it in a section 20 subsidiary. Finally, the Board has recently adopted a system for analyzing market risk that will better measure the capital adequacy of a banking organization.

Moreover, based on its experience supervising section 20 subsidiaries over the past nine years, the Board does not believe that the activities of a section 20 subsidiary are so uniquely risky as to merit a capital treatment different from other nonbank affiliates, which are not subject to a deduction requirement.

Firewall 1(b) (Deduction of Extensions of Credit From Holding Company Capital)

Text of 1989 Order. Applicant shall also deduct from its regulatory capital any credit it or a nonbank subsidiary extends directly or indirectly to the underwriting subsidiary unless the extension of credit is fully secured by U.S. Treasury securities or other marketable securities and is collateralized in the same manner and to the same extent as would be required under section 23A(c) of the Federal Reserve Act if the extension of credit were made by a member bank. In the case of the risk-based component of the Board's Capital Guidelines, the deductions for unsecured or not fully-secured or inadequately collateralized loans shall be taken 50 percent from Tier 1 and 50 percent from Tier 2 as described above. Notwithstanding these adjustments, Applicant should continue to maintain adequate capital on a fully consolidated basis.

1987 and 1990 Order. This restriction was not included in the *1987 Order.* A similar deduction was required under the *1990 Order.*

Request for Comment. The Board proposes to eliminate the deduction required by this firewall for the same reasons as Firewall 1(a),[6] but retain the requirement that a bank holding company maintain adequate capital on a fully consolidated basis as a condition for operating a section 20 subsidiary.

Firewall 2 (Prior Approval Requirement for Investments in Subsidiary)

Text of 1989 Order. No Applicant nor any of its nonbank subsidiaries shall, directly or indirectly, provide any funds to, or for the benefit of, an underwriting subsidiary, whether in the form of capital, secured or unsecured extensions of credit, or transfer of assets, without prior notice to and approval by the Board.

1987 and 1990 Order. This restriction was not included in the *1987 Order.* The same restriction was included in the *1990 Order.*

Board Action. The Board is repealing this restriction, which requires prior notice and Board approval before a bank holding company or its nonbank subsidiaries may advance funds to its section 20 subsidiary. As the firewall is procedural, the Board is not seeking comment on the change, which will be effective immediately.

The prior approval requirement, which is applied only to investments in a section 20 subsidiary, was intended to ensure that resources needed to support a bank holding company's insured subsidiaries were not diverted to the underwriting subsidiary. However, in practice, bank holding companies require sufficient funding flexibility to accommodate business growth over a multi-year period, and the Board has thus been faced with the choice of allowing them this flexibility by approving open-ended funding plans or micromanaging the funding of section 20 subsidiaries. The Board has opted for the former course, relying on supervisory tools that allow the Board to institute corrective action should it determine that excessive bank holding company resources are being diverted to a section 20 subsidiary. The normal supervisory process, which includes annual inspections, off-site monitoring, and review of annual reports, has proven sufficient to determine whether a bank holding company is disadvantaging its insured depository institution subsidiaries by making imprudent investments in a nonbank subsidiary. The Board therefore believes that the prior approval firewall can be eliminated, especially as section 23A of the Federal Reserve Act will continue to limit any transfer of funds from an insured depository institution affiliate.[7]

Firewall 3 (Requirement of Capital Plan)

Text of 1989 Order. Before commencing the new activities, each Applicant must submit to the Board acceptable plans to raise additional capital as required by this Order or demonstrate that it is strongly capitalized and will remain so after making the capital adjustments authorized or required by this Order. An Applicant may not commence the proposed activities until it has received a Board determination that the capital plan satisfies the requirements of this Order and has raised the additional capital required under the plan.

1987 and 1990 Order. This restriction was not included in the *1987 Order* or the *1990 Order.*

Request for Comment. The Board analyzes the capital adequacy, financial condition, and business plan of each applicant before approving its application to engage in underwriting and dealing pursuant to section 20. The Board has authority, independent of this firewall, to require an applicant to raise additional capital whenever appropriate. The Board proposes to eliminate this firewall as superfluous.

Firewall 4 (Capital Adequacy Requirement)

Text of 1989 Order. The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.

1987 and 1990 Order. Same.

Request for comment. The Board seeks comment on whether to retain this firewall, which has been understood to require section 20 subsidiaries to maintain capital levels consistent with industry norms for independent investment banks. The purpose of this capital requirement was to prevent a section 20 subsidiary from operating below industry capital standards by trading on the reputation of its affiliated bank. The requirement thus seeks to prevent section 20 subsidiaries from being able to leverage themselves more than, and gain a competitive advantage over, their independent competitors, and to serve as a buffer to protect the affiliated bank.

This restriction has proven confusing and controversial, as "industry norms" are difficult to determine. Although the SEC imposes capital and "haircut" requirements on all broker-dealers, including section 20 subsidiaries, these levels cannot be considered industry norms.[8] Most investment banks,

[6] The Board's Capital Guidelines may continue to require certain deductions from regulatory capital independent of this restriction, and those deductions would be unaffected.

[7] 12 U.S.C. 371c.

[8] 17 CFR 240.15c3-1. The SEC capital rule is intended to allow prompt liquidation of a broker-dealer in order to satisfy the claims of its creditors, and broker-dealers failing to meet SEC capital requirements are immediately liquidated. Thus,

particularly significant underwriters, maintain capital greatly in excess of SEC minimums, and Federal Reserve examiners have accordingly expected section 20 subsidiaries to maintain capital before haircuts that is at least 100 percent greater capital than SEC haircut requirements. Some section 20 subsidiaries have complained that their competitors maintain a lesser amount of capital. They also argue that whereas SEC capital requirements allow all capital to be concentrated in the broker-dealer and dedicated to meeting capital requirements, a bank holding company must meet capital requirements at the bank and holding company levels as well.

Moreover, the Board already measures bank holding company capital on a consolidated basis, including the capital and assets of the section 20 subsidiary. Therefore, the Board believes that it may be unnecessary to impose a separate capital requirement on the bank holding company's section 20 subsidiary. The Board notes that such capital requirements have not been generally imposed on other holding company subsidiaries.

II. Credit Extensions to Customers of the Underwriting Subsidiary

The purpose of Firewalls 5–12 is to prevent a bank or bank holding company from exposing itself to loss in order to benefit the underwriting or dealing activities of its affiliate. They are the firewalls most directly linked to the hazards of commercial and investment banking affiliation that motivated the authors of the Glass-Steagall Act. The Board has noted that preserving the soundness and impartiality of credit is one of its major concerns under the banking laws.

However, as financial intermediation has evolved, corporate customers frequently seek to obtain a variety of funding mechanisms from one organization. By prohibiting banks from providing routine credit enhancements in tandem with a section 20 affiliate, the existing firewalls hamper the ability of bank holding companies to serve as full-service financial services providers and reduce options for customers. For example, existing corporate customers of a bank may wish to issue commercial paper or issue debt in some other form. Although the bank may refer the customer to its section 20 affiliate, the bank is prohibited from providing credit enhancements even though it may be the institution best suited to perform a credit analysis—and, with smaller customers, perhaps the only institution willing to perform a credit analysis.

Furthermore, these restrictions do not apply to credit extensions or credit enhancements extended in conjunction with underwriting of bank-eligible securities by a section 20 affiliate, and there has not been significant abuse in this area.[9] As with bank-eligible securities, even in the absence of these firewalls, protections for the bank would remain; those protections are discussed below in the context of each firewall. Finally, as noted above, the Board is proposing to reserve its authority to impose the funding, credit extension, and credit enhancement firewalls in the event that an affiliated bank or thrift becomes less than well capitalized and the bank holding company does not promptly restore it to the well-capitalized level.

Firewall 5 (Restriction on Credit Enhancement)

Text of 1989 Order. No Applicant or subsidiary shall directly or indirectly extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, guarantee, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten or distributed by the underwriting subsidiary.

1987 and 1990 Order. The *1987 Order* was substantially the same, and the *1990 Order* applied the same restrictions to U.S. affiliates and branches and agencies of foreign banks.

Request for Comment. The Board proposes to eliminate the credit enhancement firewall, as it believes that other protections adequately serve its purposes, and its burden on section 20 subsidiaries and their customers therefore cannot be justified. First, a bank would be required to hold capital against all credit enhancements extended to customers of its section 20 affiliate. Notably, at the time the firewalls were adopted, the existing regulatory capital regime did not take account of off-balance-sheet obligations. Thus, a bank exposing itself to loss by issuing a standby letter of credit, guarantee, or other credit enhancement would not have been required to hold capital against that exposure. Under the current risk-based capital system, a bank would be required to hold capital against the credit equivalent amount of such an obligation.[10]

Second, the amount of credit that a bank could extend to an issuer of securities underwritten by a section 20 affiliate would also be limited by loan-to-one borrower rules. For example, national banks may only lend an amount equal to 15 percent of their capital on an uncollateralized basis and an additional 10 percent of their capital on a collateralized basis, and credit enhancements generally would be aggregated along with all other credit extended to an issuer in measuring compliance with these limits.[11]

Third, the proposed operating standards include the existing firewalls emphasizing the importance of credit standards and documentation. Such controls should ensure that any credit enhancement is extended consistent with the internal procedures of the bank, that independent credit judgment is exercised, and that documentation is maintained that would allow examiners to assess compliance with these policies. A credit that would generally fail to meet the bank's credit standards should not be extended because the credit would directly or indirectly benefit a section 20 affiliate.

Finally, section 23B of the Federal Reserve Act would require that all credit enhancements extended to an issuer whose securities are being underwritten by a section 20 affiliate be on an arm's-length basis. Thus, for example, a bank could not offer such credit enhancements below market prices, or to customers who were poor credit risks, in order to generate underwriting business for a section 20 affiliate. Similarly, section 106 of the Bank Holding Company Act Amendments of 1970 would prohibit a bank from offering discounted credit enhancements on the condition that an issuer obtain investment banking services from a section 20 affiliate.

Firewall 6 (Restriction on Funding Purchases of Securities)

Text of 1989 Order. No Applicant or subsidiary (other than the underwriting subsidiary) shall knowingly extend credit to a customer directly or indirectly secured by, or for the purpose of purchasing, any ineligible security that an affiliated underwriting subsidiary underwrites during the period of the underwriting or for 30 days thereafter, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting

healthy broker-dealers do not operate near SEC minimum requirements.

[9] Furthermore, since 1981, national banks have been allowed to credit enhance their own private placements of bank-ineligible securities. The Board is not aware of any unmanageable losses having arisen from this activity.

[10] *See, e.g.*, 12 CFR 208, Appendix A.III.D (risk-based capital standards for state member banks).

[11] 12 U.S.C. 84; 12 CFR 32.2.

subsidiary makes a market. This limitation extends to all customers of Applicant and its subsidiaries, including broker-dealers and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities where an affiliated bank is the clearing bank for such broker-dealer.

1987 and 1990 Order. The *1987 Order* did not extend the restriction for 30 days after the underwriting period, but was otherwise substantially the same. The 1990 Order applied the same restrictions to U.S. affiliates and branches and agencies of foreign banks, and also prohibited the section 20 subsidiary from arranging for an extension of credit by the foreign bank or its subsidiaries.

Request for Comment. Firewall 6 addresses what the Board believes to be one of the most important potential conflicts of interests arising from the affiliation of commercial and investment banking: the possibility that a bank would extend credit below market rates in order to induce customers to purchase securities underwritten by its section 20 affiliate or that it holds in inventory. The primary concerns are threefold: that such extensions of credit may not be repaid, thereby harming the bank; that customers will be induced by easy credit into purchasing risky securities, thereby harming the customer; and that a section 20 affiliate could reap a competitive advantage over competitors who do not have a federally subsidized affiliate to provide credit to their customers.

Section 11(d) of the Securities Exchange Act of 1934 addresses some of the same concerns as Firewall 6. Section 11(d) prohibits a broker-dealer (including a section 20 affiliate) that is acting as an underwriter from extending or arranging for credit to customers purchasing the newly issued securities during the underwriting period. Thus, a section 20 subsidiary acting as underwriter would be prohibited from arranging for an affiliated bank to make loans to customers for purchases during an underwriting period. Still, section 11(d) would not apply in the absence of arranging and, unlike Firewall 6, would not cover loans to purchase a security in which a section 20 affiliate makes a market or purchases from parties other than the section 20 affiliate.

Section 23B of the Federal Reserve Act, and in some cases section 23A of the Federal Reserve Act, would address many of these remaining concerns and overlap the restrictions of section 11(d). Section 23B would apply to loans to fund purchases by customers of securities from a section 20 affiliate during the existence of the underwriting or selling syndicate, and to any loan to purchase a security from the inventory of the section 20 affiliate, including securities in which the section 20 affiliate makes a market.[12] Section 23B requires that inter-affiliate transactions be on market terms. To the extent that the bank extended credit knowing that the proceeds would be transferred to an affiliate, section 23A would also apply.[13] Section 23A limits transactions with any one affiliate to 10 percent of the bank's capital, and transactions with all affiliates to 20 percent of capital, and also requires that collateral be pledged to a bank for any extension of credit.

The Board seeks comment on whether these protections are sufficient to address the conflicts of interests that motivated creation of Firewall 6.

Firewall 7 (Restriction on Extensions of Credit for Repayment of Underwritten Securities)

Text of 1989 Order. No Applicant or any of its subsidiaries may, directly or indirectly, extend credit to issuers of the ineligible securities underwritten by an affiliated underwriting subsidiary for the purpose of the payment of principal, interest or dividends on such securities. To assure compliance with the foregoing, any credit lines extended to an issuer by any bank holding company or any subsidiary shall provide for substantially different timing, terms, conditions and maturities from the ineligible securities being underwritten. It would be clear, for example, that a credit has substantially different terms and timing if it is for a documented special purpose (other than the payment of principal, interest or dividends) or there is substantial participation by other lenders.

1987 and 1990 Order. The *1987 Order* did not prohibit extensions of credit for the payment of dividends but was otherwise substantially the same. The *1990 Order* applied the same restrictions to U.S. affiliates and branches and agencies of foreign banks, and also included an arranging restriction.

Request for Comment. The Board proposes to eliminate this restriction. The Board stated in 1987 that it was adopting this firewall in order to prevent a bank from making unwise loans to improve the financial condition of companies whose securities were underwritten or dealt in by the section 20 affiliate, either to assist in the marketing of the securities or to prevent the customers of the section 20 affiliate from incurring losses on securities sold by the subsidiary. However, the firewall has proven burdensome and has had unintended effects. For example, banks face compliance problems renewing a company's revolving line of credit if a section 20 subsidiary has underwritten an offering by that company since the credit was first extended; the bank must either recruit other lenders to participate in the renewal or amend the line of credit in order to specify its purpose. As a result, companies seeking the best short-term funding options sometimes find it easier to move from the bank credit market to the commercial paper market than the reverse.

In addition, other restrictions would apply in the absence of the firewall. Section 23B of the Federal Reserve Act would generally apply to extensions of credit for the purpose of payment of principal, interest or dividends that are currently covered by Firewall 7. In addition, the conflict of interest addressed by Firewall 7 appears more tenuous than those addressed by the prior two credit firewalls, as most of the funds extended do not flow to the section 20 affiliate. Thus, the Board believes that section 23B, together with the capital requirements discussed above, should be sufficient protection against this conflict of interest.

Firewall 8 (Procedures for Extensions of Credit)

Text of 1989 Order. Each Applicant shall adopt appropriate procedures, including maintenance of necessary documentary records, to assure that any extension of credit by it or any of its subsidiaries to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's length basis for purposes other than payment of principal, interest, or dividends on the issuer's ineligible securities being underwritten or dealt in by the underwriting subsidiary. An extension of credit is considered to be on an arm's length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiary.

1987 and 1990 Order. The *1987 Order* did not restrict extensions of credit for the payment of dividends but was otherwise substantially the same. The *1990 Order* applied the same restrictions to U.S. affiliates and branches and agencies of foreign banks.

---

[12] Section 23B applies to "any transaction or series of transactions with a third party * * * if an affiliate is a participant in such transaction or series of transactions." 12 U.S.C. 371c-1(a)(2)(E).

[13] 12 U.S.C. 371c(a)(2).

Request for Comment. The Board proposes to eliminate this firewall. Section 23B, enacted since this firewall was initially adopted, requires extensions of credit by a bank in conjunction with an issuance of securities underwritten by a section 20 affiliate to be on arm's-length terms. The federal banking agencies examine for compliance with section 23B, and require any bank that does not maintain those procedures necessary to ensure compliance to adopt them immediately.

Although the firewall also includes extensions of credit by nonbank subsidiaries, those extensions of credit do not directly implicate the federal safety net. In amending section 23A and adopting section 23B in 1987, Congress did not apply their restrictions to the parent bank holding company or any other nonbank lender. Moreover, the bank holding company will remain subject to capital requirements.

Firewall 9 (Restriction on Thrifts)

Text of 1989 Order. In any transaction involving an underwriting subsidiary, Applicants' thrift subsidiaries shall observe the limitations of sections 23A and 23B of the Federal Reserve Act as if the thrifts were banks.

1987 and 1990 Order. The *1987 Order* did not include this restriction. The *1990 Order* was the same.

Request for Comment. This condition became superfluous when the Home Owners' Loan Act was amended to apply sections 23A and 23B of the Federal Reserve Act to a thrift as if were a member bank [14]. The Board proposes to eliminate it.

Firewall 10 (Restriction on Industrial Revenue Bonds)

Text of 1989 Order. The requirements relating to credit extensions to issuers noted in paragraphs 5–9 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds.

1987 and 1990 Order. Same.

Request for Comment. As the Board is proposing to eliminate the incorporated restrictions, the Board is proposing to eliminate this restriction as well.

Firewall 11 (Loan Documentation and Exposure Limits)

Text of 1989 Order. Applicants shall cause their subsidiary banks and thrifts to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in financing transactions underwritten or arranged by an underwriting subsidiary as set forth in this Order. The Reserve Banks shall ensure that these policies and procedures are in place at Applicants' subsidiary banks and thrifts and Applicants shall assure that loan documentation is available for review by Reserve Banks to ensure that an independent and thorough credit evaluation has been undertaken in connection with bank or thrift participation in such financing packages and that such lending complies with the requirements of this Order and section 23B of the Federal Reserve Act.

1987 and 1990 Order. This restriction was not included in the *1987 Order.* The *1990 Order* applied the same restriction to U.S. affiliates and branches and agencies of a foreign bank.

Request for Comment. The Board is proposing to include this restriction in slightly amended form in its operating standards for all section 20 subsidiaries.

Firewall 12 (Procedures for Limiting Exposure to One Customer)

Text of 1989 Order. Applicants should also establish appropriate policies, procedures, and limitations regarding exposure of the holding company on a consolidated basis to any single customer whose securities are underwritten or dealt in by the underwriting subsidiary.

1987 and 1990 Order. This restriction was not included in the *1987 Order.* The *1990 Order* applied the same restriction to U.S. affiliates and branches and agencies of foreign banks.

Request for Comment. The Board is seeking comment on whether to include this restriction in its operating standards for section 20 subsidiaries. The firewall restricts the ability of a holding company to expose itself to one issuer in support of its section 20 subsidiary. However, the need for internal limits and the appropriate sophistication of those limits varies greatly from company to company, and might be better addressed through the examination process.

III. Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

Firewall 13 (Interlocks Restriction)

Text of 1989 Order (as amended). [15] Directors, officers or employees of a bank or thrift shall not serve as a majority of the board of directors or the chief executive officer of an affiliated section 20 subsidiary, and directors, officers or employees of a section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer of an affiliated bank or thrift. The underwriting subsidiary will have separate offices from any affiliated bank or thrift.

1987 and 1990 Order. The *1987 Order* is the same. The *1990 Order* applies the same restriction to the U.S. bank and thrift subsidiaries and branches and agencies of foreign banks.

Request for Comment. The Board recently amended the interlocks restriction, and is not proposing further changes to that restriction. However, Firewall 13 also contains a requirement that a section 20 subsidiary have separate offices from any affiliated bank, thrift, branch or agency. The purpose of this restriction was to ensure that customers of a section 20 subsidiary clearly understand that they are not dealing with a bank or thrift affiliate, and that the products they are purchasing are not federally insured or bank guaranteed.

The Board is proposing to eliminate the separate office requirement. First, in the Board's experience, maintaining separate offices for functions that do not involve retail customers—for example, back-office functions—serves no purpose and represents a needless expense. Second, for sales to retail customers, the Board proposes to rely on the Interagency Statement on Retail Sales of Nondeposit Investment Products, which largely duplicates this restriction. According to the Interagency Statement, sales or recommendations of nondeposit investment products on the premises of a depository institution—including sales by a section 20 affiliate—should be conducted in a physical location distinct from the area where retail deposits are taken.

IV. Disclosure by the Underwriting Subsidiary

Firewall 14 (Customer Disclosures)

Text of 1989 Order. An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its bank and thrift affiliates and pointing out that an affiliated bank or thrift could be a lender to an issuer and referring the customer to the disclosure documents for details. In addition, the statement shall state that securities sold, offered, or recommended by the underwriting subsidiary are not deposits, are not insured by the Federal Deposit Insurance Corporation, are not guaranteed by an affiliated bank or thrift, and are not otherwise an obligation or responsibility of such a bank or thrift (unless such is the case). The underwriting subsidiary should also disclose any material lending

[14] 12 U.S.C. 1468(a)(1).

[15] 61 FR 57679, 57683 (1996).

relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.

1987 and 1990 Order. The *1987 Order* required a less detailed but similar disclosure. The *1990 Order* extended the same restriction to U.S. bank and thrift affiliates and branches and agencies of foreign banks.

Request for Comment. The Board continues to believe that customer disclosures are important to ensuring that customers of a section 20 subsidiary clearly understand that its products are not federally insured or otherwise guaranteed by an affiliated bank. Indeed, the Board relied on disclosures in concluding that it was appropriate to eliminate firewalls on cross-marketing and employee interlocks. In order to ease the burden of compliance, though, the Board is proposing to amend the disclosure firewall to follow the Interagency Statement on Retail Sales of Nondeposit Investment Products that applies to sales by bank employees or on bank premises. A section 20 subsidiary would be required to provide each of its retail customers the same disclosures that the Interagency Statement mandates for retail customers of banks, even when it was operating off bank premises. This would narrow the firewall by no longer requiring disclosures to institutional customers (who should be aware of whether a product is federally insured or bank guaranteed) but broaden the firewall to require an acknowledgement of the disclosure by retail customers.

V. Marketing Activities on Behalf of an Underwriting Subsidiary

Firewall 15 (Restriction on Advertising Bank Connection)

Text of 1989 Order. No underwriting subsidiary nor any affiliated bank or thrift institution will engage in advertising or enter into an agreement stating or suggesting that an affiliated bank or thrift is responsible in any way for the underwriting subsidiary's obligations as required under section 23B of the Federal Reserve Act.

1987 and 1990 Order. The *1987 Order* did not contain the reference to section 23B of the Federal Reserve Act, but was otherwise identical. The *1990 Order* extended the same restriction to bank and thrift affiliates and branches and agencies of a foreign bank.

Request for Comment. This restriction has been superseded by section 23B(c) of the Federal Reserve Act, and the Board is proposing to eliminate it.

Firewall 16 (Cross-marketing and Agency Activities by Banks)

Text of 1989 Order. Reserved.[16]

1987 and 1990 Order. Same.

VI. Investment Advice by Bank/Thrift Affiliates

Firewall 17

Text of 1989 Order. An affiliated bank or thrift institution may not express an opinion on the value or the advisability of the purchase or the sale of ineligible securities underwritten or dealt in by an affiliated underwriting subsidiary unless the bank or thrift notifies the customer that the underwriting subsidiary is underwriting, making a market, distributing or dealing in the security.

1987 and 1990 Order. The *1987 Order* was substantially the same. The *1990 Order* applied the same restrictions to U.S. affiliates and branches and agencies of foreign banks.

Request for Comment. The Board proposes to retain this restriction. An SEC rule (Rule 10b–10) and NASD rule (Rule 2250) require a broker-dealer to disclose to a customer that it is a market maker in a security before selling or recommending that security. These restrictions are based on the conflict of interest between the broker-dealer's duty to advise its customers and its financial interest in selling its security. The firewall extends this restriction to an affiliated bank based on the concern that it would have a similar financial incentive to give advice that would benefit its affiliate. A disclosure to the customer appears to be a sufficient means of addressing that conflict. Accordingly, the proposal retains this requirement, combining it with another disclosure standard.

Nonetheless, the Board is concerned with the difficulty of complying with, and examining for compliance with, this standard, particularly with respect to large bank holding companies operating around the world. The Board seeks comment on whether a bank or thrift should only be prohibited from expressing an opinion without disclosure if it knows of its affiliate's role in the transaction. The Board also seeks comment on whether, with this knowledge requirement or without it, this standard is enforceable.

Firewall 18 (Restriction on Fiduciary Purchases During Underwriting Period or From Market Maker)

Text of 1989 Order. No Applicant nor any of its bank, thrift, or trust or investment advisory subsidiaries shall purchase, as a trustee or in any other fiduciary capacity, for accounts over which they have investment discretion ineligible securities (a) underwritten by the underwriting subsidiary as lead underwriter or syndicate member during the period of any underwriting or selling syndicate, and for a period of 60 days after the termination thereof, and (b) from the underwriting subsidiary if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.

1987 and 1990 Order. The *1987 Order* did not restrict purchases of securities in which the section 20 subsidiary makes a market but was otherwise the same. The *1990 Order* applied the same restrictions to U.S. affiliates and branches and agencies of foreign banks.

Request for Comment. The Board proposes to eliminate this restriction. Section 23B(b)(1)(B) of the Federal Reserve Act largely duplicates the restrictions of Firewall 18 when a bank or thrift is making the purchase.[17] Section 23B prohibits a bank from purchasing, as principal or fiduciary, any security for which a section 20 affiliate is a principal underwriter during the existence of the underwriting or selling syndicate, unless such a purchase has been approved by a majority of the bank's board of directors who are not officers of any bank or any affiliate. If the purchase is as fiduciary, the purchase must be permitted by the instrument creating the fiduciary relationship, court order, or state law.

Firewall 18 is broader than section 23B in that it applies for 60 days after the underwriting period. The Board does not believe that it should reimpose a restriction that Congress decided was unnecessary, and is not aware of any compelling reason to do so.

Firewall 18 is also broader than section 23B in that the firewall applies when a bank holding company or its nonbank subsidiary acting as fiduciary purchases the securities. However, if the purchases are fiduciary, the Board believes that other protections remain. For example, if the purchase were on behalf of a pension plan, then the company would be subject to ERISA.[18] If the purchase were on behalf of a mutual fund, then sections 10 and 17 of

[16] This firewall was rescinded. 61 FR 57679, 57683 (1996).

[17] In its 1987 order, the Board noted that section 23B was pending as proposed legislation, and appears to have created the firewall in anticipation of that legislation.

[18] 29 U.S.C. 1002(21), 1104.

the Investment Company Act of 1940 restrict the ability of the mutual fund to purchase securities from an affiliate of the investment advisor.[19]

VII. Extensions of Credit and Purchases and Sales of Assets

Firewall 19 (Restrictions on Purchases as Principal During Underwriting Period or From Market Maker)

Text of 1989 Order (as amended). No Applicant nor any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, or shall purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.

In the case of ineligible securities that are being issued in a simultaneous cross-border underwriting in which the underwriting subsidiary and a foreign affiliate or affiliates are participating, such securities may be purchased or sold pursuant to an inter-syndicate agreement for the period of the underwriting where the purchase or sale results from *bona fide* indications of interest from customers. Such purchases or sales shall not be made for the purpose of providing liquidity or capital support to the underwriting subsidiary or otherwise to evade the requirements of this Order. An underwriting subsidiary shall maintain documentation on such transactions.[20]

1987 and 1990 Order. The *1987 Order* was the same. The *1990 Order* was substantially the same.

Request for Comment. The Board proposes to eliminate this restriction, which precludes bank and nonbank subsidiaries of a bank holding company subsidiary from obtaining attractive issues underwritten or dealt in by a section 20 affiliate. As with Firewall 18, section 23B prohibits a bank from purchasing, as principal or fiduciary, any security for which a section 20 affiliate is a principal underwriter during the existence of the underwriting or selling syndicate, unless such a purchase has been approved by a majority of the bank's board of directors who are not officers of the bank or any affiliate. Since 1989, the Board has authorized bank holding companies engaged in private placement activities to place up to 50 percent of an issue of securities with their nonbank affiliates,[21] and no supervisory concerns have arisen from this practice.

Furthermore, if the bank purchases the security as principal directly from the section 20 affiliate, section 23A would apply. The bank would also be required to hold capital against these exposures. Finally, member banks are limited to purchasing only investment securities.[22]

Firewall 20 (Restriction on Underwriting and Dealing in Affiliates' Securities)

Text of 1989 Order (as amended).[23] An underwriting subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interest in, or secured by, obligations originated or sponsored by its affiliates (except for grantor trusts or special purpose corporations created to facilitate underwriting of securities backed by residential mortgages originated by a non-affiliated lender). An underwriting subsidiary may underwrite or deal in ineligible securities issued by (or representing interests in, or secured by, obligations of) affiliates provided the securities are (1) rated by an unaffiliated, nationally recognized statistical rating organization, or (2) issued or guaranteed by FNMA, FHLMC or GNMA (or represent interests in securities issued or guaranteed by FNMA, FHLMC, or GNMA).

1987 and 1990 Order. Same.

Request for Comment. The Board proposes to eliminate this restriction, which prohibits a section 20 affiliate from underwriting securities issued by an affiliated bank. The purpose of the restriction was to address the conflicts of interest presented because a section 20 subsidiary may have an incentive to overstate the quality of the securities being issued by its affiliate.

However, Rule 2720 of the National Association of Securities Dealers already imposes substantially the same restriction. Rule 2720, to which section 20 subsidiaries are subject, provides that if a member of the NASD proposes to underwrite, participate as a member of the underwriting syndicate or selling group, or otherwise assist in the distribution of a public offering of its own or an affiliate's securities, then the price or yield of the issue must be set by a qualified independent underwriter who shall also participate in the preparation of the registration statement and prospectus, offering circular, or similar document, exercising due diligence.

Furthermore, the Board previously has granted waivers from Firewall 20 to allow section 20 subsidiaries to underwrite equity securities issued by affiliates.[24] In granting these waivers the Board relied in each case on the fact that there were independent sources, such as third-party underwriters acting as syndicate managers, judging the creditworthiness and pricing of the securities offered.

Firewall 21(a) (Prohibition on Extensions of Credit to Section 20 Subsidiary)

Text of 1989 Order. Applicants shall assure that no bank or thrift subsidiary shall, directly or indirectly, extend credit in any manner to an affiliated underwriting subsidiary or a subsidiary thereof; or issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of the underwriting subsidiary or a subsidiary thereof.

1987 and 1990 Order. This restriction was not contained in the *1987 Order.*

The *1990 Order* applied the same restrictions to U.S. bank and thrift subsidiaries and branches and agencies of foreign banks.

Request for Comment. The Board proposes to eliminate this restriction except insofar as it applies to intra-day extensions of credit for clearing purposes. The purpose of the restriction was to prevent any bank funding of a section 20 affiliate.

Because this firewall was not applied under the *1987 Order,* bank subsidiaries of the fourteen companies operating under that order have therefore been free to, and have in fact, funded their section 20 affiliates. In nine years of supervising companies operating under the 1987 Order, the Board has not encountered significant problems arising from such funding.

Such transactions are subject to sections 23A or 23B of the Federal Reserve Act, which address potential conflicts of interest. Thus, even if the firewall were repealed, a bank would not be able to expose more than 10 percent of its capital to the section 20 affiliate directly, would have to deal with the section 20 affiliate on arm's-length (market) terms, could not purchase low-quality assets from the affiliate, and could not purchase securities underwritten by a section 20

[19] 15 U.S.C. 80a–10, 80a–17.

[20] *1990 Order* at 158, 164–65, 172 (1990).

[21] *J.P. Morgan & Co.,* 76 Federal Reserve Bulletin 26, 28 (1990).

[22] 12 U.S.C. 24(Seventh), 335.

[23] 75 Federal Reserve Bulletin 751 (1989).

[24] *See* Letter, dated May 2, 1996, from Jennifer J. Johnson, Deputy Secretary of the Board to Thomas A. Plant; Letter, dated January 6, 1994, from Jennifer J. Johnson, Associate Secretary of the Board to Kevin Barnard, Esq.

affiliate during the existence of the underwriting or selling syndicate unless the bank's board of directors approves.[25]

One issue arises with respect to whether intra-day extensions of credit should continue to be restricted. The Board proposes to include an operating standard prohibiting intra-day extensions of credit for clearing purposes unless they are (1) On market terms consistent with section 23B of the Federal Reserve Act, and (2) fully secured. In effect, the Board would be requiring that (1) The bank apply the same internal exposure limits and collateral requirements in clearing for a section 20 affiliate that it applies to third parties, and (2) even if its general policy does not require the bank to be fully secured in clearing, the bank be fully secured in clearing for its section 20 affiliate. The Board seeks comment on whether the latter requirement is feasible.

Firewall 21(b)

Text of 1989 Order. This prohibition shall not apply to an extension of credit by a bank or thrift to an underwriting subsidiary that is incidental to the provision of clearing services by the bank or thrift to the underwriting subsidiary with respect to securities of the United States or its agencies, or securities on which the principal and interest are fully guaranteed by the United States or its agencies, if the extension of credit is fully secured by such securities, is on market terms, and is repaid on the same calendar day. If the intra-day clearing of such securities cannot be completed because of a *bona fide* fail or operational problem incidental to the clearing process that is beyond the control of the bank or thrift and the underwriting subsidiary, the bank or thrift may continue the intra-day extension of credit overnight provided the extension of credit is fully secured as to principal and interest as described above, is on market terms, and is repaid as early as possible on the next business day.

1987 and 1990 Orders. No exception was necessary in the *1987 Order.* The *1990 Order* contained the same exception.

Request for Comment. If Firewall 21(a) were eliminated, the Board would propose to eliminate Firewall 21(b) as moot.

Firewall 22 (Financial Assets Restriction)

Text of 1989 Order (as amended).[26] No bank or thrift (or U.S. branch or agency of a foreign bank) shall, directly or indirectly, for its own account, purchase financial assets of an affiliated underwriting subsidiary or a subsidiary thereof or sell such assets to the underwriting subsidiary or subsidiary thereof. This limitation shall not apply to the purchase and sale of assets having a readily identifiable and publicly available market quotation and purchased at that market quotation for purposes of section 23A of the Federal Reserve Act, 12 U.S.C. 371c(d)(6), provided that those assets are not subject to a repurchase or reverse repurchase agreement between the underwriting subsidiary and its bank or thrift affiliate.

1987 and 1990 Orders. The *1990 Order* is the same. The *1987 Order* did not include a financial assets restriction.

Request for Comment. The Board proposes to eliminate this firewall, which is designed to prevent a bank from using purchases and sales as a means of funding a section 20 affiliate. Section 23B of the Federal Reserve Act would still require that all such purchases be made on arm's-length terms, and section 23A would impose quantitative limits. Section 23A(a)(3) also generally prohibits a bank from purchasing a low-quality asset from an affiliate. A "low-quality asset" is defined to include: (A) An asset classified as "substandard", "doubtful", or "loss" or treated as "other loans especially mentioned" in the section 20 affiliate's most recent report of examination or inspection; (B) an asset in a non-accrual status; (C) an asset on which principal or interest payments are more than thirty days past due; or (D) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.[27] Moreover, the National Bank Act limits the type of investment securities that a national bank may hold, generally to investment grade securities.

Elimination of this restriction would allow repurchase and reverse repurchase agreements as a funding vehicle between a section 20 subsidiary and its affiliated banks. Such agreements would have to be consistent with sections 23A and 23B, however.

VIII. Limitations on Transfers of Information

Firewall 23 (Disclosure of Nonpublic Information)

Text of 1989 Order. No bank or thrift shall disclose to an underwriting subsidiary, nor shall an underwriting subsidiary disclose to an affiliated bank or thrift, any nonpublic customer information (including an evaluation of the creditworthiness of an issuer or other customer of that bank or thrift, or underwriting subsidiary) without the consent of that customer.

1987 and 1990 Order. The *1987 Order* was substantially the same. The *1990 Order* applied the same restrictions to U.S. bank and thrift subsidiaries and branches and agencies of foreign banks.

Request for Comment. The Board proposes to include this restriction in its operating standards, as it constitutes an important customer protection.

IX. Reports

Firewall 24 (Reports to Federal Reserve)

Text of 1989 Order. Applicants shall submit quarterly to the appropriate Federal Reserve Bank FOCUS reports filed with the NASD or other self-regulatory organizations, and detailed information breaking down the underwriting subsidiaries' business with respect to eligible and ineligible securities, in order to permit monitoring of the underwriting subsidiaries' compliance with the provisions of this Order.

1987 and 1990 Order. Same.

Request for Comment. The Board proposes to retain this requirement in modified form as one of the operating standards.

X. Transfer of Activities and Formation of Subsidiaries of an Underwriting Subsidiary To Engage in Underwriting and Dealing

Firewall 25 (Scope of Order)

Text of 1989 Order. The Board's approval of the proposed underwriting and dealing activities extends only to the subsidiaries described above for which approval has been sought in the instant applications. The activities may not be conducted by Applicants in any other subsidiary without prior Board

[25] The Board is proposing to impose a new operating standard that applies sections 23A and 23B to U.S. branches and agencies of foreign banks for this purpose. Currently, branches and agencies are not covered by these requirements, most notably the collateral requirement of section 23A. This exemption has not given section 20 affiliates of foreign banks any material competitive advantage over their domestic counterparts; generally, *all* lending has been prohibited by Firewall 21(a). However, if that firewall were removed in reliance on sections 23A and 23B, foreign banks would have a competitive advantage unless those provisions were applied to their branches and agencies, as their branches and agencies could fund a section 20 affiliate without requiring collateral. With respect to foreign banks operating under the *1990 Order*, the proposal represents relief from a restriction. Although this proposal would impose new requirements on foreign banks operating under the *1987 Order*, the Board specifically reserved its right to impose new restrictions should circumstances change to make such requirements appropriate. *See Sanwa Bank, Ltd.*, 76 Federal Reserve Bulletin 568, 570 (1990).

[26] 61 FR 57679, 57683 (1996).

[27] 12 U.S.C. 371c (a)(3), (b)(10).

review. Pursuant to Regulation Y, no corporate reorganization of any underwriting subsidiary, such as the establishment of subsidiaries of the underwriting subsidiary to conduct the activities, may be consummated without prior Board approval.

1987 and 1990 Order. Same.

Request for Comment. The Board proposes to eliminate this firewall. Each order approving section 20 activities can make plain the scope and organizational structure of the activities approved.

XI. Limitations on Reciprocal Arrangements and Discriminatory Treatment

Firewall 26 (Prohibition on Reciprocity Arrangements)

Text of 1989 Order. No Applicant nor any of its subsidiaries may, directly or indirectly, enter into any reciprocal arrangement. A reciprocal arrangement means any agreement, understanding, or other arrangement under which one bank holding company (or subsidiary thereof) agrees to engage in a transaction with, or on behalf of, another bank holding company (or subsidiary thereof), in exchange for the agreement of the second bank holding company (or any subsidiary thereof) to engage in a transaction with, or on behalf of, the first bank holding company (or any subsidiary thereof) for the purpose of evading any requirement of this Order or any prohibition on transactions between, or for the benefit of, affiliates of banks established pursuant to federal banking law or regulation.

1987 and 1990 Order. The *1990 Order* is the same, but the restriction is not included in the *1987 Order.*

Request for Comment. The Board proposes to eliminate this firewall. Anti-competitive reciprocity arrangements are prohibited by the antitrust laws, and reciprocity arrangements involving a bank are subject to a special *per se* prohibition in section 106 of the Bank Holding Company Act Amendments of 1970.[28] The Board could also rely on the examination process to identify any evasions of the proposed operating standards that do not run afoul of a statutory prohibition.

Firewall 27 (Prohibition on Discriminatory Treatment)

Text of 1989 Order. No bank or thrift affiliate of an underwriting subsidiary shall, directly or indirectly:

(a) acting alone or with others, extend or deny credit or services (including clearing services), or vary the terms or conditions thereof, if the effect of such action would be to treat an unaffiliated securities firm less favorably than its affiliated underwriting subsidiary, unless the bank or thrift demonstrates that the extension or denial is based on objective criteria and is consistent with sound business practices; or

(b) extend or deny credit or services or vary the terms or conditions thereof with the intent of creating a competitive advantage for an underwriting subsidiary of an affiliated bank holding company.

1987 and 1990 Order. This restriction is not contained in the *1987 Order.* The *1990 Order* applied the same restrictions to U.S. affiliates and branches and agencies of foreign banks.

Request for Comment. This firewall addresses a potential conflict of interest that arises when a bank is dealing with competitors of its section 20 affiliate. The firewall prohibits the bank from denying services to such competitors or charging them higher prices than it would charge its affiliate. The Board is proposing to eliminate the firewall because other laws adequately address the potential conflict.

First, the Board notes that whereas securities firms had been restricted by section 8(a) of the Securities Exchange Act of 1934 in the types of lenders from which they could obtain loans secured by securities collateral—generally, to banks and other broker-dealers—section 8(a) was recently repealed, and such restriction thereby eliminated.[29] Thus, the possibility that a bank would be able to enforce unfavorable credit terms on a competitor of a section 20 affiliate is remote.

Second, section 106 of the Bank Holding Company Act Amendments of 1970 prohibits a bank from, among other things, restricting availability of, or offering discounts on, its products on the condition that the customer not obtain products from any competitor of the bank or its affiliates.

XII. Requirement for Supervisory Review Before Commencement of Activities

Firewall 28 (Infrastructure Review)

Text of 1989 Order. An Applicant may not commence the proposed debt and equity securities underwriting and dealing activities until the Board has determined that the Applicant has established policies and procedures to ensure compliance with the requirements of this Order, including computer, audit and accounting systems, internal risk management controls and the necessary operational and managerial infrastructure. In this regard, the Board will review in one year whether Applicants may commence underwriting and dealing in equity securities based on a determination by the Board that they have established the managerial and operational infrastructure and other policies and procedures necessary to comply with the requirements of this Order.

1987 and 1990 Order. The *1987 Order* does not contain this restriction. The *1990 Order* contains the same restriction.

Request for Comment. The purpose of this restriction is to ensure that a bank holding company has the necessary systems, internal controls, and infrastructure to operate a section 20 subsidiary. The Board believes that these systems are vital to the successful operation of a section 20 subsidiary. However, because the Board and not the section 20 subsidiary performs the review, the Board intends to require an infrastructure review in the context of each application rather than including it as an "operating standard" for section 20 subsidiaries.

The Board generally will continue to conduct an inspection prior to allowing commencement of underwriting and dealing in corporate debt or equity securities pursuant to the *1989 Order.* In special cases such as an acquisition, the inspection will occur as soon as practicable after consummation. Although the existing firewall suggests that a review of the infrastructure for equity securities activities might not occur for a year after approval of an application, the Board has substantially modified and shortened the pre-approval inspection period for equity securities activities. Such inspections now frequently begin shortly after the filing of an application, and may be completed before the application is considered by the Board. Thus, the pre-commencement examination generally does not create a substantial delay beyond the application processing period.

List of Subjects 12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding Companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, the Board proposes to amend 12 CFR Part 225 as follows:

[28] 12 U.S.C. 1972(1).

[29] 15 U.S.C. 78h(a) (1995); National Securities Markets Improvement Act of 1996, Pub. L. 104–290 (1996).

PART 225—BANK HOLDING COMPANIES 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, 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3310, 3331–3351, 3908, and 3909.

2. An undesignated center heading and § 225.200 would be added to read as follows:

Conditions to Orders

§ 225.200 Conditions to Board's section 20 Orders.

(a) *Introduction.* Section 20 of the Glass-Steagall Act and section 4(c)(8) of the Bank Holding Company Act allow subsidiaries of bank holding companies to engage to a limited extent in underwriting and dealing in securities in which a member bank could not engage. Pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934, these so-called section 20 subsidiaries are required to register with the SEC as broker-dealers and are subject to all the financial reporting, anti-fraud and financial responsibility rules applicable to broker-dealers. In addition, member banks are restricted in their transactions with section 20 affiliates by sections 23A and 23B of the Federal Reserve Act. The Board expects a section 20 subsidiary, like any other subsidiary of a bank holding company, to be operated prudently. Doing so would include observing corporate formalities (such as the maintenance of separate accounting and corporate records), maintaining adequate capital, and instituting appropriate risk management, including independent trading and exposure limits consistent with parent company guidelines. However, given the unique risks of affiliation between a section 20 subsidiary and a depository institution, the Board particularly expects the bank holding company to ensure that its subsidiary banks are well capitalized, and requires adherence to the following operating standards as a condition to each order approving establishment of a section 20 subsidiary.

(b) *Conditions.*—(1) *Capital.* (i) The bank holding company or foreign bank shall maintain adequate capital on a fully consolidated basis.

(ii) In the event that a bank or thrift affiliate of a section 20 subsidiary shall become less than well capitalized (as defined in section 38 of the Federal Deposit Insurance Act), and the bank holding company or foreign bank shall fail to restore it promptly to the well capitalized level, the Board may reimpose the funding, credit extension and credit enhancement firewalls contained in its 1989 order allowing underwriting and dealing in bank-ineligible securities.[1]

(2) *Internal controls.* (i) Each bank holding company or foreign bank shall cause its subsidiary banks, thrifts, and U.S. branches and agencies to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in transactions underwritten or arranged by a section 20 affiliate.

(ii) Each bank holding company or foreign bank shall ensure that an independent and thorough credit evaluation has been undertaken in connection with bank, thrift, or U.S. branch or agency participation in such financing transactions, and that adequate documentation of that evaluation is maintained for review by examiners of its appropriate Federal banking agency and the Federal Reserve.

(3) *Interlocks restriction.* Directors, officers or employees of a bank holding company's or foreign bank's U.S. bank or thrift subsidiaries, branches or agencies shall not serve as a majority of the board of directors or the chief executive officer of an affiliated section 20 subsidiary, and directors, officers or employees of a section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer[2] of an affiliated U.S. bank or thrift subsidiary, branch or agency, except that the manager of a branch or agency may act as a director of the underwriting subsidiary.

(4) *Customer disclosure.* A section 20 subsidiary shall provide each of its retail customers the disclosures, and obtain the customer acknowledgement, required by the Interagency Statement on Retail Sales of Nondeposit Investment Products, even when the section 20 subsidiary is dealing with the customer off bank premises. An affiliated bank or thrift institution may not express an opinion on the value or the advisability of the purchase or the sale of ineligible securities underwritten or dealt in by an affiliated underwriting subsidiary unless the bank or thrift notifies the customer that the underwriting subsidiary is underwriting, making a market, distributing or dealing in the security.

(5) *Credit for clearing purposes.* Any intra-day extension of credit for purposes of clearing securities that is extended to a section 20 subsidiary by an affiliated bank, thrift, branch or agency shall be:

(i) On market terms consistent with section 23B of the Federal Reserve Act; and

(ii) Fully secured.

(6) *Confidentiality of customer information.* A section 20 subsidiary and its affiliated banks, thrifts, branches or agencies shall not share with each other any nonpublic customer information without the consent of that customer.

(7) *Reporting requirement.* Each bank holding company or foreign bank shall submit quarterly to the appropriate Federal Reserve Bank FOCUS reports filed with the NASD or other self-regulatory organizations, and information necessary to monitor compliance with these operating standards and section 20 of the Glass-Steagall Act, on forms provided by the Board.

(8) *Foreign banks.* A foreign bank shall ensure that any extension of credit by its U.S. branch or agency to a section 20 affiliate, and any purchase by such branch or agency, as principal or fiduciary, of securities for which a section 20 affiliate is a principal underwriter, conforms to sections 23A and 23B of the Federal Reserve Act, and that its branches and agencies not advertise nor suggest that they are responsible for the obligations of a section 20 affiliate, consistent with section 23B(c) of the Federal Reserve Act.

(c) *Establishment of additional limitations.* Based upon the supervisory process and experience with the activities, the Board may establish additional limitations on the conduct of these activities to ensure that the section 20 subsidiaries' activities are consistent with safety and soundness, conflict of interest and other considerations relevant under the Bank Holding Company Act.

By order of the Board of Governors of the Federal Reserve System, January 10, 1997.

William W. Wiles,

Secretary of the Board.

[FR Doc. 97–1010 Filed 1–16–97; 8:45 am]

BILLING CODE 6210–01–P

[1] Firewalls 5–8, 19, 21 and 22 of *J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp.*, 75 Federal Reserve Bulletin 192, 214–16 (1989) and, for foreign banks, *Canadian Imperial Bank of Commerce, The Royal Bank of Canada, Barclays PLC and Barclays Bank PLC*, 76 Federal Reserve Bulletin 158, (1990). The Federal Reserve Bulletin is available for sale from Publication Services—Mail Stop 127, Board of Governors of the Federal Reserve System, Washington, DC 20551.

[2] For purposes of this standard, the manager of a U.S. branch or agency of a foreign bank normally will be considered to be the chief executive officer of the branch or agency.