SECURITIES UNDERWRITING ACTIVITIES BY SECTION 20
SUBSIDIARIES OF BANK HOLDING COMPANIES

Proposed Alternative Methods to Measure Compliance
With the “Engaged Principally” Test of Section 20
of the Glass-Steagall Act

Comments Requested by August 12

To All Bank Holding Companies, Branches
and Agencies of Foreign Banks, and Others
Concerned, in the Second Federal Reserve District:

The following statement has been issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has requested public comment on a proposal to provide an alternative to the current test used to measure whether a section 20 subsidiary is in compliance with the “engaged principally” criterion of section 20 of the Glass-Steagall Act. Section 20 prohibits a member bank from being affiliated with a company that is “engaged principally” in underwriting and dealing in ineligible securities.

Comment is requested by August 12, 1994.

The current test is based on the revenue earned from ineligible securities activities relative to the total revenue of the section 20 subsidiary. This proposal arises now due to the Board’s increased experience in reviewing and monitoring the operations and activities of section 20 subsidiaries and in order to allow these subsidiaries additional flexibility in the conduct of their securities operations. The Board is requesting comment on whether asset values or sales volume data, or a combination of both measures, should be used as a new alternative test.

Printed on the following pages is the text of the proposal, which has been published in the Federal Register of July 12. Comments thereon should be submitted by August 12, and may be sent to the Board of Governors, as specified in the notice, or to our Banking Applications Department.

WILLIAM J. MCDONOUGH,
President.
FEDERAL RESERVE SYSTEM

10 Percent 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: Request for comments.

SUMMARY: In 1987 and 1989 the Board authorized bank holding companies to establish separate nonbank subsidiaries ("section 20 subsidiaries") to underwrite and deal in securities that a bank may not underwrite and deal in directly ("ineligible securities"). In order to ensure compliance with section 20 of the Glass-Steagall Act (12 U.S.C. 377), the Board required that the amount of revenue a section 20 subsidiary derives from ineligible securities underwriting and dealing activities may not exceed 10 percent of the total revenue of the subsidiary. Section 20 prohibits a member bank of the Federal Reserve System from being affiliated with a company that is "engaged principally" in underwriting and dealing in securities.

In January 1993, after notice and the opportunity for public comment, the Board authorized section 20 subsidiaries to use an alternative indexed method to compute compliance with the 10 percent revenue limitation to account for unusual changes in the level and structure of interest rates since 1989, when the 10 percent limit was adopted. When the Board adopted the indexed revenue test, the Board deferred adoption of another alternative test for the 10 percent limit that would be based on assets, rather than revenue.

Inasmuch as the Board has had increased experience in reviewing and monitoring the operations and activities of the section 20 subsidiaries, and in order to allow these subsidiaries additional flexibility in the conduct of their securities operations, the Board now proposes to modify its orders approving the establishment of the section 20 subsidiaries to allow such subsidiaries the option of using an alternative measure to the revenue-based tests for assessing compliance with the 10 percent limit. The Board requests comment on whether asset values, sales volume data, or both measures should be used as a new alternative to the revenue test.

DATES: Comments must be received by August 12, 1994.

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: 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), Dorthes Thompson (202/452–3544), Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

1. Background

A. Ten Percent Limit on Ineligible Securities Activities of Section 20 Subsidiaries

Beginning with orders issued in 1987, the Board has authorized bank holding companies to establish nonbank subsidiaries ("section 20 subsidiaries") to underwrite and deal in securities that a bank may not underwrite and deal in directly ("ineligible securities"). In order to assure compliance with section 20 of the Glass-Steagall Act, the Board limited the amount of ineligible securities that these section 20 subsidiaries could underwrite and deal in. Section 20 provides that a member bank may not be affiliated with a company that is "engaged principally" in underwriting and dealing in securities. In particular, the Board


12 U.S.C. 377. The Board and the courts have ruled that section 20 does not prohibit a member bank from being affiliated with a company that is engaged principally in underwriting and dealing in securities that banks may underwrite and deal in directly ("eligible securities"). See Citicorp, supra.
determined that a bank affiliate would not be "engaged principally" in ineligible securities activities for purposes of section 20 if those activities were not substantial relative to the other activities of the subsidiary. The Board ruled that ineligible securities activities are not a substantial part of a subsidiary's business if the gross revenue derived from those activities does not exceed 10 percent of the total gross revenues of the subsidiary, when revenue is averaged over a rolling 8-quarter period. Subject to this limitation, the Board has approved the establishment of over 30 section 20 subsidiaries, several of which are authorized to underwrite and deal in debt and equity securities generally.

B. Adoption of Alternative Indexed Revenue Test

In July 1992, the Board proposed to establish two alternative methods that a section 20 subsidiary could elect to use to determine compliance with the 10 percent limit on ineligible securities activities in place of the gross revenue test.1 In proposing these alternative tests, the Board noted that historically unusual changes in the level and structure of interest rates have distorted the revenue test as a measure of the relative importance of ineligible securities activities in a manner that was not anticipated when the 10 percent limit was adopted in 1989.2 To address this problem, the Board first proposed an alternative revenue test indexed to interest rate changes that would allow for adjustment of the current revenue of a section 20 subsidiary to account for the unanticipated interest rate conditions. In January 1993, the Board adopted an optional alternative indexed revenue test.3

C. Proposed Asset-Based Test

At the same time that the indexed revenue test was proposed, the Board also proposed an alternative asset-based test. Specifically, the Board proposed that the 10 percent limit would be computed by using average daily assets held in connection with ineligible securities activities and with other activities. The Board recognized that in 1987, when it initially decided to use revenue as the appropriate measure of the section 20 limit on ineligible securities activities, the Board had expressed two concerns about a test based on average assets. One concern was that an asset-based test might be manipulated, for example, through "matched book" repurchase and reverse repurchase agreements for government securities. The second concern was that an average asset test, even if computed on a daily basis, would not include securities that were underwritten by the section 20 subsidiary but that were held only for a few hours, which is typical in many underwriting transactions. Accordingly, when the Board proposed an alternative asset-based test in 1992, the Board requested comment on possible modifications to address these concerns.

A number of banking organizations commenting on the Board’s proposal supported adoption of an asset-based alternative measure for computing the 10 percent limit. These comments stated that, like the indexed revenue proposal, a limit based on assets would be less susceptible than the unadjusted revenue test to unusual changes in interest rate conditions. Those supporting the asset-based test also stated that this test would be easier and less costly to apply than a measure that required adjustments to revenue data and would allow for greater predictability in the management of the operations of the subsidiary.

Many commenters also opposed establishing any specific restrictions to address the potential for manipulative transactions. These commenters believed that the capital and funding requirements needed to support such transactions, as well as earnings considerations and market-imposed credit risk constraints, would effectively curtail the excessive use of asset transactions conducted solely to increase the level of eligible assets. Commenters also observed that implementation of such separate limits would be difficult in practice.

On the question of the treatment of intra-day holdings of securities that are being underwritten, while there was some support for including the value of such securities for purposes of applying an asset-based test, other comments opposed counting the value of such holdings on the grounds that the 10 percent limit should measure only assets that pose a risk to the section 20 subsidiary.

After considering these comments, the Board decided to defer adoption of an alternative asset-based test, noting that the Board was not then able to assess the potential practical effect of the test.

II. Proposed Alternative Test

A. Need for an Improved Alternative to the Gross Revenue Test

Since the decision to defer consideration of the asset-based test, the Board has had a greater opportunity to review and analyze the operations of section 20 subsidiaries. At the outset, the Board notes that, during this time period and in the entire seven year period since the Board first approved the creation of section 20 subsidiaries, the Board has not uncovered evidence of unsafe or unsound practices, conflicts of interest, or other conduct related to the operations of these subsidiaries that has impaired the condition of the affiliated depository institutions or the banking organizations as a whole. The available evidence further suggests that these subsidiaries have exerted a beneficial procompetitive influence on the securities markets in which they compete.

When the section 20 subsidiaries were first authorized, the Board selected revenue, rather than asset values or sales volume, as the best overall measure of ineligible securities activities because the Board believed that such a test would pose the fewest operational difficulties and provide the most accurate indication of the relative importance of specific activities. The Board also noted that although the applicants had argued that a variety of factors could be used to judge "engaged principally" status, a single uniform standard was desirable.4 However, subsequent events have shown that the susceptibility of results from the gross revenue measure to distortion caused by changes in interest rate conditions casts doubt on the appropriateness of that test. Although the indexed revenue test addresses these concerns, it necessarily involves increased operational difficulties. For some section 20 subsidiaries, the costs and resources needed to implement the indexed revenue test, with the need for complicated duration models and the calculation of the duration of all

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2 The Board pointed out that, in contrast to conditions in 1989, there was an unusually wide difference between short- and long-term rates. Since eligible securities tend to be shorter term than ineligible securities, the unusually sharp increase in the steepness of the yield curve had the effect of making it appear, based on revenue data, that the eligible securities activities of at least some section 20 subsidiaries had been reduced, even though the relative proportion of eligible and ineligible securities activities being conducted by those subsidiaries remained essentially the same.
3 79 Federal Reserve Bulletin 228 (1993). 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 based on the average duration of a section 20 subsidiary’s eligible and ineligible securities portfolio. The adjustment factors, which vary according to specific time periods of average duration, represent the ratio of interest rates on Treasury securities in the most recent quarter to those in September 1989.
4 Citicorp, supra. 73 Federal Reserve Bulletin at 494.
securities in a section 20 subsidiary’s portfolio on a regular basis, may provide a disincentive for using that test.\(^7\)

Accordingly, and in order to provide additional flexibility to section 20 subsidiaries in the conduct of authorized activities, the Board now believes it is desirable to consider adoption of another optional measure in addition to revenue for applying 10 percent limit on ineligible securities activities. The Board believes that either asset values or sales volume, or a combination of both measures, should be considered as a new alternative measure.

**B. Asset-Based Test as an Alternative Measure**

Any asset-based test would limit a section 20 subsidiary’s average daily assets held in connection with underwriting and dealing in ineligible securities to 10 percent of its total average daily assets, computed on a rolling 8-quarter basis. Because, as the Board observed when an asset-based test was previously proposed, a measure relying on asset values would be less sensitive to unanticipated changes in interest rate conditions than a test based on revenues, such a test would address these distortions. Also, it appears that for at least some section 20 subsidiaries a test relying on asset values may be easier in practice to apply than the indexed revenue test. Moreover, as explained below, in light of its greater experience with the operations of the section 20 subsidiaries, the Board is now of the view that the concerns previously expressed about the operation of an asset-based test can be appropriately mitigated.

The Board believes that the use of assets acquired in connection with particular types of securities activities may represent a permissible measure of compliance with the statutory limitation in section 20 on ineligible securities activities. Asset values do provide a rough approximation of risk to the section 20 subsidiary, and risk to banking organizations was one of the concerns behind passage of the Glass-Steagall Act. The Board notes that the New York State Banking Department, in applying a state law restriction on the level of ineligible securities activities of affiliates of state-chartered banks, allows the use of either assets or revenue as a measure of compliance with the law.\(^8\)

Underwriting

The Board believes that, if an asset-based test is adopted as an alternative measure, the value of any securities underwritten by a subsidiary would have to be accounted for in computing average daily assets, even where the securities are disposed of prior to the end of the day. The literal language of section 20 covers any underwriting activity. Thus, under the proposed asset-based test, if securities underwritten by a section 20 subsidiary are recorded as assets of the subsidiary, but are disposed of before the end of the day on which underwriting activity takes place, then the securities would be treated as if they were carried as assets on the books of the subsidiary as of the end of that day. If securities are underwritten by the section 20 subsidiary on a “best efforts” or agency basis the securities would be treated as assets of the subsidiary for each day that underwriting activity occurs with respect to that particular security.\(^9\)

Anti-Manipulation Limits

Should an asset-based test be adopted as an alternative measure, the Board does not propose that any specific limits be incorporated to address the potential for manipulative transactions carried out solely to inflate artificially a section 20 subsidiary’s base of eligible assets. Many of the comments on the previously proposed asset-based test stated that there are sufficient financial and market constraints on the holding of excessive eligible securities solely to support increased ineligible securities activities. Even in the case of matched book-type transactions, counterparties typically impose limits on the amount of transactions they will engage in with any particular section 20 subsidiary, in order to control credit risk. The Board’s minimum consolidated leverage ratio and the SEC’s net capital rule, which is applicable to a section 20 subsidiary, would impose additional constraints. In addition, the acquisition of significant amounts of eligible securities by a section 20 subsidiary in matched book or similar transactions would also tend to have an overall negative impact on the earnings performance of the consolidated bank holding company organization, given the small profit margins typical in such transactions. Finally, the Board believes that it has the authority to take appropriate corrective action where manipulative transactions are detected.

**C. Sales Volume Test as Alternative Measure**

The Board is also requesting comment on adoption of sales volume as an alternative measure. If sales volume data is used as the measure of an alternative test for applying the 10 percent limit, then the dollar volume of a section 20 subsidiary’s sales of ineligible securities as a result of underwriting and dealing in such securities could not be allowed to exceed 10 percent of its total sales volume over a rolling 8-quarter period. The Board believes that the value of various types of securities and other assets sold by a section 20 subsidiary bears a relationship to the subsidiary’s level of activity with respect to each type of security or other asset. Use of such data is thus consistent with the statutory requirements. Under a sales volume test, intra-day transactions like underwriting and dealing sales would be automatically covered, even if the assets involved were not recorded on the subsidiary’s books at the end of the day. In addition, like an asset-based test, a sales volume test would be less sensitive to changes in interest rate relationships. Such a test may also be easier to comply with than the current alternative of indexed revenues.

**Repurchase Transactions and Other Sales Transactions**

One question raised by the use of sales volume as a test of the 10 percent limit is whether securities repurchase agreements (“repo transactions”) should be treated as “sales” and therefore covered under such a test. Repo transactions are hybrids, having some characteristics of collateralized lending and some characteristics of an outright sale of securities. The Federal Reserve, for purposes of open market operations, has taken the position that repo transactions are sales rather than loans. The Board requests comment on how repo transactions should be treated for purposes of a sales volume test, if such a test were adopted as an appropriate alternative measure.

In addition, the Board invites comments concerning reporting and other administrative issues associated with implementing a sales volume test. The Board specifically requests comment on how sales volume should be computed for various types of transactions involving the same kinds of underlying securities in different market places. For example, Treasury bonds may be sold in the cash market, on a contract basis, or indirectly, by
purchasing a put option or selling a futures contract. Although each type of transaction **may be reported differently** for balance sheet purposes, all of the various kinds of transactions may have an identical impact on the section 20 subsidiary's risk profile.

The Board is considering adopting instructions similar to those contained in the current Federal Reserve Report Series Form FR 2004, Schedule B "Weekly Report of Cumulative Dealer Transactions" for collection of sales volume information. Accordingly, comments are requested concerning whether the instructions and definitions for reporting sales volume data in the FR 2004 would provide an adequate basis for developing sales volume reporting for section 20 subsidiaries. Comments are also requested concerning the definition and reporting of various types of transactions that are not addressed in the existing FR 2004 report instructions.

**Manipulative Transactions**

When the Board first approved the establishment of the section 20 subsidiaries, it considered and rejected using a sales volume test, on the ground that the eligible securities sales volume of a section 20 subsidiary, like asset values, could be easily inflated by repeated matched book transactions intended for no other purpose than to inflate the subsidiary's eligible sales volume base. As noted above, many of the comments on the previously proposed asset-based test pointed out the credit risk and market limitations on the extent to which a section 20 subsidiary may engage in matched book or similar transactions. While these limits may be less effective where a section 20 subsidiary engages in unusual sales of securities with its own affiliate, rather than with a third party, solely for the purpose of increasing the volume of eligible securities sales, these matters can be addressed during the examination process and, as noted above, corrective action can be taken where manipulative transactions are found.

**D. Compliance With Both Measures**

A possible means for addressing the disadvantages of asset values and sales volume alone as appropriate measures is to require a section 20 subsidiary electing an alternative test to comply with both measures. The Board seeks comment on this possible requirement.

**E. Implementation of Any Alternative Test**

The Board notes that comments received on the asset-based test previously proposed suggested that, if such a test were adopted, some section 20 subsidiaries may not have access to sufficiently detailed asset data for earlier quarters to allow computation of such a test on a rolling 8-quarter basis and may not be able to obtain this information easily. Therefore, the Board proposes that, if an alternative measure is adopted using either asset values or sales volume, or a combination of both measures, a section 20 subsidiary would be allowed, at its election, initially to comply with such a test on a prospective basis only for the first two-year period. The Board followed this approach when the indexed revenue test was adopted.

As was also the case with respect to adoption of the indexed revenue test, the Board proposes that, regardless of which test may be adopted as an alternative measure, any section 20 subsidiary electing to use a new test would be required to continue using that test for a period of at least two years, in order to prevent frequent switching between tests that would impair an accurate assessment of the relative importance of the subsidiary's ineligible securities activities.

**F. Proposed Elimination of Indexed Revenue Test**

The Board also seeks comment as to why, if a new alternative measure is adopted, the indexed revenue test should not be eliminated because there would no longer be a need for that alternative measure. However, a section 20 subsidiary would be allowed to continue to elect to use the unadjusted revenue test, if the subsidiary wishes to avoid the costs associated with converting to any new test.

**G. Proposed Modification of Board Orders**

The Board proposes that its orders approving the establishment of section 20 subsidiaries be modified to provide that a section 20 subsidiary may elect, as an alternative to the existing revenue tests, to apply an asset-based test to assess compliance with the 10 percent limit on ineligible securities activities. Under such a test, a section 20 subsidiary would be viewed as in compliance with that section for any quarter if the average daily assets held in connection with underwriting and dealing in ineligible securities for that quarter, when added to the average daily assets held in connection with ineligible securities activities for the previous seven quarters, does not exceed 10 percent of the average daily total assets of the subsidiary for that quarter and for the seven previous quarters.

In the alternative, the Board proposes that section 20 subsidiaries be authorized to elect to apply, as an alternative to the existing revenue test, a sales volume test to assess compliance with the 10 percent limit. Under such a test, a section 20 subsidiary would be viewed as in compliance with that section for any quarter if the total dollar volume of sales of ineligible securities from underwriting and dealing activities for that quarter, when added to the total dollar volume of such sales for the previous seven quarters, does not exceed 10 percent of the total dollar volume of sales of all securities and other assets by the subsidiary for that quarter and for the seven previous quarters.

Finally, as a third alternative, the Board proposes that section 20 subsidiaries be authorized to apply an alternative test measured by both asset values and sales volume. Under such a test, a section 20 subsidiary would be viewed as in compliance with section 20 for any quarter if the subsidiary simultaneously satisfied both the asset-based and sales volume measures described above.


William W. Wiles, Secretary of the Board.

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