FEDERAL DEPOSIT INSURANCE CORPORATION

12 C.F.R. Part 337

UNSAFE AND UNSOUND BANKING PRACTICES

AGENCY: Federal Deposit Insurance Corporation ("FDIC").

ACTION: Proposed Rule.

SUMMARY: The FDIC has determined that it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary that engages in securities activities nor for an insured nonmember bank to become affiliated with a company engaged in securities activities. At the same time, however, the FDIC has found that some risk may be associated with those activities. In order to address that risk and to ensure the legality of insured nonmember bank indirect involvement in securities activities, the FDIC is proposing to amend its regulations to (1) define bona fide subsidiary, (2) limit an insured nonmember bank's permissible direct and indirect investments in its securities subsidiary or subsidiaries, (3) require notice of intent to invest in a securities subsidiary, (4) limit the permissible securities activities of insured nonmember bank subsidiaries, and (5) place certain other restrictions on loans, extensions of credit, and other transactions between insured nonmember banks and their subsidiaries or affiliates that engage in securities activities. This action is a continuation of a rulemaking initiated by the FDIC on May 9, 1983 with the adoption of a proposed amendment to Part 337 which was published for public comment at 48 Fed. Reg. 22155.

DATE: Comments must be received by [30 days from date of publication].

ADDRESS: Send comments to Hoyle L. Robinson, Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. Comments may be hand delivered to Room 6108 between the hours of 8:30 a.m. and 5:00 p.m.

FOR FURTHER INFORMATION CONTACT: Pamela E. F. LeCren, Senior Attorney, Legal Division, (202-389-4171), Room 4126 E, 550 17th Street, N.W., Washington, D.C. 20429

SUPPLEMENTARY INFORMATION: On August 23, 1982, the Board of Directors of the FDIC adopted a policy statement concerning the applicability of the Glass-Steagall Act to securities activities of subsidiaries of nonmember banks. The policy statement, which was published in the Federal Register on September 3, 1982 (47 Fed. Reg. 38984), concluded that, in the opinion of the Board of Directors, the Banking Act of 1933 (popularly known as the Glass-Steagall Act and codified in various provisions of title 12 of the United States Code) does not by its express terms prohibit an insured nonmember bank from establishing an affiliate relationship with or organizing or acquiring a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing stocks, bonds, debentures, notes, or other securities. Although the policy statement was not designed to address the safety and soundness of such activities, it did state that the FDIC recognized its ongoing responsibility to ensure the safe and sound operation of insured nonmember banks and that, depending on the facts, potential risks can be inherent in a bank subsidiary's involvement in particular securities activities.

In keeping with that statement, the FDIC on September 20, 1982 adopted an Advance Notice of Proposed Rulemaking (47 Fed. Reg. 42121) designed to solicit comment on the need, if any, for rulemaking with regard to securities activities of affiliates and subsidiaries of insured nonmember banks. After carefully reviewing the comments received in response to that notice and after reviewing in conjunction therewith the purposes of the Glass-Steagall Act as articulated in the Act's legislative history and recent case law construing the Act, the FDIC adopted on May 9, 1983 a proposed regulation (May, 1983 proposal) addressing the securities activities of subsidiaries and affiliates of insured nonmember banks. As stated in the preamble to the May, 1983 proposal (48 Fed. Reg. 22155), "[The] proposal is a recognition by the FDIC that at least some of [the] hazards [contemplated by the Glass-Steagall Act] can and do exist [when a bank is indirectly involved in securities activities] even though, in the FDIC's opinion, a bank's involvement in securities activities is not unsafe or unsound in all instances. . . . Rather than deny insured nonmember banks the opportunity of acquiring or forming securities subsidiaries because of the presence of some risk, the FDIC is proposing to eliminate or lessen the risks that can be present by placing a number of restrictions on a nonmember bank's indirect involvement in the securities area."

The basic features of the May, 1983 proposal were as follows: (1) a requirement that a bank give FDIC notice of intent to invest in a securities subsidiary; (2) a prohibition on an insured nonmember bank establishing or acquiring a subsidiary that underwrites securities unless the underwriting activity is done on a best-efforts basis, is the underwriting of top rated debt securities, and/or is the underwriting of a money market type mutual fund; (3) a limit on the bank's investment in one or more securities subsidiaries to twenty percent of the bank's equity capital; (4) a limit on the amount of loans or other extensions of credit the bank can make to its securities subsidiary or affiliate; (5) a prohibition on the bank making loans to any customer where the purpose of the loan is to acquire securities currently being underwritten or distributed by the bank's subsidiary or affiliate or accepting such securities as collateral on a loan or other

extension of credit; (6) a prohibition on the bank directly or indirectly making loans or other extensions of credit to companies whose securities are currently being underwritten or distributed by the bank's subsidiary or affiliate if those securities are not rated in the top four rating categories by a nationally recognized rating service; (7) a prohibition on the bank as trustee purchasing in its sole discretion any security currently being underwritten, distributed, or issued by the bank's subsidiary or affiliate or any security currently being underwritten, distributed, or issued by any investment company advised by the bank's subsidiary or affiliate; and (8) a prohibition on the bank transacting business through its trust department with the bank's securities subsidiary or affiliate unless the transactions are comparable to transactions with an unaffiliated securities company.

Additionally, the May, 1983 proposal defined the term "bona fide subsidiary" as a subsidiary of an insured nonmember bank that at a minimum (i) is adequately capitalized; (ii) is physically separate in its operations from the operation of the bank; (iii) maintains separate accounting and other corporate records; (iv) observes separate formalities such as separate board of directors meetings; (v) maintains separate employees who are compensated by the subsidiary; and (vi) conducts business separately from, functions independently of, and is not identified with, the banking business of the insured nonmember bank.

The May proposal was published for a sixty-day comment period which ended on July 18, 1983. In addition to inviting written comments during that time period, the FDIC invited oral testimony at a one-day public hearing that was held on June 17, 1983. The FDIC received 35 written comments and heard oral testimony from two witnesses at the June 17 public hearing. Because of the complexity of the issues involved and the relatively small number of comments received during the comment period, the FDIC has determined to issue a revised proposed regulation. The new proposed regulation was formulated after carefully reviewing the written comments as well as testimony given before various congressional committees that was given directly in connection with, or was relevant to, FDIC's rulemaking. The written and oral comments as well as the testimony given before Congress are summarized below where relevant to an explanation of the new proposed regulation.

1. <u>Bona Fide Subsidiary.</u>

The term "bona fide subsidiary" as proposed for comment required at a minimum that the subsidiary (i) be adequately capitalized; (ii) be physically separate in its operations from the operation of the bank; (iii) maintain separate accounting and other corporate records; (iv) observe separate formalities such as separate board of directors' meetings; (v) maintain separate employees who are compensated by the subsidiary; and (vi) conduct business separately from, function independently of, and not be identified with, the banking business of the insured nonmember bank.

In proposing the above definition the FDIC indicated that it was not necessarily implying that any association between a bank and its securities subsidiary in the public's mind could harm the reputation of the bank but rather that the FDIC was attempting to ensure the separateness of the subsidiary and the bank. Inasmuch as the bank would be prohibited by the

Glass-Steagall Act from engaging in many activities the subsidiary might undertake, the separation is essential. If a bank's subsidiary is not sufficiently distinct from its parent, the subsidiary may be found to be an alter ego or a mere instrumentality of the bank and the bank held to be engaging in securities activities in violation of the Glass-Steagall Act. The definition was also designed to ensure the separateness of the subsidiary from the bank as a means of safeguarding the soundness of the parent bank. As stated in the proposal, "the parent bank is less likely to be harmed if the subsidiary has adequate capital and thus can itself absorb losses as well as liabilities arising from the securities operation."

The proposed regulation adopts a definition of "bona fide subsidiary" that is substantially the same as that which was originally proposed for comment with a few significant revisions. The proposed definition retains the requirement found in the May, 1983 proposal that the subsidiary be adequately capitalized. This requirement was generally viewed as proper by those commenting on the May, 1983 proposal. The Investment Company Institute ("ICI") in commenting unfavorably on the May, 1983 proposal did, however, opine that the parent bank could not be sufficiently insulated from the subsidiary's financial losses nor the possibility of liability under the securities laws regardless of to what degree the subsidiary is capitalized. After considering this comment, we agree that a parent bank may be considered a "controlling person" of the securities subsidiary and thus potentially subject to liability to the same extent as the subsidiary for any violations of the securities laws on the part of the subsidiary. That liability is not absolute, however. The bank as a "controlling person" may not be liable if it had no knowledge of the circumstances which gave rise to the violation, the bank acted in good faith, and the bank did not directly or indirectly induce the violation. We therefore have concluded that it is possible to structure the relationship between a parent bank and its subsidiary to avoid or lessen the bank's exposure under the securities laws for the acts of the subsidiary.

Although the proposed regulation requires that the subsidiary be adequately capitalized, it does not define what constitutes adequate capital. No definition has been incorporated in the proposed regulation as the adequacy of any particular subsidiary's capital can vary from a safety and soundness point of view. The FDIC maintains the position previously stated in the May, 1983 proposal that the bank's subsidiary must, at a minimum, comply with any applicable capital requirements imposed by the Securities and Exchange Commission ("SEC") or imposed under State law. That level of capital is merely a starting point, however, and the FDIC reserves the right to determine that the subsidiary's activities and/or the parent bank's condition warrant that the subsidiary be capitalized over and above any such requirement. It is FDIC's intention to make this assessment during the "notice" period (see subsection (d) of the proposed regulation discussed below) and to inform the bank at that time whether in FDIC's opinion the capital position of the subsidiary is adequate. It is FDIC's belief that such a flexible approach will better serve FDIC's supervisory interest in maintaining the safety and soundness of insured nonmember banks.

The proposed definition also retains the requirement found in the May, 1983 proposal that the subsidiary maintain separate accounting and other corporate records and that the subsidiary observe separate formalities such as separate board of directors' meetings. Also retained is the requirement that the

subsidiary maintain separate employees who are compensated by the subsidiary. In addition, however, bank employees will be permitted, under the proposal, to perform so-called "back office" operations (such as accounting, data processing, and recordkeeping), provided the bank is fully compensated for such services in an arm's-length transaction. Comment is specifically directed to whether the language in footnote 4 of the proposed regulation, which contains this exception, can or should be further clarified.

The separate employee requirement was criticized in a substantial number of comments in response to the May, 1983 proposal. The comments observed that the requirement would be costly and inefficient, would prevent the bank subsidiary from entering the securities area slowly, and would prevent the bank from making available to the subsidiary the expertise of bank personnel already familiar with securities operations. The FDIC acknowledges that the separate employee requirement can produce some additional costs to insured nonmember banks but anticipates that the exception contained in the proposed regulation for back office operations (i.e., allowing bank employees to perform administrative, noncustomer contact type activities) reduces the inefficiency and added costs that might otherwise be produced. The requirement has also been retained in the proposed regulation as it is felt that the use of separate employees in customer contact positions is an extremely important factor in maintaining the separate corporate identity of the subsidiary and the bank. Comment is specifically requested concerning the separate employee requirement and the "back office" exception and the problems, ramifications, and burdens, etc. that might be associated therewith.

The proposed regulation retains the basic requirement as set forth in the May, 1983 proposal that the subsidiary's operation be separate from the operation of the bank. The wording has been changed to require that "physically separate" operation of a subsidiary means the securities subsidiary is not located on the same floor of a banking building where deposits are received. FDIC's purpose in changing the wording of the definition is to more clearly demarcate the bank's depository business from its subsidiary's securities business and to prevent customer confusion regarding the separation. As several commenters expressed concern over the requirement for a physically separate facility and recommended that a separate facility is not necessary so long as the manner in which the subsidiary's operation is conducted makes clear to the customer with whom he or she is dealing, we are specifically inviting comment on the problems, ramifications, and burdens that the above restriction might generate. The FDIC also particularly invites comments on whether sufficient separation can be maintained without requiring "physical separation", and, if so, how such a distinction of operations could be maintained if the same physical quarters were used for both operations. Lastly, in order to clearly provide that the subsidiary's operations be distinct from the parent bank's, the proposed definition of bona fide subsidiary has been reworded to require that the subsidiary "conduct business pursuant to policies and procedures independent from the bank so that customers of the subsidiary are aware that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank."

The proposed definition expressly requires that the subsidiary not share a common name or logo with the bank. Name identification is a factor used by

the courts in deciding whether to pierce the corporate veil, is a factor in public identification of the securities operation with the bank, plays a role in the public's misconception as to the insured status of investments placed with the subsidiary, and plays a role in engendering an expectation that the bank is liable for the obligations of the subsidiary. Additionally, as stated in one comment, a bank may be reluctant to allow a subsidiary to fail if that subsidiary carries the bank's name. For these reasons the FDIC continues to propose to prohibit the use of a common name or logo with the bank despite comments urging that we not do so. Furthermore, the FDIC does not feel at this time that the above restriction will competitively harm insured nonmember bank subsidiaries. We wish to specifically direct comment, however, to what problems, ramifications, burdens, etc. might be generated by prohibiting the use of common names or logos.

Insured nonmember banks should note that if the subsidiary <u>only</u> conducts activities that the bank itself could conduct, the need for the subsidiary to not be identified with the bank in order to avoid a Glass-Steagall Act violation is eliminated. The FDIC, however, still intends at this time to require that there be sufficient differentiation between the bank and its subsidiary in its name, advertisements, promotions, etc. so as to avoid any public misconception as to the insured status of any accounts or other investments held by the subsidiary.

The proposed definition also requires that the subsidiary not share common officers with the bank and that a majority of its board of directors not be directors or officers of the bank. The officer/director requirement is being expressly added to the proposed definition in order to: (1) ensure that the subsidiary operates independently from the parent bank, and (2) reduce the likelihood under the "controlling person" doctrine (see above) that the parent bank may be held liable for any securities laws violations on the part of the subsidiary. We would like to receive comment on the problems, ramifications, burdens, etc. that this requirement might generate.

2. <u>Underwriting.</u>

The May, 1983 proposal would have prohibited an insured nonmember bank from establishing or acquiring a subsidiary that underwrites securities unless the subsidiary's underwriting activities in which the bank itself could not lawfully engage were limited to: (1) the underwriting of investment quality debt securities (either on a firm commitment or best-efforts basis); (2) the underwriting of money market fund type mutual funds; and/or (3) the underwriting of any security other than an investment quality debt security (e.g., equity securities) on a best-efforts basis. The term "investment quality debt security" was defined in the May, 1983 proposal as a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are not predominantly speculative. The definition specifically included obligations rated by a nationally recognized rating service that were rated in the top four rating categories. As stated in the May, 1983 proposal, FDIC's intent in limiting equity underwriting to a best-efforts basis was to insulate the parent bank from whatever risks might be associated with those underwritings. The insulation presumably would result from the fact that the best-efforts underwriter does not agree to purchase any unsold portion of an issue but only agrees to use best-efforts to sell the securities.

A substantial portion of the overall comments the FDIC received in regard to the May, 1983 proposal were directed to the provision described above. A number of comments objected to the decision to differentiate in the treatment of insured nonmember bank subsidiaries depending upon the type of securities underwritten by the subsidiary. These comments went on to express the view that the critical factor is not the activity conducted by the subsidiary, but rather how well the subsidiary is capitalized, the level of experience of its personnel, and whether or not the subsidiary follows prudent management practices. These comments, as well as others, advised the FDIC to permit debt and equity underwriting on a firm commitment basis and to eliminate the best-efforts restriction. The reasons cited were: (1) retaining the best-efforts restriction will effectively preclude insured nonmember bank subsidiaries from the equity underwriting market; (2) a firm commitment underwriting is arguably less risky than a best-efforts underwriting as traditionally only marginal issues are underwritten on a best-effort basis; and (3) practically speaking, there is no greater risk in a firm commitment underwriting than in a best-efforts underwriting as, in the case of the former, most of the issue is presold.

Most of the comments addressing the best-efforts issue (as well as SEC Commissioners Shad and Longstreth in their testimony before Congress) criticized the best-efforts restriction. The criticism primarily focused on the fact that rather than protecting the parent bank, the best-efforts restriction could potentially harm the bank. That criticism can be summarized as follows: (1) the restriction will force nonmember banks to be identified through their subsidiaries with marginal firms that have a greater failure rate and whose securities are typically of a lower quality; (2) as it is customary for underwriters to make after-markets, the bank's subsidiary may end up purchasing the securities even though it is not contractually obligated to do so; (3) as the nonmember bank's subsidiary could not effectively compete if the best-efforts restriction is retained, the subsidiary may find ways around the restriction and thus expose the bank to greater risks; and (4) best-efforts underwriting will expose the bank's subsidiary to due diligence litigation.

The FDIC also received comments to the May, 1983 proposal as follows: (1) the ban on mutual fund underwriting is too restrictive, (2) the FDIC should permit insured nonmember banks to underwrite mutual funds that invest in top quality equity securities and top quality debt securities, (3) the loss experience associated with underwriting equity issues is no greater than that associated with underwriting debt issues, and (4) several comments (including the comments of SEC Commissioner Shad in his Congressional testimony) indicating that debt issues are not risk free as modest market declines can eliminate the underwriting spreads on investment quality debt issues. With the exception of comments falling within item four, and putting aside the comments that challenged the entire rulemaking posture (the FDIC received nine such comments), FDIC did not receive any comments suggesting that bank subsidiaries should be precluded from underwriting investment quality debt securities.

The FDIC proposed regulation reflects several revisions that are based upon the above comments. The proposed regulation permits an insured nonmember bank to establish or acquire a subsidiary that underwrites investment quality debt securities, underwrites investment quality equity securities (see discussion in paragraph 3 below), underwrites mutual funds that invest exclusively in

investment quality equity securities and/or investment quality debt securities, and/or underwrites money market fund type mutual funds. The proposed regulation thus eliminates the catch-all found in the May, 1983 proposal that would have permitted the bank's subsidiary to underwrite any security on a best-efforts basis. The FDIC was convinced upon a reading of the comments that the best-efforts aspect of the May, 1983 proposal would not have provided the insulation to insured nonmember banks that it was intended to provide. Inasmuch as the restriction did not appear to provide any benefit to insured nonmember banks, but in fact may have been detrimental, the restriction has been eliminated in the proposed regulation.

While the proposed regulation still permits equity underwriting, it is actually more conservative than the May, 1983 proposal in that it limits the ability of the bank's subsidiary to underwrite securities solely to investment quality equities. Such securities are normally traded on an exchange thus eliminating the problem raised by several comments that, as an underwriter, the bank subsidiary may be forced to make an after-market for the securities it underwrites. Even if the subsidiary were to do so, as the only securities that may be underwritten are high quality securities, the market making should not create any undue risk.

By permitting the bank's subsidiary to underwrite mutual funds that invest exclusively in one or both types of investment quality securities the proposed regulation is simply treating the activity as an indirect underwriting of securities eligible for direct underwriting. The proposed regulation would not permit the underwriting of mutual funds that are more speculative in nature; i.e., whose value per share tend to fluctuate due to the nature of the investments (commodities, future contracts, oil leases). Nor would the proposed regulation permit the bank's subsidiary to underwrite any debt or equity security if that security is not of investment quality.

The proposed regulation does not restrict a nonmember bank's affiliation with a securities company depending upon the activities conducted by that company as it does in the case of the bank's subsidiary. The FDIC did receive one comment in response to the May, 1983 proposal stating that the need to limit underwriting is just as important in the case of affiliates as in the case of a bank subsidiary. The FDIC is still of the opinion, however, that there is less of a possibility that losses suffered by the bank's parent or sister affiliate due to underwriting activities will adversely impact the bank. This is so especially if the parent's ability to move funds out of the bank is limited as under the proposed regulation.

3. Investment Quality Debt Security/Investment Quality Equity Security.

The May, 1983 proposal defined the term "investment quality debt security" to mean a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are not predominantly speculative and was specifically said to include obligations rated in the top four rating categories by a nationally recognized rating service. The definition as revised in the proposed regulation reads as follows: "'Investment quality debt security' shall mean a marketable obligation in the form of a bond, note, or debenture that is rated in the top four rating categories by a nationally recognized rating service or a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are equivalent to the investment characteristics of such a top rated obligation." The revised

proposed definition responds to comments to the May, 1983 proposal that the phrase "speculative investment characteristics" is overly vague and to comments which indicated that by limiting the definition of investment quality debt securities to rated securities, the FDIC may foreclose access to capital markets by smaller companies. The revised proposed definition allows a bank subsidiary to underwrite debt securities that are of comparable quality to highly rated debt securities. As the nonrated debt obligations must still be of high quality in order for the bank's subsidiary to engage in the underwriting, the FDIC does not feel that the change in the definition will expose the parent bank to any additional risks.

The proposed regulation defines the term "investment quality equity security" to mean a marketable common or preferred corporate stock that is rated medium grade, average, or better by a nationally recognized rating service. As the science of rating equity securities is not as precise as the science of rating debt securities, nor is it as developed, the proposed definition of investment quality equity security does not contain a similar reference to nonrated equities that have equivalent investment characteristics to top rated equities. Although this definition will permit insured nonmember bank subsidiaries less flexibility in the underwriting of equity securities, the FDIC feels that this prudential restriction is warranted.

4. Filing of Notice.

The proposed regulation retains the requirement found in the May, 1983 proposal that the bank give the appropriate FDIC regional office written notice of intent to establish or acquire a subsidiary that engages in any securities activity at least 60 days prior to consummation of the acquisition or commencement of the operation of the subsidiary, whichever is earlier. The proposed regulation also requires that in addition to the 60-day advance notice, a bank must file a written follow-up notice with the appropriate FDIC regional office within 10 days after the acquisition is consummated or the subsidiary commences operation, whichever is earlier. The proposed regulation does not specify the content of the written notice of intent. By not specifying the content of the notice, the FDIC is permitting a bank to satisfy the notice requirement in any way it finds most convenient. For example, if the subsidiary will be registered with the SEC, a copy of the SEC filing may simply be forwarded to the appropriate FDIC regional office. The FDIC is thus rejecting several comments in response to the May, 1983 proposal which suggested that the content of the notice be specifically set forth in the regulation.

The notice provision in the proposed regulation contains one additional requirement not contained in the May, 1983 proposal. Where the 60-day advance notice pertains solely to an instance where a bank transfers to its subsidiary securities activities previously performed by the bank, the bank is required under the proposed regulation to file an additional notice with the regional office if the subsidiary expands into restricted activities; i.e., the underwriting activities referenced in subparagraph (b)(1)(i) of the proposed regulation. This notice serves as a supervisory mechanism which will apprise FDIC of which insured nonmember banks are conducting securities activities through their subsidiaries which pose potential risks to which the bank would not otherwise be exposed. The subsequent notice is a one-time notice; i.e.,

the first time the subsidiary commences any activity covered by subparagraph (b)(1)(i), notice must be filed. No subsequent notice is required if the subsidiary later begins another covered underwriting activity that was not the activity which triggered the above notice.

It is the FDIC's intent to use the notices required by the proposed regulation as a point of reference. The regional office will contact the bank seeking further information if the bank's condition or other facts warrant a closer review. It is for this reason that the proposed regulation requires that the initial notice be received at least 60 days in advance. The 60-day notice can be waived at the FDIC's discretion where such period is impractical; e.g., where the acquisition is the result of a purchase and assumption transaction or an emergency merger. The subsequent notice must be received in the regional office within 30 days after the subsidiary commences the triggering underwriting activity. Prior notice is not required in this instance as it was felt to do so would be too impractical and would interfere unduly in the day-to-day operations of the subsidiary. None of the proposed notice requirements are an approval process although the FDIC would not be precluded from intervening in an intended acquisition or establishment of a subsidiary or from objecting to the expansion of activities if such intervention or objection were warranted, for example, if the subsidiary would not appear to meet the requirements for a bona fide subsidiary or the bank's investment in the subsidiary would appear to exceed the limits set by the proposed regulation.

The proposed regulation does not require a written notice when a bank becomes affiliated with a securities company. For the most part, affiliation with a securities company will arise out of a change in bank control or come to FDIC's attention when a bank seeks deposit insurance. As the FDIC will become aware of the affiliation prior to consummation in both instances, there is no need to create an additional notice requirement.

5. Lending Restrictions.

The May, 1983 proposal contained a number of restrictions designed to prevent abuse of a bank's credit facilities. As stated in the preamble to the May, 1983 proposal, such abuse can arise in several ways; e.g. the making of imprudent loans to companies whose securities are underwritten or distributed by the bank's subsidiary or affiliate in an effort to improve the condition of the company and thus the marketability of the company's securities. The May, 1983 proposal would have prohibited a bank from: (1) making extensions of credit to any company whose securities are currently underwritten or distributed by the bank's subsidiary or affiliate unless those securities are rated in the top four rating categories by a nationally recognized rating service, (2) making any extension of credit to a money market fund currently underwritten or distributed by the bank's subsidiary or affiliate, (3) making any extension of credit where the proceeds are to be used to acquire securities currently underwritten or distributed by the bank's subsidiary or affiliate, (4) accepting securities currently underwritten or distributed by the bank's subsidiary or affiliate as collateral on an extension of credit, (5) making any extension of credit to its securities subsidiary or affiliate

that does not comport with the restrictions contained in section 23A of the Federal Reserve Act, and (6) making any extension of credit to any investment company advised by the bank's subsidiary or affiliate if the extension of credit does not comport with section 23A of the Federal Reserve Act.

The proposed regulation makes a number of changes to this portion of the May, 1983 proposal. The prohibition on a bank lending to companies whose nonrated securities are underwritten or distributed by the bank's subsidiary found in the May, 1983 proposal has not been retained. As the proposed regulation does not permit the bank's subsidiary to underwrite securities unless the securities are of investment quality, the restriction as it was earlier proposed is no longer necessary; i.e., the concern that the bank may make imprudent loans to companies whose low quality securities are being underwritten by the bank's subsidiary in order to improve the marketability of the companies' securities is no longer present. The restriction found in the May, 1983 proposal on extensions of credit to companies whose low quality securities are underwritten or distributed by the bank's affiliate has been retained, however, as the proposed regulation does not contain a similar requirement that the bank's affiliate solely underwrite investment quality securities. Thus, under the proposed regulation, a bank cannot make any extensions of credit to a company whose securities are currently underwritten or distributed by the bank's affiliate if those securities are not of investment quality.

Five comments received in response to the May, 1983 proposal expressed the opinion that the lending restriction as it was then proposed would serve only to constrict credit sources for smaller firms whose securities are not rated by a nationally recognized rating service. The proposed revision of the definition of investment quality debt security to include unrated debt obligations of comparable quality to highly rated debt obligations is an effort to be responsive to these comments. (See discussion in paragraph 3.) FDIC does not feel that the broadened definition will reduce the effectiveness of the lending restriction as the unrated debt securities must still be high quality in order for the company to be eligible for loans from the bank. The proposed regulation will still prohibit the bank from making extensions of credit to companies whose unrated and/or poorly rated equity securities are underwritten or distributed by the bank's affiliate.

In response to a comment to the May, 1983 proposal, a footnote has been added to the proposed regulation indicating that paragraph (e)(3) is not to be construed to prohibit the bank from honoring a loan commitment or revolving loan agreement, or funding a line of credit, where such were entered into prior in time to the underwriting or distribution. Finally, all of the restrictions contained in subsection (e) that use the phrase "any security currently being distributed or underwritten" [emphasis added] have been footnoted in response to several comments in response to the May, 1983 proposal requesting that the relevant time period be more clearly defined. The footnote provides that in complying with the provisions of the proposed regulation which reference a current distribution or current underwriting, the bank may rely upon the affiliate's or subsidiary's statement that the underwriting or distribution of any particular security has terminated.

The proposed regulation retains the prohibition found in the May, 1983 proposal on a bank making any extension of credit or loan directly or indirectly to any money market fund or mutual fund whose shares are currently being underwritten or distributed by a subsidiary or affiliate of the bank. For purposes of clarity, both restrictions are expressly set forth in paragraph (e)(4) of the proposed regulation. As stated in the preamble to the May, 1983 proposal, FDIC considered exempting mutual funds and money market funds from the reach of the lending restriction. Such an exemption was rejected, however, inasmuch as the credit needs of such funds are most likely to arise when the fund is having liquidity problems. If interest rates should rise sharply and large numbers of shareholders, especially institutional investors, redeem their shares to put their money directly into higher paying investments, a fund could face a liquidity crisis. A bank may thus be tempted to make an unsound loan to the fund in order to prevent the fund from suffering a loss by selling portfolio assets at a depressed price to meet liquidity needs. As the FDIC received no comments critical of the restriction, and it is still our opinion that the restriction is warranted, it has been retained in the proposed regulation. Money market funds have been targeted within that prohibition despite their relative stability as at present there is no self-regulatory organization such as the National Association of Securities Dealers ("NASD") to watch-dog money market funds.

The May, 1983 proposal contained a prohibition on a bank accepting as collateral on a loan or extension of credit securities of any company whose securities are currently being distributed or underwritten by the bank's subsidiary or affiliate or accepting as collateral any shares currently being distributed or underwritten by an investment company advised by the bank's subsidiary or affiliate. The proposed regulation has deleted the restriction on the acceptance of collateral in response to several comments which indicated that there was no need to impose such a restriction if the loan was in no way connected with the underwriting or the distribution.

The proposed regulation retains the restriction on a bank extending credit for the purpose of acquiring securities currently being underwritten or distributed by the bank's subsidiary or affiliate, securities issued by an investment company advised by a bank's subsidiary or affiliate, or securities issued by the bank's subsidiary or affiliate. The proposed restriction contains a new exception, however, that would permit the bank to extend credit to any employees of the subsidiary or affiliate where the purpose of the loan is to acquire securities of the subsidiary or affiliate through an employee stock bonus or stock purchase plan adopted by the board of directors or board of trustees of the subsidiary or affiliate. This exception, and a footnote indicating that the bank may rely in good faith on the customer's statement as to the purpose of the loan, are being proposed in response to several comments in response to the May, 1983 proposal.

The wording of the purpose lending restriction has been slightly modified in the proposed regulation. It now refers to securities issued by an investment company advised by the bank's subsidiary or affiliate. The reference to securities "underwritten or distributed" by an investment company has been deleted. A comment in response to the May, 1983 proposal pointed out that investment companies normally do not underwrite or distribute their own securities and that therefore the references in the May, 1983 proposal to

securities underwritten or distributed by an investment company were inaccurate. Corresponding changes have been made in other portions of the proposed regulation which refer to investment companies advised by the bank's subsidiary or affiliate.

The proposed regulation retains the provision found in the May, 1983 proposal that subjects extensions of credit to the bank's subsidiary to the same loan ceiling and other restrictions as would be applicable under section 23A of the Federal Reserve Act if the subsidiary were an affiliate for the purposes of that statute. The proposed regulation also retains the restriction which subjects extensions of credit to an investment company advised by a bank's subsidiary to the same loan ceiling and other restrictions that would be applicable under section 23A of the Federal Reserve Act if the subsidiary were an affiliate within the meaning of section 23A. As loans or extensions of credit to the bank's affiliate as that term is defined in the proposed regulation are already covered by the language of section 23A, placing affiliates under the restrictions of paragraph (e)(6) will not establish any additional requirements. Additionally, as section 23A covers extension of credit to investment companies advised by the bank's affiliates, placing affiliates under the restriction of paragraph (e)(7) will not establish any additional requirements. In response to comments on these two provisions received in response to the May, 1983 proposal, the proposed regulation expressly incorporates the exemptions contained in section 23A as well as the restrictions. Additionally, paragraph (e)(6) has been clarified to indicate that it does not operate to modify the investment restriction contained in paragraph (b)(2) of the proposed regulation. (See discussion in paragraph 7 below.)

6. <u>Trust Department Restrictions</u>.

The May, 1983 proposal contained a provision that would have prohibited an insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution or underwriting of stocks, bonds, debentures, notes or other securities or acts as an investment adviser to any investment company that sells, distributes, or underwrites any such security, from purchasing in its sole discretion as fiduciary or co-fiduciary any security currently being issued, distributed, or underwritten by that subsidiary or affiliate or purchasing in its sole discretion any security currently being distributed, underwritten, or issued by any investment company advised by the subsidiary or affiliate. The May, 1983 proposal also would have prohibited an insured nonmember bank from transacting business through its trust department with its securities subsidiary or affiliate unless the transactions are comparable to transactions with an unaffiliated securities company or a securities company that is not a subsidiary of the bank.

The FDIC received relatively few comments regarding these two proposed restrictions, the first of which was designed to curtail the dumping of poor issues into the trust department. Two comments indicated that the restrictions, were unnecessary as they were simply a restatement of common law. One comment indicated that the proposal was too restrictive. One comment indicated that the proposed restrictions were satisfactory. Three

comments, including that of SEC Commissioner Shad, suggested that the trust department should be entirely prohibited from dealing with its securities subsidiary or affiliate. One comment suggested that the phrase "in its sole discretion" be clarified.

The proposed regulation permits insured nonmember banks to purchase, as fiduciary or co-fiduciary, securities currently distributed, underwritten or issued by the bank's subsidiary or affiliate or currently issued by an investment company advised by the bank's subsidiary or affiliate where those purchases are expressly authorized by the trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure. The language change adds clarity to the provision and is, at the same time, consistent with the common law obligation of a fiduciary to refrain from self dealing in the administration of a trust account. It is also consistent with statements regarding trust department examinations found in FDIC's Manual of Examination Policies. The FDIC is preliminarily rejecting as overly broad the suggestion that the trust department be prohibited entirely from dealing with the bank's securities subsidiary or affiliate. We recognize the possibility for some abuses and the potential for conflicts of interest in the administration of trust accounts, however, we are presently of the opinion that the restriction contained in the proposed regulation should adequately protect against such abuses and conflicts of interest.

The proposed regulation retains the provision found in the May, 1983 proposal indicating that the bank shall not transact business through it's trust department with its securities subsidiary or affiliate unless the transactions are comparable to transactions with unaffiliated securities companies or a securities company that is not a subsidiary of the bank. This requirement will help to insulate the bank from the possibility that its securities affiliate will drain off profits from the bank by setting a higher than normal fee for executing transactions. The proposed regulation will not prohibit a bank trust department from using the broker/dealer services of its subsidiary or affiliate to execute transactions on behalf of its fiduciary accounts. The decision to utilize the related broker/dealer must, however, fully comport with the bank's fiduciary obligation to its trust department customer and must be fully disclosed.

7. Investment Ceiling

The proposed regulation restricts an insured nonmember bank's direct and indirect investment in one or more securities subsidiaries to 20% of the bank's equity capital unless the FDIC approves a greater investment. This provision is essentially the same as was proposed for comment in May, 1983; i.e. the 20% of equity capital test has been retained with one change. The term investment has been clarified by the addition of the phrase "direct and indirect". The proposed regulation thus places a limit on a bank's subsequent extensions of credit to its subsidiary. The total figure cannot exceed 20% of the bank's equity capital. The limit is subject, however, to any lesser investment cap established by State law.

While none of the comments addressing the proposed investment limitation as contained in the May, 1983 proposal criticized restricting a nonmember bank's investment in a securities company, several expressed the view that a 20%

ceiling was high. The 20% ceiling has been retained in the proposed regulation, however, as the limitation covers direct investments as well as subsequent extensions of credit. The provision operates in tandem with paragraph (e)(6) which requires that extensions of credit by an insured nonmember bank to its securities subsidiary conform to the requirements as to amount, collateral, etc. found in section 23A of the Federal Reserve Act. If, for example, the bank's direct investment in its subsidiary equals 10% of the bank's equity capital, the bank may make an additional indirect investment in the subsidiary by way of one or more extensions of credit not exceeding in the aggregate an additional 10% of the banks equity capital. If, however, the bank's direct investment equals 5% of the bank's equity capital, paragraph (e)(6) would still restrict the bank's subsequent permissable extensions of credit to 10% of the bank's equity capital as section 23A of the Federal Reserve Act establishes a lending cap of 10% . Furthermore, the bank's direct investment in the subsidiary may range up to 20% of the bank's equity capital. If such were the case, however, the bank could not make any extensions of credit to the subsidiary under paragraph (e)(6).

The investment limitation in the proposed regulation is designed to create a buffer between the operation of a bank's subsidiary (or subsidiaries) and the bank in addition to the buffer provided by the subsidiary's capital position. Although the FDIC will have the authority under section 10 of the FDI Act (12 U.S.C. 1820) to examine the affairs of the securities subsidiaries or affiliates as shall be necessary to disclose fully the relations between the bank and those subsidiaries or affiliates and the effect of such relations upon the bank, the FDIC does not actually "supervise" the subsidiaries or affiliates. It will be difficult for the FDIC to accurately judge the adequacy of a subsidiary's capital from a safety and soundness point of view on a daily basis, especially as factual circumstances may vary. The FDIC has therefore determined that the possibility of adverse impact to the bank should the subsidiary fail or suffer extreme loss is appropriately limited by placing a ceiling on the bank's investment in the subsidiary.

As reflected in what is now a footnote to paragraph (b)(2), the bank's direct investment in the securities subsidiary will not be counted toward the bank's regulatory capital. This provides the FDIC with an enforcement tool to help safeguard the bank's safety and soundness. If, for example, the FDIC should determine after receiving notice under subsection (d) that an insured nonmember bank's equity capital is not adequate after making the necessary adjustments indicated in footnote 5, the bank would not be able to proceed with the acquisition or establishment of the subsidiary.

8. <u>Affiliation with a Securities Company</u>.

The proposed regulation prohibits an insured nonmember bank from becoming affiliated with a securities company unless: (1) the securities business of the affiliate is physically separate in its operation from the operation of the bank and does not operate on the same floor of a building on which the bank receives deposits; (2) the bank does not share common officers with the affiliate; (3) a majority of the board of directors of the bank is composed of persons who are neither directors nor officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities on behalf of the affiliate on the premises of the bank that involve customer contact; (5) the bank and affiliate do not share a common name or logo; and (6) the affiliate conducts business pursuant to

policies and procedures independent from the bank so that customers of the affiliate are aware that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

The May, 1983 proposal only required that the securities business of the bank's affiliate be "kept separate and distinct from the banking business of the insured nonmember bank". The FDIC did not necessarily mean to imply that the affiliate could more closely mingle its operations with the bank than could the bank mingle operations with its subsidiary. The FDIC is therefore specifically proposing restrictions that parallel those set forth for subsidiaries. The FDIC feels that the restrictions are as warranted in the case of an affiliate as in the case of a subsidiary. The restrictions would appear necessary in order to avoid customer confusion, to avoid conflicts of interest, to avoid a finding that the bank is itself engaged in prohibited securities activities, and to avoid a finding that the affiliated securities company is taking deposits in violation of section 21 of the Glass-Steagall Act. If the FDIC approves deposit insurance for a newly chartered bank whose parent is a securities company and the bank is so closely intertwined with its parent that one could find the parent securities company is taking deposits, the FDIC would, by its action, countenance a violation of the Glass-Steagall Act. The FDIC is specifically interested in receiving comment on the necessity of these restrictions and is especially interested in receiving comment addressing the problems, ramifications, burdens, etc. that might be associated with the director/officer restriction and prohibition on the use of common names or logos.

9. <u>Tying</u>.

The proposed regulation contains a prohibition on an insured nonmember bank either directly or indirectly conditioning an extension of credit to any company on the requirement that the company contract, or agree to contract, with the bank's subsidiary or affiliate to underwrite or distribute that company's securities. The provision also prohibits a bank from conditioning an extension of credit to any person on the requirement that that person purchase any security currently underwritten or distributed by the bank's subsidiary or affiliate. Although insured nonmember banks that are part of a bank holding company system are subject to similar anti-tying restrictions under the Bank Holding Company Act Amendments of 1970, that Act would not seem to cover banks that are not held by bank holding companies in that the restrictions cover the tying of a loan with some additional credit, property, or service from the bank, the bank's holding company, or any other subsidiary of the bank's holding company. (12 U.S.C. 1972). The restriction in the proposed regulation fills that gap and serves as a reminder to all insured nonmember banks not to engage in unlawful tying practices. As a large number of insured nonmember banks are held by bank holding companies, the imposition of this requirement would not represent a major change from the status quo.

10. <u>Construction of the terms "Underwrite", "Distribute", and "Security"</u>.

It is not FDIC's intent by proposing this regulation to prevent an insured nonmember bank subsidiary from engaging in any securities underwriting activity that the insured nonmember bank may itself lawfully pursue under the Glass-Steagall Act. Those activities are set forth in 12 U.S.C. 24 (Seventh) and include underwriting obligations of the United States, general obligations of any state or political subdivision thereof, and numerous other obligations

specifically named therein. Insured nonmember banks should keep in mind that the terms "underwrite" and "distribute", and the phrase "stocks, bonds, debentures, notes, or other securities" are to be construed consistently with the securities laws and regulations except where the context requires otherwise. A securities subsidiary or affiliate of an insured nonmember bank while engaged in the conduct of securities activities will be subject to the securities laws and regulations, the oversight of the SEC, and oversight by entities such as the NASD. The above terms are therefore to have the meaning proscribed by the securities laws and regulations when used in connection with the subsidiary or affiliate. References in the proposed regulation to these terms as used in conjunction with an insured nonmember bank (see subparagraph (b)(1)(i), and subsections (f) and (g)) are to be construed consistently with the Glass-Steagall Act.

The courts have repeatedly stated that the prohibitions of the Glass-Steagall Act are to be defined with reference to the purposes of that statute and that the definitions of the terms used therein (i.e.; distribute, underwrite, security) do not necessarily coincide with the definition of the same terms as used in the securities laws. (See A. G. Becker, Inc. v. Board of Governors of the Federal Reserve System, 693 F.2d 136 (D.C. Cir. 1982) cert. granted, 52 U.S.L.W. 3262 (October 4, 1983); National Association of Securities Dealers Inc. v. Securities and Exchange Commission, 420 F.2d 83 (D.C. Cir. 1969); New York Stock Exchange Inc. v. Smith, 404 F.Supp. 1091 (D.D.C. 1975), vacated on other grounds, 562 F.2d 736 (D.C. Cir. 1977)). The FDIC therefore intends to utilize a functional analysis in determining whether a particular activity constitutes underwriting or distributing of a security under the Glass-Steagall Act.

11. Definition of "Affiliate", "Subsidiary", and "Extension of Credit".

The proposed regulation defines the term "affiliate" essentially as found in the May, 1983 proposal; i.e., to mean a company that directly or indirectly controls an insured nonmember bank and any company that is in turn controlled by such a company. The proposed regulation has expanded the definition of affiliate, however, from that found in the May, 1983 proposal to cover a company controlled by a person or group of persons that controls an insured nonmember bank. "Control" is defined as the power to directly or indirectly vote 25 percent of a bank's or company's stock, the ability to control the election of a majority of a bank's or company's directors or trustees, or the ability to exercise a controlling influence over the management and policies of a bank or company. Again, this definition has not changed from the May, 1983 proposal. At a minimum, the proposed regulation treats as affiliates of the bank a bank's parent company, a company that controls 25% or more of the bank's stock, and companies controlled by either of the above.

The term "subsidiary" is defined in the proposed regulation to mean a company controlled by a bank. The remainder of the definition as proposed in May, 1983 which would have included as a subsidiary any company a majority of whose directors or trustees are directors or trustees of an insured nonmember bank has been deleted. This language has been dropped inasmuch as the term "bona fide subsidiary" as contained in the proposed regulation prohibits the bank's subsidiary from sharing a majority of its directors and officers with the bank if the subsidiary conducts securities activities that the bank could not

itself conduct. As "company" is defined in the proposed regulation to include corporations other than banks, partnerships, business trusts, associations, joint ventures, pool syndicates or other similar business organizations, a securities company operated by several banks in a co-operative effort can be considered a subsidiary of each of the banks. Although it is possible for a mutual fund (i.e.; a business trust) to be a subsidiary of the bank if controlled by the bank, we anticipate that this will not generally be the case. The term "extension of credit" has generally the same meaning as found in Federal Reserve Board Regulation O (12 C.F.R. § 215.3) which concerns insider transactions. The term as defined herein, however, covers purchases "whether or not under repurchase agreement" of securities, other assets, or obligations. The "whether or not" language has been included in the proposed regulation in an attempt to control the extent to which a bank may indirectly pour money into the subsidiary by means of purchasing securities and other assets from the subsidiary. Lastly, the May, 1983 proposal covered the "grant" of a line of credit as an extension of credit whereas the proposed regulation covers a "draw" upon a line of credit as an extension of credit rather than simply the grant.

12. "Phase Out" Provision.

The proposed regulation requires all insured nonmember banks that established or acquired securities subsidiaries prior to the effective date of the regulation or which became affiliated with securities companies prior to the effective date of the regulation to bring themselves into compliance with the regulation within two years. Any bank that established or acquired a securities subsidiary prior to the relevant date must, however, comply with subsection 337.4 (b)(1)(ii) and sections 337.4(c) and 337.4(e) as soon as practicable. Subsection 337.4(b)(1)(ii) requires that the subsidiary be a bona fide subsidiary if it conducts activities not permitted to the bank under the Glass-Steagall Act, section 337.4(c) pertains to affiliations with securities companies, and section 337.4(e) places lending and other restrictions on the bank. The proposed regulation also requires that any insured nonmember bank that is subject to the phase-out provisions established by the regulation must inform the FDIC in writing within thirty days from the effective date of the regulation that it has a subsidiary or affiliate that conducts securities activities. This notice will provide FDIC with a mechanism to monitor compliance with the phase out requirement. The FDIC is specifically requesting comment addressing two issues: (1) is immediate compliance more appropriate than a phase out provision in view of FDIC's stance that the restricted activities may pose a safety or soundness problem, and (2) if a phase out provision is adopted, should it be longer than two years or shorter.

13. Section 337.4(f) and 337.4(g)

These sections of the proposed regulation are being reproposed without change. They serve to remind insured nonmember banks that (1) it is not FDIC's intent to prohibit a bank subsidiary from conducting any securities activity that the bank itself could lawfully conduct under the Glass-Steagall Act, and (2) that the regulation does not authorize the bank to itself conduct any securities activities that are not lawful under the Glass-Steagall Act. We wish to stress that the proposed regulation does not authorize any insured

nonmember bank to either directly, or indirectly through a subsidiary, conduct any securities activity. An insured nonmember bank must derive that authority, if at all, from some other source, such as state law.

14. Paperwork Reduction Act.

The notice requirements contained in the proposed regulation do not constitute "collections of information" for purposes of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.) and therefore are not subject to the Office of Management and Budget ("OMB") clearance provisions of that Act. This is because the notice requirements fall within the exception to the definition of "information" set out in subsection 1320.7(k)(1) of OMB regulations implementing the "collection of information clearance" provisions of the Act (5 C.F.R. 1320). It is recognized, however, that the notice requirements do place an affirmative obligation on a bank to notify the FDIC of its intended action and to confirm whether or not the subsidiary was acquired or established. Any costs associated with these notices would appear, however, to be minimal. The proposed regulation does not specify the content of the written notices nor require the bank to provide any specific information. Inasmuch as the bank subsidiary will in all likelihood be filing with the SEC, no additional paperwork burdens of any kind should be created.

15. Regulatory Flexibility Analysis.

In accordance with FDIC's policy statement entitled "Development and Review of FDIC Rules and Regulations" and the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FDIC conducted an analysis of the impact of the proposed regulation. The results of that analysis follow.

In general, participation by bank subsidiaries in the underwriting market for new securities issues offers a number of potential benefits. Bank participation will likely lower underwriting costs for issuers in a number of markets. This competitive benefit should be particularly noticeable in local and regional markets where the number of bidders for a new issue is generally small.

Additionally, increased activity in the secondary market for securities will increase the liquidity of any new issue. This will increase the attractiveness of new securities issues to potential investors. The presence of new entrants in the underwriting and discount brokerage markets should increase investor awareness, provide for greater customer convenience and lower brokerage costs to investors (both for users of discount brokerage and full service brokerage services) as fee and service competition increases. All of the above factors will tend to benefit the U.S. economy as more money flows into the capital markets.

The proposed regulation should not interfere substantially with the realization of these potential benefits. Moreover, it should provide additional benefits in that it reduces the potential for conflicts of interest, helps ensure that banks are adequately insulated from their subsidiaries, and prevents these subsidiaries from engaging in excessive risk taking. Furthermore, the proposed regulation should not, in any way, give certain competitors unfair advantage or work to the detriment of small banks.

There would be an overall cost to the economy if the advent of bank securities subsidiaries could be expected to jeopardize the viability of the nation's banking institutions. That does not appear to be the case, however, and certainly is not the case when the structure of the proposed regulation is taken into consideration. For example, the proposal is structured so as to insulate the bank from the activities of the subsidiary as well as any financial repercussions generated by losses on the part of the subsidiary. The subsidiary will only be able to underwrite top-rated securities or underwrite shares in money market funds which are recognized as relatively sound investments. Thus, there is less of a likelihood that the subsidiary will incur losses that it could not safely absorb. The bank is further insulated as it will not be able to make purpose loans, prop up companies whose securities are underwritten by the bank's subsidiary or affiliate, make excessive loans to its securities subsidiary or affiliate, invest an excessive amount of capital in the subsidiary, or move poor issues into the bank's trust department.

Several provisions of the proposed regulation are designed to address the potential for conflicts of interest. It should be pointed out, however, that conflicts of interest can never be entirely eliminated. Nor would it be desirable to attempt to do so as the costs associated with excessive restrictions and government oversight would far outweigh the potential benefits from any incremental reduction in conflicts of interest.

The proposed regulation should not be detrimental to small banks. Setting the investment cap in the subsidiary at 20 percent of equity capital should enable even relatively small insured nonmember banks to indirectly compete in the securities market through a subsidiary. Moreover, there are no restrictions against joint ventures, i.e. more than one bank or financial institution can join together to form a securities subsidiary. The requirements that the securities business of the affiliate be physically distinct in its operation from the operation of the bank and that a majority of the bank's officers and directors not be officers or directors of the affiliate should not be an excessive burden on small banks.

Lastly, the proposed regulation may duplicate, overlap, or conflict with existing Federal laws and regulations governing the establishment and operation of securities companies, section 23A of the Federal Reserve Act (12 U.S.C 371c), the Bank Service Corporation Act, as amended by the Garn-St Germain Depository Institutions Act (12 U.S.C. 1861 et seq.), and the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.).

List of Subjects in 12 C.F.R. Part 337:

Bank, banking; Federal Deposit Insurance Corporation; Securities; State nonmember banks.

In consideration of the foregoing, the FDIC hereby proposes to amend Part 337 of title 12 of the Code of Federal Regulations as follows:

Part 337 - Unsafe and Unsound Banking Practices

1. The authority citation for Part 337 is amended to read as follows:

   AUTHORITY: sec. 6, 64 Stat. 876, 12 U.S.C. 1816; sec. 8(b), Section 2[8(b)] of the Act of September 21, 1950 (Pub. L. No. 797), as added by section 202 of title II of the Act of October 16, 1966 (Pub. L. No. 89-695; 80 Stat. 1046), as amended by section 110 of title I of the Act of October 28, 1974 (Pub. L. No. 93-495; 88 Stat. 1506); section 11 of the Act of September 17, 1978 (Pub. L. No. 95-369; 92 Stat. 624); sections 107(a)(1) and 107(b) of title I of the Act of November 10, 1978 (Pub. L. No. 95-630; 92 Stat. 3649 and 3653); and sections 404(c), 425(b), and 425(c) of title IV of the Act of October 15, 1982 (Pub. L. No. 97-320; 96 Stat. 1512 and 1524); 12 U.S.C. 1818(b); sec. 9, 64 Stat. 881-882, 12 U.S.C. 1819; sec. 18(j)(2); 92 Stat. 3664, 12 U.S.C. 1828(j)(2), sec. 422, 96 Stat. 1469, (Pub. L. 97-320).

2. It is proposed that Part 337 is amended by adding new section 337.4 to read as follows:

§ 337.4 Securities Activities of Subsidiaries of Insured Nonmember Banks: Bank Transactions with Affiliated Securities Companies.

(a) Definitions: for the purposes of this section,

(1) "Affiliate" shall mean any company that directly or indirectly, through one or more intermediaries, controls an insured nonmember bank, and shall include any company controlled by a company, person, or group of persons that controls an insured nonmember bank.

(2) "Bona fide subsidiary" means a subsidiary of an insured nonmember bank that at a minimum (i) is adequately capitalized; (ii) is physically separate in its operations from the operation of the bank and does not operate on the same floor of a building on which deposits are received; (iii) does not share a common name or logo with the bank; (iv) maintains separate accounting and other corporate records; (v) observes separate formalities such as separate board of directors' meetings; (vi) maintains separate employees who are compensated by the subsidiary; 4/ (vii) shares no common officer with the bank; (viii) a majority of its board of directors is composed of persons who are neither directors nor officers of the bank; and (ix) conducts business pursuant to policies and procedures independent from the bank so that customers of the subsidiary are aware that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

4/ This requirement shall not be construed to prohibit the use by the subsidiary of bank employees to perform functions which do not relate to customer contact such as accounting, data processing and recordkeeping, so long as the bank and the subsidiary contract for such services on terms and conditions comparable to those agreed to by independent entities.

(3) "Company" shall mean any corporation (other than a bank), any partnership, business trust, association, joint venture, pool syndicate, or other similar business organization.

(4) "Control" shall mean the power to directly or indirectly vote 25 per centum or more of the voting stock of a bank or company, the ability to control in any manner the election of a majority of a bank's or company's directors or trustees, or the ability to exercise a controlling influence over the management and policies of a bank or company.

(5) "Extension of credit" shall mean the making or renewal of any loan, a draw upon a line of credit, or an extending of credit in any manner whatsoever and includes, but is not limited to:

(i) a purchase, whether or not under repurchase agreement, of securities, other assets, or obligations;

(ii) an advance by means of an overdraft, cash item, or otherwise;

(iii) issuance of a standby letter of credit (or other similar arrangement regardless of name or description);

(iv) an acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which a natural person or company may be liable as maker, drawer, endorser, guarantor, or surety;

(v) a discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, whether with or without recourse;

(vi) an increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (A) accrued interest or (B) taxes, insurance, or other expenses incidental to the existing indebtedness; or

(vii) any other transaction as a result of which a natural person or company becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

(6) "Investment quality debt security" shall mean a marketable obligation in the form of a bond, note, or debenture that is rated in the top four rating categories by a nationally recognized rating service or a marketable obligation in the form of a bond, note, or debenture the investment characteristics of which are equivalent to the investment characteristics of such a top-rated obligation.

(7) "Investment quality equity security" shall mean marketable common or preferred corporate stock that is rated medium grade, average or better by a nationally recognized rating service.

(8) "Subsidiary" shall mean any company controlled by an insured nonmember bank.

(b) Investment in securities subsidiaries.

(1) An insured nonmember bank may not establish or acquire a subsidiary that engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities; conducts any activities for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer; acts as an investment adviser to any investment company; or engages in any other securities activity unless:

(i) the subsidiary's underwriting activities that would not be authorized to the bank under section 16 of the Glass-Steagall Act (12 U.S.C. 24 (Seventh)) as made applicable to insured nonmember banks by section 21 of the Glass-Steagall Act (12 U.S.C. 378) are limited to, and thereafter continue to be limited to, one or more of the following: (A) underwriting of investment quality debt securities; (B) underwriting of investment quality equity securities; (C) underwriting of mutual funds whose investments are exclusively limited to investment quality debt securities and/or investment quality equity securities; or (D) underwriting of mutual funds whose investments are exclusively limited to obligations of the United States or Unites States Government agencies, repurchase agreements involving such obligations, bank certificates of deposit, banker's acceptances and other bank money instruments, short-term corporate debt instruments, and other similar investments normally associated with a money market fund; and

(ii) the subsidiary is, and thereafter continues to be, a bona fide subsidiary if that subsidiary conducts securities activities not authorized to the bank under section 16 of the Glass-Steagall Act as made applicable to insured nonmember banks by section 21 of the Glass-Steagall Act.

(2) An insured nonmember bank's direct and indirect investment in one or more subsidiaries under subparagraph (b)(1) shall not exceed in the aggregate 20 per centum of the bank's equity capital as defined by FDIC for capital adequacy purposes unless prior approval for a greater investment is obtained from the FDIC.5/

(c) Affiliation with a securities company.

An insured nonmember bank is prohibited from becoming affiliated with any company that directly or indirectly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities; acts as an investment adviser to any investment company; conducts any activity for which the affiliate must register with the Securities and

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5/ An insured nonmember bank's direct investment in a securities subsidiary will not be counted toward the bank's regulatory capital.

Exchange Commission as a broker/dealer; or engages in any other securities activity unless: (i) the securities business of the affiliate is physically separate in its operation from the operation of the bank and does not operate on the same floor of a building on which the bank receives deposits; (ii) the bank and affiliate share no common officer; (iii) a majority of the board of directors of the bank is composed of persons who are neither directors nor officers of the affiliate; (iv) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities on behalf of the affiliate on the premises of the bank that involve customer contact; (v) the bank and affiliate do not share a common name or logo; and (vi) the affiliate conducts business pursuant to policies and procedures independent from the bank so that customers of the affiliate are aware that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

(d) Filing of notice.
Every insured nonmember bank that intends to acquire or establish a subsidiary that (1) engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities; (2) acts as an investment adviser to any investment company; (3) conducts any activity for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer; or (4) engages in any other securities activity, shall notify the regional director of the FDIC region in which the bank is located of such intent. Notice shall be in writing and must be received in the regional office at least 60 days prior to consummation of the acquisition or commencement of the operation of the subsidiary, whichever is earlier. The bank shall also notify the regional office in writing within 10 days after the consummation of the acquisition or commencement of the operation of the subsidiary, whichever is earlier. The 60-day notice requirement may be waived in FDIC's discretion where such notice is impracticable such as in the case of a purchase and assumption transaction or an emergency merger. Where the above notices pertain solely to the transfer of securities activities previously performed by the bank to the subsidiary, an additional written notice must be filed with the regional office if the subsidiary commences any securities activity covered by section 337.4(b)(1)(i) of this part. This notice must be received in the regional office within thirty days after the subsidiary commences the new activity.

(e) Restrictions.
An insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities, or acts as an investment adviser to any investment company shall not:

(1) purchase as fiduciary or co-fiduciary any security currently distributed, currently underwritten, or issued by such subsidiary or affiliate or purchase as fiduciary or co-fiduciary any security currently issued by an investment company advised by such subsidiary

or affiliate, unless the purchase is expressly authorized by the trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure;

(2) transact business through its trust department with such subsidiary or affiliate unless the transactions are at least comparable to transactions with an unaffiliated securities company or a securities company that is not a subsidiary of the bank;

(3) extend credit or make any loan directly or indirecly to any company the stocks, bonds, debentures, notes or other securities of which are currently underwritten or distributed by an affiliate of the bank unless the company's stocks, bonds, debentures, notes or other securities that are underwritten or distributed (i) qualify as investment quality debt securities, or (ii) qualify as investment quality equity securities; 6/

(4) extend credit or make any loan directly or indirectly to any money market fund or mutual fund whose shares are currently underwritten or distributed by a subsidiary or affiliate of the bank;

(5) extend credit or make any loan where the purpose of the extension of credit or loan is to acquire (i) any stock, bond, debenture, note, or other security currently underwritten or distributed by such subsidiary or affiliate; (ii) any security currently issued by an investment company advised by such subsidiary or affiliate; or (iii) any stock, bond, debenture, note, or other security issued by such subsidiary or affiliate, except that a bank may extend credit or make a loan to employees of the subsidiary or affiliate for the purpose of acquiring securities of such subsidiary or affiliate through an employee stock bonus or stock purchase plan adopted by the board of directors or board trustees of the subsidiary or affiliate; 7/

(6) make any loan or extension of credit to a subsidiary or affiliate of the bank that (i) distributes or underwrites stocks, bonds, debentures, notes, or other securities, or (ii) advises any investment company, if such loans or extensions of credit would be in excess of the limit as to amount, and not in accordance with the restrictions as to collateral, etc., imposed on "covered transactions" by § 23A of the Federal Reserve Act (12 U.S.C. 371c)

6/ This restriction shall not be construed to prohibit the bank from honoring a loan committment or revolving loan agreement or funding a line of credit where the loan committment, revolving loan agreement, or line of credit was entered into prior in time to the underwriting or distribution.

7/ In complying with section 337.4(e)(5) of this part, the bank shall be entitled to rely in good faith on the customer's statement as to the purpose of the extension of credit or loan.

and that are not within any exemptions established thereby; however, nothing herein shall be construed as limiting the amount of a bank's direct investment in such subsidiary other than as set out in section 337.4(b)(2) of this part;

(7) make any loan or extension of credit to any investment company for which the bank's subsidiary or affiliate acts as an investment adviser if the loan or extension of credit would be in excess of the limit as to amount, and not in accordance with the restrictions as to collateral, etc., imposed on "covered transactions" by § 23A of the Federal Reserve Act and that are not within any exemptions established thereby; and

(8) directly or indirectly condition any loan or extension of credit to any company on the requirement that the company contract with, or agree to contract with, the bank's subsidiary or affiliate to underwrite or distribute the company's securities or directly or indirectly condition any loan or extension of credit to any person on the requirement that that person purchase any security currently underwritten or distributed by the bank's subsidiary or affiliate.8/

(f) Nothing in this section prohibits an insured nonmember bank from establishing or acquiring a subsidiary that sells, distributes, or underwrites stocks, bonds, debentures, notes, or other securities or engages in any other securities activity if those activities would be permitted to an insured nonmember bank by sections 16 and 21 of the Glass-Steagall Act (12 U.S.C. §§ 24 (Seventh) and 378).

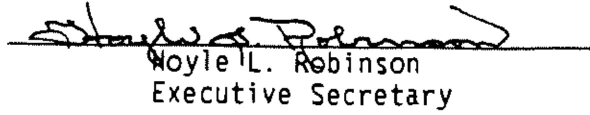
(g) Nothing in this section authorizes an insured nonmember bank to directly engage in any securities activity not authorized to it under sections 16 and 21 of the Glass-Steagall Act (12 U.S.C. §§ 24 (Seventh) and 378).

(h) An insured nonmember bank that prior to [insert effective date of regulation] became affiliated with a securities company or prior to that date established or acquired a subsidiary that engages in securities activities, shall have two years from [insert effective date of regulation] to bring itself into compliance with section 337.4 of this part, except that, such bank must comply with subparagraph 337.4(b)(1)(ii), 337.4(c) and 337.4(e) as soon as practicable and must inform the regional director of the FDIC region in which the bank is located not later than 30 days after [the effective date of the regulation] that the bank is affiliated with a company that engages in securities activities or has a subsidiary that engages in securities activities.

8/ An insured nonmember bank in complying with the requirements of subparagraphs 337.4(e)(1), (e)(3), and (e)(4) of this part concerning "current" underwritings and distributions may rely upon the affiliate's or subsidiary's statement that the underwriting or distribution of any particular security has terminated.

By Order of the Board of Directors, 23rd day of April, 1984.

FEDERAL DEPOSIT INSURANCE CORPORATION



Hoyle L. Robinson
Executive Secretary

(SEAL)