FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 337

Unsafe and Unsound Banking Practices

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

ACTION: Final 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 if authorized under state law. At the same time, however, the FDIC has found that some risk may be associated with those activities. In order to address that risk the FDIC is amending its regulations to (1) define bona fide subsidiary, (2) require notice of intent to invest in a securities subsidiary, (3) limit the permissible securities activities of insured nonmember bank subsidiaries, and (4) 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.

EFFECTIVE DATE: December 28, 1984.

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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 FR 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 prohibit an insured nonmember bank from establishing an affiliate relationship with or organizing or acquiring a subsidiary corportion 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 presented by 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 FR 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, 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. 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 1983 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 issued a revised proposed regulation dealing with same subject matter on May 1, 1984 (49 FR 18497). The new proposed regulation was formulated after carefully reviewing the written comments on the May 1983 proposal as well as testimony given before various congressional committees that was given directly in connection with, or was relevant to, FDIC's rulemaking. The revised proposal, which is detailed below, was issued for a thirty-day comment period during which FDIC received 22 comments. Those comments are summarized below where relevant to an explanation of the final regulation.

Of the total of fifty-nine comments received during both comment periods, twelve were totally opposed to FDIC pursuing the rulemaking. Of the twelve comments opposing the rulemaking, two that were received during the 30-day comment period resubmitted comments which had been filed with the FDIC in response to the May 1983 proposal. The basis for the objections to the rulemaking included the following: (1) The proposal is beyond FDIC's authority, (2) the proposal is contrary to the Glass-Steagall Act, (3) action with regard to this area is best left to the states, (4) FDIC should let Congress deal with the question, (5) there is no need for a regulation in the area, (6) the proposal will not produce and benefits, (7) securities activities are inherently unsafe and unsound and banks should

not be exposed to those risks at all, (8) the proposal will cause a mass exodus from the Federal Reserve System, and (9) at the most, the FDIC should issue a policy statement concerning insured nonmember bank indirect involvement in securities activities and not a regulation.

The FDIC acknowledges these comments but has determined to go forward with the rulemaking. FDIC is not attempting to usurp the prerogative of the state supervisors to regulate insured state nonmember banks nor the right of Congress to define the proper scope of a bank's direct and indirect securities activities under the Glass-Steagall Act. FDIC is merely seeking to fulfill its statutory responsibility to ensure the safe and sound operation of insured nonmember banks and to address the realities of the present market place. Moreover, the FDIC does not feel that indirect securities activities are inherently unsafe or unsound in all instances. The FDIC does recognize that certain risks may be involved depending upon the securities activities in which a nonmember bank subsidiary is engaged and that certain conflicts of interest can arise from securities activities. The risks and the conflicts of interest can, however, in our opinion, be adequately addressed by proper regulation. FDIC also rejects the argument that the proposal will cause a mass exodus from the Federal Reserve System. Such a forecast is merely speculative and is, in our opinion, unwarranted. Lastly, we have rejected the suggestion that the FDIC merely adopt a policy statement rather than a regulation as the latter is a preferable enforcement tool.

The FDIC also rejects the argument that the agency's position on the Glass-Steagall Act as set out in its policy statement is incorrect. The FDIC is merely applying the clear language of the statute. The only provision of the Glass-Steagall Act that prohibits affiliations between banks and corporations engaged in securities activities applies solely to member banks of the Federal Reserve System. Section 20 of the Glass-Steagall Act specifically provides that no *member* bank shall be affiliated with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution of stocks, bonds, debentures, notes or other securities. Section 32 of the Glass-Steagall Act prohibits persons who are officers, directors, or employees of corporations that are primarily engaged in certain securities activities, or partners or employees of partnerships so engaged, from serving as directors, officers, or employees of *member* banks. Section 21 of the Glass-Steagall Act which does apply to banks whether or not they are members of the Federal Reserve System was found by the Supreme Court to not reach companies related by ownership to banks. In *Board of Governors of the Federal Reserve System* v. *Investment Company Institute,* 450 U.S. 46 (1981) the Court at footnote 24 indicated that "Section 21 prohibits firms engaged in the securities business from also receiving deposits . . . and the language of § 21 cannot be read to include within its prohibition separate organizations related by ownership with a bank, which does receive deposits." FDIC's literal approach to the Glass-Steagall Act is also fully consistent with two recent Supreme Court cases involving the Glass-Steagall Act, *Securities Industry Association* v. *Board of Governors of the Federal Reserve System,* 104 S.Ct. 2979 (1984) ("Becker") and *Securities Industry Association* v. *Board of Governors of the Federal Reserve System,* 104 S.Ct. 3003 (1984) ("Schwab"). In both instances the Court relied on the plain language of the Glass-Steagall Act in deciding the cases and went so far as to state that it was constrained to abide by the literal meaning of the statute.

The FDIC's action in adopting this regulation is fully within the agency's authority and is consistent with its stated goal of safeguarding the safety and soundness of insured nonmember banks. The courts have recognized that defining what constitutes an unsafe or unsound banking practice in a particular fact situation is within the domain of the banking agencies. The 5th Circuit on two occasions stated that "One of the purposes of the banking acts is clearly to commit the progressive definition and eradication of such practices to the expertise of the appropriate regulatory agencies." *Groos National Bank* v. *Comptroller of the Currency,* 573 F.2d 880, 897 (5th Cir. 1978); *First National Bank of LaMargue* v. *Smith,* 610 F.2d 1258, 1265 (5th Cir. 1980). The United States Court of Appeals for the D.C. Circuit has stated with regard to the Comptroller of the Currency's authority under section 8 of the Federal Deposit Insuance Act (12 U.S.C. 1818), one of the statutory provisions from which FDIC derives authority for this rulemaking, that "the Comptroller is entitled to accomplish his regulatory responsibilities over 'unsafe and unsound' practices both by cease and desist proceedings and by rules defining and explicating the practices which in his discretion he finds threatening to a stable and effective national banking system." *Independent Bankers Association of America* v. *Heimann,* 613 F.2d 1164, 1169 (D.C. Cir. 1979). Finally, the FDIC wishes to make clear that it is not, by adopting this final regulation, waiving its right to address on a case-by-case basis practices, conduct, or acts it finds to constitute unsafe and unsound practices that are not specifically addressed by this regulation. The FDIC will continue to monitor bank direct and indirect involvement in securities activities and will take whatever future action is appropriate.

The provisions of the final regulation and a further summary of the comments received by FDIC are detailed below.

1. Bona Fide Subsidiary

The term "bona fide subsidiary" as proposed for the thirty-day comment period required at a minimum that the subsidiary (i) be adequately capitalized; (ii) be physically separate in its operations from the operation of the bank and not operate on the same floor of a building on which deposits are received; (iii) not share a common name of logo with the bank; (iv) maintain separate accounting and other corporate records; (v) observe separate formalities such as separate board of directors' meetings; (vi) maintain separate employees who are compensated by the subsidiary; (vii) share no common officer with the bank; (viii) have a majority of directors that are neither directors nor officers of the bank; and (ix) 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.

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. That separation is essential inasmuch as the bank would be prohibited by the Glass-Steagall Act from engaging in many activities the subsidiary might undertake. 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 May, 1983 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 final regulation adopts a definition of "bona fide subsidiary" that is substantially the same as that which was most recently proposed for comment with a few significant revisions. The final definition retains the requirement that the subsidiary be adequately capitalized. This requirement was generally viewed as proper by those commenting on the May 1983 proposal. No comment was directed to this aspect of the proposed definition during the thirty-day comment period with the exception of the comment of the Investment Company Institute ("ICI") which resubmitted its comment filed in response to the May 1983 proposal. The ICI in commenting unfavorably on the May 1983 proposal opined 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, FDIC agreed 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. The FDIC therefore 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 final regulation requires that the subsidiary be adequately capitalized, it does not define what constitutes adequate capital. No definition had been incorporated in the final regulation as the adequacy of any particular subsidiary's capital can vary from a safety and soundness point of view. It is FDIC's position, however, 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 section (d) of the final 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 final definition also retains the requirement that the subsidiary maintain separate accounting and other corporate records and that the subsidiary observe separate formalities such as separate board of directors' meetings. No adverse comments were received as to either of these two requirements. Also retained is the requirement that the subsidiary maintain separate employees who are compensated by the subsidiary. Bank employees will be permitted, however, to perform so-called "back office" operations (such as accounting, data processing, and recordkeeping) provided that the bank is fully compensated for such services in an arm's-length transaction. In response to commenta that the language of the exclusion for "back-office" operations was ambiguous, the FDIC has reworded footnote 5 of the final regulation which contains that exclusion to permit use of dual employees to perform functions which do not "directly involve customer contact." The proposal had excluded functions which do not "relate to" customer contact.

The separate employee requirements was criticized in a sustantial number of comments in response to the May 1983 proposal and in two comments filed during the 30-day comment period. Overall, the comments observed that the requirement would be costly and inefficient, would prevent the bank subsidiary from entering the securities area slowly, would prevent the bank from making available to the subsidiary the expertise of bank personnel already familiar with securities operations, and would probably most adversely impact smaller banks. 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 final regulation for back office operations (*i.e.*, allowing bank employees to perform administrative, non-customer contact type activities) reduces the inefficiency and added costs that might otherwise be produced. One comment, while recommending that the restriction be liberalized, did agree that the exclusion should alleviate some of the problems cited above. The separate employee requirement has also been retained in the final 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. The requirement is also expected to have the added benefit of encouraging banks to hire experienced personnel to operate the subsidiary.

The final regulation retains the basic requirement that the subsidiary's operation be separated from the operation of the bank, however, the language indicating that "physically separate" operation of a subsidiary requires that the securities subsidiary not be located on the same floor of a banking building where deposits are received has been modified. The May 1983 proposal had required that the subsidiary's operation merely be physically separate and had not specified that the subsidiary could not operate on the same floor as the bank. The FDIC's purpose in changing the wording of the definition to that contained in the 30-day proposal was to more clearly demarcate the bank's depository business from the subsidiary's securities business and to prevent customer confusion regarding the separation. Several comments objected to this restriction as being overly broad and unnecessary, *i.e.* customer confusion can be avoided by less restrictive means and is adequately safeguarded against if the other proposed restrictions contained in the definition of bona fide subsidiary are observed. It was pointed out that as worded, the physically separate requirement would even prohibit a subsidiary of the bank from operating in a separate office with a separate entrance if the office happened to be on the same floor of a building where the bank operates.

The FDIC reevaluated its position and although the agency has determined to retain the requirement that the subsidiary's operation be physically separate and distinct, the minimum separation necessary to meet that regulatory standard has been modified.

The revised language would permit the subsidiary's to operate out of an office within a branch of the bank so long as the subsidiary's office is clearly identified and the bank and the subsidiary do not share a common entrance. The regulation, however, would permit both to share a common outer lobby or corridor. Existing operations within bank branches will be required to make whatever physical changes are necessary in order for the subsidiary to have separate offices that do not share a common entrance (other than a common outer lobby or corridor) with the bank. In all instances the subsidiary's offices must be clearly identified as belonging to the subsidiary.

The FDIC is adopting the physical separation requirement as described above despite the criticism it has received as we find our concern over public misconception as to with what entity the public is dealing to be a paramount concern. We are not comfortable with any less stringent requirement for fear that a bank customer may believe he or she is dealing with the bank or a department of the bank when making securities investments. For example, if the bank's subsidiary underwrites money market funds and an employee of the subsidiary counsels investors at a desk within the branch, there is the unavoidable possibility that the bank customer may confuse the investment in a money market fund underwritten by the subsidiary as a deposit of the bank even if the customer is given a written disclosure to the contrary. Although proper disclosures can go a long way in avoiding such customer confusion, disclosure *plus* other measures will more effectively separate the identities of the players.

The proposed definition of bona fide subsidiary required that the subsidiary not share a common name or logo with the bank. As previously stated by FDIC, 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, a bank may be reluctant to allow a subsidiary to fail if that subsidiary carries the bank's name. The comments on the common name prohibition for the most part have been consistently critical and, in sum, opined that: a business's name is an asset on which it should be permitted to trade, name identification will not necessarily confuse the public, and as nonbanking companies may freely use a common name for any number of enterprises, it is unfair to prohibit banks from doing the same.

Despite this criticism, FDIC has determined to retain the prohibition on the use of a common name or logo by a bank and its securities subsidiary. The final regulation expressly indicates, however, that the restriction does not preclude a bank from advertising and/or otherwise disclosing the relationship between its subsidiary and itself. For example, bank X may advertise the securities services of its full service brokerage subsidiary, Y company, and denote Y company as a subsidiary of bank X. In this way, a bank may still obtain some benefits of name recognition but the public confusion that may arise if the subsidiary uses a common name (especially if that subsidiary operates out of the bank's branch) is lessened. We continue to feel that this restriction will not unduly competitively harm insured nonmember bank subsidiaries.

Insured nonmember banks should note that if the subsidiary *only* 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 to require that there be sufficient differentiation between the bank and its subsidiary in its name, advertisements, promotions, customer contacts, etc., so as to avoid any public misconception as to the insured status of any accounts or other investments held by the subsidiary.

The final definition of bona fide subsidiary retains the proposed requirement 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 has been adopted 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. Five comments addressed the officer interlock restriction, some of which commented in the context of the same restriction found in proposed section 337.4(c) dealing with bank affiliation with securities companies. All five comments criticized the prohibition on any officer of the bank being an officer of the subsidiary (in the case of an affiliate any officer of the affiliate being an officer of the bank). In sum, the comments indicated that the restriction was not necessary in order to achieve a corporate separation under the law, that sharing of officers reduces costs, the restriction will adversely impact smaller banks, and that any conflicts of interest, etc. that might be associated with shared officers are sufficiently addressed under existing banking laws and regulations. While one of the comments extended its criticism to the restriction on the composition of the board of directors, several other comments supported that aspect of the restriction.

While FDIC agrees that shared officers and directors will not in and of itself cause the corporate form to be ignored, it is a factor, along with the other criteria set out in the definition of bona fide subsidiary, that a court will consider in deciding whether or not to do so. More importantly, shared officers and directors can play a significant role in determining the liability, if any, under the securities laws of the bank as a "controlling person." This restriction will also help to ensure that the bank subsidiary employs experienced managers. We do not anticipate that the restriction will be unduly burdensome for smaller banks that wish to establish securities subsidiaries as: (1) We expect smaller banks to confine their securities operations to brokerage or underwriting activities that the bank itself could lawfully conduct rather than to enter into underwriting activities the bank could not pursue (in the former instance the subsidiary need not be a bona fide subsidiary), and (2) should a bank establish a securities subsidiary that must be bona fide because of the nature of the activities it pursues, there is no minimum required number of experienced officers it needs to employ to do so. Depending upon the size and nature of the operation, one experienced officer may be sufficient to ensure that the securities operation is well managed.

The final regulation adopts the proposed requirement that the subsidiary conduct business pursuant to independent policies and procedures. The wording has been slightly modified in response to a comment that the phrase "so that customers of the subsidiary are aware that the subsidiary is a separate organization . . ." is ambiguous. The provision as reworded requires the subsidiary to employ "policies and procedures designed to inform customers and prospective customers of the subsidiary that the

subsidiary is a separate organization . . .".

To briefly summarize, FDIC is adopting the definition of bona fide subsidiary substantially as proposed. We recognize that one cannot assure that a court will not pierce the corporate veil between a bank and its subsidiary by establishing a list of requirements and we further recognize that a court would probably not ignore the corporate form on the basis of one or perhaps two of the criteria the agency has set out. We hope rather to assure through this definition that the bank's subsidiary will be a well managed, fiscally independent, separate corporate body whose operation will not pose a threat to the bank and whose obligations and liabilities as well as the securities products it offers to the public will be perceived by the public to be its own. It is not our intent to establish inordinate burdens nor preclude innovation neither of which consequence do we feel will flow from our action.

The measures that FDIC is requiring to separate the subsidiary from its parent bank are borrowed from corporate law. Similar measures were required by the Federal Home Loan Bank Board when it approved the operation of a savings and loan association service company that would (1) offer securities brokerage and investment advisory services, and (2) operate out of savings and loan association branch offices. The Bank Board's action was challenged in Federal District court and upheld. In response to the charge that the host savings and loan association would be engaging in securities activities in violation of the Glass-Steagall Act, the court refused to pierce the corporate veil between the service corporation and the savings and loan association stating that in view of the prophylactic measures required by the Bank Board, the two organizations must be treated separately. (*Securities Industry Association* v. *Federal Home Loan Bank Board*, 588 F.Supp. 749 (D.D.C., 1984).

2. Underwriting

The regulations as published for 30-day comment restricted a nonmember bank subsidiary's securities underwriting activities that the bank could not lawfully itself conduct to the following: (1) underwriting of investment quality debt securities; (2) underwriting of investment quality equity securities; (3) underwriting of mutual funds whose investments are exclusively limited to investment quality debt securities and/or investment quality equity securities; and (4) underwriting of money market type mutual funds. The term "investment quality debt security" was defined to 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 term "investment quality equity security" was defined to mean marketable common or preferred corporate stock that is rated medium grade, average or better by a nationally recognized rating service.

Upon a review of the comments, FDIC has determined to revise the definition of investment quality equity security (see discussion in paragraph #3 below) and make the following changes to the underwriting restrictions as set out in proposed § 337.4(b)(1)(i): (1) The reference in § 337.4(b)(1)(i) (as well as elsewhere in the regulation) to mutual funds has been replaced with a reference to investment companies, (2) insured nonmember banks will be permitted to establish or acquire subsidiaries that underwrite investment companies not more than 25% of whose investments consist of investments other than investment quality debt securities and/or investment quality equity securities, and (3) if the subsidiary of an insured nonmember bank meets certain enumerated conditions (*i.e.* is a "qualified underwriter") the subsidiary's underwriting activities will not be limited to those identified in subparagraph (b)(1)(i) (*i.e.* investment quality debt, investment quality equity, money market funds, and qualifying investment companies).

The first revisions to § 337.4(b)(1)(i) is being made in response to a comment which pointed out that by using the term "mutual fund" the regulation excluded from eligibility for underwriting a number of other types of investment companies all of which are subject to regulation under the Investment Company Act of 1940, for example, unit investment trusts which are investment companies that have a defined investment portfolio that does not change. Inasmuch as FDIC did not intend such a result, the final regulation substitutes the term "investment company" for the term "mutual fund".

The second revision to paragraph (b)(1)(i) eliminates the requirement that an investment company invest "exclusively" in investment quality debt or investment quality equity securities in order for the investment company to be eligible for underwriting by the bank's subsidiary. FDIC received several comments which criticized the requirement as overly restrictive. As pointed out by one comment, the restriction would in fact exclude most mutual funds from eligibility as mutual funds are typically diversified within the meaning of the Investment Company Act of 1940; *i.e.* up to 25% of their investments are in securities that would not qualify as investment quality securities under the proposal.

The most significant revision to the proposal allows a "qualified underwriter" to engage in any underwriting activity; *i.e.* there are no product restrictions on the subsidiary if it meets the conditions enumerated in § 337.4(b)(2). Those conditions are: (1) Membership in good standing in the National Association of Securities Dealers ("NASD"), (2) continuous operation for the five year period preceding notice to FDIC as required by this part, (3) no officer, director, general partner, employee, or 10 percent shareholder of any class of voting securities of the subsidiary has been convicted within five years of the notice required by this part of any felony or misdemeanor in connection with the purchase or sale of any security, involving the making of a false filing with the Securities and Exchange Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser, (4) neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders of any class of voting securities of the subsidiary is subject to any state or federal administrative order or court order, judgment, or decree entered within five years of the notice required by this part temporarily or preliminarily enjoining or restraining such person or the subsidiary from engaging in, or continuing, any conduct or practice in connection with the purchase or sale of any security involving the making of a false filing with the Securities Exchange Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser, (5) none of the subsidiary's directors, officers, general partners, employees, or 10 percent shareholders are subject to an order entered within five years of the notice required by this part of the Securities and Exchange Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78O, 78o–4) or section 203 (c) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3(c), (f)), and (6)

all officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five years experience in similar activities at NASD member securities firms.

FDIC has determined to adopt the "qualified underwriter" approach after reconsidering comments which urged FDIC to concentrate on the subsidiary's management rather than establishing product restrictions. This approach is also being adopted in light of several comments which brought to our attention that, in attempting to establish an objective standard to measure the investment quality of equity securities by defining "investment quality equity security" as proposed, FDIC excluded from eligibility for underwriting (1) entire industries whose equity securities are not ranked, (*e.g.* auto companies, steel companies, airlines), (2) equity securities of any company that has not been in operation for ten years or more (ranking is typically done by reviewing a stock's performance over a ten-year period in relationship to other stocks), and (3) equity investments other than common or preferred stock such as limited partnerships. Two comments pointed out that: (1) There is no customary or obligatory after market for shares of limited partnerships, (2) neither the subsidiary nor the bank would be identified with any such distribution as only the managing underwriter is named in the prospectus, and (3) there is no capital commitment on the part of the selling broker. (See paragraph #3 below.)

While FDIC recognizes that there are problems with trying to objectively define what constitutes an investment quality equity security and that there are no guarantees that investment grade equity securities are sound investments, it is still FDIC's feeling that it is appropriate to adopt a guarded stance at the outset with respect to equity underwriting even if utilizing an imperfect standard. FDIC has therefore retained the basic concept of product restrictions where a nonmember bank subsidiary is a de novo entrant into the securities underwriting market. If a nonmember bank acquires a functioning underwriter that is a "qualified underwriter" within the parameters of section 337.4(b)(2), that subsidiary is permitted a wider latitude in its underwriting activities under the final regulation. If the de novo subsidiary meets the remaining conditions for a qualified underwriter after it has been in operation for five years, the subsidiary may, after giving FDIC notice pursuant to § 337.4(d), expand its underwriting activities to ones other than those set out in § 337.4(b)(1)(i). In either case, the FDIC will not be precluded from intervening in, or objecting to, the acquisition of the qualified underwriter, or expansion of underwriting activities into ones permitted to a qualified underwriter, if such intervention or objection is warranted.

While the final regulation permits unlimited underwriting (in the sense of product restrictions) to qualified underwriting subsidiaries of insured nonmember banks, any de novo subsidiary will be limited to underwriting of investment quality debt and equity securities, underwriting investment companies that primarily invest in such securities, and underwriting money market funds. (Investment quality equity securities are normally traded on an exchange thus eliminating pressures on the subsidiary to create an after market. Even if the subsidiary were to create an after market in such securities, there should not be any undue risk due to the high quality of the securities.) By adopting this two-tier approach, FDIC hopes to allow nonmember bank subsidiaries the flexibility of slowly moving into larger securities markets as they gain more experience. At the same time, by permitting experienced securities underwriting firms owned by nonmember banks to engage in a larger product market, the FDIC is avoiding what would have been the unintended result of the proposal: precluding underwriting of securities of smaller, regional companies; companies that have not been operating for ten years or more; and companies whose securities are not ranked because their securities are not felt to be "amenable" to the ranking process. While the parent nonmember banks of such qualified underwriters are arguably exposed to greater risks, the FDIC feels that the requirement that the subsidiary be bona fide and the requirement that the subsidiary be well managed and experienced coupled with the other restrictions of the final regulation sufficiently offset those risks.

Lastly, as was the case with the 30-day proposal, the final regulation does not restrict a nonmember bank's affiliation with a securities company depending upon the activities conducted by that company. As it has indicated in earlier **Federal Register** notices, FDIC feels 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 especially so as the affiliate's ability to move funds out of the bank is limited by several provisions of the final regulation. In any event, the FDIC will have the opportunity when processing change in bank control applications to disapprove a bank's affiliation with a securities company if warranted under that Act.

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. The definition specifically included obligations rated in the top four rating categories by a nationally recognized rating service. The definition as revised in the most recent proposal provided that " '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 definition responded to comments on the May 1983 proposal that the phrase "speculative investment characteristics" was 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 by smaller companies to capital markets.

The definition of investment quality debt security is being adopted as most recently proposed without modification. Only one comment was directed to the definition. It expressed approval of the language as proposed. The 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 broader definition will expose the parent bank to any additional risks.

The most recent proposal defined 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. The proposed definition of investment quality equity security did not encompass nonrated equities that have equivalent investment characteristics to top rated equities as, as explained in the supplemental information to the proposal, the science of rating equity

securities is not as precise as the science of rating debt securities, nor is it as developed.

In attempting to define what constitutes an investment quality equity security FDIC relied upon ratings of common and preferred corporate stock. According to a comment on the proposed definition, common stock is not rated, but is "ranked" with reference to its standing relative to other common stocks based on a ten-year history of earnings and dividends. The comment further indicated that (1) a significant group of companies in major industries is not ranked; *e.g.* most auto companies, steel companies, and airlines, and (2) some common stocks are not ranked at all because they are not considered amenable to the ranking process. In short, according to the comment, reliance on rankings of common stock to determine what constitutes an investment quality equity security is misplaced and is too narrow of an approach. Lastly, the comment indicated that, at the very least, FDIC's definition should allow for the underwriting of highly rated preferred corporate stock (preferred stock is "rated" in the same manner and according to much the same standards as bonds are rated) and/or underwriting of unrated preferred stock whose investment characteristics are equivalent to the investment characteristics to top rated preferred stock.

Upon consideration of the above, FDIC has determined to modify the definition of investment quality equity to read as follows: "Investment quality equity security shall mean marketable common stock ranked or graded in the top four categories or equivalent categories by a nationally recognized rating service and marketable preferred corporate stock that is rated in the top four rating categories by a nationally recognized rating service or has investment characteristics that are equivalent to the investment characteristics of such top-rated preferred stock."

Although FDIC acknowledges that using ranking of common stocks as an objective measure of the investment quality of corporate securities is not free from shortcomings, FDIC has determined to retain this limitation on the permissible corporate underwriting activities of subsidiaries of insured nonmember banks for the reasons more fully set forth in paragraph #2 above describing the underwriting provisions of the final regulation.

4. Filing of Notice

The final regulation adopts the notice provision as proposed with minor changes. Under the final regulation the bank must 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 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 operations, whichever is earlier. The 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 satify 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.

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 final 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) and paragraph (b)(2) of the final regulation. Likewise, if the subsidiary gives the FDIC 60 days advance notice regarding the establishment or acquisition of a subsidiary that will engage in subparagraph (b)(1)(i) activities, an additional notice must be given to the regional office if the subsidiary commences broadened underwriting activities as permitted by paragraph (b)(2).

These notices serve as a supervisory mechanism that will apprise FDIC of which insured nonmember banks are conducting securities activities through their subsidiaries that 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 paragraph (b)(1)(i) or (b)(2), notice must be filed. No subsequent notice is required if the subsidiary later begins another underwriting activity covered by (b)(1)(i) or (b)(2) that was not the activity which triggered the above notice. The only comment received by FDIC during the most recent comment period which addressed the notice requirements objected to a bank having to give FDIC notice if it transfers securities activities from the bank to a subsidiary. The requirement is being retained, however, as FDIC does not feel that the requirement is burdensome and moreover because the information will aid FDIC in discharging its supervisory responsibilities.

It is the FDIC's intent to use the notices required by the final 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 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 unduly interfere in the day-to-day operations of the subsidiary. None of the notice requirements are an approval process although the FDIC will 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 is warranted, for example, if the subsidiary would not appear to meet the requirements for a bona fide subsidiary, or any details of the planned transaction (such as the source of funding for the establishment or acquisition of the subsidiary) present any supervisory concerns.

The final 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 most recent proposal contained a number of restrictions designed to prevent abuse of a bank's credit facilities. Such abuse can arise in several ways, for example, 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 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 affiliate unless those securities qualify as investment quality debt securities or investment quality equity securities, (2) making any extension of credit to a money market fund or mutual 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 issued, underwritten or distributed by the bank's subsidiary or affiliate or currently issued by an investment company advised by the bank's subsidiary or affiliate, (4) making any extension of credit to its securities subsidiary or affiliate that does not comport with section 23A of the Federal Reserve Act, (5) 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, (6) directly or indirectly conditioning any extension of credit to a company on the requirement that the company contract or agree to contract with the bank's subsidiary or affiliate to underwrite or distribute the company's securities, and (7) directly or indirectly conditioning any 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. (Items 6 and 7 are discussed in paragraph #9 below.)

The lending restrictions are being adopted as most recently proposed with two minor changes: (1) The reference to "money market fund" and "mutual fund" contained in paragraph (e)(4) has been replaced with the term "investment company", and (2) the restriction on extensions of credit to companies whose non-investment quality securities are currently underwritten or distributed by the bank's affiliate has been expanded to cover companies whose non-investment quality securities are currently underwritten or distributed by the bank's subsidiary. The expanded coverage is necessary as qualified underwriting subsidiaries of nonmember banks may underwrite securities that are not investment quality. The lending restrictions and the basis for their adoption are discussed separately below.

Paragraph (e)(3) of the final regulation prohibits a bank from extending credit to any company the stocks, bonds, debentures, notes or other securities of which are currently underwritten or distributed by a subsidiary or affiliate of the bank unless those securities qualify as investment quality debt securities or investment quality equity securities. Paragraph (e)(3) is designed to address the concern that a bank may make imprudent loans to companies whose lower quality 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 its securities. Inasmuch as the securities in question must be investment quality in order for the company to be eligible for extensions of credit from the bank, the above concern is eliminated. If the bank's subsidiary is engaging in underwriting activities as permitted by section 337.4(b)(2), the bank would not be able to extend credit to any company whose securities the bank's subsidiary currently underwrites or distributes assuming of course that the securities in question are not investment quality.

In determining whether an underwriting or distribution is "current", the bank may rely upon the affiliate's or subsidiary's statement that any particular underwriting or distribution has terminated. A footnote to paragraph (e)(3) indicates that the restrictions of (e)(3) are not to be construed as prohibiting the bank from honoring a loan commitment or revolving loan agreement or funding a line of credit where such loan commitment, revolving loan agreement, or line of credit was entered into prior in time to the underwriting or distribution. It is felt that this exclusion coupled with the definition of investment quality debt security and investment quality equity security (both of which take into consideration unrated debt and unrated preferred corporate stock that has investment characteristics equivalent to those of highly rated securities) prevents the restrictions of paragraph (e)(3) from having an adverse effect on the availability of credit. The same footnote also provides that the restrictions of (e)(3) do not apply to extensions of credit to non-U.S. companies whose securities are underwritten or distributed outside the United States by an insured nonmember bank's non-U.S. affiliate. This exclusion has been added in response to comments from several foreign banks. (See paragraph #14 below.)

Paragraph (e)(4) of the final regulation prohibits a bank from making any extension of credit or loan directly or indirectly to any investment company whose shares are currently underwritten or distributed by a subsidiary or affiliate of the bank. As stated in the preamble to the 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, the final regulation retains the provision as proposed with the exception of the reference change to "investment company". Money market funds have been targeted within the prohibition despite their relative stability as at present there is no self-regulatory organization such as the NASD to watch-dog money market funds.

Paragraph (e)(5) of the final regulation prohibits a bank from extending credit for the purpose of acquiring securities currently 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 provision contains an exception that would permit the bank to extend credit to any employee 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. Footnote 11 indicates that the bank in complying with paragraph (e)(5) may rely in good faith on the customer's statement as to the purpose of the loan. FDIC received one comment addressing the above described purpose lending restriction. That comment urged FDIC to merely require that any purpose loan by the bank comply with safe and sound banking practice rather than prohibiting purpose loans in their entirety. FDIC still feels, however, that this prudential restriction is warranted especially in a supervisory environment which is progressively moving toward fewer on-site examinations at greater intervals.

Paragraph (e)(6) of the final regulation subjects extensions of credit by a bank 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 that subsidiary were an affiliate for the purposes of that statute. Paragraph (e)(6) also places extensions of credit to the bank's affiliate under the same restrictions. Paragraph (e)(7) subjects extensions of credit by a bank to an investment company advised by the bank's subsidiary to the same loan ceiling and other restrictions that would be applicable under section 23A of the Federal Reserve Act if that subsidiary were an affiliate within the meaning of section 23A and makes extensions of credit to investment companies advised by the bank's affiliate subject to the same restrictions. As loans or extensions of credit to the bank's affiliate as that term is defined in the regulation are already covered by the language of section 23A, placing affiliates under the restrictions of paragraph (e)(6) does not establish any additional requirements. Additionally, as section 23A covers extensions of credit to investment companies advised by the bank's affiliates, placing affiliates under the restriction of paragraph (e)(7) does not establish any additional requirements. The final regulation expressly incorporates the exemptions contained in section 23A as well as the restrictions. These provisions did not receive any adverse comment during the 30-day comment period and thus are being adopted as proposed. (FDIC did receive one comment opining that Congress did not intend for subsidiaries of banks that advise mutual funds to be subject to section 23A. Although that may or may not be the case, FDIC has determined that certain risks may be present even when the subsidiary merely acts as an adviser to an investment company and that those risks are appropriately addressed by section 23A-type restrictions.)

6. Trust Department Restrictions

One safety and soundness problem associated with securities activities of subsidiaries and affiliates of nonmember banks is dumping of poor securities into the bank's trust department. The May 1983 proposal contained a provision designed to address that concern 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 later provision was designed to insulate the bank from the possibility that its securities subsidiary or affiliate will drain off profits from the bank.

In response to comments that the phrase "in its sole discretion" should be clarified, paragraph (e)(1) of the proposed regulation was reworded to permit 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 tbe trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure. As FDIC indicated in its earlier publications, the provision merely restated the common law obligation of a fiduciary to refrain from self dealing and was at the same time consistent with the following statement regarding trust department examinations found in FDIC's Manual of Examination Policies: "It is a general axiom that a bank has a definite moral responsibility, as well as legal, not to deal with itself in the administration of a fiduciary account."

FDIC's examination manual also goes on to state that a bank should not invest fiduciary funds in its own obligations or stock unless court order, local law or the trust instrument authorizes the purchase and retention of the obligation or stock, or specific authority for the investment is obtained from all interested parties.

FDIC received several comments addressed to paragraph (e)(1) of the proposal all of which objected to the provision as worded. The comments indicated that the "expressly authorized" requirement was too strict; the requirement might neccesitate redrafting existing trust instruments which in some cases could prove impossible; obtaining specific authority from all interested parties could be costly and perhaps impossible; and the provision may preempt existing law or at best cause confusion. In response to these comments, paragraph (e)(1) has been revised in the final regulation so as to provide that the bank is prohibited from purchasing in its discretion as fiduciary, co-fiduciary, or managing agent any security currently underwritten, distributed, or issued by the bank's subsidiary or affiliate or any security issued by an investment company advised by the bank's subsidiary or affiliate unless one of three conditions are met: (1) The purchase is expressly authorized by the managing agency agreement, trust instrument, court order, or local law, or specific authority for the purchase is obtained from all interested parties after full disclosure, (2) the purchase, although not expressly authorized under item 1, is otherwise consistent with the bank's fiduciary obligation, or (3) the purchase is permissible under any applicable federal and/or state statute or regulation. Condition three is designed to take into account, for example, federal law governing employee benefit and pension plans which would permit, in certain instances, transactions involving such funds and affiliates of the funds' trustees. Condition two is responsive to the comment that in order to meet its fiduciary obligation, a trustee is not always required to obtain the authorizations covered by item one.

FDIC feels that paragraph (e)(1) as adopted in final should provide sufficient flexibility so as to not conflict with existing fiduciary common law and/or federal or state statutes or regulations governing the operation of trust departments and the duty of fiduciaries. At the same time it should prevent abuses that might otherwise arise. It should be noted that (e)(1) as adopted also covers purchases by the bank in its discretion as managing agent. Paragraph (e)(1) thus covers a situation where the bank is the managing agent for an investment account and the bank has investment discretion over that account. Although the bank is not a fiduciary with respect to that agency account in the same sense as if it were a trustee of a trust account, the bank still has certain obligations with respect to the account and it is in a position through its investment discretion to take securities off the hands of its subsidiary or affiliate. FDIC has therefore concluded that (e)(1) is appropriately expanded to cover such instances.

The final regulation adopts paragraph (e)(2) as proposed. Under that provision the bank is prohibited from transacting business through its trust department with the bank's 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. The purpose of (e)(2) is to ensure that when a bank's subsidiary or affiliate executes securities transactions on behalf of the bank's trust accounts, the costs associated with those executions (both to the bank and the trust account) are not inflated, *i.e.* not substantially greater than would have been incurred if dealing with an unaffiliated securities company. To the extent those costs are inflated, the bank, may suffer, *i.e.* the subsidiary or affiliate may drain off profits from the bank, or the trust customers may suffer, *i.e.* the higher costs are passed on to the customer.

FDIC received one comment urging that paragraph (e)(2) be amended to require that such transactions be at cost as a beneficiary of a trust is entitled to a trustee which is free from the incentive to generate transactions in order to produce commission income. FDIC has not adopted an "at cost" requirement as the requirement of paragraph (e)(1) should adequately ensure against churning and other acts that can constitute a breach of fiduciary obligation on the part of the trustee when the bank is dealing with its subsidiary or affiliate. It should be noted that (e)(2) does not prohibit a bank's trust department from using the broker/dealer services of its subsidiary or affiliate to execute transactions on behalf of fiduciary accounts. The bank's decision to utilize the subsidiary's or affiliate's services (and the transaction as a whole) must fully comport, however, with the bank's fiduciary obligation to its trust department customers. It is not FDIC's intent to countenance any transaction or practice which, although "comparable" to transactions with unaffiliated securities companies, is otherwise a breach of fiduciary obligation.

7. Investment Ceiling

Paragraph (b)(3) of the proposed regulation would have restricted an insured nonmember bank's direct and indirect investment in one or more securities subsidiaries to 20% of the bank's primary capital unless the FDIC approves a greater investment. Although few of the comments received over the course of the rulemaking criticized the proposed investment restriction, the FDIC has determined to eliminate that portion of the regulation. The final regulation retains, however, the statement that the bank's investment in its securities subsidiary will not count toward the bank's capital. The investment limitation is being eliminated as the FDIC, upon further reflection, concluded that the investment ceiling was unnecessary inasmuch as the bank's investment in the subsidiary will be excluded from the bank's capital.

The exclusion provides the FDIC with a strong enforcement tool to help safeguard the bank's safety and soundness. If, for example, the FDIC should determine after receiving notice that an insured nonmember bank's capital would not be adequate after making the necessary adjustments, the bank could be subject to enforcement action if it were to proceed with the acquisition or establishment of the subsidiary. The automatic exclusion of the investment from the bank's capital will provide the FDIC greater assurance that the bank and subsidiary are independent, financially viable entities and will prevent institutions with marginal capital from taking on additional activities that could pose additional risks.

8. Affiliation With a Securities Company

Section 337.4(c) of the proposed regulation would have prohibited 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". Inasmuch as 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 specifically proposed restrictions that paralleled those set forth for subsidiaries of insured nonmember banks. In doing so, the FDIC indicated that it felt that the restrictions were as warranted in the case of an affiliate as in the case of a subsidiary. The proposal further indicated that it was felt that the restrictions were 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. For example, 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 specifically sought comment on the necessity of the above restrictions and the problems, ramifications, burdens, etc., if any, that might be associated with the director/officer restriction and the prohibition on the use of common names or logos. With the exception of the comments to be discussed below, the comments FDIC received which addressed the proposed restriction on bank affiliations with securities companies have essentially been outlined in paragraph #1 above which discusses the definition of bona fide subsidiary. (Inasmuch as the restrictions in proposed section 337.4(c) essentially parallel the restrictions for bona fide subsidiaries, comments directed to one provision, for the most part, raised issues equally applicable to the other.)

One comment made on behalf of several securities companies which are presently affiliated with insured nonmember banks or which intend to affiliate therewith made the argument that FDIC has not adequately supported its case for restricting the affiliation of a nonmember bank with a securities company *i.e.*, even if there is a basis to define bona fide subsidiary as proposed, there is a fundamental difference between a bank being owned or otherwise affiliated with a securities company and a bank establishing or acquiring a securities subsidiary. This

comment, as well as others, primarily focused on the prohibition on the use of a common name or logo, the restriction on shared officers, and the restriction on the composition of the bank's board of directors. One comment suggested exempting banks that are presently affiliated with securities companies from the common name prohibition (either by a premanent grandfather or through a list of exemptive criteria such as the amount of the affiliate's revenue, capital, or assets, the length of time the affilitate has been in business, and the location of a majority of the affiliate's offices). Such banks, said the comment, have expended considerable amounts of money in promotional activities (albeit less than that which would have been expended if they could not have relied on the name identification of their parent) and would need to expend far more to recapture the market position they presently hold if they are required to change their names.

Additionally, several comments objected to the proposed requirement that the affiliate conduct business pursuant to independent policies and procedures. One such comment felt that the requirement constituted an unwarranted intrusion on the affiliate's operations and was beyond FDIC's authority. Several others pointed out that under the language as proposed, an affiliate of a nonmember bank could not broker the bank's deposits as the provision requires the affiliate to make its customers aware that investments recommended or sold by the affiliate are not bank deposits, are not insured by the FDIC, nor are obligations of the bank. Lastly, several comments pointed out that § 337.4(c) would require that the affiliated securities company comply with the restrictions contained therein regardless of whether the securities company was solely conducting activities of the sort permitted to the bank under the Glass-Steagall Act. A subsidiary of a bank on the other hand only need meet the criteria for a bona fide subsidiary if it conducts securities activities which the bank could not conduct. After carefully weighing these comments, FDIC has determined to go forward with proposed § 337.4(c) with certain modifications described below.

The final regulation restricts under section 337.4(c) the affiliation of a securities company and a nonmember bank where the affiliate directly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities. The language change thus tracks the language of section 21 of the Glass-Steagall Act and in effect cuts back the scope of the provision from that which was proposed. Under the new language, to the extent that the affiliate engages in any other securities activities (*i.e.* ones not encompassed by section 21 of the Glass-Steagall Act) the affiliate is not subject to § 337.4(c). As in the case of a nonmember bank subsidiary, however, it is still FDIC's intent to require that there be sufficient differentiation between the bank and its affiliate in the bank's name, advertisements, promotions, etc. so as to avoid any public misconception as to with whom it is dealing. Also, under the provision as revised in the final regulation, only a securities company that *directly* engages in the sale, distribution, or underwriting of securities is subject to the restrictions of § 337.4(c). (The proposal would have covered compaines directly or indirectly engaged in securities activities.) For example, a nonmember bank may share officers with its parent holding company that does not itself engage in securities activities except where those persons are also officers of a company controlled by the bank's parent (*i.e.*, an affiliate of the bank as defined in § 337.4(a)(1)) that underwrites securities).

A securities company subject to § 337.4(c) will not be required to be physically separate in its operations from the operations of its affiliated nonmember bank in the sense of not operating on the same floor of a building on which the bank receives deposits. As is the case with a subsidiary, however, the final regulation retains the requirement that the affiliate be physically separate and distinct in its operations from the operation of the bank. The final regulation thus would allow the affiliated securities company to have a separate office located in the branch so long as it was clearly demarcated as belonging to the affiliate and conversely would allow the bank to be housed in the same building, on the same floor as the affiliate so long as separate, clearly demarcated offices are maintained. In both instances, access to the affiliate's offices may not be through a common entrance with the exception that a common outer lobby or corridor is permitted.

The final regulation requires that the affiliate conduct business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate 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, nor are otherwise obligations of, nor guaranteed by, the bank. A footnote has been added to the provision to clarify that this restriction is not to be construed to prohibit the affiliate from engaging in the brokering of deposits to the extent otherwise permitted by law and/or regulation. Lastly, the final regulation retains the prohibition on the use of a common name or logo. Section 337.4(c) has been amended, however, to indicate that this prohibition does not preclude the bank from disclosing in its promotions, advertisements, etc. that it is affiliated with a securities company. The remaining portions of § 337.4(c) are being adopted as proposed. The FDIC rejected the idea of grandfathering banks presently sharing a common name or logo with securities affiliated because of the continued possibility of public confusion. Likewise, an asset or revenue based exemption is, in the FDIC's opinion, inappropriate as public confusion may still result. Additionally, a numerical or ratio test would be unmanageable over time and potentially more disruptive for banks affiliated with securities companies.

The FDIC is taking the above described action in an attempt to address three concerns: (1) Safety and soundness (FDIC wants to ensure that the bank is independent and operated in a manner consistent with safe and sound banking practice); (2) protection of the insurance fund (FDIC wants to avoid claims against the bank arising out of the public's misconception as to with whom it is dealing); and (3) compliance with section 21 of the Glass-Steagall Act which prohibits companies engaged in the business of issuing, selling, distributing, or underwriting securities from taking deposits (if the bank is a "captive" institution, the affiliate may be found to be taking deposits). The FDIC feels that the elements contained in § 337.4(c) of the final regulation all play an important part in achieving those ends. Taken as a whole, we do not feel that the restrictions are overly burdensome nor that they will interfere with the internal operations of the affiliate. Nor do we feel that the prohibition on common names or logos (the restriction which received the most criticism) will put nonmember banks affiliated with securities companies at an undue disadvantage or deprive them of the goodwill of their affiliate's name. Nonmember bank's presently affiliated with securities companies that share a common name or logo with their affiliate may still obtain some of the benefits of name recognition by identifying themselves as being affiliated with the securities company. Such banks also

have some flexibility in coming into compliance with the bank on common name or logo as they are required to conform to § 337.4(c) as soon as practicable, but not to exceed one year without the FDIC's consent.

9. Tying

The final regulation adopts without revision the anti-tying prohibition that was proposed for comment. Paragraph (e)(8) of the final regulation prohibits an insured nonmember bank from 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. Paragraph (e)(8) 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 final 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. Construction of the Terms "Underwrite", "Distribute", and "Security"

It is not FDIC's intent by adopting 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 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 "stock, 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 be construed consistently with the securities laws and regulations when used in connection with the subsidiary or affiliate. Reference in the final regulation to these terms as used in conjunction with an insured nonmember bank (see paragraphs (b)(l)(i), (f) and (g)) are to be construed consistently with the Glass-Steagall Act.

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

The final regulation defines the term "affiliate" to mean a company that directly or indirectly controls an insured nonmember bank and any company under common control with an insured nonmember bank. The term "affiliate" as defined herein differs from the proposed definition which included as an affiliate "any company controlled by a company, person, or group of persons that controls an insured nonmember bank." The phrase "any company under common control with an insured nonmember bank" has been substituted in the final regulation in order to clarify the scope of the definition. "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. At a minimum, the final 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 final regulation to mean a company controlled by a bank. As "company" is defined in the final 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. All of the above terms are being adopted in the final regulation as most recently proposed as none of the definitions received comment.

The term "extension of credit" as defined in the final regulation has generally the same meaning as found in Federal Reserve Board Regulation O (12 FR 215.3) which concerns insider transactions. The term as defined herein covers, however, purchases "whether or not under repurchase argeement" of securities, other assets, or obligations. The "whether or not" language is included in the final 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. The term also differs from that used in Regulation O in that a "draw" upon a line of credit is an extension of credit whereas a "grant" of a line of credit is not.

Although the term extension of credit is defined to include a purchase of securities, it is not FDIC's intent to prohibit a bank from purchasing, at a customer's direction, securities underwritten or distributed by the bank's subsidiary or affiliate. FDIC received a comment which inquired whether or not such a purchase would be permitted under paragraphs (e)(3) and (e)(4) of the regulation inasmuch as those provisions prohibit extensions of credit (said term including purchases of securities) to investment companies whose securities are underwritten or distributed by a bank's subsidiary or affiliate and extensions of credit to companies whose lower quality securities are underwritten or distributed. The answer is no. Likewise, a bank is not prohibited under paragraph (e)(7) from purchasing at the direction of a bank customer shares of an investment company advised by a subsidiary or affiliate of the bank, *i.e.* the purchase may be made without regard to the limitations and restrictions of section 23A of the Federal Reserve Act. Any purchases, however, by the bank for its own account of securities issued, distributed, or underwritten by the bank's subsidiary or affiliate or an investment company advised by the bank's subsidiary or affiliate is encompassed within the scope of the term extension of credit.

12. "Phase-Out" Provision

The final 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 §§ 337.4(b)(1)(ii), 337.4(c) and 337.4(e) as soon as practicable such time not to exceed, however, one year unless the FDIC consents. Section 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 § 337.4(e) places lending and other restrictions on the bank. The final regulation also requires that any insured nonmember bank that is subject to the phase-out provision 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 phase-out provision as adopted differs from the proposal in one respect. The final regulation more clearly denotes what the FDIC feels is a reasonable time period for a nonmember bank to comply with certain provisions of the regulation. The final regulation is still flexible on compliance as to those provisions, however, as the bank may request a longer time period to come into compliance.

The FDIC specifically requested comment addressing two issues with respect to the phase-out provision: (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. FDIC did not receive any comments addressing either point. We did receive a comment urging FDIC to make the regulation prospective only, *i.e.* exempt banks that became affiliated with securities companies prior to the effective date of the regulation from the requirements of § 337.4(c). FDIC does not feel that an exemption is warranted in view of the agency's concerns as outlined in paragraph #8 above. Furthermore, FDIC does not feel that compliance with the regulation by such banks will be onerous inasmuch as the affected banks are given one year to comply with the regulation. To the extent that such banks have supplies of stationery and other printed matter on hand which carry the same name as the bank's securities affiliate (something in contravention of § 337.4(c)(v)), the banks will not be precluded from using the existing supplies. FDIC will expect the bank to take reasonable steps toward compliance as soon as possible and to ultimately comply within one year unless the FDIC otherwise consents.

Lastly, any insured nonmember bank that is presently subject to an outstanding order imposing conditions that are inconsistent with the final regulation, or that has agreed to conditions that are inconsistent with the final regulation, is still subject thereto and must file a request with FDIC's Board of Directors that the inconsistent conditions be listed.

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

These sections of the final regulation are being adopted 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 final 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. Foreign Banks and Insured Branches of Foreign Banks

FDIC received during the most recent public comment period several comments urging FDIC to exempt insured branches of foreign banks from the restrictions of the regulation. One comment urged that FDIC exempt domestic U.S. bank subsidiaries of foreign banks as well. The comments indicated that, as proposed, the regulation could have an extraterritorial effect, *i.e.* it could prohibit U.S. branches or commercial bank subsidiaries of foreign banks from making loans to non-U.S. companies whose securities are underwritten or distributed outside the United States by non-U.S. subsidiaries or affiliates of the parent foreign bank. The comments also indicated that application of the proposal to insured branches of foreign banks would be inconsistent with the International Banking Act which grandfathered nonbanking activities of foreign banks and their affiliates in the United States. That Act also gave the Federal Reserve Board the authority to terminate grandfather status as to any particular foreign bank after December 31, 1985 if that agency determines such action is necessary to prevent undue economic concentration, decreased competition, conflicts of interest, or unsound banking practices in the United States. The interposition of an FDIC regulation is, according to these comments, unnecessary.

After carefully weighing these comments, the FDIC has determined to exempt foreign banks and insured branches of foreign banks by defining the term "insured nonmember bank" for the purposes of § 337.4 to exclude foreign banks with insured branches in the United States. The final regulation does *not* exclude domestic insured nonmember banks that are owned by foreign banks. It should be noted, however, that inasmuch as the final regulation defines "company" to exclude a bank, the foreign bank parent of a domestic bank does not fall within the definition of the term "affiliate" which itself refers to a "company" that directly or indirectly controls an insured nonmember bank. Any nonbank subsidiaries of the parent foreign bank would qualify, however, as affiliates of the U.S. bank subsidiary. The final regulation also provides that the lending restriction contained in § 337.4(e)(3) does not apply to extensions of credit to non-U.S. companies whose securities are underwritten or distributed outside the United States by an insured nonmember bank's non-U.S. affiliate or affiliates. The regulation has been changed in this manner in order to avoid any extraterritorial effect and also because equity securities of non-U.S. companies are not ranked by any nationally recognized rating service.

15. Federal Savings Banks

FDIC received a comment from the National Council of Savings Institutions requesting that FDIC expressly set forth in the regulation that federally chartered savings banks insured by FDIC are not subject to the regulation. FDIC has not done so, however, as it is FDIC's intent to include such institutions within the scope of the regulation. (The term "insured nonmember bank" has been defined in the final regulation so as to clearly cover FDIC insured federal savings banks. (The securities activities conducted by subsidiaries and affiliates of federal savings banks can impact bank safety and soundness and ultimately the insurance fund. As the insurer of such institutions, FDIC has the authority under section 8(a) of the Federal Deposit Insurance Act (12 U.S.C. 1818(a)) and the agency's general rulemaking authority to adopt rules and regulations applicable to such institutions designed to safeguard the

insurance fund and ensure compliance with the Glass-Steagall Act.

16. Paperwork Reduction Act

The notice requirements contained in the final 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 § 1320.7(k)(1) of OMB regulations implementing the "collection of information clearance" provisions of the Act (5 CFR Part 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, to confirm whether or not the subsidiary was acquired or established, and to notify FDIC if the subsidiary's activities are expanded. Any costs associated with these notices would appear, however, to be minimal. The final 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.

17. 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, which were published in the Federal Register along with the 30-day proposal, are republished below inasmuch as FDIC's conclusions drawn from the regulatory assessment of the final regulation do not differ from FDIC's conclusions with respect to the most recent proposal.

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 final 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 to ensure that banks are adequately insulated from their subsidiaries, and prevents the subsidiaries from engaging in excessive risk taking. Furthermore, the final 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 final regulation is taken into consideration. For example, the regulation 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 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 of 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 final 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 final regulation should not be detrimental to small banks. The absence of an investment cap in the subsidiary should enable even relatively small insured nonmember banks to indirectly compete in the securites 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 subsidiary and affiliate be physically separate and 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 subsidiary of affiliate, and that no officer of the bank be an officer of the subsidiary or affiliate should not be an excessive burden or small banks.

List of Subjects in 12 CFR Part 337

Banks, banking, Securities, State nonmember banks.

In consideration of the foregoing, the FDIC hereby amends 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(a), section 2[8(a)] of the Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 879), effective September 21, 1950, as amended by section 204 of title II of the Act of October 18, 1966 (Pub. L. No. 89–695; 80 Stat. 1054), effective October 16, 1966; section 6(c)(14) of the Act of September 17, 1978 (Pub. L. No. 95–369; 92 Stat. 816), effective September 17, 1978; and section 113(g) of title 1 of the Act of October 15, 1982 (Pub. L. No. 97–320; 96 Stat. 1473 and 1474), effective October 15, 1982; 12 U.S.C. 1818(a); 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 18, 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. No. 97–320); sec. 11(a), section 2[11(a)] of the Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 884), effective September 21, 1950, as amended by section 301(c) of title III of the Act of October 16, 1966 (Pub. L. No. 89–695; 80 Stat. 1055), effective October 16, 1966; section 7(a)(3) of title I of the Act of December 23, 1969 (Pub. L. No. 91–151; 83 Stat. 375) effective December 23, 1969; sections 101(a)(3) and 102(a)(3) of title I of the Act of October 28, 1974 (Pub. L. No. 93–495; 88 Stat. 1500 and 1502), effective November 27, 1974; section 1401(a) of title XIV of the Act of November 10, 1978 (Pub. L. No. 95–630; 92 Stat. 3712), effective March 10, 1979; section 323 of title III of the Act of December 21, 1979 (Pub. L. No. 96–153; 93 Stat. 1120); section 308 of title III of the Act of March 31, 1980 (Pub. L. No. 96–221; 94 Stat. 147), effective March 31,

1980; and section 103 of title I of the Act of December 26, 1981 (Pub. L. No. 97-110; 95 Stat. 1514), effective December 26, 1981; sec. 11(f), section 2[11(f)] of the Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 885), effective September 21, 1950, as amended by section 6(c)(20) of the Act of September 17, 1978 (Pub. L. No. 95-369; 92 Stat. 619), effective September 17, 1978, 12 U.S.C. 1821(f).

2. Part 337 is amended by adding new § 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 or is under common control with 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 and distinct in its operations from the operation of the bank;[4] (iii) does not share a common name or logo with the bank;[5] (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;[6] (vii) shares no common officers 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 independent policies and procedures designed to inform customers and prospective customers of the subsidiary 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.

(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) "Insured nonmember bank" shall mean state and federally chartered banks insured by FDIC that are not members of the Federal Reserve System. The term shall not include foreign banks with insured branches in the United States nor insured branches of foreign banks.

(7) "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.

(8) "Investment quality equity security" shall mean marketable common stock that is ranked or graded in the top four categories or equivalent categories by a nationally recognized rating service, marketable preferred corporate stock that is rated in the top four rating categories by a nationally recognized rating service, or marketable preferred corporate stock that has investment characteristics that are equivalent to the investment characteristics of top rated preferred corporate stock.

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

(b) *Investment in securities subsidiories.* (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) Except as otherwise provided by § 337.4(b)(2), 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 investment companies not more than 25 percent of whose investments consist of investments other than investment quality debt securities and/or investment quality equity securities; or (D) underwriting of investment companies not more than 25 percent of whose investments consist of investments other than obligations of the United States or United 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

[4] The subsidiary must have separate offices that share no common entrance with the bank except that access to the subsidiary's and bank's offices may be through a common outer lobby or common corridor. In all instances the subsidiary's offices must be clearly identified as belonging to the subsidiary.

[5] This requirement shall not prohibit the subsidiary from advertising or otherwise disclosing its relationship to the insured nonmember bank.

[6] This requirement shall not be construed to prohibit the use by the subsidiary of bank employees to perform functions which do not directly involve 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.

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) Paragraph (b)(1)(i) of this section notwithstanding, a subsidiary of an insured nonmember bank may engage in underwriting activities other than as limited thereby provided that the following conditions are met:

(i) The subsidiary is a member in good standing of the National Association of Securities Dealers ("NASD");

(ii) The subsidiary has been in continuous operation for the five year period preceding notice to the FDIC as required by this part;

(iii) No director, officer, general partner, employee, or 10 percent shareholder of any class of voting securities of the subsidiary has been convicted within five years of the notice required by this part of any felony or misdemeanor in connection with the purchase or sale of any security involving the making of a false filing with the Securities and Exchange Commission or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser;

(iv) Neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders of any class of voting securities of the subsidiary is subject to any state or federal administrative order or court order, judgment, or decree entered within five years of the notice required by this part temporarily or preliminarily enjoining or restraining such person or the subsidiary from engaging in, or continuing, any conduct or practice in connection with the purchase or sale of any security involving the making of a false filing with the Securities and Exchange Commission or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, or investment adviser;

(v) None of the subsidiary's directors, officers, general partners, employees, or 10 percent shareholders of any class of voting securities of the subsidiary are subject to an order entered within five years of the notice required by this part of the Securities and Exchange Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o, 78o–4) or section 203(c) or (f) of the Investment Advisors Act of 1940 (15 U.S.C. 80b–3(c), (f)); and

(vi) All officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five year experience in similar activities at NASD member securities firms.

(3) An insured nonmember bank's direct investment in a securities subsidiary described in paragraphs (b)(1) or (b)(2) of this section will not be counted toward the bank's capital.

(c) *Affiliation with a securities company.* An insured nonmember bank is prohibited from becoming affiliated with any company that directly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities unless: (1) The securities business of the affiliate is physically separate and distinct from the operation of the bank; [7] (2) the bank and affiliate share no common officers; (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; [8] and (6) the affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate 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.[9]

(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 §337.4 (b)(1)(i) or (b)(2) of this part. This notice must be received in the regional office within thirty days after the subsidiary commences the new activity. If the 60-day advance notice and 10-day follow-up notice pertain to the establishment or acquisition of a subsidiary that engages in underwriting activities as limited by § 337.4(b)(1)(i), an additional written notice must be filed with the regional office if the subsidiary commences underwriting activities as permitted by § 337.4(b)(2) 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 in its discretion as fiduciary, co-fiduciary, or managing agent any security currently distributed, currently underwritten, or issued by such subsidiary or affiliate or purchase as fiduciary, co-fiduciary, or managing agent any security currently issued by an investment company advised by such subsidiary or affiliate, unless (i) 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, (ii) the purchase, although not expressly authorized under paragraph (e)(1)(i) of this section, is otherwise consistent with the insured nonmember bank's fiduciary obligation, or (iii) the purchase is permissible under applicable federal and/or state statute or regulation;

(2) Transact business through its trust department with such subsidiary or affiliate unless the transactions are at

[7] The affiliate must have separate offices that share no common entrance with the bank except that access to the affiliate's and bank's offices may be through a common outer lobby or common corridor. In all instances the affiliate's offices must be clearly identified as belonging to the affiliate.

[8] This requirement shall not prohibit the bank from advertising or otherwise disclosing its relationship to the affiliate.

[9] This requirement shall not be construed to prohibit the affiliate from brokering deposits to the extent and in the manner as otherwise permitted by statute and regulation.

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 indirectly to any company the stocks, bonds, debentures, notes or other securities of which are currently underwritten or distributed by such subsidiary or 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;[10]

(4) Extend credit or make any loan directly or indirectly to any investment company whose shares are currently underwritten or distributed by such 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; [11]

(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 imposed on "covered transactions" by section 23A of the Federal Reserve Act (12 U.S.C. 371c) and that are not within any exemptions established thereby;

(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 imposed on "covered transactions" by section 23A of the Federal Reserved 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.[12]

(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 December 28, 1984 to bring itself into compliance with § 337.4 of this Part, except that, such bank must comply with paragraphs 337.4(b)(1)(ii), 337.4(c) and 337.4(e) as soon as practicable (but not more than one year from [insert effective date of regulation] without the FDIC's consent) and must inform the regional director of the FDIC region in which the bank is located not later than 30 days after December 28, 1984 that the bank is affiliated with a company that engages in securities activities or has a subsidiary that engages in securities activities.

By Order of the Board of Directors, 19th day of November 1984.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson,

Executive Secretary.

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[10] This restriction shall not be construed to prohibit the bank from honoring a loan commitment or revolving loan agreement or funding a line of credit where the loan commitment, revolving loan agreement, or line of credit was entered into prior in time to the underwriting or distribution. This restriction does not apply to any extension of credit to a non-U.S. company whose securities are underwritten or distributed outside the United States by a non-U.S. affiliate of an insured nonmember bank.

[11] In complying with § 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.

[12] An insured nonmember bank in complying with the requirements of §§ 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.