ATTACHMENT E

PROHIBITIONS AND RESTRICTIONS ON SECURITIES ACTIVITIES IMPOSED BY SECTION 20 OF THE GLASS-STEAGALL ACT AND BY THE BANK HOLDING COMPANY ACT

Section 20 of the Glass-Steagall Act ("Section 20") (12 U.S.C. §377) prohibits banks that are members of the Federal Reserve System ("member banks") from affiliating with organizations that are "engaged principally" in underwriting, distributing or selling securities. Section 20 states, in relevant part, that: "no member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale . . . of stocks, bonds, debentures, notes, or other securities . . . ." 12 U.S.C. §377. The statute defines an "affiliate" to include any corporation, business trust, association or other similar organization --

> (1) Of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 percent of the number of shares voted for the election of directors, trustees, or other persons exercising similar functions . . .
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> (2) Of which control is held, directly or indirectly, through stock ownership . . . by the shareholders of the member bank who own or control either a majority of the shares of such bank or more than 50 percent of the number of shares voted for the election of directors of such bank . . .
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> (3) Of which a majority of directors, trustees, or other persons exercising similar functions are directors of any one member bank; or
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> (4) Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more that 50 percent of the number of shares voted for the election of directors of a member bank . . . . 12 U.S.C. §221a.

In contrast to Section 16 of the Glass-Steagall Act, which imposes an absolute ban on bank securities underwriting activities, Section 20 prohibits affiliations between banks and entities that are "engaged principally" in securities underwriting activities. Therefore, affiliations are permitted

as long as the nonbank institution is not engaged "principally" in the securities activities restricted by Section 20. Section 20 itself, however, does not define the term "principally engaged." The legislative history of Section 20 also fails to define or explain the precise meaning of the term.[1] To date, the United States Supreme Court has not ruled on the question and very few lower federal courts have addressed it.[2] Thus, the meaning of the term "engaged principally" is not firmly resolved. Based on court decisions on other related provisions of the Glass-Steagall Act, and absent further clarification by the United States Supreme Court, the term "engaged principally" is not confined to the majority of a firm's business. Instead, any bank affiliate engaged in securities underwriting as a "substantial activity" would be in violation of Section 20.[3] A determination of what level of activity is "substantial," however, is still required.

The Federal Reserve has approved numerous applications allowing so-called "Section 20 subsidiaries" to underwrite and deal in securities (that are not exempt from the Glass-Steagall restrictions (i.e.,"ineligible securities")) on the grounds that the subsidiaries are not "engaged principally" in such activities, and thus their affiliation with member banks is not proscribed by Section 20.[4] In a precedential order issued in 1987 ("1987 Order") the Board of Governors of the Federal Reserve System imposed a "five-to-ten-percent" standard to differentiate permissible from impermissible levels of securities underwriting activities. The Board explained its rationale, in part, as follows:

> [T]he Board believes it is bound by the statutory language of section 20 [of the Glass-Steagall Act] to conclude that a member bank affiliate may underwrite and deal in the ineligible securities proposed in the application, provided that this line of business does not constitute a principal or substantial activity for the affiliate. The

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[1] See Banking Law, Vol. 5, § 96.02[3] (Matthew Bender, 1994).

[2] In Board of Governors v. Agnew, 329 U.S. 441 (1947), the United States Supreme court defined the term "primarily" to mean "substantial." This was in the context of section 32 of the Glass-Steagall Act, however, and not Section 20. (Section 32 restricts officer, director and employee overlap between member banks and entities "primarily engaged" in securities underwriting.)

[3] Cf. Board of Governors v. Agnew, supra

[4] The Federal Reserve has approved the establishment of over thirty "Section 20 subsidiaries." 59 Fed. Reg. 35,517 (1994).

> Board reaffirms its conclusion . . . that Congress intended that the 'engaged principally' standard permit a level of otherwise impermissible underwriting activity in an affiliate that would not be quantitatively so substantial as to present a danger to affiliated banks . . . .
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> With respect to the appropriate quantitative level of ineligible activity permitted under section 20, the Board concludes that a member bank affiliate would not be substantially engaged in underwriting or dealing in ineligible securities if its gross revenue from that activity does not exceed a range of between five to ten percent of its total gross revenues . . . . " Citicorp, J.P. Morgan & Co., Inc., and Bankers Trust New York Corp., 73 Fed. Res. Bull. 473, 475 (1987).[5]

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[5] The Federal Reserve Board's standard was sustained by the Second Circuit Court of Appeals in Sec. Ind. Ass'n v. Board of Governors, 839 F.2d 47, 68 (2d Cir. 1988), cert. denied, 486 U.S. 1059 (1988).

In July 1994, the Federal Reserve requested comments on proposed alternatives to the current "gross revenue" and "indexed gross revenue" tests. 59 Fed Reg. 35,516 (1994).

With specified exceptions, the Bank Holding Company Act[6] ("BHC Act) prohibits a Bank Holding Company ("BHC") from acquiring direct or indirect ownership or control of any voting shares of any company that is not a bank (12 U.S.C. §1843(a)). Under Section 4(c)(8) of the BHC Act (Id. at 1843(c)(8)) that prohibition does not apply to a BHC's acquisition of "shares of any company the activities of which the [Federal Reserve] Board . . . has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto . . . ."[7] In the 1987 Order the Federal Reserve concluded that underwriting and dealing in "ineligible securities" is "closely related" and a "proper incident" to banking under the BHC Act.[8]

Specifically, the Board of Governors stated that "underwriting and dealing in commercial paper, municipal revenue bonds and 1-4 family mortgage-related securities, under the limitations discussed in [the 1987] Order, are closely related to banking, because banks provide services that are so operationally and functionally similar to the proposed services that banking organizations are particularly well equipped to provide such services . . . [T]he proposed activities are natural extensions

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[6] The BHC Act requires approval by the Federal Reserve for the formation of a BHC. 12 U.S.C. §1841 et seq. A BHC is any "company" that has "control" over any "bank" or over any company that is or becomes a BHC. The BHC Act defines a "company," in part, as a corporation, partnership, business trust, association, or similar organization. Id. at 1841(b). A "bank" includes an "insured bank" under the Federal Deposit Insurance Act that: (1) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties, and (2) is engaged in the business of making commercial loans. Id. at 1841(c).

Under the BHC Act a company "controls" a bank if: (1) the company directly or indirectly owns, controls, or has the power to vote at least 25 percent of any class of the bank's voting securities; (2) the company controls the election of a majority of the bank's board of directors or trustees; or (3) the Federal Reserve determines after the opportunity for hearing that the company exercises a controlling influence over the bank's management or policies. Id. at 1841(a).

[7] This exception is implemented by the Federal Reserve in Regulation Y of the Federal Reserve's regulations. 12 C.F.R. §225.

[8] 1987 Order, p. 477.

of activities currently conducted by banks . . . ."[9] The Board of Governors also concluded that the "proposed underwriting and dealing activities" were a "proper incident to banking [because they] may reasonably be expected to result in substantial public benefits that outweigh possible adverse effects."[10]

In the orders that the Federal Reserve has issued in connection with the permissible securities underwriting activities of member bank affiliates, the Federal Reserve has expressed concerns about the potential for adverse effects that might result from the proposed activities, such as unsound banking practices, conflicts of interest, unfair competition, undue concentration of resources and loss of public confidence. Because of these concerns, the Federal Reserve has included limitations and conditions in its "Section 20" orders. There were separate protections in the Federal Reserve's original order of which the following are the most significant:

- In determining compliance with capital adequacy requirements, the applicant is required to deduct from its consolidated capital any investment in the underwriting subsidiary that is treated as capital in the underwriting subsidiary.

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

- No applicant or subsidiary shall extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten by an affiliated underwriting subsidiary.

- There will be no officer, director or employee interlocks between an underwriting subsidiary and any of the BHC's bank or thrift subsidiaries.

- An underwriting subsidiary will provide each of its customers with a special disclosure statement

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[9] 1987 Order, p. 487.

[10] 1987 Order, p.489.

describing the difference between the underwriting subsidiary and its banking affiliates.

- An affiliated bank may not express an opinion with respect to the advisability of the purchase of the ineligible securities underwritten or dealt in by an underwriting subsidiary unless the bank affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security.

- No applicant or any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period.

- No lending affiliates of an underwriting subsidiary may disclose to the underwriting subsidiary any non-public customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary (other than as required by securities laws and with the issuer's consent) and no officers or employees of the underwriting subsidiary may disclose such information to its affiliates.[11]

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[11] 1987 Order, pp. 503-504.