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THE SECURITIES AND CAPITAL MARKETS
IMPLICATIONS OF THE REFORM OF THE
U.S. FINANCIAL SERVICES INDUSTRY

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In November 1999, the Gramm-Leach-Bliley Act (the “Act”) was signed into law. The Act represents an extensive restructuring of the laws that govern the financial services industry in the United States. As a result of the repeal of certain provisions of the Glass-Steagall Act and certain other restrictions, banks will now be able to affiliate with securities firms and insurance companies under a common holding company, and engage in activities that are deemed “financial in nature.”

The Act creates two new vehicles—a financial holding company and a financial subsidiary— through which banks can engage in a broad range of financial services or affiliate with other types of financial service providers, such as securities firms and insurance companies. The Act designates the Federal Reserve Board (the “FRB”) as the “umbrella” regulator for holding companies, but also establishes a system of functional regulation whereby the Securities and Exchange Commission and the self-regulatory organizations will regulate the holding company’s subsidiaries engaged in securities activities and insurance regulators will regulate the subsidiaries engaged in insurance activities.

This memorandum addresses the implications for banks and securities firms in respect of securities related-activities. The provisions of the Act discussed below take effect March 11, 2000, except for those discussed under Part C, which take effect in May 2001.

A. Affiliation Rules

The Act repeals sections 20 and 32 of the Glass-Steagall Act. Section 20 of the Glass Steagall Act prohibited banks from affiliating with companies “engaged principally” in securities underwriting activities (in particular the “issue, flotation, underwriting, public sale or retail or wholesale distribution of securities”). Section 32 of the Glass Steagall Act prohibited certain officer/director interlocks between banks and securities firms. Under provisions of the Act, qualifying banks may now affiliate with securities firms and engage in securities underwriting activities directly or through operating subsidiaries rather than through Section 20 affiliates. Securities underwriting activities of qualifying banks and bank holding companies will no longer be limited by the FRB’s gross revenue limitations. Investment banks will be able to convert to a financial holding company structure and acquire or affiliate with commercial banks.

The Act did not repeal the provision of the Glass-Steagall Act that prevents a Federal Reserve member bank (though not a bank holding company) from buying securities for its own account or the provision that prohibits a securities firm from underwriting securities and receiving deposits.

B. Financial Holding Companies and Financial Subsidiaries

The Act creates two new categories of regulated entities, a new holding company structure, through which a bank can engage in all of the Act’s newly authorized financial activities, and a new financial subsidiary, which allows a bank to engage through a direct operating subsidiary in most, but not all, of the newly authorized activities.

1. Financial Holding Companies

The Act permits eligible bank holding companies (“BHCs”) to qualify as newly-created financial holding companies (“FHCs”). FHCs can engage, in addition to closely related nonbanking activities permitted under Section 4(c)(8) of the Bank Holding Company Act (“BHCA”) on the date of enactment of the Act, in activities of a “financial nature or incidental to such financial activities,” as well as activities that are “complementary” to financial activities and do not pose a risk to safety and soundness of depository institutions or the financial system. (A BHC is a company that controls a bank or another BHC. Control is deemed to exist if the company has the power to vote more than 25% of the voting securities of the bank or BHC, controls the election of a majority of the directors of the bank or BHC, or is found by the FRB to exercise a controlling influence over the management or policies of a bank or BHC.) The FRB has the authority to define, in consultation with the Treasury Department, activities that are financial in nature or incidental to such activities. The Act also sets forth

a list of preapproved financial activities. The Act does not define “complementary,” leaving it to the FRB to make determinations as to what is complementary on a case-by-case basis.

(a) Eligibility

In order to conduct new activities or acquire and retain shares of a company that were not permissible for a BHC to conduct or acquire before enactment of the Act, a BHC must meet certain eligibility criteria (the BHC's depository institution subsidiaries must be well capitalized and well managed) and must have filed a declaration with the FRB that it elects to be an FHC and must have certified that it meets the eligibility criteria. In addition, the depository institution subsidiaries must have received in their most recent Community Reinvestment Act examination a rating of at least “satisfactory” for the FHC to commence any new permitted activity or acquire control of any company engaged in any such activity. Generally, an FHC need only provide after-the-fact notice to the FRB within 30 calendar days of acquiring a company or commencing any activity under the FHC provisions. Prior approval is required only for the acquisition of a savings association.

If an FHC ceases to be well managed or well capitalized, the FHC must agree to come into compliance and, pending compliance, the FRB can impose limitations on the FHC. If noncompliance continues beyond 180 days, the FRB may order divestiture of a depository institution or the FHC can limit its activities to those permitted under Section 4(c)(8). These provisions are not triggered by an FHC's failure to obtain a satisfactory CRA rating.

(b) Newly Authorized Activities

Financial activities include the following preapproved activities, as well as activities determined by the FRB in the future, subject to Treasury approval, to be financial in nature or incidental to such activities. The FRB will also determine which activities are complementary to financial activities. The preapproved list of financial activities includes:

- lending and other traditional banking activities;
- providing financial, investment or economic advisory services, including to a registered investment company;
- underwriting, dealing in or making a market in securities;
- mutual fund distributions;
- engaging in activities deemed by the FRB to be “closely related to banking”; and
- engaging in activities approved by the FRB for US banks operating abroad.

An FHC can engage in merchant banking activities (acquiring or controlling shares, assets or ownership interests (including debt or equity securities) of a company engaged in a nonbanking activity) through securities and insurance affiliates, but banks and their subsidiaries may not directly conduct such activities. The FRB and the Treasury Department can reconsider the prohibition on bank subsidiaries engaging in merchant banking activities after five years. This provision broadens the scope of activities beyond the limited merchant banking options available to BHCs: investments through small business investment companies; the Regulation Y provision permitting ownership of up to 25% of nonbanking companies and the Regulation K provision allowing affiliates to hold up to 40% of a foreign company. An FHC can invest in a nonfinancial company (whether or not controlling) if the shares, assets or ownership interest:

- are not held directly by a depository institution or a subsidiary of a depository institution;
- are held by a securities affiliate of the FHC or an investment advisor affiliate of an insurance affiliate and are part of bona fide investment or merchant banking activities;
- are held for a period of time to enable their sale or disposition on a reasonable basis consistent with the financial viability of these activities (including investment for the purpose of appreciation and ultimate disposition); and
- are not held under circumstances where the investor routinely manages or operates the portfolio company, except as necessary or required to obtain a reasonable return upon disposition.

(c) Consequences

As a result of the FHC structure, a bank may now affiliate with a securities firm that is actively involved in underwriting. The revenue limits applied to Section 20 subsidiaries would no longer apply. Securities firms can also convert to an FHC and acquire a bank. The FRB would regulate the FHC, but not the securities operations conducted by the securities subsidiary of the FHC.

BHCs that do not elect to be, or do not qualify as, an FHC may continue to engage in all closely related nonbanking activities permitted under Section 4(c)(8) of the BHCA, as in effect in November 1999. They will not be permitted to engage in any activities deemed financial in nature. Thus, a BHC that owns a “Section 20” subsidiary and does not qualify as an FHC presumably would continue to adhere to the current Section 20 operating standards and 25% gross revenue limitation unless such standards are subsequently modified by the FRB. Although section 20 has been repealed, it is unclear whether the gross revenue limitations would be removed from the section 20 orders currently in place.

(d) Non-US Banks

In the case of declarations filed with the FRB by non-US banks with branches, agencies or commercial lending subsidiaries in the United States to be treated as an FHC, the FRB will apply “comparable” capital standards and management standards similar to those for US banks, giving due regard to the principle of national treatment and equality of competitive opportunity. Non-US banks that do not opt to become FHCs will need to continue to limit their activities to Section 4(c)(8) permitted activities. A non-US bank that becomes an FHC will lose any grandfathered rights under the International Banking Act to engage in activities which are permissible for FHCs. After November 2001, the FRB can impose on any non-US bank that is conducting grandfathered financial activities, but has not elected FHC status, requirements and restrictions on such activities comparable to those imposed on FHCs, including the requirement to conduct such activities in accordance with prudential safeguards (see below). A non-US bank can continue to engage in grandfathered nonfinancial activities, whether or not it elects to become an FHC.

(e) Grandfather Provisions

An FHC whose activities are at least 85% financial (e.g., a securities firm that has commercial operations and that acquires a commercial bank) has 10 years (with the possibility of a five-year extension on a case-by-case basis) before it must divest itself of its commercial operations. Bank holding companies and foreign banks are specifically excluded from taking advantage of these grandfather provisions.

2. Financial Subsidiaries

Instead of using an FHC as the vehicle for conducting newly authorized financial activities, a national bank can use one of its direct subsidiaries. The Act allows national banks to engage in activities that are financial in nature or incidental to such activities, provided they are conducted through “financial subsidiaries.” The bank can own or invest in a financial subsidiary.

Unlike an FHC, a financial subsidiary may not engage in certain newly authorized activities as a principal. In particular, financial subsidiaries may not engage as principal in real estate development or investment, or in merchant banking activities, though merchant banking activities may be permitted after five years. A financial subsidiary also may not engage in nonfinancial activities approved by the FRB as complementary.

A national bank may control a financial subsidiary if:

- it and its depository institutions are well capitalized and well managed and the consolidated total assets of all of its financial subsidiaries do not exceed the lesser of 45% of the consolidated total assets of the national bank and \$50 billion;
- in the case of financial subsidiaries that conduct activities as principal, the national bank is one of the one hundred largest insured banks in the United States and its long-term debt is rated among the top three investment grade ratings;
- the national bank has obtained the approval of the Office of the Comptroller of the Currency (“OCC”) for the financial subsidiary; and
- the national bank meets the CRA requirements applicable to FHCs.

In calculating its capital adequacy, a national bank will be required to deduct its equity investment, including retained earnings, in its financial subsidiaries, and may not consolidate the assets and liabilities of the financial subsidiaries. The bank must also have in place procedures for identifying and managing financial and operational risks, and policies and procedures to preserve the separate corporate identity and limited liability of the bank.

A financial subsidiary can also engage in activities permissible for the bank to conduct itself, subject to the same terms that govern the conduct of such activities by the bank.

C. Functional Regulation

The Act amends the Securities Exchange Act of 1934 Act to eliminate the broad exemption of banks from broker-dealer registration and to incorporate functional regulation of bank securities activities. Banks may continue to engage in the following activities without registering as broker-dealers, based on the exclusion of the following activities (subject to certain conditions, including but not limited to those described below) from the definition of “broker”:

- trust and fiduciary activities;
- safekeeping and custodial arrangements;
- transactions in commercial paper, exempt securities and Brady bonds;

- employee benefit, dividend reinvestment and issuer plans conducted as part of transfer agency activities (provided (i) the bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities; (ii) the transactions (A) are executed through a registered broker-dealer, including an affiliate, or (B) constitute a cross trade or other substantially similar trade by the bank or between the bank and an affiliated fiduciary and are not in contravention of fiduciary principles or (C) are conducted in some other manner permitted by SEC rules and (iii) in the case of reinvestment plans and issuer plans, the bank does not net buy and sell orders except for odd-lot plans or SEC-registered plans);
- sweep accounts;
- private placements under Section 3(b) or 4(2) of the Securities Act of 1933 (provided the bank is not affiliated with a broker-dealer engaged in underwriting, dealing or market making in any securities and provided that if the bank is not affiliated with any broker or dealer it limits its private placements of securities, other than government or municipal securities, to not more than 25% of its capital);
- third-party networking arrangements to offer brokerage services;
- loan participations deemed by the SEC to be securities (provided sales are to qualified investors (as defined) or to non-qualified investors that have the opportunity to review and assess material information and have the requisite sophistication);
- transactions involving deposit accounts, savings accounts, certificates of deposit, banker's acceptances and bank letters of credit;
- transactions involving swaps (provided that equity swaps may not be sold to persons that are not qualified investors); and
- up to 500 transactions annually, provided the transactions are not effected by bank employees that are also broker-dealer employees;

and based on the exclusion of the following activities from the definition of “dealer”:

- purchases or sales of commercial paper, exempt securities and Brady bonds;
- purchases or sales of securities for investment, trust or fiduciary purposes;
- issuances or sales to qualified investors of asset-backed securities where the underlying assets are banking products or originated by (i) the bank, (ii) a nonbroker-dealer affiliate of the bank or (iii) a syndicate of which the bank is a member if the obligations are mortgages or consumer-related receivables;
- loan participations deemed by the SEC to be securities (provided sales are to qualified investors or to non-qualified investors that have the opportunity to review and assess material information and have the requisite sophistication);
- transactions involving deposit accounts, savings accounts, certificates of deposit, banker's acceptances and bank letters of credit; and

- transactions involving swaps (provided that equity swaps may not be sold to persons that are not qualified investors).

For purposes of the foregoing, a qualified investor includes registered investment companies; Section 3(c)(7) entities; various financial institutions; banks, savings associations, brokers, dealers, insurance companies and business development companies; foreign banks; foreign governments and entities and individuals that own and invest at least \$25 million in investments on a discretionary basis (\$10 million, in the case of exclusions from the definition of broker for loan participations and swaps and from the definition of dealer for loan participations, swaps and asset-backed securities).

If the SEC imposes broker-dealer registration on banks engaged in transactions in “new hybrid products” that were not subject to regulation as a security by the SEC prior to enactment of the Act, the FRB may challenge the SEC's jurisdiction over such products in court.

US branches or agencies of non-US banks may also continue to conduct the foregoing activities without becoming subject to broker-dealer registration.

As a result of the general elimination of the exemption from broker-dealer registration, US banks, as well as branches and agencies of non-US banks, will in effect be required to “push out” to separate subsidiaries registered under the 1934 Act all of the activities that would trigger broker-dealer registration. Otherwise, the entire bank would be subject to registration and regulation as a broker-dealer.

The Act requires the NASD to create a limited qualification category for persons associated with an NASD member who effect securities under the private placement exemption, and will deem any bank employee to be so qualified, without testing, if such employee effected private placement sales during the six months ended November 12, 1999.

D. Investment Bank Holding Companies

The Act creates a new investment bank holding company structure under the 1934 Act. An IBHC is any entity that owns or controls one or more broker-dealers. An IBHC may elect to be supervised by the SEC. An IBHC may not be:

- an affiliate of a savings association or insured bank, other than a trust company, credit card bank, foreign branch, banking corporation authorized to do foreign banking business or nonbank bank; or
- a foreign bank, foreign company or foreign bank that owns a bank or branch in the United States that is subject to the nonbanking provisions of the BHCA.

The purpose of this structure is to enable the SEC to be the home country regulator for purposes of international banking law requirements. The SEC can require an IBHC and its affiliates to maintain records and has the authority to perform examinations of the IBHC and its affiliates. The SEC must defer to banking regulators with respect to interpretations and enforcement of banking laws applicable to the activities, conduct, ownership and operations of banks, trust companies, credit card banks, foreign branches, banking corporations authorized to do foreign banking business and nonbank banks.

E. Regulatory Oversight

The FRB will regulate FHCs. In addition, the FRB will regulate banking activities of the FHC's subsidiaries, while the SEC will regulate the activities of the functionally regulated securities subsidiaries.

The FRB will be able to examine broker-dealer subsidiaries only in limited circumstances (for example, where it believes the activities of the subsidiary pose a material risk to a depository institution). In addition, the FRB can require a holding company and any of its subsidiaries (including a securities subsidiary) to submit reports regarding financial condition, systems for monitoring and controlling financial and operating risks, transactions with depository institution subsidiaries and compliance with banking laws that it is empowered to enforce.

The FRB may not adopt capital or capital adequacy requirements for a functionally regulated subsidiary of a BHC that is in compliance with the applicable capital adequacy requirements of another federal securities or state insurance regulator. Thus, securities subsidiaries of an FHC must comply with SEC and SRO net capital rules.

The federal banking authorities (the FRB, the OCC or the Federal Deposit Insurance Corporation ("FDIC"), as applicable) may impose prudential safeguards on relationships or transactions between depository institutions and their subsidiaries that are appropriate to avoid risk to safety and soundness of insured institutions or other unsound business practices. Thus banking operations must comply with applicable FRB, OCC or FDIC standards, and securities firms will need to comply with FRB/FDIC standards in connection with transactions with their banking affiliates. This authority also extends to imposing safeguards on relationships and transactions between a branch, agency or commercial lending company of a non-US bank in the United States and any affiliate in the United States of such non-US bank.

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This memorandum only addresses the provisions of Title I of the Act affecting affiliations between banks and securities firms and the provisions of Title II, which provides for the functional regulation of broker-dealers and bank investment company activities. It does not address any of the reforms relating to affiliations between banks and insurance companies or the provision of insurance-related products and services. Moreover, the memorandum provides only a general overview of these matters, and is not intended to provide legal advice. Therefore, no legal, regulatory or business decision should be based on its content. Questions concerning the matters discussed in this memorandum should be directed to Mark S. Bergman ((212) 373-3258) or Miriam Klepner ((212) 373-3338).