Financial Modernization in the United States: What New Financial Activities U.S. Banks and Foreign Banks in the United States Can Now Pursue

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After more than ten years of congressional debate over repealing the depression era Glass-Steagall Act, which separated securities and insurance businesses from banking in the United States, Congress passed the Gramm-Leach-Bliley Act (GLBA) on November 12, 1999.[1] As a side drama, the Board of Governors of the Federal Reserve System (the Board) won the bank regulator turf war between itself and the U.S. Treasury's Office of the Comptroller of the Currency (OCC). The GLBA allows only financial holding companies (FHC), a subset of bank holding companies (BHC) that are regulated by the Board, to engage in certain important new financial activities, including merchant banking (the ownership of securities of a company for purposes of ultimate resale). Before the GLBA, a BHC could essentially own no more than five percent of the voting equity and twenty-five percent of the total equity of such entities. In addition, the BHC had to be a passive investor. Now, a FHC can acquire a direct or indirect interest in a business engaged in any kind of trade or business without any revenue limitations imposed on it. Prior to the passage of the GLBA, a BHC could operate section 20 affiliates that had revenue limitations on their corporate securities underwriting activities.

However, the GLBA did not completely dismantle the walls separating commerce and banking in the United States. The number of nonbank activities that a BHC can engage in through a FHC has expanded, but many of them may only be conducted in securities affiliates and nonbank subsidiaries. In addition, the Board has placed aggregate limits on the amount of merchant banking activities a FHC may engage in that is tied to its Tier 1

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1. Gramm-Leach-Bliley Act (GLBA), Pub. L. No. 106–102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 U.S.C. and 15 U.S.C.).

capital. Congress still harbors a concern that if a banking organization is able to engage in commerce in an unrestricted manner, there will be the risk that certain safeguards provided solely for the benefit of depository institutions in the United States, such as federal deposit insurance and access to the Discount Window, will be relied on to engage in financial activities and subsequently risk the stability of the financial system generally.[2] The GLBA did repeal Section 20 of the Glass-Steagall Act (Section 20), which prohibited banks from engaging in securities underwriting.[3] In addition, section 32 of the Banking Act of 1933 was also repealed, which had prohibited officers, directors, or employees of any corporation or other partnership primarily engaged in securities underwriting and dealing from serving at the same time as an officer, director, or employee of a national bank.[4]

This article will summarize three major changes in U.S. banking and its regulation and supervision as a result of the GLBA and discuss the regulations that have been issued on an interim basis to implement these changes. Those three changes are: (1) BHCs that elect FHC status engaging indirectly and directly in certain financial activities previously prohibited along with new capital requirements to do so, (2) new restrictions on mixing banking and commerce, and (3) new umbrella supervision by the Board of consolidated FHCs and functional supervision of financial activities by traditional regulators of those activities.

I. New Financial Activities U.S. Banks May Engage In

A. FHC Election by U.S. Banks and Foreign Banks

Only qualified BHCs may elect to become a FHC and engage in all of the activities on the GLBA laundry list of financial activities. To be a FHC, all depository institutions controlled by the BHC must be and remain well capitalized and well managed and must have received no less than a satisfactory Credit Reinvestment Act (CRA) rating in their most recent CRA examination. Furthermore, the BHC must file with the Board a declaration that it elects to be a FHC.[5] The declaration will become effective within thirty-one days of its receipt by the Board unless the Board notifies the BHC.[6] The same procedure applies to foreign banks whose banking presence in the United States is through a bank subsidiary. In addition, foreign banks whose banking presence in the United States is through a branch, agency, or commercial lending company can also take advantage of the thirty-one-day notification procedure as a result of an amendment to the interim rule regarding FHC election.[7] National banks may also make such an election if they qualify under similar well-capitalized, well-managed, satisfactory-CRA-rating requirements as adopted by the OCC.[8] In determining if a national bank is well capitalized, it must deduct its equity investment in financial subsidiaries.[9] Both the Board and the OCC issued interim rules effective March

2. *See* Chairman Alan Greenspan, Remarks before the Annual Meeting of the American Council on Life Insurance (Nov. 15, 1999).

3. Glass-Steagall Act, 12 U.S.C. § 377 (repealed 1999); and GLBA § 101(a).

4. Banking Act of 1933, 12 U.S.C. § 78 (repealed 1999); and GLBA § 101(b).

5. Bank Holding Companies Act, 12 U.S.C. § 1843(l) (2000); and GLBA § 103(a).

6. *Procedures to Become a Financial Holding Company and Guidance Regarding the Initial Monitoring of Acquisitions and the Commencement of New Activities by Financial Holding Companies*, SR 00-1 (Sup.) (Feb. 8, 2000).

7. Amendment to Board of Governors Interim Rule, 12 C.F.R. §§ 225.81 and 225.90–94 (2000) [hereinafter Amendment to Board Interim Rule].

8. *See* 12 U.S.C. § 24a; and GLBA § 121(a).

9. 12 U.S.C. § 24a(a)2(C); and GLBA § 121(a).

11, 2000, establishing procedures to elect FHC status or engage in certain financial activities through a financial subsidiary that involves self-certification of meeting the well-capitalized, well-managed requirements.[10]

By granting foreign banks that operate a branch, agency, or commercial lending company in the United States the right to elect to be a FHC, the GLBA has attempted to level the playing field for foreign banks active in the U.S. banking market.[11] However, the Board's interim rule has not been well received by foreign banks, especially those located in the European Union, who have complained of extraterritorial application of U.S. requirements regarding capital. In a letter to the Board signed by John Mogg, the European Commission's director-general for financial services, complaints of adverse discriminatory treatment against foreign banks were filed. In addition, European officials have rumored that the European Commission may consider more extreme measures, including taking the United States to the World Trade Organization (WTO) or imposing retaliatory measures against U.S. banks operating in Europe, if the Board does not change the standards applied to foreign banks to meet the FHC election when the interim rule is finalized.[12]

The Board's interim rule requires that a foreign bank wishing to elect to become a FHC meet the same risk-based capital standards as domestic FHCs if its country has adopted the Capital Accord of the Basle Committee on Banking Supervision (Basle Accord). If the foreign bank's home country has not adopted the Basle Accord, the foreign bank must obtain a prior determination that its capital is otherwise comparable to the capital that would be required by a U.S. bank. The Board has also imposed a lower leverage ratio on foreign banks requiring the foreign bank's ratio of Tier 1 capital to total assets to be three percent, rather than the more stringent five percent requirement for U.S. banks. In reducing the leverage ratio requirement, the Board recognized that foreign banks are likely to engage in both banking and nonbanking operations abroad that lower their leverage ratio. If a foreign bank fails to meet the leverage or other capital ratios, it can appeal to the Board for further consideration. The Board will refer to the management ratings for the U.S. operation of the foreign bank and the views of the home country supervisor to determine if the foreign bank is well managed.[13] U.S. and foreign banks started taking advantage of this election to become a FHC on March 13, 2000, the first business day following the effective date of the FHC provisions in the GLBA.[14] The list of FHCs is growing, with 420 BHCs electing FHC status as of October 2000.[15] However, only twenty-six foreign banks, including those located in Canada and Puerto Rico, have elected FHC status, and, therefore, the European Commission's complaints of discriminatory treatment may have some validity.

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10. Board of Governors Interim Rule, 65 Fed. Reg. 3,785 (Jan. 25, 2000) [hereinafter Board Interim Rule]; OCC Interim Rule, 65 Fed. Reg. 3,157 (Jan. 20, 2000) [hereinafter OCC Interim Rule]. Once finalized, the Board Interim Rule will amend Regulation Y, 12 C.F.R. pt. 225, by adding a subpart I. *See also* Amendment to Board Interim Rule, *supra* note 7, § 225.81(c) (granting foreign banks the use of the same thirty-one-day notice procedure for FHC election applicable to U.S. BHCs).

11. 12 U.S.C. § 1843(l)(3); and GLBA § 141.

12. *See* Gwen Robinson, *EU Protests to US over "Foreign Bank Bias,"* FIN. TIMES, Mar. 24, 2000, at 4; *New Rules Biased Against Foreign Banks, European Union Complains in Letter to Fed*, BUS. NEWS ANALYSIS, Mar. 27, 2000.

13. Board Interim Rule, *supra* note 10, proposed 12 C.F.R. § 225.90; Governor Lawrence H. Meyer, Remarks before the American Law Institute and American Bar Association (Feb. 3, 2000).

14. 12 U.S.C. § 24; and GLBA § 161.

15. *See* http://www.federalreserve.gov/generalinfo/fhc.

The GLBA contains detailed provisions to address situations when a FHC later fails to maintain the requirements it met to become a FHC. At first, the GLBA calls for the FHC to agree with the Board to correct conditions. If the failure is not corrected within 180 days, the FHC must either divest control of any bank subsidiary or cease to engage in financial activities not listed in section 4(c)(8) of the Bank Holding Company Act.[16] Therefore, a U.S. banking group cannot take advantage of the right to mix banking and commerce as a FHC if it fails to keep its banking subsidiaries' vital signs and its capital and management strong. A nonbank entity that acquires a bank will still have to apply to the Board for its approval to become a BHC and may simultaneously file its election to be a FHC if it meets those requirements.[17] After the GLBA has passed its fourth year of enactment, at the end of 2003, the Board and Treasury will issue a report to Congress that reviews all the financial activities that have been allowed and disallowed. This report will advise Congress on the "risks posed by commercial activities of financial holding companies to the safety and soundness of affiliate depository institutions," as well as the effect of the GLBA financial provisions on the levels of consolidation within the U.S. banking market as a result of mergers and acquisitions among and between large financial entities.[18]

What is novel about the GLBA laundry list of financial activities is that a FHC does not need any prior bank regulatory approval to engage in any of the GLBA laundry list of financial activities or to acquire a nonbank company that engages in those activities, such as a registered broker-dealer or investment advisor, assuming the FHC still meets the requirements to elect FHC status. Rather, the FHC must provide the Board with written notice within thirty calendar days after commencing the activity or acquiring the nonbank company.[19] As a result, one can expect a lot of merger and acquisition activity in the U.S. banking market once all the Board and Treasury interim rules regarding merchant banking, financial activities, FHC election, and capital requirements are finalized. U.S. standards for merger and acquisition activity are scheduled to change by the end of 2000, which should prompt this merger activity that is expected to continue for the next couple of years as investment banks, insurance firms, and securities firms determine how best to take advantage of the financial activities permissible within the FHC structure offered by the GLBA.

B. Financial Subsidiaries

Under the GLBA, financial subsidiaries, defined as a subsidiary in which a national bank controls or holds an interest, are given the same rights to engage in the GLBA financial laundry list of activities except for four important financial activities in which only FHCs may engage. In addition, the Board granted state-member banks the same rights to establish financial subsidiaries that national banks have pursuant to an interim rule expected to be finalized without comment.[20] Financial subsidiaries may not engage in: (1) insurance or annuity underwriting, (2) insurance company portfolio investment, (3) real estate invest-

16. 12 U.S.C. § 1843(m)(1)–(4); and GLBA § 103(a). Section 4(c)(8) of the Bank Holding Company Act is enacted at 12 U.S.C. § 1843(c)(8) and was the original Board laundry list of nonbanking activities that a BHC could engage in before passage of the GLBA.

17. 12 U.S.C. § 1842(a).

18. 12 U.S.C. § 1843; and GLBA § 103(d).

19. 12 U.S.C. § 1843(k)(6); and GLBA § 103(a).

20. Financial Subsidiaries of State Member Banks, Board Interim Rule, 12 C.F.R. §§ 208.71–.75 (2000).

ment or development, or (4) merchant banking subject to the joint Board-Treasury review in 2004.[21] Financial subsidiaries may also elect to engage in the remaining financial activities listed in the GLBA and can do so by filing a certification with the OCC or the Board that they have met the statutory qualifications.[22] However, financial subsidiaries have the right to engage in OCC-approved, nonbank activities that national bank operating subsidiaries have been allowed to engage in subject to conditions specified by the OCC in its prior orders. At the end of 2004, the Board and Treasury will have joint authority to allow financial subsidiaries to engage in the full range of merchant banking activities subject to applicable restrictions.[23]

C. New Financial Activities

For the past ten years, banks in the United States have sought to conduct certain prohibited or restricted activities, such as securities and insurance activities, through merger or acquisition or through Section 20 subsidiaries. The most obvious example of this trend is the recent merger of Citibank and Travelers Group to become CitiGroup, with its famous subsidiary, Salomon Smith Barney. The Board granted its approval for the merger with the proviso that CitiGroup would have to divest the bank–impermissible securities and insurance activities if, within five years post-merger, U.S. law still prohibited the mixing of banking and commerce within a BHC.[24]

U.S. law now allows certain qualifying BHCs and foreign banks, which are treated as BHCs due to their establishment of a banking subsidiary or their operation of a branch, agency, or commercial lending company in the United States, to elect FHC status through which they can engage in certain specified financial activities. In addition, the Board and Treasury are, by regulation and order, determining jointly other activities "to be financial in nature or incidental to such financial activity or . . . complimentary to a financial activity [that] do[es] not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[25] Congress provided statutory factors for regulators to consider in deciding which activities are financial in nature or incidental to such financial activity.[26]

The GLBA sets out the following activities as de facto financial in nature but puts restraints on how these activities are conducted within the FHC structure. The statutory GLBA laundry list of financial activities includes: (1) lending, exchanging, transferring, investing for others, or safeguarding money or securities; (2) acting as principal, agent, or broker in providing insurance against loss, damage, illness, death, and disability; (3) providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940); (4) issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly; (5) underwriting, dealing in, or making a market in securities; (6) engaging

21. 12 U.S.C. § 24a(a)(2)(A)–(B); GLBA § 121(a); *see also* H.R. No. 106–434 at 154 (1999).

22. *Id.*; *see also* OCC Interim Rule, *supra* note 10.

23. 12 U.S.C. § 1843(k)(7)(B); and GLBA § 103(a).

24. Board Order Conditionally Approving the Application Filed by Travelers Group to Become a Bank Holding Company by Acquiring Citibank and Its Banks and Non-bank Subsidiaries (Sept. 23, 1998), *at* http://www.federalreserve.gov/infoletters.

25. 12 U.S.C. § 1843(k)(2)(a)(i); and GLBA § 103(a)(1).

26. 12 U.S.C. § 1843(k)(2)(a)(ii); and GLBA § 103(a)(2).

in any activity that the Board has determined by order or regulation on or before November 11, 1999, to be so closely related to banking to be a proper incident thereto (subject to the same terms and conditions contained in such order or regulation, unless modified by the Board); (7) engaging in merchant banking or investment banking activities by acquiring interests, shares, or assets in other companies through specified securities and insurance affiliates; and (8) engaging in insurance company portfolio investment.[27]

1. *Financial Activities Interim Rule*

The Board fleshed out the meaning and limits of the laundry list of financial activities in the GLBA in an interim rule effective on March 11, 2000, with comments accepted until May 12, 2000.[28] In addition to those activities listed in the GLBA, FHCs may also engage in the following activities that are financial in nature or incidental to a financial activity: (1) activities listed in 12 C.F.R. § 225.28 and identified as activities that were so closely related to banking as to be a proper incident thereto by the Board; (2) any activity that the Board determined by order in effect prior to November 19, 1999, to be so closely related to banking as to be a proper incident thereto; (3) management consulting services on an advisory basis; (4) operation of a travel agency in connection with the provision of financial services; and (5) organizing, sponsoring, or managing a mutual fund (with limitations such as no management control and no FHC fund ownership over twenty-five percent of equity within one year of sponsorship).[29] During Summer 2000, the Board issued a proposed rule that would allow FHCs to act as "finder" by bringing together buyers and sellers of financial and nonfinancial products for transactions that the parties would normally negotiate for themselves. An example of a finder activity includes FHC hosting of an Internet marketplace consisting of links to the Websites of third-party buyers and sellers.[30]

A FHC does not need to obtain Board approval to engage in any of the aforementioned activities but must comply with the GLBA notice procedures within thirty calendar days after commencing the activity or consummating the acquisition.[31] The Board has requested comments on what standards should be applied to determine if activities are "complimentary to . . . financial activiti[es,]" but the interim rule currently requires the FHC to obtain prior approval from the Board to conduct such complimentary activity.[32] In addition, the Board will accept requests for a determination that an activity is financial in nature or incidental to a financial activity that requires the FHC to provide detailed information about the activity and why it considers it to be financial in nature or incidental to a financial activity.[33]

2. *Merchant Banking Regulations*

The merchant banking activities conducted by a FHC through its "securities affiliate" or its insurance affiliate with an investment adviser arm are the subject of a joint regulation

27. 12 U.S.C. § 1843(k)(4)(A)–(I); and GLBA § 103(a). Amendment to Board Interim Rule, *supra* note 7, 12 C.F.R. §§ 225.170–75, 12 C.F.R. §§ 1500.1–.7.

28. Board Interim Rule Listing Financial Activities Permissible for FHCs, 12 C.F.R. § 225.85–.89 (2000) [hereinafter Financial Activity Interim Rule].

29. *Id.* § 225.86. The last three activities listed in the article were activities that BHCs previously could only pursue abroad pursuant to Regulation K. *Id.* § 211.

30. Board Proposal on FHC Finder Activities (Aug. 3, 2000).

31. Financial Activity Interim Rule, *supra* note 28, § 225.87.

32. *Id.* § 225.89.

33. *See id.* § 225.88.

issued by the Board and Treasury in interim rule form on March 17, 2000.[34] This interim rule establishes six standards for FHCs engaging in merchant banking. First, a FHC may only engage in merchant banking activities through its control of a nonbanking subsidiary, such as its securities affiliate (broker/dealer) or its insurance affiliate with an investment adviser affiliate.[35] A FHC may not acquire or control merchant banking investments on behalf of a depository institution or subsidiary of a depository institution. Obviously, this raises concerns that the barriers between banking and commerce have not been eradicated at all by the GLBA. This aspect of the interim rule for merchant banking regulation immediately prompted anticompetitive howls from the U.S. banking industry. The Board's standard response to such complaints is to remind the banking industry of the contagion risk to the financial system in general if depository institutions engage in risky activities such as merchant banking. Second, a FHC may not routinely manage or operate a portfolio company, which is defined as any company or entity that is engaged in an activity that is not authorized for a FHC under section 4 of the Bank Holding Company Act. Management covers certain situations in which any director, officer, employee, or agent of the FHC serves as an officer or employee of the portfolio company or otherwise influences or participates in the day-to-day operations or management decisions of the portfolio company. In special circumstances, a FHC is allowed to manage a portfolio company "to address a material risk to the value or operation of the portfolio company, such as a significant operating loss or loss of senior management."[36]

Third, a FHC may only hold a merchant banking investment for ten years or less, with the holding period slightly longer for investments in private equity funds, a period of twelve years. The Board and Treasury will consider requests for extensions of holding periods under "extraordinary circumstances"; however, there will be penalty charges to the FHC's Tier 1 capital equal to 100 percent of the carrying value of the investment for doing so.[37] A private equity fund is defined as a company formed for the purpose of engaging exclusively in the business of investing in shares and other ownership interests in companies for resale and that issues equity ownership interests to at least ten investors that are not affiliated with and are not officers, directors, employees, or principal shareholders of the FHC. In addition, a private equity fund cannot have more than twenty-five percent of its total equity held, owned, or controlled directly or indirectly by the FHC or its directors, officers, employees, or principal shareholders and its initial term cannot be more than twelve years (which may be extended for an additional three one-year periods with majority fund equity holder approval). This holding period standard ensures that the FHC is holding the merchant banking investments for resale only until a point in time when financial gain is assured.

Fourth, a FHC will have to keep within the aggregate limits applied to its merchant banking activities as set by the Board and Treasury in the interim rule. The aggregate carrying value of a FHC's merchant banking investments may not exceed either: (a) the lesser of thirty percent of the FHC's Tier 1 capital or $6 billion, or (b) the lesser of twenty percent of the FHC's Tier 1 capital or $4 billion excluding interests in private equity funds from the overall merchant banking investment value. A FHC may exceed these thresholds

34. Board and Treasury Joint Interim Rule on Merchant Banking Activities and Proposed Capital Charge, 12 C.F.R. §§ 225.170–75, 1500.1–.7 (2000) [hereinafter Merchant Banking Interim Rule].

35. *See id.* § 225.170.

36. *Id.* § 225.171(d)(i).

37. *Id.* § 225.172(b)(4).

with the prior approval of the Board.[38] Fear prompts these aggregate value limits. The Board and Treasury are fearful of BHCs' rapid entry into the merchant banking market as newly elected FHCs, and what that rapid entry might do to the safety and soundness of depository institutions affiliated with FHCs engaged in merchant banking activities. Therefore, until these banking agencies have gained experience supervising these activities and the industry has gained experience with FHCs involved in merchant banking, these aggregate limits are likely to remain.

The fifth standard set in the interim rule for the merchant banking regulations is an overall requirement that a FHC develop risk-management reporting and record-keeping policies and systems to monitor the overall merchant banking investment held by the FHC and the risks that it produces. In addition, these systems must demonstrate a FHC's compliance with the statutory and regulatory provisions regarding these activities. To name just a few, these policies and systems must be able to monitor and assess the value of each investment, the value of the aggregate portfolio, and the diversification of the portfolio; monitor the terms, amounts, and type of transactions and relationships between the FHC and each company in which the FHC has an interest; and verify the corporate separateness between the FHC and each company in which the FHC has an interest. In addition, a FHC must maintain specific records and file annual and quarterly reports with the Board regarding its merchant banking investments.[39] The Board will be issuing forms to facilitate the filing of these reports.

The interim rule for the merchant banking regulations relaxes the GLBA's strict thirty-day notice requirement for smaller merchant banking investments involving the acquisition of a company. Instead, a FHC need only file with the Board a notice providing specified information about a merchant banking investment where both the acquisition represents in excess of five percent of the voting shares, assets, or ownership interests of the company and the cost of the investment exceeds the lesser of five percent of the Tier 1 capital of the FHC or $200 million.[40] The Board has stated its intent to conduct a review of each FHC's policies and systems, in particular to review the investment and risk management systems, shortly after the FHC commences merchant banking activities.[41]

Lastly, the interim rule for the merchant banking regulations imposes a prohibition on cross-marketing between FHC-controlled depository institutions and FHC-controlled portfolio companies and/or private equity firms.[42] Nondepository affiliates of the FHC are not subject to this cross-marketing prohibition. The interim rule does not define what cross-marketing is. However, the Board and Treasury have stated that cross-marketing would not "appear" to cover efforts by an affiliated depository institution to syndicate a loan to a portfolio company; the purchase by an affiliated depository institution, for its own use, of products and services of a portfolio company; or the provision of services or extensions of credit by the depository institution directly to the portfolio company. However, these later two transactions would be covered by the requirements of sections 23A and 23B of the

38. *Id.* § 225.173.
39. *Id.* § 225.174.
40. *Id.* § 225.175.
41. The Board issued a supervisory letter in August 2000 that explains what Board examiners may look at both at the FHC level and at the merchant banking level, if necessary. *Framework for Financial Holding Company Supervision* (SR 00-13 (SUP) Aug. 15, 2000).
42. 12 C.F.R. § 225.175.

Federal Reserve Act, as discussed later, if the portfolio company is an affiliate of the depository institution.[43] The application of affiliate status to merchant banking investments controlled by the FHC and cross-marketing prohibitions between the bank affiliates and others are discussed separately in the section on restrictions remaining on mixing banking and commerce below.

3. *Capital Proposal for Merchant Banking Activities of FHCs*

Amid much controversy, the Board issued a proposed rule developed in consultation with Treasury that would govern the regulatory capital treatment for equity investments in nonfinancial companies held by BHCs. This proposed rule was issued at the same time the Board issued the interim rule for merchant banking regulations on March 17, 2000. The proposed rule would impose a fifty percent capital requirement on merchant banking investments and certain similar investments at the holding company level on a consolidated basis. The Board invited comments on the proposed rule until mid-May 2000, but has not, as of October 2000, sought to finalize the proposal. Under the proposal, a FHC would be required to deduct from its regulatory Tier 1 capital an amount equal to fifty percent of the total carrying value of all merchant banking investments, as reflected on its consolidated financial statements.[44] This capital charge would apply to all equity instruments and all debt instruments that are convertible into equity held by the FHC under the merchant banking provisions of the GLBA and regulations. It would also apply to all loans extended by a FHC to a portfolio company in which the FHC owns fifteen percent or more of the equity or ownership interests of the company. Certain loans will be exempted from the capital charge, such as short-term secured loans for working capital purposes, loans in which at least fifty percent has been participated by third parties, and loans that are guaranteed by the U.S. government. In addition, loans from depository institutions under the BHC group that are fully collateralized and otherwise comply with section 23A of the Federal Reserve Act will also be exempt from the proposed capital charge. Lastly, there will also be a fifty percent capital charge for those nonfinancial investment activities conducted by BHCs and their subsidiaries as well.[45]

The banking industry expressed its disappointment with this proposal and accused the Board of taking away any financial liberalization or modernization that was achieved in the GLBA by imposing such steep capital requirements.[46] In defending its proposal, the Board has claimed that all depository institutions under BHCs will remain well capitalized on a consolidated basis even after applying the proposed capital charge to all of the investments currently made by these companies.[47] This begs the question, if BHCs are able to engage in merchant banking only since March 13, 2000, how can the Board's assessment of BHCs have any relevance on what the BHCs might like to engage in as FHCs in the merchant banking arena? In addition, is the proposed regulatory capital charge just another barrier, in different form from the Glass-Steagall Act, separating banking and commerce?

43. Merchant Banking Interim Rule, *supra* note 34, at 24 (Explanatory Comments).
44. *Id.* at 1, 25–26.
45. *Id.* at 26–28.
46. Dean Anason, *Debate over Capital Requirements Delays Merchant Banking*, AM. BANKER, Mar. 15, 2000, at 1.
47. Merchant Banking Interim Rule, *supra* note 34, at 26.

In its self-conducted survey, the Board claimed to have found that most firms engaging in merchant banking activities hold much more capital than their normal regulatory capital charge for banking assets under the Basle Accord, which translates into an eight percent minimum capital charge. Overall, the Board perceives merchant banking investments to be generally riskier, more illiquid, and more volatile than banking assets prompting the fifty percent capital charge. However, the Board has decided not to apply the proposed capital charge to investments made by insurance company subsidiaries of FHCs held pursuant to the GLBA. Moreover, the Board is aware of the opportunities this may present for arbitrage between an insurance company and its FHC affiliates to avoid the regulatory capital charges arising out of the FHC's merchant banking activities. The banking industry has been very active in commenting on the Board's proposal and it is likely that the final rule, after the interim rule is published and commented on, will take a slightly different form from what has been described above. However, the regulatory capital charges will be located in section II.B of appendix A to part 225 to amend clause (v) to state that portfolio investments must be deducted from the sum of core Tier 1 capital elements in the manner provided in the final rule. In addition, section II.B would also be amended by adding a new section II.B.5 governing portfolio investments to state the percentage, now set at fifty percent, of the value of all portfolio investments made by a parent BHC or by its direct or indirect subsidiaries that must be deducted from the consolidated parent banking organization's Tier 1 capital components.[48]

II. Restrictions Remaining on Mixing Commerce and Banking

The GLBA does expand the field of financial activities in which banks may engage but it requires them to do so as a FHC that involves regulation as a BHC as well. The GLBA has amended the firewalls that have existed between banks and their affiliates, otherwise known as sections 23A and 23B of the Federal Reserve Act. These provisions create quantitative constraints on bank loans to, and asset purchases from, affiliates and operating subsidiaries of BHCs and national banks respectively. Section 23A limits (1) the amount of "covered transactions" between an affiliate and a bank to not more than ten percent of the capital stock of the bank, and (2) the amount of covered transactions between all affiliates of a bank and that bank to not more than twenty percent of the capital stock of the bank.[49] Section 23B requires that all covered transactions reflect market prices and that they be collateralized.[50] Covered transactions include the following transactions between a bank and its affiliate: (1) loans or extensions of credit, (2) purchases or investments in securities issued by an affiliate, (3) repurchase agreements, (4) acceptance of securities issued by an affiliate as collateral securing a loan or extension of credit, or (5) an issuance of a guarantee, an acceptance, or letter of credit including an endorsement or standby letter of credit on behalf of an affiliate.[51]

The GLBA extends these provisions to the fund flows between banks and the financial subsidiaries and securities and insurance affiliates in the FHC group. Transactions between

48. *Id.* at 29.
49. 12 U.S.C. § 371c(a)(1)(A) (2000).
50. *Id.* § 371c-1.
51. *Id.* § 371c(b)(7).

banks and financial subsidiaries are deemed affiliate transactions and therefore covered transactions, and in certain circumstances, transactions between holding companies and the financial subsidiaries of banks are also considered affiliate transactions.[52] The GLBA specifies that covered transactions between a bank and any individual financial subsidiary will not be subject to the cap of ten percent of the bank's capital stock.[53] However, the amount of covered transactions between a bank and a financial subsidiary will be subject to the twenty percent aggregate limit on transactions with all affiliates found in section 23A(1)(B).

The Board is working on new regulations interpreting sections 23A and 23B to consolidate past advice and orders, as well as to exercise the discretion granted to it under the GLBA. In particular, the GLBA calls for the Board to adopt final rules addressing the applicability of section 23A of the Federal Reserve Act to derivative transactions between a bank and its affiliates, as well as to grants of intra-day credit by banks to their affiliates by May 2001.[54] On March 10, 2000, the Board issued an interim rule that requires intra-day extensions of credit by a bank, thrift, U.S. branch, or agency of a foreign bank to a securities affiliate engaged in securities underwriting, dealing, or market making pursuant to the provisions in the GLBA to be on market terms pursuant to section 23B. In addition, the interim rule applies the limitations found in sections 23A and 23B to certain covered transactions to foreign banks that have elected FHC status with respect to lending and securities purchase transactions between a U.S. branch or agency of a foreign bank and their U.S. securities affiliates engaged in securities underwriting, dealing, or market making pursuant to the GLBA.[55] These interim rules are designed to fill the gap while the Board decides how the final regulations called for in GLBA regarding intra-day credit should take shape.

There are cross-marketing restrictions placed on depository institutions controlled by a FHC that prohibit them from offering or marketing any product or service of a company whose activities are conducted or whose shares are owned or controlled by the FHC pursuant to a grandfathered activity or to a merchant banking or insurance portfolio investment activity. In addition, FHC-controlled depository institutions are prohibited from using a company whose activities are conducted or whose shares are owned or controlled by the same FHC through its merchant banking activities to market or offer its products or services.[56] However, the GLBA specifically refers to the use of statement inserts or Internet Websites to market the others' products or services as examples of permissible cross-marketing if the Board determines that it is within the public interest, does not undermine the separation of banking and commerce, is consistent with safety and soundness of depository institutions, and does not violate section 106 of the Bank Holding Company Act Amendments of 1970.[57]

The merchant banking regulations, issued jointly by the Board and Treasury as an interim rule, expressly prohibit cross-marketing between FHC-controlled depository institutions and FHC-controlled portfolio companies or private equity funds. There is a rebuttable presumption that a FHC controls a portfolio company if the FHC, directly or indirectly,

52. *Id.* § 371c(e)(4); and GLBA § 121(b).
53. *Id.* § 371c(e)(3); and GLBA § 121(b).
54. 12 U.S.C. § 371c(f)(3); and GLBA § 121(b).
55. Board Interim Rule Regarding Intra-day Credit, 12 C.F.R. § 225.4 (2000).
56. 12 U.S.C. § 1843(n)(5)(A); and GLBA § 103(a).
57. 12 U.S.C. § 1843(n)(5)(B); and GLBA § 103(a).

owns or controls fifteen percent or more of the equity capital of that company. The same presumption will apply to private equity funds if a FHC controls or has sponsored and advises the private equity fund and the fund owns or controls the equity capital of the company.[58]

III. Streamlining Supervision of BHCs and Functional Regulation

The GLBA's provisions on supervision of FHCs have been nicknamed "Fed-lite" to emphasize the umbrella supervision that the Board will have over both BHCs, of which FHCs are a subset, and the reliance on functional regulation of certain subsidiaries and affiliates of that FHC by the Securities Exchange Commission (SEC) in particular, and by the State insurance regulators in general, both referred to as "functional regulators." The GLBA Fed-lite provisions limit the Board's authority to examine, impose capital requirements on, or obtain reports from subsidiaries of FHCs that are regulated by the functional regulators.[59] In addition, the Board may not prescribe regulations or use any of its powers to restrain or restrict functionally regulated subsidiaries of a BHC unless Board action is needed to prevent or rectify an unsafe or unsound practice or breach of a fiduciary duty by such subsidiary that poses a material risk to the soundness of the affiliated depository institutions or to the domestic or international payment system.[60]

The GLBA repeals the exemptions from the definitions of broker and dealer under Federal securities laws that applied to banks. As a result, banks and their affiliates and subsidiaries are subject to the same regulation as all other securities product providers and FHCs will have to push all their securities underwriting activity into SEC-regulated entities.[61] However, there is an exemption for certain specific securities activities that banks have traditionally pursued. These exceptions include trust activities, third-party networking arrangements, bank-eligible securities activities with commercial paper and exempted securities, employee and shareholder benefit plans, sweep accounts, affiliate transactions, private placements, safekeeping and custody services, asset-backed securities, derivatives, and "identified banking products."[62] An identified banking product is: (1) a deposit account, savings account, or certificate of deposit; (2) a banker's acceptance; (3) a letter of credit issued or loan made by a bank; (4) a debit account at a bank arising from a credit card or similar arrangement; (5) a loan participation in which a bank or affiliate participates or that it owns that is sold to qualified investors or other sophisticated investors; and (6) any swap agreement including credit and equity swaps, except for equity swaps that are sold directly to any person other than a qualified investor.[63] The banking regulators will continue to regulate banks' swaps business that falls within the definition of "identified banking products," which include warrants, notes, or options, as well as credit swaps and only equity swaps with qualified investors (persons and companies with over $25 million in investment

58. Interim Rule Jointly Issued by the Board and Treasury, 12 C.F.R. §§ 225.175, 1500 (2000).

59. 12 U.S.C. § 1844(c); and GLBA § 111.

60. 12 U.S.C. § 1848(a); and GLBA § 113. See *Framework for Financial Holding Company Supervision, supra* note 41, regarding umbrella regulation of FHC by the Board.

61. *See* 15 U.S.C. § 78c(a)(4) (2000); and GLBA § 201. The SEC is in the process of issuing interim rules to implement its expanded authority under the Act. More information is available at http://www.sec.gov.

62. 15 U.S.C. § 78 c(a)(4)(B)(ix) (2000).

63. 15 U.S.C. § 78c; and GLBA § 206.

(assets). The SEC can regulate bank sales of new hybrid products by rulemaking if the SEC finds that the new product is a security and that the product is a new "hybrid produc[t]."[64] These changes to U.S. securities regulation will take effect in May 2001.[65]

Banks that advise mutual funds will be subject to the same regulatory scheme as other advisers to mutual funds and, therefore, that aspect of a FHC's business will be subject to the Investment Company Act of 1940 and the Investment Advisers Act.[66] Without going into too much detail, the GLBA preserves and in some respects enhances state regulation of insurance activities, including acting as the functional regulator for insurance activities of federally chartered banks.[67] However, the GLBA prohibits federally chartered banks and their subsidiaries from underwriting insurance except for certain authorized products.[68] Therefore, the GLBA requires information sharing between all the above-mentioned regulators to avoid duplicate supervision and excessive regulatory burden on FHCs in particular. The Board can examine subsidiaries that are functionally regulated only if: (1) the Board has reasonable cause to believe that the entity is engaged in activities that pose a material risk to an affiliated depository institution, (2) the Board determines an examination is necessary to inform the Board of the risk management systems of the company, or (3) the Board has reasonable cause to believe the entity is not in compliance with the banking laws.[69] However, the FHC is required to file quarterly and annual reports on its merchant banking activities as described in the section above on the interim rule for merchant banking regulations.

Lastly, under the title of prudential safeguards, the GLBA gives the Board broad authority, by regulation or order, to impose restrictions or requirements on relationships or transactions between a depository institution subsidiary and any affiliate of such institution if the Board finds such action is necessary: (1) to maintain consistency with the purposes of the GLBA, and other federal law applicable to depository institution subsidiaries of a BHC, or (2) to prevent an evasion of the above-mentioned laws or to avoid a risk to the safety and soundness of a depository institution.[70] The Board has the same powers with respect to relationships or transactions between a branch, agency, or commercial lending company of a foreign bank in the United States and any affiliate in the United States of such foreign bank.[71]

IV. Conclusion

It is still the early days of the newly modernized U.S. banking market in which banks can act through FHCs to engage in traditional U.S. investment banking, broker–dealer activities, and insurance activities. The Board has pledged to process the domestic BHC elections to become FHCs as quickly as possible, but not later than thirty days after the receipt of the declaration to become a FHC. However, it will only be after all the regulations

64. 15 U.S.C. § 78o(i); and GLBA § 205.
65. 12 U.S.C. § 1828; and GLBA § 209.
66. 15 U.S.C. § 80b-2(a)(11)(A); and GLBA § 217.
67. 15 U.S.C. § 6711; and GLBA § 301.
68. 15 U.S.C. § 6712; and GLBA § 302.
69. 12 U.S.C. § 1844(c)(1)(B); and GLBA § 111.
70. 12 U.S.C. § 1828a(b)(1)–(2); GLBA § 114. See *Framework for Financial Holding Company Supervision*, *supra* note 41, regarding umbrella regulation of FHC of the Board.
71. 12 U.S.C. § 1828a(b)(4); and GLBA § 114.

that are called for in the GLBA are finalized that banks will determine the best organizational structure in which to deliver their services to the marketplace. We are likely to see unusual mergers, by U.S. standards, between securities firms and banks, both big and small, and perhaps the creation of de novo banks to create a FHC headed by the merchant banking entity. Lastly, if the Board eases the FHC-driven, well-capitalized requirements for foreign banks as requested, foreign banks in the United States may just show U.S. institutions the way forward, utilizing the experience many of these foreign banks already have in mixing banking and commerce.