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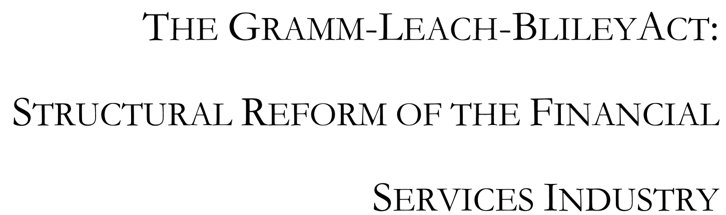

THE GRAMM-LEACH-BLILEY ACT: STRUCTURAL REFORM OF THE FINANCIAL SERVICES INDUSTRY

November 16, 1999

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On November 12, 1999, President Clinton signed into law S.900, the "Gramm-Leach-Bliley Act," P.L. 106-102 (113 Stat. 1338), a measure widely viewed as the most significant single piece of legislation to affect the financial services industry in decades. The Act is the product of multiple architects and it reflects the policy views of many competing, and often conflicting, political and business constituencies. As a result, it contains a number of compromises. Its impact on the structure of the industry will be significant.

Some central themes of the Act are:

- eliminating obsolete barriers in the United States to the development of affiliations, whether *de novo* or by acquisition, among representatives of different sectors of the financial services industry, so that now commercial banks, securities firms and insurance companies may acquire and be acquired by one another;

- limiting access to these new opportunities to organizations which are well capitalized and well managed and which perform at least satisfactorily under the Community Reinvestment Act;

- opting for a "functional" regulatory approach, meaning that each industry segment of a multi-industry organization will be regulated by the agency charged by law with the regulation of (and therefore presumably the most expert in) that industry;

- affording flexibility (within limits) to the regulated organization as to whether a new competitive opportunity can best be exploited at the holding company level or the level of the operating institution;

- establishing new regulatory mechanisms designed to encourage consultation and cooperation, rather than confrontation and "turf protection," among the various federal and state agencies charged with the regulation of these evolving multi-industry organizations; and

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- in general, fostering increased competition in the financial services industry within a broad framework of transparency and consumer protection.

The Act also addresses the widely felt need to increase privacy protection in the collection and use of customer information; criminalizes "pretextual" access by unauthorized persons to customer data; forecloses the future development of "diversified" unitary savings and loan holding companies; modernizes the structure, operations and capital base of the Federal Home Loan Bank System; and imposes disclosure and reporting requirements on certain agreements between community groups and depository institutions subject to the Community Reinvestment Act and their affiliates and on the use of such groups' funds.

This report analyzes the key Sections of the Gramm-Leach-Bliley Act and highlights the portions of the statute which we believe are the most likely to impact the future policies, operations and strategic planning of organizations active in the financial services industry.

Facilitating Financial Services Affiliations (Title I)

Title I of the Gramm-Leach-Bliley Act eliminates many of the historic legal barriers to affiliations among banks, securities firms and insurance companies. It repeals Sections 20 and 30 of the Banking Act of 1933 (the Glass-Steagall Act) which prohibited affiliations between banks and firms principally engaged in underwriting and dealing in securities and which generally barred officer and director interlocks between member banks and such firms. In their place, a new Section 4(k) is added to the Bank Holding Company Act of 1956 (the BHCA), which expands, and provides the framework for further regulatory expansion of, the activities permitted to be conducted by bank holding companies and their subsidiaries. Separate provisions, discussed below, also expand the activities in which national banks and state-chartered insured banks may engage through subsidiaries; they also provide a comparable framework for further expansion.

Financial Holding Companies

Under the new standard, a bank holding company (which generally includes foreign banking organizations with branches, agencies or commercial lending subsidiaries in the United States) filing an election to be treated as a "financial holding company" (an FHC) may engage in any activity, and may acquire shares of any company engaged in any activity, that the Board of Governors of the Federal Reserve System (the Board) determines (by regulation or order) to be either (i) financial in nature or incidental to such financial activity or (ii) complementary to

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a financial activity and not to pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

The Act identifies some specific activities which are determined *per se* to meet this test and prescribes a consultative process, involving the shared input of both the Board and the Office of the Comptroller of the Currency (OCC) within the Department of the Treasury, for the future definition of activities determined to meet the test. In essence, the process permits either agency to initiate the process of defining an additional permitted holding company activity but requires the approval or acquiescence of the other agency. The Act and Conference Report accompanying the legislation reflect the desire of Congress that this inter-agency process be consultative and cooperative rather than confrontational.

New Section 4(k)(4) of the BHCA identifies a laundry list of specific additional activities deemed "financial in nature" for these purposes. The significance of their definition (including additional activities to be added in the future) lies in the ability of qualifying FHCs to engage in such activities without regulatory approval (except with regard to acquiring a savings association under existing authority), provided notice is given to the Board within 30 days after the activity is commenced. The listed activities include:

> (i) lending, exchanging, transferring, investing for others, or safeguarding money or securities;
>
> (ii) insuring, guaranteeing and indemnifying against loss, as principal, agent or broker;
>
> (iii) providing financial, investment or economic advisory services, including advising investment companies;
>
> (iv) issuing and selling instruments representing interests in pools of assets permissible for a bank to hold directly;
>
> (v) securities underwriting, dealing and market making;
>
> (vi) engaging in activities which have heretofore been determined to meet the "closely related" and "proper incident" tests under Section 4(c)(8) of the Act;
>
> (vii) engaging in activities in the United States which the Board has previously authorized bank holding companies and their subsidiaries to conduct abroad under Section 4(c)(13);
>
> (viii) certain "merchant banking" activities (discussed below); and
>
> (ix) certain "insurance company portfolio investment" activities (discussed below).

The additional permitted (financial) activities include certain merchant banking and insurance company portfolio activities. These consist of acquiring shares, assets or ownership interests in a company or other entity, whether or not constituting control, if (i) the holding is not situated in a depository institution or subsidiary thereof but instead is in the holding company or a non-bank subsidiary; (ii) the acquisition, in the case of merchant banking activities, must be made by a securities affiliate or an investment advisory affiliate of an insurance company, in either case as part of a *bona fide* underwriting, merchant banking or investment banking activity (including acquisitions for purposes of appreciation and resale); (iii) the acquisition, in the case of insurance company portfolio activities, must be made by and insurance company (other than one engaged only in credit-related insurance) in the ordinary course of its business in accordance with relevant state insurance law; (iv) the holding (in the case of merchant banking) is only for a period of time needed to enable sale or disposition on a reasonable basis; and (v) during the period of the holding the bank holding company does not engage in routine management or operation of the company or entity. After five years, the Board and the OCC may by joint rulemaking sunset the condition in clause (i) with regard to merchant banking.

Consistent with the elimination of the prior Board approval requirement, the Act amends the Hart-Scott-Rodino Antitrust Improvements Act of 1976 to clarify that the existing exemption from the pre-merger notification requirement for certain bank holding company transactions does not apply to portions of the transaction that are subject to the new Section 4(k), and do not require Board approval under Section 3, of the BHCA.

The Act directs the Board to define (on a basis to be prescribed by the Board) certain additional activities as "financial in nature." These include (x) the expansion of activity (i) above (lending, exchanging, etc.) to financial assets other than money or securities (*e.g.,* commodities); (y) providing any device or other instrumentality for transferring money or other financial assets; and (z) arranging, effecting or facilitating financial transactions for third parties.

Conditions to New Activities

A bank holding company cannot engage in the additional activities permitted to FHCs unless all of its depository institution subsidiaries are "well capitalized" and "well managed" based upon defined examination standards. In addition, the right to commence, or acquire control of a company engaged in, any of the new activities is conditioned upon the receipt by all of the holding company's depository institution subsidiaries of a "satisfactory" or better Community Reinvestment Act (CRA) rating in their most recent examinations. There are limited, temporary exceptions for institutions acquired during the preceding 12 months. The Act prescribes a cure procedure for FHCs that subsequently fall out of compliance with either the well capitalized or the well managed standard. In addition to suspending the right of these "fallen angels" during the period of non-compliance to engage in additional new activities, or to acquire other companies

engaged in the new activities, if compliance is not restored by a deadline date the Board may require the FHC either to divest control of any subsidiary depository institutions or generally to cease engaging directly or indirectly in the new activity. In contrast, a subsequent failure to meet the CRA "satisfactory" standard will block further expansion into the new activities pending restoration of compliance but will not threaten divestiture or suspension of the right to engage in any new activities already commenced at the time of the failure.

The Act creates a "basket" clause for certain non-conforming (but lawful) activities of a company which is not now a bank holding company or foreign bank, but hereafter becomes one (*e.g.,* an insurance company or brokerage firm acquiring a bank under the new authority), to retain the existing non-conforming activities (*i.e.,* activities not "financial" in the context of Section 4(k)) if less than 15% of consolidated gross revenues (subsidiary depository institution revenues excluded) are derived from them. However, the grandfather privilege eventually sunsets and in the meantime entails, among others, restrictions on expansion of non-conforming activities through mergers, etc. and certain cross-marketing restrictions. There are other grandfather provisions, similarly conditioned, which permit the continuation of certain lawful commodities-related holdings and activities in the United States held as of September 30, 1997 if the assets in question do not exceed 5% of total consolidated assets of the bank holding company.

Harmonizing State Regulation

The Act contains detailed provisions attempting to reconcile traditional state regulation of entities such as insurance companies with the new federally granted powers. It reaffirms the principle that persons engaging in the insurance business as principal or agent must be licensed under state law. However, it prohibits the states from preventing or restricting a depository institution or affiliate from being affiliated with any person in any manner permitted by federal law (including the Act) or preventing or significantly restricting a depository institution or affiliate from engaging in any insurance sales, solicitation or cross-marketing activities. Nonetheless, the Act provides as safe harbors a detailed set of 13 provisions (see below) the substance of which can be enacted by the states to regulate insurance sales, solicitation and cross marketing activities. In addition, state statutes regulating insurance activities other than sales, solicitation and cross marketing are not preempted but must be nondiscriminatory.

Streamlining Bank Holding Company Regulation

The principle of "functional regulation" is affirmed in the provisions of the Act intended to streamline bank holding company regulation. In general, the regulation of an affiliate engaged, for example, in insurance, securities or commodities activities is assigned to the state or federal insurance, securities or commodities regulator which has traditionally regulated that industry.

The Board is assigned the role of "umbrella regulator" of FHCs with authority to require them and their subsidiaries to report on financial condition, risk control and certain other aspects of their business. Its authority to examine a functionally regulated subsidiary is limited, however, and the Board cannot impose capital requirements on any such subsidiary which is in compliance with the corresponding requirements of its functional regulator. The Board may not require a parent brokerage or insurance firm to inject funds into a subsidiary depository institution or holding company if the parent's functional regulator notifies the Board in writing that to do so would threaten to materially adversely affect the regulated parent, but in that case the Board may respond by requiring divestiture. The Board may not indirectly promulgate rules affecting a functionally regulated affiliate unless both (i) the rule is necessary to address a material risk to the safety and soundness of a depository institution or the payments system generally; and (ii) the risk cannot be appropriately addressed through direct regulation of the depository institution.

National Bank Subsidiaries
The Act expands the permissible powers of national bank subsidiaries in a manner similar to the scheme for holding companies. Assuming the bank and all of its depository institution affiliates meet the well-capitalized, well-managed and CRA-satisfactory tests referred to above, a subsidiary of an eligible national bank, in addition to its present ability to engage in activities permissible for the bank itself and certain other activities (*e.g.,* Edge Act subsidiaries) authorized by specific statutes, may, with OCC approval, henceforth engage in any activities that are, or are incidental to activities that are, financial in nature as have been determined by the Board for FHC purposes or as are determined by the OCC in consultation and coordination with the Board. However, a national bank subsidiary may not engage as principal in insurance underwriting, annuity issuance, insurance company portfolio investment activities, real estate investment or development activities generally or (at least for the first five years) merchant banking activities. A cure procedure, similar to the one established for FHCs, is provided for national banks that subsequently fall out of compliance with either the well-capitalized or the well-managed standard.

A national bank is eligible to have such expanded-power subsidiaries (termed "Financial Subsidiaries") if (i) the aggregate consolidated total assets of all of its financial subsidiaries do not exceed the lesser of 45% of the parent bank's consolidated total assets or $50 billion (to be indexed); and (ii) when the Financial Subsidiary proposes to engage in the activity or activities as principal, the parent bank is one of the 100-largest insured banks and has at least one outstanding issue of debt securities currently rated within the three-highest investment grade rating categories. (For banks ranked 51-100 in size, the OCC and the Board may establish an alternative standard for those lacking a qualifying rated debt issue outstanding.) In regard to the requirements described in this paragraph, "fallen angel" banks are not subjected to a cure procedure, but are prevented from making further equity investments in Financial Subsidiaries until compliance is restored.

As a safeguard, the parent national bank for capital adequacy measurement purposes must deduct from its assets and tangible equity (essentially write off) its investment in all of its Financial Subsidiaries (including retained earnings) and may not consolidate with its assets and liabilities those of its Financial Subsidiaries.

Affiliate Restrictions

Sections 23A and 23B of the Federal Reserve Act restrict certain credit, asset purchase and other transactions between a bank (or subsidiary thereof) and an affiliate of the bank under a scheme designed to protect the federally insured depository institution. Subsidiaries of the bank itself have historically been exempted from these restrictions on their dealings with the bank because their subsidiary status generally obviates the affiliate risks Sections 23A and 23B were designed to control. The Act amends Sections 23A and 23B to essentially reverse this structure in the case of bank Financial Subsidiaries. Thus, transactions between a bank and one of its Financial Subsidiaries are subjected to the restrictions of Sections 23A and 23B, and, conversely, transactions between a bank Financial Subsidiary and a holding company affiliate of the parent bank are not subject to such restrictions.

State Chartered Bank Treatment

The Act adds a new Section 46 to the Federal Deposit Insurance Act essentially to conform the treatment of Financial Subsidiaries of FDIC-insured state chartered banks (insofar as federal law is concerned) to that described above as applicable in the case of national banks.

Other Matters

Unlike the case with FHCs, the expansion of permissible national bank activities applies only to those conducted through subsidiaries of the bank and not to activities conducted by the bank directly, except that the Act does expand directly the powers of national banks in one respect. Well capitalized national banks are now permitted to deal in, underwrite and purchase for their own accounts, free of the limitations and restrictions contained in 12 U.S.C. 24(7), obligations (including limited obligation and revenue bonds) of states and their political subdivisions and certain municipal corporate instrumentalities.

The legislation originally included detailed provisions for the creation of uninsured "wholesale financial institutions" (or "woofies"). However, a dispute as to whether these institutions would or would not be subject to the Community Reinvestment Act was resolved in the Conference Committee by the elimination of those provisions altogether.

Implications for the Banking and Insurance Industries (Titles I and III)

Continuation of State Regulation

By way of overview, the Act reaffirms the McCarran-Ferguson Act, which recognizes the states' prerogative to regulate the business of insurance. States may continue to regulate changes in ownership of stock in an insurance company, provided that doing so does not lead to discriminatory results and provided also that, in the case of a proposed acquisition by an FHC, the state regulatory review period (which typically takes six months or more) is limited to 60 days. Finally, the Act leaves undisturbed (subject, in some instances, to the *Barnett* standard and a non-discrimination standard) the states' authority to regulate deceptive advertising, fee structures of insurance agents and the conditions under which customer information may be released to third parties.

Notwithstanding its reaffirmation of the states' rights to regulate the insurance business, the Act seeks to achieve shared federal and state responsibility for the regulation of insurance. Titles I and III of the Act also set the stage for a series of state legislative initiatives involving the 13 "safe harbor" restrictions sanctioned by the Act. These restrictions, or "restrictions that are substantially the same as but no more burdensome of restrictive than" these restrictions, may be applied to banks free of the *Barnett Bank* "prevent or significantly interfere with" standard. These 13 restrictions all relate to the manner in which the banks are able to sell insurance products, from advertising, payment of commissions or fees and release of insurance information through requirements as to disclosures, acknowledgments and maintenance of separate books and records. Section 104 of the Act (Operation of Sate Law) becomes effective immediately.

Other Provisions Affecting Bank Sales of Insurance

Federal banking agencies are charged with implementing a set of federal consumer protection regulations mandated to be in place within a year of the Act's passage. These regulations will apply to retail sales practices, solicitations, advertising or offers of any insurance product by any depository institution or any person that is engaged in such activities at an office of the institution or on behalf of the institution. These regulations must address sales practices, disclosures and advertising, and separation of banking and nonbanking activities and must establish a consumer complaint mechanism for "receiving and expeditiously addressing consumer complaints alleging a violation of" such new regulations. When the federal regulations are inconsistent with state regulations, the federal guidance takes precedence only when federal regulators have jointly concluded that the federal protection is greater than that which the state has afforded. This double dose of regulation without benefit of federal preemption makes uniformity of regulation of banks' sales of insurance products, at least over the short term, a difficult goal to achieve.

Section 121 of the Act authorizes the conduct of insurance sales as agent in a bank subsidiary, free of "Place of 5,000" limitations. In order to establish and retain a financial subsidiary, the national bank must be and remain well capitalized and well managed, and have and maintain at least a "satisfactory" CRA rating. Investments in such subsidiaries are deducted from the bank's regulatory capital if the subsidiary engages as principal in the bank's impermissible activity and the national bank must remain well capitalized after the deduction. Investments in and extensions of credit to the subsidiary are subject to the same standards and limits that would apply if the subsidiary were an "affiliate" under sections 23A and 23B of the Federal Reserve Act. Various corporate separateness requirements apply to relations between the bank and its financial subsidiary.

What becomes of the "operating subsidiary" developed by the OCC in reliance upon authority found in 12 U.S.C. § 24 (Seventh) and as contained in regulations (12 CFR § 5.34)? The Conference Report on the legislation expresses an intent that the Act supersede and replace the regulations, but there is no repeal of this authority in the bill, so the "op sub" may remain a viable choice for a national bank as a place to conduct activities permissible for a national bank. Section 92 of the National Bank Act, a 1916 statute which contains the "Place of 5,000" restriction, has been left intact, leaving this restriction applicable to national banks choosing to sell insurance directly or through the op sub.

Other important provisions which will impact a bank's ability to sell insurance include new litigation procedures and standards which will apply to disputes between federal banking and state insurance regulators.

In case of a regulatory conflict between a state insurance regulator and a federal regulator regarding insurance issues (including whether a state law, rule, regulation, order, or interpretation regarding any insurance sales or solicitation activity is properly treated as preempted under federal law), either regulator may seek "expedited judicial review" of such determination by a United States Court of Appeals for the circuit in which the State is located or in U.S. Court of Appeals for the District of Columbia Circuit.. The standard of review for the court is essentially a *de novo* review on the merits of all questions presented under state and federal law, including the nature of the product or activity and the history and purpose of its regulation "without unequal deference." (Section 304.) While the court is instructed in the Act to complete its review of such a petition within sixty (60) days of filing, the appetite of an appellate court for cases of this nature, as well as the practical import of such Congressional instruction is open to question.

Redomestication of Mutual Insurers

Title III of the Act allows a mutual insurance company whose domiciliary state does not permit conversion to the mutual holding company form to redomesticate to a jurisdiction whose state laws do allow that form of demutualization. The stock insurer may be positioned as either an

indirect or a direct subsidiary of the newly formed mutual holding company. To sanction such redomestication, the insurance regulator in the new domicile must determine that the mutual insurer's plan of reorganization complies with certain specified requirements, including the receipt of approval of the reorganization plan from a majority of the insurer's board of directors and policy holders. The policy holders' voting rights must be left intact as they relate to the reorganized insurer. If the reorganized insurer contemplates a public offering of equity securities, the plan of reorganization must comply with the federal securities laws and must be approved by the insurance regulators of the insurer's new domicile. Furthermore, the officers and directors of the reorganized insurer are prohibited from receiving stock options or option grants until the completion of a public offering or the lapse of six months, whichever occurs first. The Act addresses a state's ability to preempt these redomestication rules whether by the passage of new laws and regulations or by the application of existing laws. States are prohibited from treating redomesticated insurers or their affiliates differently from domestic insurers.

Certain Investments by an FHC Insurance Company Subsidiary

The Act permits an insurance company that is an FHC or a subsidiary thereof to invest funds from policyholders in companies that are not engaged in financial activities (as defined in the Act). If a bank affiliated insurance company seeks to acquire a controlling or other ownership interest in a company, it must comply with four requirements. First, the shares in the target company cannot be held by a bank or its subsidiaries. Second, the ownership interest must be held by an insurance company that is predominately engaged in underwriting insurance (other than credit related insurance) or in providing annuities. Third, the ownership interest must be made in the ordinary course of business and in compliance with the state law governing such investments. Fourth, the FHC may not routinely manage or operate the company in which the insurance company took the ownership interest, except in the limited circumstance in which the management or operation is necessary to assure a reasonable return on the investment and occurs only when the insurance company is acting to safeguard its investment.

Insurance Agents' Licensing Requirements

Finally, the Act lays the foundation for the establishment of a uniform system for the licensing of insurance agents through the creation of a private entity to be called the National Association of Registered Agents and Brokers (NARAB), which is to be managed by state insurance regulators. However, NARAB will come into existence only if a majority of the states fail to establish, within a three-year period, uniform or reciprocal licensing provisions as determined by the National Association of Insurance Commissioners (NAIC). Once it has made a determination that the states have failed in this respect, the NAIC must establish NARAB within two years thereafter. If it does not, NAIC will lose its mandate to the President, who would then appoint NARAB's board with the advice and consent of the Senate. If established, NARAB's membership would be voluntary. NARAB would have the authority to receive and investigate

consumer complaints and to inspect records. In appropriate cases, NARAB would refer complaints against a member company to the applicable state insurance regulators for possible disciplinary action.

Functional Regulation of Securities and Related Activities (Title II)

Under the major federal securities laws (particularly the Securities Exchange Act of 1934, as amended (the 1934 Act), which regulates exchanges, trading issues and securities firms generally, the terms "broker" and "dealer" have historically been defined with an express exclusion for banks. Subtitle A of Title II of the Act addresses these exclusions. The expressed purpose of Subtitle B of Title II is to better conform the 1934 Act and the Investment Company Act of 1940 (the 1940 Act) to the activities of banks in the investment company (or mutual fund) arena. Subtitle C covers the regulation and supervision of so-called "investment bank holding companies," and Subtitle D addresses briefly the regulation of the loan loss reserve practices and policies of banks and their holding companies. Subtitles A and B take effect in 18 months; Subtitles C and D take effect immediately.

Brokers

Consistent with the theme of functional regulation (*i.e.*, the separation of the regulation of an institution into activity components so that each activity of the institution is regulated by the regulator expert in that activity), Subtitle A of Title II eliminates the 1934 Act exemption from "broker" status for banks which engage in securities-related businesses beyond a limited set of activities for which the traditional exclusion is preserved. Thus, under the amended definition of broker a bank may still avoid the requirement to register as a broker if its securities-related activities are confined to:

- certain networking arrangements with third parties (*i.e.*, securities sales from adjacent cordoned-off areas through registered third-party broker agents);
- "traditional" trust department trade execution activities;
- stock purchase plans, both within the employee benefit plan context and in connection with dividend reinvestment plans generally;
- transactions in certain money market securities and other instruments (commercial paper, Brady bonds, etc.);
- sweep activities using no load money market mutual funds;

- accommodation transactions for affiliates that are not registered broker-dealers or merchant banking firms;
- "private" offerings (subject to capital limitations);
- safekeeping (*i.e.*, custody) activities, including securities lending;
- effecting transactions in "identified banking products" (deposit and debit accounts, for example);
- transactions in municipal securities; and
- a "basket" category for a *de minimus* level of otherwise non-exempt transaction activity (500 transactions per calendar year).

There are two major caveats: First, securities transactions involved with trust, stock purchase plan and asset safekeeping services must be executed through a registered broker or dealer or "crossed" between accounts in a manner consistent with fiduciary principles. Second, in order for its trust activities to be shielded from broker regulation, the bank will have to be compensated chiefly from administrative and other fees (which may be based on assets) and may not publicly solicit brokerage business. The upshot of the changes is that going forward the banking industry's retail (and, in some respects, institutional) securities brokerage activities will generally be conducted through subsidiaries registered with the Securities and Exchange Commission (the SEC) and the National Association of Securities Dealers (the NASD).

Dealers

To a similar extent, the new Act generally eliminates the long-standing exclusion from "dealer" status accorded to banks. In its place, the Act provides an exclusion from dealer status for persons buying and selling securities for their own account (either individually or in a fiduciary capacity), but *not* as part of a regular business, and a further exclusion specifically tailored to banks that engage in certain enumerated activities. Among these enumerated activities are:

- buying and selling certain money market securities and other instruments (*e.g.*, commercial paper and Brady bonds);
- buying and selling securities for "investment purposes" or for accounts as to which the bank acts as trustee or fiduciary;
- issuing or selling to "qualified investors" (discussed below) asset-backed securities representing interests in loans and other assets originated predominantly by the bank or an affiliate thereof (other than a broker or dealer); and

- effecting transactions in certain "identified banking products" (*e.g.*, deposit products, letters of credit, debit accounts arising from credit card transactions, loan participations and swap agreements).

Qualified Investors

The Act defines the term "qualified investor" to include registered investment companies, qualified purchaser funds, banks, brokers, insurance companies, SBICs, employee benefit plans (other than IRAs), certain investors that own and invest on a discretionary basis $25,000,000 or more in investments, foreign governments and supranational entities. Certain exempted activities (*e.g.*, asset-backed securities issuances and loan participation and equity swap agreement transactions) qualify for the exemption only when conducted with regard to such qualified investors. The Act further allows bank employees who effected securities sales as a part of a primary offering of securities constituting a "private offering" under the Securities Act of 1933 (the 1933 Act) more than six months prior to the Act's date of enactment to qualify for a new "limited qualification category" for associated persons of entities that are members of registered securities associations (*e.g.*, brokers).

Banks must keep records sufficient to demonstrate their compliance with the terms of these exemptions. The details of these recordkeeping requirements are to be determined by the appropriate banking agency in consultation with the SEC. The resulting information must be made available to the SEC upon request.

The Act establishes a consultative protocol to be followed by the SEC and the Board of Governors of the Federal Reserve System (the Board) in determining whether a bank's introduction of a "new hybrid product" may implicate the bank's requirement to register as a broker or dealer. The provision bars the SEC from imposing upon a bank by rulemaking a broker registration requirement in connection with the bank's introduction of a new hybrid product unless the SEC determines that (i) the product is a security and (ii) imposing the registration requirement is necessary for the protection of investors. The provision establishes a detailed process through which the Board may object to any SEC rulemaking which may result and lodges with the United States Court of Appeals for the District of Columbia Circuit exclusive jurisdiction over any resulting dispute between the agencies. The term "new hybrid product" is defined expressly to exclude "identified banking products" and equity swaps.

Bank Investment Company Activities

Subtitle B of Title II is aimed specifically at the operations of banks in the investment company arena. The subtitle grants authority to the SEC, following consultation with the federal banking agencies, to adopt rules and regulations prescribing the terms under which a bank or bank affiliate

may serve as custodian for the assets of an investment company which is advised or sponsored by, or the shares of which are distributed by, the bank or an affiliate thereof. It further bars the lending of money to a fund by a bank which is an affiliated person of the fund (or affiliated person of such person) in contravention of any rules adopted by the SEC (again in consultation with the federal banking agencies).

The Act further amends the criteria for determining when a mutual fund trustee or director is an "interested person" of the fund. It adds a provision imposing "interested person" status on any person (including any affiliated person thereof) who within the preceding six months either executed transactions for, or engaged in principal transactions with, or distributed the shares of, or loaned money to any of (i) the fund in question, (ii) any fund managed by the same adviser (or held out to investors as a related fund), or (iii) any account over which the fund's adviser has brokerage discretion.

Along with the repeal of Section 32 of the Banking Act of 1933, as amended (the Glass-Steagall Act), discussed earlier in this report (dealing with interlocks), the Act specifies that the 1940 Act's limitation on trustees being affiliated with a single bank applies to the bank together with its subsidiaries and affiliates, as well as any one bank holding company (again including its subsidiaries and affiliates).

The Act codifies the SEC's and the federal banking agencies' long-held views as to the unlawfulness of representing or implying that investment company shares are guaranteed, sponsored, recommended or approved by the United States or that such shares are either FDIC-insured or represent obligations of the bank. Any investment company advised by a bank or whose shares are sold through a bank must make prominent disclosure of the fact that its shares are not FDIC insured. The SEC is given the authority, in consultation with the federal banking agencies, to adopt rules governing the content and placement of the requisite disclosure.

The definition of "broker" under the 1940 Act is amended to make it congruent with the revised definition of the same term under the 1934 Act. Generally, the revised 1934 Act definition will apply to banks more broadly; it does, however, exclude any person who might otherwise be deemed a broker solely because such person serves as principal underwriter for one or more investment companies.

Subtitle B of Title II of the new Act eliminates the blanket exclusion of banks from the definition of "investment adviser" under the Advisers Act in the case of banks which advise registered investment companies. Significantly, if the bank performs its fund advisory activities through a "separately identifiable department or division," that department or division is deemed to be the investment adviser for these purposes. Such a unit must be supervised by one or more officers designated by the bank's board of directors as responsible for day-to-day operations of the bank

in its capacity as adviser to one or more investment companies. The separate department or division must keep separate (or at least "extractable") records that are accessible to the SEC.

The Act establishes a framework for consultation among federal banking agencies and the SEC regarding reports of examinations pertaining to the investment advisory activities of a bank, bank holding company or separate bank division registered under the Advisers Act.

Bank Common Trust Funds, etc.

For many years, the 1933 Act, the 1934 Act and the 1940 Act have contained exemptions for bank common trust funds. In all three cases, the exemption is continued under the new Act only if (i) the common trust fund is employed "solely as an aid to the administration of trusts, estates or other accounts created and maintained for a fiduciary purpose," (ii) the common trust fund is not advertised or sold to the general public and (iii) the fees and expenses charged by the common trust fund do not contravene fiduciary principles established under applicable federal or state law.

Section 9(a) of the 1940 Act disqualifies certain ineligible persons (*e.g.*, certain persons convicted or enjoined as a result of misconduct as a broker, dealer, transfer agent, etc.) from serving as employee, officer, etc. of, among others, a registered investment company or principal underwriter thereof. The Act extends these prohibitions to include as well persons convicted or enjoined as a result of misconduct as a bank.

SEC Supervision of Investment Bank Holding Companies

Subtitle C of Title II establishes a new regulatory scheme applicable to the activities of "investment bank holding companies" (IBHCs). An IBHC is a person other than a natural person that owns or controls one or more brokers or dealers and includes the associated persons thereof (*e.g.*, employees). Those IBHCs not affiliated with a bank, foreign bank or savings association (with certain limited exceptions) may elect to be supervised by the SEC. An IBHC may later withdraw this election, but its withdrawal becomes effective only after the lapse of one year after notice is given (subject to SEC acceleration or postponement in certain circumstances).

The Act establishes the elements of SEC supervision of IBHCs, from recordkeeping and reporting requirements through SEC examination authority, particularly with regard to the IBHC's operations, dealings and other relationships with its broker and dealer affiliates. The SEC's supervisory authority over IBHCs electing SEC supervision does not compromise the authority of the banking and insurance regulators in regard to the banking and insurance-related activities of IBHCs.

Bank and Bank Holding Company Reserves

Finally, Subtitle D of Title II addresses the recent controversies which have arisen between the SEC and the federal banking agencies on the subject of loan loss reserves and the alleged use of such reserves as a method of managing earnings. The SEC has tended to exert pressure (often notwithstanding the expressed reservations of the federal banking agencies) on individual banking institutions and holding companies to reduce the levels of their reserves, claiming that the levels established reflect excessive caution and in effect serve as rainy day funds for future earnings. Subtitle D requires the SEC to consult and coordinate comments with the appropriate federal banking agencies before taking action or rendering any opinion with regard to the manner in which an insured depository institution or holding company thereof reports in its financial statements its loan loss reserves, including the amount of the reserve.

Unitary Savings and Loan Holding Companies (Title IV)

Under the Home Owners' Loan Act, savings and loan holding companies are subject to significant restrictions on the types of non-savings and loan activities which can be conducted by the holding company and its affiliates. Generally, these restrictions are similar to the ones imposed on bank holding companies under the Bank Holding Company Act.

Under pre-Act law, these activity restrictions did not apply to savings and loan holding companies and their subsidiaries if the holding company controlled only one savings and loan association (with exceptions allowing additional associations acquired in FDIC-assisted transactions), provided that the savings and loan association(s) held constituted "qualified thrift lenders" (a statutory standard designed to test quantitatively the level of the association's dedication to housing finance). This "unitary" thrift holding company exception permitted, for example, automobile manufacturers to acquire and hold a single savings association.

The Act terminates the unitary thrift holding company exception prospectively, so that future activities and acquisitions of savings and loan holding companies, whether the latter hold one or more subsidiary savings associations, and those of companies seeking to acquire one or more savings associations, must be confined to the limited activities and holdings historically permitted to multiple savings and loan holding companies.

A grandfather exception is provided for companies that were savings and loan holding companies on May 4, 1999, or that thereafter became savings and loan holding companies pursuant to an application pending with the Office of Thrift Supervision on that date, if certain conditions are met. A separate exception exempts certain family trusts becoming savings and loan holding companies if the family controlled the affected savings association on May 4, 1999 (or thereafter acquired such control pursuant to an application pending on that date).

Privacy (Title V)

The privacy provisions in the Act (Title V, Subtitle A) apply to financial institutions engaging in a laundry list of financial activities which include the activities of banks, broker-dealers, investment advisers, investment companies, insurance companies and other forms of financial institutions.

The category of information being protected ("nonpublic personal information") is quite broad and includes any personally identifiable financial information provided by a consumer to a financial institution resulting from any transaction with the consumer or any service performed for the consumer or otherwise obtained by the financial institution. Section 502(e) of the Act states certain exceptions from this protection, including information being provided to a consumer reporting agency in accordance with the Fair Credit Reporting Act, or in a consumer report reported by a consumer reporting agency. For these purposes, the term "consumer" has a standard definition: an individual who obtains from a financial institution financial products or services which are to be used primarily for personal, family or household purposes. The Act prohibits disclosure of such personal information by the financial institution to any nonaffiliated third party, unless the financial institution has provided a disclosure of its privacy policy to the consumer and also given the consumer the chance to "opt out" or to direct that such information not be disclosed to such third parties. (The resulting adoption of the "opt out" test, over the competing "opt in" test proposed, was one of the more controversial provisions of the entire legislation.) In another controversial provision, only disclosures to non-affiliates are covered by the prohibition; Subtitle A of Title V does not prohibit disclosure by a financial institution to its affiliates.

The restriction against disclosure also does not prevent a financial institution from providing nonpublic personal information to a nonaffiliated third party in order for that party to perform services for or to function on behalf of the financial institution, including marketing of the financial institution's own products or services, or financial products or services offered pursuant to joint agreements between two or more financial institutions (subject to regulatory restrictions to be developed), so long as the financial institution fully discloses to the consumer that the information is being provided and the third party agrees to main the confidentiality of such information.

Subtitle A of Title V will take effect six months after the regulations thereunder are promulgated. Congressional proponents of more vigorous privacy protection ("opt in" customer permission before any sharing of information may occur) have already introduced legislation (H.R. 3321) intended to readdress the privacy issue. Privacy is also a hot topic in several state legislatures. The privacy provisions in Title V expressly allow the states to enact laws which afford greater protection to the consumer, even if such laws conflict with the scheme provided by the Act.

Thus, the benefits of the more relaxed privacy provisions reflected in the Act may be limited and temporary. The Fair Credit Reporting Act may also affect the interplay between federal and state law on the privacy issue.

Subtitle B of Title V imposes criminal penalties and other sanctions against persons who engage in “pretext calling.” This practice consists of making false statements or representations to financial institutions in order to obtain customer information. Subtitle B is effective immediately.

This paper is intended to show you how many opportunities this Act creates for banks, insurance companies, securities and other financial services companies to do business together. We are happy to clarify any questions that you may have and direct you as you proceed in this new climate.

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