

TAKING ADVANTAGE OF THE SECURITIES AND CAPITAL MARKETS PROVISIONS IN THE GRAMM-LEACH-BLILEY ACT

INTRODUCTION

The Gramm-Leach-Bliley Act represents a broad rewrite of our nation's financial services laws. The Act repeals certain provisions of the Glass-Steagall Act and other restrictions applicable to banks and bank holding companies. As a result, banks will now be able to affiliate with securities firms and insurance companies within the same holding company, and holding companies will be able to engage in any activity that is "deemed financial in nature."

Bank subsidiaries also gain important authority under this legislation. Bank subsidiaries are explicitly authorized to engage in activities – such as securities underwriting and dealing – that are not permissible for parent banks. Finally, the Act addresses other important issues including privacy, identity theft, unitary thrifts and reform of the Federal Home Loan Bank system. This paper discusses the securities and capital markets provisions of this landmark legislation.

NEW ACTIVITIES

Title I of the Gramm-Leach-Bliley Act ("the Act") establishes a new framework for determining what type of nonbanking activities are permissible for bank holding companies or financial holding companies as they are soon to be called. Currently, section 4(c)(8) of the Bank Holding Company Act of 1956 ("BHCA"), 12 U.S.C.1843(c)(8), permits bank holding companies to acquire any company that the Federal Reserve Board ("Board") has determined "to be so closely related to banking as to be a proper incident thereto...." That standard will now change, under new section 4(k) of the BHCA, to "financial in nature or incidental to such financial activity" or "complementary to a financial activity".¹ See Section 103.

Under new section 4(k), certain activities are listed as being "financial in nature" including "underwriting, dealing in, or making a market in securities," and "merchant banking." In addition, national banks and state banks (if the state bank chartering authority permits) may engage in certain "financial in nature" activities through financial services subsidiaries. Activities prohibited to financial services subsidiaries include merchant banking but not securities underwriting and dealing.

¹ The Act provides that current section 4(c)(8) of the BHCA will sunset or no longer serve as authority for engaging in new nonbanking activities on the date of enactment of the Act. Activities previously approved under authority of section 4(c)(8) will be considered "financial in nature" under new section 4(k)(4)(F) of the BHCA.

To engage in these new activities, all depository institutions of a financial holding company must be well capitalized, well managed and have no less than a satisfactory CRA rating. Assuming these conditions are met, a financial holding company need only provide written notice to the Board within 30 calendar days after commencing the financial in nature activity or acquiring the firm engaging in that activity.

Title I is effective 120 days after enactment or March 11, 2000. *See* Section 161.

Underwriting, Dealing in, or Making a Market in Securities

In addition to delineating that underwriting and dealing in securities are a “financial in nature” activity, the Act also repeals Section 20 of the Glass-Steagall Act.² *See* Section 101. Section 20 prohibits banks from affiliating with any company that is “engaged principally” in underwriting and dealing. The Board has previously interpreted “engaged principally” as permitting bank affiliates to underwrite and deal in bank-ineligible securities³ so long as the gross revenue derived from these activities does not exceed 25 percent of the total gross revenue of the subsidiary.⁴

By repealing Section 20 and adding underwriting and dealing to the list of financial in nature activities, financial holding companies will be permitted to underwrite and deal in all types of securities without limit.⁵ All types of securities includes mutual fund shares, both affiliated and unaffiliated, which heretofore bank holding companies have not been permitted to underwrite or distribute.

The Gramm-Leach-Bliley Act also repeals Section 32 of the Glass-Steagall Act which generally bars personnel interlocks between a bank and firm that is “primarily engaged” in underwriting and distribution of securities.⁶ *See* Section 101. While, as discussed below, repeal of Section 32 is particularly significant with respect to bank-affiliated mutual fund boards, it should not be overlooked that personnel interlocks between a bank and an underwriting firm, affiliated or otherwise, are now permissible.

The Act also permits financial holding companies to make a market in securities. The Board has previously taken the position that shares held in connection with market making activities couldn’t exceed five percent of the outstanding voting shares of the company.⁷ Now,

² *See* 12 U.S.C. 377.

³ Bank-ineligible securities are securities that a member bank may not underwrite or deal in.

⁴ *See* Announcement of Increase in the Amount of Revenue that Section 20 Subsidiaries May Derive from Underwriting and Dealing in Securities, 83 FRB 98 (1997).

⁵ Banking organizations that choose not to convert their Section 20 firms to financial in nature firms authorized under new section 4(k) of the BHCA may need to seek Board relief from their authorizing 4(c)(8) orders.

⁶ *See* 12 U.S.C. 78.

⁷ *See* Section 4(c)(6) of the BHCA, 12 U.S.C. 1843(c)(6); Order Approving Travelers Group and Citicorp Merger, 84 FRB 985, 1006 (Nov. 1998).

however, market making is an explicitly enumerated authority under new section 4(k) of the BHCA, not limited by the investment limits set out under section 4(c)(6). *See* Section 103.

These new activities may be conducted in either a subsidiary of a financial services holding company or in a financial services subsidiary of a national bank. *See* Section 121. A state-chartered bank could conduct these new activities in a financial subsidiary if permitted under its home state's laws.

Various capital requirements and other safety and soundness provisions are extended to the financial services subsidiaries of national and state-chartered institutions, including Sections 23A and 23B⁸ of the Federal Reserve Act.

Merchant Banking

In recognition of “the essential role” that merchant banking plays in modern finance, the Act authorizes merchant banking activities as “financial in nature.” Merchant banking is defined as directly or indirectly acquiring or controlling “shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership) of a company or other entity, ... engaged in any activity not authorized” under new section 4(k) of the BHCA. *See* Section 103.

To ensure that merchant banking activities do not “breach the barrier between banking and commerce,” the Act provides that:

- “the shares, assets, or ownership interests are not acquired or held by a depository institution or subsidiary of a depository;”⁹
- the ownership interests “are acquired and held by a securities affiliate¹⁰ or an affiliate thereof as part of a bona fide underwriting, merchant or investment banking activity,

⁸ In a related matter, section 121 directs the Board, within 18 months, to address as covered transactions credit exposures arising out of derivative transactions between member banks and their affiliates and intraday extensions of credit by member banks to their affiliates. The Act also amends Section 23B(b)(2) to eliminate the independent board requirement and, instead, allow a majority of the bank directors to approve a principal or fiduciary acquisition of securities from an affiliate underwriter if the board determines that the investment is sound. *See* Section 738. Section 738 is effective upon enactment, or November 12, 1999.

⁹ The Act provides that, after five years, merchant banking activities may be conducted in a financial subsidiary of a national bank if the Board and the Department of Treasury jointly authorize such activity. *See* Sections 103 and 122. The Act also permits merchant banking activities to be conducted through an insurance underwriting firm or a registered investment advisory affiliate to the insurance underwriting firm. *See* Section 103.

¹⁰ The current definition of “affiliate” under regulations promulgated under authority of the BHCA remains unchanged. *See* Section 225.2(a) of Regulation Y, 12 CFR 225.2(a). However, nowhere in either the BHCA or the Gramm-Leach-Bliley Act is “ securities affiliate” defined.

including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment;”

- “such shares, ... are held for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the activities described ... [above];” and
- “during the period such shares, ...are held, the bank holding company does not routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.”

Three other provisions applicable to merchant banking activities should also be noted. First, the Act gives (but does not direct) the Board and the Secretary of the Treasury the authority to issue joint regulations implementing the merchant banking authority. *See* Section 103.

Second, depository institutions are prohibited from cross-marketing banking products through companies in which a securities affiliate has taken a portfolio investment or merchant banking stake. Conversely, depository institutions are prohibited from serving as a conduit for the sale of products and services produced by a firm in which the securities affiliate has made an investment. *See* Section 103.

Finally, the authority to engage in merchant banking activities contemplates that bank holding companies may make controlling investments in commercial firms. Once that investment becomes a controlling interest in the commercial firm, however, any transactions between the firm and the depository institution will be subject to all the limitations and restrictions of Sections 23A and 23B of the Federal Reserve Act.

The Gramm-Leach-Bliley Act amends Section 23A(b) to provide that an affiliate will be presumed to control any firm in which it has made a portfolio or merchant banking investment if the affiliate owns or controls 15% or more of the equity capital of that firm. That presumption can be rebutted, however, under guidance that has yet to be issued by the Board. *See* Section 121(b).

Municipal Revenue Bond Underwriting Authority

National banks are, under the Act, authorized to underwrite and deal directly in municipal revenue bonds, so long as the bank is well capitalized. *See* Section 151. A subsidiary of a national bank would be permitted to engage in these newly bank-eligible activities.¹¹ This provision is especially important to the community banking firms that wish to offer full financial services to their local and state government customers without being required to incur the expense of establishing a bank holding company affiliate firm.

State chartered banks would also gain this same authority if their state laws so authorized.

¹¹ This could include the traditional “business of banking” subsidiary, as well as the newly authorized financial services subsidiary.

BROKER-DEALER PROVISIONS

Banks are currently exempt from registering as broker-dealers under the Securities Exchange Act of 1934 (“Securities Exchange Act”). Under the Gramm-Leach-Bliley Act, banks will lose this blanket exemption. Consequently, if a bank were to engage in brokerage or dealing as defined under the Securities Exchange Act, the bank would have to register as a broker-dealer and be subject to regulation and oversight by the Securities and Exchange Commission (“SEC”) and the National Association of Securities Dealers (“NASD”). As a practical matter, however, a bank would not register the entire bank. Instead, it would move the securities activities at issue out of the bank and into a separate brokerage subsidiary or affiliate.

The Securities Exchange Act provides that “effecting transactions in securities for the account of others” is a brokerage activity. Arguably, any number of banking activities – including bank networking arrangements and trust and investment management activities – involve “effecting transactions in securities for the account of others.” Similarly, the definition of “dealing:” “buying and selling securities for [one’s] own account through a broker or otherwise,” could impact many legitimate banking activities.

The Gramm-Leach-Bliley Act appropriately recognizes that traditional banking activities involving securities transactions should not trigger broker-dealer registration requirements. Accordingly, the Act lists several exemptions under which banks would not be required to push certain activities out of the bank and into a broker-dealer affiliate (the so-called “push-out” exemptions).

Section 204 of the Act requires that the federal bank regulators, after consulting with the SEC, adopt record keeping requirements for banks relying on the exemptions from broker-dealer registration discussed below.

The loss of the blanket exemption from registration and the several push-out exemptions take effect 18 months after enactment or May 12, 2001. *See* Section 209.

Banking Products – In General

Brokerage or principal transactions involving certain “banking products” would be exempt from push-out even if the SEC were to label such a product a “security.” The protected banking products are divided into two categories: “identified banking products”; and “new hybrid products.”

“Identified banking products.”

The list of “identified banking products” includes deposits; banker’s acceptances; letters of credit; loans; debit accounts and certain loan participations (as described below).¹² It also

¹² The definition of “identified banking products” is codified in a free-standing provision of law, neither in the banking laws nor securities laws.

includes any swap agreement,¹³ including credit and equity swaps, except for equity swaps that are sold directly to non-qualified investors, a defined term under the Act.¹⁴ If an equity swap is not sold directly to non-qualified investor, e.g., it is sold through a registered broker-dealer, then the instrument may be deemed to be an identified banking product that can remain in the bank. *See* Sections 201, 202 and 206.

“New hybrid products.”

A new hybrid product is an instrument that is not on the list of “identified banking products” and is also not regulated as a “security” as of the date of enactment of the Gramm-Leach-Bliley Act. The SEC is given initial authority – under the federal securities laws – to determine, through rulemaking, whether a new product must be pushed out of a bank.¹⁵ The Board can seek judicial review of that determination.¹⁶ The filing of any petition by the Board operates as a stay of the SEC’s rulemaking until a final court decision is reached. Moreover, the Court is required to make a final determination based on whether the product is more appropriately regulated under the banking laws or the securities laws; the court is directed to give deference to neither the views of the Board or the SEC. *See* Section 205.

Third Party Brokerage Arrangements

The Act exempts from push-out support services provided by bank employees to third-party and affiliated brokers in connection with the sale of securities to bank customers. *See* Section 201. In order to qualify for the exemption, such networking services must satisfy a number of conditions that closely parallel similar requirements in the Interagency Statement on Retail Sales of Nondeposit Investment Products (“Interagency Statement”).¹⁷ These conditions are:

¹³ Swap agreement is defined under the Act to mean “any individually negotiated agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets.” *See* Section 206(b).

¹⁴ “Qualified investor” with respect to swap transactions includes regulated companies, various institutional investors, corporations and individuals with an investment portfolio of not less than \$25 million and any state or local government with an investment portfolio of not less than \$50 million. *See* Section 207.

¹⁵ Consultation with the Board is required before the SEC can commence any rulemaking. In addition, the SEC is required to consider the Board’s views “with respect to the nature of the new hybrid product; the history, purpose, extent, and appropriateness of the regulation of the new product under the Federal banking laws; and the impact of the proposed rule on the banking industry.” *See* Section 205.

¹⁶ Other aggrieved parties may seek judicial review of the SEC rulemaking under Section 25 of the Securities Exchange Act, 15 U.S.C. 78y.

¹⁷ The Interagency Statement was jointly issued by the Board, the Federal Deposit Insurance Corporation (“FDIC”), the Office of the Comptroller of the Currency (“OCC”), and the Office of Thrift Supervision (“OTS”) on February 15, 1994. It was subsequently amended on September 15, 1995.

- Clear identification that the broker is providing the brokerage services;
- Brokerage services are provided in an area that is clearly marked and, to the extent practicable, physically separate from routine deposit-taking activities;
- Advertising or promotional materials clearly indicate that the brokerage services are being provided by the broker, not the bank;
- Such materials comply with the federal securities laws before they are distributed;
- Bank employees perform only ministerial or clerical functions in connection with the brokerage activities (but they can forward customer funds or securities and can generally describe the range of investment vehicles available;)¹⁸
- Bank employees (other than those who are “associated persons” of a broker-dealer) do not directly receive “incentive compensation” for any brokerage transaction (but they can receive referral fees if the compensation is a one-time cash fee of a fixed dollar amount and the fee is not contingent on a transaction occurring;
- All customers who receive brokerage services are fully disclosed to the broker-dealer;
- The bank does not carry a securities account of the customer except as a custodian or trustee; and
- The customer is informed that the securities are provided by the broker, not the bank, and the securities are not deposits or other obligations of the bank, are not guaranteed by the bank, and are not insured by the Federal Deposit Insurance Corporation.

U.S. Government, Commercial Paper and Other Securities

The Act exempts from push-out transactions involving commercial paper, commercial bills, U.S. government and agency securities,¹⁹ Brady Bonds, certain qualified Canadian government obligations, and North American Development Bank obligations. *See* Sections 201 and 202.

¹⁸ The NASD recently approved revisions to Rule 1060 and accompanying interpretation, IM-3010, subjecting bank employees who describe generally investment products available from an affiliated or third-party broker-dealer to NASD jurisdiction and oversight. The Rule and interpretation, currently pending before the SEC, are in conflict with the networking exemption. The Joint Explanatory Statement of the Committee of Conference directs that revisions should be made to exempt banks and their employees from the provisions’ coverage.

¹⁹ The Act employs the term “exempted securities,” which, under the Securities Exchange Act definition, includes U.S. government and agency securities. *See* Section 3(a)(12), 15 U.S.C. 78c(a)(12).

Municipal Securities

The Act exempts from broker registration banks that effect transactions in municipal securities. *See* Section 201. No similar exemption from dealer registration is provided because banks are required under current law to register as municipal securities dealers with their primary bank regulator. *See* Section 15B of the Securities Exchange Act, 15 U.S.C. 78oB.

Trust and Fiduciary Services

If a bank effects a securities transaction in connection with providing trust or fiduciary services, the bank is exempt from pushing these activities out of the bank and into a registered broker-dealer if three basic conditions are satisfied. *See* Section 201. First, the bank can not publicly solicit brokerage business, other than by advertising that it effects transactions in securities as part of its overall advertising of its general trust business.

Second, the bank's compensation for effecting transactions in securities must consist ***chiefly*** of an administration or annual fee; a percentage of assets under management; a flat or capped per order processing fee that does not exceed the cost of executing the securities transaction for trust or fiduciary customers, or a combination of such fees.

Third, the bank would have to direct all trades of publicly traded domestic securities through a registered broker-dealer (which could include an affiliate), except for certain cross trades made by the bank or between the bank and an affiliated fiduciary.

"Fiduciary capacity" is defined under the Act, and although it does not cross-reference the OCC's Part 9 definition, it parallels that definition word-for-word. *See* Section 201.

Safekeeping and Custody

The Act exempts from push-out activities conducted in connection with safekeeping and custody services. *See* Section 201. Such services involve the bank, as part of customary banking activities—

- Providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers;
- Facilitating the transfer of funds or securities as custodian or clearing agency, in connection with the clearance and settlement of its customer transactions in securities;
- Effecting securities lending or borrowing transactions for customers, investing pledged collateral for customers, in connection with the safekeeping, custody and clearing activities, described above;
- Holding securities pledged by a customer to another person, or securities subject to purchase or resale agreements for a customer, or facilitating the pledging or transfer

for such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; or

- Serving as custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.²⁰

The Act provides that this exemption will not apply if the bank acts as a carrying broker for any broker or dealer, unless the carrying broker activities are limited to transactions in government securities. Carrying brokerage is not a defined term under the Securities Exchange Act but is generally used to mean having control or custody of customer securities and funds.

This push-out exemption is very important to the banking industry. As more and more individuals change employers or retire, self-directed Individual Retirement Accounts (“IRAs”) will become important vehicles, allowing consumers to individually manage their 401(k) retirement plan distributions. Under regulations issued by the Internal Revenue Service, banks must offer these IRAs in either a trustee or custodial capacity. Services provided to these accounts by banks functioning in a trustee or fiduciary capacity will be exempt from brokerage registration under the trust exemption discussed above. Services rendered by banks as a custodian will also be exempt under this safekeeping and custody exemption.

Stock Purchase Plan Services

Banks that conduct stock transfer agency activities sometimes effect transactions in securities in connection with employee benefit plans, dividend reinvestment plans, and issuer open enrollment plans. Such transactions in securities would be exempt from push-out if three conditions are satisfied. *See* Section 201.

First, the bank could not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plans. However, delivery of the types of written material permitted by the SEC as the date of enactment (or as permitted by the SEC in the future) would not trigger a push-out.

Second, the bank could not net shareholders’ buy and sell orders, other than for programs for odd-lot holders or plans registered with the SEC. (This condition would not apply to employee benefit plan activities).

Third, as with the trust exemption, the bank would have to execute any brokerage transactions through a registered broker-dealer (which could include an affiliate), except for certain cross trades made by the bank or between the bank and an affiliated fiduciary.

²⁰ Similar to the trust exemption, the bank would have to execute any brokerage transactions through a registered broker-dealer (which could include an affiliate), except for certain cross trades made by the bank or between the bank and an affiliated fiduciary.

Loan Participations

The Act includes loan participations on the list of “identified banking products.” Loan participations deemed to be securities by the SEC would be eligible for two different types of exemption from push-out, depending on the circumstances. *See* Sections 201 and 202.

First, an exemption from push-out would apply if the participation were sold to a “qualified investor.”²¹

Second, an exemption would apply for sales to non-qualified investors if the participations were sold to persons that (1) have the opportunity to review and assess any material information; and (2) have the sophistication necessary to evaluate such instruments, as determined by generally applicable banking standards.

Private Placements

The Act exempts private placements from push-out only if the bank is not affiliated with a broker-dealer that engages in underwriting, dealing or market making in any securities, other than exempted securities. *See* Section 201. If a bank is not affiliated with ANY broker-dealer, the dollar value of any single offering of private placement securities cannot exceed 25 percent of the capital of the bank.²²

Anticipating that some bank employees currently engaged in private placement activities will be required to move their private placement activities to a broker-dealer affiliate, the Act directs the self-regulatory organizations to develop a limited qualification category that would apply to those bank employees who, in the six months preceding enactment of the Gramm-Leach-Bliley Act, engaged in private placement activity. This limited qualification category would allow these employees to qualify without the need to take a qualifying exam. *See* Section 203.

Sweep Account Activities

More and more banks are offering their commercial, trust and other customers the ability to make cash deposits productive by sweeping the cash on an overnight basis into an instrument earning some sort of return. Interest in these sweep services is particularly strong with small business customers. Many banks sweep customers funds into U.S. government or deposit accounts. Money market mutual funds are another popular option.

²¹ “Qualified investor” for purposes of loan participations and asset-back securities, *see* discussion below, includes regulated companies, certain institutional investors, corporations and individuals with investment portfolios valued at no less than \$10 million and state and local governments with investment portfolios valued at no less than \$50 million.

²² The limitation on the size of any single private placement conducted in the bank does not apply to government and municipal securities.

The Act would exempt banks that sweep customer funds into no load money market mutual funds.²³ *See* Section 201. To qualify for the exemption, the sweep service must be conducted as part of a program for the investment or reinvestment of bank deposits.

Asset-backed Transactions

Asset-backed transactions are exempt from dealer registration requirements if the assets²⁴ are predominantly originated by the bank, a non-broker-dealer affiliate of the bank, or a syndicate of banks of which the bank is a member. *See* Section 202. The syndicate option is only available if the assets are mortgage or consumer-related receivable obligations.

Investment and Affiliate Transactions

Under the Act, a bank will not be required to register as a dealer if it buys or sells securities for investment purposes for its own account or for accounts for which the bank acts as a trustee or fiduciary. *See* Section 202. A bank will also be permitted to engage in brokerage transactions on behalf of affiliated firms, so long as the affiliate is not a registered broker-dealer or engaged in merchant banking activities. *See* Section 201.

De Minimis Exception

Finally, the Act provides that if a bank conducts brokerage transactions that do not fall within any of the above listed categories, such as accommodation trades for certain bank customers, then the bank must not effect more than 500 transactions in any one calendar year. *See* Section 201. Nor can an employee of the bank who is also an employee of the broker or dealer effect the transaction. Presumably, a dual employee that effects securities transactions in his or her capacity as an employee of the broker-dealer would come within the networking exemption described above.

MUTUAL FUND PROVISIONS

The Act permits bank holding companies, through either a subsidiary of a bank or through a non-bank subsidiary of the holding company, to underwrite and distribute mutual funds, including third-party mutual funds. *See* Section 101(a). In addition, Section 32 of the Glass-Steagall Act is repealed, thereby permitting common officers, directors, and employees between a bank and a registered investment company. *See* Section 101(b).

²³ Sweep account services involving U.S. government securities, deposit accounts (should they be considered securities by the SEC) or trust customers would be exempt under the exemptions applicable to U.S. government securities, identified banking products, or trust and fiduciary services.

²⁴ Assets cannot include securities that the bank does not issue.

As Title I provisions, these provisions are effective 120 days after enactment or March 11, 2000. *See* Section 161.

The amendments to the Investment Company Act of 1940 and the Investment Advisers Act of 1940 discussed below are effective in 18 months or May 12, 2001.

Investment Adviser Registration

Banks would lose their blanket exemption from investment adviser registration under the Investment Advisers Act of 1940 *only* with respect to their investment advisory activities involving *registered* investment companies. *See* Section 217(a). All other investment advisory activities conducted in the bank, including bank investment advisory activities involving private equity and other unregistered mutual funds, would continue to be exempt from federal investment adviser registration requirements.

Investment adviser registration will subject bank mutual fund investment advisory activities to regulation by the SEC under the Investment Advisers Act of 1940. That Act and the rules promulgated under the Act regulate advertising, solicitation, and receipt of performance fees by registered investment advisers. In addition, investment adviser registration requires establishment of procedures to prevent the misuse of non-public information; maintenance by the adviser of certain books and records; supervision of investment advisory firm employees; compliance with the general anti-fraud provisions of the federal securities laws; and statutory disqualification from performing certain services for a mutual fund if the adviser violates the law.

With respect to bank or bank-affiliate registered investment advisory activities, Section 220 of the Gramm-Leach-Bliley Act encourages the SEC and the federal banking agencies to coordinate and share with each other examination reports, records and other information, presumably in an effort to reduce regulatory burdens associated with becoming a registered investment adviser.

The “SIDD” Option

In an attempt to give banks the maximum flexibility to structure investment advisory business in a way that makes the most business sense, the bill provides that banks may register their in-house investment advisory units as “separately identifiable departments or divisions” or SIDDs. *See* Section 217(b). In this way, banks, though required to register as investment advisers, may keep their investment advisory units in the bank, in a bank subsidiary, or in a holding company subsidiary.

Banks contemplating this option should be aware that Arthur Levitt, Chairman of the SEC, has testified that the investment adviser registration will give SEC examiners the ability to review bank mutual fund adviser’s activities in order to compare trading activity in a mutual fund portfolio to that in the bank’s trust accounts and determine whether there has been an

improper allocation of orders.²⁵ While the trust industry is united in its belief that investment adviser registration does not give the SEC the ability to look at individual trust account transactions, banks weighing investment adviser registration options should factor into their analyses this claim of authority on the part of the SEC's Chairman.

Common Trust Funds

New Thrift Power

The Act revises the definition of "bank" for the purposes of the Investment Company Act of 1940. *See* Section 223. Under amended Section 2(a)(5)(A) of the Investment Company Act, "bank" is defined to include "a depository institution (as defined in section 3 of the Federal Deposit Insurance Act)."²⁶ Section 3 of the Federal Deposit Insurance Act defines "depository institution" as "any bank or savings association." "Savings association" is, in turn, defined as any federal savings association chartered under the Home Owners' Loan Act or any state savings association chartered under the laws of its State. As a consequence, the exemption from registration for bank common and collective funds under Section 3(c)(3) and 3(c)(11) of the Investment Company Act has now been expanded to include common and collective pooled funds offered by thrift institutions.

Interests in these pooled funds are also exempt from registration under the Securities Act of 1933. Specifically, Section 3(a)(2) of the Securities Act cross-references the definition of "bank" under the Investment Company Act of 1940 in connection with exempting from registration requirements interests in bank common and collective funds. As a result, both the interests in bank common and collective funds, as well as the funds themselves are exempt from SEC registration. This new thrift power will make the thrift charter much more attractive to those financial institutions interested in offering trust and fiduciary services to their clients.

Codification of SEC No-Action Letters

The Gramm-Leach-Bliley Act codifies existing SEC no-action letters with respect to the common trust fund exemption from registration under the federal securities laws. *See* Section 221. Specifically, the exemptions from registration under the Securities Act, the Securities Exchange Act of 1934 and the Investment Company Act require that:

- the common trust fund be employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for fiduciary²⁷ purposes;

²⁵ *See* Testimony of Arthur Levitt, Chairman of the Securities and Exchange Commission, *H.R. 10, The Financial Services Act of 1999*, before the Committee on Commerce, House of Representatives, May 5, 1999.

²⁶ Section 2(a)(5)(A) of the Investment Company Act also defines a "bank" as "a branch or agency of a foreign bank (as such terms are defined in section 1(b) of the International Banking Act of 1978)."

²⁷ Title II of the Gramm-Leach-Bliley Act defines "fiduciary capacity" as "(i) in the capacity as trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under uniform gift to minor act, or as an investment adviser if the bank receives a fee for its investment advice; (ii) in any capacity

- interests in the fund are not advertised, except in connection with the ordinary advertising of the bank’s fiduciary services, and are not offered to the general public; and
- fees and expenses charged by such fund are not in contravention of fiduciary principles established under applicable federal or state law.

The first two conditions of the exemption are drawn from current SEC no-action letters interpreting the exemption from registration under Section 3(c)(3).²⁸ The fees and expenses requirement is intended to ensure that any fees and expenses charged by the fund are measured against fiduciary principles established under the Employee Retirement Income and Security Act, Part 9 administered by the OCC, or state statutory, decisional or common law addressing fees and expenses in connection with fiduciary principles of law.

Mutual Fund Custodians

The Act gives the SEC authority to adopt rules and regulations and issue orders prescribing conditions under which a bank or an affiliate can serve as custodian to an affiliated registered investment company or a unit investment trust. *See* Section 211. Many banks currently serve as custodians to third party and affiliated mutual funds²⁹ and this provision does not contemplate putting an end to this activity. Rather, the Act now gives to the SEC explicit authority to adopt rules concerning bank self-custody activities but, at the same time, requires the SEC in promulgating self-custody rules and regulations to consult with and take into consideration the views of the federal banking agencies.

Bank Lending to Affiliated Mutual Funds

Section 212 prohibits persons affiliated³⁰ with a registered mutual fund, including a bank, from lending money or property to the registered mutual fund or any company controlled by the fund except in accordance with SEC rules. In connection with promulgating any such rules, the SEC must consult with, and take into consideration the views of, the federal banking agencies.

in which the bank possesses investment discretion on behalf of another; or (iii) in any other similar capacity.” *See* Section 201 (adding new Section 3(a)(4)(D) to the Securities Exchange Act).

²⁸ *See e.g.*, Santa Barbara Bank & Trust, (pub. avail. Nov. 1, 1991); United Missouri Bank of Kansas City, N.A. (pub. avail. Dec. 31, 1981).

²⁹ Commercial banks have always served as custodians to mutual funds. Indeed, Section 17(f) of the Investment Company Act of 1940 and SEC Rule 17f-1 recognize the importance of commercial banks serving as fund custodians. With respect to affiliated mutual funds, banks may, like non-bank affiliated mutual funds, self-custody their own funds in accordance with the SEC’s self-custody rule, Rule 17f-2.

³⁰ “Affiliated person” is generally defined under the Investment Company Act by reference to concepts of control (direct, indirect or common). *See* Section 2(a)(3).

Mutual Fund Boards of Directors

Currently, registered mutual funds are prohibited from having a majority of their board of directors consist of officers, directors, or employees of any one bank. *See* Section 10(c). Section 213(c) would expand the prohibition to include officers, directors, and employees of any one bank (together with its affiliates and subsidiaries) or bank holding company (together with its affiliates and subsidiaries).

Currently, the Investment Company Act limits the composition of registered mutual fund boards to no more than 60 percent “interested persons.”³¹ *See* Section 10(a). The Act would expand the definition of “interested persons” to include any person who, during the preceding six months, executed any portfolio transaction for, engaged in any principal transactions with, distributed shares for, or loaned money or other property to, the registered investment company, any related investment company, or any account for which the investment adviser has brokerage placement discretion. *See* Section 213(a) and 213(b).

Disclosure

The Act takes a page out of the federal banking agencies’ Interagency Statement on the Retail Sales of Nondeposit Investment Products by making it unlawful for any person selling shares of registered mutual fund shares to represent or imply that that security:

- has been guaranteed, sponsored, recommended, or approved by the United States, or any agency, instrumentality or office of the United States;
- has been insured by the FDIC; or
- is guaranteed by or is otherwise an obligation of any bank or insured depository institution.

The Act also codifies guidance issued by the SEC in May 1993 concerning mutual funds advised by banks or, alternatively, sold through banks.³² Specifically, the Act specifically requires prominent disclosure of the fact that the FDIC or any other government agency does not insure mutual fund shares. If the SEC is to adopt rules and regulations or issue orders concerning such disclosure, the Act mandates that the SEC consult with, and take into consideration the views of, the federal banking agencies.

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³¹ The SEC has recommended that the Congress revise Section 10(a) to limit “interested persons” on mutual fund boards to no more than 50 percent.

³² *See* Letter from Barbara Green, Deputy Director of the SEC’s Division of Investment Management, dated May 13, 1993.

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