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Memo

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Date: May 24, 2002

To: Members of Drafting Committee to Revise the Uniform Securities Act

Re: Comments on May 2002 USA Draft

The American Bankers Association respectfully asks the Drafting Committee to reconsider two actions tentatively approved at its April meeting. One relates to addition of the "unsolicited" qualification to the de minimis exception in USA Sec. 102(4)(C).[1] The second involves elimination of the private placement exception in the same section. In this regard, we urge the Committee at a minimum to delete the unnecessary "unsolicited" qualification and to include the private placement exception. Please also note the other issues addressed.

Overview. This memo is intended to answer questions raised at the last meeting and supplement our earlier memo dated March 5, 2002. Proponents of these restrictions have not offered adequate evidence to justify the need for these limitations. U.S. Senate Report No. 106-44 indicates that banks have provided these services without any problems for years and that the activities are supervised by banking regulators.[2] If adopted as proposed, Sec. 102(4)(C) will prevent and restrict a depository institution from engaging in activities authorized by federal law.

The Gramm-Leach-Bliley (G-L-B) Act[3] appropriately recognizes that certain traditional banking activities involving securities transactions – including the de minimis and private placement ones – do not make a bank a broker or dealer nor require registration and may be performed in the bank. One reason the de minimis exception was included in the G-L-B Act was to continue to permit banks to provide accommodation trades for certain customers.[4] Community banks and others have advised us that this is critical to them and their customers, particularly where no registered broker is located in the town. With respect to private placements, federal banking regulators have long permitted banks to offer this service subject to numerous regulations.[5] Banks have provided private placement services for years as an adjunct to granting credit to customers.[6]

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[1] Although the Committee intended (as reflected in the Reporter's Preface) to limit the "unsolicited" qualification to de minimis transactions, this intent is not clear in Section 102(4)(C)'s terminology and punctuation.
[2] See Sen. Rep. 106-44, 106th Cong., 1st Sess. at 10-11 (1999).
[3] Pub. L. No. 106-102, 113 Stat. 1338 (1999).
[4] See Sen. Rep. 106-44, 106th Cong., 1st Sess. at 48 (1999).
[5] See SEC Release No. 34-44291, File No. S7-12-01 (Effective Date: May 11, 2001).
[6] See <u>Securities Activities of Banks</u> (Third Edition) by Melanie L. Fein, Chapter 10.

Regulations and Examinations. These de minimis and private placement activities are subject to extensive regulations, some of which are highlighted in our previous memo. All FDIC-insured institutions (regardless of size) are regularly examined by federal or state bank examiners.

Effect on Consumers and Businesses. By imposing these restrictions, many banks will no longer be permitted to offer the services they now provide in the bank. Instead the bank must consider costly alternatives, such as establishing a broker-dealer affiliate or registering as a broker-dealer. It is impractical for many small banks to establish broker-dealer affiliates,[7] and the SEC believes that it is not a viable option for a bank to register as a broker-dealer because of the disparate capital and regulatory requirements applicable to banks and securities firms.[8] The unfortunate result: some banks will decline to provide these services, and the needs of bank customers will go unmet. No valid public policy interests would be served by denying banks the ability to provide products in the most effective and efficient distribution system, especially where to do so would deprive consumers and businesses of these benefits.

Current State Laws. At least 33 state laws now exclude banks or depository institutions entirely from the definition of broker-dealer or a related term. It appears that at least four additional states (Connecticut, Delaware, New York, and Tennessee) give banks the benefit of the major G-L-B Act push-out exceptions. The laws of eight states might be read as denying banks some or all aspects of the de minimis and private placement provisions. Regardless of the exact numbers, however, it is clear that adoption of the proposed limits in Sec. 102(4)(C) will be contrary to the overwhelming number of state laws. Many state bankers associations and banks will justifiably question the benefit of a USA that eliminates the minimal G-L-B push-out provisions. Indeed, those whose laws exclude banks entirely from the broker-dealer definition may be quite content with present law and oppose the Act altogether. Again, keep in mind that even including the de minimis and private placement provisions represents a drastic cut from the total exclusion from the broker-dealer definition which banks now enjoy under many state laws.

Regulatory Flexibility and Delayed Effective Date. The USA provisions in Sec. 102(4)(C) are tied to specific exceptions in the Securities Exchange Act of 1934. The SEC has not yet finalized rules regarding these broker and dealer exceptions and other exemptions for banks and savings institutions and recently issued an order extending the temporary exemptions for such institutions from the definitions of "broker" until May 12, 2003, and "dealer" until November 12, 2002. The order noted that the SEC expects to extend the temporary exemptions as appropriate so that banks will have a sufficient transition period to bring their operations into compliance with the new statutory scheme and amended rules. The SEC cited comments to the effect that banks may need as much as a year to develop compliance systems to adapt to the G-L-B Act in light of the amended rules.[9]

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[7] See Securities Activities of Banks (Third Edition) by Melanie L. Fein, Sec. 3.04[B][5][d].
[8] See SEC Release No. 34-44291, File No. S7-12-01 (Effective Date: May 11, 2001).
[9] See SEC Release No. 34-45897, File No. S7-12-01 (May 8, 2002).

Given the uncertainty regarding SEC rules and the importance of an adequate transition period for banks and savings institutions, we again recommend inclusion of various regulatory flexibility provisions and a delayed effective date. Otherwise there will be a marked inconsistency – USA will require that banks comply with specific federal law push-out provisions even though the SEC has extended the dates for compliance with these same federal law provisions. The SEC's interim final rules also grant banks additional exemptions from the definitions of "broker" and "dealer."[10] The situation is further complicated because the SEC's extension order provides different dates that banks are exempt for the definition of "broker" (until May 12, 2003) and "dealer" (until November 12, 2002), while the USA does not separately define these terms but instead uses a combined term – "broker-dealer."

Conflicts with Federal Law. Addition of the "unsolicited" qualification and the failure to include the private placement exception prevent and restrict depository institutions from engaging in activities permitted by federal law. A significant provision of the G-L-B Act contains a broad preemption standard preventing states from exercising such authority: "no State may, by statute, regulation, order, interpretation, or other action, prevent or restrict a depository institution or an affiliate thereof from engaging directly or indirectly, either by itself or in conjunction with an affiliate, or any other person, in any activity authorized or permitted under this Act."[11] Title II of the G-L-B Act excludes certain traditional bank "activities" – including the private placement and de minimis ones – from the definition of "broker" and allows them to be conducted in the bank without registering as a "broker." As noted above, federal law is clear: states may not "prevent or restrict" depository institutions from engaging in these traditional bank activities.

Proponents of these restrictions argue that G-L-B Act Sec. 104(f)[12] provides authority for states to impose these limitations. We strongly disagree. That section is very limited in scope. It provides only that the broad preemption subsection quoted above shall not be construed to affect the jurisdiction of the securities commission of any State "to require . . . the licensure or registration of brokers, dealers, or investment advisers . . . ." USA Sec. 102(4)(C) impermissibly exceeds this narrow authority because it "prevents or restricts" depository institutions from engaging in private placements and de minimis transactions within the bank without registration.[13] The proponents' interpretation also ignores the definition of "broker" in Sec. 201 of the G-L-B Act,[14] which excepts a bank engaging in specified traditional bank activities from the term. Indeed, such a tortured interpretation would permit states to redefine the term broker-dealer and bring any of the excepted traditional bank activities (including deposit and savings account transactions) within the term. This would be an absurd result. Statutes must be read as a harmonious whole.

[10] See SEC Release No. 34-44291, File No. S7-12-01 (Effective Date: May 11, 2001).
[11] See Sec. 104(d)(1) of G-L-B Act codified in 15 U.S.C. 6701(d)(1).
[12] Codified at 15 U.S.C. 6701(f).
[13] See 15 U.S.C. 6701(d)(1) and (d)(4)(D).
[14] Codified at 15 U.S.C. 78c(a)(4).

Courts not only consider the particular statute in question but also the entire legislative scheme of which it is a part.[15]

The G-L-B Act's legislative history makes clear that allowing states to pick and choose which traditional bank products a bank may offer without registering as a broker is not allowed. Such state action would render the G-L-B Act bank securities powers meaningless. The Senate Report on the legislation contains the following: "The repeal of Glass-Steagall's anti-affiliation rules and the blanket exemption for banks from broker-dealer registration raises the issue whether, and under what circumstances, such products and activities should be 'pushed out' of (i.e., moved out of) a bank and into a registered broker-dealer affiliate. The Committee does not believe that an extensive 'push-out' of or restrictions on the conduct of traditional banking services is warranted. Banks have historically provided securities services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without any problems for years. . . . . With respect to private placements, the Committee believes that, to the extent that these transactions are conducted pursuant to applicable Federal law or the rules and regulations thereunder, there is no compelling reason to 'push-out' these activities (which have been supervised by banking regulators)."[16]

Proponents also argue that various statutes under which the SEC operates[17] preserve the jurisdiction of state securities commissions to prevent and restrict bank activities as proposed in USA Sec. 102(4)(C). Again this argument misses the mark. It ignores the broad preemption quoted above in 15 U.S.C. 6701(d)(1) and the limiting language of the various SEC statutes cited in footnote 17. Except for specified insurance activities not relevant here, 15 U.S.C. 6701(d)(1) prohibits states from preventing or restricting bank activities. Moreover, the limiting language of the various statutes cited in footnote 17 does not allow states to override the prohibition in 15 U.S.C. 6701(d)(1). This limiting language provides in general that nothing in a specified chapter or subchapter [of which 15 U.S.C. 6701(d)(1) is NOT a part] affects the jurisdiction of a state securities commission insofar as it does not conflict with the provisions of this chapter or subchapter. Proponents ignore the fact that the broad preemption provision in 15 U.S.C. 6701(d)(1) is not codified in any of the specified chapters or subchapters and thus may not be overridden by states. They also ignore the fact that eliminating the private placement exception and restricting the de minimis one as proposed will conflict with the definition of "broker" in 15 U.S.C. 78c(a)(4), thereby violating Sec. 28(a) of the Securities Exchange Act of 1934.[18]

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[15] See Sutherland Statutory Construction (Sixth Edition) by Norman J. Singer, Sec. 46:05.
[16] Sen. Rep. 106-44, 106th Cong., 1st Sess. at 10-11 (1999).
[17] 15 U.S.C 78bb(a) [Sec. 28(a) of Securities Exchange Act of 1934]; 15 U.S.C. 79u [Sec. 21 of the Public Utilities Holding Company Act of 1935]; 15 U.S.C. 77zzz [Sec. 326 of the Trust Indenture Act of 1939]; 15 U.S.C. 80b-18a [Sec. 222 of the Investment Advisers Act of 1940]; 15 U.S.C. 80a-49 [Sec. 50 of the Investment Act of 1940].
[18] Codified in 15 U.S.C. 78bb(a).

Additional Preemption Authority. Even where federal law has not completely displaced state law, courts have found that state law is preempted to the extent it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[19] The above-quoted legislative history makes clear that Congress determined there was no compelling reason to push-out these traditional bank activities because (1) they are supervised by banking regulators and (2) these services have been provided by banks for years without any problems.

Moreover, the G-L-B Act has established a comprehensive scheme for regulation by the banking agencies of these activities. G-L-B Act Sec. 204 mandates that each appropriate federal banking agency establish recordkeeping requirements for banks relying on the push-out exceptions, and that such requirements "shall be sufficient to demonstrate compliance with the terms of such exceptions." Requiring banks to push-out private placement activities and certain de minimis transactions would frustrate the objective of Congress and conflict with the G-L-B Act. The SEC agrees: "In enacting the G-L-B Act, Congress determined that functional regulation was appropriate – that is, when a bank was conducting a securities business outside of the enumerated exceptions, that bank should be registered as a broker-dealer."[20] Sec. 111 of the G-L-B Act reflects this Congressional intent. It contains provisions permitting regulation of securities activities of a functionally regulated subsidiary of a depository institution by the SEC and state securities authorities as appropriate. These provisions make clear, however, that a bank performing excepted securities activities is not a functionally regulated subsidiary.

National Bank Issues. USA Sec. 102(4)(C) conflicts with provisions of the National Bank Act. National banks are incorporated under federal law. They are federal instrumentalities whose activities and purposes state regulators may not frustrate.[21] State authority over national banks, because of their federal charter, is limited under the "federal instrumentality" doctrine. The Supreme Court has precluded states from applying state statutes to national banks when those laws "expressly conflict with the laws of the United States or frustrate the purpose for which the national banks were created, or impair their efficiency to discharge the duties imposed on them by the law of the United States."[22] The Court also has stated that national banks are not subject to state laws that "infringe the national banking laws or impose an undue burden on the performance of the banks' function."[23]

The National Bank Act authorizes national banks to engage in a number of securities activities. It also provides that they may exercise "all such incidental powers as shall

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[19] Pacific Gas and Elec. Co. v. State Energy Resource Conservation and Development Commission, 461 U.S. 190 (1983) and Fidelity Fed. Savings and Loan Association v. de la Cuesta, 458 U.S. 141(1982).
[20] SEC Release No. 34-44291, File No. S7-12-01 (Effective Date: May 11, 2001).
[21] See Mercantile Nat. Bank v. Langdeau, 371 U.S. 555 (1963) and Marquette Nat. Bank v. First of Omaha Service Corp., 439 U.S. 299 (1978).
[22] McClellan v. Chipman, 164 U.S. 347, 357 (1897).
[23] Anderson Nat. Bank v. Luckett, 321 U.S. 233, 248 (1944).

be necessary to carry on the business of banking."[24] Courts have interpreted this authority liberally. For example, the U.S. Court of Appeals for the Ninth Circuit has ruled that "whatever the scope of such powers may be, we believe the power of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking."[25] In the landmark VALIC case, the Supreme Court, in upholding the power of national banks to sell annuities, stated: "We expressly hold that the 'business of banking' is not limited to the enumerated powers in Sec. 24 (Seventh) and that the Comptroller [of the Currency] therefore has discretion to authorize activities beyond those specifically enumerated." The VALIC decision clarified that this authority included activities that are convenient or useful to the "business of banking," as well as convenient or useful to the expressly enumerated powers under the National Bank Act.[26]

Applying the above standards, there can be no doubt that national banks are authorized to conduct private placements and de minimis transactions in the bank without registration and that state law preventing such would frustrate and "stand as an obstacle to the accomplishment and execution of the full purposes and objectives of federal law." In addition, there is considerable authority that a state cannot circumvent the preemptive effect of federal law by indirectly doing that which it cannot do directly.[27] As the Supreme Court recently held in Lorillard Tobacco Co. v. Attorney General of Mass.,[28] federal law preempts generally applicable state laws concerning deceptive and unfair practices whenever a state government applies those general state laws in a targeted way so as to regulate a field specifically preempted by federal law. The label a state attaches to its laws is irrelevant to the preemption analysis.

Visitorial Powers. We have previously alerted you to the significant limitations on banks' being subject to visitorial powers, such as those affecting national banks contained in 12 U.S.C. 484 and 12 C.F.R. Sec. 7.4000. We have urged a thorough review of USA provisions relating to inspection and examination of books and records and enforcement authority and have suggested amendments. We continue to urge your consideration of these important matters.

Various rulings and court decisions emphasize the exclusivity of the Comptroller of the Currency's supervisory, enforcement, and regulatory authority over national banks. For example, the U.S. Court of Appeals for the Third Circuit has said that "questions about the applicability of state legislation to national banks must be distinguished from the related inquiry of who is responsible for enforcing national bank compliance. In analyzing the latter issue, we find that important federal interests take precedence over competing state concerns. . . . . Congress has delegated enforcement of statutes and regulation against national banks to the

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[24] 12 U.S.C. 24 (Seventh).
[25] M & M Leasing Corp. v. Seattle First Nat. Bank, 563 F. 2d 1377 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978).
[26] Nations Bank v. Variable Annuity Life Ins. Co., 115 S. Ct. 810 (1995).
[27] See FSLIC v. Kidwell, 716 F. Supp. 1315 (N.D. Cal. 1989), vacated in part on other grounds, 937 F. 2d 612 (9th Cir. 1991).
[28] Nos. 00-596 and 00-597, 2001 WL 721016 (U.S. June 28, 2001).

Comptroller of the Currency."[29] The Court ruled that state officials do not have power to issue a cease and desist order against a national bank even should it be determined that the bank had violated the requirements of a specific state statute to which it was subject. The Court concluded that enforcement exclusivity in the federal agency is reasonable and practical. It also recognized the OCC's broad enforcement authority under 12 U.S.C. 1818 to initiate cease and desist proceedings against a national bank that violates a law. Other OCC powers include the right to terminate unsafe or unsound practices, impose monetary penalties, and require restitution or other affirmative action to remedy violations. This Third Circuit decision is consistent with the opinion of the U.S. Court of Appeals for the Ninth Circuit in Conference of Federal Savings and Loan Associations v. Stein[30] with respect to federal savings and loan associations. There the Court held that the regulatory control of the Federal Home Loan Bank Board over federal associations is so pervasive as to leave no room for state regulatory control.

Other Issues. To date we have identified the following other issues:

• The language in USA Sec. 102(4)(C) relating to entities subject to Securities Exchange Act Sec. 15(e) cites an incorrect provision – Sec. 3(a)(5)(E). It should be Sec. 3(a)(4)(E). Also, the exclusion should not apply to a set of activities but instead to a bank that satisfies the conditions described in Sec. 3(a)(4)(E) of the Securities Exchange Act of 1934. The first suggested amendment (below) should also resolve this issue.

• A regulatory flexibility provision is needed in USA Sec. 102(15)(G).

• The definition of bank in USA Sec. 102(3) should be clarified to include a savings institution.

Suggested Amendments. We suggest the following amendments:

• Amend Section 102(4)(C) along the lines recommended by the federal banking agencies in their letter dated May 24, 2002.

• Appropriate language should be included in USA that recognizes the significant limitations on banks' and savings institutions' being subject to visitorial powers, such as those affecting national banks contained in 12 U.S.C. 484 and 12 C.F.R. Sec. 7.4000.

• The Act's effective date should be delayed for several reasons, including those outlined herein.

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[29] National State Bank v. Long, 630 F. 2d 981 (3rd Cir. 1980).
[30] 604 F. 2d 1256 (9th Cir. 1979), aff'd mem., 445 U.S. 921 (1979).

• Amend Sec. 102(15)(G) by inserting the following immediately before the semicolon (;): "or by Securities and Exchange Commission rule, regulation, or order under such Act".

• Amend Sec. 102(3)(C) by inserting the following after "institution,": "including a savings institution,".

Thank you for the opportunity to comment on this latest draft, and we shall appreciate your consideration of our views. Should you have questions, I may be reached at (202) 663-5030 or lwilson@aba.com. I plan to be present at your June Committee meeting and may provide additional comments at that time.

Respectfully,

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