UNC SCHOOL OF LAW

NORTH CAROLINA BANKING INSTITUTE

Volume 1 | Issue 1 Article 12

1997

Section 20 Affiliates of Bank Holding Companies

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SECTION 20 AFFILIATES OF BANK HOLDING COMPANIES

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I. HISTORICAL PERSPECTIVE: 1933-1986

Prior to 1993, national and most state banks were prohibited from underwriting and dealing in securities.[1]

In 1933, the so-called Glass-Steagall Act provisions of the Banking Act of 1933 severely limited underwriting and dealing by national banks,[2] state member banks,[3] all depository institutions,[4] and affiliates of national banks and state member banks.[5] The limitations were, however, differently phrased.

Sections 16, 5, and 21 contained flat prohibitions. There were exceptions for "bank eligible" securities, principally government securities. The direct prohibitions in Section 16 and 5 do not apply to brokerage and permit investments in "investment securities" (generally investment grade debt securities).

Section 20 prohibited affiliations between a member bank and a securities firm only if the securities firm was "engaged principally" in underwriting and dealing.

In addition, Section 32 prohibited personnel interlocks between national and state member banks and securities firms primarily engaged in underwriting and dealing.

In 1956, the Bank Holding Company Act (BHCA) prohibited bank holding companies from engaging in any non-banking activities, unless the Federal Reserve Board determined that the activity was "so closely related to the business of banking . . . as to be a proper incident thereto."[6]

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1. *See* McFadden Act of 1927, ch. 191, 44 Stat. 1224 (1927) (codified at 12 U.S.C. § 24 (1994)).
2. *See* Glass-Steagall Act § 16.
3. *See id.* at § 5.
4. *See id.* at § 21.
5. *See id.* at § 20.
6. *See id.* at § 4(c)(6).

This provision was used by the Federal Reserve Board to extend the Section 20 anti-affiliation provision to state non-member banks that were within a holding company structure. It also enabled the Federal Reserve Board to prohibit, under the Section 4(c)(8) standards, affiliations between a bank and a securities firm within a bank holding company structure, even if that securities firm satisfies the Section 20 "engaged principally" test.

Between 1933 and 1984, there appear to have been no attempts by banking organizations to establish securities affiliates that met the Section 20 "engaged principally" test.

In 1984, Citicorp filed an application under the BHCA for a subsidiary to engage in underwriting and dealing, defining "engaged principally" in terms of not more than twenty percent of the subsidiary's business being generated from underwriting and dealing in bank ineligible securities. The Federal Reserve Board's reaction was negative, and Citicorp withdrew its application.[7]

II. THE "COMMERCIAL PAPER" SECTION 20 AFFILIATE

In 1987, the Federal Reserve Board approved an application by Bankers Trust to engage in private placements of commercial paper.[8]

III. THE "THREE (LATER FOUR) DWARFS" SECTION 20 AFFILIATES

In 1987, the Board approved applications by Citicorp, J.P. Morgan, and Bankers Trust to establish a Section 20 affiliate under the BHCA to underwrite and deal in commercial paper, municipal revenue bonds, and mortgage backed-securities.[9]

The Federal Reserve Board subsequently approved a Section 20 application by Chemical Bank to underwrite and deal in consumer receivable securities.

A. The 1987 Order Restrictions

1. Section 20

The "engaged principally" test was defined by the Federal Reserve Board so that: (1) the Section 20 subsidiary could not obtain more than five percent of its gross revenues from underwriting and dealing in bank ineligible securities (Revenue Limit) and (2) the Section 20 subsidiary could not have more than five percent of the

7. *See* 71 Fed. Res. Bull. 225 (1985).
8. *See* 73 Fed. Res. Bull. 138 (1987).
9. *See* 73 Fed. Res. Bull. 473 (1987) (the 1987 Order).

domestic market for any type of security (Market Limit).

2. Section 4(c)(8)

The Federal Reserve Board imposed a series of so-called "firewalls" which were designed to deal with issues of bank safety and soundness, unfair competition and conflicts of interest.

B. SIA Challenge to the 1987 Order

SIA challenged the 1987 Order, but the Federal Reserve Board was upheld.[10] The applicants intervened and challenged the Market Limit; the court upheld this challenge.

IV. THE CORPORATE DEBT AND EQUITY SECTION 20 AFFILIATES

In 1989, the Federal Reserve Board approved applications for Section 20 affiliates to underwrite and deal in debt and equity securities.[11] Additional firewalls were imposed. Supervisory (infrastructure) review was required, including risk management and internal controls. SIA-sponsored litigation was again rejected.[12]

V. MINOR LIBERALIZATION: 1989-1995

In 1989, the Federal Reserve Board increased the Revenue Limit from five percent to ten percent.[13] In 1993, the Federal Reserve Board approved an alternative, index-based method for calculating the Revenue Limit.[14]

VI. MAJOR LIBERALIZATION AND PROPOSED LIBERALIZATION IN 1996

In 1996, the Federal Reserve Board proposed and adopted major revisions to the regulatory regime for Section 20 affiliates.

In September 1996, the Federal Reserve Board reversed its prior position and ruled that interest earned on debt securities in which a national bank may invest in (investment securities) constitutes eligible revenues.[15] In December 1996, the Federal Reserve Board increased the Revenue Limit from ten percent to twenty-five

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10. *See* Securities Indus. Ass'n v. Board of Govs., 839 F.2d 47 (2d Cir. 1987).
11. *See* 75 Fed. Res. Bull. 192 (1989).
12. *See* Securities Indus. Ass'n v. Board of Govs., 900 F.2d. 360 (D.C. Cir. 1990).
13. *See* 75 Fed. Res. Bull. 771 (1989).
14. *See* 79 Fed. Res. Bull. 226 (1993).
15. *See* Federal Reserve Press Release, Sept. 11, 1996.

percent.[16]

In July 1996, the Federal Reserve Board again reproposed the modification of three firewalls, a modification that was first proposed in 1990. These proposals were adopted in September 1996.[17] The firewall prohibiting virtually all interlocks was limited to the CEO and a majority of the directors. The firewall prohibiting a bank from cross-marketing services of its Section 20 affiliate was eliminated. The firewall prohibiting asset transactions between a bank and its Section 20 affiliate (other than U.S. government securities) was liberalized to exempt assets with a broad and liquid market.

Late in 1996, the Federal Reserve Board proposed the elimination of most of the remaining firewalls and the recodification of the other firewalls as "operating standards."[18]

VII. IMPLICATIONS OF THE 1996 REGULATORY REVISIONS

The 1996 revisions have created the potential for substantial internal growth by Section 20 affiliates. Of perhaps even more importance, the 1996 revisions have created the potential for bank holding company acquisitions of securities firms. Such acquisitions have previously been few and very small in size.[19]

The ten percent Revenue Limit has been a major obstacle. The new twenty-five percent Revenue Limit positions many, and possibly most, securities firms as eligible targets for acquisition by bank holding companies. Even if a security firm is ineligible revenues exceed the twenty-five percent limit, a matched book and other arrangements can be utilized in an effort to increase eligible revenues in order to meet the Revenue Limit.

Proposed firewall liberalization would enable Section 20 affiliates to be more competitive. The proposed reduction in special capital requirements for Section 20 affiliates (twice normal SEC requirements) is of particular importance.

A potential obstacle to bank holding company acquisitions of securities firms is that some securities firms' activities may be impermissible for bank holding companies. Examples of these impermissible activities include: merchant banking, commodities, insurance, and real estate investments.

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16. *See* 61 Fed. Reg. 68750 (1996).
17. *See* 61 Fed. Reg. 57679.
18. *See* 62 Fed. Reg. 2622 (1997). Appendix I outlines the proposed revisions.
19. *See*, Dauphin-Hopper Soliday, 77 Fed. Res. Bull. 672 (1992).

VIII. CALCULATION OF THE REVENUE LIMIT

The objective is to reduce ineligible revenues (which is difficult to accomplish) or increase eligible revenues or both. Early Federal Reserve rules made compliance more difficult.

Use of revenues rather than assets to calculate the "engaged principally" test was later reaffirmed. The Federal Reserve will not permit multiple Section 20 affiliates to calculate Revenue Limit on a combined basis or permit a Section 20 affiliate to compute the Revenue Limit on a consolidated basis with its subsidiaries.

A significant problem in creating eligible revenues has been the SEC's net capital rules under the Securities Exchange Act, which effectively precludes a Section 20 affiliate from conducting non-securities activities (e.g. the loans) as a principal.

The Federal Reserve has, however, permitted banks to shift non-capital intensive activities, such as marketing and advisory services, to Section 20 affiliates. In addition, services performed for affiliates under Section 4(c)(1) of the BHCA is an effective way to create eligible revenues.

IX. OTHER POSSIBLE STRUCTURE FOR SECURITIES ACTIVITIES

The FDIC permits subsidiaries of state nonmember banks to underwrite and deal in securities, subject to certain limitations.[20]

The Comptroller's recently adopted revision of its "Part 5" regulations has the potential for enabling national banks to underwrite and deal in securities through a subsidiary.

The BHCA should not apply to a subsidiary of a bank.[21]

However, Section 20 would apply to a subsidiary of a national bank.

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20. *See* 12 C.F.R. § 337.4 (1996); *see also* Inv. Co. Inst. v. Fed. Deposit Corp. 815 F.2d 1540 (D.C. Cir. 1987).

21. *See* Citicorp v. Board of Govs., 936 F.2d 66 (2d Cir. 1991).