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The Federal Reserve's Proposed Interpretation Regarding the Anti-Tying Restrictions of Section 106 of the Bank Holding Company Act Amendments of 1970

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I. INTRODUCTION

On August 25, 2003, the Board of Governors of the Federal Reserve System (Federal Reserve) issued a proposed interpretation (Proposal) of the anti-tying restrictions of section 106 of the Bank Holding Company Act amendments of 1970 (section 106). The proposal marks the first comprehensive guidance issued by the Federal Reserve regarding section 106 since its enactment over thirty years ago. In addition, the Federal Reserve issued supervisory guidance specifying the appropriate internal controls that banking organizations should have in place to ensure compliance with section 106.

In general terms, section 106 prohibits banks from conditioning the availability of a product, such as a loan or its pricing, on the requirement that the customer obtain some additional product or service from the bank or its affiliates. For example, under section 106, it would be impermissible for a commercial bank to offer a loan product, or a discounted rate on a loan product, to a company on the condition that the company

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engage the commercial bank's investment banking affiliate to provide mergers acquisitions advice or securities underwriting. Although relatively simple in its terms, section 106 can be difficult to apply as the permissibility of a transaction or series of transactions will often depend on a number of factors, including the parties' understandings and prior course of conduct. In addition, as the Federal Reserve noted in the Proposal, "the actions, statements and policies of the bank involved in the particular transaction often play an important role in determining whether the bank has violated section 106."

The Federal Reserve is the regulator charged with the responsibility of enforcing the tying rules and examining bank holding companies for compliance with them.

As discussed below, section 106 is subject to a number of exceptions. For example, section 106 does not bar a nonbank affiliate of the bank from conditioning the availability of a product, or varying its terms, on the condition that the customer purchase a product from it or one of its affiliates. Hence, a nonbank subsidiary could offer to make a loan to a customer contingent on the customer obtaining investment banking products or services from the subsidiary or one of its affiliates. In addition, section 106 exempts from its prohibitions certain traditional banking products — i.e., a "loan, discount, deposit, or trust service."

Section 106 was adopted by Congress in 1970 as part of a broader set of amendments to the Bank Holding Company Act that significantly expanded the ability of bank holding companies to engage in nonbanking activities. The underlying legislative intent of section 106 was to ensure that, as banking organizations entered new lines of business, they would not have an unfair competitive advantage by virtue of their banking powers over other types of financial services organizations. As the Federal Reserve cited, in enacting section 106, "Congress expressed

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concern that banks might use their ability to offer bank products — credit in particular — in a coercive manner to give a competitive advantage in markets for nonbanking products and services (such as insurance sales).”

Over the past year, the Federal Reserve’s enforcement of section 106 has received heightened attention as a result of numerous newspaper accounts of allegedly widespread “pay to play” tactics by commercial banks. In addition, Congressman John Dingell has written several letters to the Federal Reserve and the Office of the Comptroller of the Currency (OCC) urging them to increase their enforcement efforts in this area. As a result, the Federal Reserve and the OCC conducted a targeted review of several large bank holding companies in order to assess their level of compliance with the tying rules. While this review did not yield any public enforcement actions from either regulator, it is a given that banks have become increasingly aggressive in cross-marketing financial services and products to their customers, particularly in the investment banking arena. This market development has generally been attributed to the Gramm-Leach-Bliley Act, which removed the remaining regulatory barriers to commercial banks entering the investment banking business.

14. See generally Dingell Letter, supra note 12, at 4-5 (discussing the growth of investment banking activities).
Another less cited reason is the large-scale consolidation that has occurred over the past several years among the biggest banks. The Citicorp/Travelers, Bank of America/NationsBank, and J.P. Morgan/Chase mergers, among others, have created huge banks with balance sheets many times larger than stand-alone investment banks. These banks have come to realize that their capacity to make and hold loans is a powerful competitive weapon which permits them to offer "one stop shopping" for corporate transactions to a degree that investment banks cannot. The creation of these enormous banks coincided with the near-withdrawal of Japanese banks from the U.S. commercial lending markets, which placed more of a premium on the ability of banks to provide credit.

The Proposal covers a wide range of open questions regarding section 106, including three areas in which detailed guidance from the Federal Reserve has been long awaited:

(i) the scope of the traditional bank product exceptions;

(ii) the permissibility of so-called "mixed product arrangements," which involve both traditional bank products that are exempt from section 106 and other products, which are not exempt; and

(iii) the permissibility of voluntary tying arrangements, which are sought or, in some cases demanded, by a customer.16

II. STATUTORY OVERVIEW

Section 106 prohibits banks from extending credit, leasing or selling any property or furnishing any service, or fixing or varying the consideration for any of the foregoing, on the condition or requirement that the customer do any of the following:

1. "[O]btain some additional credit, property, or service from [the] bank other than a loan, discount, deposit or trust service;"\(^{17}\)

2. "[P]rovide some additional credit, property, or service to [the] bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;"\(^{18}\)

3. Obtain from or provide to an affiliate of the bank "some additional credit, property or service;"\(^{19}\) or

4. "[N]ot obtain some other credit, property or service from a competitor of [the] bank,” or of an affiliate of the bank, unless the condition is “reasonably impose[d] in a credit transaction to assure the soundness of the credit.”\(^{20}\)

Importantly, section 106 applies only to tying arrangements that are imposed by a bank, which is defined in section 106 to include virtually all institutions chartered as banks, including “insured banks” defined by section 3 of the Federal Deposit Insurance Act.\(^{21}\) Included in section 106's scope are limited purpose credit card banks, industrial loan corporations, limited-purpose trust companies, and Edge Act and Agreement corporations.\(^{22}\) Note that U.S. branches, agencies, and commercial lending companies of foreign banks are subject to section 106 largely to the same extent as U.S. banks.\(^{23}\) Section 106 does not apply to transactions conducted by a non-U.S. branch of a foreign bank.

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18. Id. § 1792(1)(C) (emphasis added).
19. Id. §1792(1)(B), (D).
20. Id. §1792(1)(E) (emphasis added).
22. 68 Fed. Reg. at 52,033, n.64.
Anti-tying restrictions, almost identical to those imposed on banks under section 106, also apply to savings associations pursuant to the Home Owners' Loan Act. The statute does not apply to tying arrangements imposed by a nonbank affiliate of a bank. Thus, for example, section 106 bars a bank from making a bridge loan to a company on the condition that the company retains the bank's affiliated investment bank to underwrite any future securities offering by the company to repay the loan. However, section 106 does not bar a nonbank affiliate of the bank from making a bridge loan with these conditions. In addition, section 106 does not bar the bank from offering the bridge loan on the condition that the company obtains a longer term loan from the bank to repay the bridge loan. For purposes of section 106, an affiliate of a bank is a "a bank holding company of such bank, [or] . . . any other subsidiary of such bank holding company." All companies which control a bank subject to section 106 receive bank holding company treatment. This is true regardless of whether the company is registered as a bank holding company under the Bank Holding Company Act. All natural persons that control a bank subject to section 106 are treated as "bank holding companies." Any company that person controls will be treated as a bank affiliate or bank holding company subsidiary for section 106 purposes.

27. See id. at 52,033.
28. 12 U.S.C. § 1972(1)(B),(D). The exclusive dealing prohibition in Section 106(1)(E) similarly prohibits a bank from requiring that a customer not obtain an additional product from a competitor of the "bank holding company of such bank, or any subsidiary of such bank holding company." Id. at § 1972(1)(E).
   A company that controls a bank (as defined under section 2(c) of the Bank Holding Company Act) and that is not considered a bank holding company by reason of section 2(a)(5) of the BHC Act, however, is not considered a bank holding company for purposes of section 106 and, thus, is not considered an affiliate of the bank for purposes of this statement.
30. 68 Fed. Reg. at 52,033.
31. Id. at 52,033.
III. NECESSARY ELEMENTS TO A SECTION 106 VIOLATION

Under the Proposal, two essential elements characterize a tying arrangement by a bank that violates section 106:

(1) The arrangement must involve two or more separate products: the customer’s desired product(s) and one or more separate tied products; and

(2) The bank must force the customer to obtain (or provide) the tied product(s) from (or to) the bank or an affiliate in order to obtain the customer’s desired product(s) from the bank. 33

Accordingly, a tying arrangement, established by section 106, must involve at least two distinct products. 34 The Proposal notes that two products are generally “separate and distinct” under section 106 “only if there is sufficient consumer demand for each of the products individually that it would be efficient for a firm to provide the two products separately.” 35 Hence, a bank may require that a borrower provide certain collateral to receive a loan or a more favorable interest rate on a loan. 36 Because the bank is only providing one product to the customer, section 106 does not apply. 37

Moreover, section 106 applies exclusively to situations where a bank conditions the provision of a particular product, or discount on such product, (desired product) on the purchase, or provision to the bank, of another product (tied product) by the customer. 38 In the Proposal, the Federal Reserve interprets this element literally, concluding that “section 106 applies only if each of two requirements are met: (1) A condition or requirement exists that ties the customer’s desired product to another product; and

33. 68 Fed. Reg. at 52,027.
34. Id.
35. Id. at 50,027 n.23.
36. Id. at 50,027.
37. Id.
38. Id. at 52,028.
This condition or requirement was imposed or forced on the customer by the bank. While it has been generally understood that a violation of section 106 must contain a condition or requirement that the customer obtain or provide an additional product or service, the Federal Reserve has not previously determined in any published interpretation that there must also be an element of coercion in order for a violation of section 106 to occur. Indeed, at least one court has determined that section 106 prohibits a “voluntary tie,” i.e., a tying of products that the customer agrees to voluntarily. As the Federal Reserve noted in the Proposal:

In this regard, section 106 was intended to prohibit banks from using their ability to offer bank products, and credit in particular, as leverage to force a customer to purchase (or provide) another product from (or to) the bank or an affiliate. It was not the purpose of the statute to prohibit bank customers from using their own bargaining power to obtain a package of desired products from a bank and its affiliates or a price discount on those products. Similarly, it was not the purpose of the statute to prohibit customers from voluntarily seeking and obtaining multiple products that the customer desires from a bank or its affiliates.

It bears noting that, under the Proposal, coercive actions may be “explicit or implicit” and can be in the form of either oral or written communications. The Federal Reserve’s coercion requirement thus does not provide substantial protection to banks from avoiding tying violations. Moreover, it adds considerable complexity to an inquiry as to whether a tying violation has

39. Id.
41. 68 Fed. Reg. at 52,029 (emphasis added).
42. Id.
TYING RESTRICTIONS

occurred.43 The Proposal notes that the terms of the bank’s offer to the customer is the best evidence as to whether a tying violation has occurred:

Other information that may be useful in determining whether a condition or requirement exists and, if so, whether the bank coerced the customer into accepting the condition or requirement include any correspondence and conversations between the bank and the customer concerning the transaction; the marketing or other materials presented to the customer by the bank or an affiliate; the bank’s course of dealings with the customer and other similarly situated customers; the banking organization’s policies and procedures; the customer’s course of dealings with the bank and other financial institutions; the financial resources and level of sophistication of the customer; and whether the customer was represented by legal counsel or other advisors.44

Needless to say, a factual investigation of this scope, particularly one that involves both oral and written communications, will often be a nearly impossible burden.

IV. EXCEPTIONS

A. Traditional Bank Products Exception

Section 106 contains an express exception for transactions by banks where the products are limited to the enumerated traditional banking products of “loan[s], discount[s], deposit[s], or trust service[s].”45 The Federal Reserve’s Regulation Y extended the traditional bank product exception to transactions where the product being tied is a traditional bank product offered by an

43. See id. at 52,029.
44. Id. at 52,029.
affiliate of the bank. Under this exception, if a customer requests a specific product, whether or not it is a traditional bank product, the bank or affiliate can require that the customer also purchase a traditional bank product in order to obtain the requested product. Historically, the Federal Reserve has interpreted the scope of the traditional bank products exception conservatively and has not issued interpretations significantly expanding their scope beyond the four products expressly listed in section 106. However, in the Proposal the Federal Reserve lists the following products as being among those that are traditional bank products:

- All types of extensions of credit, including loans, lines of credit, and backup lines of credit;
- Letters of credit and financial guarantees;
- Lease transactions that are the functional equivalent of an extension of credit;
- Credit derivatives where the bank or affiliate is the seller of credit protection;
- Acquiring, brokering, arranging, syndicating and servicing loans or other extensions of credit;
- All forms of deposit accounts, including demand, negotiable order of withdrawal (NOW), savings and time deposit accounts;
- Safe deposit box services;
- Escrow services;

46. Regulation Y, 12 C.F.R. § 225.7(b) (2003).
47. 68 Fed. Reg. at 52,030.
48. Notably, the Proposal states that an “extension of credit” for this purpose does not include underwriting, privately placing or brokering debt securities.” Id. at 52,030 n.43.
• Payment and settlement services, including check clearing, check guaranty, ACH, wire transfer, and debit card services;

• Payroll services;

• Traveler's check and money order services;

• Cash management services;\(^{49}\)

• Services provided, as trustee or guardian, or as executor or administrator of an estate;

• Discretionary asset management services provided as fiduciary;\(^{50}\)

• Custody services (including securities lending services); and

• Paying agent, transfer agent and registrar services.\(^{51}\)

The traditional bank products exception is particularly relevant when evaluating the permissibility of mixed-product arrangements. In assessing these arrangements, the Federal Reserve posits a "meaningful option" test in the Proposal.\(^{52}\) Under this test, if a bank responds to a customer's request for a loan by informing the customer that it must purchase other products in order to be eligible for the loan and offers the

\(^{49}\) The Proposal defines "cash management services" to be "the payment and collection services that are provided to customers to speed collection of receivables, control payments and efficiently manage deposit balances." \textit{Id.} at 52,030 n.45. It further states, "[c]ash management services may include one or more of the traditional bank products listed separately above, such as deposit, payment and lockbox services." \textit{Id.}

\(^{50}\) The Proposal states that a "bank has discretionary authority over an account for these purposes if the bank, acting in a fiduciary capacity, has sole or shared authority (whether or not that authority is exercised) to determine what assets to purchase or sell on behalf of the account." \textit{Id.} at 52,030 n.46.

\(^{51}\) 68 Fed. Reg. at 52,030.

\(^{52}\) \textit{Id.} at 52,031.
customer an assortment of products from which to select, the
customer must have a "meaningful option to satisfy the bank's
condition solely through the purchase of the traditional bank
products."\textsuperscript{53} If the customer is not presented with "a meaningful
option to satisfy the bank's condition solely through the purchase
of the traditional bank products," the arrangement would not be
consistent with section 106 because the customer would effectively
be required to purchase a non-traditional bank product in order to
acquire the requested product.\textsuperscript{54}

\textbf{B. Other exceptions}

Section 106 also contains exceptions from its limitations on
reciprocity and exclusive dealing.\textsuperscript{55} The availability of these
exceptions is largely unaffected by the Proposal. "The reciprocity
restrictions of section 106 generally prohibit a bank from condi-
tioning the availability or price of a product (the desired product)
on a requirement that the customer \textit{provide} another product (the
tied product) to the bank or an affiliate," except where the product
to be provided by the customer is "'related to and usually provided
in connection with a loan, discount, deposit, or trust service' (a
'usually connected product')."\textsuperscript{56} Regulation Y extends this
exception to include circumstances where a bank requires its
customer to provide a bank affiliate with a "usually connected
product."\textsuperscript{57} The exclusive dealing restrictions bar banks from
conditioning the receipt of particular bank products or prices on a
customer's pledge \textit{not to obtain} products from a competitor bank
or its affiliates.\textsuperscript{58} However, an exception to this rule applies to
reasonable conditions mandated by a bank which "ensure the
soundness of credit."\textsuperscript{59} Regulation Y also contains several "safe

\textsuperscript{53} \textit{Id.} (emphasis added).
\textsuperscript{54} \textit{Id.}
\textsuperscript{55} \textit{Id.} at 52,031-32.
\textsuperscript{56} \textit{Id.} at 52,031 (quoting 12 U.S.C. § 1972(1)(C)).
\textsuperscript{57} \textit{Id.} at 52,031; 12 C.F.R. § 225.7(b)(1)(ii).
\textsuperscript{59} 68 Fed. Reg. at 52,032.
harbors" from section 106's prohibitions, including those related to combined-balance discount packages and foreign transactions.60

V. Appropriate Internal Controls

The Proposal reflects a flexible approach to evaluating the adequacy of internal controls aimed at ensuring compliance with section 106.61 It notes that the “types of anti-tying policies, procedures and systems appropriate for a particular bank depends on the size of the bank, and the nature, scope and complexity of the bank’s activities (including activities conducted in conjunction with affiliates).”62 Section 106's limitations should be reflected in a banking organization's “policies and procedures, including the institution's corporate policies and procedures concerning credit approval, new product approval and pricing, and marketing.”63 As with almost all compliance programs, employee training and education as to the limitations of section 106 is paramount.64

The Proposal advocates that banks evaluate which personnel positions pose the greatest risk with respect to section 106 and ensure that they receive the most comprehensive training.65 Some of the positions cited in the Proposal are "corporate relationship managers, syndicated lending personnel, persons with authority to approve credit extensions or establish pricing policies for the bank and other personnel that have direct contact with customers for purposes of marketing or selling the bank's products."66 Interestingly, the Proposal recommends that banks "review their employee compensation programs in order to ensure that such programs do not provide employees

60. 12 C.F.R. § 225.7(b)(2), (3); 68 Fed. Reg. at 52,032-33. Allowable combined-balance discounts include a bank’s ability “to offer certain combined-balance discount programs to individuals without making a specific determination that the particular customer has a meaningful option of qualifying for the discounts within the program solely through the use of the deposit products (a traditional bank product) included in the program.” 68 Fed. Reg. at 52,035 n.76.
61. See id. at 52,033-35.
62. Id. at 52,034.
63. Id.
64. Id.
65. Id.
inappropriate incentives to tie products in a manner prohibited by section 106." The Proposal also recommends that banking organizations have in place policies and procedures that:

- Provide personnel with questions concerning section 106 access to knowledgeable legal or compliance professionals,

- Apply standardized procedures to the processing of customer complaints which allege that the bank has violated section 106; and

- Prohibit adverse actions against a customer by the banking organization or its employees upon the filing of a section 106 complaint with the bank or a regulator by the customer.

The Federal Reserve also states in the Proposal that mixed-product arrangements require special policies and procedures given the complexity that can be involved in establishing whether a violation of section 106 has occurred. For these types of transactions, a bank's policies, procedures and documentation should consider:

- The factors and types of information that the bank will review in forming a good faith belief that any customer offered a mixed-product arrangement has a meaningful option to satisfy the bank's condition *solely* through the purchase of one or more of the traditional bank products included in the arrangement. Information relevant to this determination may include:

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67. *Id.* at 52,034 n.73.
68. *Id.* at 52,034.
69. *Id.*
70. *Id.*
71. *Id.* at 52,034-35.
The range and types of traditional bank products that are offered by the bank and its affiliates and included in the mixed-product arrangement;

The manner in which traditional bank products and non-traditional products are treated for purposes of determining whether a customer has or would meet the condition associated with the arrangement;

The types and amounts of traditional bank products typically required or obtained by companies that are comparable in size, credit quality, and nature, scope and complexity of business operations to the customer;

Information provided by the customer concerning the types and amounts of traditional bank products needed or desired by the customer and the customer's ability to obtain those products from the bank or its affiliates;

The bank personnel authorized to make the analysis described above for individual customers or classes of customers and the training and guidelines provided these personnel; and

The internal processes and controls, including approval and documentation requirements, the bank uses to ensure that the analysis described above is (i) performed by the bank for a customer before the customer is offered a mixed-product arrangement and (ii) adequately reflected in the records of the bank.\(^72\)

The Proposal states that, in the case of “mixed-product arrangements, banks may not weight, discourage the use of, or otherwise treat traditional bank products in a manner that is designed to deprive customers of a meaningful choice.”\(^73\)

\(^72\) 68 Fed. Reg. at 52,034-35 (emphasis added).
\(^73\) Id. at 52,034 n.75.
The Proposal warns that the permissibility of a mixed-product arrangement is particularly difficult to justify where these arrangements are offered to individuals.\textsuperscript{74} Reasons for this include that individuals typically have less bargaining power than companies and are often less financially sophisticated.\textsuperscript{75} Hence, banking organizations should generally refrain from offering these arrangements to individuals unless they are in compliance with another exception or the combined-balance discount referenced above.\textsuperscript{76}

VI. ENFORCEMENT EFFORTS TO DATE

Two days after the release of the Proposal, the Federal Reserve announced the issuance of a formal enforcement action against WestLB AG and its New York branch.\textsuperscript{77} The order cited violations of section 106 and related unsafe and unsound banking practices and imposed a civil money penalty in the amount of $3 million.\textsuperscript{78} The enforcement order against WestLB marked the first time that the Federal Reserve had announced a formal enforcement action against a banking organization primarily focused on violations of section 106. The enforcement action appears to have resulted from complaints regarding WestLB's compliance with section 106 that were forwarded to the Federal Reserve by Congressman John Dingell in September 2002.\textsuperscript{79}

\textsuperscript{74} Id. at 52,035.
\textsuperscript{75} Id.
\textsuperscript{76} Id.; see supra note 60 and accompanying text (discussion of combined-balance discounts).
\textsuperscript{78} Id.
Previously, the Federal Reserve had conducted special targeted reviews of compliance with the tying rules, as recently as 2002 in response to numerous newspaper accounts of widespread “pay to play” tactics by commercial banks and in the early 1990s in response to a letter from Morgan Stanley & Co. complaining of widespread tying practices. While evidence of isolated violations may have been found, no public enforcement actions were announced as a result of these reviews.

VII. CONCLUSION

In its Proposal, the Federal Reserve has provided much needed guidance with respect to the scope and application of section 106. Over the past several years, many regulatory barriers have either been eroded by regulatory interpretations or done away with altogether by legislation, such as the Gramm-Leach-Bliley Act. As a result of these developments, the remaining regulatory limitations, such as Section 106 as well as section 23A of the Federal Reserve Act regulating affiliate transactions, have come to be perceived by many as key protections. Accordingly, it has become increasingly incumbent upon the Federal Reserve to define the boundaries of these protections. It is not by coincidence that the Proposal, the first comprehensive guidance issued by the Federal Reserve relating to section 106, was preceded by the adoption by the Federal Reserve of Regulation W in 2002, the first comprehensive guidance to section 23A, which was enacted in 1933.

While the Proposal is a significant step forward in applying a statute that is over thirty years old to today’s financial services industry, more work needs to be done by the Federal Reserve to ensure that the Proposal is not overly burdensome on the banking industry to follow and the Federal Reserve to enforce. As noted above, the Proposal states that some of the considerations that may be relevant in determining whether a tying violation has occurred include:

any correspondence and conversations between the bank and the customer concerning the transaction;

• [any] marketing materials presented to the customer by the bank or an affiliate;

• the bank’s course of dealings with the customer and other similarly situated customers;

• the banking organization’s policies and procedures;

• the customer’s course of dealings with the bank and other financial institutions; [and]

• the financial . . . sophistication of the customer. 82

It would be highly difficult for banking organizations to take these factors into account in ensuring that each transaction that it enters, which involves more than one product, complies with section 106. Just as importantly, it would be virtually impossible for the Federal Reserve to monitor whether a section 106 violation has occurred. At best, bank examiners would be able to analyze a handful of transactions during the course of an examination and, even then, would have great difficulty in assessing some of these factors, such as conversations between the bank and the customer and the customer’s course of dealing with the bank and other financial institutions. Such a fact-intensive approach runs the risk of eventually collapsing under its own weight.

Nevertheless, despite these difficulties, the Proposal is welcome guidance in a relatively undefined area of law. Banking organizations are well advised to carefully evaluate the state of their internal controls with respect to section 106. With the continuing insistence of Congressman John D. Dingell for the Federal Reserve to investigate potential tying abuses and enforce anti-tying regulations as well as the Federal Reserve’s recent

82. 68 Fed. Reg. at 52,029.
action against WestLB AG, it is clear that banking organizations who are found to have violated section 106 will be dealt with harshly by the Federal Reserve and the OCC.\footnote{See supra notes 77-79 and accompanying text.}