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DOES THE TERM “BANK BROKER-DEALER” STILL HAVE MEANING?

The Authors examine whether, in the aftermath of the Gramm-Leach-Bliley Act, bank-affiliated broker-dealers still face different regulatory restrictions than securities firms that are not part of banking organizations. The Authors conclude that, at least at this stage in the implementation of the Gramm-Leach-Bliley Act, important regulatory distinctions remain between securities firms that are part of banking organizations and those that are not.

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During the twentieth century, the financial services industry witnessed both the separation and rejoining of the banking and securities businesses. The severing of the two business lines occurred in the wake of the Great Depression when Congress passed the Banking Act of 1933 (the relevant portions of which are commonly known as the Glass-Steagall Act); the reunification of the businesses is the product of years of industry efforts that culminated in the enactment of comprehensive financial modernization legislation in 1999, in the form of the Gramm-Leach-Bliley Act (GLBA).

In the half century between the two Acts, the term “bank broker-dealer” came into common use. That term was a label used for broker-dealers registered with the Securities and Exchange Commission (SEC) that were permitted to be part of banking organizations. As a result of the prohibitions of the Glass-Steagall Act and other banking statutes, these broker-dealers were allowed to conduct only limited securities activities and, thus, were distinguished from securities firms that were not affiliated with banks. Although the special restrictions placed on bank broker-dealers lessened over the years as industry participants (backed by banking regulators) pushed the limits of

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the Glass-Steagall Act, many significant limitations on bank broker-dealers remained in place until the enactment of GLBA.

GLBA was thought to be the death knell of the term bank broker-dealer because the law repealed the Glass-Steagall Act and paved the way for the establishment of a so-called “two-way street” in the financial services industry. That “two-way street” was designed to enable securities firms and banks to affiliate freely with each other and to ensure that securities firms, once they became partners with banks, were not restricted in their activities simply because of their bank affiliation.

In this Article, we examine whether GLBA has achieved its legislative aims or whether broker-dealers that are part of banking organizations continue to face more and different regulatory restrictions than their brethren that lack bank affiliation. In Part I of this Article, we first provide background on the separation and gradual reunification of banking and securities.¹ In Part II, we review the key parts of GLBA that established a framework for affiliations between banks and securities firms.² In Part III, we review the GLBA implementation process and assess the rules issued by the regulatory agencies and the affect on securities firms.³ We conclude that, as a result of regulatory interpretations of the Act, a true “two-way street” between the banking and securities businesses has not yet been achieved. For this reason, we find that the term bank broker-dealer still has relevance in the post-GLBA world.

I. SECURITIES ACTIVITIES AND BANKING—A SLOW EVOLUTION

From 1933 until the enactment of GLBA in 1999, banking organizations were restricted—albeit to lesser and lesser degrees over time—from participating fully in the securities business. The restrictions on and limitations to the affiliation of banks and full-service broker-dealers were found in portions of the Banking Act

1. See notes 4-60 and accompanying text.

2. See *infra* notes 61-93 and accompanying text.

3. See *infra* notes 94-152 and accompanying text.

of 1933, informally known as the Glass-Steagall Act,⁴ and reinforced by the Bank Holding Company Act of 1956 (BHCA).⁵

The process by which banking organizations gained access to the securities business and securities firms were permitted to affiliate with banks was long and arduous. Only as a result of more than two decades of persistent efforts by industry participants, first in the regulatory arena and then courts, were banks and their broker-dealer affiliates allowed to offer various securities services to their customers.

The changes rendered over those many years were essentially endorsed and codified by GLBA, which formally repealed the statutory barriers that long restricted the activities of bank broker-dealers. In return for the repeal of the affiliation restrictions, GLBA also eliminated the statutory exemption that banks enjoyed from the securities regulatory scheme.

A. *The Pre-Existing Statutory Framework*

The Glass-Steagall Act was born of the Great Depression. As a consequence of highly publicized hearings conducted in 1933 that documented various abuses involving large commercial banks and their securities affiliates, Congress believed that banks and their securities affiliates were substantially responsible for the collapse of the American economy in the late-1920s and early-1930s.⁶ Today, economists offer competing theories on the cause of the Depression, but few, if any, believe that the combination or intermingling of banking and securities activities were the cause of this catastrophic economic failure.⁷ Many economists also dispute

4. Banking Act of 1933, Pub. L. No. 33-66, 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C.).

5. Banking Holding Company Act of 1956, 12 U.S.C. §§ 1841-49 (2000).

6. See ROBERT E. LITAN, WHAT SHOULD BANKS DO? 27 (1987) (citing *Stock Exchange Practices: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency on S. Res. 84 and S. Res. 239*, 72nd Cong. (1933)); see also Carter H. Golembe, *History Disputes Tales of Pre-1933 Securities Irregularities by Banks*, BANKING POL'Y REP., Apr. 3, 1995 (describing the alleged misdeeds of banking firms and their securities affiliates and the critical re-examination of those allegations by economic historians).

7. See Peter J. Ferrara, *The Regulatory Separation of Banking from Securities and Commerce in the Modern financial Marketplace*, 33 ARIZ. L. REV. 583, 585-86 (1991); Laura J. Cox, Note, *The Impact of the Citicorp-Travelers Group Merger on*

the contention, which undergirded the Glass-Steagall framework, that securities activities are inherently riskier than traditional banking activities.⁸ Indeed, today, some commentators have gone so far as to argue that the Glass-Steagall Act was enacted “on the basis of inaccurate information, and . . . swept into law in an atmosphere of near hysteria”⁹

The Glass-Steagall Act consisted of four statutory sections—sections 16, 20, 21, and 32—each of which is designed to operate in a different fashion to divorce the banking and securities businesses. Sections 16 and 21 deal with the *direct* combination of the securities and bank businesses; sections 20 and 32 dealt with the *indirect* combination of the two business lines. Sections 20 and 32 were repealed in 1999 by GLBA.¹⁰

Section 16 generally prohibits national banks and state-chartered banks that are members of the Federal Reserve System (state-member banks) from underwriting and dealing in securities, except for certain federal, state, and local government bonds. Section 16 also generally prohibits national banks and state-member banks from purchasing and holding securities as principal, except for certain exempted securities, which largely consist of government bonds.¹¹

Section 21 is essentially the flip side to section 16; it approaches the separation of banking and securities from the securities side.¹² Under this section, any company engaged in underwriting or dealing in securities—other than government

Financial Modernization and the Repeal of Glass-Steagall, 23 NOVA LAW REV. 899, 901-05 (1999).

8. See LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 50 (2001) (citing GEORGE W. BENSTON, THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING 32 (1990)); Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501, 512-13 (1989).

9. Carter H. Golembe, *The Simple Message to Congress: Just Repeal Glass-Steagall*, BANKING POL'Y REP., Dec. 4, 1995; accord Golembe, *supra* note 6.

10. See *infra* notes 67 and accompanying text.

11. See 12 U.S.C. § 24(seventh) (2000). By its terms, section 16 applies only to national banks. State banks that are members of the Federal Reserve System are subject to the same restrictions by 12 U.S.C. § 335 (2000), which provides that “[s]tate member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under [Section 16].” 12 U.S.C. § 335.

12. 12 U.S.C. § 377, repealed by Gramm-Leach-Bliley Act of 1999, Pub. L. 106-102, Title I, § 101(a), 113 Stat. 134 (Nov. 12, 1999).

bonds in which banks may underwrite and deal under section 16—is barred from accepting deposits.¹³

Section 20 generally prohibited national banks and state-member banks from being “affiliated” with any company “engaged principally” in underwriting and dealing in securities.¹⁴ Thus, this section prevented a bank from owning, or being under common ownership with, a securities firm engaged principally in securities underwriting and dealing activities.¹⁵ Finally, section 32 prevented personnel interlocks between banks and entities “primarily engaged” in the issuance, underwriting, public sale or distribution of securities.¹⁶

The restrictions of the Glass-Steagall Act were “strengthen[ed]” by the BHCA.¹⁷ Any company that controls a bank organized in the United States is a bank holding company that must register as such with the Federal Reserve and is subject to the restrictions and limitations of the BHCA. This statute was enacted by Congress in 1956 and expanded in scope in 1970 at the urging of the Federal Reserve,¹⁸ and it was conceived of principally as an anti-monopoly measure.¹⁹

Until recently, when it was materially amended by GLBA, the BHCA generally restricted bank holding companies from owning or controlling organizations that were not banks.²⁰ There were, however, a number of exceptions to this general proscription; the most important exception existed in section

13. 12 U.S.C. § 378(a)(1) (2000).

14. 12 U.S.C. § 377, *repealed* by Gramm-Leach-Bliley Act of 1999, Pub. L. 106-102, Title I, § 101(a), 113 Stat. 134 (Nov. 12, 1999).

15. “Affiliate” is defined to include subsidiaries, parent companies, sister companies that have the same parent, and companies having interlocking directors (in each case involving majority of stock or directors). *See* ROBERT L. TORTORIELLO, *GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES I-5* (4th ed. 2000).

16. 12 U.S.C. § 78, *repealed* by Gramm-Leach-Bliley Act of 1999, Pub. L. 89-695, Title II, § 101(b), 113 Stat. 134 (Nov. 12, 1999).

17. *Bd. of Governors of the Fed. Reserve Sys. v. Inv. Co. Inst.*, 450 U.S. 46, 72 (1981).

18. This statute was enacted to cover holding companies owning only a single bank.

19. *See* PAULINE B. HELLER & MELANIE L. FEIN, *FEDERAL HOLDING COMPANY LAW* § 17.01[1] (2001).

20. *See Note, The Demise of the Bank/Nonbank Distinction: An Argument for Deregulating the Activities of Bank Holding Companies*, 98 HARV. L. REV. 650, 652 (1985) (“a bank holding company faces a sharp limitation on permissible activities”).

4(c)(8) of the BHCA, which permitted bank holding companies to invest in and control any company the activities of which the Federal Reserve determined “to be so closely related to banking [or managing or controlling banks] as to be a proper incident thereto.”²¹ It was through interpretation of section 4(c)(8) of the BHCA and (section 20 of the Glass-Steagall Act) that the Federal Reserve permitted bank holding companies to engage in securities activities.²²

Another important aspect of federal banking law was the complete exemption that banks enjoyed from the regulatory scheme under the Securities Exchange Act of 1934 (Exchange Act) that applied to securities broker-dealers.²³ The bank exemption, which did not apply to the affiliates of banks and bank holding companies (but only to banks), began to increase in importance as banks themselves began to engage in additional retail and institutional securities brokerage and private placement activities.²⁴

B. Regulatory Reform

The rules separating the banking and securities industries were largely unchallenged from the 1930s until the 1970s. During this time, banks were quite content to operate within the confines of the Glass-Steagall Act. After all, banking was a highly regulated and protected industry that was able to operate very profitably; there was a tremendous influx into the banking system of relatively cheap deposits and a ready market of low-risk, marketable assets (such as traditional bank loans) in which those

21. 12 U.S.C. § 1843(c)(8) (2000); accord Stephen K. Halpert, *The Separation of Banking and Commerce Reconsidered*, 13 J. CORP. L. 481, 489-90 (1988).

22. HELLER & FEIN, *supra* note 19, § 4.01 (detailing the political and industry pressures that led the Federal Reserve from its initially restrictive posture regarding the activities permissible under section 4(c)(8) to taking a far more expansive approach).

23. 15 U.S.C. § 78c(a)(4) (2000) (definition of broker); 15 U.S.C. § 78c(a)(5) (definition of dealer).

24. See, e.g., Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, 66 Fed. Reg. 27,760, 27,761 (May 18, 2001) (to be codified at 17 C.F.R. pts. 200 and 240); see *infra* notes 25-46 and accompanying text (discussing the process by which banking firms began to engage in securities activities either directly or through bank broker-dealers).

cheap deposits could be invested. For several decades, banks earned a good and relatively risk-free living off the spread between those deposits and assets.²⁵

That began to change gradually commencing in the 1950s; by the 1970s, banks were facing significant pressures on both sides of their balance sheet from non-bank purveyors of financial services. On the liability side of the balance sheet, depositors switched from demand deposits to interest-bearing time deposits, increasing the costs of deposits to banks. In addition, sophisticated corporate and individual savers began to move money entirely out of the banking system and into non-banking financial instruments, such as money market funds.²⁶

On the asset half of the balance sheet, banks lost their traditional base of corporate borrowers. Many commercial firms, particularly the most creditworthy of them, found that they could borrow more cheaply by issuing short-term debt. This trend not only deprived banks of part of their stable customer base, but also forced banks to compete more vigorously for the right to lend to riskier borrowers, which lacked access to the commercial paper market.²⁷

At the same time that the banking business became less profitable and more volatile the securities business was undergoing significant change. For instance, the advent of computerized portfolio strategies, new derivatives, and hedging techniques made securities underwriting risks more manageable and, in certain respects, less risky than the commercial lending business.²⁸ The Glass-Steagall Act and, to a somewhat lesser extent, the BHCA, however, prevented banking firms from acquiring broker-dealer affiliates and gaining access to the securities business. The very statutes that originally served to protect and insulate banks now acted like straitjackets and caged them in.

Banking regulators were concerned with the changes occurring in the banking industry. By the 1980s, faced with declines in bank asset quality and profitability, the regulators

25. See Garten, *supra* note 8, at 514-19.

26. See *id.* at 522. This disintermediation was caused both by technological innovations that allowed funds to be moved quickly and inexpensively in and out of bank and non-bank financial instruments, and by the inability of banks to pay market rates of interest on their deposits because of regulatory ceilings. See *id.*

27. *Id.* at 523-34.

28. See MELANIE L. FEIN, SECURITIES ACTIVITIES OF BANKS § 1.03, at 6-7 (2000).

began to be increasingly receptive to attempts by banks to diversify and to enter the securities business. Regulators were forced to adopt innovative positions because Congress was gridlocked over the issue of financial services reform and various attempts at legislative change met with failure.²⁹ Through innovative interpretations of the existing statutory scheme, regulators began to permit banking firms to engage in an ever-broader array of securities activities despite the Glass-Steagall Act and BHCA.³⁰

1. Brokerage and Riskless Principal Activities

In the early 1980s, the Federal Reserve (which, as noted above, regulates bank holding companies) and the Office of the Comptroller of the Currency (OCC) (which regulates national banks) interpreted section 16 of the Glass-Steagall Act to permit bank holding companies and national banks, respectively, to acquire securities affiliates and to engage in discount brokerage activities.³¹ The authority was expanded later in the 1980s and early 1990s to allow banks and bank affiliates to offer full-service brokerage³² and riskless principal services.³³

29. See, e.g., Golembe, *supra* note 6; Garten, *supra* note 8, at 503 n.7 (noting that Congress “repeatedly has considered but failed to enact legislation repealing the Glass-Steagall Act’s fifty-year-old ban on bank securities activities”). That legislative gridlock broke in 1999, with the passage of GLBA. See *infra* notes 61-93 and accompanying text.

30. See FEIN, *supra* note 28, §1.03, at 7-8.

31. See *In re Security Pacific National Bank*, [1982-1983 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284, at 86,255 (Aug. 26, 1982); OCC Interpretive Letter No. 363, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,533 at 77,828 (May 23, 1986); BankAmerica Corp., 69 Fed. Res. Bull. 105 (1983) (order approving application to engage in combined investment advisory and securities execution services). A discount broker buys and sells securities for its customers as agent and does not provide any recommendations or investment advice. Accordingly, commissions charged by discount brokers are typically lower than those charged by “full-service” brokers. See, e.g., FEIN, *supra* note 28, § 6.02[A], at 6-5.

32. See OCC Interpretive Letter No. 386, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,610, at 77,932 (June 1, 1987); National Westminster Bank PLC, 72 Fed. Res. Bull. 584 (1986) (order approving application to engage in combined investment advisory and securities execution services); 12 C.F.R. § 225.25(b) (1991).

33. See OCC Interpretive Letter No. 375, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,545, at 77,853 (Sept. 25, 1986); Bankers Trust New York Corp., 75 Fed. Res. Bull. 829 (1989) (order approving application to act as agent in

2. Securities Underwriting and Dealing

By the late 1980s, the Federal Reserve interpreted section 20 of the Glass-Steagall Act and section 4(c)(8) of the BHCA to permit bank holding companies to engage through broker-dealer affiliates in underwriting and dealing, first, in commercial paper and certain other debt securities and, later, in corporate debt and equity securities to a "limited extent" and subject to various prudential restrictions and firewalls.³⁴ The Federal Reserve allowed bank holding companies to engage in this activity because, in its view, section 20 of the Glass-Steagall Act only restricted bank affiliates from being "engaged principally" in underwriting and dealing activities. The Federal Reserve took the position that an affiliate would not be "engaged principally" in securities underwriting and dealing so long as its underwriting and dealing revenues were a limited percent of the affiliates total gross revenues.³⁵

the private placement of all types of securities and to act as riskless principal in buying and selling securities).

34. Initially, the Federal Reserve approved underwriting and dealing in four types of securities: commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer-receivable securities. See *Citicorp et al.*, 73 Fed. Res. Bull. 473 (1987) (order approving applications to engage in limited underwriting and dealing in certain securities). In 1989, the Federal Reserve approved underwriting and dealing in corporate debt securities. See *J.P. Morgan & Co. Inc. et al.*, 75 Fed. Res. Bull. 192 (1989) (order conditionally approving applications to engage, to a limited extent, in underwriting and dealing in securities). Subsequently, the Federal Reserve approved equity securities underwriting and dealing activities. See *Chase Manhattan Corp.*, 80 Fed. Res. Bull. 731 (1994) (order approving an application to engage in underwriting and dealing in bank-ineligible securities on a limited basis). The Federal Reserve did not, however, approve the underwriting of open-end investment companies, i.e., mutual funds. Accordingly, bank affiliates could not act as mutual fund distributors. See, e.g., FEIN, *supra* note 28, § 9.03[B], at 9-28.

35. See *Citicorp et al.*, *supra* note 34. The other parts of gross revenue could consist of revenue from other securities activities, including, for example, brokerage activities. *Id.* The Federal Reserve also applied a market share test in determining whether a section 20 affiliate was "engaged principally" in securities underwriting and dealing; under that test, an affiliate could not underwrite more than five percent of the total amount of a type of security. That test did not withstand judicial scrutiny. See, e.g., *id.*; *Sec. Indus. Assoc. v. Bd. of Governors of the Fed. Reserve Sys.*, 839 F.2d 47 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988). The Federal Reserve also took the position that securities underwriting and dealing activities were permissible under section 4(c)(8) of the BHCA. See FEIN, *supra* note 28, § 9.03[B], at 9-13. Revenue limits are only applied to "bank ineligible" securities. *Sec. Indus. Assoc. v. Bd. of Governors*, 839 F.2d 47 (2d Cir. 1988).

Initially, the Federal Reserve limited a section 20 affiliate's total securities underwriting and dealing revenues to merely five percent of the company's gross revenues.³⁶ That sum was first raised to ten percent.³⁷ In 1996, the Federal Reserve increased the revenue limit to twenty-five percent.³⁸

A banking firm wishing either to acquire a securities firm engaged in securities underwriting and dealing activities or to form a de novo section 20 affiliate had to file an extensive application with the Federal Reserve, had to subject the securities affiliate to examination and review by the Federal Reserve, and had to agree to comply with dozens of so-called "firewalls" on section 20 companies.³⁹ These firewalls were meant to separate firmly the section 20 underwriting and dealing affiliate from its sister bank. The firewalls addressed concerns of safety and soundness, conflicts of interest and other perceived risks to banks (and the federal deposit insurance fund) from their affiliates' securities activities.⁴⁰

The firewalls were by all accounts a heavy price to pay for bank broker-dealers engaging in securities underwriting and dealing; the firewalls imposed numerous inefficiencies and raised the costs for section 20 affiliates. These costs and inefficiencies were not borne by securities firms that were not affiliated with banks; accordingly, bank broker-dealers that were section 20 companies were hindered from competing effectively and on a level playing field with their non-bank-affiliated competitors.⁴¹

As the Federal Reserve became more familiar with section 20 companies and their securities businesses, it began to relax the

36. See Citicorp et al., *supra* note 34, at 476.

37. Section 20 affiliates had to file regular financial statements with the Federal Reserve demonstrating their compliance with the gross revenue limit. The limit was calculated on a two-year rolling basis; that is, the revenue from securities underwriting and dealing for each quarter, when added to the gross revenue from such activities for the previous seven fiscal quarters, could not exceed the Federal Reserve's revenue threshold when compared with the total revenues of the section 20 affiliate for that same eight quarter period. See FEIN, *supra* note 28, § 9.03[B], at 9-19 to 9-24.

38. See *id.* at 9-20; Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (Dec. 30, 1996).

39. See TORTORIELLO, *supra* note 15, at III-2 to III-11.

40. See J.P. Morgan & Co. Inc. et al., *supra* note 34.

41. See, e.g., FEIN, *supra* note 28, § 9.05[A], at 9-49; TORTORIELLO, *supra* note 15, at III-15.

firewall restrictions. Eventually, the Federal Reserve narrowed the firewalls—of which there were more than twenty—to eight manageable operating standards.⁴² The operating standards permitted bank-affiliated securities firms to engage in underwriting and dealing under a framework that was closer to that of (but still not identical to) other securities industry competitors.⁴³

3. Merchant Banking

Regulatory reform, however successful, did not break down one of the more important limitations on bank-affiliated firms—the ability to engage in merchant banking activities. Merchant banking is the activity of taking an equity position in a so-called “portfolio company” (typically a non-public company) as an investment.⁴⁴ The equity position is usually taken with an eye to its sale at a profit when the portfolio company has grown and perhaps is ready to go public.

Banking firms were able to engage only in limited merchant banking activities under the Glass-Steagall Act and BHCA. Banks themselves could generally only invest in certain debt securities and were prohibited from taking equity stakes in companies.⁴⁵ Bank holding companies were able to do more, but also were limited in the investment stakes that they could take in non-financial companies. In general, bank holding companies could not acquire more than five percent of the voting stock of any portfolio company.⁴⁶ Despite urgings and reform proposals

42. 12 C.F.R. § 225.200(b)(1)-(8) (2001).

43. The OCC subsequently permitted special subsidiaries of national banks—so called “operating subsidiaries”—also to underwrite and deal in securities. The OCC largely followed the Federal Reserve’s section 20 framework. See, e.g., OCC Conditional Approval No. 262 (Dec. 11, 1997) (permitting a national bank to underwrite and deal in municipal revenue bonds to a limited extent).

44. TORTORIELLO, *supra* note 15, at 14; BROOME & MARKHAM, *supra* note 8, at 758.

45. 12 U.S.C. § 24(seventh) (2000) (“nothing herein contained shall authorize the purchase by [a national bank] for its own account of any shares of stock of any corporation”).

46. 12 U.S.C. § 1843(c)(6) (2000). Section 4(c)(6) of the BHCA generally limited bank holding companies from acquiring more than five percent of the voting shares of any portfolio company. *Id.* As noted above, however, bank holding companies could acquire control of those companies engaged exclusively in activities deemed

advanced by the banking industry, the Federal Reserve did not agree to raise this five percent limit, which it determined to be statutorily mandated.

C. Court Decisions

Many of the key regulatory agency decisions that expanded the power of banks and bank holding companies to acquire securities firms and to engage in securities brokerage, riskless principal, and underwriting and dealing activities were challenged by the securities industry, which alleged that the regulatory decisions contravened the prohibitions and restrictions of the Glass-Steagall Act.⁴⁷ The federal courts eventually upheld the key banking agency interpretations of the Glass-Steagall Act.

The first major judicial case, however, represented a loss for the banking industry. In the 1971 case of *Investment Company Institute v. Camp*,⁴⁸ which scholars regard as the “high water mark of the Glass-Steagall Act,” the Supreme Court held that a bank-sponsored investment vehicle was a security.⁴⁹ As such, the Court found that a bank could not operate the investment vehicle under the prohibitions of the Glass-Steagall Act.⁵⁰

The Supreme Court reached this conclusion based on its analysis of the “subtle hazards” that it concluded the Glass-Steagall Act was intended to proscribe.⁵¹ According to the Court, there were many subtle hazards that Congress in 1933 feared, including, for example:

“closely related to banking” with Federal Reserve approval. *See supra* notes 21-22 and accompanying text.

47. To some extent, the problem also was one of reciprocity—many in the securities industry felt that the regulatory decisions that paved the way for increasing participation of banking organizations in the securities business did not permit securities firms also to conduct banking activities. For instance, securities firms (and others) were thwarted by Congress in their ability to establish “nonbank” banks—banks that either accepted deposits or made commercial loans and thereby averted the restrictions of the BHCA. The courts had permitted such nonbank banks to be formed, for example, see *Bd. of Governors of the Fed. Reserve Sys. v. Dimension Finan. Corp.*, 474 U.S. 361 (1985), but Congress overturned the courts’ decisions in the Competitive Equality of Banking Act of 1987 (CEBA), Pub. L. 100-86, 101 Stat. 554 (1987).

48. 401 U.S. 617 (1971).

49. BROOME & MARKHAM, *supra* note 8, at 735.

50. *Camp*, 401 U.S. at 635.

51. *Id.* at 630.

that the promotional needs of investment banking might lead commercial banks to lend their reputation for prudence and restraint to the enterprise of selling particular stocks and securities, and that this could not be done without that reputation being undercut by the risks necessarily incident to the investment banking business. There was also perceived the danger that when commercial banks were subject to the promotional demands of investment banking, they might be tempted to make loans to customers with the expectation that the loan would facilitate the purchase of stocks and securities. There was evidence before Congress that loans for investment written by commercial banks had done much to feed the speculative fever of the late 1920's.⁵²

Camp and its expansive "subtle hazards" reading of the Glass-Steagall Act has subsequently been highly criticized.⁵³ Scholars have argued that the decision was overly broad and went far beyond what was necessary for the Court to reach its decision in *Camp*.⁵⁴

Subsequent court decisions focused less on the broad "subtle hazards" approach and more on the plain meaning of the relevant statutory proscriptions.⁵⁵ Later courts also proved more willing than the Court in *Camp* to defer to the bank regulatory

52. *Id.* at 632.

53. See FEIN, *supra* note 28, §4.04[B], at 4-30.

54. See James R. Smoot, *Striking Camp and Moving to Higher Ground: The Hazardous Subtleties of "Subtle Hazards" in Bank Regulation*, 4 GEO. MASON L. REV. 21, 42 (1995); see also Helen A. Garten, *Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314, 326 (1990) (noting that, "[a]s an accurate statement of the real motives behind the Glass-Steagall Act, the *Camp* subtle hazards are somewhat suspect"). Others have contended that, although *Camp* represented an immediate setback for the banking industry and its attempt to secure greater securities powers for banks and their affiliates, the case laid the seedbed for subsequent agency and court interpretations that favored the banking industry. According to this view, although *Camp* did not uphold the OCC's position in that case, the Court did note the need to defer to give substantial weight to agency interpretations. See *Regulatory Reform in Transition: The Dismantling of the Glass-Steagall Act*, 47 ADMIN. L. REV. 545, 553-54 (1995).

55. See FEIN, *supra* note 28, § 4.04[A], at 4-27 to 4-29.

agencies' interpretations of the Glass-Steagall Act and BHCA, in part as a result of the Supreme Court's intervening decision on the standard of administrative review in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*⁵⁶

A landmark case that followed this approach of strictly reading the statutory language and deferring to agency interpretation was *Securities Industry Association v. Board of Governors of the Federal Reserve System*,⁵⁷ in which the U.S. Court of Appeals for the Second Circuit upheld the Federal Reserve's reading of section 20 of the Glass-Steagall Act to permit bank holding company affiliates to engage in securities underwriting and dealing to a limited extent. In reaching this decision, the court carefully tracked the "engaged principally" language in section 20 of the Glass-Steagall Act and concluded that this wording was not intended to "sever completely the commercial and investment banking industries."⁵⁸ Instead, the court believed that the language evidenced a decision by Congress to tolerate at least some securities underwriting and dealing activities in bank affiliates so long as those securities activities were not the chief activities of those affiliates.⁵⁹ The court concluded that the Act's "key phrase" was "intrinsically ambiguous" and chose to uphold the Federal Reserve's reading of the "engaged principally" language as reasonable.⁶⁰

56. In *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, the Supreme Court held that, in judging an agency's construction of a statute, a court must undertake a two-step inquiry. 467 U.S. 837, 842 (1984). First, it must ask if Congress has spoken directly to the question at issue. *Id.* If it has, and the intent of Congress is clear, then the inquiry there ends. *Id.* at 842-43. If Congress has not so spoken, then the question is whether the agency's interpretation is rational and "based on a permissible construction of the statute." *Id.* at 843. If it is, the court must uphold the agency's interpretation and not substitute the court's own view for that of the agency. *Id.* The breadth and scope of *Chevron's* reach has been the subject of more recent Supreme Court jurisprudence. See, e.g., *United States v. Mead Corp.*, 533 U.S. 218 (2001); *Christensen v. Harris County*, 529 U.S. 576 (2000).

57. 839 F.2d 47, *cert. denied*, 486 U.S. 1059 (1988).

58. *Id.* at 58.

59. *Id.* at 58-60.

60. *Id.* at 63.

II. THE GRAMM-LEACH-BLILEY ACT—ONE CAUTIOUS STEP FORWARD

While the regulatory and litigation process gradually reshaped the relationship between securities firms and banks, dozens of legislative attempts were made to repeal formally the Glass-Steagall Act and end that Act's separation of the banking and securities industries.⁶¹ In fact, Senator Glass himself—for whom the original act was named—initiated the first of these attempts merely one year after the Act's enactment.⁶²

These legislative reform efforts repeatedly failed because it was impossible to achieve consensus among: (a) the banking, securities, and insurance industries, which were the three industries most affected by reform legislation; (b) interested regulatory agencies (chiefly the Treasury Department, the OCC, and the Federal Reserve) as to which would play a lead role in regulating an integrated financial services industry that was no longer artificially Balkanized; and (c) between the congressional committees that oversee the banking and securities industries as to which would have principal draftsmanship over reform legislation and jurisdiction over the unified financial services industry once legislation was enacted.⁶³

The drama, intrigue and, ultimately, disappointments that characterized the legislative efforts at repealing the Glass-Steagall Act came to a resounding conclusion on November 12, 1999, when President Clinton signed into law GLBA⁶⁴—arguably the most important federal banking legislation in over 65 years.⁶⁵ To be

61. See, e.g., Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, 66 Fed. Reg. 27,760, 27,761 n.7 (to be codified at 17 C.F.R. pts. 200 and 240) (SEC chronicle of recent reform bills); Edward D. Sullivan, *Glass-Steagall Update: Proposals to Modernize the Structure of the Financial Services Industry*, 112 BANKING L. J. 977, 984-92 (1995) (detailing various then-existing proposals to repeal Glass-Steagall and reform the financial services industry).

62. See BROOME & MARKHAM, *supra* note 8, at 754.

63. See FEIN, *supra* note 28, § 1.06, at 1-22 to 1-33.

64. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified at scattered sections of 12, 15, 16, 18 U.S.C.).

65. Whether GLBA should be regarded as truly landmark legislation or merely a codification of prior regulatory positions is a subject of much debate. See, e.g., Jonathan R. Macey, *The Business of Banking: Before and After Gramm-Leach-Bliley*, 25 J. CORP. L. 691, 691-92 (2000); Satish M. Kini, *Gramm-Leach-Bliley's Bumpy Start Doesn't Justify Thinking It a Failure*, AM. BANKER, Apr. 27, 2001, at 13; Alan E.

sure, this was vital (and much overdue) legislation, which finally brought the regulatory structure for the American financial services industry out of the Depression Era and into the 21st century. But the legislation was not truly revolutionary. For instance, GLBA essentially codified the bank regulatory agencies' prior interpretations and built on the existing bank holding company framework. Similarly, while GLBA removed the artificial barriers that separated banking from securities (and insurance), the Act largely left in place lines between banking and "commercial" (i.e., non-financial) activities.⁶⁶

The very first provision of GLBA strikes formally the two sections of the Glass-Steagall Act—sections 20 and 32—that dealt with the securities activities of bank-affiliated broker-dealers.⁶⁷ GLBA, however, left alone sections 16 and 21 of the Glass-Steagall Act, which, as noted above, principally deal with the *direct* securities activities of banks.⁶⁸

GLBA was designed to permit banks, securities firms and insurance companies to affiliate freely, and the Act provided two

Sorcher, *Deregulation: One Year and Counting*, INVESTMENT NEWS, Dec. 11, 2000, at 12.

66. When the Act was being considered by Congress, Federal Reserve Chairman Greenspan, among others, argued vociferously that, while financial modernization was much needed, such modernization should not move beyond permitting affiliations among financial service providers to allow the full integration of banking and commercial enterprises. *The Federal Reserve's First Monetary Policy Report to Congress for 1999 (Humphrey-Hawkins): Need for Financial Modernization, Before the Committee on Banking, Housing, and Urban Affairs, 106th Cong. (Feb. 23, 1999)* (testimony of Alan Greenspan, Federal Reserve Chairman), available at www.federalreserve.gov/boarddocs/testimony/1999 (last visited Feb. 23, 2002). This full integration, Chairman Greenspan contended, should be reserved for the future—once Congress and the regulators had had an opportunity to study and understand how the underlying federal government subsidies of deposit insurance, discount window access, and guaranteed final settlement through Fedwire could be folded into a commercial firm. *Id.*

For a proposal on how to allow the full integration of banking and commerce, see Mark E. Van Der Weide & Satish M. Kini, *Subordinated Debt: A Capital Markets Approach to Bank Regulation*, 41 B.C. L. REV. 195, 247-48 (2000).

67. See Gramm-Leach-Bliley Act § 101. Although section 20 of the Glass-Steagall Act was repealed, this did not mean that banking firms wishing to engage in full-scope securities underwriting and dealing activities (beyond the confines of the Federal Reserve's section 20 regulatory decisions) could automatically do so. Instead, interested banks and bank holding companies first had to meet certain qualifications to be able to take advantage of the statutory change. See, e.g., TORTORIELLO, *supra* note 15, at 6; *infra* notes 71-72 and accompanying text.

68. See *supra* note 10 and accompanying text.

alternative frameworks for such affiliations. The Act also contains important provisions eliminating the long-standing exclusions that banks had enjoyed from most securities broker-dealer registration requirements.⁶⁹

A. *Structural Alternatives for Affiliations Between Banks and Securities Firms*

GLBA provides two structural alternatives that banks and securities firms may use to affiliate with each other and to engage in a full range of securities activities. Under option one, a bank holding company may elect to become a “financial holding company” and engage in expanded financial activities through an affiliate of the holding company.⁷⁰ Under the second option, a national bank may form a “financial subsidiary” and engage in many, *but not all*, of the same securities activities through this separately incorporated subsidiary of the bank.⁷¹

1. The Financial Holding Company Approach

GLBA amended the BHCA by adding to it several new subsections that together establish the procedures and structure for affiliations between banks and securities firms, as well as insurance companies and other financial service purveyors. To begin with, new section 4(k) of the BHCA generally permits bank holding companies and foreign banks that meet certain qualification requirements to become financial holding companies and to engage broadly in any activity that is (a) “financial in

69. GLBA also contains numerous other provisions, including those that established the Federal Reserve’s primacy as “umbrella” supervisor of financial firms and establishing privacy safeguards that govern how banks, securities firms, and other financial institutions may handle and share confidential consumer information. For a description of some of the GLBA’s key provisions, see TORTORIELLO, *supra* note 15, at 1-54; Russell J. Brummer & Satish M. Kini, *Regulatory Implementation of Financial Modernisation in the United States: Issues and Challenges*, GLOBAL BANKING & FIN. POL’Y REV. 2001/2002 211 (on file with author); Nina Hval, *Financial Modernization in the United States: What New Financial Activities U.S. Banks and Foreign Banks in the United States Can Now Pursue*, 34 INT’L LAW 1133 (2000); Alan E. Sorcher, *Gramm-Leach-Bliley Review: Has the Promise of Less Regulation Led to More Rules*, 2 J. INV. COMPLIANCE 7 (2001).

70. See *infra* notes 72-80 and accompanying text.

71. See *infra* notes 81-86 and accompanying text.

nature,” (b) “incidental” to such financial activity, or (c) “complementary” to such financial activity.⁷²

Among the activities expressly permitted for financial holding companies as “financial in nature” or “incidental” are a number of securities activities, including securities brokerage, securities underwriting, dealing, and market making (without the section 20 revenue limitations), acting as underwriter for mutual funds, and merchant banking.⁷³ These activities are permitted under GLBA without reference to the regulatory restrictions previously imposed on them by the Federal Reserve’s pre-GLBA regulatory framework.⁷⁴ In addition, financial holding companies generally may engage de novo in these activities or acquire securities firms engaged in these activities without prior notice to the Federal Reserve,⁷⁵ which was not the case for bank holding companies under the pre-GLBA structure.⁷⁶

New section 4(l) of the BHCA generally provides the standards that bank holding companies must meet and maintain to qualify for financial holding company status. These requirements include meeting certain minimum capital and management standards, as well as requirements under the Community Reinvestment Act (CRA), for insured depository institution subsidiaries of bank holding companies.⁷⁷ New section 4(m) includes provisions specifying how the Federal Reserve may regulate financial holding companies that fail to maintain the standards set forth under section 4(l).⁷⁸

Securities firms seeking to acquire a bank and qualify as a financial holding company must still apply to the Federal Reserve to become a bank holding company under section 3 of the

72. See 12 U.S.C. § 1843(k) (2000).

73. See *id.* § 1843(k)(4).

74. See, e.g., TORTORIELLO, *supra* note 15, at 13.

75. See 12 C.F.R. § 225.87 (2000) (noting the requirements for post-commencement notice, in certain situations).

76. See PAULINE B. HELLER, FEDERAL RESERVE BANK HOLDING COMPANY LAW § 7.03 (American Lawyer Media 1994) (detailing the various types of notice and application requirements that applied under the BHCA).

77. See 12 U.S.C. § 1843(l) (2000); 12 C.F.R. §§ 225.81, 225.82 (2001).

78. See 12 U.S.C. § 1843(m); 12 C.F.R. §§ 225.83, 225.84; see also *In re Dexia*, S.A., Nos. 01-14-CMP-FB-1,-2,-3 (Jan. 9, 2002) (order of civil money penalty against banking firm for falling out of the standards required to be maintained by financial holding companies), available at <http://www.Federalreserve.gov/boarddocs/press/enforcement/2002/20020114/attachment.pdf> (last visited Feb. 10, 2002).

BHCA.⁷⁹ Such an application needs to be accompanied with detailed financial information, is open for public comment, and likely would be approved only after several months of processing.⁸⁰

2. Financial Subsidiary of a National Bank

Under GLBA, banks and securities firms have an alternative approach to engage in expanded financial activities: banks are permitted to form “financial subsidiaries” and—subject to certain exclusions—may engage through these subsidiaries in the same financial activities in which an affiliate of a financial holding company may engage, including: (a) securities brokerage; (b) securities underwriting, dealing, and market making without any revenue limitations; and (c) mutual fund underwriting.⁸¹ The key activities specifically *excluded* for a financial subsidiary are: insurance underwriting; insurance investments; real estate investments; and merchant banking (for at least five years from the enactment of the GLBA).⁸²

Like financial holding companies, national banks seeking to engage in expanded activities through financial subsidiaries must meet and maintain certain qualification standards. In particular, a national bank and each depository institution affiliate of the national bank must meet capital and management qualifications and must have satisfactory CRA records.⁸³ Various adverse consequences—akin to those applicable to financial holding

79. 12 U.S.C. § 1842 (2000).

80. *See, e.g.*, The Charles Schwab Corp., §7 Fed. Res. Bull. 233 (2001) (order approving acquisition and merger of Bank Holding Companies).

81. The authority for national banks is found at 12 U.S.C. § 24a (2000); 12 C.F.R. § 5.39 (2001). State banks also may establish similar subsidiaries subject to many of the conditions that are applicable to national banks. 12 U.S.C. § 1831w (2000); 12 C.F.R. § 208.7 (2001).

82. 12 U.S.C. § 24a(a)(2)(B); 12 C.F.R. § 5.39(f). Financial subsidiaries also may not engage in activities that are “complementary” to financial activities. 12 U.S.C. § 24a(a)(2)(A). After November 12, 2004, the Federal Reserve and Treasury Department may, through joint rulemaking, authorize banking for financial subsidiaries.

83. *See* 12 U.S.C. § 24a(a)(2)(C). For purposes of making its capital calculations, the national bank must deduct its investment, including retained earnings, in its financial subsidiary. 12 U.S.C. § 24a(c); 12 C.F.R. § 5.39(h)(1)(i).

companies—can flow from the failure to maintain the necessary capital, management, and CRA standards.⁸⁴

National banks wishing to form financial subsidiaries are subject to certain additional limitations not applicable to financial holding companies. To begin with, financial subsidiaries are subject to a size limitation: the total assets of all of the financial subsidiaries of a national bank may not exceed forty-five percent of the assets of the bank or fifty billion dollars, whichever sum is larger.⁸⁵ In addition, if the national bank is one of the 100 largest in the country, it must issue debt that is rated in one of the top three investment grade categories.⁸⁶

B. Functional Regulation of Securities Activities

In addition to permitting new securities and bank affiliations, GLBA essentially eliminated the blanket exemption that banks had long enjoyed from the broker-dealer registration requirements of the Exchange Act⁸⁷ (and the investment adviser registration requirements of the Investment Advisers Act of 1940).⁸⁸ Under these exemptions, banks (but generally not bank affiliates) had been able to engage in securities brokerage, investment advisory and other securities activities without registering with the SEC and without complying with the various rules to which securities firms doing analogous activities were required to comply.⁸⁹

Under GLBA, banks' blanket securities exclusion was eliminated, and banks engaged in securities activities are required to register with the SEC and comply with the agencies' rules applying to securities firms. The broad exemption was eliminated

84. 12 U.S.C. § 24a(e), (f); 12 C.F.R. § 5.39(g).

85. 12 U.S.C. § 24a(a)(2)(D); 12 C.F.R. § 5.39(g)(2).

86. 12 U.S.C. § 24a(a)(3); 12 C.F.R. § 5.39(g)(3).

87. 15 U.S.C. § 78c(a)(4)(B), (5) (2000).

88. 15 U.S.C. § 80b-1 (2000).

89. Broker-dealer registration plays a significant role in securities regulation and requires that persons associated with a broker-dealer must pass a qualification exam requiring substantive knowledge of the securities business. In addition to this requirement, there are continuing education requirements and additional examinations on supervisory procedures for those in management. SEC and self-regulatory organization rules are also directed at sales practice abuses—those that have committed abuses may be barred from working in the industry or subject to conditions on their employment, such as enhanced supervision.

because GLBA generally incorporated the principle of functional regulation—one set of rules should govern the same financial activity regardless of the entity conducting the activity. Because of the net capital requirements and other rules that apply to broker-dealers, banks generally cannot themselves register with the SEC. Accordingly, the result of GLBA's provisions is to require banks to "push out" most of their securities brokerage, dealing, and investment advisory activities to affiliated broker-dealers and investment advisers that are appropriately registered under the securities laws.⁹⁰

Notwithstanding this general statutory requirement to push-out securities activities, banks were permitted to continue to engage in certain activities that were specifically identified in GLBA as continuing to be permissible for them to conduct directly without having to register with the SEC as a broker-dealer. These "excepted" activities are designed to permit banks to continue to provide those securities services that they have traditionally offered.⁹¹ Excepted activities include, among others: effecting securities transactions in connection with providing traditional banking trust or fiduciary services; securities safekeeping and custody activities; and third-party brokerage or "networking" arrangements, in which a bank enters into a contract with a broker-dealer to provide securities services to the bank's customers.⁹²

The precise scope of these "excepted" activities became a major point of contention between the banking regulators and banking industry, on the one hand, and the SEC, on the other. The former interpreted the exceptions broadly to encompass a full range of activities that they regarded as attendant to their traditional banking businesses. The SEC, however, read the exceptions more narrowly.⁹³

90. See Gramm-Leach-Bliley Act, Pub. L. 106-102, Title II.

91. H.R. CONF. REP. NO. 106-434, at 163-64 (1999); S. REP. NO. 106-44, at 10 (1999).

92. 15 U.S.C. § 78c(a)(4)(B) (2000).

93. Compare 66 Fed. Reg. 27,760 (May 18, 2001) (to be codified at 17 C.F.R. pts. 200, 240) (initial SEC proposal interpreting GLBA's push out exemptions), with Letter from the Federal Bank Regulatory Agencies, to Jonathan G. Katz, Secretary of the SEC, (June 29, 2001) (laying out the banking agencies' strong objection to the SEC's position), available at <http://www.federalreserve.gov/boarddocs/press/general/2001/20010702/attachment.pdf> (last visited Feb. 19, 2002). See also Alan E. Sørcher,

III. IMPLEMENTATION OF THE GLBA: TWO STEPS BACK?

The question remains open, two-and-a-half years since the enactment of GLBA, as to what the law's ultimate impact will be. At this stage, it is apparent that GLBA has not resulted in the dramatic cross-industry merger activity that many had expected. Even senior members of the Federal Reserve, including then-Governor Laurence H. Meyer, have had to admit some degree of surprise about the lack of sizeable cross-industry combinations stemming from the GLBA.⁹⁴ To date, only two securities firms have acquired banks.⁹⁵

The paucity of large cross-industry transactions of the sort envisioned in 1999, when GLBA was enacted, of course, raises the obvious question as to why those original expectations have not

Critics of Securities Activities Rule Should Consider the Consumer Upside, AM. BANKER, Aug. 24, 2001, at 6.

94. See Laurence H. Meyer, Implementing the Gramm-Leach-Bliley Act: One Year Later, Speech before the American Law Institute and American Bar Association (Feb. 15, 2001), available at <http://www.federalreserve.gov/boarddocs/speeches> (last visited Feb. 19, 2002); see also Anthony M. Santomero, The Causes and Effects of Financial Modernization, Speech before the Annual Meeting of the New Jersey Bankers Association (Mar. 17, 2001), available at <http://www.phil.frb.org/publicaffairs/speeches> (last visited Feb. 19, 2002). Although over 500 organizations have elected financial holding company status, the overwhelming majority of these entities were formerly U.S. bank holding companies. Moreover, many of these organizations are smaller, regional banking organizations that appear to have elected financial holding company status not to make landmark securities acquisitions but, instead, to engage in insurance agency activities without the encumbrances of the pre-GLBA framework; to be able to make relatively small-scale non-banking equity investments without the restrictions placed on such investments by section 4(c)(6) of the BHCA and similar pre-GLBA statutory provisions; or simply to avoid the rigorous and time-consuming notice, application and other requirements applicable to bank holding companies seeking to engage in new activities under the BHCA. See Kini, *supra* note 65.

95. The first acquisition was Charles Schwab's purchase of U.S. Trust Corporation. See *The Charles Schwab Corp.*, 87 Fed. Res. Bull. 233 (2001) (order approving acquisition and merger of Bank Holding Companies). More recently Friedman, Billings & Ramsey bought a small depository institution. See *Friedman, Billings, and Ramsey Group, Inc.*, 87 Fed. Res. Bull. 346 (2001) (order approving formation of BHCs and Determination on FHC Elections). A few other cross-industry deals have been consummated. For instance, two large Swiss banking organizations (Credit Suisse Group and UBS AG) also acquired large securities companies (Donaldson, Lufkin & Jenrette and PaineWebber, respectively). But it is likely that these transactions could have been restructured and consummated under the old Glass-Steagall Act and the BHCA, as it existed prior to its amendment by GLBA.

been met. We submit that at least one explanation—albeit not the exclusive reason—is that the regulatory implementation of GLBA has dampened some of the early enthusiasm among securities firms to become affiliated with banks.⁹⁶

Of primary importance in this regard are the merchant banking rules promulgated by the Federal Reserve in conjunction with the Treasury Department and the other banking regulators. The merchant banking rulemaking—which resulted in a comprehensive series of restrictions on the merchant banking activities of bank affiliates that stand-alone securities firms do not face—sent a signal to the industry that the Federal Reserve intended to regulate and supervise financial holding company activities in the same relatively conservative manner that it had employed in the regulation of bank holding companies under the BHCA.

96. This is not, admittedly, the only plausible explanation. Others also deserve consideration. To begin with, it is quite possible that the initial expectations for GLBA were too great. As noted in Part II, GLBA in many respects merely codified and formalized reasonably well-established regulatory interpretations and positions that applied to bank holding companies. See *supra* notes 61-93 and accompanying text.

And, as described in Part I.B, the Glass-Steagall Act, at least in its dying days, really did not present such a significant barrier to the affiliation of banks with securities firms, although the bank generally had to be the purchaser. See *supra* notes 25-46 and accompanying text. By the time GLBA passed, many possible combinations had already occurred. The regulatory barriers to other types of combinations, such as banking and insurance mergers, were more imposing. Here, GLBA did represent a more significant departure from the past. Yet, even in this context, there were ways for insurance and other non-banking firms to acquire depository institutions. For example, many insurance companies and a broad range of other non-banking organizations availed themselves of the unitary thrift option, which allowed such companies to own a single depository institution (a savings association) while engaging in any type of financial or non-financial activities. See, e.g., Ira L. Tannenbaum, *The Unitary Thrift Holding Company and the Thrift Charter after the Gramm-Leach-Bliley Act*, BANKING L. & POL. REP. (Dec. 20, 1999).

Thus, when GLBA was finally enacted, after more than two decades of gestation, there was little “pent up” demand on the part of banking, securities and insurance firms to affiliate with each other. Instead, those firms that wanted to offer their customers the full panoply of securities, banking and insurance products had—through various legal mechanisms and structures—found ways to do so. This, of course, remains the case today. For example, a few securities firms, without becoming a FHC, currently own “non-bank” depository institutions and are able to offer FDIC-insured money market accounts through these institutions to their brokerage clients.

The merchant banking rules and other rules implementing GLBA likely led at least some securities firms to decide to take a “wait-and-see” attitude before electing financial holding company status.⁹⁷ These rules also made clear that the distinction between bank broker-dealers and securities firms not affiliated with banks was not dead.

A. *Merchant Banking Limitations*

Merchant banking is an important part of the business of many securities firms, and the most serious limitations on broker-dealers that are part of financial holding companies result from the rules issued by the Federal Reserve and Treasury Department on merchant banking activities.

As noted above,⁹⁸ GLBA permits financial holding companies to make merchant banking or venture capital investments. The Act imposes a specific set of limits and restrictions on such investment activities. Namely, GLBA requires that: (1) investments cannot be held by a depository institution; (2) investments generally must be held by a securities affiliate or an affiliate thereof; (3) investments must be made as part of a bona fide merchant banking activity; (4) investments may only be retained for such period of time that will permit their disposition on a reasonable basis; (5) financial holding companies may not engage in routine management of a merchant banking portfolio company, except as necessary to protect their investment in that company; (6) there should be limits on cross-marketing between merchant banking portfolio companies and depository institutions controlled by the same FHC; (7) there should be special affiliate transactions restrictions between depository institutions and commonly controlled merchant banking portfolio firms; and (8) financial subsidiaries of national banks should not be permitted to engage in merchant banking for at least five years from the enactment of GLBA and, thereafter, should only be allowed to do so if the Federal Reserve and Treasury jointly agree to authorize it.⁹⁹ GLBA also grants the Federal Reserve and Treasury

97. See, e.g., Christopher H. Schmitt, *Greenspan vs. the Banks: Is a Rematch in the Making?*, BUS. WK., May 21, 2001, at 53.

98. See *supra* notes 70-86 and accompanying text.

99. See 12 U.S.C. § 1843(k)(4)(H) (2000); 12 U.S.C. § 371c(b)(11) (2000).

authority to issue such “implementing” regulations as they feel necessary to assure compliance with the purposes of and prevent evasions of the Act.¹⁰⁰

Industry representatives hoped that financial holding companies’ merchant banking activities would be governed exclusively (or at least principally) by GLBA’s limitations; instead, on March 17, 2000, the Federal Reserve and Treasury Department issued rules governing merchant banking activities.¹⁰¹ First, the agencies issued an interim rule that included detailed provisions on recordkeeping, reporting and risk management practices for merchant banking investments; holding periods for such investments; corporate separateness and limits on involvement in management; and an absolute dollar cap on the total merchant banking investments that can be made by a financial holding company. At the same time, the Federal Reserve issued a proposed rule that would have imposed a fifty percent capital requirement on merchant banking investments and certain similar investments made under pre-existing BHCA authority.¹⁰² The proposed fifty percent capital charge was a significant additional burden—the charge was materially greater than the eight percent capital level required for almost all other financial holding company activities.¹⁰³

Industry reaction to the twin rules—and, in particular, the capital rule—was swift and furious.¹⁰⁴ Industry commentators, joined by several members of Congress, contended that these rules were not envisioned by Congress when it enacted GLBA and

100. See 12 U.S.C. § 1843(k)(7)(A).

101. 65 Fed. Reg. 16,480 (Mar. 28, 2000) (to be codified at 12 C.F.R. pt. 225).

102. See *id.* Under the proposal, a financial holding company would generally have been required to deduct fifty percent of the total carrying value of all merchant banking investments from the company’s required regulatory Tier 1 capital. In addition, the proposal would have applied the same capital treatment to investments in non-financial companies held under section 4(c)(6) of the BHCA, which allowed bank holding companies to own five percent of the voting shares of any company. See *id.*

103. For a description of bank holding company capital requirements, see MICHAEL G. CAPATIDES, *A GUIDE TO THE CAPITAL MARKETS ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES* 318-27 (1993).

104. See Satish M. Kini, *Banking Agencies Propose Revised Capital Rules Governing Merchant Banking in Non-financial Companies*, 118 *BANKING L. J.* 334, 336 (2001); Rob Garver, *Further Easing Sought in Merchant Banking Regs*, *AM. BANKER*, Apr. 3, 2001, at 1.

would have a significantly adverse affect on the ability of financial holding companies to make merchant banking and other permissible investments on the same scale and to the same extent as securities firms that are not affiliated with a bank. In addition, industry commentators contended that, because merchant banking is such an important part of the business of many securities firms, the existence of these restrictions would discourage securities firms from becoming financial holding companies and hamper and limit affiliations between banking and securities companies. In short, according to the industry, the merchant banking rules would recreate the segmentation of and the “uneven playing field” in the financial services industry that is at the very core of what Congress sought to abolish with the repeal of Glass-Steagall Act and the enactment of the GLBA.¹⁰⁵

In the face of such vociferous objection, the Federal Reserve and Treasury Department retreated to some extent from their original set of merchant banking rules. In January 2001, the Federal Reserve and Treasury Department issued a final merchant banking rule that, from the industry’s vantage point, was a bit less objectionable.¹⁰⁶ For example, the final rule essentially eliminated the interim rule’s caps or limits on total merchant banking investments. Under the interim rule, a financial holding company’s total merchant banking investments (including interests in private equity funds) could not exceed the lesser of six billion dollars or thirty percent of its Tier 1 capital. In addition, the interim rule prohibited a financial holding company’s merchant banking investments (excluding interests in private equity funds) from exceeding the lesser of four billion dollars or twenty percent of its Tier 1 capital. The final rule also eliminated entirely the six billion and four billion dollar-based limits on total merchant banking investments. The final rule further sunset the two remaining Tier 1 limits so that they would be eliminated once the Federal Reserve adopted a final capital rule for merchant banking

105. See, e.g., Rob Blackwell, *Industry Rips Interim Rules Limiting Merchant Banking*, AM. BANKER, June 14, 2001, at 4.

106. Bank Holding Companies and Change in Bank Control, 66 Fed. Reg. 8466 (Jan. 31, 2001) (to be codified at 12 C.F.R. pts. 225 and 1500).

investments¹⁰⁷ (which the Federal Reserve did in January 2002).¹⁰⁸

Despite these and other changes made to the rule in response to industry comments, the merchant banking rule continues to present a fairly complex and burdensome array of restrictions and limitations on merchant banking activities that do not apply to the venture capital activities of stand-alone securities firms.¹⁰⁹

The complexity of the rule is most evident in its treatment of “private equity funds.” The final rule imposes greater restrictions on merchant banking investments made directly by financial holding companies and comparatively fewer restrictions and limits on portfolio investments made by financial holding companies through private fund vehicles.¹¹⁰ But the definition of private equity funds is a complex five-part standard. The rule then imposes different sets of operational, recordkeeping and reporting restrictions on funds that meet that definition than on those that do not.¹¹¹ In addition, the final rule places different sets of limits on funds—both those that qualify for private equity fund status and those that do not—that are “controlled” by financial holding companies from those funds that are not.¹¹² Thus, a single financial holding company may face four different sets of restrictions that apply to its fund investments: one for private equity funds that are controlled by a FHC; a second for private equity funds that are not controlled by a FHC; a third for funds that do not qualify for private equity fund status and that are controlled by a FHC; and a fourth for funds that do not meet the

107. *Id.* at 8,467.

108. 67 Fed. Reg. 3784 (Jan. 25, 2002) (to be codified at 12 C.F.R. pts. 3, 208, 225, and 325).

109. See Rob Garver, *Reaction to Capital Rule: A Better Brand of Onerous*, AM. BANKER, Dec. 11, 2001, at 1; Alan E. Sorcher & James D. Spellman, *Federal Regulators Should Return to Gramm-Leach-Bliley's Intent*, AM. BANKER, May 7, 2001, at 31.

110. Private equity funds pool a financial holding company's investments with those of third parties. Investments made through private equity funds generally require less regulatory scrutiny because of the market discipline offered by the third party fund investors. See, e.g., Bank Holding Companies and Change in Bank Control, 65 Fed. Reg. 16,460, 16,461 (Mar. 28, 2000) (to be codified at 12 C.F.R. pts. 225 and 1500).

111. *Id.*

112. *Id.*

private equity fund definition and that are not controlled by a FHC.¹¹³

The rule's limits and restrictions are evident from many provisions. For instance, the rule imposes a restriction on the ability of financial holding companies to hold investments beyond ten years (or fifteen years for private equity fund investments).¹¹⁴ The rule also places restrictions on the types of covenants and agreements that financial holding companies may enter into with portfolio companies.¹¹⁵ In addition, the final rule contains a variety of restrictions on the types of financial holding company employees and officers that may be involved in the activities of a portfolio company. The result is that financial holding companies face compliance burdens under the Federal Reserve and Treasury Department's merchant banking rule that securities firms not affiliated with banks do not face.¹¹⁶

As with the final merchant banking rule, the final capital rule represents a measured improvement over the Federal Reserve's original proposal of March 2000. The rule requires firms to take a deduction ranging between eight and twenty-five percent from their Tier 1 capital depending on the level of their equity investments.¹¹⁷

Arguably, the Federal Reserve could have taken a different tack—one that would have been less burdensome. It could have

113. *Id.*

114. These pre-set holding periods arguably are at odds with the flexibility provided by GLBA's provision that merchant banking investments be permitted to be held for such period of time to "enable the sale or disposition thereof on a reasonable basis consistent with the financial viability" of the investment. 12 U.S.C. § 1843(k)(4)(H)(iii) (2000). By imposing a time frame on holding investments, the rule may cause financial holding companies to sell certain investments prematurely, rather than when financially optimal.

115. These covenants enable firms to protect their merchant banking investments.

116. Additional burdens may result from yet undefined reporting requirements. In promulgating their final rule, the Federal Reserve and Treasury have reaffirmed that financial holding companies will be required to submit quarterly reports on their merchant banking portfolios and annual information with details on particular merchant banking investments, including anticipated exit strategies. Detailed reporting requirements will impose needless costs on merchant banking activities, are unnecessary given the other forms of regulatory supervision to which financial holding companies are subject and flatly contradicts GLBA's dictate to the Board to reduce the regulatory burden that it inflicts on financial holding companies.

117. 67 Fed. Reg. 3784 (Jan. 25, 2002) (to be codified at 12 C.F.R. pts. 3, 208, 225, and 325).

allowed firms to rely on internal capital allocation models to control the risks of non-financial investment activities. Such models, which are used by securities firms to manage merchant banking risks, allow each institution to measure and capture the complexity of that firm's merchant banking investment program, accounting for the risks and capital needs that are specific to the nature and level of the firm's portfolio investment activities. Internal models also offer the advantage that they can be fine-tuned on a continuous basis to accommodate developments and changes in economic, investment and portfolio conditions in a manner that the Federal Reserve's rules cannot.¹¹⁸

Securities firms that are not part of a financial holding company do not face the types of regulatory restrictions and capital requirements that are set forth in the twin merchant banking rules. Accordingly, bank affiliates that engage in merchant banking activities face restrictions that their brethren investment banks do not.¹¹⁹

B. Restricting the Ability to Diversify

Another area where differences exist for securities firms and entities that are part of financial holding companies is in their ability to engage in so-called "expanded" financial activities. Broker-dealers and other companies that are part of financial holding companies are limited to activities that are deemed "financial in nature," "incidental thereto," or complementary to a financial activity.¹²⁰ Under GLBA, they are not allowed to engage

118. In addition, reliance on an internal model/supervisory framework serves to encourage institutions to improve continuously risk management systems and capabilities so as to produce more sophisticated, reliable and accurate capital measurements. By contrast, the approach taken by the Federal Reserve—by applying the same capital charge to all institutions that make the same level of merchant banking and non-financial equity investments as a percentage of their Tier 1 capital—penalizes institutions regardless of how carefully they monitor and manage their portfolio investment activities.

119. The regulatory agencies' approach was posited on the belief that merchant banking activity poses substantially greater risks than other permissible activities for financial holding companies. That belief, however, appears to run counter to the well-established track record of securities firms in making and managing their merchant banking investments—even during the recent large declines in the U.S. equity and venture capital markets.

120. 12 U.S.C. § 1843(k)(1) (2000).

in activities outside of these three boxes and to conduct “commercial” businesses.¹²¹ Securities firms that are not affiliated with banks face no such restrictions.

The significance to a financial institution of being able to diversify its activities, without restriction, should not be overlooked. After all, that legal flexibility affords the institution the opportunity to react quickly to business opportunities and market changes. GLBA was viewed as creating an opportunity for bank-affiliated firms to take advantage of such market developments. For this reason, the Act permitted financial holding companies (and financial subsidiaries, albeit to a somewhat lesser extent) to engage in a broad spectrum of financial activities.¹²² The Act also eliminated many of the prior approval and application requirements that existed in the pre-existing bank regulatory framework.¹²³

GLBA included a laundry list of activities deemed permissible for banking affiliates and further contemplated that this list would be expanded through regulatory action to keep pace with changes in the marketplace and technology.¹²⁴ Indeed, the Act vested the Federal Reserve and Treasury with broad authority to add new activities to the list.¹²⁵

121. There is an exception for certain “grandfathered” commercial activities. See 12 U.S.C. § 1843(n).

122. An expansive list of activities is permissible under GLBA that are defined to be “financial in nature” or “incidental” to a financial activity. Gramm-Leach-Bliley Act § 103(a).

123. Companies that qualify as financial holding companies may engage in, generally, any of the activities on the approved list without the Federal Reserve’s prior approval; however, a financial holding company must notify the appropriate Federal Reserve Bank in writing within thirty days after commencing a new activity on the list or acquiring shares of company engaged in such activity. 12 U.S.C. § 1843(k)(6); 12 C.F.R. § 225.87.

124. See Meyer, *supra* note 94 (noting that GLBA “creatively and pragmatically permits the Federal Reserve . . . to respond to evolving market trends and technology without requiring the drawn out and always lagging process of amending statutes in response to market developments”).

125. The Federal Reserve, in consultation with the Treasury, is authorized by GLBA to determine that an activity is “financial in nature” or “incidental to a financial activity.” The Federal Reserve may also add to the list of permissible activities by finding that an activity is complementary to a financial activity and does not pose certain other risks. Financial Holding Companies, 12 C.F.R. §§ 225.88, 225.89 (Jan. 18, 2002). In that connection, the Federal Reserve’s rules establish a procedure to request that the Federal Reserve determine that a particular activity is complementary to a financial activity, and to receive approval to engage in that

There have been several rules and proposed rules regarding new activities, such as “finder” activities, data processing functions, and real estate brokerage and management services. But, to date, it appears that the agencies are taking a rather cautious approach to permitting firms to broaden their reach.

1. Finder Activities

Acting as a “finder” is defined as bringing together buyers and sellers of products or services for transactions that the parties themselves negotiate.¹²⁶ For example, a financial institution may host an Internet marketplace by including links to the websites of buyers and sellers on its own website. In addition, a financial institution, under the finder activity, could allow buyers and sellers to post information on its website concerning products and services and to enter into transactions among themselves.¹²⁷

The Federal Reserve has approved acting as a “finder” as a permissible activity for a financial holding company, but it has not adopted a very expansive approach in defining the permitted range of activities.¹²⁸ In issuing its finder rule, the Federal Reserve found that acting as a finder is an activity that is “incidental” to a financial activity, and is therefore a permissible activity pursuant to the GLBA.¹²⁹

The main shortcomings of the activity begin with the Federal Reserve’s classification of the activity as being “incidental” to financial activity, as opposed to being “financial in nature.” That classification is more than semantic, because it limits the ability to have other related activities added on to the main activity. To explain, an activity defined as “financial” can later be broadened through the authorization of further activities

activity.

126. Financial Holding Companies, 12 C.F.R § 225.86 (d)(1)(ii) (Jan. 18, 2002).

127. *Id.*

128. 12 C.F.R § 225.86(d)(1). National banks and their subsidiaries already were permitted to engage in finder activities prior to the GLBA’s enactment. *See* 12 C.F.R. § 7.1002; OCC Interpretive Letter No. 875 (Oct. 31, 1999) [1999-2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,369; OCC Interpretive Letter No. 856 (Mar. 5, 1999) [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,313.

129. *See* 65 Fed. Reg. at 80,735-02 (Dec. 22, 2000) (to be codified at 12 C.F.R. pt. 203).

that are incidental to it. On the other hand, an activity defined as “incidental” cannot be broadened in that same fashion.

The rule also limits the authority of a finder to act only as an intermediary. For instance, the rule prevents a finder from negotiating for or binding third parties, and prevents a finder from becoming a principal in the underlying transaction.¹³⁰ Financial holding companies are also prohibited from providing distribution services for products offered or sold through their finder services.¹³¹

Many financial holding companies will benefit from the new rule because it does broaden the range of services that they can provide. The finder activity particularly holds much promise, as the Internet becomes a medium of choice for various types of financial and business activities. The restrictions and limitations imposed by the Federal Reserve, however, may harness some of the real value of the finder services. Moreover, these restrictions and limitations do not exist in the case of securities firms that are not affiliated with banks.

2. Data Processing

The Federal Reserve also issued proposals expanding data processing activities, and permitting certain data storage and Internet hosting activities.¹³² Once again, however, the Federal Reserve placed restrictions on these activities.

Prior to the enactment of GLBA, the Federal Reserve permitted bank holding companies to engage in unlimited financial data processing activities, and in a limited amount of non-financial data processing.¹³³ Specifically, the Federal Reserve restricted the total revenues earned from non-financial data processing to thirty percent of the total annual revenues earned from data processing and data transmission.¹³⁴

After the enactment of GLBA, the Federal Reserve proposed to permit all bank holding companies (not exclusively

130. Financial Holding Companies, 12 C.F.R. § 225.86 (d)(1)(iii)(B)(1) (Jan. 18, 2002).

131. *Id.*

132. 65 Fed. Reg. 80,384 (Dec. 21, 2000) (to be codified at 12 C.F.R. pt. 225).

133. 12 C.F.R. § 225.28(b)(14) (Jan. 19, 2002).

134. *Id.*

financial holding companies) to conduct a greater amount of nonfinancial data processing.¹³⁵ Specifically, the Federal Reserve proposed to increase the limit on non-financial data processing from thirty to forty-nine percent. The Federal Reserve also proposed to allow financial holding companies—as an activity that is complementary to financial activities—to own companies engaged in certain types of data storage, general data processing, Internet and portal hosting activities, and advisory activities involving data processing.¹³⁶ Under the proposal, investment in these activities is limited to an aggregate investment cap of five percent of a financial holding company's Tier 1 capital.¹³⁷ In addition, investments in general data processing companies may be made without reference to the type of data processed or transmitted by the companies—so long as at least twenty percent of the companies' revenues are derived from (a) providing data processing services to depository institutions and their affiliates; (b) processing financial data; and/or (c) sale of other financial products and services.¹³⁸

As with the finder rule, the Federal Reserve's proposal to authorize new data processing activities was welcome but a bit narrower in scope than many had hoped. Arguably, the Federal Reserve has the authority under the GLBA to permit financial holding companies to engage in broader nonfinancial data processing. Processing financial data could easily be viewed as an activity that is financial in nature, and processing nonfinancial data could be determined to be an activity that is incidental to a financial activity. Because financial holding company activities need not be limited by the "closely related to banking" standard found in section 4(c)(8) of the BHCA¹³⁹ but, instead, can be

135. 65 Fed. Reg. 80,384, 80,385 (Dec. 21, 2000) (to be codified at 12 C.F.R. pt. 225).

136. The proposal also sought comment on whether financial holding companies should be permitted to make investments in companies engaged in developing new technologies related to the sale of financial products and services, companies that provide communication links for the delivery of financial products, and companies that engage in the electronic sale and delivery of products and services. Although it is not clear whether the Federal Reserve will act on this part of the proposal, these kinds of investments are essential if financial holding companies are to compete with other sectors venturing into financial services. *Id.* at 80,386.

137. *Id.*

138. *Id.*

139. See *supra* notes 21-24 and accompanying text.

authorized by the broader “financial in nature” or “incidental” standards, GLBA could be read to authorize financial holding companies to conduct nonfinancial data processing beyond the forty-nine percent threshold.¹⁴⁰

The forty-nine percent revenue limit put financial holding companies at a competitive disadvantage to other firms engaged in data processing activities by creating an artificial limit on the financial holding companies’ activities. This limit could result in pricing distortions and inefficiencies that do not exist for providers not subject to these restrictions. Moreover, as the lines between financial and nonfinancial data become harder to maintain (and the distinction is already rather ephemeral), this forty-nine percent revenue limit will become more difficult and costly to monitor.

The Federal Reserve’s proposal to allow financial holding companies, as complementary activities, to own or invest in companies engaged in certain types of data storage, general data processing and data transmission services, electronic information portal services, and advisory activities involving data processing also fails to extend as broadly as many desired. The proposal falls short because conducting data storage and related activities should be considered to be a financial in nature activity and not a complementary activity. Again, this distinction is significant because the Federal Reserve may impose conditions on the conduct of complementary activities that it could not impose on financial in nature activities.¹⁴¹ Moreover, data storage could well be considered to be financial in nature because acting as a custodian of files is almost identical in kind to the “safekeeping and custody” services that banks have traditionally provided.

The requirement that investments in the three categories of activities be limited to five percent of the financial holding company’s Tier 1 capital is also problematic. While the Federal Reserve’s intent with this seems to be to limit the potential risk to the safety and soundness of a financial holding company, this five

140. The Federal Reserve has acknowledged that the “financial in nature” standard is broader than the “closely related to banking” standard. *See, e.g.*, 65 Fed. Reg. at 80,385 (Dec. 21, 2000) (to be codified at 12 C.F.R. pt. 225).

141. The Federal Reserve may only authorize complementary activities that do not “pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.” 12 U.S.C. § 1843(k)(1) (2000).

percent cap appears to be arbitrary.¹⁴² In addition, the restrictions on general data processing and data transmission services go too far and will prevent financial holding companies from engaging in a full range of data processing activities.

As the Internet and electronic commerce become increasingly important parts of the financial marketplace and economy, financial holding companies should have the ability to engage in a full range of e-commerce and data processing activities. Their inability to do so places financial holding companies and their securities affiliates at a competitive disadvantage to firms that are not affiliated with banks. Such disadvantages distinguish stand-alone securities firms from bank-affiliated ones.

3. Real Estate Brokerage and Management

In other areas as well, bank affiliates are restricted in their activities. For instance, as of the date of this writing, they are not permitted to engage in real estate brokerage and real estate management activities. No such restrictions exist for other broker-dealers and their affiliates, although most (by choice) do not engage in such activities.

The Federal Reserve and the Treasury have proposed to allow financial holding companies and financial subsidiaries to engage in real estate brokerage and management activities.¹⁴³ This proposal has, however, engendered significant opposition from real estate brokers.¹⁴⁴

If this proposal is carried forward, another restriction on bank affiliates will fall away. If it is stopped because of the real

142. Moreover, it is not clear whether the five percent cap would apply to all activities that are heretofore defined as complementary, or will just apply to three categories of activities enumerated in the present proposal. The ability of financial holding companies to take advantage of the complementary activities would certainly be limited if all complementary activities—those in this rule and all future authorized activities—are limited to five percent of an institution's Tier 1 capital.

143. 66 Fed. Reg. 307 (proposed Jan. 3, 2001) (to be codified at 12 C.F.R. pts. 225 and 1501).

144. See, e.g., Dean Anason, *DC Speaks: Realtor Group Fighting to Keep Banks Off Its Turf*, AM. BANKER, June 8, 2001, at 4.

estate brokers' opposition, it will demonstrate the limits of GLBA.¹⁴⁵

C. Referral Fees Under Third-Party Brokerage Arrangements

A final set of restrictions exists in the way that banks interact with broker-dealers under so-called third-party brokerage (or networking) arrangements. Under such arrangements, broker-dealers offer brokerage services to bank customers, frequently by operating on bank premises.¹⁴⁶ Networking arrangements are of particular importance to many bank broker-dealers, which rely on such arrangements for their business.

Networking arrangements existed prior to GLBA. Up until GLBA, these arrangements had been conducted pursuant to SEC no-action positions,¹⁴⁷ the rules of the National Association of Securities Dealers,¹⁴⁸ and guidance issued by the federal bank regulatory agencies.¹⁴⁹ These rules allowed bank personnel (who are not registered and licensed under the federal securities laws) to earn nominal referral fees for referrals to the registered representatives of broker-dealers. These fees—which could not be made contingent to the success of the referral—are a key part of the networking arrangements.

Under the interim rules issued by the SEC to implement GLBA's push-out provisions,¹⁵⁰ it appears that banks and broker-dealers that enter into networking arrangements will now be subject to additional restrictions on the referral fees that they may

145. 12 C.F.R. § 225.86 (d)(1) (iii) specifically excludes this activity since a finder needs a real estate agent's or broker's license.

146. 15 U.S.C. 78c(a)(4)(B)(i) (2000).

147. Chubb Securities Corp., SEC No-Action Letter, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,829, at 78,387 (Nov. 24, 1993), available at 1993 SEC No-Act. LEXIS 1204 (Nov. 24, 1993).

148. NATIONAL ASSOCIATION OF SECURITIES DEALERS, NASD MANUAL: RULES 0100-3420, 120-122 (giving the full text of Rule 2350), available at <http://www.barreau.qc.ca/congres/2001/pdf/19-garcia-manual.pdf> (last visited Feb. 24, 2002).

149. Uniform Guidance on Mutual Fund Sales, Interagency Guidelines, 7 Fed. Banking L. Rep. (CCH) ¶ 70-101, at 82,551-58 (Feb. 15, 1994); Clarification of Interagency Guidelines, 7 Fed. Banking L. Rep. (CCH) ¶ 70-111, at 82,575-78 (Sept. 12, 1995). These guidelines were jointly issued by the Federal Reserve, the OCC, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

150. See *supra* note 91 and accompanying text.

pay.¹⁵¹ In the interim rules, the SEC limited the referral fees that could be paid to only: (1) “[a] payment that does not exceed one hour of the gross cash wages of the unregistered bank employee making a referral;” or (2) “[p]oints in a system or program that covers a range of bank products and non-securities related services where the points count toward a bonus that is cash or non-cash if the points (and their value) awarded for referrals involving securities are not greater than the points (and their value) awarded for activities not involving securities.”¹⁵²

The interim rules’ limitations on referral fees, whether in the form of monetary payments or in the form of award points, create additional burdens and are detrimental to the overall securities referral programs between broker-dealers and their affiliated or networked banks.

IV. CONCLUSION

The landscape of financial services today looks far different than during the early part of the twentieth century. This is due to many factors, including the consolidation that occurred in the mid 1990s, the rapid advance of technology, the globalization of our economy and GLBA.

In this new world, securities firms that have not partnered with a bank—the “unaffiliated broker-dealers”—face some difficult strategic questions. For instance, can these firms go it alone without having the ability to provide credit facilities to customers to the same extent as banks? In an increasingly global economy, can firms operate profitably without the efficiencies and resources of a worldwide organization?

As firms struggle with these issues, one factor they will weigh in considering whether to become affiliated with a bank is the extra level of regulation of bank-affiliated firms. Although the level of regulation is not likely to be the sole determinative factor

151. Interim Rule § 240.3b-17(g), at 66 Fed. Reg. 27,799 (May 18, 2001).

152. *Id.* The rules also provide that securities referral fees – whether points or cash—may not be related to: (1) size or value of any securities transaction; (2) amount of securities-related assets gathered; (3) size or value of a customer’s bank or securities account; or (4) financial status of a customer. GLBA’s safeguard—the prohibition of the payment of a referral fee that is contingent on whether the referral results in a transaction—is sufficient to protect investors. *Id.*

in the outcome of these decisions, the restrictions that are part and parcel of bank affiliation must be carefully evaluated.

Indeed, despite GLBA, broker-dealers that are part of banking firms still face restrictions that their brethren do not; thus, at least for now, it is safe to say that the term “bank broker-dealer” still has meaning.