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New Operating Standards for Section 20 Subsidiaries: The Federal Reserve Board's Prudent March toward Financial Services Modernization

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The New Operating Standards for Section 20 Subsidiaries: The Federal Reserve Board's Prudent March Toward Financial Services Modernization

I. INTRODUCTION

On September 10, 1997, the Federal Reserve Board (Board) announced its approval of the notice of NationsBank Corporation to acquire Montgomery Securities of San Francisco, an investment banking firm with total consolidated assets of $2.5 billion.[1] The newly acquired section 20 subsidiary, now known as NationsBanc Montgomery Securities, L.L.C., will have the backing of $21 billion in equity capital,[2] which will enable it to broaden its stock and bond trading and enhance its ability to conduct larger securitized transactions.[3] NationsBank will be able to offer its customers a broad range of financial products, through the subsidiary, which plans to retain its emphasis on research and investment banking.[4] This dramatic development was made possible by the Board's promulgation of new Operating Standards for section 20 subsidiaries, which allow bank holding companies (BHCs) access to traditionally non-banking areas.[5]

On August 21, 1997, the Board ordered substantial revisions to the regulatory regime that limits BHCs' affiliation with subsidiaries engaged in securities underwriting and dealing

1. *See* Order Approving Notice to Engage in Certain Non-Banking Activities, 83 Fed. Res. Bull. 924, 927 (1997).

2. *See* NationsBanc Montgomery Securities Addendum to the 1997 Annual Report, (date visited Feb. 28, 1998) <http://www.nationsbancmontgomery.com/mont_info/annual_report/add.html>.

3. *See id.*

4. *See id.*

5. *See infra* note 40 and accompanying text; *see also infra* notes 14-17 and accompanying text (explaining why banks, until very recently, have been barred from involvement in investment activities). *See generally* John W. Milligan, *Bankers Who Would be Brokers*, U.S. BANKER, Oct. 1997, at 26 (describing the flurry of BHCs' acquisition of securities firms, including First Union of Wheat First Butcher Singer Securities, Bankers Trust of Alex Brown & Co., BankAmerica of Robertson, Stephens & Co., CIBC of Oppenheimer, and SBC Warburg of Dillon, Reed & Company).

activities.[6] These limitations, previously dubbed "firewalls,"[7] were replaced by a significantly truncated and modified set of eight Operating Standards.[8] The Board believes that these new standards will increase the competitiveness of BHCs in the delivery of one-stop financial services, while simultaneously protecting bank depositors from the conflicts of interest that arguably arise with the affiliation of commercial and investment banking activities.[9]

This Comment briefly describes the well-entrenched arguments for and against the historical restrictions on the involvement of traditional banks in investment banking activity.[10] The Comment next reviews each of the old firewalls, focusing on the reasoning behind the Board's decision to abandon some limitations and retain others in the new Operating Standards.[11] Then the Comment examines the objectives of the Board's changes, and discusses the extent to which these objectives are reflected in the new Operating Standards.[12] Finally, the Comment concludes that the Board's Operating Standards successfully maintain a reasonable yet vigilant approach to financial industry oversight, by striking a balance between the benefits of open and free competition and the safety and soundness of circumspect fiscal policy.[13]

II. BACKGROUND

Section 20 of the Glass-Steagall Act (Glass-Steagall),[14]

6. *See* Bank Holding Companies and Change in Bank Control (Regulation Y); Amendments to Restrictions in the Board's Section 20 Orders, 62 Fed. Reg. 45,295 (1997) [hereinafter Regulation Y Amendments] (to be codified at 12 C.F.R. pt. 225).

7. *See id.* at 45,296.

8. *See id.* The Order lists the coverage of the Operating Standards as "capital requirements for bank holding company and section 20 subsidiary; internal controls; interlock restrictions; customer disclosure; credit for clearing purposes; funding of securities purchases from a section 20 affiliate; reporting requirement; and application of sections 23A and 23B to foreign banks." *Id.* at 45,297.

9. *See id.*

10. *See infra* notes 14-36 and accompanying text.

11. *See infra* notes 37-159 and accompanying text.

12. *See infra* notes 160-90 and accompanying text.

13. *See infra* note 191 and accompanying text.

14. 12 U.S.C. § 377 (1994). The Glass-Steagall Act (Glass-Steagall) was part of the Banking Act of 1933. *See* THOMAS L. HAZEN, THE LAWS OF SECURITIES REGULATION § 19.5 (3d ed. 1996).

enacted in the wake of the Great Depression, mandates that a member bank of the Federal Reserve System is barred from affiliation with any company that is "engaged principally" in underwriting and dealing in securities.[15] At the time of Glass-Steagall's enactment, the financial industry, indeed the entire country, was reeling from an economic meltdown that some attributed, at least in part,[16] to the involvement of traditional banks in the underwriting and dealing of securities.[17] Modern studies of the Great Depression, however, reveal that the logic behind Glass-Steagall's enactment may have been fundamentally flawed.[18]

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15. *See* 12 U.S.C. § 377.

16. Whether one takes the position that bank practices contributed to the 1929 Crash or that banks merely were not immune to the tolls exacted on any other sector of the economy, the effects of the Crash upon banks, and the repercussions which followed, cannot be denied. "The great number of banks in the hands of receivers created a situation in which a very large number of persons were unable to meet their obligations or to get the use of their funds." Vincent Di Lorenzo, *Public Confidence and the Banking System: The Policy Basis for Continued Separation of Commercial and Investment Banking*, 35 AM. U. L. REV. 647, 654 n.30 (1986). *See generally* Don More, Note, *The Virtues of Glass-Steagall: An Argument Against Legislative Repeal*, 1991 COLUM. BUS. L. REV. 443 (arguing that retaining Glass-Steagall is central to the stability of U.S. banking).

17. The sentiment of the times is best captured by recalling the words of Sen. Glass:

> In large degree, the (Federal Reserve) system has been transformed into an investment banking system, whereas the fixed purpose of Congress was to set up a commercial banking system and to preclude speculative operations .... Let me tell (the) Senators the meaning, and, in the last analysis, the result of that sort of administration of the law. It means that a member bank may engage in any sort of speculative business it may please, and then, when its reserve in the Federal Reserve Bank is impaired, it may take its eligible paper for rediscount and use the credit and the currency thus afforded to reestablish its reserve, and not to relend for commercial, industrial, or agricultural purposes .... It was never intended that its facilities should be used for any investment purposes, or for speculative purposes, in that roundabout way.

Di Lorenzo, *supra* note 16, at 657-58 n.45 (quoting 75 CONG. REC. 9,884 (1932)).

18. *See* William E. Isaac & Melanie L. Fein, *Facing the Future: Life Without Glass-Steagall*, 37 CATH. U. L. REV. 281, 286 (1988). In 1988, a presidential task force studying the Great Depression reported the following:

> [T]he condition of the banking system seems to have followed rather than led the decline in the level of real economic activity.... [T]he Great Depression appears to have been caused not by the stock market Crash but by the interaction of a number of diverse circumstances (such as the declines in agriculture and housing) and misguided policies (such as the Smoot-Hawley Tariff, the tight monetary policy in late 1931 and the tax increase in the summer of 1932). Thus, as long as a similar set of circumstances and policy initiatives are avoided, a comparable economic contraction should remain only a remote possibility.

Id. at 286 n.22 (quoting PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS, REPORT, Consequently, some believe that a large portion of the regulatory structure that exists today, which was spawned in the post-Depression New Deal era, is derived from a misinterpretation of history.[19] Indeed, the current Chairman of the Federal Reserve Board, Alan Greenspan, seems to favor this view.[20]

Nevertheless, many commenters favor a continued separation of investment and commercial banking based on one of two major thought paradigms; the first is the subtle hazards theory. This theory concerns itself with the possibility of a liquidity shortfall in the wake of undermined public confidence in the banking system.[21] This theory finds support from the "prisoner's dilemma"[22] hypothesis

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STUDY VIII: A COMPARISON OF 1929 AND 1987 at VIII-3, VIII-10 (1988)).

19. *See id.* at 287. *Cf.* Robert M. Garsson, *Most Major Nations Are Said to Permit Securities Underwriting Within Bank*, AM. BANKER, Oct. 6, 1995, at 2 (describing a report that found only four of forty-six nations [Japan, South Korea, Singapore, and the United States] required underwriting affiliates to be separate from their parent banks and subject to firewall regulations).

20. *See* Isaac & Fein, *supra* note 18, at 287. Professors Isaac and Fein quote current Federal Reserve Board Chairman Alan Greenspan as stating: "[R]esearch over the past 50 years concludes, contrary to Congress' view at the time, that bank securities activities were not a cause of the Great Depression and that banks with securities affiliates did not fail in proportionately greater numbers than banks more generally." *Id.* at 287 n.23 (quoting *The Financial Modernization Act of 1987 and the Financial Services Oversight Act: Hearings on S. 1886 and S. 1891 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 2-11 (1987) (testimony of Alan Greenspan, Chairman, Federal Reserve Board)).

21. *See* Investment Co. Inst. v. Camp, 401 U.S. 617, 630-31 (1971) ("[Commercial bank involvement in securities activities] places new promotional and other pressures on the bank which in turn create new temptations. For example, pressures are created because the bank and the affiliate are closely associated in the public mind, and should the affiliate fare badly, public confidence in the bank might be impaired."); *see also* Di Lorenzo, *supra* note 16, at 667. This argument is not premised on actual financial soundness, but perception:

> The viability of banking institutions depends not only on long-term profitability, but on public perception of profitability and safety. Without this public perception, banks immediately experience customer risk aversion: an unwillingness to leave funds on deposit. As a result, they may suffer a liquidity crisis (which produces insolvency), even though prospects for long-term profitability remain positive.

Id.

22. *See* David G. Odel, *Puzzling Banking Law: Its Effect and Purposes*, 67 U. COLO. L. REV. 477, 523 (1996). The prisoner's dilemma is described as follows:

> [I]solated individuals, if faced with a one-time prospect of either choosing to act on faith that another isolated individual will act harmoniously or choosing to act without relying on the other isolated individual to act harmoniously, will rationally choose the latter even if the rewards for harmonious action are known by both isolated parties to be higher.

Id. at 523 n.137.

which, applied in the "bank run" context, theorizes that individual depositors have an incentive to withdraw funds if there is even a hint of possible insolvency.[23] The proponents of this line of thought assert that the fungible nature of bank operations, at least to individual depositors, makes it particularly vulnerable to liquidity insolvency, since the bulk of those funds can be withdrawn on demand.[24] The advocates of the subtle hazards doctrine find support for their view of a potential liquidity crisis from a snapshot comparison of bank activities during the Great Depression and the present time, which reveals a similarity in bank asset allocation.[25] Although deposits have been somewhat diminished as a liability on banks' balance sheets,[26] the subtle hazard contingent would argue that such a liquidity crisis, conjuring images of the bank run[27] in "It's a Wonderful Life,"[28] remains a distinct possibility.

The second argument against the collapse of the partition between commercial and investment banking is that the enhanced equity capital[29] made available to investment banks that associate

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23. *See id.* at 523. Professor Odel describes a bank run as follows:

> Depositors know that banks maintain only a fraction of their deposits in reserve to facilitate routine payment functions and occasional depositor withdrawals. If depositors believe that an economic harm is likely to befall the bank or its customers that might later render the bank insolvent, individual depositors have an incentive to withdraw their funds first. If many depositors run to the bank to beat one another in a withdrawal race, however, those depositors can collectively hasten a bank's demise.

Id.

24. *See* Di Lorenzo, *supra* note 16, at 667.

25. *See* Odel, *supra* note 22, at 523. A direct comparison demonstrates the similarity in commercial banks' asset allocation: "For instance, 57.8% of all commercial bank assets were held in the form of loans in 1929, compared with 56.23% of commercial bank assets in 1993; 21.9% of commercial bank assets in 1929 were invested in securities, compared with 25.38 % in 1993." *Id.* at 523-24 n.139 (quoting BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES 1021 (1989); Profit and Balance Sheet Developments in U.S. Commercial Banking in 1993, 80 Fed. Res. Bull. 483, 498 (1994)).

26. *See id.* at 523-24. In 1929, the liabilities of commercial banks from customer deposits was 79%, but by 1993 they had dipped to 60%. *See id.* at 524 n.140.

27. *See id.* at 523; *see also supra* note 23 and accompanying text.

28. IT'S A WONDERFUL LIFE (Liberty Films 1946).

29. *See* Nationsbanc Montgomery Securities Addendum to the 1997 Annual Report, *supra* note 2. Addressing the enhanced financial resources of Montgomery Securities upon its acquisition by NationsBank: "Our global distribution of equities and large block trading will continue to distinguish us in the marketplace. *But with the backing of $21 billion in equity capital, we will expand stock and bond trading. . . .*" *Id.* (emphasis added).

with major BHCs exacerbates the speculative nature of the stock market and increases the likelihood of a painful crash.[30] Referring back to the 1920's, advocates of this viewpoint assert that bank involvement in equities diverted large amounts of America's financial resources to the stock market, and created the frothy speculation that preceded the 1929 Crash.[31] Like the proponents of the subtle hazards theory, this group of dissenters to the convergence of commercial and investment banking maintains a remedial goal of limiting banks to their traditional commercial banking function as providers of credit.[32]

The supporters of increased commercial bank participation in investment banking activity, conversely, assert that bank involvement in securities activities before the Depression was not the cause of the Crash.[33] Therefore, they argue that the premise behind separating investment and commercial banking is, to a large extent, a fallacy.[34] Furthermore, they assert that insistence upon an artificial separation of commercial and investment banking, wrought by a cumbersome, repetitive scheme of regulations, does nothing but decrease the competitiveness of banks in an ever-demanding financial marketplace.[35] Supporters of increased bank powers claim that banks have already been assaulted by intrusions into many of their traditional domains,[36] warranting a corresponding entry of banks into the securities business to meet the diverse demands of customers.

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30. *See* More, *supra* note 16, at 441.

31. *See id.* at 441-42.

32. *See id.* at 440; *see also* Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 716-17 (1987). *See generally* Di Lorenzo, *supra* note 16, at 649-57.

33. *See* Isaac & Fein, *supra* note 18, at 285.

34. *See id.* at 285-90.

35. *See id.* at 281; *see also Avoid Firewalls That Are Too Strong, Volcker Tells Banking Committee*, 64 Banking Rep. (BNA) 732 (1995) (reporting that "[former Federal Reserve Board Chairman Paul Volcker] said that having firewalls that completely insulate the commercial bank from the investment bank operations in an affiliated group will frustrate financial institutions' attempts to capitalize on economic synergies and organizations' desire 'to operate as a coherent whole.'").

36. Non-traditional depositor options, such as money market funds, have proliferated among broker dealers, including on-line securities brokers, resulting in a diversion of billions of dollars from the traditional holder of deposits, banks. *See* Joseph M. Heppt, Note, *An Alternative to Throwing Stones: A Proposal for the Reform of Glass-Steagall*, 52 BROOK. L. REV. 281, 297 (1986).

III. THE NEW OPERATING STANDARDS FOR SECTION 20 SUBSIDIARIES

A. *Background*

The Glass-Steagall Act[37] prohibits a member bank of the Federal Reserve System from being affiliated with a company that is "engaged principally" in underwriting and dealing in securities that the bank itself would be ineligible to deal in or underwrite.[38] Since 1987, the Board has promulgated a series of orders which allow bank holding companies (BHCs) to establish section 20 subsidiaries[39] to engage in activities which the BHC itself can not. While providing the BHCs access to securities activities, the Board also established limitations on such activities.[40] The bulk of these limitations, or firewalls, were adopted in the Board's first Order allowing BHCs, through their section 20 subsidiaries, to underwrite and deal in commercial paper, municipal bonds, and related securities.[41] Other firewalls were added in 1989 when the Board announced that the section 20 subsidiaries could underwrite and deal in all varieties of equity and debt securities.[42] The restrictions were instituted to

37. 2 U.S.C. § 377 (1994).

38. *See id.*

39. Section 20 subsidiaries are investment banking firms that "engage in activities associated with securities underwriting, making a market in securities, and arranging mergers, acquisitions and restructuring. . . . Investment banking also includes the services of brokers or dealers in secondary market transactions. . . ." James R. Smoot, *Bank Operating Subsidiaries: Free at Last or More of the Same?* 46 DEPAUL L. REV. 651, 657 n.24 (1997) (quoting ENCYCLOPEDIA OF BANKING AND FINANCE 661 (Charles J. Woelfel ed., 10th ed. 1994)).

40. *See* H. Rodgin Cohen, *Section 20 Affiliates of Bank Holding Companies*, 1 N.C. BANKING INST. 113, 114-15 (1997); *see, e.g.*, J.P. Morgan & Co., 75 Fed. Res. Bull. 192 (1989); Citicorp, 73 Fed. Res. Bull. 473 (1987). A major limitation upon BHCs acquisition of securities firms was the "engaged principally" test, which in 1987 limited the gross revenues of the section 20 subsidiary that could be derived from bank ineligible activities to five percent. *See* Cohen, *supra*, at 114-15. In 1989, the Board raised this limit to 10%; in 1996 the limit was raised to 25%. *See id.* at 115-16; *see also* Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engage in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (1996) (announcing the Board's decision to raise the limit). Although this liberalization is not addressed within the new Operating Standards, it was a watershed event that stimulated the recent proliferation of section 20 subsidiaries. *Cf.* Milligan, *supra* note 5, at 26 (describing several recent BHC acquisitions of securities firms).

41. *See* Regulation Y Amendments, 62 Fed. Reg. 45,295 (1997).

42. *See id.* at 45,296.

prevent the risk associated with the securities industry from being shifted to a federally insured bank, and "to mitigate the potential for conflicts of interest, unfair competition, and other adverse effects that may arise from the affiliation of commercial and investment banks."[43]

On January 8, 1997, the Board proposed to modify the existing firewalls by abrogating some and consolidating others into a new set of Operating Standards.[44] As noted previously, the Board explained that this new scheme would prudently address the need to eliminate unnecessary regulatory compliance burdens, while recognizing the wisdom of retaining the limitations that the Board's experience had indicated was warranted.[45] The Board stated that most of the risk from the alliance of commercial and investment banking is limited by the general BHC regulations, and by the securities laws and regulations of the Securities and Exchange Commission (SEC), National Association of Securities Dealers (NASD), and securities exchanges that apply to every broker-dealer, including section 20 subsidiaries.[46] Nevertheless, the Board declared that it was hesitant to dismantle all of the firewalls, because certain unique dangers inherent in the union of commercial and investment banking were not addressed in any other existing legislative or regulatory scheme.[47] This Comment discusses the previous firewalls in order and explains their status within the new Operating Standards.

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43. *Id.*

44. *See id.*

45. *See id.* at 45,296-97.

46. *See id.* at 45,296; *see also* Jane E. Willis, *Banks and Mutual Funds: A Functional Approach to Reform*, 1995 COLUM. BUS. L. REV. 221, 241-42 (arguing that sections 23A and 23B of the Federal Reserve Act mitigate against the 'subtle hazards' allegedly arising from the combination of commercial and investment banking).

47. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,296-97. To illustrate the need for these very limited but important additions to existing, non-firewall law, the Board provided the example of a customer who might be confused between commercial and investment bank products. *See id.* at 45,296.

B. The Old Firewalls and Their Status Within the New Operating Standards

1. Capital Requirements

Firewall 1(a) required BHCs to maintain adequate capital notwithstanding the funds they invested and treated as capital within their section 20 subsidiary.[48] Firewall 1(b) required the same rule as to credit extended to the section 20 subsidiary.[49] The Board rescinded the requirement that the capital or credit extended to the section 20 subsidiary be deducted from BHC capital, citing the accounting inconsistencies and inconveniences such a practice engenders.[50] The Board decided, however, to retain the requirement that BHCs must maintain adequate capital.[51] The Board also reserved its discretion to intervene, on a case by case basis, to restrict credit enhancements and excess capital flow from the BHC to the section 20 subsidiary.[52] Operating Standard #1 is the result of the Board's attempt at properly balancing the concern that BHCs might engage in overly speculative activities with the interest in promoting financial services competition; it strips away duplicative compliance burdens while retaining a right for Board intervention and requiring banks to maintain adequate capital.[53]

Firewall 2 required that BHCs obtain prior approval from the Board before making any investment in a section 20 subsidiary.[54] This firewall was repealed upon the issuance of the proposal for the new Operating Standards.[55]

Firewall 3 required BHCs to submit to the Board a detailed demonstration of how both the BHC and the section 20 subsidiary

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48. *See id.* at 45,297.

49. *See id.*

50. *See id.* ("The capital deductions (and resulting deconsolidation for regulatory capital purposes) are inconsistent with generally accepted accounting principles (GAAP) and have therefore created confusion and imposed costs by requiring bank holding companies to prepare financial statements on two bases.").

51. *See id.*

52. *See id.*

53. *See id.*

54. *See id.* at 45,298.

55. *See id.*

would maintain adequate capital.[56] In promulgating Operating Standard #1, the Board rescinded the requirement of a capital plan, since upon application for a section 20 subsidiary, liquidity reserves in the new operation will be fully examined by the Board.[57]

Firewall 4 required a section 20 subsidiary to maintain adequate capital "to support its activities and cover reasonably expected expenses and losses in accordance with industry norms."[58] The fear was that a section 20 subsidiary (cognizant of the financial and reputational strength of the BHC that owns it) might allow its capital to be maintained at low levels and rely on the BHC to bail it out, if necessary.[59] The Board rescinded this requirement to the extent that it is inconsistent with the compliance burden other broker-dealers face, such as the SEC's requirement of keeping capital above "early warning" levels.[60] The only compliance in excess of other broker-dealers is that when capital reserves fall below the "early warning requirement," the section 20 subsidiary must notify the

56. *See id.*

57. *See* J.P. Morgan & Co., 75 Fed. Res. Bull. 192 (1989). The Board was initially quite conservative in forming the firewalls, seeking to err on the safe side regarding potential dangers from the affiliation of commercial and investment banking activities. *See id.* However, through a series of orders since 1987, the Board has removed strictures which have proven unnecessary. For example, the Board removed the requirement that banks receive prior approval before any investment in section 20 subsidiary when the Board proposed the new Operating Standards earlier this year. *See id. But see* More, *supra* note 16, at 441. *See generally* Di Lorenzo, *supra* note 16, at 648-57. These commenters take the position that the original intent of the Congress in enacting Glass-Steagall is unequivocal: keep investment and commercial banking separate. *See id.* Thus these commenters believe that retaining firewalls concerning the adequacy of capital, while not going far enough, would be preferable to the continued erosion of the divide between the two activities. *See id.*

58. Regulation Y Amendments, 62 Fed. Reg. at 45,298.

59. *See id.; see also* note 29 and accompanying text. It appears that securities firms will seek to market this newly acquired financial backing as a strength that distinguishes the firms who have merged with a major commercial bank from those which have not. Such pronouncements are a rather ominous development for those who fear the overexposure of commercial bank reserves to the more speculative securities activities of the section 20 subsidiaries, and would appear to reinforce the move towards financial services consolidation.

60. *See* 17 C.F.R. § 240.17a-11(1994) (requiring broker-dealers to comply with strict capital requirements and transmit a report to the SEC within 24 hours of any failure to so comply). This seems to address the concerns of those who urge that the Board might be unable to act to protect depositors until it is too late, assuming that a firm which fails to meet its capital requirements would not also be likely to avoid full and prompt disclosure.

Board as well as the SEC.[61] The Board concluded that since it already measures BHC capital on a consolidated basis that includes the section 20 subsidiaries, the ability of a section 20 subsidiary to leverage its relationship with its parent BHC would be limited.[62]

2. Extension of Credit to the Customers of the Underwriting Subsidiary

Firewall 5 prohibited a section 20 subsidiary from "extending credit or issuing or entering into a stand-by letter of credit, asset purchase agreement, indemnity, guarantee, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of a bank ineligible securities issue underwritten or distributed by the underwriting subsidiary."[63] The Board rescinded this firewall, reasoning that this is the very type of excessive regulation that hampers the ability of BHCs to be full service financial services providers.[64] In addition, the Board pointed to existing overlaps with non-firewall protections, including the requirement that BHCs must hold capital to cover credit enhancements given to the customers of its section 20 subsidiaries[65] and the requirement that such extensions of credit must be on market terms after a careful, independent credit evaluation, rather than

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61. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,298. A respondent to the Board's solicitation of public comments urged the Board to adopt the SEC rule on the rationale that capital reserves vary greatly from firm-to-firm and from day-to-day, concluding that a minimum rather than average standard for capital adequacy for the section 20 subsidiary would be appropriate. Another commenter urged that as a practical matter, the adequacy standard is unnecessary, since section 20 subsidiaries must maintain large amounts of capital so that they can withdraw it when a significant underwriting opportunity arises.

62. *See id.*

63. *Id.*

64. *See id.* at 45,298-99. The Board gave the following example:

> For example, existing corporate customers of the bank may wish to issue commercial paper or issue debt in some other form. Although the bank may refer the customer to its [s]ection 20 affiliate, the bank is prohibited from providing credit enhancements even though it is the institution best suited to perform a credit analysis—and, with smaller customers, perhaps the only institution willing to perform a credit analysis.

Id. at 45,299.

65. *See id.; see also supra* notes 48-53 and accompanying text.

preferentially allocated.[66]

Firewall 6, to a limited extent, prohibited BHCs and their subsidiaries, including section 20 subsidiaries, from financing the purchase of a security which the agent in question knew was being underwritten by the section 20 subsidiary.[67] The limitation extended from the period of the underwriting to thirty days thereafter.[68] In addition, Firewall 6 included situations where the section 20 subsidiary was to be the market maker for the security.[69] This knowledge-based prohibition is known as the "Chinese wall,"[70] which restricts information flow on a "need to know" basis in an

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66. *See* 12 U.S.C. § 371c-1(a)(1) (1994). A bank and its section 20 subsidiary have complied with the "market terms" requirement only when transactions are:

> (A) On terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or (B) [I]n the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, non-affiliated companies.

Id. One need not be a cynic to see the potential for abuse of this "market terms" requirement. When valuation of a security is at issue, it seems likely that many different factors might be considered—and some weighted more heavily than others. This flexibility indicates that the meaning of "market terms" is quite elastic, leaving some room for transactions with favorable terms.

67. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,299. Section 23B of the Federal Reserve Act instructs that the following transactions are covered by the market terms requirement:

> (A) Any covered transaction with an affiliate. (B) The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase. (C) The payment of money or the furnishing of such services to an affiliate under contract, lease, or otherwise. (D) Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person. (E) Any transaction or series of transactions with a third party- (i) if an affiliate has a financial interest in the third party, or (ii) if an affiliate is a participant in such transaction or series of transactions.

12 U.S.C. §371c-1 (a)(2).

68. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,299.

69. *See id.*

70. A Chinese Wall is defined as:

> [A] notional information barrier between the parties of a business, especially between the market making part of a stockbrokerage firm and the brokering part. It would clearly not be in investors interests for brokers to persuade their clients to buy investments from them for no other reason then that the market maker in the firm, expecting a fall in price, were anxious to sell them.

THE OXFORD DICTIONARY FOR THE BUSINESS WORLD 141 (1st ed. 1993).

effort to eliminate conflicts of interest without the need of a burdensome paper trail.[71]

The Board decided to retain most of this firewall and embody it in Operating Standard #6. The new standard, however, no longer prohibits extensions of credit where the section 20 subsidiary is a mere market maker of the security rather than an underwriter.[72] According to the Board, the potential conflict of interest as a market maker was too attenuated to justify the disallowance of credit extensions and to therefore invoke the knowledge-based compliance requirement.[73] Several commenters urged the Board to rescind firewall 6 in its totality, reasoning that as a practical matter, banks would not make a bad loan just to earn a small fraction of those potential losses on the sale of securities.[74] In addition, commenters pointed to existing, non-firewall compliance requirements that they felt duplicated firewall 6.[75] Nevertheless, the Board concluded that

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71. *See* Eric T. Young, *Fall of Section 20 Firewalls Will Raise New Challenges*, AM. BANKER, Sept. 12, 1997, at 3 (suggesting that the move towards greater affiliation of activities should not be taken lightly by those bankers who are responsible for ensuring compliance with the new Standards). Among the new challenges is the implementation of training to address the differences that the "chinese wall/need to know" rules mean, in order to preserve the confidentiality of proprietary client information. *See id.* For example, bankers should not presume that the disappearance of some firewalls allows sharing of all client information. *See id.*

72. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,299. An underwriter acquires and distributes initial issuances of securities whereas a market maker regularly purchases and sells particular securities in the over-the-counter secondary market. *See* HAZEN, *supra* note 14, at §§ 4.24, 10.3 (3d ed. 1996).

73. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,300.

74. *See id.* at 45,299.

75. *See id.* The Board explained:

> Several commenters noted that [s]ection 11(d) of the Securities Exchange Act of 1934 addresses some of the same concerns as firewall 6. Section 11(d) prohibits a broker-dealer (including a section 20 subsidiary) that is acting as an underwriter from extending or arranging credit to customers purchasing the newly issued securities during the underwriting period and for 30 days after the underwriting period. Thus a section 20 subsidiary acting as an underwriter would be prohibited from arranging for an affiliated bank to make loans to customers for purchases during an underwriting period . . . .
>
> Commenters also noted that section 23B of the Federal Reserve Act would apply to loans to fund purchases by customers of securities from a section 20 affiliate during the existence of the underwriting or selling syndicate, and to any loan to purchase a security from the inventory of the section 20 affiliate, including securities in which the section 20 affiliate makes a market.

Id.

the existing non-firewall limitations did not go far enough to address the full range of potential abuses that such credit extensions could engender.[76] However, the Board did heed the urging of a commenter who argued for an exception to the prohibition of extending credit to a customer during the underwriting period and thirty days thereafter while the customer had a preexisting line of credit.[77] The Board attached two qualifications to this exception: "(1) the line of credit [must] not [be] entered into in contemplation of the purchase of affiliate-underwritten securities, and (2) either the line of credit is unrestricted or the extension of credit is clearly consistent with the restrictions imposed."[78]

Firewall 7 prohibited BHCs and their subsidiaries from lending to the BHCs section 20 subsidiary for the purpose of the payment of principal, interest, or dividends on securities.[79] The Board rescinded this firewall, reasoning that the potential conflict of interest that the firewall contemplated, namely the temptation of the BHC to make unwise loans to strengthen the condition of companies which its section 20 subsidiaries had underwritten, is "more attenuated than those present when credit is extended during the underwriting period."[80] In so doing, the Board continued its consistent theme of rescinding firewalls which necessitated extensive compliance costs,[81] but gave little further protection in return. In

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76. *See id.* The Board explained:

> Section 11(d) does not apply to a bank loan unless the loan is arranged by an affiliated broker-dealer, and although section 23B requires the loan to be on market terms, the Board has some concern that during an underwriting period, when the market value of the securities is uncertain, section 23B may not be an adequate protection. In sum, the Board has concluded that existing law is not a complete protection against the conflicts of interest that arise when a bank lends during the underwriting period or for 30 days thereafter.

Id.

77. *See id.*

78. *Id.* at 45,299-300.

79. *See id.* at 45,300.

80. *Id.* The Board believes that once an underwritten company makes it to market, the pecuniary and reputational risks to the section 20 subsidiary are lessened. *See id.*

81. *See id.* For instance, banks formerly faced compliance difficulties in the renewal of credit lines if their section 20 subsidiary was involved in a past underwriting of the company. In such a situation, banks previously had to pursue circuitous, costly mechanisms of credit line renewal, such as recruiting another bank to participate in the process. *See id.*

addition, the Board noted that section 23B of the Federal Reserve Act requires any lending in these circumstances to be on market terms if the section 20 affiliate is a participant in the transaction.[82]

Firewall 8 was an administrative corollary to firewall 7; it required banks to have extensively documented records that provided evidence as to the purpose and intent of the loan to the section 20 subsidiary.[83] The rationale for this firewall was to ensure that the credit was not extended to meet a section 20 subsidiary's ongoing obligations related to the payment of principal, interest, or dividends on a bank-ineligible activity.[84] The Board, consistent with its rescission of firewall 7, considered this requirement superfluous since sections 23A and 23B of the Federal Reserve Act require this extension of credit to be on market terms.[85]

Firewall 9 prohibited the extension of credit for the payment of a thrift's ongoing principal, interest, or dividend obligations on a bank-ineligible activity; like firewall 8, firewall 9 has been rescinded as superfluous.[86] In addition, firewall 10, which restricted credit extensions to parties that are major users of projects financed by industrial revenue bonds, was rescinded on the same grounds as the firewalls that restricted the issuers of such extensions of credit.[87]

Firewall 11 mandated that parent BHCs cause their subsidiary banks to promulgate operating guidelines governing the subsidiary banks' lending activities with the parent bank's section 20 subsidiary.[88] The clear intent of this firewall was to block the evasion by a parent BHC of the strictures of the firewalls by setting up a subsidiary bank to extend credit in situations where the BHC could not. The Board retained this firewall and incorporated it into Operating Standard #2.[89] The Board justified the continuation of this compliance requirement by indicating its concern about abuses arising from an unrestricted relationship between BHC lending

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82. *See id.; see also* 12 U.S.C. § 371 c-1(a)(3) (1994).
83. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,300.
84. *See id.*
85. *See supra* notes 66-67.
86. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,300.
87. *See id.* at 45,301.
88. *See id.*
89. *See id.*

subsidiaries and section 20 subsidiaries.[90]

Firewall 12 required BHCs to devise policies to prevent overexposure to the risks inherent in allocating too many of its assets to a single customer of a section 20 subsidiary.[91] The Board has rescinded this firewall, citing its continuing right to review BHC operations and exposures, and to intervene and demand divestiture of assets overcommitted to a single section 20 subsidiary customer.[92]

3. Interlocking Directors and Officers Restrictions

Firewall 13 prohibited "directors, officers or employees of a BHC from acting as a majority of the board of directors or the chief executive officer of an affiliated section 20 subsidiary, and directors, officers or employees of a section 20 subsidiary from serving as a majority of the boards of directors or the chief executive officer of an affiliated bank."[93] Furthermore, in order to prevent customer confusion regarding the federal insurability of bank deposits but not certain securities options offered by the section 20 subsidiary, the firewall mandated the maintenance of separate offices.[94]

The Board decided to maintain the prohibition on interlocks,[95] citing its symbolic (and possibly legal) importance in maintaining the separate corporate identities of the bank and its section 20

90. *See id.*

91. *See id.*

92. *See id.* Again, the Board demonstrated its preference for stripping away restrictions that are either duplicated elsewhere or whose cost inefficiency undermines competitiveness. It could be asserted, however, that by the time the Board concludes that a maverick bank has overexposed itself, the damage may have already been done. It is this fear that underlies the dissenting subtle hazards school of thought, which postulates that once members of the public know that a bank took a big loss from its exposure to a customer of its section 20 subsidiary, they will quickly withdraw their funds (since to a depositor, banks are fungible), leading to a liquidity crisis at the bank and setting off a possible chain reaction of missed obligations among lenders. *See* Di Lorenzo, *supra* note 16, at 667. This reasoning, however, arguably relies upon a hypothetical public reaction which is irrational because depositor money is protected by Federal Deposit Insurance, the foundational bulwark of bank regulatory policy.

93. Regulation Y Amendments, 62 Fed. Reg. at 45,301.

94. *See id.*

95. Interlocking directors "serve simultaneously on the boards of directors of two or more corporations that have dealings with each other." BLACK'S LAW DICTIONARY 815 (6th ed. 1990).

subsidiary.[96] The Board, however, decided to rescind the separate office requirement,[97] reasoning that this prohibition is already covered by the Interagency Statement on Retail Sales of Non-deposit Investment Products.[98] That statement instructs that retail sales by a section 20 affiliate should be conducted in a physical location that is distinct from the area in which retail deposits are being taken.[99] The Board also indicated that where the sharing of offices is in a non-retail context, the separation of banks from their section 20 subsidiary "serves no purpose and represents a needless expense."[100] The above-described changes will be promulgated as Operating Standard #3.

4. The Disclosure Requirements for Section 20 Underwriting Subsidiaries

Firewall 14 required section 20 affiliates to disclose their alliance with the BHC, including a special statement specifically describing the differences between the two corporations.[101] The key provision was the disclosure that the securities operations of the section 20 subsidiary, unlike the deposits taken by the bank, are not insured.[102] The Board decided to keep this firewall, with slight modifications as a result of replacing the firewall with the provisions found under the Interagency Statement on Retail Sales of Nondeposit

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96. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,301. The result is that the piercing of the bank's corporate veil may be more difficult for the section 20 subsidiary's potential creditors.

97. *See id.*

98. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL DEPOSIT INSURANCE CORPORATION, OFFICE OF THE COMPTROLLER OF THE CURRENCY, AND THE OFFICE OF THRIFT SUPERVISION, INTERAGENCY STATEMENT ON RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS (1994), *available in* WESTLAW, FFIN-FRRS database (FRRS 3-1579.51) [hereinafter INTERAGENCY STATEMENT].

99. *See id.*; Regulation Y Amendments, 62 Fed. Reg. at 45,301.

100. Regulation Y Amendments, 62 Fed. Reg. at 45,301.

101. *See id.*

102. *See id.* The Board related that the firewall instructed that:

> securities sold, offered, or recommended by the underwriting subsidiary are not deposits, are not insured by the Federal Deposit Insurance Corporation, are not guaranteed by an affiliated bank or thrift, and are not otherwise an obligation or responsibility of such a bank or thrift (unless such is the case).

Id.

Investment Products.[103] In addition, the Interagency Statement disclosure requirements will apply to those activities conducted off bank premises.[104] Several commenters challenged this view, arguing that since the purpose of the disclosure requirement was to prevent customer confusion regarding the applicability of Federal Deposit Insurance to their securities activities, the maintenance of separate locations should be sufficient to properly inform the customer.[105] However, the Board thought it judicious to always inform the retail customer of the implications of dealing with the separate entities including, most importantly, the absence of Federal Deposit Insurance for section 20 investments.[106] The amended firewall will be incorporated into Operating Standard #4.

5. Restrictions on Marketing Activities on Behalf of Underwriting Subsidiary

Previously, firewall 15 prohibited advertisements by the section 20 subsidiary or any affiliated bank that expressly or implicitly indicated that the parent BHC or a subsidiary bank would be responsible for any losses by the section 20 subsidiary.[107] The Board has rescinded this firewall,[108] indicating that it is duplicated by section 23(B) of the Federal Reserve Act.[109] Firewall 16, which restricted cross-marketing and agency activities by banks, was rescinded in 1996.[110]

103. *See id.* at 45,301-02; *see also* INTERAGENCY STATEMENT, *supra* note 98. Operating Standard #4 will be both narrower and broader than the existing firewall. It will be narrower in that the disclosure will not be required to institutional investors (whose level of sophistication makes such disclosure requirements wasteful) and broader in that the Interagency Statement requires an acknowledgment of the required disclosure by the retail customer. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,301-02.

104. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,301-02.

105. *See id.* at 45,302.

106. *See id.*

107. *See id.*

108. *See id.*

109. *See id.*; *see also* 12 U.S.C. § 371 c-1(c) (1994) ("A member bank or any subsidiary or affiliate of a member bank shall not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates.").

110. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,302; *see also* Review of Restrictions on Director, Officer and Employee Interlocks, Cross-Marketing Activities, and the Purchase and Sale of Financial Assets Between a Section 20 Subsidiary and an

6. Restrictions on Investment Advice

Firewall 17 prohibited a BHC from expressing an opinion on the value of bank-ineligible securities that were either underwritten by or dealt in by the BHCs section 20 subsidiary, unless the BHC revealed the nature of its relationship to the customer.[111] The Board decided to retain this firewall with an important alteration: the evaluation of a particular security by a bank employee is not prohibited unless that employee has knowledge of the section 20 subsidiary's involvement in the security.[112] Thus the Chinese wall theory[113] will govern; sensitive information will be divulged to employees on a "need to know" basis to avoid the problems associated with updating every bank employee about each transaction in which the section 20 subsidiary is involved.[114] Again, the Board is being sensitive to the efficiency needs of banks, while simultaneously recognizing the inherent potential of conflicts of interest. These changes will be incorporated into Operating Standard #4.

Firewall 18 restricted BHCs and their subsidiaries from purchasing securities for a period of sixty days if their section 20 subsidiary was the underwriter or a market maker in that security for an unlimited period, unless the contractual agreement expressly provided authorization for such purchases.[115] The Board rescinded this firewall, citing overlap with section 23B(b)(1)(B) of the Federal Reserve Act which prohibits the same activities when a bank or thrift is making the purchase.[116] Unlike previous firewall 18, section 23B does not extend the prohibition for sixty days past the underwriting period.[117] Furthermore, section 23B does not apply to BHCs or their non-bank subsidiaries when they buy securities in a fiduciary

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Affiliated Bank or Thrift, 61 Fed. Reg. 57,679, 57,683 (1996) (rescinding firewall 16).

111. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,302.

112. *See id.*

113. *See supra* note 70.

114. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,302.

115. *See id.* at 45,302-03.

116. *See id.* at 45,303; *see also* 12 U.S.C. § 371 c-1 (b)(1)(B)(1994).

117. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,303.

capacity.[118] Noting these differences, the Board explained that other regulations which prohibit such activities will apply if the entity is purchasing on behalf of a pension fund (when ERISA[119] will apply), or on behalf of a mutual fund (governed by sections 10 and 17 of the Investment Company Act of 1940[120]). Thus the Board believes adequate safeguards will remain.[121]

7. Restrictions on Extension of Credit and Purchases and Sales of Assets

Firewall 19 prohibited BHCs and their subsidiaries from buying bank-ineligible securities underwritten by a section 20 subsidiary or affiliate.[122] The firewall was intended to block a section 20 subsidiary from dumping an unattractive issue on its affiliates.[123] In practice, however, affiliated banks were denied access to all offerings placed through their section 20 subsidiaries, while unaffiliated banks could pick and choose the offerings with the most potential; this disparity created a disincentive to underwrite the more attractive offerings.[124] Citing section 23B of the Federal Reserve Act as an appropriate limitation that adequately balances the potential conflict of interests with the bank's desire to make legitimate securities purchases, the Board rescinded firewall 19.[125] In addition, the Board noted that since 1989, banks have been allowed to place up to fifty percent of an issue of securities underwritten by their section 20 subsidiary with their non-bank affiliates, and no known abuses

118. *See id.*

119. Employees Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1002(21), 1104 (1994).

120. 15 U.S.C. §§ 80a-10, 80a-17 (1994).

121. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,303.

122. *See id.*

123. *See id.*

124. *See id.* The prohibition extended to all issues, removing from consideration those issues which even from the most conservative view were objectively attractive. *See id.*

125. *See id.* The Board related that section 23B "prohibits a bank from purchasing any security for which a section 20 affiliate is a principal underwriter during the existence of the underwriting or selling syndicate," unless such a purchase has been approved by a majority of the bank's disinterested directors. *Id.* In addition, section 23A requires the bank to hold capital against any such purchases, and limits such bank purchases to investment grade securities. *See id.; see also* 12 U.S.C. § 371 (1994).

have been recorded.[126] As it had done with other old firewalls, the Board has stripped away an artifice that was duplicated, to a large extent, by preexisting regulation. Moreover, the Board continued their emphasis on a "market terms" requirement in any such transaction.[127]

Firewall 20 prohibited a section 20 subsidiary from either underwriting or making a market in any bank-ineligible security that was issued or represented an interest in any of its affiliates, unless the security was rated by an independent rating organization or guaranteed by Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), or Government National Mortgage Association (GNMA).[128] The Board rescinded this firewall, citing a similar NASD rule which requires compliance by any broker-dealer section 20 subsidiary as an adequate safeguard to combat unjustified bank purchases.[129] Once again, the Board demonstrated its disdain for unnecessary, overlapping compliance burdens, which add transaction costs that detract from a bank's competitiveness.

Firewall 21 was a broad ban on extensions of credit to a section 20 subsidiary by the BHC or any other affiliate of the section 20 subsidiary.[130] This firewall was designed to prevent a BHC from attempting to bail out imprudent underwritings of their section 20 subsidiary.[131] The concern was that absent such a firewall, a BHC might make unwise extensions of credit, which directly conflict with

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126. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,303.

127. *See id.*

128. *See id.* For general information about the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA), see *Fannie Mae's Past and Future* (visited Mar. 1, 1998) <http://www.fanniemae.com/Homebuyer/House_Am/ha_hist1.html>; *Ten Frequently Asked Questions About Freddie Mac* (visited Mar 1, 1998) <http://www.freddiemac.com/tenquest.htm#1)>; *Guides to the Programs of HUD's GNMA (Government National Mortgage Association* (visited Mar. 1, 1998) <http://www.hud.gov/local/mil/wisggnma.html>.

129. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,303 (citing NASD Rule 2720 (1997) (providing three requirements: (1) the security must be independently grade-rated, (2) the price or yield of the security must also be set by an independent entity, and (3) if the security is an equity security, there must be an independent secondary market in such security)).

130. *See id.* at 45,303-04.

131. *See id.* at 45,304.

its fiduciary duty to depositors.[132] The Board rescinded this firewall, except that to the extent intra-day (same day) credit extensions are made, they must be made on market terms.[133] The revised provision will be known as Operating Standard #5.[134] In addition, the Board noted that existing rules within section 23A will still govern.[135] Operating Standard #8 adopts identical provisions to Operating Standard #5, but in the context of foreign bank extensions of credit.[136]

Firewall 22 prohibited a BHC from purchasing the financial assets of a section 20 subsidiary, or selling bank assets to the subsidiary; the only exception was for assets which possessed publicly-available market value quotations, which would ensure the transaction was on market terms.[137] The concern was that absent such a restriction, this asset sale situation would provide a funding opportunity that undermined the purposes of firewall 21, which had prohibited direct credit extensions.[138] The Board has rescinded this firewall, again relying on section 23A of the Federal Reserve Act to set quantitative limits on such transactions, to prohibit the purchase of a low quality assets from an affiliate, and to require such purchases to be on market terms.[139] The Board sounded a note of caution, however, by instructing section 20 subsidiaries that relying solely upon the BHC for funding is an imprudent decision.[140]

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132. *See id.*

133. *See id.*

134. *See id.*

135. *See id.; see also* 12 U.S.C. § 371 (1994). The Board stated that a bank: [w]ill still have to deal with the [s]ection 20 affiliate on market terms, will be prohibited from purchasing low-quality assets from the affiliate,and will be prohibited from purchasing securities underwritten by a [s]ection 20 affiliate during the existence of the underwriting or selling syndicate period unless a majority of the bank's outside board of directors approves. Regulation Y Amendments, 62 Fed. Reg. at 45,304.

136. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,307.

137. *See id.* at 45,304-05.

138. *See id.* at 45,305.

139. *See id.; see also* 12 U.S.C. § 371.

140. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,305. The Board provides unsolicited financial advice by noting: "[A]s a safety and soundness matter, [the Board] generally emphasizes that [s]ection 20 subsidiaries should develop diverse funding sources. Thus, a [s]ection 20 subsidiary should not rely on repurchase agreements with an affiliated bank as its sole funding source." *Id.*

8. Limits on the Transfer of Information

Firewall 23 prohibited a BHC from disclosing any nonpublic customer information to any of its subsidiaries, including its section 20 affiliate, unless the customer in question specifically consented to such transfer of information.[141] The Board had proposed to retain this provision, but decided to rescind it in response to extensive dissent to the firewall by commenters who argued that BHCs were being put at a competitive disadvantage by the requirement.[142] The Board pointed to existing rules that prevent abusive practices in such exchanges of information, including the Fair Credit Reporting Act[143] and state consumer privacy statutes,[144] as providing adequate protection in the absence of such a firewall.[145]

9. Reports Required by the Federal Reserve Board

Firewall 24 required BHCs to submit quarterly reports to the Federal Reserve; these reports had to include extensive information regarding the activities of the BHCs section 20 subsidiary.[146] Continuing in its theme of disclosure and vigilant monitoring of section 20 subsidiaries, the Board decided to retain this provision, which now will be known as Operating Standard #7.[147]

10. Scope of an Approval of Section 20 Subsidiary

Firewall 25 limited the scope of an order approving a section 20 subsidiary to the specific approval sought in the application.[148] The firewall stated that the Board must reevaluate any revised structure of the BHC and its subsidiaries, since otherwise further

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141. *See id.*

142. *See id.* The Board was persuaded that investment banks who were unaffiliated with a bank were gaining the access through participation in joint-lending operations, and that such a rescission was necessary to level the playing field between banks with section 20 subsidiaries and those without. *See id.*

143. 15 U.S.C. § 1681 (1994).

144. *See, e.g.*, N.C. GEN. STAT. § 53B (1994).

145. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,305.

146. *See id.*

147. *See id.*

148. *See id.*

corporate structural changes might be misunderstood as falling within the initial approval.[149] The Board decided to rescind this firewall, explaining that individual notices of approval are sufficiently detailed to clearly enunciate the extent of Board approval.[150]

11. Limits on Reciprocal Arrangements and Discriminatory Treatment

Firewall 26 prevented BHCs and their subsidiaries from agreeing with other banks or their subsidiaries to enter into any arrangement designed to evade firewalls or any other regulatory requirement.[151] The Board decided to rescind this firewall, citing section 106 of the Bank Holding Company Act Amendments of 1970[152] as containing a special per se prohibition on such reciprocal arrangements.[153]

Firewall 27 prohibited BHCs from extending more favorable terms to an affiliated section 20 subsidiary than to a competitor of its section 20 subsidiary.[154] The Board rescinded this firewall, citing existing prohibitions on discriminatory dealings and the recently enhanced ability of investment banks to obtain credit[155] as sufficient to mitigate such activities.[156]

12. Infrastructure Review Prior to Commencement of Section 20 Activities

Firewall 28 required a comprehensive Board review of a

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149. *See id.*

150. *See id.*

151. *See id.*

152. 12 U.S.C. § 1972(1) (1994).

153. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,305.

154. *See id.* at 45,306.

155. *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 104(b)(1), 110 Stat. 3423 (1996) (repealing § 8(a) of the Securities Act of 1934, 15 U.S.C. § 78h(a) (1994), which restricted investment bank funding sources to commercial banks and other broker-dealers).

156. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,306. For example, the Board pointed to section 106 of the Bank Holding Act Amendments of 1970, which prohibits banks from conditioning the availability of a particular discount on the customer's agreement not to deal with the bank's competitors. *See id.* (citing 12 U.S.C. § 1972(1) (1)).

BHCs entire infrastructure before approval was granted to begin any bank-ineligible operations through a section 20 subsidiary.[157] The Board decided against incorporating such a broad inspection into an operating standard, but the Board retained its right of general oversight. Thus the Board will continue to examine the institutions in light of the specific application at hand.[158] The new review process, by focusing on the proposed affiliation itself, will be much more efficient than an all-inclusive review of each firm's financial details. This comports with the Board's commitment to provide an efficient path to approval and consummation of section 20 subsidiary operations.[159]

IV. ANALYSIS

The Board, in promulgating the new Operating Standards, followed several themes, both stated and implied. These themes represent the doctrinal priorities of the Board, our nation's financial gatekeeper. This Section will describe the stated and implied objectives of the revised regulations, and will examine how these themes are applied in each of the Operating Standards.

A. Objectives of the Operating Standards

The Board summarized its overall theme in promulgation of the Operating Standards when it described its desire to "eliminat[e] those restrictions that have proven to be unduly burdensome or unnecessary in light of other laws or regulations."[160] For example, firewall 8, which required bank holding companies (BHCs) to adopt policies and procedures for extensions of credit to their section 20 subsidiaries, met its demise on the grounds that section 23A of the Federal Reserve Act[161] already required such extensions of credit to be on market terms.[162] The purpose of this and other changes to the

157. *See id.*
158. *See id.*
159. *See id.*
160. *Id.* at 45,295.
161. 12 U.S.C. § 371c-1 (1994).
162. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,300.

old firewalls was to increase the competitive position of BHCs in delivering a wider range of financial options to their customers by reducing unnecessary compliance costs.[163]

In addition, the Board followed several unstated themes in refining its regulations. First, the changes imply that the Board believes that sunlight is the most powerful disinfectant. That is, the Board apparently feels that open disclosure is a valuable weapon against potential abuses, as evidenced by the promulgation of Operating Standard #4.[164] That standard requires (1) an explanation to the customer of the differences between traditional bank products and investment bank products, and (2) disclosure that the BHCs section 20 subsidiary was involved in an issue's underwriting or market making whenever a bank employee with knowledge of such a connection recommends such securities.[165]

Second, the Board evidently believes that compliance with "market terms" can be the vaccine for abusive possibilities in the section 20 relationship.[166] Yet two contrary arguments may be asserted that such a reliance is misplaced. First, in the securities context, value (or price) is a relative factor, mobile at every second and measurable by differing valuation standards. It seems possible that such a yardstick might be too skittish a standard to gauge compliance, especially when market terms are being set by the very institution tempted to exploit such an expansive standard. Second, the Board's retention of a strict prohibition against certain activities, as where a bank lends during the underwriting period or thirty days thereafter,[167] demonstrates its recognition that reliance on the market

163. *See id.* at 45,296; *see also* Patricia A. McCoy, *The Notional Business Judgment Rule in Banking*, 44 CATH. U. L. REV. 1031, 1044 (1995) (asserting that the loosening of restrictions on BHCs involvement in securities activities resulted from the presence of securities firms in traditional banking activities).

164. *See supra* notes 101-06 and accompanying text.

165. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,301-02.

166. Throughout the Operating Standards, this often is the default policing mechanism that the Board embraces. *See, e.g., supra* note 66 and accompanying text (dismantling firewall 5 restriction on credit enhancements); *supra* note 82 and accompanying text (removing firewall 7 restriction on extension of credit for repayment of underwritten securities). *But see supra* note 66 (detailing the market terms requirement and the inherent potential for its exploitation). This indeed is one area where the Board must remain continually vigilant.

167. *See supra* notes 67-78 and accompanying text (retaining firewall 6 as Operating Standard #6).

will not always adequately address potential abuses in the section 20 relationship. This view, however, can be countered by the assertion that the most effective deterrent to aberrant bank behavior is our swiftly punitive equity market. In other words, investors in the BHCs stock, who are quite naturally interested in the preservation and enhancement of their own wealth, will adequately motivate a BHC to wisely allocate capital. Since BHCs do not wish to see an unforgiving assault on their stock market value, they are likely to respect shareholder concerns about unfair transactions.

B. The Board's Objectives in the Context of the Operating Standards

Operating Standard #1 delineates the capital requirements for banks and their section 20 subsidiaries. In creating the new standard, the Board rescinded the rule that BHCs must deduct the capital they invest in their section 20 subsidiary, but maintained a capital adequacy requirement and reserved the right of the Board to intervene in the event of unduly speculative investment.[168] This Standard is representative of the Board's stated desire to strip away cumbersome regulations, which undermine BHCs competitiveness in the delivery of financial services by increasing BHCs regulatory compliance costs.[169]

Importantly, the Board correctly balanced this efficiency concern with the realization that "subtle hazards"[170] are still possible, by requiring BHCs to maintain adequate capital.[171] This comports with the concern that BHCs with unbridled discretion might be tempted to pass too much capital to their section 20 subsidiary, making the BHC vulnerable to sudden, large withdrawal demands. Advocates of the subtle hazards theory, however, would urge that this Standard only operates in the context of a stable marketplace.[172] They theorize that in the event of a massive stock market decline, a "capital adequacy" standard will be too passive to stem a run on

168. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,306.
169. *See id.* at 45,295-96.
170. *See supra* notes 21-28 and accompanying text.
171. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,297.
172. *See supra* notes 21-28 and accompanying text.

banks who are overexposed to stock market risks.[173] However, the banking system cannot be presumed to be immune from the losses encountered in a broad-based market decline. To burden BHCs with compliance costs based upon the speculative fear of a substantial market decline ignores the reality that BHCs must compete with firms unsaddled by these encumbrances. Thus, Operating Standard #1 properly balances the concern regarding overly speculative activities with the interest in promoting financial services competition, by stripping away unduly burdensome compliance measures while retaining a right for Board intervention and requiring banks to maintain adequate capital.

Despite the prudence of this measure, one can see the conflict that it presents with the Board's desire to let the marketplace be the ultimate check on BHC policy. In other words, why not let the market influence BHCs to properly allocate their resources, by decreasing the BHCs stock value in the event of imprudent investment of bank capital? The Board, however, thought it necessary to bolster this market incentive with a minimal adequacy requirement and a right of intervention.[174] This is a prudent decision: it gives BHCs discretion in investment decisions, but only when backed by a strong capital reserve. The requirement also serves as a constant reminder that the Board retains its right to peer over BHCs shoulders to ensure that depositors' money is not exposed to unnecessary risk.

Operating Standard #2 embodies the internal controls requirement retained from firewall 11. The Standard requires a section 20 subsidiary to construct detailed procedures governing borrowing from its parent BHC.[175] The Board adopted this measure to prevent circumvention of the strictures on BHCs lending practices through bank subsidiaries formed to effectuate the same activities.[176] Although this seems to be a reasonable measure since compliance will not require anything beyond adherence to the rules applicable to the parent BHC, the Standard adds unnecessary costs by requiring

173. *See supra* notes 21-28 and accompanying text.

174. *See supra* notes 51-53 and accompanying text.

175. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,307; *see also supra* notes 63-92 and accompanying text.

176. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,301.

banks to promulgate operating guidelines when a simple direction from the Board that the rules apply to all subsidiaries might suffice. However, while creating operating guidelines will surely require banks to expend some resources in the beginning, the costs will not be continuous since the guidelines would likely be applicable to all of the BHCs subsidiaries.

Operating Standard # 3 restricts the interlocking of the BHC and its section 20 subsidiary.[177] The Board's decision to retain this restriction represents a desire that BHCs and their section 20 subsidiaries retain individual corporate identities, thereby reducing the chance of piercing the corporate veil and preventing unduly tempting conflicts of interest.[178] Although as a practical matter the BHC will ultimately provide directional mandates, it is reasonable to limit the chance that an aggrieved customer of a section 20 subsidiary will be able to recover a judgment against the parent BHC.

Significantly, the Board rescinded the requirement from firewall 13 that the section 20 subsidiary retain a separate office. The Board reasoned that reliance on the Interagency Statement on Retail Sales of Non-Deposit Investment Products,[179] which mirrors the requirements of former firewall 13, would suffice.[180] A likely quarrel with this revision, however, is that the Interagency Statement requires that retail sales by a section 20 subsidiary be conducted in a location that is only physically distinct from where retail deposits are taken; thus, depository transactions and section 20 retail sales could take place under the same roof. Critics might argue that this creates confusion over the difference between insured deposits in the bank and uninsured investments with the section 20 subsidiary. The Board, however, certainly weighed this "subtle hazard" against the efficiency goals of the Standards, and decided that the disclosure requirements of Operating Standard #4, discussed below, would provide adequate protection for this concern. This approach is indicative of the Board's theme that disclosure is the answer for "subtle hazard"-type concerns; that is, if consumers can be

177. *See id.* at 45,307.
178. *See id.* at 45,301.
179. INTERAGENCY STATEMENT, *supra* note 98.
180. *See id.*; *see also supra* notes 97-100 and accompanying text.

adequately protected through being informed, why add a compliance burden that increases transaction costs for banks, thereby undermining their competitiveness?

Operating Standard #4, which in large part retains the customer disclosure requirements of firewall 14,[181] represents the tension between the reduction in compliance costs and the Board's continued concern that consumers realize the implications of placing their funds with a section 20 subsidiary rather than in a traditional bank account. While it does seem prudent to disclose the differences to customers, one can argue that such a disclosure is unnecessary when the section 20 subsidiary is located off the premises of the parent BHC. Unaffiliated investment banking firms, the major source of competition to the section 20 subsidiaries, do not have to roll out such disclosures, and thereby do not provide as full of a picture of associated "risk" as do affiliated firms. For example, if a customer visits investment banking firm A, an affiliate of a BHC, and is subjected to a litany of risk disclosures, it is quite conceivable that the same customer might not be as likely to purchase a financial product or service as he or she would if these "risks" were not disclosed, which would be the case at unaffiliated investment bank B. Clearly, customer disclosure to prevent confusion is necessary, but it need not extend to premises which present no impression that the products of the investment bank are insured as those of a commercial bank. The resulting tangible and intangible compliance costs evidence a departure from the Board's interest in promoting a fair playing field for affiliated and unaffiliated investment banking firms. In addition, such an extension of the disclosure requirement might encourage the inclusion of all activities under one roof, since the regulatory compliance burden will be the same. In that event, the combination of activities would ultimately prove much more confusing than if the section 20 activities were simply conducted at a separate site.

A better answer might be to allow BHCs to choose between two options. First, the banking portion of the BHC and the BHCs section 20 subsidiary could maintain completely separate retail locations, and avoid the disclosure requirements embodied in

181. *See supra* notes 101-06 and accompanying text.

Operating Standard #4. Alternatively, they could have separate and distinct retail locations under one roof, but retain the disclosure requirements. By adopting this policy, the Board would allow BHCs to decide whether efficiencies gained by combined operations are worth the burden of continued disclosures, which may deter customer purchases.

In addition to the disclosure requirements, Operating Standard #4 places limits on investment advice when a section 20 subsidiary is involved in the underwriting or market-making of the security at issue.[182] This rule, which allows advice on an affiliated security absent knowledge of the affiliation by the retail agent in question,[183] demonstrates the Board's interest in replacing blanket prohibitions, which restrict advice and increase compliance costs, with a less burdensome standard that can adequately protect against potential conflicts of interest.

Operating Standard #5, the requirement that intra-day credit from a BHC to its section 20 subsidiary must be on market terms and must be fully secured,[184] directly implicates the chief concern regarding investment and commercial bank affiliation. With this regulation, the Board seeks to ensure that the sizable assets of the BHC are not imprudently exposed to its section 20 affiliates' operations. Previously, firewall 21 barred all extensions of credit, fearing the conflicts between the duty owed depositors and the duty and incentive to aid the affiliate.[185] Foregoing a complete ban on such lending, Operating Standard #5 instead seeks to prevent hasty loan extensions, as might be motivated by a severe decline in the stock market, made without regard to the normal considerations such lending would entail, including compliance with market terms. This approach ensures fair competition, by requiring prudence in such extensions of credit rather than a blanket prohibition which, in effect, punishes a section 20 subsidiary simply because of its affiliation with a BHC.

Operating Standard #6 prohibits an agent of a BHC or its subsidiary from knowingly financing the purchase of a security

182. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,307.

183. *See id.*

184. *See id.*

185. *See id.* at 45,303-04; *see also supra* notes 130-36 and accompanying text.

underwritten by the section 20 subsidiary during the underwriting period or thirty days thereafter, absent a pre-existing unrelated line of credit.[186] This is a corollary to the "Chinese wall"[187] knowledge-based regulation embodied in Operating Standard #4. By requiring knowledge on the part of the lending agent, the Board seeks to curtail layers of regulation when the same purposes can be achieved through less restrictive means. Here, requiring the absence of knowledge of the affiliation means that the incentive to extend credit in unwarranted situations will be addressed without forcing costly and continuous bank holding company-wide updates regarding who can be a customer for lending purposes. Moreover, this regulation comports with the theme of disclosure. The knowledge-based rule meets disclosure concerns—no retail agent will be selling a security (because of Operating Standard 4) or extending loans to purchase a security (because of Operating Standard 6) that the agent knows has been underwritten by the section 20 subsidiary, absent full disclosure of that relationship.[188]

Operating Standard #7 certainly aligns with the Board's theme of disclosure. The regulation requires banks to submit to the Board copies of their required reporting to self-regulatory organizations, including detailed information regarding their section 20 activities.[189] Moreover, it is telling that this requirement, formerly firewall 24, was retained while other reporting firewalls were abandoned; the difference is that this reporting requirement adequately informs the Board of section 20 activities without creating paperwork beyond that already required for the self-regulatory bodies. This, of course, comports with the Board's interest in remaining acutely aware of section 20 activities without creating undue burdens on banks affiliated with section 20 investment firms.

Operating Standard #8 essentially extends the same requirements that U.S. subsidiaries face to foreign affiliates of U.S. banks.[190]

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186. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,307.
187. *See supra* note 70 and accompanying text.
188. *See* Regulation Y Amendments, 62 Fed. Reg. at 45,307.
189. *See id.*
190. *See id.*

V. CONCLUSION

The Board's Operating Standards are a consistent set of requirements that adequately balance traditional concerns regarding potential abuses inherent in the combination of commercial and investment bank activities with the reality that BHCs competitiveness in an increasingly full service environment requires the peeling away of excess regulatory compliance costs that undermine banks' ability to compete with other purveyors of financial services.

Ultimately, the soundness of the Board's operating standards will be put to the test in the context of a serious stock market decline. Opponents of bank involvement in investment banking activities through section 20 subsidiaries rely on psychological theories that, conveniently, are not readily examined absent such a doomsday scenario. Dissenters point to market crashes of the past as fodder for their arguments against bank participation in investment banking activities, but in reality, every market has its own defining characteristics that make such analogies tenuous at best.

Admittedly, much of the weakening of the separation between commercial and investment banking has come in the context of a sustained bull market—the Dow Jones Industrial Average has more than quadrupled since the crash of 1987.[191] However, one cannot ignore the fact that financial services institutions, in order to remain competitive into the next century, must be able to offer a full range of financial products within appropriate limitations that do not unnecessarily increase transaction costs. Furthermore, in an increasingly interdependent global economy, it may be unrealistic to believe that government-designed protective measures can fully insulate any significant institution from the calamity of a serious bear market. To premise unduly restrictive regulations upon such fears

191. *See* Randy Schultz, *The Blackest of Mondays: The Oct. 19, 1987 Crash Reduced Stock Values by $1 Trillion* (last modified Oct. 13, 1997) <http://cnnfn.com/markets/9710/13/crash_main/>. The Dow Jones Industrial Average (DJIA) at the close of business on October 19, 1987 was 1,738.74. *See id.* On February 27, 1998, the DJIA closed at 8,545.72. *See Markets Diary*, WALL ST. J., Mar. 2, 1998, at C1.

ignores the truth that no one, from an individual to the most complex multinational financial institution, stands immune from the inevitably shifting tides of investor sentiment.

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