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Does the Choice of Corporate Form to House New Financial
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**STRUCTURING THE FINANCIAL SERVICE CONGLOMERATES OF THE
FUTURE: DOES THE CHOICE OF CORPORATE FORM TO HOUSE NEW
FINANCIAL ACTIVITIES OF NATIONAL BANKS MATTER?**

CONSTANCE Z. WAGNER¹

ABSTRACT

The Gramm-Leach-Bliley Act became law on November 12, 1999, bringing to an end a twenty year effort to expand bank powers by amending the Glass-Steagall Act and the Bank Holding Company Act of 1956. Although styled as banking reform legislation, the new law will have a wide-ranging impact on the financial services industry generally. A wave of merger activity will likely occur in this industry because many of the legal restrictions on bank affiliations with other financial services providers have been removed. An end result of the new legislation will be the creation of financial services conglomerates offering a combination of banking, securities, and insurance products under one roof.

The appropriate corporate structure for expanded banking activities was a key issue in the debates over the new legislation, specifically whether banks should be allowed to conduct new financial activities exclusively through a bank holding company affiliate or whether use of a bank operating subsidiary should also be permitted. Under Gramm-Leach-Bliley, the primary vehicle for new activities will be the bank holding company affiliate. Bank operating subsidiaries may also be used by national banks for a more limited range of new activities and subject to certain restrictions and conditions not applicable in the case of the holding company affiliate. The new law reflects a compromise position in the corporate structure debate. Given the polemical nature of the debate, such a compromise was probably essential to ensure passage of the legislation. Nevertheless, the compromise is not justified in drawing a distinction between the bank holding company affiliate and the bank operating subsidiary as vehicles for new activities. The author reaches this conclusion after analyzing the history of the

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corporate structure debate and the Gramm-Leach-Bliley compromise from a public policy perspective. She suggests further that Gramm-Leach-Bliley represents a missed opportunity to clarify what is at stake and has resulted instead in a further obfuscation of the issues.

I. INTRODUCTION: THE NEW WORLD OF DEREGULATED FINANCIAL ACTIVITIES FOR NATIONAL BANKS AND THEIR AFFILIATES

Banking in the U.S. is a heavily regulated industry due to the important role that banks play in economic life.² National banks, the focus of this article, have been restricted historically in the conduct of their operations in many and various ways, including controlled entry, restrictions on structure, expansion, geographic location and permissible activities, limitations on portfolio composition, minimum capitalization requirements, customer disclosure requirements, and continuous government reporting and supervision of operations.³ Critics of the bank regulatory system have charged that sweeping changes in the marketplace, including technological developments and the phenomenon of globalization, have rendered such regulation at least partially obsolete and in need of overhaul.⁴ From the

² Banks perform the essential functions of issuing transaction accounts, serving as a back up source of liquidity to all other institutions, and serving as the transmission belt for monetary policy. See E. Gerald Corrigan, *Are Banks Special?*, FED. RES. BANK OF MINNEAPOLIS ANN. REP. 1982, at 7. The role of banks has also been described as processing payments and settlements, intermediating between savers and borrowers, and helping to spread risk from markets and institutions who wish to avoid risk to those who are willing and able to assume it. See ROBERT E. LITAN & JOTHANAN RAUCH, *AMERICAN FINANCE FOR THE 21ST CENTURY* 11-13 (1997).

³ For a description of these limitations, see KENNETH SPONG, *BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION AND EFFECTS* 51-220 (4th ed. 1994); see also MICHAEL P. MALLOY, *BANK REGULATION* 34-195 (1999).

⁴ For recent government studies of the need for financial regulation reform, see *Report of The President's Commission on Financial Structure & Regulation*, 93rd Cong. 1 (1973); *Blueprint For Reform: The Report of the Task Group on Regulation of Financial Services*, 98th Cong. 1 (1984); *Bush Task Group Report on Regulation of Financial Services: Blueprint for Reform, Hearings Before a House Subcommittee of the Committee on Government Operations*, 99th Cong. 1, pt. 1 and 2 (1985); *The Banking Industry in Turmoil: A Report on the Condition of The U.S. Banking Industry and the Bank Insurance Fund, Presented to the Financial Institution Subcommittee of The House Comm. on Banking, Housing and Urban Affairs*, 101st Cong. 2 (1990); *Modernizing the Financial System*, U.S. Treasury Department

perspective of the banks themselves, the most problematic areas of regulation in recent years have been geographic and activities restrictions contained in federal statutes.⁵ Briefly stated, these restrictions confined bank operations to a single state, with very limited exceptions, and constrained bank services to a narrow spectrum of activities traditionally engaged in by banks or deemed to be incidental to such activities.

While geographic and activities constraints have been defended on a variety of policy grounds,⁶ these restrictions have long been unpopular with many bankers, bank regulators, and economists. Such restrictions have been identified as a precipitating cause of the declining competitiveness of the American commercial banking industry, as compared to other financial institutions in the U.S. and to banks in other countries. Banks have experienced stiff competition in their core businesses of deposit-taking and lending in recent years from non-depository financial institutions, including mutual funds, insurance companies, pension funds, finance companies, and government entities. These changes are the result of advances in computer technology that have facilitated information processing and led to the development of new financial instruments by non-bank financial institutions that compete directly with traditional bank products. Because of legal restrictions, banks have been unable to respond by expanding into new lines of business and new geographic locations.⁷ Such restrictions have a negative

Recommendations for Safer, More Competitive Banks, FED. BANKING L. REPORTS, No. 1377 (1991); LITAN & RAUCH, *supra* note 2.

⁵ See *Financial Services Restructuring: Hearings on H.R. 10 and H.R. 668 Before the House Comm. on Banking and Financial Services*, 105th Cong. (1997) (testimony of William T. McConnell on behalf of the American Bankers Ass'n).

⁶ Restrictions on geographic expansion have been justified on the grounds that the size of banking organizations should be limited to prevent the undue concentration of economic power. Such restrictions also reflect a preference for locally controlled banks that will develop local economies. See SPONG, *supra* note 3, at 137-38. The policy rationales for activities restrictions are discussed *infra* in Section II.A.

⁷ The resulting erosion in banks' core businesses is evidenced by various indicators. For example, the total assets held by U.S. banks increased in absolute terms but declined relative to the share held by all domestic financial service firms between 1980 and 1990. Total deposits declined in the same period. See JAMES R. BARTH, ET AL., *THE FUTURE OF AMERICAN BANKING* 73-75 (1992). The percentage of U.S. financial assets held by domestic commercial banks declined precipitously over the period 1950-1989, with significant gains shown by pension funds and mutual funds. See *id.* at 82-83; see also George G. Kaufman, *Is Banking a Declining Industry? A Historical Perspective*, *ECONOMIC PERSPECTIVES*, May/June.

impact on bank profits and deprive consumers of the lower priced and better quality services that would be available if more competition were allowed.⁸ Removing such restrictions would also allow banks to take advantage of increased economies of scope and scale, which could be passed along to consumers in the form of lower prices for services, and to reduce the riskiness of their portfolios through diversification.⁹

Banks have lobbied in recent years to alter or remove both geographic and activities restrictions. In the case of geographic constraints, Congress has dismantled to a substantial degree the federal laws preventing nationwide expansion by banks. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Riegle-Neal Act")¹⁰ amended provisions of the McFadden Act¹¹ preventing interstate branching and eliminated the Douglas Amendment¹² to the Bank Holding Company Act preventing interstate banking through a holding company structure. As a result of this new regulatory regime, interstate bank mergers are becoming commonplace. It is likely that the trend towards nationwide banking will continue in the future.¹³

1994, at 2–21. Prior to recent mergers between several large U.S. banks, another often-cited statistic was the decline in the number of U.S. banks ranked in the top tier of banks internationally. See *The Euromoney Five Hundred*, EUROMONEY, Jun. 1991, at 70.

⁸ See ROBERT E. LITAN, WHAT SHOULD BANKS DO? 61–63 (1987) (discussing benefits of enhanced competition if legal restrictions on financial product line expansion were dropped). See also Randall S. Kroszner & Philip E. Strahan, *The Political Economy of Deregulation: Evidence from the Relaxation of Bank Branching Restrictions in the United States*, Federal Reserve Bank of New York Research Paper, 1, 15–17, 23, 25 Jun. (1997); Jith Jayaratne & Philip E. Strahan, *The Benefits of Branching Deregulation*, FED. RES. BD. N.Y. ECONOMIC POL'Y REV., Dec. 1997, at 13 (discussing benefits of enhanced competition if geographic restraints were dropped).

⁹ See LITAN, *supra* note 8, at 74–89 (discussing such benefits flowing from removing financial product line restrictions).

¹⁰ See Pub. L. No. 103–328, 108 Stat. 2338 (1994) (codified in scattered sections of 12 U.S.C.).

¹¹ See 12 U.S.C. § 36(c) (1999).

¹² The Douglas Amendment was codified at 12 U.S.C. § 1842(d) (1999) (repealed 1994).

¹³ Interstate bank mergers announced since passage of the Riegle-Neal Act include the Nationsbank–Bank of America merger and the First Chicago–Banc One merger. See *Mergers and Acquisitions: Bank America, Nationsbank Plan Merger; Banc*

In the case of activities restrictions, Congress enacted financial modernization legislation at the end of 1999 that substantially liberalized the area. The Gramm-Leach-Bliley Act ("Gramm-Leach-Bliley"),¹⁴ which became law on November 12, 1999, grants banks the authority to engage in a wide variety of financial activities, including securities and insurance underwriting, that were previously prohibited or available only to a limited extent through the regulatory approval process. Although styled as banking reform legislation, the new law will have a wide-ranging impact on the financial services industry generally. A wave of merger activity will likely occur in this industry as a result of the legislation because many of the legal restrictions on bank affiliations with other financial service providers have been removed. An end result of the new legislation will be the creation of financial service conglomerates offering a combination of banking, securities, and insurance products under one roof.¹⁵

Although bills proposing similar reforms had been introduced on a number of occasions over a twenty year period prior to enactment of Gramm-Leach-Bliley, Congress failed to enact reforms earlier for a variety of reasons, including lobby pressure from other financial service providers fearful of increased competition from banks with expanded powers and disagreements among members of Congress and regulators on fundamental issues of bank regulation.¹⁶ In the face of Congressional inaction, banks

One, First Chicago Also Unveil Pact, 70 BANKING REPORTER (BNA) 631, Apr. 14, 1998.

¹⁴ See Gramm-Leach-Bliley Act of 1999, 106th Cong., 1st Sess. The provisions dealing with the establishment and regulation of a new type of holding company to engage in the expanded activities become effective on March 12, 2000. See *id.* at § 161. Separate effective dates are specified for other provisions.

¹⁵ Senate Banking Committee, Press Release, Oct. 22, 1999, available at <<http://www.senate.gov/~banking/pre199/1022fsm.htm>> (visited Oct. 24, 1999) [hereinafter Senate Press Release].

¹⁶ Some of the legislation that was introduced includes: Financial Institutions Deregulation Act, S. 1609, 98th Cong. (1983); H.R. 3537, 98th Cong. (1983); Financial Services Competitive Equity Act, S.2851, 98th Cong. (1984); Deposit Insurance Reform and Competitive Enhancement Act, S. 2592, 99th Cong. (1986); Financial Services Competitive Enhancement Act, S. 2592, 99th Cong. (1986); Financial Modernization Act of 1987, S.1886, 100th Cong. (1987); Financial Services Competition Act of 1997, H.R. 428, 105th Cong. (1997); Financial Services Act of 1998, H.R. 10, 105th Cong. (1998); Financial Services Act of 1999, H.R. 10, 106th Cong. (1999); and Financial Services Modernization Act, S. 900, 106th Cong. (1999).

seeking expanded powers turned to their federal banking regulators and received permission to engage in a wide variety of securities, insurance and other financial activities, either directly or through affiliates.¹⁷ This was achieved through the regulatory approval process applicable to the commencement of a new activity by a bank or any subsidiary or affiliate. In the years immediately prior to the passage of Gramm-Leach-Bliley, the federal banking regulators acted to further accelerate and deepen the process of deregulation of activities restrictions. These actions included (1) liberalization of Federal Reserve Board ("Board") rules governing operation of Section 20 securities underwriting affiliates of banks and expansion of the right to engage in other nonbanking activities by bank holding company affiliates, and (2) revision of Comptroller of the Currency's ("Comptroller" or "OCC") rules governing corporate activities of national banks to allow operating subsidiaries of such banks to engage in new activities that are not currently permissible for national banks themselves, including revenue bond underwriting.

Deregulating activities restrictions in this way has been criticized on a number of grounds. First, the process is cumbersome, consuming both vast amounts of time and money, and the resulting approval can be relied on only by the applicant and not by others engaging in the same activity. Second, in the opinion of some commentators, decisions about fundamental changes in bank policy should be made by Congress, not by banking regulators. One of the forces driving reform legislation proposals was concern about the policy implications of so-called piecemeal deregulation of activities restrictions without Congressional input.¹⁸

The gradual erosion of activities restrictions through the regulatory approval process, combined with increasing pressure for legislative reform, made it inevitable that activities restrictions would give way. While the battle over expanded financial activities has been largely fought and won by the banks, commercial activities still remain off limits for banks in the new legislation, and it is unlikely that the wall between banking and commerce will be dismantled at any time in the near future.¹⁹

¹⁷ See MICHAEL P. MALLOY, *BANK REGULATION*, at 166–176, 186–190 (1999).

¹⁸ See *Financial Modernization: Hearings on H.R. 10 Before the Senate Banking Comm.*, 105th Cong. (1998) (opening statement of Chairman Alfonse D'Amato).

¹⁹ See *Financial Services Modernization: Hearings on H.R. 10 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 106th Cong. (1999) (testimony of Donna Tanoue, Chairman of the FDIC). See also *Financial Services Modernization: Hearings on H.R. 10 Before the House Comm. On Banking and Financial Services*,

By the time Gramm-Leach-Bliley came before Congress, the focus of the debate had shifted from whether deregulation of activities restrictions should occur at all to the precise set of conditions under which it should take place. One of the most controversial issues in the Congressional debates over Gramm-Leach-Bliley was the appropriate site for conducting new financial activities within the corporate structure of a bank. In the United States, most commentators on the corporate structure issue take the position that such activities should not be conducted within banks themselves, but rather in separately-incorporated entities.²⁰ Prior to the passage of Gramm-Leach-Bliley, the two structures available under U.S. banking law and regulatory practice were the bank holding company affiliate and the bank operating subsidiary. While the holding company affiliate had been used for some time for nonbanking financial activities, including underwriting and dealing in securities a bank could not underwrite and deal in directly ("bank ineligible securities"), the use of the bank operating subsidiary for such activities was a new phenomenon, made possible by recent amendments to OCC regulations affecting the corporate activities of national banks.

Two viewpoints emerged in the corporate structure debate. One view was that new activities must be conducted exclusively through a holding company affiliate in order to insulate the bank from risks associated with such activities and to prevent such activities from being subsidized by federal government programs aimed at protecting depositors of commercial banks. The Board and some securities and insurance industry lobbyists took

106th Cong. (1999) (testimony of Alan Greenspan, Chairman of the Board of Governors, Federal Reserve System) [hereafter Greenspan 1999 testimony].

²⁰ The universal banking model adopted in some countries, including Germany, in which banking and nonbanking financial activities carrying a high degree of risk are combined in one entity, has not been considered as viable in the U.S. The reasons for this include 1) fear that banks in diversified organizations would be exposed to greater risk of failure, putting bank deposits at risk, 2) the desire to prevent banks from using federally insured deposits to fund nonbanking activities, to the competitive disadvantage of financial service providers operating without a federal government subsidy, and 3) the belief that separate corporations would facilitate regulation and supervision of activities. See LITAN, *supra* note 8, at 145. Banking modernization proposals of the past two decades have invariably suggested permitting expanded financial activities only through separate nonbank subsidiaries of a parent holding company. For example, the Treasury Department under the Reagan administration proposed financial modernization legislation that adopted this model. See Financial Institutions Deregulation Act, S. REP. NO. 98-1609, CONG. REC. 18647 (1983).

this position. The other view was that banks should also be allowed to locate the new activities in an operating subsidiary. The Department of the Treasury ("Treasury Department" or "Treasury"), the OCC, and the Federal Deposit Insurance Corporation ("FDIC"), as well as many bankers and economists, supported this view. Gramm-Leach-Bliley adopted a compromise position on the issue. The primary vehicle for new financial activities will be the bank holding company affiliate. However, bank operating subsidiaries also may be used by national banks for a more limited range of new activities and subject to certain restrictions and conditions not applicable in the case of the holding company affiliate.

While the new legislation resolved the corporate structure debate, there are still many unanswered questions regarding the policy basis for and the implications of the compromise. For instance, exactly what is at stake in the debate has never been fully elaborated. Most discussions of the issue have taken place in two fora: 1) research and policy position papers issued by the federal bank regulatory agencies, and 2) Congressional testimony and other public statements by high-ranking officials of such agencies. In addition, a few studies were published very recently by economists and legal academics.²¹ These discussions have focused primarily on the public policy rationales for banking regulation, which will be discussed in Section II of this article. Another theme runs through the debate, however, namely the question of which federal banking agency would emerge as the winner in what some viewed as a regulatory turf war. It was suggested that this debate related to whether the Board or the OCC would have greater regulatory authority over new financial activities, with the regulators being accused of seeking an expansion of authority for its own sake and not for any reason related to protecting the public interest.²² If exclusive use of a bank holding company affiliate was required by Congress, the Board would continue to exercise significant regulatory power because it regulates bank holding companies. On the other hand, if banks were permitted to use a bank

²¹ See Bernard Shull & Lawrence J. White, *The Right Corporate Structure for Expanded Bank Activities*, 115 *BANKING L.J.* 5 (1998); João dos Santos, *Securities Activities in Banking Conglomerates: Should Their Location Be Regulated?* (Federal Reserve Bank of Cleveland Working Paper 9704, 1997); Bevis Longstreth & Ivan E. Mattei, *Organizational Freedom for Banks: The Case in Support*, 97 *COLUM. L. REV.* 1895 (1997); Patricia A. McCoy, *Financial Modernization and Banking Structure*, in *BANKING LAW MANUAL* at § 8.02 (2000).

²² See Carter H. Golembe, *Banking Agency Turf War: It's Not Like Wendy's and McDonald's*, 17 *No. 10 BANKING POL'Y REP.* 1 (1998); Longstreth & Mattei, *supra* note 21, at 1920-21.

operating subsidiary, it is possible that the operating subsidiary would become the preferred vehicle, with the OCC as the regulator of national banks and their operating subsidiaries gaining increased regulatory authority at the expense of the Board.²³ According to Board Chairman Alan Greenspan, the issue “appears to be very small” but it will determine “the financial regulatory structure of the United States for the next generation.”²⁴

Chairman Greenspan has expressed worry publicly, as has former Secretary of the Treasury Robert E. Rubin, about how the resolution of this issue will affect each regulator’s ability to influence the future of banking and economic policy in this country.²⁵

Although the regulatory turf war angle may have some explanatory force, the author has chosen not to focus on it in this article, preferring to assume the statements of the participants in the debate were made in good faith and to take at face value the terms of the debate as it has been framed in public fora. This article will examine the corporate structure issue through the lens of the traditional public policy concerns justifying banking regulation.

²³ Chairman Greenspan pointed out in his Congressional testimony on April 28, 1999 that “[t]hose activities, when performed in bank subsidiaries and financed with bank equity capital would increase the potential profit to the overall banking organization. It would also inevitably induce the gravitation to subsidiaries of banks, not only of the new powers authorized by H.R. 10, but all of those powers currently financed in holding company affiliates at higher costs of capital than those available to the bank.” Greenspan 1999 testimony, *supra* note 19.

²⁴ David Wessel & Jacob M. Schlesinger, *Fed Chief is Worried by Developing Nation Debt*, WALL ST. J., May 8, 1998, at A2.

²⁵ Chairman Greenspan noted that Congress “purposefully appointed responsibility for this nation’s financial institutions among the elected executive branch and independent regulatory agencies,” and changing this system “would be contrary to the deliberate steps that Congress has taken to ensure a proper balance in the regulation of this nation’s dual banking system.” Greenspan 1999 testimony, *supra* note 19. Former Treasury Secretary Rubin noted in Congressional testimony on May 6, 1999 that “one of an elected Administration’s critical responsibilities is the formation of economic policy, and an important component of that policy is banking policy. In order for the elected Administration to have an effective role in banking policy it must have a strong connection with the banking system, that connection would be weakened if new financial activities were off limits to OCC supervision.” *Financial Services Act of 1999: Hearings on H.R. 10 Before The Comm. on Commerce, Finance and Hazardous Materials*, 106th Cong. (1999) (testimony of Robert E. Rubin, Secretary of the Treasury).

To rephrase the terms of the debate in a slightly different way, the issue is whether there is a compelling governmental interest in limiting new financial activities for national banks to a particular corporate structure, as opposed to permitting banks to choose their own corporate structure. The resolution of this debate in Gramm-Leach-Bliley will have an impact not only on the financial services industry, but on other constituencies as well, including bank customers and taxpayers.²⁶ It is therefore appropriate to analyze the debate in terms of the public policy rationales that underlie banking regulation in order to determine whether one choice is preferable to the other. The author will attempt to answer three questions. First, is there any public policy reason to eliminate use of either the operating subsidiary or holding company affiliate as a vehicle for new financial activities? Second, is there any public policy reason to prefer one structure over another? Third, if there is no compelling governmental interest in eliminating one structure or preferring one over the other, should banks be free to choose the corporate structure they use for their operations?

This article will be structured as follows. In order to provide an analytical framework for discussion of the corporate structure debate, Part II will review the public policy rationales traditionally advanced to support activities restrictions applicable to national banks and their affiliates, as well as some additional policy rationales advanced in connection with the debate. Part II will also examine the origin of the debate, which is traceable to regulatory changes immediately preceding the passage of Gramm-Leach-Bliley that expanded the authority of national banks to conduct new financial activities through both operating subsidiaries and holding company affiliates. Part III will review the corporate structure debate in the context of passage of Gramm-Leach-Bliley, including the compromise position reached in this legislation. The major viewpoints in the corporate structure debate will be considered. Part IV will evaluate the debate over choice of corporate structure for new financial activities from the perspective of the public policy rationales for bank regulation. Part V sets forth the author's conclusions.

The author concludes that dictating the structure that banks must use for conducting new financial activities is unwarranted from the perspective

²⁶ For example, if banks are permitted to choose their corporate structure based on cost considerations, customers will benefit from lower-priced products. If greatly increased risks to banks will be the result of product line deregulation, taxpayers may pay the price of resolving bank insolvencies if federal deposit insurance funds are insufficient, as they did in the case of the savings and loan insolvency crisis of the 1980's.

of preserving bank safety and soundness, and avoiding conflicts of interest, the policy rationales traditionally advanced for restricting the activities of banks. This conclusion is based on an analysis of both the theoretical risks that may be associated with conducting new financial activities, as well as the limited available empirical evidence regarding conduct of new financial activities by banks and their affiliates. In fact, mandating use of a holding company affiliate might actually undermine bank safety and soundness because it is arguable that banks would be deprived of certain benefits, such as increased efficiency, cost-savings, and increased income, associated with use of an operating subsidiary. Such analysis also does not suggest that one form is to be preferred over another. The current debate has failed to adequately take account of corporate separateness and the use of firewalls as factors that can insulate banks from the additional risks associated with new financial activities.

The author also considers the debate from the perspective of a policy rationale not traditionally raised to justify activities restrictions but that has been often discussed in the corporate structure debate, namely preventing the spread of the federal government subsidy intended to support commercial banking activities and protect depositors, which consists of deposit insurance from the FDIC, access to the discount window at the Board, and access to the payment system at the Board (the "federal safety net subsidy") into new areas that the U.S. Congress never intended should be covered by such subsidy. This policy rationale has been advanced to support exclusive use of the holding company affiliate structure. The author concludes that the theoretical arguments and available empirical evidence regarding the existence of such a subsidy and whether the holding company affiliate is better at containing the spread of such subsidy to new activities are inconclusive at best. Therefore, such policy rationale does not support mandated or even preferential use of the holding company affiliate structure.

Finally, the author considers the policy argument that use of a holding company affiliate should be required in order to preserve the bank regulatory functions of the Board, which regulates both bank holding companies and their nonbank affiliates, but not national bank operating subsidiaries. Although this argument was touched on in Congressional hearings on financial modernization legislation and in other public statements of members of the Board, it has not been at the center of the corporate structure debate and has not been mentioned by most commentators on the topic. Because it has not been the subject of public debate, the argument is difficult to evaluate even-handedly. It appears, however, to relate to the ability of the Board to effectively function as a

lender of last resort and to deal effectively with problems of systemic risk. This is a public policy issue of crucial significance and cannot be ignored. However, since neither the parameters of the problem nor possible solutions in this context have been publicly debated, it is not an appropriate policy basis for preferring use of the holding company affiliate.

The Gramm-Leach-Bliley compromise, which draws a distinction between use of the bank holding company affiliate and the bank operating subsidiary as vehicles for new financial activities, is not justified on public policy grounds. While the compromise offers something to both sides in the debate, it does not put to rest the policy concerns of either side. As such, Gramm-Leach-Bliley represents a missed opportunity to clarify what is at stake and has resulted instead in a further obfuscation of the issues.

II. ORIGINS OF THE CORPORATE STRUCTURE DEBATE: APPROVAL BY FEDERAL BANKING REGULATORS OF NEW FINANCIAL ACTIVITIES BY BANK AFFILIATES

A. Policy Rationales for Activities Restrictions: A Framework for Analysis of the Corporate Structure Debate

Unlike most other businesses in the United States, national banks and their affiliates historically have not been free to engage in any activity they may choose. Rather, their activities have been limited to those permitted by statute or approved by a federal banking regulator under certain circumstances. The starting point for identifying the permissible activities of national banks is Section 24 (Seventh) of the National Bank Act,²⁷ which authorizes banks to engage in the "business of banking" and activities incidental thereto. In addition to this provision, which is general in nature, there are other sections of the National Bank Act and other federal banking laws that expressly empower or expressly prohibit national banks from engaging in certain lines of business. Examples of express powers that existed prior to Gramm-Leach-Bliley include the authorization in Section 92 of the National Bank Act to act as insurance agents or brokers only in towns with less than 5000 inhabitants;²⁸ the grant of authority in Section 92a of the National Bank Act to exercise trust powers to the extent that such activity does not contravene state law;²⁹ and the ability to make loans secured by real

²⁷ See 12 U.S.C. § 24 (Seventh) (1999).

²⁸ See 12 U.S.C. § 92 (1999).

²⁹ See 12 U.S.C. § 92a (1999).

estate granted by Section 371(a) of the Federal Reserve Act.³⁰ The most prominent examples of express prohibitions that existed prior to Gramm-Leach-Bliley include the Glass-Steagall Act (“Glass-Steagall”), which effectively barred national banks from engaging in many securities underwriting and dealing activities and limited the extent to which bank affiliates may engage in such activities, among other things,³¹ and the strict limits imposed in Section 29 of the National Bank Act on the ability of national banks to buy, own, and sell real estate, effectively barring national banks from engaging in real estate development activities except development of bank premises.³² The activities of bank affiliates, including national bank affiliates, are also restricted by federal law. The most notable example prior to Gramm-Leach-Bliley was Section 1843(c)(8) of the Bank Holding Company Act,³³ which limits the activities of non-bank affiliates in a holding company structure to those deemed “closely related to banking.” Viewed collectively, these statutory provisions severely limit the ability of national banks and their affiliates to engage in nonbanking financial activities and bar such banks from engaging in commercial activities. Gramm-Leach-Bliley removed or amended some of those restrictions but did not completely deregulate the area of activities restrictions for national banks and their affiliates.

The reasons for the high level of regulation of bank activities are complex and not completely understood. The same can be said of other areas of U.S. banking regulation as well. The public policy reasons supporting banking regulation are sometimes difficult to discern and there is much disagreement in the literature about what these are, both in general and in the case of specific legislation. In general, however, it appears that the primary economic reason for banking regulation is that banking is prone to

³⁰ See 12 U.S.C. § 371a (1999).

³¹ The Glass-Steagall Act, part of the Banking Act of 1933, contained four sections limiting the securities activities of banks and bank affiliates. Gramm-Leach-Bliley repealed two of these provisions, §§ 20 and 32. Section 16 prohibits underwriting, selling and dealing in securities subject to certain exceptions. See 12 U.S.C. § 24 (Seventh) (1999). Section 21 prohibits taking deposits and engaging in commercial banking by investment banks. See 12 U.S.C. § 378(a)(1) (1999). Section 20 prohibited affiliations between banks and firms engaged principally in the underwriting of stocks or other securities. See 12 U.S.C. § 377 (repealed 1999). Section 32 prohibited individuals involved in investment banking serving as officers, directors or employees of banks. See 12 U.S.C. § 78 (repealed 1994).

³² See 12 U.S.C. § 29 (1999).

³³ See 12 U.S.C. § 1843(c)(8) (1999).

market failure; i.e., a tendency toward inherent instability and economic concentration, which is more costly to society than the costs of regulating the banking system.³⁴ The market imperfections inherent in banking are believed to be attributable to two factors. One factor is the existence of economies of scale³⁵ which, if substantial, could lead to concentration, reduction in competition, and aggregation of capital in the hands of a few. The other factor is the inherent instability attributable to the mismatch in the asset and liability sides of commercial bank balance sheets.³⁶ Although many bank depositors are entitled to withdraw their funds on demand, most bank assets are not liquid. The result is that banks are susceptible to the risk of insolvency if many depositors attempt to withdraw their funds simultaneously in a bank run.³⁷ The fear is that runs on individual banks can lead to widespread financial panic, which will affect the entire banking system and ultimately, lead to a contraction of economic activity.³⁸

U.S. banking regulation is not the product of economic considerations alone. In addition, political and social concerns about the activities of banks and their effect on society have also held sway. For example, the traditional preference in U.S. banking law for small, local institutions is attributable to the agrarian beginnings of the U.S. economy and the chronic scarcity of capital available to the agricultural sector. Fear that money center banks would drain money out of the countryside and into industrial concerns led to efforts by agrarian interests to limit consolidation in the banking industry, which was the prevailing trend until quite recently.³⁹

Several public policy rationales have emerged from these concerns. The most significant are preserving the safety and soundness of the banking and monetary system, ensuring the fair and impartial allocation of credit, and

³⁴ See S. KERRY COOPER & DONALD R. FRASER, *THE FINANCIAL MARKETPLACE* 284 (1993).

³⁵ If operating economies of scale exist, total costs increase less than proportionately to output, leading to a decrease in average unit costs as output increases.

³⁶ See Jonathan R. Macey & Geoffrey P. Miller, *Deposit Insurance, The Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities*, 12 *YALE J. ON REG.* 1, at 2 (1995).

³⁷ Due to fractional reserve banking, banks are required to maintain only a small fraction of their assets in cash or near-cash items.

³⁸ See COOPER & FRASER, *supra* note 34, at 288.

³⁹ See DWIGHT B. CRANE ET AL., *THE EFFECTS OF BANKING DEREGULATION* 17-20 (1983).

limiting the size of banks.⁴⁰ All three of these rationales have been used to justify limiting banks to the traditional core banking activities of issuing notes, accepting deposits, and extending loans.

By far the most frequently encountered rationale is safety and soundness, which underlies a very large part of banking regulation. The purpose of safety and soundness regulation is not to prevent individual banks from failing,⁴¹ but rather to avoid the destabilizing effect on the economy that is linked to financial panics triggered by bank failures. Federal deposit insurance⁴² has had a stabilizing effect on the banking system, for it lessens the likelihood that depositors will attempt to convert their deposits into currency in a financial panic.⁴³ However, it has not eliminated the need for safety and soundness regulation entirely because of the adverse consequences that flow from bank failures and this policy continues to be a major focus of banking regulation.

A second rationale for banking regulation—ensuring the impartial allocation of credit—has emerged from the significant role that banks play as sources of capital in our society.⁴⁴ Underlying this policy concern is the

⁴⁰ See LITAN, *supra* note 8, at 11–12 (1987).

⁴¹ This would have the effect of protecting incumbent management and shareholders, who are arguably responsible for the poor condition of the bank. See SPONG, *supra* note 3, at 11.

⁴² Federal deposit insurance was introduced in the Banking Act of 1933, and the FDIC was formed to administer the program and regulate state nonmember banks that had such insurance. See 12 U.S.C. §24 *et seq* (1999).

⁴³ A distinction is drawn in the economic literature between bank runs and bank panics. A bank run occurs when depositors of a particular institution attempt to liquidate their deposits in response to concerns about the stability of that bank, but then redeposit those funds elsewhere. There is not necessarily a destabilizing effect on the financial system because bank reserves remain constant. A bank panic occurs when depositors attempt to convert their deposits into currency. This has the net effect of reducing reserves for the entire banking system and causing a contraction of economic activity. The causal relationship between bank panics and economic downturns is unclear but the two phenomena have often occurred in tandem. See Ellis Tallman, *Some Unanswered Questions About Bank Panics*, FED. RES. BANK OF ATLANTA, ECON. REV., Nov./Dec. 1988, at 2–17. Although financial panics occurred in the last 1800s and early 1900s, the advent of federal deposit insurance has eliminated bank panics, although bank runs still occur. See COOPER & FRASER, *supra* note 34, at 288.

⁴⁴ Commercial banks serve as financial intermediaries in funneling funds from savers to those who need capital. See MARCIA STIGUM, *THE MONEY MARKET*, 13–16 (3rd ed. 1990).

belief that banks should allocate capital based on strictly neutral economic criteria in order to maximize economic efficiency and ensure that all qualified parties have equal access to credit. One type of regulation that is the product of this policy concern is strict regulation of conflict of interest transactions involving extensions of credit to insiders and affiliates.

A third rationale is limitations on concentration in the banking industry. The concern underlying this policy is clearly linked to the economic rationale for banking regulation discussed above, as well as political and social concerns about the dangers of a very few institutions having control over vast aggregations of capital.

These public policy rationales are useful tools in explaining banking regulation in general terms, but they are sometimes difficult to apply in particular cases. The reasons that certain laws were adopted in the first place may be shrouded by the mists of time, if in fact there were clearly discernible reasons to begin with. Some regulation can best be explained as the product of historical accident and political compromise, rather than rational policy choices. A case in point is Glass-Steagall, which was long understood to be the product of concerns about the impact on commercial banks of the activities of their securities affiliates.⁴⁵ Such activities were believed to be a precipitating factor in the stock market crash that led to the Great Depression and to the banking crisis that preceded passage of the Banking Act of 1933.⁴⁶ According to the Supreme Court, speaking in one of the earliest cases involving a challenge to the restrictions imposed by Glass-Steagall, the policy basis for the legislation was a determination by Congress that "policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the hazards, and financial dangers, that arise when commercial banks engage in the activities proscribed by the Act."⁴⁷ These included not only "the obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments," but also the more "subtle hazards" associated with entry into the securities business by a bank affiliate.⁴⁸ The Court was referring to conflict of interest transactions which a bank might be compelled to enter into to assist its securities affiliate and which would impair a bank's ability to function as an

⁴⁵ See *Investment Co. Inst. v. Camp*, 401 U.S. 617, 629-630 (1971).

⁴⁶ See Pub. L. No. 106-55, 48 Stat. 162 (1933) (codified in scattered Sections of 12 U.S.C. Chapters 2, 3, and 6).

⁴⁷ See *ICI v. Camp*, 401 U.S., at 630.

⁴⁸ See *id.*

impartial source of credit, including unsound loans by the bank to the affiliate, customers of the affiliate or the company whose stock was underwritten by the affiliate.⁴⁹

This long-standing view of the policy basis for Glass-Steagall has been challenged by recent scholarship. Some scholars have questioned the traditional view that the activities of securities affiliates, in combination with conflict of interest transactions entered into by banks as a consequence or such affiliations, were the cause of the banking crisis of the 1930's.⁵⁰ Other scholars have offered alternative explanations of the legislation, claiming that it represents the triumph of Senator Glass' strong belief that commercial banks should return to their core business of making working capital loans,⁵¹ or that it attests to the lobbying strength of the investment banking industry, which supported Glass-Steagall in order to limit competition in the underwriting business from commercial banks.⁵² A number of scholars have questioned whether legislation passed during the Depression still adequately serves the public,⁵³ arguing that changed economic conditions should result in a reordering of the policy behind banking regulation and corresponding changes in the law.⁵⁴ This wide-spread questioning of the continuing viability of Glass-Steagall led to calls for its repeal. One of the major accomplishments of Gramm-Leach-Bliley is that it repealed Glass-Steagall in part.

The corporate structure debate has taken place largely in the context of Congressional consideration of Gramm-Leach-Bliley and predecessor financial modernization bills, which proposed to amend or repeal not only Glass-Steagall and the National Bank Act relating to activities restrictions. It was largely conceded in such debates that the new securities and insurance

⁴⁹ See *id.* at 631.

⁵⁰ See GEORGE J. BENSTON, *THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING*, at 20-121 (1990).

⁵¹ See Daniel C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 693-694 (1987).

⁵² See Jonathan R. Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, at 15-20 (1984).

⁵³ See LITAN & RAUCH, *supra* note 2, at 33-59.

⁵⁴ See LITAN & RAUCH, *supra* note 2, at 10 (arguing that financial market regulation should emerge from the shadow of the Depression, with its emphasis on market segmentation and failure containment and start to focus on encouraging competition and failure containment).

activities requiring a bank to take risk as a principal, and not merely as an agent, should not be conducted within the bank itself but rather in a separately incorporated entity. The open question, which occupied countless hours of debate in front of various Congressional committees, concerned where such separate entity may be located within the corporate structure of the bank. Prior to passage of Gramm-Leach-Bliley, the two choices available under U.S. banking law and regulatory agency practice were the bank holding company affiliate and the bank operating subsidiary.⁵⁵ The origin of the debate over corporate structure can be traced to actions taken by federal banking regulators making such choices available for new activities. The traditional choice has been the bank holding company affiliate. Bank holding company affiliates have long been thought to be able to engage in nonbanking financial activities that are beyond the pale for banks to engage in directly. This conclusion is based upon a comparison of the wording of 12 U.S.C. Section 24 (Seventh), governing the powers of national banks, with the wording of 12 U.S.C. Section 1843(c)(8), governing the nonbanking activities of bank holding company affiliates. Section 24 (Seventh) permits banks to engage in "the business of banking," while Section 1843(c)(8) permits bank holding company affiliates to engage in activities that are "closely related to banking." This difference in wording appears to permit a broader range of activities for bank holding company affiliates than for national banks.⁵⁶ The Board approved various nonbanking activities to be conducted in such affiliates on the authority of Section 1843(c)(8) by regulation and by order.⁵⁷ The Board argued in congressional hearings on financial modernization legislation that the only appropriate vehicle for new activities was the bank holding company affiliate and contended that the bank operating subsidiary should not be used for this purpose.

In contrast to the bank holding company affiliate, which is well-established as a vehicle for nonbanking activities, the bank operating subsidiary is a relatively new arrival on the scene. The OCC took the position in its rulemakings and orders that such subsidiaries could be used for nonbanking financial activities that national banks may not engage in

⁵⁵ Recently, the Office of the Comptroller of the Currency has permitted use of limited liability companies by national banks to structure non-banking activities in a joint venture format. See Russell J. Bruemmer, *LLCs: A Vehicle for Joint Venturing Non-Banking Activities*, 15 No. 7 BANKING POL'Y REP. 1 (1996).

⁵⁶ See JONATHAN MACEY & GEOFFREY MILLER, *BANKING LAW*, 365 (2nd ed. 1997).

⁵⁷ See MALLOY, *supra* note 17, at 186-190.

directly, such as underwriting bank ineligible securities, and has argued this view in Congressional testimony. The Treasury Department and FDIC also supported this view in Congressional hearings.

The debate over appropriate corporate structure has largely centered on the power to engage in securities underwriting, and accordingly that will be the focus of this article. Further, the article will focus on national banks, although the Gramm-Leach-Bliley compromise on the corporate structure issue will impact other types of banks as well. It is recent actions taken by the OCC to expand the powers of national bank operating subsidiaries that led to the debate. The OCC and the Board have divergent views in the debate and it seems appropriate that the focus should be where their regulatory authority overlaps, namely in regulating banking organizations that contain national banks.

The Gramm-Leach-Bliley compromise on corporate structure for new financial activities for banks presents an opportunity to assess which policy considerations are driving the form that banking legislation takes, and whether appropriate policy choices are being made. The confusion about the policy foundations of banking law discussed above is not just a matter of historic interest, but is still evident today. Very often in recent Congressional debates about financial modernization, there has been disagreement about what the guiding principles should be. At times, the same public policy rationale has been used to justify widely disparate positions. This can be interpreted in several ways. It may mean that the policy rationale is not well-understood. It can also mean that the problem being addressed by the proposed legislation is so complex that it is unclear how public policy analysis should apply to it. Finally, it can mean that something else is being beneath the guise of public policy. Sometimes, one is left with the uncomfortable feeling that the public interest will not be well-served by the choices that are being made in the process of legislative reform.

The policies that have been most frequently mentioned in the corporate structure debate include two of the traditional rationales mentioned above, namely safety and soundness and ensuring the impartial allocation of credit by avoiding conflict of interest transactions. Both of these rationales will be discussed in Part IV. The third traditional rationale mentioned above, avoiding excessive concentrations of economic power, has not been a specific focus of the debate. It should be noted, however, that community groups testifying in front of Congress about financial modernization have expressed their concern about the formation of large financial

conglomerates.⁵⁸ Two additional rationales relevant to the debate will also be discussed in Part IV, namely limiting the spread of the federal safety net subsidy and maintaining the regulatory authority of the Board in order to preserve its ability to act as lender of last resort and deal with systemic risk.

The first of these arguments, limiting spread of the federal safety net subsidy, has emerged as the primary argument for exclusive use of the holding company affiliate. The policy basis for the argument seems to consist of two components. One is that taxpayers bear the cost of the federal safety net subsidy and should not be required to pay for risk associated with new activities of banks that go beyond what the federal deposit insurance scheme was intended to protect, namely small depositors' funds. The other is that permitting the spread of the subsidy to new activities will distort competition in the marketplace by giving an advantage to commercial banks at the expense of other financial institutions offering near equivalents of bank services.

The other argument relating to preserving the regulatory authority of the Federal Reserve has not been previously discussed in the literature on the corporate structure debate. It is an argument in favor of use of the holding company affiliate, if not in all cases, at least in the case of very large banks whose failure might pose risks to the financial system as a whole. For the most part, these are banks that are already within a holding company structure. The exact parameters of this policy argument are difficult to define, because the argument has been only hinted at in Congressional debate and has never been fully explored in a public forum. However, this policy is of such critical importance that it cannot be ignored in the corporate structure debate.

The next section of this Part II will explore the origins of the corporate structure debate in actions by federal banking regulators permitting new financial activities, including underwriting bank ineligible securities, by national bank affiliates. Gramm-Leach-Bliley changed the landscape of activities restrictions to a significant degree and foreclosed the need for the regulatory approval process through which deregulation in activities restrictions had been largely achieved. While such developments are now primarily of historical interest due to Gramm-Leach-Bliley, reviewing such

⁵⁸ See *Finance Services Restructuring: Hearings on the Financial Services Act of 1998 Before the Comm. on Banking, House, and Urban Affairs, 105th Cong. (1998)* (testimony of Ralph Nader) (testimony of Allen J. Fishbein, General Counsel of The Ctr. For Community Change and Dir. of the Center's Neighborhood Revitalization Project).

regulatory developments is nevertheless crucial for understanding how the issue arose and for shedding light on the policy issues underlying the debate. The focus will be on the most recent developments that gave rise to the corporate structure debate in Congress.

B. Deregulation of Activities Restrictions Applicable to National Banks and their Affiliates through Action by Federal Banking Regulators

In the years immediately preceding Gramm-Leach-Bliley, there was a gradual increase in the permissible activities of national banks and their affiliates under existing law and without any statutory amendments that expressly authorized new activities or removed existing prohibitions. This was achieved through an expansive reading of the statutory restrictions on bank activities by federal banking regulators charged with approving new lines of business for banks and their affiliates. Most noteworthy are the developments with respect to the interpretation of national bank powers under Section 24 (Seventh) of the National Bank Act by the OCC,⁵⁹

⁵⁹ The language of Section 24 (Seventh) is vague and has been interpreted in a variety of ways by courts and commentators, with considerable disagreement over what activities are covered. See Edward L. Symons, Jr., *The Business of Banking in Historical Perspective*, 51 GEO. WASH. L. REV. 676, 678-684 (1983) (analysis of narrow and broad views of bank powers); see also Ralph F. Huck, *What is the Banking Business?*, BUS. LAW. (January 1966) 537-554, at 537-539 (criticism of narrow view); Richard Beatty, *What Are the Legal Limits to the Expansion of National Bank Services?*, 86 BANKING L.J. 3, 19 (1969) (description of broad view); Harfield, *Sermon on Genesis 17:20; Exodus 1:10 (A Proposal for Testing the Propriety of Expanding Bank Services)*, 85 BANKING L.J. 565, 567 (1968) (arguing for broad view). Prior to the decision in *Nations Bank of North Carolina, N.A. v. Variable Annuity Life Ins. ("VALIC")*, 513 U.S. 251 (1995), there was no definitive interpretation of the meaning of Section 24 (Seventh) by the Supreme Court. Other federal courts read the language fairly restrictively, often in a way that seemed consistent with the narrow view of national bank powers. See *Arnold Tours Inc. v. Camp*, 474 F.2d 427 (1st Cir. 1972). The legal landscape changed radically with the decision in *VALIC*, in which the Supreme Court stated that the business of banking for national banks is not restricted to the five specifically enumerated powers, but includes other activities that the Comptroller deems to be part of the business of banking, within reasonable bounds. See 513 U.S. 251, 258, fn. 2. The OCC seized upon the language in *VALIC* as an affirmation of its authority to determine the boundaries of permissible powers for national banks. It can be inferred from recent OCC activity, including rulemakings and rulings on applications to engage in new activities, that the OCC will be aggressive in exercising its discretion to widen the

including the power to own and conduct nonbanking activities in operating subsidiaries, and the interpretation of Section 20 of Glass-Steagall and Section 1843(c)(8) of the Bank Holding Company Act by the Board.⁶⁰

Deregulation through the regulatory approval process was controversial. On numerous occasions, approval by a federal bank regulator of a bank's application to engage in a new activity, directly or through a subsidiary or an affiliate, was challenged by competitors in litigation in the federal courts. Many of these regulatory approvals were upheld by federal courts, including the Supreme Court.⁶¹ In addition to litigation challenges

scope of permissible activities. Recent developments with respect to operating subsidiaries are discussed *infra*. In addition, the chief counsel of the OCC has published her views on the outer limits of national bank powers and incidental activities, which is based on an analysis of *VALIC* and other court cases on national bank powers. See Julie L. Williams & Mark P. Jacobsen, *The Business of Banking: Looking to the Future*, 50 BUS. LAW. 783, 785 (1995); see also Julie L. Williams & James E. F. Gillespie, Jr., *The Business of Banking: Looking to the Future – Part II*, 52 BUS. LAW. 1279, 1285 (1997). These tests have now become the standard used by the Comptroller in its corporate decisions on new activities. See Office of the Comptroller of the Currency, Interpretive Letter #743 (October 17, 1996)(found at 1996 WL 636764).

⁶⁰ These developments will be discussed *infra* in Section II.B.1.

⁶¹ The development in the case of securities activities has been dramatic. The first significant decision in *ICI v. Camp*, *supra* note 45, was a defeat for the Comptroller with the Supreme Court overturning an approval allowing a national bank to offer shares of a common investment fund to the public on the grounds that the proposed activity violated Sections 16 and 21 of Glass-Steagall. After *Camp*, however, the Supreme Court and the federal appellate courts have affirmed regulatory authorization of banks and/or their affiliates and subsidiaries to engage in various securities activities including, among other things: acting as investment advisers to closed-end investment companies, *Board of Governors v. Investment Co. Inst.*, 450 U.S. 46 (1981); retail securities brokerage activities, *Securities Indus. Ass'n. v. Board of Governors*, 468 U.S. 207 (1984); commercial paper placement, *Securities Indus. Ass'n. v. Board of Governors*, 468 U.S. 137 (1984), *Securities Indus. Ass'n. v. Board of Governors*, 807 F.2d 1052 (D.C.Cir. 1986) (on remand from U.S. Supreme Court); providing automatic stock purchase services, *New York Stock Exch., Inc. v. Smith*, 404 F. Supp. 1091 (D.D.C. 1975), vacated (*sub nom.* *New York Exch., Inc. v. Bloom*), 562 F.2d 736 (D.C.Cir. 1977); providing securities brokerage services and investment advice in combination, *Securities Indus. Ass'n. v. Board of Governors*, 821 F.2d 810 (D.C.Cir. 1987); underwriting and dealing in certain bank eligible securities, including mortgage-backed securities, government-issued securities, and municipal revenue bonds, 73 F.R.B. 473 (1987), *aff'd (sub nom.* *Securities Indus. Ass'n. v. Board of Governors*), 839 F.2d 47 (2d Cir.), *cert. denied*,

by competitors, some U.S. Congressmen charged that the process of deregulation through the regulatory process was flawed, claiming that it was a "piecemeal" approach in which regulatory "loopholes" were exploited.⁶² They asserted that action needed to be taken by Congress in order for the deregulation of activities restrictions to be legitimate.⁶³ Such statements implied that the process was inefficient, corrupt and possibly even dangerous for the banking system. Such criticisms overlooked two important aspects. First, the federal regulators' approvals were based upon interpretations of statutory language, which were upheld as reasonable by federal courts in most cases. Second, federal banking regulators acted with due regard for considerations of prudential regulation, including safety and soundness and avoiding the possibility of conflict of interest transactions, by imposing special conditions on such approvals. The deregulation of activities restrictions through the regulatory approval process prior to Gramm-Leach-Bliley will be discussed in detail below.

1. Bank Holding Company Affiliates

a. Use of Holding Company Affiliates for Nonbanking Activities

Prior to Gramm-Leach-Bliley, the holding company affiliate was the traditional vehicle for expansion by banks into nonbanking financial activities that were impermissible for a bank to engage in directly, including underwriting bank ineligible securities. This section will focus on the state of the law prior to passage of Gramm-Leach-Bliley and will not describe

486 U.S. 1059 (1988); underwriting and dealing in commercial paper, *Securities Indus. Ass'n. v. Board of Governors*, 847 F.2d 890 (D.C.Cir. 1988); and selling mortgage passthrough certificates, *Securities Indus. Ass'n. v. Clarke*, 885 F.2d 1034 (2d Cir. 1989).

⁶² Representative Marge Roukema, a member of the House Banking Committee, wanted to hold Congressional hearings on the approval by the OCC of revenue bond underwriting through a national bank operating subsidiary, calling the action "piecemeal" and likely to interfere with Congress' ability to "pass financial reform legislation." See Carter H. Golembe, *How Important is Congress in the Drive to Modernize Banking*, 17 No. 3 BANKING POL'Y REP. 1 (1996).

⁶³ Representative Roukema suggested the House Banking Committee urge the bank regulatory agencies to take no action on banking modernization because "they have got to understand that we ultimately will be writing this legislation." Jaret Seiberg, *House Vote on Reform Not Likely Until Spring*, AM. BANKER, Nov. 2, 1997, at 1.

changes brought about by the new legislation. However, it must be noted that Gramm-Leach-Bliley provides for the establishment of a new type of bank holding company called a financial holding company that may engage in a wide range of financial activities previously unavailable or available only to a limited extent through the regulatory approval process. Although Gramm-Leach-Bliley does not eliminate the traditional bank holding company, most banks will likely choose to become financial holding companies in order to engage in expanded financial activities if they can meet the conditions set forth in the statute. Therefore, the regulatory approval process described in this Section is primarily of historical interest.

Although Section 1843 of the Bank Holding Company Act generally prohibits banks in a holding company structure from being affiliated with nonbank subsidiaries,⁶⁴ pursuant to Section 1843(c)(8), the Board, by order or regulation, after notice and opportunity for public comment, may permit a holding company to own shares of a company engaged in activities determined to be "closely related to banking."⁶⁵ In addition, the proposed activity must meet a second test, namely whether the public benefits of such new activity will outweigh any potential adverse effects.⁶⁶ Pursuant to this grant of authority, the Board permitted bank holding company subsidiaries to engage in some limited forms of nonbanking activities pursuant to individual orders and through regulation, namely the so-called "laundry list"⁶⁷ in Board Regulation Y, which governs the operation of bank holding

⁶⁴ Bank holding companies are prohibited from owning or controlling, directly or indirectly, the voting shares of any company that is not a bank, as defined in the statute. See 12 U.S.C. § 1843(a) (1999).

⁶⁵ The statute states that the activity must be found "to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." See 12 U.S.C. § 1843(c)(8) (1999).

⁶⁶ See *id.* This test was added by the 1970 amendments to the Bank Holding Company Act and require the Board to determine whether the performance of nonbanking activities by an affiliate of a bank holding company can reasonably be expected to produce benefits to the public such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

⁶⁷ 12 C.F.R. § 225.28. According to the Board, the "laundry list" is intended to serve the purpose of providing a convenient and detailed list of most of the activities that the Board has found to be closely related to banking and therefore permissible for bank holding companies. 62 Fed. Reg. 9290, 9301-9302 (1997).

companies.⁶⁸ The “laundry list” is expansive in its scope, especially after amendments that were made in 1997 as part of a comprehensive revision of Regulation Y.⁶⁹ Bank holding company affiliates were permitted to engage in a wide variety of nonbanking activities by virtue of this authority,⁷⁰

⁶⁸ See 12 C.F.R. Part 225 (1999).

⁶⁹ See Federal Reserve System, Final Rule, Bank Holding Companies and Change in Bank Control (Regulation Y) (February 28, 1997), 62 Fed. Reg. 9290 (1997). The changes were the product of a comprehensive review of Regulation Y mandated by the Riegle Community Development and Regulatory Improvement Act of 1994, see 12 U.S.C. § 4803 (1999), in order to improve efficiency, reduce unnecessary costs, and eliminate unwarranted constraints on credit availability. See 61 Fed. Reg. 47242 (1996). The most significant amendments to Regulation Y fall into one of four categories. First, changes to application and notice procedures for both bank and nonbank acquisitions were made. Among other things, the new rules permit a streamlined review process for bank and non-bank acquisitions meeting certain qualifying criteria, eliminate the prior notice and approval requirements of the Bank Holding Company Act for bank holding companies meeting certain qualifying criteria to engage de novo in any nonbanking activity approved by the Board by regulation, and establish a streamlined review process for engaging de novo in nonbanking activities previously approved by the Board by order. See 62 Fed. Reg. 9290, 9290–9293 (1997). See 12 C.F.R. Part 225 (1999). Second, the scope of permissible nonbanking activities was broadened. See 62 Fed. Reg. 9290, 9301 (1997), 12 C.F.R. § 225.22 (1999). Third, many regulatory restrictions on nonbanking activities were eliminated. See 62 Fed. Reg. 9290, 9302 (1997). Fourth, tying restrictions applicable to bank holding companies and their bank and nonbank affiliates were removed or liberalized. See 62 Fed. Reg. 9290, 9312 (1997); 12 C.F.R. § 225.7 (1999). Miscellaneous changes to reduce the regulatory burden of complying with Regulation Y were made. See 62 Fed. Reg. 9290, 9316–18 (1997).

⁷⁰ Among the permissible nonbanking activities that were added to the laundry “list” of activities deemed closely related to banking are riskless principal transactions, private placement services, foreign exchange trading for a bank holding company’s own account, dealing and related activities in gold, silver, platinum and palladium, employee benefits consulting, career counseling services, asset management, servicing and collection activities, acquiring and resolving debt in default, printing and selling checks and providing real estate settlement services. See 62 Fed. Reg. 9290, 9302 (1997); 12 C.F.R. § 225.28 (1999). In addition, the scope of permissible derivatives and foreign exchange activities has been broadened to give bank holding companies the same ability to conduct these activities as banks and certain restrictions applicable to bank holding companies that were not applicable to banks are also removed. See 62 Fed. Reg. 9290, 9302 (1997). 12 C.F.R. § 225.28(b)(8)(ii) (1999). The revisions also removed a significant number of restrictions contained in Regulation Y that were considered outmoded, had been

including securities and insurance activities that require the affiliate to act in an agency capacity.⁷¹ Safety and soundness concerns for banks arising as a result of being affiliated with a company engaged in nonbanking activities are addressed in Sections 23A and 23B of the Federal Reserve Act, which prohibits certain transactions, including lending and purchases and sales of assets, between banks and affiliates.⁷² These firewalls are intended to insulate banks from the risks associated with conflict of interest transactions, that might flow from such affiliations.

The 1997 Regulation Y amendments indicated that the Board was prepared to deregulate activities restrictions applicable to bank holding companies on an ongoing basis. Several principles guided the Board's reform of nonbanking activities restrictions, most importantly the idea that bank holding companies should be permitted to conduct nonbanking activities to the fullest extent permissible under the Bank Holding Company Act and that Regulation Y should be flexible enough to allow for development within the banking industry of permissible activities without creating unnecessary additional filing burdens.⁷³ The Board indicated that it would be proactive in authorizing new activities, especially as new activities are permitted for banks or as new financial services are developed, reiterating its view that under the Bank Holding Company Act, bank holding companies are authorized to conduct activities beyond the scope of activities that insured banks may conduct.⁷⁴ The Board also conducted a comprehensive revision of the restrictions that govern the conduct of permissible nonbanking activities. A guiding principle in this regard was

superseded by Board order or did not apply to insured depository institutions conducting the same activity. Examples of such restrictions include those relating to investment advisory activities of bank holding companies with respect to mutual funds and other investment companies, data processing and management consulting activities, and acquisitions of assets used in lending related activities in the ordinary course of business. *See* 62 Fed. Reg. 9290, 9302-9305 (1997).

⁷¹ Examples are insurance agency for credit insurance, *see* 12 C.F.R. § 225.28(b)(11)(1999), and securities brokerage and investment advisory services, *see* 12 C.F.R. § 225.28(b)(7)(1999).

⁷² *See* 12 U.S.C. §§ 371c, 371c-1 (1999).

⁷³ *See* 61 Fed. Reg. 47242, 47243 (1996).

⁷⁴ *See id.* The Board indicated in the release accompanying the final rule that it would consider amending the laundry list as new activities are authorized for banks, as experience with a narrowly defined activities indicated that the activity could be more broadly defined or as developments occurred in technology or the marketplace for financial products and services. *See* 62 Fed. Reg. 9290, 9303 (1997).

that a bank holding company should not be subject to supervisory restrictions on conducting an activity that would not apply to an insured depository institution conducting the same activity. Another principle was that supervisory principles should be governed by market developments and the Board's experience and should be uniformly applied to insured depository institutions and their affiliates on an interagency basis.⁷⁵

Although the changes to Regulation Y liberalizing nonbanking activities restrictions were substantial, certain areas of activities restrictions were not touched. The 1997 Regulation Y amendments failed to permit sales of annuities and nationwide sales of insurance from small towns under 5000, pursuant to 12 U.S.C. § 92, which had been previously authorized by the OCC for national banks,⁷⁶ failed to treat municipal bonds as bank eligible securities that could be underwritten in a Section 4(c)(8) subsidiary not subject to gross revenue limitations rather than a Section 20 subsidiary, failed to permit mutual fund underwriting and distribution through Section 20 subsidiaries or Section 4(c)(8) subsidiaries subject to gross revenue limitations but with revenue based upon fee income rather than gross sales, and failed to consider best efforts underwriting as an eligible activity permissible for a Section 4(c)(8) subsidiary.⁷⁷

b. Expansion of Permitted Securities Activities Through Use of Section 20 Subsidiaries.

Perhaps the most dramatic use of Board authority to expand bank powers pursuant to 12 U.S.C. § 1843(c)(8) was the issuance of so-called Section 20 orders to various bank holding companies. Prior to Gramm-Leach-Bliley, Glass-Steagall prohibited national banks from underwriting or dealing in all securities, with limited exceptions, most notably U.S. government securities.⁷⁸ The limited category of securities which national banks could underwrite and deal in without restriction are referred to as bank ineligible securities.⁷⁹ In contrast, bank ineligible securities are those securities that a national bank would not be permitted to underwrite or deal

⁷⁵ See 61 Fed. Reg. 47242, 47243 (1996).

⁷⁶ See *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25 (1996). See VALIC, *supra* note 59.

⁷⁷ See Melanie L. Fein, *Fed's Proposed Overhaul of Regulation Y Goes Far, But Could Be Bolder*, 15 BANKING POL'Y REP. 4, 6-7 (1996).

⁷⁸ See 12 U.S.C. § 24 (Seventh) (1999).

⁷⁹ The permissible securities activities of national banks are governed by regulations set forth at 12 C.F.R. Part 1.

in.⁸⁰ Even though, prior to Gramm-Leach-Bliley, Section 20 of Glass-Steagall prohibited affiliations of member banks of the Federal Reserve System⁸¹ with corporations “engaged principally” in the securities business, the Board orders permitted the bank holding company applicants to engage in limited securities underwriting and dealing activities in bank ineligible securities through nonbank subsidiaries. The Board determined that this activity was permissible under Section 1843(c)(8) of the BHCA because it was closely related to banking.⁸²

The Board issued its first Section 20 order in 1987, when it approved applications by three bank holding companies to underwrite and deal in commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer-receivable-related securities (tier-one securities).⁸³ In 1989, the Board allowed five bank holding companies to underwrite and deal in all debt and equity securities (tier-two securities).⁸⁴ Subsequently, other bank holding companies were granted authority to engage in underwriting and dealing in bank ineligible securities through Section 20 subsidiaries on the same terms as in the 1987 and 1989 orders. As of the end of 1996, forty-one Section 20 subsidiaries were authorized to engage in underwriting and dealing activities with respect to bank ineligible securities.⁸⁵ Fifteen of the Section 20 subsidiaries had authority to underwrite and deal in tier-one

⁸⁰ See 61 Fed. Reg. 68750 (1996).

⁸¹ See 12 U.S.C. § 377 (repealed 1999).

⁸² See 1987 Order, *infra* note 83, at 487.

⁸³ See Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp., 73 Fed. Res. Bulletin 473 (1987) [hereinafter 1987 Order], *aff'd*, Securities Industry Ass'n v. Board of Governors of Fed. Reserve Sys., 839 F.2d 47 (2d Cir.1988), *cert. denied*, 486 U.S. 1059 (1988)(Citicorp); see also Chemical New York Corp., Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, Manufacturers Hanover Corp., and Security Pacific Corp., 73 Fed. Res. Bull. 731 (1987) (approving underwriting and dealing in consumer-receivable-related securities, after having deferred decision for 60 days in its 1987 Order).

⁸⁴ See J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp., 75 Fed. Res. Bull. 192 (1989) [hereinafter 1989 Order], *aff'd*, Securities Industries Ass'n v. Board of Governors of Fed. Reserve Sys., 900 F.2d 360 (D.C. Cir. 1990).

⁸⁵ Revenue Limit on Bank Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities. See 61 Fed. Reg. 68750, 68751 (1996). More recent data is available in Section 20 Securities Subsidiaries (last modified Mar. 4, 1999) (visited May 3, 1999) <<http://www.bog.frb.fed.us/generalinfo/section20>>.

securities pursuant to the terms of the 1987 Order. Twenty-three Section 20 subsidiaries had authority to underwrite and deal in all tier-two securities and three had authority to underwrite and deal in all debt securities, pursuant to the terms of the 1989 Order.

The 1987 and 1989 Orders were based on an interpretation by the Board of the phrase "engaged principally" in Section 20 of Glass-Steagall to mean "substantial" or "primary."⁸⁶ According to the Board, a holding company affiliate of a bank could engage in a limited amount of securities underwriting and dealing activity without being deemed to be "engaged principally" in such activity for purposes of Section 20 of the Glass-Steagall Act.⁸⁷ The Board devised a revenue test to determine whether a company is "engaged principally" in underwriting and dealing for purposes of Section 20. The revenue test provided that a Section 20 subsidiary may not derive more than a fixed percent of its total revenue from underwriting and dealing in bank ineligible securities.⁸⁸ This fixed percent was originally set at 5%⁸⁹ but has recently been raised to 25%, as described below.

In addition to these limitations, the Board imposed various conditions or firewalls intended to guard against conflict of interest transactions that might affect the safety and soundness of affiliated banks. Twenty-eight firewalls were imposed in the original Section 20 orders, which can be grouped into categories by common subject matter.⁹⁰ The most

⁸⁶ 61 Fed. Reg. 68750, 68751 (1996). An alternative meaning of principal, namely "chief," "main," or "largest," which would have permitted up to 50 percent of the Section 20 subsidiary's business to be derived from securities underwriting and dealing was rejected by the Board. 1987 Order, *supra* note 83, at 477-78, 482-83.

⁸⁷ *Id.*

⁸⁸ The Board arrived at this revenue test through a series of interpretive steps, in a series of orders. See *Bankers Trust New York Corporation*, 73 Fed. Res. Bull. 138 (1987); 1987 Order, *supra* note 83; *Modifications to Section 20 Orders*, 75 Fed. Res. Bull. 751 (1989); *Order Approving Modifications to the Section 20 Orders*, 79 Fed. Res. Bull. 226 (1993).

⁸⁹ See 1987 Order, *supra* note 83, at 485.

⁹⁰ The categories included the following: 1) capital adequacy conditions, 2) prohibitions and other limitations on credit extensions by a bank to customers of an affiliated Section 20 subsidiary, 3) prohibition on director and officer interlocks between banks and an affiliated Section 20 subsidiary, 4) required customer disclosure by an underwriting subsidiary describing the difference between the bank and such bank affiliate, 5) restrictions on marketing on behalf of a Section 20 subsidiary, 6) requirement that investment advice given by a bank regarding bank

important limitations were those relating to capital adequacy, limitations on credit extensions by a bank to customers of a Section 20 subsidiary, and limitations on credit extensions by a bank to customers of a Section 20 subsidiary. As discussed below, the Board has recently removed these firewalls and replaced them with a greatly simplified set of operating standards.

c. Recent Changes to Section 20 Subsidiary Restrictions.

In 1996 and 1997, the Board made two important revisions to the conditions imposed in previous Board orders permitting limited securities activities through Section 20 subsidiaries. First, the Board raised the limit on income from bank ineligible securities from 10% to 25%.⁹¹ Second, the Board modified the firewalls imposed in prior Section 20 orders, replacing them with a series of eight operating standards.⁹² These changes signaled an even greater willingness on the part of the Board to deregulate the conditions

ineligible securities underwritten by a Section 20 affiliate be accompanied by disclosures about the affiliate's role, 7) limit on extension of credit and purchase of assets involving a Section 20 subsidiary, 8) limitations on disclosure of customer information between a bank and a Section 20 subsidiary, 9) requirement of reports; 10) requirement that securities activities be conducted only by the subsidiary for which approval has been sought and prohibition on corporate reorganizations without board consent, 11) prohibition on reciprocity arrangements between bank holding companies intended to evade the firewall and limitations on discriminatory arrangements in which Section 20 subsidiaries are favored over competitors, and 12) requirement of a supervisory review by the Board prior to commencement of approved securities activities. 62 Fed. Reg. 45295, 45297-45306 (1997). 62 Fed. Reg. 2622 (1997).

⁹¹ See Federal Reserve System, Notice, Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities (1996), 61 Fed. Reg. 68750 [hereinafter Section 20 Notice]. The change, announced December 20, 1996, became effective March 6, 1997. Section 20 subsidiaries would therefore be allowed to employ the 25% limit for the first quarter of 1997. See Board of Governors of the Federal Reserve System, Announcements, Increase in the Amount of Revenue that Section 20 Subsidiaries May Derive from Underwriting and Dealing in Securities (1997), 83 Fed. Res. Bull. (1997).

⁹² See Federal Reserve System, Final Conditions to Board Orders, Bank Holding Companies and Change in Bank Control (Regulation Y); Amendments to Restrictions in the Board's Section 20 Orders, 62 Fed. Reg. 4529 (1997); Proposed Rules, Proposed Conditions to Board Orders, 62 Fed. Reg. 2622 (1997).

under which bank affiliates were permitted to underwrite and deal in bank ineligible securities.

i. Increase in Revenue Limit

The Board made the change because it had supervised Section 20 subsidiaries over a nine year period without significant problems and it recognized that developments in the securities markets had occurred since the revenue limitation was adopted in 1987.⁹³ As a consequence, the Board decided that a Section 20 subsidiary would not be engaged principally in such activities so long as ineligible revenue did not exceed 25% of total revenue.⁹⁴ The impact of this change was felt immediately with the announcement of several acquisitions involving major financial services

⁹³ See Section 20 Notice, *supra* note 91, at 68751. 61 Fed. Reg. 68750, 68751 (1996). The Board believed that the prior limit of 10% had unduly restricted the underwriting and dealing activity of Section 20 subsidiaries to a level that fell short of being "engaged principally" for purposes of Section 20, noting that changes in the product mix that Section 20 subsidiaries are permitted to offer and developments in the securities markets had affected the relationship between revenue and securities activity since the original Section 20 orders in 1987. *Id.* The Board further explained its rationale by citing evidence that revenues of Section 20 subsidiaries related to ineligible securities underwriting had increased without a corresponding increase in the number or size of transactions, due to greater revenues generated in connection with corporate debt activities. The Board noted that the reason for higher revenues on tier-two securities activities was related to higher risk but also to factors such as financial innovation in structuring transactions, ability to foresee shifting public needs gained from an experienced sales force, research on the issuer that is credited by the market, the ability to use marketing expertise to avoid losses, and accuracy in pricing. *Id.* at 68753. It also noted that revenues related to eligible securities activities had decreased without a corresponding decrease in level of activity, due to lower commissions as a result of increased competition. *Id.*

⁹⁴ The Board noted that it had not revised its legal interpretation of the term "engaged principally" to mean "substantial" or "primary", rather than "chief", "main" or largest." *Id.* The Board also rejected the notion that the revenue limit should not be raised because of the fact that several Section 20 subsidiaries were among the largest underwriters in the U.S. or because banks would be permitted to affiliate with the largest investment banks in the U.S. According to the Board, such arguments were an attempt to reintroduce a market share limitation on securities activities by Section 20 subsidiaries, an approach that was explicitly rejected by the Second Circuit Court of Appeals in a challenge to the original Board Section 20 order in 1987. *Securities Industry Ass'n v. Board of Governors*, 839 F.2d 47, 68 (2d Cir. 1987), *cert denied*, 486 U.S. 1059 (1988).

firms, which were made possible only because of the change in the revenue limit.⁹⁵ This development suggests that the Board's revision to the revenue limit was not merely a response to market change, but also a facilitator of it.

ii. Revision of Firewalls

The Board also substantially revised the limitations that had been imposed on operation of Section 20 subsidiaries pursuant to Board orders.⁹⁶ The bulk of these limitations, or firewalls, were adopted in the 1987 Order.⁹⁷ Other firewalls were added in the 1989 Order.⁹⁸ The purpose of these restrictions was to prevent the risks associated with securities underwriting and dealing from being passed from a Section 20 subsidiary to an affiliated 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."⁹⁹

The Board noted it initially had imposed a "very conservative regime" for firewalls due to the historical context in which such orders were issued. Due to the long-standing separation between commercial and investment banking effected by Glass-Steagall, the Board had little experience supervising investment banks and was concerned about the unknown risks that might be presented if affiliations between commercial and investment banks were allowed. Such affiliations were thought by many

⁹⁵ In April 1997, Bankers Trust New York Corp. announced plans to acquire the securities firm of Alex Brown Inc. of Baltimore, a deal made possible because of the Board's move to raise the Section 20 revenue cap to 25%. See Niles S. Campbell, *Roukema Objects to Bank's Request to Underwrite Municipal Revenue Bonds*, BNA Banking Daily (Apr. 17, 1997). Other acquisitions included First Union of Wheat First Butcher Singer Securities, BankAmerica of Robertson, Stephens & Co., CIBC of Oppenheimer, and SBC Warburg of Dillon, Reed & Company. See John W. Milligan, *Bankers Who Would Be Brokers*, U.S. BANKER, October 1997, at 26.

⁹⁶ Bank Holding Companies and Change in Bank Control (Regulation Y); Amendments to Restrictions in the Board's Section 20 Orders. See 62 Fed. Reg. 45, 295 (1997) [hereinafter Section 20 Firewall Amendments]. The changes were the product of a comprehensive review of Regulation Y mandated by the Riegle Community Development and Regulatory Improvement Act of 1994, 12 U.S.C. § 4803 (1999), in order to improve efficiency, reduce unnecessary costs, and eliminate unwarranted constraints on credit availability. See 62 Fed. Reg. 45295, 45296 (1997).

⁹⁷ See 62 Fed. Reg. 29545, 45296 (1997).

⁹⁸ See *id.*

⁹⁹ *Id.*

commentators at the time to have caused losses in the banking industry before 1933, but recent research on this topic indicated this belief was largely inaccurate.¹⁰⁰ The Board was uncertain about whether functional regulation by the Securities and Exchange Commission of the broker-dealer function of Section 20 subsidiaries would afford adequate protection.¹⁰¹ Finally, statutory changes enacted since 1987 either duplicated some of the firewalls or otherwise addressed the risks that the firewalls were formulated to protect against.¹⁰² When it adopted the firewalls in its Section 20 orders, the Board indicated that its concern about affiliations between holding company subsidiaries and insured banks might abate with time and that it would continue to review such restrictions as its experience in supervising Section 20 subsidiaries expanded.¹⁰³ After conducting a comprehensive review of the firewalls, the Board concluded that many of them could be eliminated entirely and the rest could be incorporated in a smaller number of operating standards.¹⁰⁴ The Board noted that, in its experience, the risks of securities underwriting and dealing had proven to be manageable in a bank holding company framework, and that both bank

¹⁰⁰ See 62 Fed. Reg. 2622 (1997).

¹⁰¹ See *id.* at 2623.

¹⁰² See *id.* The Board pointed to enactment of Section 23B of the Federal Reserve Act, which duplicated or overlapped many of the firewalls, enactment of risk-based capital standards, and adoption of the Interagency Statement on Retail Sales of Nondeposit Investment Products. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision; Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994), 1994 WL 836461 [hereinafter Retail Sales Statement]. The four federal bank and thrift regulatory agencies have issued a joint statement on retail sales of nondeposit investment products because the agencies believed that retail customers must be fully informed about the risks associated with mutual fund or other nondeposit investment products. Depository institutions selling such products must now inform customers that the products: 1) are not FDIC-insured; 2) are not deposits or other obligations of the institution and are not guaranteed by the institution, and 3) involve investment risks. The Statement also outlines the steps banks and thrifts should take to minimize customer confusion. According to the Board, this Statement is the primary means to avoid misleading retail banking customers about the nature of the products they are purchasing. See 62 Fed. Reg. 2622, 2623 (1997).

¹⁰³ See 62 Fed. Reg. 2622, 2623 (1997).

¹⁰⁴ Technically, the Board rescinded the firewalls in the 1987 and 1989 Orders and any other orders incorporating those conditions. See 62 Fed. Reg. 45295, 45306 (1997).

holding companies and banks had undertaken and managed activities posing similar risks for which no firewalls were used.¹⁰⁵ Most of the affiliation risks between commercial and investment banking were in the Board's opinion adequately addressed by general bank and bank holding company laws and regulations, as well as by securities laws and regulations of the Securities and Exchange Commission, National Association of Securities Dealers, and securities exchanges applicable to every broker-dealer, including Section 20 subsidiaries.¹⁰⁶ Those risks not adequately addressed by existing laws and regulations, such as the risk that a customer might be confused about whether a product was offered by an insured bank or an uninsured affiliate, were covered by the new operating standards.¹⁰⁷

To replace the firewalls that were rescinded, the Board established eight operating standards, covering the following areas: capital,¹⁰⁸ internal controls,¹⁰⁹ interlock restriction,¹¹⁰ customer disclosure,¹¹¹ intra-day credit

¹⁰⁵ See 62 Fed. Reg. 2622, 2623 (1997).

¹⁰⁶ See 62 Fed. Reg. 45295, 45297 (1997).

¹⁰⁷ See *id.*

¹⁰⁸ See 12 C.F.R. § 225.200(b)(1) (1999). A bank holding company shall maintain either adequate or strong capital depending on whether its Section 20 subsidiary is underwriting tier-one or tier-two securities. A bank affiliate of a Section 20 must remain well-capitalized or the Board may impose additional conditions. Special capital rules apply to foreign banks.

¹⁰⁹ See 12 C.F.R. § 225.200(b)(2) (1999). A bank holding company or foreign bank operating a Section 20 subsidiary must cause its bank subsidiaries, branches and agencies to adopt policies and procedures including risk exposure limits to govern participating in transactions involving the securities subsidiary.

¹¹⁰ See 12 C.F.R. § 225.200(b)(3) (1999). Directors, officers or employees of a bank or thrift subsidiary of a bank holding company (or a bank or thrift subsidiary or branch or agency of a foreign bank) shall not serve as a majority of the board of directors or the chief executive officer of an affiliated Section 20 subsidiary. Directors, officers or employees of a Section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer of an affiliated bank or thrift subsidiary or branch or agency.

¹¹¹ See 12 C.F.R. § 225.200(b)(4) (1999). A Section 20 subsidiary shall give its retail customers the disclosures required by the Retail Sales Statement. See *supra* note 102. Before expressing an opinion on a bank ineligible security being underwritten or dealt in by an affiliated Section 20 subsidiary, directors, officers and employees of a bank, thrift, branch or agency must disclose the affiliate's role.

extensions,¹¹² restrictions on funding purchases of securities during underwriting period,¹¹³ reporting requirements,¹¹⁴ and foreign bank compliance.¹¹⁵ The most important changes addressed the firewalls regarding funding of a Section 20 subsidiary by an affiliated bank, credit enhancements provided by a bank to issuers of securities underwritten by a Section 20 affiliate, and loans provided by a bank to customers purchasing products of Section 20 affiliates. These changes were thought to allow Section 20 subsidiaries to operate more readily in conjunction with an affiliated bank, thereby maximizing synergies, enhancing services, and possibly reducing costs.¹¹⁶ In addition, the Board stated that a Section 20 subsidiary like any other subsidiary of a bank holding company must be operated prudently. Prudent operation was deemed to include observing corporate formalities, such as maintaining separate corporate and accounting records, and instituting appropriate risk management, such as independent trading and exposure limits consistent with parent company guidelines.¹¹⁷

Both the increase in the revenue limit and the lowering of the firewalls applicable to Section 20 subsidiaries signaled the Board's attempt to strike a balance between the concerns of regulators, including safety and soundness and consumer protection, and the interests of bankers in remaining competitive in the marketplace.¹¹⁸ The changes also indicated

¹¹² See 12 C.F.R. § 225.200(b)(5) (1999). Intra-day credit extensions to a Section 20 subsidiary by an affiliated, bank, thrift, branch or agency must be on market terms consistent with Section 23B of the Federal Reserve Act.

¹¹³ See 12 C.F.R. § 225.200(b)(6) (1999). Banks, thrifts, branches and agencies may not extend credit to a customer secured by or to fund the purchase of a bank ineligible security currently or within the last 30 days underwritten by a Section 20 affiliate, except under limited circumstances.

¹¹⁴ See 12 C.F.R. § 225.200(b)(7) (1999). Certain reports filed with securities regulators must be filed with the Board along with Board forms required to monitor compliance with the operating standards and Section 20 of Glass-Steagall.

¹¹⁵ See 12 C.F.R. § 225.200(b)(8) (1999). Foreign banks must ensure that certain transactions between their branches and agencies and Section 20 subsidiaries are on terms consistent with Sections 23A and 23B of the Federal Reserve Act.

¹¹⁶ See 62 Fed. Reg. 2622, 2623 (1997).

¹¹⁷ See 62 Fed. Reg. 45295, 45306 (1997).

¹¹⁸ The Board releases accompanying the proposed and final rule amending the firewalls set forth in the Section 20 orders recognized the importance of economic efficiency factors. In connection with the proposed rule, the Board stated that it believed the proposed modifications would "allow section 20 subsidiaries to operate more efficiently and serve their customers more effectively. These modifications

what the future trend of Board actions would be. First, securities activities were considered safe enough to be conducted in a non-bank affiliate of an insured bank without the need for an elaborate system of controls. Second, the existing legal framework, most notably Sections 23A and 23B of the Federal Reserve Act and securities laws and regulations applicable to broker-dealer firms, was deemed sufficient to satisfy safety and soundness concerns. Third, corporate separateness and the insulation that this affords banks from safety and soundness problems were viewed favorably. The revisions also indicated that the Board would be responsive to market developments. By the time Gramm-Leach-Bliley was passed, the Board had become increasingly proactive in deregulating activities restrictions.

2. National Bank Operating Subsidiaries

a. The New Part 5 Rules on Corporate Activities of National Banks

The operating subsidiary option for new financial activities was made possible due to 1996 amendments to OCC regulations governing the corporate activities of national banks and their operating subsidiaries contained in Part 5 of the Code of Federal Regulations.¹¹⁹ The most

would allow section 20 subsidiaries to operate more readily in conjunction with an affiliated bank, thereby maximizing synergies, enhancing services, and possibly reducing costs." 62 Fed. Reg. 2622 (Summary). In connection with the final rule, the Board stated that "the narrower set of restrictions will be fully consistent with safety and soundness and should improve operating efficiencies at section 20 subsidiaries and increase options for their customers." 62 Fed. Reg. 45295 (Summary). The Board was acting in response to a Congressional mandate under the Riegle Community Development and Regulatory Improvement Act of 1994 to streamline its regulations to improve efficiency, reduce unnecessary costs, and eliminate unwarranted constraints on credit availability, 62 Fed. Reg. 45295, 45296 (1997).

¹¹⁹ 12 C.F.R. Part 5 (1999). The changes became effective on December 31, 1996. The amendments adopted a risk-based approach so corporate applications and corporate activities of national banks and their operating subsidiaries, with different application procedures mandated depending on the type of proposed activity and the financial and operational strength of the bank. *See* OCC, Rules, Policies and Procedures for Corporate Activities, Final Rule, 61 Fed. Reg. 60342 (1996). The Part 5 changes were adopted as part of the OCC's ongoing regulatory review program to reduce unnecessary burdens and costs for national banks. *See* OCC Bulletin, Rules, Policies, and Procedures for Corporate Activities; Final Rules, OCC 96-71, December 17, 1996.

controversial change was adoption of a provision allowing operating subsidiaries to conduct activities that would be impermissible for a national bank upon application to the OCC and approval on a case by case basis ("Operating Subsidiary Rule").¹²⁰ The rule did not specify the types of activities that might be approved, although it did require such activities to be "part of or incidental to the business of banking or otherwise authorized by statute or otherwise authorized by statute."¹²¹ Former Comptroller Eugene Ludwig, who was at the helm at the time, declined to speculate publicly about the kinds of activities that the OCC might approve under the Operating Subsidiary Rule, commenting only that the OCC had no commitment to approving a particular activity, but would evaluate any applications on a case-by-case basis following a comprehensive review of supervisory, policy and legal concerns.¹²² Commentators speculated that underwriting bank ineligible securities might be approved in this way, thereby offering banks an alternative to the use of a holding company affiliate, i.e., a Section 20 subsidiary, for securities activities prohibited to banks under Glass-Steagall.¹²³ In fact, the OCC had approved several applications by national banks to conduct municipal revenue bond underwriting through subsidiaries under the Operating Subsidiary Rule by the time Gramm-Leach-Bliley was

¹²⁰ See 12 C.F.R. § 5.34(f) (1999). For a discussion of these changes, see Joseph J. Norton, *The Glass-Steagall Act and Related Bank Legislative Reform in the United States: Non-Legislative Bank Regulation and Modernization - The Recent Comptroller of the Currency "Op-Sub" Regulation*, 14 *BANKING & FIN. L. REV.* 1 (1998); James R. Smoot, *Bank Operating Subsidiaries: Free At Last or More of the Same?* 46 *DEPAUL L. REV.* 651 (1997); McCoy, *supra* note 20, at § 8.06. Note, *National Bank Operating Subsidiaries: How Far Has the OCC Opened the Door to Nonbanking Activities?* 2 *N.C. BANKING INST.* (1998); Note, *The New American Universal Bank*, 110 *HARV. L. REV.* 1310 (1997).

¹²¹ 12 C.F.R. § 5.34(d)(1) (1999). Under the Part 5 regulations, a national bank is authorized to establish or acquire an operating subsidiary to conduct, or may conduct in an existing operating subsidiary, activities that are part of or incidental to the business of banking, as determined by the Comptroller pursuant to 12 U.S.C. § 24 (Seventh) (1998), and other activities permissible for national banks or their subsidiaries under other statutory authority. See 12 C.F.R. § 5.34(d)(1) (1999).

¹²² See *Ludwig Defends OCC Authority to Act on Op Sub Proposal*, 14 No. 5 *BANKING POL'Y REP.* 2 (1995) [hereinafter Ludwig].

¹²³ See *id.* (noting that Ludwig has stated that Glass-Steagall clearly authorizes national banks to establish Section 20 subsidiaries and that the OCC is expected to allow operating subsidiaries to conduct virtually every activity that is permissible for a bank holding company). See also *Ludwig Adopts Two-Year-Old Op Sub Proposal*, 15 No. 23 *BANKING POL'Y REP.* 2 (1996).

adopted. This section will describe the state of the law prior to passage of Gramm-Leach-Bliley. However, it should be noted that Gramm-Leach-Bliley provides for the establishment of financial subsidiaries by national banks that may engage in underwriting bank ineligible securities, among other things. Therefore, the regulatory approval process under the Operating Subsidiary Rule described in this section is primarily of historical interest.

Applications under the Operating Subsidiary Rule differed from other applications under the Part 5 rules in two significant respects. Banks were subject to a higher level of scrutiny by the OCC during the approval process than would be the case if they sought to conduct banking activities in such subsidiary and were required to comply with special regulatory safeguards. In general, a national bank seeking to acquire or establish, or commence new activities in, an operating subsidiary is required to submit an application and obtain prior OCC approval.¹²⁴ The OCC reviews the application to determine whether the proposed activity is legally permissible for an operating subsidiary, to ensure that the proposal is consistent with safe and sound banking practices and OCC policy, and does not endanger the safety or soundness of the parent national bank.¹²⁵

Different application procedures apply under the Part 5 rules depending on the novelty, complexity, and risk of the proposed activity and the financial and operational capacities of the parent bank.¹²⁶ Applications under the Operating Subsidiary Rule fell into the application category with the most heightened level of scrutiny, requiring an extensive review process, including public notice and comment on the application.¹²⁷

Numerous safeguards became applicable automatically to applicant banks and operating subsidiaries for approvals under the Operating

¹²⁴ See 12 C.F.R. § 5.34(b) (1999).

¹²⁵ See 12 C.F.R. § 5.34(e)(1)(iii) (1999).

¹²⁶ There are three categories of application procedures established. The first category required after the fact notice to be given in order to engage in banking-related activities that the OCC has previously approved for operating subsidiaries on a case by case basis and which are listed in the regulation. 12 C.F.R. § 5.34(e)(2)(i), (ii) (1999). The second category provided for an expedited review process in order to engage in activities that the OCC has previously approved on a case by case basis but that are more complex and may require more specialized expertise than those activities falling in the notice category, and therefore warrant prior OCC review. 12 C.F.R. § 5.34(e)(3) (1999). A third category applied to approvals under the Operating Subsidiary Rule. 12 C.F.R. § 5.34(f) (1999).

¹²⁷ 12 C.F.R. § 5.34(f) (1999).

Subsidiary Rule.¹²⁸ There were two categories of safeguards:¹²⁹ 1) those intended to ensure the subsidiary's independent legal status (corporate requirement safeguards),¹³⁰ and 2) those intended to protect the safety and soundness of the parent bank when the subsidiary is engaged in principal activities (supervisory requirement safeguards).¹³¹

In addition to these built-in safeguards, the OCC was permitted to impose additional conditions on a case-by-case basis as deemed appropriate depending on the particular bank or activity involved.¹³² The purpose of this

¹²⁸ 61 Fed. Reg. 60342, 60351 (1996).

¹²⁹ *See id.* at 60354.

¹³⁰ The corporate requirement safeguards applicable to the operating subsidiary included physical separation from the parent bank and compensation by the subsidiary of subsidiary employees; holding out as a separate entity from the parent bank in written material and in direct contact with customers; use of a different name than the parent bank; adequate capitalization based on industry norms to support its activities and to cover expenses and losses; maintenance of separate accounting and corporate records; conduct of its operations pursuant to independent policies and procedures intended to inform customers of separate status; arm's length terms in service contracts with the parent bank; observance of corporate formalities; board member banking expertise and independence from parent bank for at least one-third of the subsidiary's board; internal controls at both the subsidiary and parent bank level to manage the financial and operational risks associated with the subsidiary. 12 C.F.R. § 5.34(f)(2) (1999). The purpose of the corporate requirement safeguards was to reduce the risk that the parent bank will be held liable for losses of its subsidiary through attempts to pierce the corporate veil of limited liability. 61 Fed. Reg. 60342, 60354 (referring to prior OCC practice requiring such corporate separateness for operating subsidiaries engaged in derivatives activities and to FDIC proposed rules for real estate subsidiaries of insured state banks). *See* FDIC, Proposed Rules, 12 C.F.R. § 362, Activities and Investments of Insured State Banks, 621 Fed. Reg. 43486, 43491 (proposed Aug. 23, 1996).

¹³¹ The supervisory requirement safeguards included reduction of the bank's capital and total assets by an amount equal to the bank's equity investment in the subsidiary and non-consolidation of the subsidiary's assets and liabilities with those of the bank; application of Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. §§ 371c, 371c-1) to transactions between the bank and the subsidiary and OCC enforcement of such standards; and status of the parent bank as an eligible bank both prior to and after commencement of the activity. The purpose of the supervisory requirement safeguards was to contain risk, reduce potential conflicts of interest, ensure the safe and sound operation of the parent bank, and, in the case of the arm's length standards, eliminate the possibility of a subsidy flowing from the bank to its subsidiary. 61 Fed. Reg. 60342, 60354 (1996).

¹³² *See id.* at 60351.

approach was to ensure that the OCC would be able to fulfill its obligation to identify, manage, and control risk.¹³³

b. The Controversy Over the Operating Subsidiary Rule

The Operating Subsidiary Rule was extremely controversial, eliciting the greatest number of comments in response to publication of the proposed changes to the Part 5 rules.¹³⁴ There were two aspects to the controversy, one involving the legal authority for permitting an operating subsidiary of a national bank greater powers than the bank itself and the second amounting to a political controversy over whether operating subsidiaries of national banks should be permitted to engage in the same lines of business as holding company affiliates.

i. The Legal Authority Issue

Adoption of the new Part 5 regulations, including Section 5.34(f), was supported by a legal opinion prepared by the chief legal counsel of the OCC.¹³⁵ Given the traditional view of bank operating subsidiaries, writing such a legal opinion was a difficult task. The legal arguments advanced to support the OCC's position were weak in some key areas and the opinion failed completely to address certain prickly legal issues. One was left with the impression that the OCC was on shaky legal ground. The line of argument in the opinion consisted of two main points. First, national banks had the legal right to own subsidiaries through which they could conduct their business. Second, an operating subsidiary could be permitted to engage in banking activities or activities incidental thereto that would be prohibited to the parent bank if the rationale for the prohibition does not apply to the subsidiary and a Congressional purpose would not be frustrated.

The legal opinion suffered from two major defects. One was that the first strand of the argument was based on implied banking powers and not on the specific grant of authority in a statute. With respect to the second strand

¹³³ See *id.*

¹³⁴ See 61 Fed. Reg. 60342, 60350 (1996). The OCC noted that commenters opposing such rules included several trade associations that generally questioned bank entry into certain lines of business.

¹³⁵ See Memorandum dated November 18, 1996 of Julie L. Williams, Chief Counsel, to Eugene A. Ludwig, Comptroller of the Currency, RE: Legal Authority for Revised Operating Subsidiary Regulation (visited April 11, 1999) <<http://www.occ.treas.gov/interp/part5.htm>> [hereinafter OCC Legal Memorandum].

of the argument, the opinion failed to advance convincing legal arguments for why a structure long regarded by the OCC itself as nothing more than a "department" of a bank should be permitted to engage in novel activities that the bank itself cannot engage in as a matter of law.

The OCC's counsel made several points to support the contention that banks have the legal authority to own shares of operating subsidiaries through which they conduct their business. The legal authority of national banks to own subsidiaries and to conduct business through them is based on the general authority given national banks in 12 U.S.C. Section 24 (Seventh) to exercise "all such incidental powers as shall be necessary" to engage in the business of banking.¹³⁶ According to the OCC counsel's interpretation,¹³⁷ activities that are either part of or incidental to the business of banking fall into one of two broad categories: 1) those that involve "banking" activities or activities "incidental" to the delivery of banking products or services,¹³⁸ and 2) those that are incidental to conducting a banking business even though they are not banking activities or incidental to the delivery of a banking product or service.¹³⁹ The power of a national bank to own a subsidiary and to conduct business through such an entity falls within the authority of this second category. The OCC counsel conceded that owning subsidiary companies is not part of the business of banking, but then argued it is a lawful activity for a bank because it constitutes part of what the bank must do to remain in business.¹⁴⁰ This is a weak argument because it is not something that banks are required to do in order to stay in

¹³⁶ See 12 U.S.C. §24 (Seventh) (1999). The term "necessary" has been construed to mean "convenient and useful." *Arnold Tours v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

¹³⁷ See OCC Legal Memorandum, *supra* note 135, at 2-3.

¹³⁸ An example was the OCC's determination that the automobile leasing activities of a national bank were permissible because they were similar to secured lending, which is expressly permitted by 12 U.S.C. § 24 (Seventh). This determination was upheld in *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978).

¹³⁹ An example is the authority of a national bank to borrow, which is not enumerated in Section 24 (Seventh) but has been upheld by the federal courts as a permissible activity on the grounds that it is an incident to the conduct of a banking business. See *Wyman v. Wallace*, 201 U.S. 230 (1905); *Aldrich v. Chemical Nat'l Bank*, 176 U.S. 618 (1900); *Auten v. U.S. Nat'l Bank*, 174 U.S. 125 (1899).

¹⁴⁰ See OCC Legal Memorandum, *supra* note 135, at 3. The OCC counsel would draw the line regarding the types of activities a subsidiary may engage in at activities that are part of or incidental to the conduct of the banking business.

business. It is possible to conduct a banking business without the use of operating subsidiaries. A better argument is that the practice of bank ownership of operating subsidiaries is now well-established and that, in the absence of a Congressional or regulatory prohibition on further use of such subsidiaries, banks should be allowed to take advantage of the ordinary incidents of the corporate form, namely operating through a subsidiary.

In addition, the OCC counsel stated that amendments to Section 24 (Seventh) effected by the McFadden Act of 1927 and the Banking Act of 1933 did not limit the power of national banks to own shares of subsidiary corporations, as some commentators have argued, but rather were directed only at limiting involvement in investment banking activities.¹⁴¹ In fact, she argued, these amendments, in seeking to regulate national bank involvement in securities activities, served to confirm that banks had the authority to own stock.¹⁴² Another argument advanced by the OCC counsel was that since 1933, Congress, the courts, and the OCC have consistently recognized that national banks can conduct their business either directly or through operating subsidiaries.¹⁴³

The OCC counsel failed to address the existence of the Bank Service Company Act ("BSCA"),¹⁴⁴ in which Congress granted banks the authority to own subsidiaries¹⁴⁵ that may engage in a wide range of nonbanking activities.¹⁴⁶ There are several types of bank service companies authorized by the BSCA. One type may engage in clerical, bookkeeping, accounting, and statistical functions performed for a depository institution.¹⁴⁷ A second type of service company may, upon application to the relevant federal banking regulator, conduct other activities, except for deposit-taking, that are permitted to national or state banks that own such companies.¹⁴⁸ A third type may engage in any activity that the Board has determined to be permissible for a bank holding company, other than deposit taking.¹⁴⁹ The existence of this legislation undermines the OCC counsel's argument for

¹⁴¹ See *id.* at 3–9.

¹⁴² See *id.* at 9–11.

¹⁴³ See *id.* at 11–14.

¹⁴⁴ See 12 U.S.C. § 1861 *et seq.* (1999).

¹⁴⁵ See 12 U.S.C. § 1862 (1999). The BSCA contains limitations on the amount of the investment an insured bank may make in such a subsidiary.

¹⁴⁶ See MALLOY, BANK REGULATION, *supra* note 17, at 163–166.

¹⁴⁷ See 12 U.S.C. § 1863 (1999).

¹⁴⁸ See 12 U.S.C. §§ 1864, 1865 (1999).

¹⁴⁹ See 12 U.S.C. §§ 1864(f), 1865(b) (1999).

authority of national banks to own operating subsidiaries based on implied power. It suggests that if Congress were able to take action to explicitly permit bank service companies by statute, it could have done the same thing with respect to operating subsidiaries. In view of the BSCA, the absence of such statutory authority for operating subsidiaries may indicate that banks do not in fact have implied power to own shares of operating subsidiaries. Another issue that is raised by the existence of the BSCA relates to the restriction on powers to those permitted to the bank shareholders of the subsidiaries. It seems unlikely that Congress would have intended that the implied powers of an operating subsidiary could extend beyond those permissible for their parent banks when the activities of a bank service company are explicitly limited to the powers exercisable by the parent bank(s). The OCC counsel's opinion did not even raise, much less answer this question.

The second part of the legal authority argument was directed toward addressing when an operating subsidiary could engage in banking or incidental-to-banking activities that its parent bank could not engage in. The OCC counsel's opinion took the position that the operating subsidiary could be deemed to have broader powers than the national bank when the rationale for the prohibition does not apply to the subsidiary, and conduct by the subsidiary of such activity would not frustrate a Congressional purpose or prevent its parent from conducting the activity. In addressing the issue, the OCC would do so on a case-by-case basis and would consider the following factors with respect to a particular activity: 1) the form and specificity of the restriction applicable to the parent bank; 2) why the restriction applied to the parent bank; and 3) whether it would frustrate the purpose underlying the restriction on the parent bank to permit a subsidiary of the bank to engage in the particular activity.¹⁵⁰ In addition, the OCC announced that it would also consider the safety and soundness implications of the activity, other regulatory safeguards applying to the subsidiary or the activity itself, conditions imposed by the OCC in conjunction with application approval, and any additional undertakings by the bank or its operating subsidiary to address these factors.¹⁵¹

The legal basis for OCC approval of broader activities for operating subsidiaries of national banks than for national banks themselves was weak on its face. First, there was no reference to express statutory authorization

¹⁵⁰ See OCC, Rules, Policies, and Procedures for Corporate Activities, 61 Fed. Reg. 60,341, 60,352 (1996).

¹⁵¹ See *id.*

for operating subsidiaries to engage in lines of business other than those permitted to national banks. Second, the OCC seemed to be relying in part on its own interpretation of operating subsidiary powers to justify its position, stating that the basis for such broader powers for operating subsidiaries was the fact that the OCC, other Federal banking regulators and the courts had determined that limitations applicable to a national bank do not necessarily apply to its affiliates, including its operating subsidiaries. With respect to OCC practice, the agency traditionally has taken the position that federal banking laws applicable to a national bank should also be applied to the operations of a subsidiary, but it has made exceptions allowing operating subsidiaries to engage in broader activities. This happened on only a few occasions, however, in which the OCC granted permission for operating subsidiaries to act as a general partner in a partnership and other business ventures,¹⁵² even though the Supreme Court has held that it is *ultra vires* for a national bank to act in such capacity due to the risk of unlimited liability that a general partner assumes.¹⁵³ In these instances, the OCC recognized that the separate incorporation of the operating subsidiary should protect the national bank from the risk of unlimited liability flowing through to it.¹⁵⁴ In some cases, the OCC required that the bank take additional steps to protect itself, such as ensuring that the subsidiary is adequately capitalized, insulating the bank from the partnership in various ways intended to maintain separation of the two entities, and limiting commitments by the bank and its affiliates to the partnership.

In light of the expansive scope of the Operating Subsidiary Rule, the OCC had the burden of explaining away its earlier, more restrictive attitude towards bank operating subsidiaries.¹⁵⁵ The OCC did not formally authorize use of bank operating subsidiaries until 1966 and for many years took the position that such subsidiaries were “separately incorporated departments” of

¹⁵² Examples of such OCC approvals include OCC Interpretive Letter No. 289 (May 15, 1984) (bank operating subsidiary may act as a general partner with another bank to establish an automated teller machine network) and OCC Interpretive Letter No. 423 (April 11, 1988) (bank operating subsidiary may become the managing general partner of a Delaware limited partnership engaged in real estate mortgage loan investments).

¹⁵³ See *Merchants Nat'l Bank v. Wehrmann*, 202 U.S. 295, 301 (1906). The bank had taken the partnership interest as security for a debt and afterwards become owner of such interest in satisfaction of the debt.

¹⁵⁴ See OCC Interpretive Letter No. 289, *supra* note 152.

¹⁵⁵ See *Acquisition of Controlling Stock Interest in Subsidiary Operations Corporation*, 31 Fed. Reg. 11,459 (1966) (codified at 12 C.F.R. § 5.34(d)).

the bank. The implication was that such subsidiaries had the same powers, but not greater powers than the bank itself.¹⁵⁶ The OCC counsel took the position that this was not a binding legal characterization of the outer limits of operating subsidiary activities, but rather an indication of what the OCC was prepared to allow at that point in time.¹⁵⁷ The OCC decided to take a more liberal view of permissible activities for operating subsidiaries in the Operating Subsidiary Rule than its earlier stated position indicated it would, but without any express or implied statutory basis for doing so. The argument seemed to be that the OCC may determine in its discretion the limits of bank operating subsidiary powers based on its own determination that a statutory prohibition applicable to the parent bank should not apply to the bank's subsidiary on policy grounds. This is a very aggressive use of administrative agency discretion in the absence of an express or implied statutory basis for subsidiary powers that are greater than those of the parent. If this is indeed the argument, it seems to offend commonly understood notions of the role of administrative agencies in interpreting statutes.

As additional support for her position, the OCC legal counsel cited both OCC and federal court precedent permitting geographic expansion in the case of an operating subsidiary that would be prohibited for the national bank.¹⁵⁸ This precedent seems inapposite to the question at hand for it concerns geographic restrictions and not activities restrictions, which are governed by a different regulatory scheme and driven by different policy considerations. Finally, the OCC cited decisions of the Supreme Court and several federal courts upholding Board orders or regulations approving securities-related activities of holding company affiliates that a bank itself could not conduct.¹⁵⁹ Again, the precedent cited does not directly support the OCC's position, because the power of a nonbank subsidiary of a holding company to engage in broader activities than a bank subsidiary itself may conduct is supported by Section 4(c)(8) of the Bank Holding Company Act. There was no such express statutory authority in the case of bank operating subsidiaries prior to passage of Gramm-Leach-Bliley.

¹⁵⁶ See The OCC described the operating subsidiary as "a corporation the function or functions of which are limited to one or several of the functions or activities that a national bank is authorized to carry on." *Id.* at 11,460.

¹⁵⁷ See OCC Legal Memorandum, *supra* note 135, at 18.

¹⁵⁸ See *id.* at 17-18.

¹⁵⁹ See *id.* at 16.

ii. The Political Controversy

The Operating Subsidiary Rule raised the possibility that operating subsidiaries of national banks would be permitted to conduct the same types of activities as affiliates of bank holding companies, including Section 20 securities subsidiaries.¹⁶⁰ In the case of the NationsBank application under the Operating Subsidiary Rule relating to real estate development activities, which is discussed below, the possibility was raised that operating subsidiaries might even be allowed to engage in a wider range of activities than holding company affiliates. This provoked the Board to publicly criticize the Operating Subsidiary Rule.¹⁶¹ In addition, the Board filed comments in opposition in response to Federal Register notices on the first two applications under the Operating Subsidiary Rule filed by Zions Bank and NationsBank, which are discussed below.¹⁶² These comments, viewed as a whole, indicated that there was more at stake in the debate over the Operating Subsidiary Rule than questions regarding the legal basis for the

¹⁶⁰ See Ludwig, *supra* note 122

¹⁶¹ Chairman Alan Greenspan noted in Congressional testimony that “[t]he bank subsidiary may be a marginally more efficient way of delivering [expanded financial] services, but we believe it cannot avoid being a funnel for transferring the sovereign credit subsidy directly from the bank to finance the new powers, thereby imparting a subsidized competitive advantage to the subsidiary of the bank.” *Hearings on Financial Restructuring Before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Banking and Financial Services*, 105th Cong. (1997). He also stated that the operating subsidiary rule, coupled with provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, makes it inherently more cumbersome for state banks to participate in interstate branching and threatens the dual banking system and the viability of state banks. He said he feared the advantages enjoyed by national banks might coax many state banks into switching charters. *See id.* The objections raised by the Federal Reserve will be further discussed *infra* in Part III.

¹⁶² The comments of the Board on the Zions Bank application underscored the Board’s fundamental opposition to the operating subsidiary as a vehicle for expansion of banking activities. Letter dated May 19, 1997 of the Board, to Eugene A. Ludwig, Comptroller of the Currency (on file with the author). The Board expressed serious doubts that Congress created a statutory scheme that would allow express prohibitions on the activities of national banks to be overridden by administrative interpretation and thought the OCC should deny any application to allow a national bank to engage through a subsidiary in an activity that is not permissible for a national bank to conduct directly.

new rules or even safety and soundness considerations.¹⁶³ The Board's remarks raised fundamental policy questions regarding the proper allocation of regulatory authority within the federal government. Some commentators suggested that because an operating subsidiary could conceivably conduct any activity that is financial in nature under the Operating Subsidiary Rule, the Board feared that the operating subsidiary might replace the bank holding company, which is regulated by the Board, as the preferred vehicle for expansion of activities by bank affiliates, which in turn would adversely affect the Board's preeminent role in banking regulation.¹⁶⁴

c. OCC Approvals Under the Operating Subsidiary Rule

As had been predicted by commentators even before the Operating Subsidiary Rule was adopted, the OCC granted approvals permitting national bank operating subsidiaries to underwrite and deal in bank ineligible securities soon after the rule became effective. An application to engage in real estate development and real estate lease financing was filed but was not acted upon.¹⁶⁵

i. Revenue Bond Underwriting and Dealing

The first application approved under the Operating Subsidiary Rule was submitted by Zions First National Bank of Salt Lake City, Utah, ("Zions").¹⁶⁶ The application sought authority for Zions Investment

¹⁶³ Chairman Alan Greenspan has stated in Congressional testimony that safety and soundness issues are not raised by use of the operating subsidiary. See *Financial Services Restructuring: Hearings Before the House of Representatives Committee on Banking and Financial Services*, 105th Cong. (1997) (statement of Chairman Greenspan) (stating in relevant part as follows: "... my concerns are not safety and soundness. It is the issue of creating subsidies for individual institutions which their competitors do not have. It is a level playing field issue.")

¹⁶⁴ See *Fed Opposes Zions Op-sub Proposals on Revenue Bonds*, 16 BANKING POL'Y REP. 2 (1997).

¹⁶⁵ This information is based on a search of the OCC Website (visited Apr. 11, 1999) <<http://www.occ.treas.gov>> and was confirmed in a telephone conversation with a staff attorney of the OCC Securities and Corporate Practices Division on Apr. 5, 1999.

¹⁶⁶ See Letter dated April 8, 1997 of W. David Hemingway, Executive Vice President, Zions First National Bank to Ellen Shepherd, Acting Licensing Manager, Office of the Comptroller of the Currency, Western District, *available in* (visited

Securities Inc. ("Zions Investment"), a wholly-owned subsidiary of Zions, to underwrite, deal in, and invest in securities of states and their political subdivisions, including both general obligation bonds and revenue bonds considered bank ineligible securities under Section 16 of Glass-Steagall. The Zions Application undertook that Zions Investment would not be engaged principally in underwriting and dealing activities and stated that its revenue to be derived from such activity would be limited to 25% of its total revenues.¹⁶⁷ The OCC approved the application after having concluded that the proposed activities were legally authorized and consistent with safe and sound banking practices.¹⁶⁸

a. Legal Authorization

The basis for the Comptroller's decision was a determination that underwriting and dealing in revenue bonds was permissible for subsidiaries of national banks because such activities are authorized under Section 24 (Seventh) of the National Bank Act and as proposed to be conducted would be allowed under Section 20 of Glass-Steagall.¹⁶⁹ Some of the arguments in the Zions Approval closely resemble those advanced by the Board in its Section 20 orders, and in fact these are the strongest arguments made. Other

Apr. 10, 1999) <<http://www.occ.treas.gov/ftp/regs/zionsapp.pdf>> and <<http://www.occ.treas.gov/ftp/regs/zionsmem.pdf>> [hereinafter Zions Application].

¹⁶⁷ Zions Investment was already engaged in the business of providing brokerage and investment advisory services relating to securities and investment products, including corporate equity securities, U.S. government securities, annuities and other securities, was registered as a broker-dealer with the Securities and Exchange Commission, and was a member of the National Association of Securities Dealers. Zions had engaged for many years in underwriting and dealing in general obligation securities, certain revenue bonds considered eligible for banks to underwrite and deal in, such as bonds for housing, university or dormitory purposes (bank eligible securities), and U.S. government and agency securities. Zions planned to act as clearing agent for, and as broker and investment adviser regarding, securities underwritten by Zions Investment after making full disclosure to customers. See Zions Application, *supra* note 166, at 3-4.

¹⁶⁸ Office of the Comptroller of the Currency, Conditional Approval #262, Application by Zions First National Bank, Salt Lake City, Utah, to Commerce New Activities in an Operating Subsidiary (Engage in Underwriting, Dealing in, and Investing in Securities of States and Their Political Subdivisions) (December 11, 1997), available in (visited Apr. 10, 1999) <<http://www.occ.treas.gov/release/zionsdec.pdf>> [hereinafter Zions Approval], at 3-4.

¹⁶⁹ See *id.* at 5-6.

arguments parallel those made in the OCC counsel's opinion supporting the Operating Subsidiary Rule and suffer from the same defects discussed earlier.

First, the power to underwrite and deal in debt securities like the municipal revenue bonds in question was an enumerated power under Section 24 (Seventh),¹⁷⁰ or in the alternative, such activity constituted part of the general business of banking because of the financial nature of the activity and the relationship to other traditional banking functions.¹⁷¹ This closely resembles the Board's argument in the Section 20 orders that underwriting and dealing in bank ineligible securities was appropriate for a holding company affiliate under Section 1843(c)(8) because it was "closely related to banking."¹⁷²

Second, national banks are empowered to own operating subsidiaries as an incident to their banking activities. This argument was made in the legal opinion supporting the Operating Subsidiary Rule and did not improve with age.

Third, a national bank operating subsidiary may engage in securities underwriting and dealing activities on the authority of Section 20 of Glass-Steagall. That section, which prohibited national banks from affiliations with corporations "engaged principally" in securities underwriting or dealing, was interpreted by the Board in the Section 20 orders to permit non-bank affiliates of banks in a holding company structure to engage in underwriting and dealing in bank ineligible securities on a limited basis on the theory that such an affiliate would not be deemed to be engaged principally in the activities prohibited by Section 20. This interpretation has been upheld by the federal courts.¹⁷³ The OCC took up this line of reasoning in the Zions Approval and refined it further. In the OCC's view, an operating subsidiary of a national bank may be deemed to be an affiliate for

¹⁷⁰ *See id.* at 9.

¹⁷¹ *See id.* at 9-14. The OCC argued that such underwriting and dealing was a functional equivalent of other activities conducted by national banks as a financial intermediary and is similar to securities activities of national banks involving bank eligible activities on the authority of Section 16 of Glass-Steagall; such activity would produce benefits to local governments and taxpayers and increase bank revenues; and the risks in underwriting and dealing with revenue bonds is no greater than associated with underwriting and dealing in bank eligible securities and investing in revenue bonds. *See id.*

¹⁷² *See id.*

¹⁷³ *See supra* Section II.B.1.

purposes of Section 20.¹⁷⁴ Therefore, an operating subsidiary should be able to underwrite and deal in securities of the type not permitted for its parent, as long as it is not “engaged principally” in such activities.¹⁷⁵ Employing the Board’s recent reinterpretation of the expression “engaged principally,” this meant that an operating subsidiary like Zions Investment that would limit the revenue derived from underwriting and dealing in bank ineligible revenue bonds to no more than 25% of total revenues would not be deemed to violate Section 20 of Glass-Steagall.

Fourth, national banks are authorized to own operating subsidiaries engaged in activities not permissible for the bank to engage in directly.¹⁷⁶ This argument was made in the legal opinion supporting the Operating Subsidiary Rule and was not refined further. It was perhaps the weakest link in the chain of argument in the Zions Approval.¹⁷⁷

b. Consistency with Safe and Sound Banking Practice

This portion of the Comptroller’s decision was based on its conclusion that the proposed activities would be conducted in a manner that would present limited risk to the bank and its operating subsidiary and would be conducted in a safe and sound manner.¹⁷⁸ First, the proposed activities represented only an incremental expansion of the municipal securities activities already conducted by national banks generally and by Zions in

¹⁷⁴ See 12 U.S.C. § 221.a(b)(1).(1998). This interpretation is based upon the applicable definition of affiliate, which includes “a corporation . . . of which a member bank directly or indirectly owns or controls a majority of the voting shares or more than 50% of the number of shares voted for the election of directors . . .” *Id.* Since operating subsidiary is defined in 12 C.F.R. § 5.34(d)(2) to include entities in which the parent bank “owns more than 50% of the voting (or similar type of controlling) interest of the subsidiary; or the parent bank otherwise controls the subsidiary and no other party controls more than 50% of the voting (or similar type of controlling) interest of the subsidiary . . .,” the OCC argued that, applying the literal language of the statute, an operating subsidiary is an “affiliate” for purposes of Section 20 of Glass-Steagall. 12 C.F.R. § 5.34(d)(2)(1999), Zions Approval, *supra* note 168, at 19.

¹⁷⁵ See *id.* at 19.

¹⁷⁶ See *id.* at 20.

¹⁷⁷ See *id.* at 20-23.

¹⁷⁸ See *id.* at 24.

particular.¹⁷⁹ Second, the OCC emphasized the corporate separateness of the operating subsidiary, noting that any potential risk associated with the new activities would not negatively affect the bank, because it would be insulated both structurally and operationally from the operating subsidiary as a result of the corporate separateness requirements of the Operating Subsidiary Rule.¹⁸⁰ Third, the OCC relied on the comprehensive supervision and functional regulation by securities regulatory authorities and the role of the OCC in ensuring that the bank comply with safety and soundness regulations and conditions imposed under the Operating Subsidiary Rule and the conditional approval.¹⁸¹ Fourth, the OCC cited the safety and soundness conditions and safeguards on the bank and the operating subsidiary pursuant to the Operating Subsidiary Rule, which were intended to contain risk, reduce potential conflicts of interest, and ensure the safe and sound operation of both entities, and the additional conditions applicable under the conditional approval.¹⁸² Several of these conditions were patterned after the new operating standards fashioned by the Board for Section 20 subsidiaries and were tailored to address the risks of affiliation with an insured bank that are not adequately dealt with through banking laws.¹⁸³

¹⁷⁹ The fact that Zions was a primary dealer in government securities was viewed as a factor mitigating risk. The OCC was persuaded by conversations with other regulators, namely the National Association of Securities Dealers, Regulation, Inc., the Securities and Exchange Commission, the Board and the Federal Reserve Bank of New York regarding their supervision of Section 20 subsidiaries that there were no unique compliance or supervisory problems relating to underwriting and dealing in revenue bonds through such subsidiaries. The OCC cited the statement of a former chairman of the FDIC that there have not been many problems associated with bona fide securities subsidiaries of insured nonmember state banks under FDIC supervision. *See id.*

¹⁸⁰ *See id.* at 25-26.

¹⁸¹ *See id.* at 26-27.

¹⁸² *See id.* at 27-28. These conditions included internal controls of the bank governing participation in transactions underwritten or arranged by the subsidiary, compliance of intra-day credit extensions by the bank to the subsidiary with the terms of Section 23B of the Federal Reserve Act, a prohibition on bank lending to customers for the purpose of buying securities underwritten by the subsidiary during the underwriting period, the requirement of disclosures mandated under the Retail Sales Statement (*see supra* note 102) to avoid customer confusion, and a prohibition on bank employee recommendations of securities underwritten by the subsidiary without disclosure of the subsidiary's underwriter status.

¹⁸³ *See* 62 Fed. Reg. 45295, 45296 (1997); 12 C.F.R. § 225.200 (1999).

In addition to the Zions Approval, the OCC approved other applications under the Operating Subsidiary Rule to engage in revenue bond underwriting and dealing.¹⁸⁴ The activities to be undertaken were the same as those approved in the Zions Approval, and the banks and their operating subsidiaries were subject to the same conditions.¹⁸⁵ In these approvals, the OCC adopted virtually identical standards as the Board adopted in its Section 20 orders for securities underwriting by bank affiliates. Both regulators adopted a policy of permitting limited underwriting and dealing in bank ineligible securities. Both used a 25% revenue test as the qualifying standard and required that the bank affiliate comply with regulatory firewalls. Many of the safeguards adopted in the OCC approvals are identical to the operating standards adopted by the Board to replace the firewalls previously applicable to Section 20 subsidiaries. One could conclude that the OCC followed the lead of the Board in order to foreclose the argument that use of an operating subsidiary raised safety and soundness concerns or the potential for conflict of interest transactions that might be damaging to banks.

ii. Real Estate Development

NationsBank of Charlotte, North Carolina filed an application under the Operating Subsidiary Rule seeking authority to conduct real estate development activities.¹⁸⁶ The NationsBank proposal was more

¹⁸⁴ See OCC Corporate Decision 98-48 (Oct. 20, 1998) (National Bank of Commerce of Memphis, Tennessee); OCC Conditional Approval No. 297 (Dec. 9, 1998) (UMB Bank of Kansas City, Missouri); and OCC Conditional Approval No. 309 (Apr. 12, 1999) (First Tennessee).

¹⁸⁵ See *id.*

¹⁸⁶ Letter of Richard K. Kim, Assistant General Counsel, NationsBank Corporation to Mr. Steven J. Weiss, Deputy Comptroller, Office of the Comptroller of the Currency, (March 26, 1997) available in (visited Apr. 10, 1999) <<http://www.occ.treas.gov/ftp/regs/tryonap.pdf>> [hereinafter NationsBank Application]. The real estate development subsidiary, Tryon Development Partners, was to be organized as a corporation or other form of limited liability company with NationsBank as the sole shareholder. It planned to develop real estate in locations that NationsBank already occupied for bank premises. Its immediate plan was to build residential condominium units adjacent to an office building that had been owned by the bank for 25 years and was the site of a bank branch. The bank also anticipated that the operating subsidiary would engage in the future in further real estate development in the areas adjacent to or near the bank premises but planned to request prior approval from the OCC before commencing such activities. See *id.* at 1-2.

controversial than the Zions Application because national banks are effectively precluded from real estate development activities due to the general prohibition on ownership of real estate contained in Section 29 of the National Bank Act.¹⁸⁷ In addition, real estate development activities are not permissible for bank holding company affiliates pursuant to Board Regulation Y.¹⁸⁸ Although this application was filed prior to the Zions Application, it was not acted upon, no doubt due to its controversial nature.

III. THE CORPORATE STRUCTURE ISSUE IN THE GRAMM-LEACH-BLILEY ACT

A. The Compromise Position of the Gramm-Leach-Bliley Act and Its Legislative History

Gramm-Leach-Bliley was signed into law by President Clinton on November 12, 1999, after having passed the Senate and House on November 4, 1999.¹⁸⁹ It expanded the universe of financial activities permissible to banks and their affiliates by partially repealing Glass-Steagall and amending the Bank Holding Company Act. Gramm-Leach-Bliley reflects a compromise on the corporate structure issue that is somewhere between the two polar viewpoints in the debate. Before detailing the outcome, the

¹⁸⁷ 12 U.S.C. § 29 prohibits banks from acquiring or holding real estate unless such real estate is used in the transaction of its business or was taken as security in connection with debt owed to the bank. *See* 12 U.S.C. §29 (1999).

¹⁸⁸ *See* 12 C.F.R. Part 225 (1999).

¹⁸⁹ Separate financial modernization bills were passed by each house of Congress within the first six months of the opening of the 106th Congress. The Senate passed S. 900, the Financial Services Modernization Act of 1999, by a vote of 54-44 on May 6, 1999 and the House of Representatives passed H.R. 10, the Financial Services Act of 1999, by a vote of 343-86 on July 1, 1999. The bills were referred to a conference committee, which began meeting on August 3, 1999 and concluded its work on October 12, 1999. A conference report dated November 1, 1999 was signed by the majority of the conferees on November 2, 1999. On November 4, 1999, Gramm-Leach-Bliley passed the Senate by a vote of 90-8 and the House by a vote of 362-57. Senate Banking Committee Press Release, November 5, 1999, *Time Line of Gramm-Leach-Bliley Act*, available in (visited Jan. 25, 2000) <<http://www.senate.gov/~banking/pre199/1105tme.htm>>. The conference report is available in (visited Nov. 29, 1999) <http://www.senate.gov/~banking/conf/somfinal.htm>. The text of Gramm-Leach-Bililey is available in (visited Nov. 29, 1999) <http://www.gov/~banking/conf/>.

legislative history will be discussed in order to better understand the compromise that was reached.

Early versions of financial modernization legislation introduced in Congress over the past two decades proposed liberalizing bank activities restrictions but required new financial activities to be conducted exclusively through a holding company affiliate, essentially adopting the position of the Board. The operating subsidiary option was included in later bills in large part due to Treasury Department efforts. The Treasury Department's proposal on the corporate structure issue, detailed in a report on financial modernization legislation prepared for Congress on behalf of the Clinton administration in 1997 ("Treasury Department Modernization Proposal"), would have permitted operating subsidiaries of national banks to engage in the same activities as bank holding company affiliates subject to the same affiliate transaction rules.¹⁹⁰ Throughout the debate over financial modernization legislation in both the 105th and 106th Congresses, the Clinton administration remained steadfast in its view that financial modernization required equivalent treatment of bank operating subsidiaries and bank holding company affiliates and threatened to veto legislation that did not meet this standard.¹⁹¹

¹⁹⁰ Department of the Treasury, News Release, *Treasury Provides Blueprint for Financial Modernization* (May 21, 1997), available in 1997 WL 272500. *Financial Services Restructuring, Hearings on Financial Modernization Before the House Committee on Banking and Financial Services, 105th Cong. (1997)* (testimony of Robert E. Rubin, Secretary at the Treasury) (testimony of Jerry Hawke, Treasury Under Secretary For Domestic Finance). First, bank holding companies meeting certain criteria and subject to certain safeguards would be permitted to engage in the full range of financial activities, including securities brokerage, underwriting, and dealing; insurance brokerage and underwriting; mutual fund sponsorship; investment advisory services; and merchant banking. Second, national banks would be permitted to conduct any financial activity through subsidiaries, other than real estate development. National banks would be permitted to engage directly in any activity previously approved for national banks or federally chartered thrifts, except for real estate development. National banks would also be permitted to act as general agents for the sale of insurance, would be prohibited from engaging in any insurance underwriting activity other than what was then currently permissible (e.g. underwriting of credit-related insurance), and would be permitted to underwrite and deal in municipal revenue bonds in addition to other securities activities currently permissible for such banks.

¹⁹¹ Gibson, Dunn & Crutcher, *H.R. 10 – The Financial Services Act of 1999, Working Summary No. 2*, at 3 (April 28, 1999) [hereinafter Gibson, Dunn & Crutcher 1999].

Gramm-Leach-Bliley had its origins in comprehensive bank reform legislation introduced in the 105th Congress as H.R. 10, the Financial Services Act of 1998 (“1998 Version of H.R. 10”).¹⁹² Although that bill envisioned sweeping changes in federal law that would permit affiliations between banks and other financial service firms,¹⁹³ the bill restricted bank operating subsidiaries’ activities to those that could be conducted by the bank itself.¹⁹⁴ It therefore fell short of the treatment of operating subsidiaries advocated in the Treasury Department Modernization Proposal. Although H.R. 10 passed the full House and was approved with amendments by the Senate Banking Committee,¹⁹⁵ it failed to be considered by the full Senate due to disagreements over several key issues, including the status of operating subsidiaries, which triggered the threat of a presidential veto.¹⁹⁶

Financial modernization legislation was reintroduced in the House at the beginning of the 106th Congress as H.R.10, the Financial Services Act of 1999.¹⁹⁷ Congressman James Leach, Chairman of the House Banking Committee, indicated that the purpose behind the legislation was “to level the competitive playing field within the financial services industry, to increase competition so that costs of services will go down for customers and to boost the international competitive position of American firms.”¹⁹⁸ He

¹⁹² See H.R. Rep. No. 531 (1998), available in 1998 WL 239626 (reprinting the text of H.R. 10 that was referred out of the House Rules Committee and passed the House on May 13, 1998 by a vote of 214–213).

¹⁹³ The 1998 Version of H.R. 10 contemplated the repeal of Sections 20 and 32 of Glass-Steagall, among other changes. See *id.*

¹⁹⁴ See H.R. 10, 105th Cong. §121 (1998).

¹⁹⁵ An amended version of H.R. 10 passed the Senate Banking Committee by a vote of 16–2 on September 11, 1998.

¹⁹⁶ See 15 Bank Policy Rep. *Veto Threat Stalls Financial Modernization Legislation* (Oct. 13, 1998). Another cause was the threat by Senator Phil Gramm (R-Texas) to filibuster over a perceived increase in bank responsibilities under the Community Reinvestment Act. See *id.* The chair of the House Banking and Financial Services Committee, James A. Leach, introduced a revised version of H.R. 10 entitled H.R. 4870 at the end of the session as a bridge to the 106th Congress. See Gibson, Dunn & Crutcher, *H.R. 10 – The Financial Services Act of 1998*, at 1 (Dec. 21, 1998) (on file with the author).

¹⁹⁷ See H.R. 10, 106th Cong. (1999) introduced January 6, 1999 by Rep. Leach.

¹⁹⁸ *Modernization Bill*, CONGRESSIONAL PRESS RELEASES (Jan. 6, 1999). Congressman Leach also stated that “an important by-product of this legislation will be to provide consumers and smaller businesses in more rural states with access to a

also stated that financial services modernization would be a top priority of the House Banking Committee in the 106th Congress,¹⁹⁹ reflecting a growing consensus that reform of activities restrictions was urgently needed in order for U.S. financial firms to be able to innovate and to compete globally.²⁰⁰

As reintroduced, H.R. 10 contained provisions granting expansive powers for affiliates of bank holding companies, but restricting operating subsidiaries of national banks to financial agency activities.²⁰¹ As in the case of the 1998 Version of H.R. 10, the Clinton administration threatened to veto the bill if it contained such limitations on operating subsidiaries.²⁰² After referral to the House Banking and Commerce Committees, the bill was amended to include provisions on operating subsidiaries, among other

wider variety of financial products by empowering local institutions to offer a full range of products and services." *Id.*

¹⁹⁹ See House of Representatives, Committee on Banking and Financial Services, Press Release (Jan. 6, 1999), available in (visited May 7, 1999) <<http://www.house.gov/banking/16991pr.htm>> .

²⁰⁰ Members of banking industry groups and executives of financial services firms made this point on a number of occasions in commenting on the proposed legislation. For example, the chief legislative council of the American Bankers Association noted that American banks dominate globally but if laws are not changed, "U.S. financial institutions will be placed at a growing disadvantage." *Investment Banks See the Future in Full-Service Arena*, NATIONAL POST, Jan. 10, 1999, at C10. Merrill Lynch Chairman David H. Komansky noted that "we're now the only developed country in the world that hasn't lifted the barriers separating commercial banking, securities and insurance. Decisions made in Washington in the weeks and months ahead will play a key role in determining America's position in this new global financial marketplace." *Merrill Lynch Chairman Calls for Financial Services Regulatory Reform*, U.S. NEWSWIRE, Jan. 15, 1999. The Council of Economic Advisers reported to the President in 1983 that Glass-Steagall "now makes no important contribution to the protection of the public against bank failures or undue concentrations of economic power. ECON. REP. OF THE PRESIDENT, 1983 ANN. REP. OF COUNCIL OF ECON. ADVISORS, H.R., DOC NO. 98-2, AT 122 (1983). Chairman Greenspan, testifying in front of the Senate Banking Committee on H.R. 10 in 1998, stated that reform legislation was necessary to ensure the continued competitiveness of U.S. financial institutions and to enable such institutions to continue to innovate, operate efficiently and provide the best possible services to consumers. *Hearings on H.R. 10 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 105th Cong. (1998). (testimony of Alan Greenspan).

²⁰¹ See January 6, 1999 Press Release, *supra* note 199.

²⁰² See Gibson, Dunn & Crutcher – 1999, *supra* note 191, at 47.

changes,²⁰³ and was eventually passed by the full House (“1999 Version of H.R. 10”).²⁰⁴ The 1999 Version of H.R. 10 permitted the establishment of a new type of banking holding company called a “financial holding company,” which would be allowed to engage in new financial activities,²⁰⁵ and also permitted national banks to engage in certain of those activities through use of operating subsidiaries called “financial subsidiaries.”²⁰⁶ Permitted financial activities for financial holding companies were those set forth in the bill and those determined by the Board, in consultation with the Secretary of the Treasury, to be financial in nature, incidental thereto, or complementary to authorized activities.²⁰⁷ Permitted financial activities for financial subsidiaries were those authorized for financial holding companies and those determined by the Secretary of the Treasury, in consultation with the Board, to be financial in nature or incidental thereto.²⁰⁸ Financial activities that were expressly permitted included securities and insurance underwriting and merchant banking activities.²⁰⁹ However, certain activities were expressly prohibited for operating subsidiaries, namely insurance underwriting (other than credit insurance), issuing annuities, engaging in real estate investment or development, and investing in insurance companies.²¹⁰ Operating subsidiaries were prohibited from engaging in other activities that exceeded national bank powers, except to the extent expressly provided by other federal statutes, including the BSCA and Sections 25 and 25A of the Federal Reserve Act relating to the establishment of Edge Act subsidiaries.²¹¹ In

²⁰³ The House Banking Committee reported an amended version of H.R. 10 on March 23, 1999, which reflected a compromise reached with the ranking Democrat on the House Banking Committee, Representative John LaFalce, by including a broader operating subsidiary provision. House of Representatives, Committee on Banking and Financial Services, Press Release, March 11, 1999 *available in* (visited May 7, 1999) <<http://www.house.gov/banking/16991pr.htm>>. The House Commerce Committee reported an amended version of the bill on June 15, 1999. H.R. 10, Bill Summary and Status, *available in* (visited Oct. 11, 1999) <http://thomas.loc.gov>.

²⁰⁴ See H.R. 10, version dated July 12, 1999, *available in* (visited Oct. 11, 1999) <<http://www.house.gov/banking/hrashp.pdf>>.

²⁰⁵ See H.R. 10, 106th Cong. §103(a) (1999).

²⁰⁶ See H.R. 10, 106th Cong. §121(a) (1999).

²⁰⁷ See H.R. 10, 106th Cong. §103(a) (1999).

²⁰⁸ See H.R. 10, 106th Cong. §121(a) (1999).

²⁰⁹ See H.R. 10, 106th Cong. §103(a) (1999).

²¹⁰ See H.R. 10, 106th Cong. §121(a) (1999).

²¹¹ See *id.*

order to become a financial holding company, all subsidiary depository institutions were required to be well-capitalized, well-managed, have a Community Reinvestment Act rating of satisfactory or better, and the holding company must have filed a declaration with the Board.²¹² In order for a national bank to establish a financial subsidiary, the bank and all its depository institution affiliates were required to be well-capitalized, well-managed, and have a Community Reinvestment Act rating of satisfactory or better, and the bank must have received the approval of the Comptroller.²¹³ Only smaller national banks were allowed to establish financial subsidiaries outside of a holding company framework. A national bank with assets of \$10 billion or more was permitted to establish a financial subsidiary only if such bank were owned by a bank holding company.²¹⁴ Firewalls intended to promote safety and soundness considerations were made applicable to banks and their financial subsidiaries and also to transactions between financial subsidiaries and other affiliates.²¹⁵ These included: limitations on the equity investment of a bank in a financial subsidiary,²¹⁶ maintenance of procedures for identifying and managing financial and operational risks posed by the financial subsidiary, maintenance of separate corporate status for the financial subsidiary, and application of Section 23B of the Federal Reserve Act to transactions between a financial subsidiary and a bank.²¹⁷

Financial modernization legislation was introduced in the Senate at the beginning of the 106th Congress as S.900, the Financial Services Modernization Act of 1999.²¹⁸ After referral out of the Senate Banking

²¹² See H.R. 10, 106th Cong. §103(a) (1999).

²¹³ See H.R. 10, 106th Cong. §121(a) (1999).

²¹⁴ See *id.*

²¹⁵ See H.R. 10, 106th Cong. §122 (1999).

²¹⁶ Such limitations included deducting equity investments in financial subsidiaries from the assets and tangible equity of the bank, prohibiting the consolidation of assets and liabilities of the financial subsidiary on the financial statements of the bank, limiting the amount of any equity investment in a financial subsidiary to the amount the bank could pay out as a dividend, without the prior approval of the relevant federal banking regulator, and treating retained earnings of the subsidiary as an outstanding equity investment of the bank. See H.R. 10, 106th Cong. §122 (b) (1999).

²¹⁷ See H.R. 10, 106th Cong. §122 (b) (1999).

²¹⁸ See S. 900, 106th Cong. (1999) introduced April 28, 1999 by Sen. Gramm.

Committee,²¹⁹ the bill was passed by the full Senate, prior to passage of H.R. 10 by the House ("1999 Senate Bill").²²⁰ The 1999 Senate Bill did not provide for the establishment of financial holding companies, but instead utilized the existing bank holding company structure. Bank holding companies were permitted to participate in a wide array of expanded activities determined to be financial in nature, as set forth in the bill or as determined by the Board in consultation with the Secretary of the Treasury, or incidental thereto, including securities and insurance underwriting and merchant banking.²²¹ The operating subsidiary option was permitted under the 1999 Senate Bill, but to a far more limited extent than under the 1999 Version of H.R. 10. A national bank with \$1 billion or less in assets that was not a subsidiary of a bank holding company could engage in new activities permitted for bank holding companies in the bill, excluding real estate development and investment,²²² through operating subsidiaries.²²³ However, larger national banks were required to conduct such new activities in a holding company affiliate.²²⁴ National banks and their insured depository institution affiliates were required to be well-capitalized and well-managed, and OCC approval was needed.²²⁵ Firewalls comparable to those used in the 1999 Version of H.R. 10 were also required.²²⁶

The Gramm-Leach-Bliley compromise on the corporate structure issue includes some elements found in both the 1999 Senate Bill and the 1999 Version of H.R. 10, but adds new features as a result of negotiations in the Financial Services Conference Committee ("Conference Committee"). Both the Treasury Department and the Board were actively involved in working out a compromise in the Conference Committee in order to ensure its passage by Congress and approval by the executive branch.²²⁷

²¹⁹ The Senate Banking Committee referred the bill out on March 4, 1999. See Senate Banking Committee Press Release, Mar. 4, 1999 *available in* (visited May 7, 1999) <<http://www.senate.gov/~banking/prel99/0304fsm.htm>>.

²²⁰ See 1999 Senate Bill, version passed May 6, 1999 *available in* (visited Oct. 11, 1999) <<http://www.house.gov/banking/S900assp.pdf>>.

²²¹ See S. 900, 106th Cong. §102(a) (1999).

²²² See S. 900, 106th Cong. §121(a) (1999).

²²³ See S. 900, 106th Cong. §122(a) (1999).

²²⁴ See *id.*

²²⁵ See S. 900, 106th Cong. § 121(a) (1999).

²²⁶ See S. 900, 106th Cong. § 122(a) (1999).

²²⁷ House Banking Committee Democrats Press Release, October 12, 1999, Statement of John J. LaFalce and Paul S. Sarbanes (criticizing the partisan nature of

The primary vehicle for new financial activities is a new type of bank holding company called a "financial holding company," which may be established under Section 4(k) of the Bank Holding Company Act to engage, directly or through affiliates, in activities deemed financial in nature, incidental activities and complementary activities that do not pose substantial safety or soundness risks for banks or the financial system.²²⁸ Activities that are financial in nature under the statute include both financial activities that bank holding companies and their affiliate already engage in, but also new powers that banks have long sought, including securities and insurance underwriting, merchant banking, and insurance company portfolio investment activities.²²⁹ The Board is authorized to make determinations, in consultation with the Secretary of the Treasury, that other activities are financial in nature or incidental thereto.²³⁰ In order to engage in these activities, the bank holding company must meet the requirements that each of its depository institution subsidiaries is well-capitalized, well-managed, and has received a Community Reinvestment Act rating of satisfactory or better, subject to an exclusion for newly acquired insured bank subsidiaries.²³¹ The bank holding company must also file with the Board a

the Conference Committee) (visited Oct. 26, 1999) <http://www.house.gov/banking_democrats/pr_991012.htm>.

²²⁸ See Gramm-Leach-Bliley, § 103(a) (new 12 U.S.C. § 1843(k)(1)).

²²⁹ See *id.* (new 12 U.S.C. § 1843(k)(4)). The list of activities includes: (1) lending, exchanging, transferring, investing for others, or safeguarding money or securities; (2) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of such insurance, in any state; (3) providing financial, investment, or economic advisory services, including advising an investment company; (4) issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly; (5) underwriting, dealing in, or making a market in securities; (6) engaging in all activities the Board determined were closely related to banking or managing or controlling banks as of November 12, 1999; (7) engaging in any activity that bank holding companies were permitted to engage in outside of the United States or that were usual in connection with the transaction of banking abroad as of November 11, 1999; (8) making portfolio investments in connection with certain underwriting and merchant banking activities; and (9) making portfolio investments in the ordinary course of business as an insurance underwriter.

²³⁰ Such determinations may be made by regulation or order. See *id.* (new 12 U.S.C. § 1843(k)(1), (2)).

²³¹ Gramm-Leach-Bliley, § 103(a) (new Section 12 U.S.C. § 1843(1)); Section 103(b) (amended Section 12 U.S.C. § 2903).

declaration of election to be a financial holding company, along with a certification that the requirements of the statute have been met.²³²

National banks are permitted to control or hold an interest in "financial subsidiaries,"²³³ which may engage in financial or incidental activities permitted for financial holding companies pursuant to new Section 4(k) of the Bank Holding Company Act, except for insurance underwriting, merchant banking, insurance company portfolio investments, real estate development and real estate investment, and activities that national banks are permitted to engage in directly.²³⁴ The Secretary of the Treasury, acting in consultation with the Board, has the authority to designate additional activities as financial or incidental to financial activities.²³⁵ Certain conditions must be satisfied, including the following: (1) the national bank and each depository institution affiliate must be well-capitalized, well-managed,²³⁶ and have received Community Reinvestment Act ratings of satisfactory in their latest examinations;²³⁷ (2) the total assets of all such financial subsidiaries do not exceed the lesser of 45% of the consolidated total assets of the parent bank or \$50,000,000;²³⁸ (3)(a) the national bank must either be small; or (b) if the national bank is one of the fifty largest insured banks, its capital structure includes at least one issue of outstanding unsecured long-term debt rated within the three highest investment grade rating categories of a nationally recognized rating organization; or (c) if the

²³² See Gramm-Leach-Bliley, § 103(a) (new 12 U.S.C. § 1843(1)).

²³³ See Gramm-Leach-Bliley, § 121(a) (new 12 U.S.C. § 5136A(a)(2)). National bank ownership of operating subsidiaries approved by the OCC prior to enactment of Gramm-Leach-Bliley are grandfathered. See *id.* (12 U.S.C. § 5136A(e)).

²³⁴ See Gramm-Leach-Bliley, § 121(a) (new 12 U.S.C. § 5136A(a)(2)(B)). The Board and the Secretary of the Treasury are authorized to consider dropping the ban or merchant banking activities five years after date of enactment of Gramm-Leach-Bliley. See *id.* § 122. It should be noted that national banks themselves are given certain expanded powers, including the right to underwrite municipal revenue bonds. Gramm-Leach-Bliley, § 151 (amending 12 U.S.C. § 24 (Seventh)). In addition, insurance activities of national banks were addressed. Insurance activities as principal were barred with certain exceptions. See Gramm-Leach-Bliley, §§ 302(a), 302(b), 303.

²³⁵ See Gramm-Leach-Bliley, § 121(a) (new 12 U.S.C. § 5136A(b)).

²³⁶ See *id.* (new 12 U.S.C. § 5136A(a)(2)(C)).

²³⁷ See Gramm-Leach-Bliley, § 103(a) (new 12 U.S.C. § 1843(1)(2)), § 103(b) (new 12 U.S.C. § 2903(c)(1)), § 121(a)(2) (new 12 U.S.C. § 5136A(a)(7), (g)(5)-(f)(6)).

²³⁸ See Gramm-Leach-Bliley, Section 121(a) (new 12 U.S.C. § 5136A(a)(2)(D); (a)(3)). This requirement is subject to indexing. See *id.*

national bank is one of the second fifty largest insured banks, it meets the capital structure requirement applicable to the fifty largest insured banks or such other comparable criteria established by the Board of the Secretary of the Treasury;²³⁹ and (4) the national bank has received the approval of the OCC.²⁴⁰

Safeguards addressing safety and soundness and conflict of interest problems are put into place. A national bank must deduct the amount of its outstanding equity investment, including retained earnings in a financial subsidiary, from its assets and tangible equity, and may not consolidate its assets and liabilities with those of the financial subsidiary.²⁴¹ A national bank with a financial subsidiary must have procedures for identifying and managing risks within the financial subsidiary and for maintaining the separate corporate identity and limited liability of the financial subsidiary that adequately protect the bank.²⁴² The provisions of Sections 23A and 23B of the Federal Reserve Act are extended to financial subsidiaries.²⁴³ Those statutory firewalls will continue to apply to financial holding companies and their affiliates, as they do with respect to other bank holding companies.

While the Gramm-Leach-Bliley compromise permits use of an operating subsidiary by a national bank for new financial activities, national banks have less flexibility in using such subsidiaries than if a holding company affiliate were used. This is due to the more limited universe of new financial activities that may be conducted, the aggregate size limitations for financial activities conducted through operating subsidiaries, and the capital structure requirement applicable to large banks. A positive aspect of the compromise is that use of a bank operating subsidiary to conduct such new activities has now been put on a firm legal footing, unlike the case with approvals under the OCC's Operating Subsidiary Rule.

²³⁹ *See id.* (new 12 U.S.C. § 5136A(a)(2)(E)). This requirement does not apply in the case of ownership or control of financial subsidiaries engaged in financial activities solely as agent and not as principal. *See id.* (new 12 U.S.C. § 5136A(a)(4)).

²⁴⁰ *See id.* (new 12 U.S.C. § 5136A(1)(F)).

²⁴¹ *See id.* (new 12 U.S.C. § 5136A(c)).

²⁴² *See id.* (new 12 U.S.C. § 5136A(d)).

²⁴³ *See* Gramm-Leach-Bliley, § 121(b) (amending 12 U.S.C. § 371c).

B. Viewpoints in the Corporate Structure Debate

The corporate structure debate has polarized federal banking regulators, other financial service industry regulators, and the financial services industry itself. The Board was the leading advocate for the holding company affiliate structure. The Securities and Exchange Commission, the National Association of Insurance Commissioners, and various securities industry and insurance industry lobbyists also favored this structure. The primary advocate of the operating subsidiary model was the Treasury Department. The OCC, the FDIC, and the Office of Thrift Supervision supported this view, along with some leading economists and legal experts²⁴⁴ and some banking industry lobbyists. This Section will assess the most important arguments advanced on both sides.

1. Arguments in Favor of Exclusive Use of Holding Company Affiliates

The Board has taken the position that new activities should only be permitted in holding company affiliates and that the use of operating subsidiaries should not be permitted. Requiring new affiliations to take place within a holding company structure serves two functions. First, it best protects the federal deposit insurance funds by limiting the additional risks permitted to insured depository institutions and therefore serves a safety and soundness preserving function. Second, it limits the spread of the federal safety net and its related subsidy and moral hazard problems to entities or

²⁴⁴ One noteworthy example is the Shadow Financial Regulatory Committee ("SFRC"), an independent group of lawyers and economists active in the field of finance, which frequently comments on emerging problems and policy responses in the financial service industry. SFRC has consistently taken the position in its policy statements that there should be no difference in treatment between bank operating subsidiaries and holding company affiliates. See SFRC Statement No. 153 (Dec. 7, 1998) (visited Oct. 13, 1999) <<http://www.aei.org/shdw>> (stating in relevant part as follows: ". . . despite the Fed's arguments to the contrary, there is no prudential reason to prefer that new nonbanking financial activities be conducted in the subsidiaries of holding companies rather than the separately capitalized subsidiaries of banks. Moreover, the Committee has pointed out that the risk of extending the federal safety net is the same for separately capitalized subsidiaries of banks as for subsidiaries of holding companies. Accordingly, the Committee does not believe that either of the Fed's arguments for placing new financial activities solely in the subsidiaries of holding companies are valid.") See also SFRC Statement No. 118, 136 and 155.

activities beyond the insured depository institutions it was originally intended to support.²⁴⁵ This second argument has two corollaries. First, the public should not be paying for these new activities, but rather they should be offered at market rates. Second, extending the banking safety net to nonbanking financial activities would put non-bank competitors, namely securities and insurance firms, at a competitive disadvantage. A third argument is that permitting use of bank operating subsidiaries would cause banks to cease use of holding company affiliates, which are subject to regulation by the Board, as vehicles for new financial activities, and to use such subsidiaries, which are subject to OCC regulation, as an alternative. This in turn would undercut the Board's role as preeminent bank regulator.²⁴⁶

a. Risk to Bank Safety and Soundness

This prong of the Board's argument has not been well-developed conceptually either in Congressional testimony on financial modernization legislation, other public statements by members of the Board of Governors or in Board publications. In testimony offered at the beginning of the 106th Congress, this argument was only mentioned in passing and did not number among the primary arguments advanced by the Board for its position.²⁴⁷ In earlier Congressional testimony, Chairman Greenspan stated that, while the new activities being considered were not unusually risky, such activities did

²⁴⁵ See *Financial Services Modernization: Hearings on H.R. 10 Before the Senate Comm. Banking, Housing and Urban Affairs*, 105th Cong. (1998) (Testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System) [hereinafter Greenspan 1998 testimony]. Greenspan offered substantially identical testimony on this issue before this and other Congressional committees on numerous occasions during the 105th and 106th Congresses.

²⁴⁶ See *id.*

²⁴⁷ See Greenspan 1999 testimony, *supra* note 19. The arguments in favor of the holding company affiliate were as follows: 1) such structure will inhibit the widespread employment of federal subsidies over a wide range of activities, which would place banking organizations at an unfair competitive advantage over comparable insurance and securities firms operating independently or as bank holding company subsidiaries, 2) such subsidies would distort capital markets and the efficient allocation of both financial and real resources that are central to American prosperity, 3) new financial activities by banks should be financed by the market place and not by the sovereign credit of the U.S., and 4) the extension of the bank examination model of regulation to new nonbanking financial activities should be avoided.

present additional risk and that any losses would have to be absorbed.²⁴⁸ This thought is not developed further in Greenspan's testimony, but the logical implication is that because the operating subsidiary is owned by a national bank, the bank would have to absorb any losses in the subsidiary. If the bank were rendered insolvent through such a strategy, the federal deposit insurance funds might be drawn upon because national banks are insured by the FDIC. Other safety and soundness arguments used by the Board have been rather vague also, including references to the "greater distance" between a bank and a holding company affiliate and expressions of doubt that the corporate separateness doctrine applies to bank operating subsidiaries in the same way that it applies to affiliates in a bank holding company structure.²⁴⁹ In one instance testifying in front of Congress, Chairman Greenspan went so far as to say that safety and soundness issues were not raised by use of the operating subsidiary.²⁵⁰

Instead of advancing arguments to show that the holding company affiliate is a superior structure based on safety and soundness considerations, the Board's rebutted arguments made by the Department of the Treasury in support of the safety and soundness of the operating subsidiary structure. The most prominent examples are: 1) criticizing the Treasury's proposal for capping potential losses in the operating subsidiary in order to minimize the exposure of the safety net by requiring the bank to deduct its investment in its operating subsidiary from its regulatory capital while remaining well-capitalized and by preventing a bank from paying off the debts of its failed subsidiary,²⁵¹ 2) arguing that, even if statutory barriers were created to limit

²⁴⁸ See Greenspan 1998 testimony, *supra* note 245.

²⁴⁹ See *id.*

²⁵⁰ See Greenspan 1999 testimony, *supra* note 19.

²⁵¹ Chairman Greenspan objected that such deduction is in conflict with GAAP. Such proposed deduction also runs counter to the way that banks manage their subsidiaries, the way regulators have supervised subsidiaries and the way financial markets are likely to perceive the bank as a whole. Historically, both bank management and bank supervisors have regarded operating subsidiaries to be an integral part of the bank and have treated them as departments of the banks whose operations could have a significant impact on the bank's risk profile. Bank managers have sought to support their subsidiaries in the past and supervisors have carefully examined the operations of material subsidiaries in view of the difficulty in insulating the parent bank from problems in its subsidiaries. In addition, the financial markets will not view the subsidiary as truly separate and insulated from the bank. He stated that the requirement that bank dividend payments to a holding company must be deducted from bank capital, thereby constraining bank

the impact of subsidiary losses on the parent, there still might be an erosion of market confidence in the bank's management and health, which would affect bank stability, which depends on reputation and standing in the financial markets, 3) dismissing the Treasury's argument that operating subsidiaries are desirable because they offer operational flexibility to bank management,²⁵² and 4) ignoring evidence that Edge Act subsidiaries of U.S. banks have conducted nonbanking financial activities off-shore without problems.²⁵³

b. Spread of the Federal Safety Net Subsidy and the Attendant Moral Hazard Problem

The federal safety net refers to federal deposit insurance, access to the discount window, and to the Federal Reserve clearing system. The subsidy arises as the capital markets perceive banks as a safer risk than commercial companies, and therefore banks can finance their activities more cheaply, i.e. they have a lower cost of funds as a direct result of the federal safety net. The moral hazard problem arises because the safety net may lead to excessive risk-taking by banks and reduced market discipline. This will then lead to the need for more bank supervision to counteract the resulting moral hazard. If the federal subsidy created by the safety net is then extended to operating subsidiaries engaging in a broader range of activities than banks themselves are allowed to engage in, the moral hazard problem would be exacerbated and there would be even a greater need for a compensating increase in bank supervision.²⁵⁴

subsidization of holding company affiliate activities, is a more effective constraint than relying on the deduction from bank regulatory capital for equity investments in an operating subsidiary engaging in new activities, which is in conflict with GAAP. See Greenspan 1998 testimony, *supra* note 245.

²⁵² Chairman Greenspan argued that use of an operating subsidiary will always be more profitable because of the federal safety net subsidy and therefore, there is no real choice involved and bank management will always select the operating subsidiary. See Greenspan 1998 testimony, *supra* note 245.

²⁵³ Chairman Greenspan did not respond directly to this argument. He stated that the reason to permit Edges to engage in greater securities activities off-shore was to allow U.S. banks to be competitive abroad. He also stated that considerations of competitive equity in the U.S. argue against using a universal bank approach in the U.S. because securities and insurance firms would be placed at a competitive disadvantage. See Greenspan 1998 testimony, *supra* note 245.

²⁵⁴ Remarks by Federal Reserve Board Governor Laurence H. Meyer at the 1999 F. Hodge O'Neal Corporate & Securities law Symposium, Washington University

As stated above, this argument has two corollaries. With respect to the first corollary, the Board has taken the position that using operating subsidiaries for new activities would be a “funnel for transferring the sovereign credit subsidy directly from the bank to finance any new principal activities authorized by Congress or OCC regulatory actions.”²⁵⁵ Use of the sovereign credit affects allocation of credit and real resources in our financial system and issues of risk and degree of supervision are implicated. Therefore, decisions about use of the sovereign credit should be made by Congress after full consideration of the implications of such an extension on the competitive balance and systemic risks of the financial system. With respect to the second corollary, the Board has made the argument that operating subsidiaries will operate at a competitive advantage compared to so-called “independent” firms. Considerations of competitive equity demand a “level playing field” in the financial services industry and “full, open and fair competition.”²⁵⁶ This seems an odd comment from a banking regulator, for it goes beyond the traditional concerns of such regulators, such as safety and soundness. Assuming Greenspan was looking forward to the Board’s new role as “umbrella regulator” of banking conglomerates under Gramm-Leah-Bliley with responsibility for overseeing their financial stability, the remark becomes more comprehensible.²⁵⁷

c. Need to Preserve Board Role as Bank Regulator

This argument has not been well-developed by the Board, although it has been raised on numerous occasions in front of Congressional committees holding hearings on financial modernization legislation. The Board has long maintained that it must maintain its role as a bank regulator, in addition to its central banking functions.²⁵⁸ This argument is linked to the previous argument regarding the spread of the federal safety net subsidy. It is argued that such subsidy has resulted in lower costs of capital for banks than for their affiliates and therefore, will lead banks to locate their new activities in

School of Law (Mar. 12, 1999) (visited Mar. 13, 1999) <<http://www.bog.frb.fed.us/boarddocs/speeches/current/19990312.htm>> .

²⁵⁵ See Greenspan 1998 testimony, *supra* note 245.

²⁵⁶ See *id.* Both the securities and the insurance industries support the holding company structure as a way to ensure fair competition. See Mark M. Dumler & Edward E. Sharkey, *70-Year-Old Walls Almost Came Tumbling Down*, NATIONAL L. J., Nov. 2, 1998, at B7.

²⁵⁷ See Gramm-Leach-Bliley, § 111 (amending 12 U.S.C. § 1844(c)).

²⁵⁸ See Greenspan 1999 Testimony, *supra* note 19; Greenspan 1998 Testimony, *supra* note 245.

subsidiaries, which are subject to OCC regulation and not Board regulation.²⁵⁹

2. Arguments in Favor of Operating Subsidiary Alternative

Former Treasury Secretary Robert E. Rubin stated in Congressional hearings on H.R. 10 that the proposed legislation was extremely significant because it would become the constitution for the financial system for the twenty-first century.²⁶⁰ According to Rubin, such legislation must meet five principles, namely, protect the safety and soundness of the financial system, provide adequate consumer protection, reduce costs and improve access for consumers, businesses, and communities, promote innovation and competitiveness of the financial services industry; and permit financial services firms to choose the corporate structure that makes the most business sense.²⁶¹ Rubin noted that good financial modernization legislation would cause the evolution of the industry to occur in a more coherent and orderly way. However, he also noted that the U.S. financial services industry is currently strong and competitive abroad and would continue to be so even in the absence of modernization legislation. Therefore, it was necessary to "get the solution right." He stated that the Clinton administration had been a consistent proponent of financial modernization legislation that best serves the interests of consumers, businesses and communities but opposed, along with all major organizations of banking institutions, the version of H.R. 10 passed by the House in 1998, because it did not meet this standard. One of the chief objections of the Administration to the bill as passed by the House was that it would force banks to conduct new financial activities in bank holding company affiliates and would prohibit using subsidiaries of banks, thereby limiting the ability of participants to make their own decisions about lowering costs, improving services and providing benefits to consumers.²⁶²

²⁵⁹ See *Independent Ins. Agents of America, Inc. v. Bd. of Governors of the Federal Reserve System*, 890 F.2d 1275, 1284 (2d Cir. 1989); *Citicorp v. Bd. of Governors of the Federal Reserve System*, 936 F.2d 66, 75 (2d Cir. 1991).

²⁶⁰ See *Financial Services Modernization: Hearings on H.R. 10 Before the Senate Comm. On Banking, Housing and Urban Affairs*, 105th Cong. (1998) (testimony of Robert E. Rubin, Secretary of the Treasury) [hereinafter Rubin 1998 testimony].

²⁶¹ See *Advance Text of the Testimony to be Delivered by Treasury Secretary Robert E. Rubin to the Senate Banking Committee*, FEDERAL NEWS SERVICE, Jun. 17, 1998.

²⁶² Rubin 1998 testimony, *supra* note 260. The other objections of the Administration that Rubin mentioned were the following: 1) the bill discriminated

In addition to the Treasury Department, two of the three federal banking regulators supported use of the operating subsidiary as an alternative structure to the bank holding company affiliate. Representatives of each of these entities testified extensively in front of various Congressional committees during the 105th Congress and again in the 106th Congress.

a. Use of Operating Subsidiaries for New Activities Would Strengthen Banks

Rather than causing safety and soundness problems for banks, use of operating subsidiaries to conduct new activities is a prudent form of risk diversification that would benefit banks.²⁶³ This would occur for two reasons. First, banks conducting new activities in operating subsidiaries would receive additional income in the form of dividends from such subsidiaries and their financial position would be strengthened as a result. In comparison, use of a holding company affiliate would lead to income from the new activities being passed to the holding company, not the bank. Second, fees and other income from subsidiaries enable banks to offset the effects of cyclical downturns in other economic sectors, diminishing the volatility of bank earnings and making the system as a whole less risky.

b. Use of Operating Subsidiaries for New Activities Would Strengthen the Federal Deposit Insurance System

Rather than destabilizing the federal deposit insurance system, the system would be strengthened. This would occur because the additional

against banks and in favor of insurance companies (referring to the provision that would remove judicial deference to the OCC when considering questions involving insurance) and this would impede competition and innovation and fail to serve the interests of consumers; 2) the bill expanded the Federal Home Loan Bank System without resolving the system's fundamental problems; 3) the bill would cause assets to be shifted out of national banks and into holding company affiliates, thereby reducing resources covered by the Community Reinvestment Act, which would reduce the amount of capital available for urban economic revitalization and financing for affordable housing and small businesses. *See id.*

²⁶³ *See* Rubin 1998 testimony, *supra* note 260, *see also* *Financial Services Modernization: Hearings on H.R. 10 Before the Senate Comm. On Banking, Housing and Urban Affairs*, 105th Cong. (1998) (testimony of Julie Williams, Acting Comptroller of the Currency) [hereinafter Williams 1998 testimony].

earnings from new activities in bank subsidiaries lowers the probability of bank failure. If a holding company affiliate were used, any earnings from the new activities would flow through to the holding company, not the affiliated insured bank. The FDIC has consistently taken the position that, for this reason alone, allowing banks to conduct new activities in subsidiaries is at least as safe and sound, and probably more so, than conducting these activities in holding company affiliates.²⁶⁴ In addition, the value of the bank's investment in the subsidiary is fully available to cover the costs of failure resolution by the FDIC.²⁶⁵ This would not be true necessarily if new activities were conducted within a holding company affiliate. The ability of a Federal banking agency to require a holding company to support a troubled subsidiary is uncertain.²⁶⁶ The corrective action provisions of the Federal Deposit Insurance Act of 1991 specifically limit the ability of a Federal banking agency to require a parent bank holding company to contribute funds to an undercapitalized bank through a capital restoration plan to the lesser of 5% of the bank's assets or the amount necessary to bring the institution up to the adequately capitalized level.²⁶⁷ The Federal Reserve Board's source of strength doctrine has never been fully litigated and bank holding companies have sometimes refused to meet regulators' demands to downstream funds into a troubled bank.²⁶⁸ The operating subsidiary is a superior vehicle for this reason also.

²⁶⁴ See *Financial Services Modernization: Hearings on H.R. 10 Before the Subcommittee on Capital Markets, Securities and Government-Sponsored Entities of the House Comm. On Banking and Financial Services*, 105th Cong. (1997) (testimony of Ricki Helfer, Chairman of the FDIC) [hereinafter Helfer 1997 testimony].

²⁶⁵ See Williams 1998 testimony, *supra* note 263; see also Rubin 1998 testimony, *supra* note 260.

²⁶⁶ See Williams 1998 testimony, *supra* note 263.

²⁶⁷ See 12 U.S.C. § 1831(e)(2)(E) (1999). In addition, a holding company may decline to supply capital if it is resigned to closure of the bank subsidiary. See 12 U.S.C. § 1831o(f) (1999). 12 C.F.R. §§6.5(i)(2), 208.44(i)(2), 325.104(h)(2), 565.5(i)(2) (1999).

²⁶⁸ In *McC Corp Fin., Inc. v. Board of Governors*, 900 F.2d 852, 857 (5th Cir. 1990), *rev'd* on other grounds, 502 U.S. 32 (1991), the Fifth Circuit Court of Appeals called into question the validity on statutory grounds of the source of strength doctrine.

c. Safety and Soundness Safeguards Will Prevent Risks Caused by Use of an Operating Subsidiary

The new activities that would be permitted under proposed financial modernization legislation would not be unduly risky.²⁶⁹ However, to the extent that additional risks would be posed by a bank subsidiary engaging in new activities, the bank would be insulated from losses associated with such additional risks by principles of corporate separateness and by adoption of appropriate safeguards that would mitigate such risks. Therefore, use of an operating subsidiary would pose no greater risk to bank safety and soundness than use of a holding company structure.²⁷⁰

Corporate separateness protects the bank because the subsidiary would be separately incorporated and maintained and operated as a separate entity. Under the principle of limited liability in state corporation law in the U.S., a shareholder is not liable for losses or liabilities of a corporation beyond the amount of the shareholder's investment. In some cases, however, courts have pierced the veil of limited liability and held shareholders responsible for the losses and liabilities of a corporation. As long as the separate existence of the subsidiary is maintained, this should not occur. It is no more likely that a court would pierce the limited liability shield of the operating subsidiary and reach the assets of the bank than it would if a holding company affiliate is used. In fact, there is empirical evidence that courts are more likely to pierce the veil in the case of affiliates than they are in the case of subsidiaries.²⁷¹

Another device to insulate the bank from losses in an operating subsidiaries would be through the use of firewalls. The safeguards, which Treasury and the OCC proposed be included in any new legislation, include the following: 1) banks are required to be both well-capitalized and well-managed, subject to sanctions if they are not, 2) all of the bank's equity investment in the subsidiary must be deducted from the bank's capital and the bank must remain well-capitalized after the deduction, 3) the bank may not make an equity investment in a subsidiary that would exceed the amount

²⁶⁹ The FDIC has consistently maintained that the subsidiary structure poses no threat to safety and soundness. See Rubin 1998 testimony, *supra* note 260.

²⁷⁰ See Rubin 1998 testimony, *supra* note 260; see also Williams 1998 testimony, *supra* note 263.

²⁷¹ See Robert Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV.1036, 1074 (1991). This study has been cited in prepared testimony presented to Congress on a number of occasions.

that it could pay out as a dividend, unless it receives regulatory approval, and 4) loans or other credit extensions by a bank to a subsidiary would be subject to the same limits as bank loans and other credit extensions to an affiliate pursuant to the prudential restrictions of Sections 23A and 23B of the Federal Reserve Act and purchases of low quality assets from a subsidiary would be subject to the limitations under Section 23A applicable to transactions between banks and holding company affiliates.²⁷²

d. Permitting Banks to Choose the Corporate Structure for New Activities Would Benefit Consumers

Banks should have the flexibility to choose their own form of organization and restricting their choices will have adverse effects on consumers. There are good business reasons for an institution to prefer a subsidiary over an affiliate, namely: 1) holding companies are expensive to form and may be prohibitively expensive for small banks, thereby effectively preventing them from engaging in newly permitted financial activities, 2) bank management may wish to retain the earnings flow generated by a new line of business, 3) bank management may want to diversify earnings of the bank group, and 4) bank management may simply prefer siting new activities in subsidiaries, as a matter of corporate culture.²⁷³ Without such flexibility, banks would be less safe and sound for the reasons discussed in Section III.B.2.a. above, offer fewer choices to customers, may be under pressure to charge higher fees on the products or services they are allowed to offer and may be less able to serve the financial needs of their communities and their customers.²⁷⁴

e. No Net Safety Net Subsidy Exists. Even If Such Subsidy Existed, Firewalls Could Be Used to Contain The Spread of that Subsidy to Operating Subsidiaries

This arguments consists of two parts. The first part of the argument is that there is no net safety net subsidy available to insured banks. This is because there are very high regulatory costs associated with being an insured bank that reduce to zero any benefits that might be available because of the

²⁷² See Rubin 1998 testimony, *supra* note 260; see also Williams 1998 testimony, *supra* note 263.

²⁷³ See Rubin 1998 testimony, *supra* note 260.

²⁷⁴ See Williams 1998 testimony, *supra* note 263.

existence of the federal safety net.²⁷⁵ Therefore, there can be no danger of such a subsidy spreading if operating subsidiaries are used.

The second part of the argument is as follows. Even assuming for purposes of argument that such a subsidy exists, firewalls might be constructed that would prevent the spread of such subsidy from an insured bank to a subsidiary, the same way that firewalls limit this from happening in the case of holding company affiliates.²⁷⁶ This was the position taken by the OCC, which favored adding certain safeguard measures to H.R. 10 that would impede the flow of subsidized dollars to an operating subsidiary to the same extent that restrictions impede the flow of subsidized dollars to the bank holding company and its nonbank affiliates. These safeguards included extending the quantitative and qualitative restrictions of Sections 23A and 23B of the Federal Reserve Act to loans from a bank to a bank subsidiary, requiring that a bank deduct from regulatory capital its investment in the operating subsidiary, requiring the consolidation of the subsidiary's assets and liabilities with those of the bank, and a prohibition on bank investment in a subsidiary greater than what it can pay as a dividend to its holding company without specific regulatory approval.²⁷⁷ If such limitations were adopted, they would be more effective in preventing the spread of a subsidy than current law restricting transactions in the holding company structure. The example offered was the spread of a subsidy from a bank holding company to an affiliate. This involves a two-step process in which the subsidy is first transferred from the bank to the holding company in the form of a dividend payment and then there is a transfer of value from the holding company to the non-bank affiliate in the form of an equity investment or other transaction. Under this scenario, there are no legal restrictions to contain spread of the subsidy except the requirement that the dividend be permissible for the bank.

f. New Activities Have Been Conducted Off-Shore through Operating Subsidiaries in a Safe and Sound Manner

There is empirical evidence that new activities can be conducted safely and soundly through operating subsidiaries. This is based upon the use of Edge Act subsidiaries by U.S. banks overseas to conduct securities activities. These subsidiaries are chartered and regulated by the Federal

²⁷⁵ See *infra* Section IV.C.

²⁷⁶ See Williams 1998 testimony, *supra* note 263; see also Rubin 1998 testimony, *supra* note 260.

²⁷⁷ See Williams 1998 testimony, *supra* note 263.

Reserve Board and there is no indication that use of such subsidiaries has adversely affected the safety and soundness of their parent banks.²⁷⁸

IV. POLICY ANALYSIS OF THE CORPORATE STRUCTURE DEBATE: THE OPTIMAL STRUCTURE FOR NEW FINANCIAL ACTIVITIES

In most industry sectors in the United States, the choice of organizational form used to conduct activities is a business decision not subject to governmental regulation. The banking industry is different, some would even say "special", because of the public role that banks play in the economy.²⁷⁹ As a consequence, the choice of organizational form used by a bank for its activities may become very significant, if it can be argued that such choice will have an impact on an area of legitimate government concern. On the other hand, if there is no compelling public policy consideration that must be respected, the choice of organizational form should be a matter of private choice, as it is in other sectors of the economy.²⁸⁰

This section will analyze the corporate structure debate from the perspective of public policy. Four public policy rationales will be discussed - namely preserving safety and soundness, preventing conflicts of interest, preventing the spread of the safety net subsidy, and preserving the Board's ability to handle systemic risk. The purpose of this analysis is to determine whether there is a compelling government interest that would justify eliminating use of either the bank operating subsidiary or the bank holding company affiliate or preferring one form over the other or whether, in the alternative, banks should be permitted to view the choice as a private business decision.

A. Preserving Safety and Soundness

The safety and soundness issue arises out of the concern that certain new financial activities, like securities underwriting, carry higher levels of risk than core banking activities and may endanger bank solvency.²⁸¹ It

²⁷⁸ See Rubin 1998 testimony, *supra* note 260.

²⁷⁹ See Corrigan, *supra* note 2.

²⁸⁰ The federal banking regulators have recognized this principle in recent testimony in front of Congress on financial modernization legislation. See Williams 1998 testimony, *supra* note 263.

²⁸¹ See Shull & White, *supra* note 21, at 465.

should be noted that this view is not universally held, with some commentators arguing that permitting banks to diversify into nonbanking financial activities would actually decrease the risk of bank insolvency.²⁸² However, the safety and soundness issue will be discussed here because of the important role it has played in the corporate structure debate. There are several ways in which the additional risk undertaken by a bank affiliate in conducting such activities may affect and even endanger the stability of a bank and, by extension, the financial system. These include liability for losses incurred by an affiliate, loss of equity investment in the affiliate, loss of credit extended to an affiliate and loss of public confidence due to failure of an affiliate.²⁸³ At issue is whether one corporate structure is better than the other at insulating a bank from losses associated with new financial activities. Before undertaking a risk analysis of these factors, the available empirical evidence about the safety and soundness of use of bank affiliates to conduct new activities will be examined.

1. Empirical Evidence About Safety and Soundness of Bank Affiliates for New Activities

This topic was mentioned only on a few occasions in the debate over financial modernization legislation. There is very little evidence available because of the legal barriers that have prevented banks from undertaking nonbanking financial activities except on a limited basis. The historical experience with using either form to conduct new activities is so limited that it is difficult to say whether there are safety and soundness problems with either form or whether one is better than another in containing risk. The best information might be found in the results of examinations of banks and bank holding companies, which information is not publicly available. Therefore, any assessment of this issue must rely on less reliable information that is publicly available and on information drawn from contexts in which banks and their affiliates have been permitted to engage in limited nonbanking financial activities for some period of time, which include securities underwriting and dealing by bank holding company affiliates, but not by national bank operating subsidiaries. However, notwithstanding these

²⁸² See Gary Whalen, *Bank Organizational Form and the Risks of Expanded Activities*, OCC ECONOMICS WORKING PAPER 9 7-1 at 7 (1997). Daniel R. Fischel, Andrew M. Rosenfield & Robert S. Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 320 (1987).

²⁸³ See Longstreth & Mattei, *supra* note 21, at 1906-1912; McCoy, *supra* note 21, at §§ 8.02 and 8.05.

shortcomings, there is still some value in looking at the available evidence, information that was largely ignored in the corporate structure debate.

a. Holding Company Affiliates

As discussed in Section II.B.1., bank holding companies have been permitted by the Board since 1987 to engage in securities underwriting and dealing in bank ineligible securities through Section 20 subsidiaries, subject to the imposition of firewalls. The Board has stated that, in its experience, the risks of such securities underwriting and dealing have proven to be manageable in a holding company framework.²⁸⁴ The Board liberalized its rules regarding the operation of Section 20 subsidiaries in 1996 and 1997, indicating it believed there were no serious safety and soundness issues with conducting such activities to a limited extent in holding company affiliates. It is reasonable to infer from this evidence that the holding company affiliate is a suitable vehicle for the safe and sound conduct of new activities on a limited basis, subject to regulatory and statutory safeguards.

b. Bank Operating Subsidiaries

Operating subsidiaries have been permitted for the conduct of securities activities under U.S. law in two contexts. One is the use of Edge Act subsidiaries of U.S. banks to conduct securities activities offshore subject to supervision by the Board.²⁸⁵ In addition, state-chartered banks are permitted in some states to conduct securities activities²⁸⁶ and the FDIC takes the position that such activity is safe and sound for state-chartered, non-member insured banks under its supervision ("bona fide subsidiaries").

i. Foreign Subsidiaries

To date, there has been only one empirical study published on the performance or riskiness of these subsidiaries.²⁸⁷ This study examined the

²⁸⁴ See 62 Fed. Reg. 2622, 2623 (1997).

²⁸⁵ See 12 U.S.C. §§ 611 *et. seq.* and 12 C.F.R. §§ 211.1 *et. seq.* (1999).

²⁸⁶ See 12 U.S.C. § 1831a (1999).

²⁸⁷ See Gary Whalen, *The Securities Activities of the Foreign Subsidiaries of U.S. Banks: Evidence of Risks and Returns*, OCC Economics Working Paper 98-2 (1998) [hereinafter Whalen 1998]. Because of the historic limitations on domestic bank securities activities, the economic studies that have been conducted have focused on estimating the securities returns and risks that would accrue to banking organizations entering this line of business, relying on data from independent securities firms, often on an aggregate industry basis. Because of the methodology

risks and returns associated with U.S. bank involvement in securities activities overseas for the time period 1987-1996. The type of securities activities conducted by the banks included securities underwriting, broker-dealer activity, and merchant banking.²⁸⁸ Overall, the study concluded banks can lower their risk by engaging in overseas securities activities.²⁸⁹ With respect to the issue of whether one organizational form is superior to another, the study noted that there is virtually no empirical evidence supporting either position because laws and regulations in effect at the time neither allowed banks to choose how they organized important nontraditional activities domestically nor required them to report unconsolidated financial information on their direct subsidiaries.²⁹⁰ Comparison of the securities returns and risks of direct and indirect bank securities subsidiaries with those of holding company affiliates using industry aggregation revealed some differences in performance. The mean securities returns of the combined bank subsidiary group were slightly above those of the holding company affiliates over some time intervals, and their measured risk was lower in all periods examined. The evidence suggests that permitting U.S. banking organizations to engage in securities activities overseas through direct and indirect bank subsidiaries has not had a significant, deleterious impact on their performance. The author stated that additional research is necessary to establish the definitiveness of these findings. However, the study, which is the only empirical study on the domestic structural issue currently available,²⁹¹ suggests that the operating subsidiary should not be eliminated on safety and soundness grounds. It also suggests that the affiliate structure has not been shown to be better at containing risk than the operating subsidiary structure.

ii. FDIC Bona Fide Subsidiaries

The FDIC has permitted bona fide subsidiaries of insured nonmember banks to engage in securities activities since December 1984.²⁹²

used, the relevance of those studies to predicting actual performance is questionable. *See id.* at 3.

²⁸⁸ *See id.* at 7.

²⁸⁹ *See id.* at 32.

²⁹⁰ *See id.* at 28.

²⁹¹ *See id.* at 32.

²⁹² *See* 12 C.F.R. § 337.4 (1999). In order to qualify as a bona fide subsidiary, certain requirements must be met: the subsidiary must be adequately capitalized, have operations that are physically separate and distinct from the bank operations,

The types of activities that are permitted include securities underwriting and broker-dealer activity.²⁹³ While the experience of the FDIC with bona fide securities subsidiaries of insured nonmember banks has been limited, these subsidiaries generally have not posed safety and soundness concerns.²⁹⁴ Only one FDIC-supervised institution owns a subsidiary actively engaged in the full range of securities activities permitted by the FDIC, but over 400 insured nonmember banks have subsidiaries engaged in more limited securities-related activities. These activities include management of the bank's securities portfolio, investment advisory services, and acting as a broker-dealer. With one exception, none of these activities has given cause for a significant safety-and-soundness concern. There has been one failure of an insured institution supervised by the FDIC that conducted securities activities through a subsidiary.²⁹⁵ While not the sole cause of the failure, the business relationship with the securities subsidiary added to the cost of the failure because the bank had made a substantial unsecured loan that was used to benefit the securities subsidiary.²⁹⁶

iii. Inferences from Empirical Evidence

The empirical evidence is not conclusive because it is so limited and, in the case of operating subsidiaries, the evidence relates to entities other than national bank operating subsidiaries. However, it carries some persuasive authority because it indicates that the federal banking regulators, who are experts on assessing and taking steps to contain risk to avoid safety and soundness problems, have been willing to allow certain securities activities to be conducted to a limited extent in both holding company affiliates and operating subsidiaries.

In none of the three examples cited has there been an indication of a significant safety and soundness problem. Neither the Board nor the FDIC

maintain separate accounting and other corporate records, observe corporate formalities such as separate board of directors meeting, share no common officers or employees with the bank, compensate its own employees, have a board a majority of which is composed of persons who are neither directors nor officers of the bank, conduct business in a way that informs customers that the subsidiary is separate from the bank and its products are not FDIC insured bank deposits nor are they guaranteed by the bank. There are restrictions on loans, extensions of credit and other transactions between an insured bank and its securities subsidiary.

²⁹³ See 12 C.F.R. § 337.4(b) (1999).

²⁹⁴ See Helfer 1997 testimony, *supra* note 264.

²⁹⁵ See *id.*

²⁹⁶ See *id.*

has taken steps to limit or discontinue the securities activities in question. In fact, in recent years, the Board has permitted increased underwriting to occur in Section 20 subsidiaries, subject to a lower level of firewalls. It cannot be concluded from the limited evidence available that the operating subsidiary form should be eliminated as a vehicle for securities activities. The empirical study regarding foreign subsidiaries suggests that there is no reason to prefer the holding company affiliate for securities activities from a safety and soundness perspective.

2. Risk Analysis of Safety and Soundness Issues

a. Liability of Bank or Bank Holding Company for Losses Incurred by the Affiliate

One way that losses could flow through to the bank would be if the corporate separateness of the holding company affiliate or operating subsidiary were disregarded and the bank were held liable for losses in such affiliate or subsidiary. Piercing the corporate veil is an exception to the rule of limited liability of shareholders and is widely believed to be more likely in the case of a parent-subsidiary relationship than in the case of a corporation with shareholders who are natural persons.²⁹⁷ Piercing may also occur in a holding company structure, however, and in fact there is empirical evidence that courts are more likely to reverse pierce to reach the assets of affiliated corporations than in the case of a parent-subsidiary relationship.²⁹⁸ It should be noted that there is only one empirical study on this issue, which has often been cited in Congressional testimony to support the proposition that piercing is more likely to occur with respect to holding company affiliates than it is with respect to bank operating subsidiaries.²⁹⁹ That study is based on an analysis of decided cases drawn from an electronic data base involving a wide variety of corporations and did not study piercing in the specialized context of banks and bank holding companies. Therefore, it cannot be regarded as a conclusive study on this issue. What can be said based on the

²⁹⁷ See William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 873 (1982). See Thompson, *supra* note 271, at 1056 (arguing that, based on empirical evidence, courts are more likely to pierce in the case where the shareholder is another corporation than when the shareholders are individuals).

²⁹⁸ See Thompson, *supra* note 271, at 1057.

²⁹⁹ See Thompson, *supra* note 271.

available evidence and theoretical arguments is that the possibility exists for piercing in both contexts.

The Board has frequently argued that the holding company affiliate is a superior structure because it provides a double dose of limited liability, through the holding company as well as through the affiliate. However, based on the prior discussion and the possibility of reverse piercing, it appears that the focus of analysis should be on steps that can be taken in both contexts to avoid piercing. Studies of instances where the corporate veil of limited liability has been pierced suggest that there are predictable factors that a court will look at in making its determination, including whether corporate separateness between the two entities has been maintained and whether the subsidiary has been deliberately undercapitalized.³⁰⁰ Prior to Gramm-Leach-Bliley, both the OCC and the Board imposed corporate separateness requirements in connection with regulatory approvals to engage in underwriting of bank ineligible securities. With respect to national bank operating subsidiaries, the OCC required that elaborate steps directed at maintaining corporate separateness set forth in the Operating Subsidiary Rule be followed in connection with its approvals for such subsidiaries to engage in revenue bond underwriting.³⁰¹ With respect to holding company affiliates, the Board required that Section 20 subsidiaries be operated in a prudent manner, including maintaining corporate separateness and instituting appropriate risk management procedures.³⁰² The OCC corporate separateness requirements under the Operating Subsidiary Rule were more explicit than those set forth in the Conditions to Board's Section 20 Orders. The OCC requirements include the factors that are frequently cited by courts in determining whether to pierce the corporate veil,³⁰³ including adequate capitalization, maintenance of separate accounting and corporate records, and observance of corporate formalities. Gramm-Leach-Bliley requires that national banks owning financial subsidiaries take steps to maintain the

³⁰⁰ See Thompson, *supra* note 271, at 1064–1070.

³⁰¹ See 12 C.F.R. § 5.34(f)(2) (1999). The FDIC has adopted similar rules applicable to bona fide securities subsidiaries of insured state nonmember banks, which attempt to address the same risk.

³⁰² See 12 C.F.R. § 225.200(a) (1999) (“Conditions to Board’s Section 20 Orders”) (referring to maintenance of separate accounting and corporate records; independent trading and exposure limits consistent with parent company guidelines).

³⁰³ See Thompson, *supra* note 271, at 1064–1070.

corporate separateness of such subsidiaries and to identify and manage the financial or operational risks posed by the subsidiary.³⁰⁴

Because corporate separateness requirements can be and have been put in place for both types of entities, the focus should be on whether these requirements are adhered to, not on whether a holding company affiliate or an operating subsidiary is used. If the safeguards are adhered to, it is arguable that either corporate form should be able to insulate the bank from any undue risks associated with new financial activities. If, however, such corporate separateness requirements are not maintained, it is conceivable that the corporate veil of limited liability will be pierced and losses will flow through to the bank.

b. Loss of Equity Investment

Another potential risk is the impact on bank safety and soundness if the holding company affiliate or bank operating subsidiary failed and there were a loss of an equity investment by the corporate parent. In the case of a bank operating subsidiary, even a total loss of the investment in the subsidiary should have no effect on the stability of the bank. This was true under the OCC's Operating Subsidiary Rule because the bank was required to deduct its equity investment in an operating subsidiary from its regulatory capital and remain adequately capitalized after making such deduction.³⁰⁵ Under Gramm-Leach-Bliley, national banks must deduct the amount of their equity investments, including retain earnings, in financial subsidiaries from their assets and tangible equity and remain well-capitalized.³⁰⁶ Therefore, even a total loss of the investment should not have any effect on the bank's capital ratio.

In the case of a holding company affiliate, a loss of an equity investment would result in a corresponding reduction in the bank holding company's capital. The risk would be mitigated, however, if the investment in the affiliate were required to be taken into consideration in calculating the holding company's capital position.³⁰⁷ If the financial position of the bank

³⁰⁴ See Gramm-Leach-Bliley, § 121(a) (new 12 U.S.C. § 5136A(d)).

³⁰⁵ See *supra* Section II.B.2. This requirement only applied if the subsidiary engaged in such activity as a principal.

³⁰⁶ See Gramm-Leach-Bliley, § 121(a) (new 12 U.S.C. § 5136A(c)).

³⁰⁷ See 12 C.F.R. § 225.200(b)(1) (1999). Investments in a Section 20 subsidiary were required to be deducted from holding company capital in the 1987 Order, *supra* note 83 at 502, and the 1989 Order, *supra* note 84, at 205. This requirement changed

holding company were weakened as a result of the loss, a bank subsidiary of that holding company would be indirectly weakened because it would be deprived of the possibility of looking to the holding company as a source of strength. There are minimum capital requirements applicable to bank holding companies, which would require that the capital position of the bank holding company be restored in the event of such a loss.³⁰⁸ However, it is conceivable that the bank would be deprived of a source of strength for some period of time until the holding company took steps to improve its capital position. It should be noted that, although the Board has consistently maintained that bank holding companies should serve as a source of strength for their bank subsidiaries, the viability of the source of strength doctrine in the federal courts is questionable.³⁰⁹ However, Gramm-Leach-Bliley contains a provision on the source of strength doctrine, limiting the authority of the Board and other bank regulators to order regulated insurance or securities affiliates of a financial holding company, or subsidiaries of a depository institution owned by a financial holding company, to serve as a source of strength. This language may provide an implied basis for source of strength authority because, by limiting it in specific contexts, it assumes its existence.

c. Loss of Credit Extended to Affiliate

Another destabilizing event might be the loss of credit extended by a bank to a holding company affiliate or to an operating subsidiary. Although the risk of default exists with any credit extension by a bank, it is exacerbated in this instance because of the possibility of conflict of interest transactions, which are discussed in Section IV.B. There should not be any difference in result depending on whether a holding company affiliate or a bank operating subsidiary is used because the statutory firewalls of Sections 23A and 23B of the Federal Reserve Act are applicable in identical fashion to the two structures. In the case of a holding company affiliate, extensions of credit by an affiliated bank are subject to the arms' length, collateralization, and exposure limitations of Sections 23A and 23B.³¹⁰ The OCC's Operating Subsidiary Rule requires application of Sections 23A and 23B to extensions of credit by the national bank to an operating subsidiary

when the firewalls for Section 20 subsidiary were replaced by the operating standards in 1997. *See supra* Section II B.1.c.

³⁰⁸ *See* 12 C.F.R. part 225, app. A (1999).

³⁰⁹ *See* McCorp, *supra* note 268.

³¹⁰ *See* 12 U.S.C. § 371c, 371c-1 (1999).

when such subsidiary conducts activities as principal.³¹¹ Under Gramm-Leach-Bliley, transactions between a national bank and a financial subsidiary are subject to the Sections 23A and 23B firewalls.³¹²

There is also a possibility that a bank could be indirectly weakened because of defaults on loans made by a holding company to a holding company affiliate. Sections 23A and 23B of the Federal Reserve Act are inapplicable if a holding company affiliate seeks funding from its holding company. Loans could be funded with dividends paid to the holding company by the bank.³¹³ As a consequence, the holding company could transfer resources from the bank to the nonbank affiliate, even in cases where the bank could not do so directly. In such a case, if the affiliate were to default on its loan and cause a loss to the holding company, it would impair such holding company's ability to act as a source of strength for the bank.³¹⁴

d. Loss of Public Confidence Due to Affiliate Failure

A final risk to safety and soundness is loss of reputation of a bank or bank holding company due to failure of a holding company affiliate or operating subsidiary.³¹⁵ To the extent that new activities in an affiliate lead to extraordinary losses and the affiliate fails, the public's confidence in affiliated entities, including insured banks, will likely be affected. Public confidence in banks is an important component of safety and soundness and to the extent such confidence is lost, this may be reflected in the stock price of the bank or holding company, it may result in a downgrade in the debt or

³¹¹ See *supra* Section II.B.2.

³¹² See Gramm-Leach-Bliley, § 121(b) (amending 12 U.S.C. § 371(c)). A financial subsidiary is considered an affiliate, and not a subsidiary, of the parent bank for purposes of such provisions. Gramm-Leach-Bliley also includes anti-evasion language permitting the Board to deem an investment in, or extension of credit by, an affiliate in a financial subsidiary of a bank to be considered an investment or extension of credit by the parent bank of the financial subsidiary.

³¹³ National banks must comply with dividend restrictions. See 12 C.F.R. Part 5 (E) (1999).

³¹⁴ Prior to revision of the firewalls for Section 20 subsidiaries, holding companies were required to deduct from consolidated primary capital certain unsecured loans to such subsidiaries. See 1989 Order, *supra* note 84, at 205-206.

³¹⁵ See General Accounting Office, *Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities*, GAO/GGD-87-35, at 13 (1987). Keith R. Fisher, *Reweaving the Safety Net: Bank Diversification into Securities and Insurance Activities*, 27 WAKE FOREST L. REV. 123, 226 (1991).

equity rating of the bank or holding company, thereby raising its cost of funds, or it may result in more dramatic action, such as a bank run, which would undermine bank stability.

There is no reason to assume that this risk would be greater with one corporate structure than another. The risk can and should be addressed by taking steps to clarify in the public's mind the separateness of a holding company affiliate or operating subsidiary from any affiliated banks through disclosure requirements.³¹⁶

B. Avoiding Conflicts of Interest

Another risk is the possibility that a financially distressed affiliate or subsidiary will be assisted by its corporate parent to the disadvantage of an insured bank. In addition to raising safety and soundness concerns discussed above, there is also the danger that such assistance will result in the misallocation of credit resources because decisions are not being made on the basis of objective criteria. This offends the policy principle discussed in Section II.A. favoring the impartial allocation of credit. The types of conflict of interest transactions that might occur include imprudent loans to the affiliate, making loans at below market rates to the affiliate and sale of low-quality assets from the affiliate to the bank. In the holding company scenario, it is possible that funds could be drained out of the bank in the form of excessive dividends payable to a corporate parent in order to subsidize higher risk activities.³¹⁷ The incentive for engaging in such transactions is the problem of moral hazard, namely that the risk of loss is shifted to either the bank insurance funds or the public and away from private investors.

While the risk of self-dealing exists in all corporate settings, the use of a holding company magnifies that risk. Because of the complicated structure, monitoring and detection of misconduct is more costly and difficult.³¹⁸ In the case of financial holding companies, there is a danger that the risk of such misconduct will be greatest with respect to subsidiaries that are financial intermediaries, such as banks. This is because such subsidiaries

³¹⁶ For an example of the type of disclosure that might be effective, see Retail Sales Statement, *supra* note 102.

³¹⁷ See Shull & White, *supra* note 21, at 472; McCoy, *supra* note 21, at § 8.02.

³¹⁸ See Robert C. Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 787, 832 (1979).

tend to be larger than other subsidiaries and there is a greater likelihood that there will be less than complete stock ownership by the corporate parent.³¹⁹

The danger of conflict of interest transactions occurring that work to the detriment of insured banks is increased in a holding company structure where there is differential ownership of bank and non-bank subsidiaries.³²⁰ The danger is that the managers or controlling shareholders of related entities will bias transactions in favor of subsidiaries in which they hold the greatest interest in order to maximize the value of their investments.³²¹ There is no requirement of federal law that bank holding companies own all of the stock of their bank subsidiaries or that they maintain the same financial interest in bank and nonbank subsidiaries.³²² Therefore, it is possible that a bank in which a holding company or its controlling persons has a minority interest might be looted in the manner discussed previously in order to assist a failing nonbank affiliate engaged in securities underwriting. The same result is possible in the case of a bank operating subsidiary that operates under a holding company umbrella because the possibility of differential ownership of the operating subsidiary is not prohibited by federal law.³²³

It has been suggested that there is a greater potential for conflict of interest transactions in the case of a holding company affiliate than in the case of an operating subsidiary because, while a holding company may have incentives to manipulate transactions between and among itself and its subsidiaries, no such incentive exists with respect to a bank's dealings with its own operating subsidiaries. It has been argued that the bank's own self-interest will prevent it from engaging in transactions with an operating

³¹⁹ *Id.* at 833. Clark believed that such conflicts were the greatest danger posed by the financial holding company structure and should be closely regulated.

³²⁰ See McCoy, *supra* note 21, at § 8.02.

³²¹ See Clark, *supra* note 318, at 829.

³²² See 12 U.S.C. §§ 1841(2),(3), and 1843(2) (1999).

³²³ This result was possible, for example, under the OCC's Part 5 rules governing operating subsidiaries because such rules provided for the possibility of minority interests being held by shareholders other than the bank. See 12 C.F.R. §§ 5.34(d)(2), (e)(1)(i)(A) (1999). See McCoy, *supra* note 21, at §§ 8.02 and 8.06(1). Gramm-Leach-Bliley requires that a financial subsidiary be controlled by one or more banks, but does not prohibit differential ownership. Gramm-Leach-Bliley, § 121(a) (new 12 U.S.C. § 5136A(a)(1)).

subsidiary that would have an adverse impact upon it.³²⁴ This argument is dubious. It does not seem to apply in a case where the bank operating subsidiary is under a holding company structure because the bank's management will very likely be controlled by the holding company, which could exert pressure to engage in conflict of interest transactions.³²⁵ Even in the case of bank operating subsidiaries outside of a holding company structure, it is conceivable that bank management would be willing to lower credit standards with the expectation that the risk of doing so would be outweighed by the prospect of receiving a steady stream of dividends from a subsidiary engaged in a more profitable business than the bank itself could engage in, such as securities underwriting.

The possibility of conflict of interest transactions exists with respect to both holding company affiliates and operating subsidiaries. Sections 23A and 23B of the Federal Reserve Act³²⁶ address the problem of conflict of interest transactions entered into by member banks and their subsidiaries with affiliates.³²⁷ Section 23A limits the type and volume of transactions that may be entered into. Types of regulated transactions include loans or extensions of credit to the affiliate, purchases of securities issued by the affiliate, asset purchases, accepting securities issued by an affiliate as security for a loan to a third party, and issuing credit supports on behalf of an affiliate.³²⁸ The volume limitations prevent transactions with individual affiliates and aggregate affiliate transactions in excess of 10 and 20 percent, respectively, of a bank's capital and surplus.³²⁹ Additional protections include a ban on most sales of low quality assets to a bank³³⁰ and a

³²⁴ See Longstreth & Mattei, *supra* note 21, at 1903–1904 (suggesting that, as a result, there are greater safety and soundness problems with use of a holding company affiliate).

³²⁵ See Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L.J. 287, 290 (noting that boards of subsidiaries may approve activities that serve the interest of the parent).

³²⁶ See 12 U.S.C. §§ 371c, 371c–1 (1999). These sections originally applied only to member banks of the Federal Reserve System, but have been extended by Congress to insured nonmember banks and savings associations in the same manner they apply to member banks. See 12 U.S.C. § 1828(j); 12 U.S.C. § 1468 (1999).

³²⁷ "Affiliate" is a term of art directed at capturing control relationships involving member banks where conflicts of interest are most likely to arise. See 12 U.S.C. § 371c(b)(1) (1999).

³²⁸ See 12 U.S.C. § 371c(b)(7) (1999).

³²⁹ See 12 U.S.C. § 371c(a)(1) (1999).

³³⁰ See 12 U.S.C. § 371c(a)(3) (1999).

requirement that extensions of credit to and credit supports issued for the benefit of affiliates be collateralized.³³¹ Section 23B requires that transactions with affiliates be on an arm's length basis.³³²

Prior to Gramm-Leach-Bliley, Sections 23A and 23B did not apply to transactions between banks and their operating subsidiaries.³³³ However, the OCC's Operating Subsidiary Rule requires the application of Sections 23A and 23B to transactions between the bank and an operating subsidiary engaging in activities that are impermissible for the bank.³³⁴ Under Gramm-Leach-Bliley, transactions between a national bank and a financial subsidiary are subject to the Sections 23A and 23B firewalls.³³⁵

To summarize, many of the most significant conflict of interest transactions that may arise with respect to banks and their affiliates, both holding company affiliates and operating subsidiaries, are regulated by the provisions of Sections 23A and 23B of the Federal Reserve Act. In addition, in connection with approvals of new activities in holding company affiliates and operating subsidiaries prior to Gramm-Leach-Bliley, both the Board and the OCC imposed additional conditions to prevent other conflict of interest transactions that would damage the affiliated bank from occurring.³³⁶ These

³³¹ See 12 U.S.C. § 371c(c) (1999).

³³² See 12 U.S.C. § 371c-1(a)(1) (1999).

³³³ The definition of affiliate in the statute excludes bank subsidiaries, except to the extent that the Board has determined by regulation or order that such subsidiary should be considered an affiliate. See 12 U.S.C. § 371c(b)(2)(A) (1999). The Board proposed a rule-making in 1997 which would have applied Sections 23A and 23B to bank operating subsidiaries that engaged in activities impermissible for the bank itself, including national bank operating subsidiaries. See Federal Reserve System, Proposed Rule, Applicability of Sections 23A and 23B of the Federal Reserve Act to Transactions between a Member Bank and Its Subsidiaries, 62 Fed Reg. 37744. The Board proposed to extend Sections 23A and 23 B out of concern about the potential for conflict of interest transactions occurring between banks and their subsidiaries. 62 Fed Reg. 37744, 37746. The Board was concerned about the imposition of firewalls by the various bank regulatory agency on an ad hoc basis and believed that applying the statutory firewalls would enhance corporate separateness. See *id.* The rule has not been adopted as of October 1999.

³³⁴ See 12 C.F.R. § 5.34(f)(3)(ii) (1999).

³³⁵ See Gramm-Leach-Bliley, § 121(b) (amending 12 U.S.C. § 371c).

³³⁶ As noted previously, the Board required extensive regulatory firewalls between member banks and their affiliates in connection with its approvals of securities activities in Section 20 subsidiaries. It removed many of these firewalls in 1997 although additional restrictions on conflict of interest transactions not covered in

regulatory firewalls strengthened the statutory firewalls of Sections 23A and 23B.

Firewalls are not foolproof. It should be noted that there has been no empirical study done of the effectiveness of firewalls. However, several commentators have noted that firewalls can be evaded and may give way under circumstances where they are most needed.³³⁷ Nevertheless, a comprehensive set of firewalls is the best line of defense against unacceptable conflict of interest transactions occurring.³³⁸ Gramm-Leach-Bliley does not alter the continued application of the firewalls of Sections 23A and 23B to affiliates of financial holding companies³³⁹ and it extends those firewalls to financial subsidiaries of national banks.³⁴⁰ Gramm-Leach-Bliley also strengthens the Board's authority by providing that it may impose prudential limitations on transactions between banks and other affiliates in a financial holding company framework in order to prevent

Sections 23A and 23B remained in place, such as limitations on extensions of credit to customers to support purchases of securities underwritten by the affiliate and a requirement that intra-day extensions of credit to the affiliate be on market terms. *See supra* Section II.B.1. In connection with approvals under the Operating Subsidiary Rule, the OCC required additional safeguards similar to those imposed by the Board in its revised firewalls for Section 20 subsidiaries. *See supra* Section II.B.2.c.

³³⁷ The most often quoted remark in this regard was made by Walter Wriston, former chairman of Citibank, that "it is inconceivable that any major bank would walk away from any subsidiary of its holding company." *Hearings Before the Senate Committee on Banking, Housing & Urban Affairs*, 97th Cong. (1981) (testimony of Walter Wriston). Former FDIC Chairman Ricki Helfer has stated that the firewalls of Sections 23A and 23B "are not impenetrable . . . of course in times of stress firewalls tend to weaken, and transgressions have occurred both within and outside the reach of the regulators . . . pressure can be exerted from its holding company as well as from subsidiaries." *Hearings Before the Subcommittee on Capital Markets, Securities & Government Sponsored Enterprises of the House Committee on Banking & Financial Services*, 105th Cong (1997). *See* Shull & White, *supra* note 21, at 459-460.

³³⁸ *See* John R. Walter, *Firewalls*, 82 Federal Reserve Bank of Richmond Economic Quarterly 15 (1996) (discussing circumstances under which bank holding companies have incentives to shift losses to affiliated banks and arguing that firewalls serve to limit such risk shifting).

³³⁹ *See* Gramm-Leach-Bliley, § 103(a).

³⁴⁰ *See* Gramm-Leach-Bliley, § 121(b) (amending 12 U.S.C. § 371c).

evasions of law, significant risks to a bank, or other adverse effects, including conflicts of interest.³⁴¹

Comparing the holding company affiliate with the operating subsidiary from the perspective of avoiding conflicts of interest, it does not appear that either form should be eliminated or that one form is inherently superior to the other. The possibility of damaging conflict of interest transactions exists with both structures. An appropriate focus is whether there are adequate statutory and regulatory firewalls in place that might be counted on to prevent such transactions from occurring. Even prior to Gramm-Leach-Bliley, there seemed to be little difference, if any, between the firewall protections afforded by use of holding company affiliates or operating subsidiaries.

C. Preventing the Spread of the Federal Safety Net Subsidy

There are two aspects to this question. One issue is whether the federal safety net subsidy actually exists. The other issue is whether one corporate structure is superior to the other in containing the spread of such subsidy beyond its intended purpose, namely to protect banks and the stability of the financial system.

With respect to the existence of a subsidy, evidence has been introduced on both sides of the issue. The Board has advanced evidence that such subsidy does in fact exist.³⁴² Other economists have challenged this conclusion, including an OCC economist whose report has been cited in Congressional testimony on the issue.³⁴³ The argument made by such economists is that only a small minority of banks enjoy even a gross subsidy. This means that, even before factoring in the costs of bank regulation, a majority of banks pay more for the safety net than it is worth. Recent legislative and regulatory measures (risk-based capital requirements, prompt corrective action provisions, risk-related deposit insurance premiums) have further reduced any gross benefits from the federal safety net.³⁴⁴ These

³⁴¹ See Gramm-Leach-Bliley, § 114.

³⁴² See Myron Kwast & Wayne Passmore, *The Subsidy Provided by the Federal Safety Net: Theory and Evidence*, JOURNAL OF FINANCIAL SERVICES RESEARCH (1998). John R. Walter, *Can a Safety Net Subsidy Be Contained*, 84 FED. RESERVE BANK RICHMOND ECON. Q. 1 (1998). See also George G. Kaufman, *Comments on The Subsidy Provided by the Federal Safety Net: Theory and Evidence*, JOURNAL OF FINANCIAL SERVICES RESEARCH (1998) (criticizing Kwast & Passmore).

³⁴³ See Gary Whalen, *The Competitive Implications of Safety Net-Related Subsidies*, OCC Economics Working Paper 97-9 (1997).

³⁴⁴ See *id.* at 4.

economists argue, in addition, that the costs of complying with onerous bank regulations must be netted against any gross subsidy that in fact exists, with the end result that the net subsidy enjoyed by most banks is minimal and may even be negative.³⁴⁵ It is difficult to draw firm conclusions as to whether a subsidy exists or not based on available evidence.³⁴⁶

Assuming for purposes of argument that a subsidy does exist, the next issue is whether one structure can better contain the spread of such risk. One way in which the subsidy could spread would be through infusions of equity by the bank to its operating subsidiary. This is unlikely to occur with an operating subsidiary, because under Gramm-Leach-Bliley, as well as under OCC's Operating Subsidiary Rule, a national bank's investment in an operating subsidiary must be deducted from the bank's capital.³⁴⁷ Because the bank is required to be adequately capitalized after the investment is made, there is no greater incentive for the bank to downstream equity to its operating subsidiary than there is for the bank to upstream payments to a holding company in the form of dividends,³⁴⁸ which could then be downstreamed by the holding company to a holding company affiliate. In addition, under the OCC's Operating Subsidiary Rule, the bank was subject to risk diversification requirements limiting a bank's investment in any subsidiary to ten percent of the bank's capital and surplus. This provision further limits the ability of a bank to spread a net subsidy to an operating subsidiary through equity infusions. In contrast, in the case of the holding company, no comparable legal impediments would prevent a net subsidy from flowing from a bank through the holding company to a nonbank affiliate.

Another way that the subsidy could be spread would be through credit extensions from an insured bank to an operating subsidiary on terms more favorable than those that would be offered to a nonaffiliate. This is not permissible under either Gramm-Leach-Bliley or the OCC's Operating Subsidiary Rule, however, because banks must comply with the arm's length

³⁴⁵ See *id.* at 20.

³⁴⁶ The Financial Services Roundtable has just published a series of papers refuting the argument that a safety net subsidy exists. See Financial Services Roundtable, *Refuting the Federal Safety Net "Subsidy" Argument* (1999).

³⁴⁷ See Gramm-Leach-Bliley, § 121(a) (new 12 U.S.C. § 5136A (c)). 12 C.F.R. § 5.34(f)(3)(i) (1999).

³⁴⁸ Such payments would also have to be deducted from the bank's capital.

requirements of Section 23B of the Federal Reserve Act.³⁴⁹ In addition the collateralization and exposure limits of Section 23A are also applicable to the bank.³⁵⁰ In contrast, a holding company's extension of credit to an affiliate is outside the scope of Sections 23A and 23B. If such extension of credit were funded with dividends from an insured bank, any net subsidy could be transferred to the holding company affiliate through such an extension of credit. For these reasons, it does not appear that the holding company affiliate is a better means for containing the risk of spreading the federal safety net subsidy to nonbank activities than the operating subsidiary.

D. Preserving the Federal Reserve Board's Ability to Handle Systemic Risk

This policy argument has been hinted at in Congressional testimony,³⁵¹ but has not been at the center of the corporate structure debate. There has been no discussion of the issue by commentators on the debate, although some have suggested that it relates to the "regulatory turf issue",³⁵² which this author has assumed means a power struggle over regulatory jurisdiction with no important consequences for the public interest. While that may indeed be the case, it is also conceivable that there is an important public policy issue lurking here.

Constructing an argument based on the limited available evidence might go as follows. The Board has consistently maintained that it must be involved in bank regulation if it is to effectively perform its functions as a central bank. One of these functions is to serve as lender of last resort for troubled banks. Because the Board must bail out troubled banks whose failure may pose risks for the financial system as a whole, it must be allowed to serve as the regulator for new activities conducted by banks that fall into that category. Only in this way will it be able to act effectively to minimize the risk to the U.S. financial system caused by large bank failures arising as a result of new financial activities.³⁵³ In the context of the corporate structure

³⁴⁹ See Gramm-Leach-Bliley, § 121(b) (amending 12 U.S.C. § 371c). 12 C.F.R. § 5.34(f)(3)(ii) (1999).

³⁵⁰ See *id.*

³⁵¹ See 1999 Greenspan testimony, *supra* note 19.

³⁵² See Longstreth & Mattei, *supra* note 21, at 1921.

³⁵³ A recent example was the involvement of the Federal Reserve in the Long-Term Capital Management ("LTCM") case. Members of the Board of Governors of the Federal Reserve indicated that their actions were motivated by concerns about the impact on the financial system. See *Hearing Before the House Banking and*

debate, this meant that new financial activities of large banks must be located in holding company affiliates, which are subject to Board supervision, rather than in bank operating subsidiaries, which are not.³⁵⁴ The Board's interest in bank regulation is different in kind than that of the Comptroller because of its larger role as a central bank in the context of bank failures. Therefore, regulation by the Comptroller cannot be deemed to be a substitute for regulation by the Board with respect to large banks.

This may have been the motivating factor for the Board's insistence on use of a holding company affiliate for new financial activities in the corporate structure debate. Such structure would have addressed the Board's concern because most banks operating in the U.S. are already part of a holding company structure.³⁵⁵ The only holdouts are small community banks.³⁵⁶ This means that new financial activities conducted by large banks would automatically have been subject to Board supervision if the holding company affiliate were the exclusive vehicle for new financial activities.

The Gramm-Leach-Bliley compromise on the corporate structure issue seems to confirm this belief about the Board's motivations. The compromise requires that large national banks must have at least one highly-rated outstanding issue of unsecured long-term debt in order to own a financial subsidiary.³⁵⁷ Small national banks owning financial subsidiaries are not subject to this requirement. The asset size of a financial subsidiary owned by any national bank, regardless of size of such bank, is limited, both

Financial Services Committee on Private Sector Refinancing of the Large Hedge Fund, Long-Term Capital Management (1998) (testimony of Chairman Alan Greenspan) ("Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own"); *Hearing Before the House Subcommittee on Financial Institutions and Consumer Credit of the Banking and Financial Services Committee* (1999) (testimony of Governor Laurence Meyer).

³⁵⁴ The Board's ability to function as lender of last resort would only be impaired if a large portion of new financial activities were to be relocated in bank operating subsidiaries and it has not been established that this would occur. For the Board's view of this matter, see *supra* note 23.

³⁵⁵ See Louis Whiteman, *Some Banks Find Good Cause to Form Holding Companies*, *American Banker*, January 9, 1998. The Board estimated that by the end of 1998, fewer than 20% of banks would operate without a holding company.

³⁵⁶ See *id.* Banks operating without a holding company controlled only 4% of the assets held by U.S. banks.

³⁵⁷ The compromise is described *supra* in Section III.A.

as a percentage of total assets of the parent bank and in absolute terms. The requirement that large national banks with financial subsidiaries have at least one outstanding issue of highly rated secured debt appears to replace earlier language in the House and Senate bills requiring large national banks with financial subsidiaries to operate within a holding company structure. This suggests that the Board accepted the compromise because it believed that the use of unsecured debt would serve to curb excessive risk-taking by large banks and their holding companies through exercise of market discipline by the holders of such debt. While this is not a substitute for Board oversight of new financial activities of large banks, it serves as a means to mitigate risk. From the Board's perspective, very little additional risk is introduced into the financial system as a result of this compromise. The Board would not have had direct regulatory authority over financial subsidiaries even under the earlier House and Senate bills, although it would have had authority over the holding companies of large banks owning such subsidiaries, thereby giving it early warning of any trouble involving financial subsidiaries owned by such banks. Even under the compromise, however, it is likely that most large banks owning financial subsidiaries operate under a holding company, providing the Board with the same early warning system, regardless of an explicit requirement in the statute for a holding company structure. Another risk mitigation factor is asset size limitation on financial subsidiaries, which serves to contain within manageable parameters the potential impact on the financial system of failure of a financial subsidiary or its parent bank as a result of new financial activities. Yet another mitigating factor is the introduction of bank broker-dealer regulation by the Securities and Exchange Commission, providing additional oversight of such activities.³⁵⁸ Finally, small national banks are excluded from the unsecured debt requirement, suggesting that the concern is with larger banks, the failure of whose financial subsidiaries might have an impact on the financial system. One could reasonably conclude from this analysis that the Board's position in the corporate structure debate was driven by its concern about the potential impact of failures of large banks or their subsidiaries on the stability of the financial system, i.e. systemic risk.

When one considers the corporate structure debate from this vantage point, it becomes apparent that there is more at stake than the right of bankers to have the flexibility to make private business decisions on their own terms. Indeed, it appears that the corporate structure debate is really about the ability of regulators to fulfill their legislative mandates effectively.

³⁵⁸ Gramm-Leach-Bliley, §§ 201, 202 (amending 15 U.S.C. § 78c(a)(4), (5)).

The public policy issue of permitting the Board to effectively function as a lender of last resort is of crucial significance and should not be ignored in the corporate structure debate. However, the danger in the Gramm-Leach-Bliley compromise is that it effectively closes the door on the debate, at least for the time being, without having thoroughly examined the systemic risk factor.

V. CONCLUSION: THE OPTIMAL CORPORATE STRUCTURE FOR NEW FINANCIAL ACTIVITIES

Actions taken by federal banking regulators in the years immediately preceding Gramm-Leach-Bliley changed the landscape of activities restrictions for national banks and their affiliates. Such regulators, who are charged with safeguarding the safety and soundness of banks, concluded that certain activities considered off-limits only twenty years ago, including underwriting bank ineligible securities, could be conducted in either a holding company affiliate or an operating subsidiary of a bank. The regulators did not permit banks to engage in such new activities with reckless disregard for the increased risks perceived to accompany them, but rather placed strict limits on the amount and type of such new activities that could be conducted and required banks to comply with prudential safeguards directed at preventing the spread of risks that may exist. While such regulatory activity is not determinative of the issue of whether there is an optimal corporate structure for the conduct of new activities, it is highly persuasive. The regulators proceeded cautiously, permitting new activities only as historical experience with such activities and as the individual circumstances of each applicant bank have warranted. The logic of their actions is compelling and the flexible approach they have taken on the corporate structure issue has merit.

In contrast to the approach taken by the regulators, the Gramm-Leach-Bliley compromise adopts a rigid framework for the corporate structure banks may use for new financial activities. Under Gramm-Leach-Bliley, the holding company affiliate has emerged as the clear winner in the corporate structure debate, although use of an operating subsidiary is also permitted to a more limited extent. While Congressional concern about containing the risks associated with such deregulation is justified, the choice that was made, distinguishing between holding company affiliates and operating subsidiaries and imposing additional regulatory constraints on use of operating subsidiaries, is not warranted by the available evidence on the nature and extent of such risks. Congress has imposed restrictions on

corporate structure where it has not been satisfactorily demonstrated that additional risk exists and where no legitimate policy objective may be served by the distinction that was drawn in the legislation.

This paper set out to answer three questions. First, is there any reason to eliminate use of either the operating subsidiary or holding company affiliate as a vehicle for new financial activities based on safety and soundness considerations or for any other reason? Second, is there any reason to prefer one structure over another, whether based on safety and soundness considerations or for any other reason? Third, if there is no compelling governmental interest in eliminating one structure or preferring one over the other, should banks be free to choose the corporate structure they will use for their new lines of business? The author has concluded that the answer to the first two questions is no, while the answer to the last question is a qualified yes, subject to further consideration of the unexplored factor of systemic risk and its relationship to corporate structure in this context.

There has been a dramatic shift within the past few years in the terms of the corporate structure debate. While the holding company affiliate was long viewed as the exclusive route for new financial activities, Gramm-Leach-Bliley permits some use of operating subsidiaries. This is definitely progress, but the compromise is not ideal for it imposes far greater restrictions on choice of corporate form than many bankers and economists would like to see. The proposed legislation does have its virtues, however. Allowing smaller banks to engage in new financial activities through an operating subsidiary permits new entrants to the market without significant risks being created for the financial system. Requiring large banks to conduct such activities in operating subsidiaries subject to additional regulatory constraints reduces the potential for unmanageable risks to the financial system as a result of new financial activities. On the other hand, it is not clear that the Gramm-Leach-Bliley compromise is the most effective way to deal with the issue of systemic risk in this context. Other alternatives might have been considered if the issue had been publicly debated. The compromise has set in stone a distinction between the use of holding company affiliates and bank operating subsidiaries for conducting new financial activities that may not be necessary from a public policy perspective. Further study should have been and still should be conducted on the systemic risk issue in order to clarify what is at stake. Perhaps over time the additional restrictions imposed on use of operating subsidiaries will be relaxed, if experience shows that use of financial subsidiaries does not

create greater risks for the financial system than use of financial holding companies and their affiliates.