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Bank Securities Activities: Tie Me Up, Tie Me Down, Tie Me Not

Financial Markets Association
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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

I appreciate the opportunity to participate in FMA's 1992 Legal Issues Conference. It is my understanding that the members of this audience are interested in regulatory and congressional efforts to reform the financial services industry and, in particular, are concerned with the ramifications to these efforts by the recent public discussion of alleged "tying " activity on the part of banks and their affiliates.

While I am unable to predict with certainty what direction the Congress will take on the issue of financial services industry reform, my best guess is that some partial reform will be achieved in the next Congress but that any comprehensive legislative consensus on this issue will remain elusive. Given the importance of the tying issue to these congressional and regulatory reform efforts, it is my intention to focus today on possible responses to the tying abuse situation.

II. Current Rules

"Tying" generally is defined as any arrangement in which a bank requires a customer that desires one service, such as credit, to purchase other services or products from the bank or its affiliates as a condition of receiving the first service. Federal banking law imposes a number of prohibitions and restrictions on banks against tying arrangements and other noncompetitive practices in connection with their securities activities. I suspect that the members of this audience are more familiar than I am with these provisions of federal banking law. However, I believe as background for my presentation it is helpful to briefly review some of these restrictions.

The Bank Holding Company Act (the "BHCA")[1] prohibits a federally-insured bank from requiring a customer to purchase any other product or service from the bank or its affiliates, or to refrain from purchasing products or services from a competitor, as a condition of obtaining credit or any

1 Section 106(b) of the Bank Holding Company Act Amendments of 1970. 12 U.S.C. § 1971.

other service from the bank. This anti-tying provision applies to both Bank Municipal Securities Departments and banks affiliated with Section 20 subsidiaries. This provision authorizes the federal banking agencies to bring actions against banks that employ unlawful tying arrangements. This provision also authorizes injured bank customers to bring a private right of action to obtain injunctive relief and treble damages. The Board of Governors of the Federal Reserve System (the "Board") has extended this tying prohibition by regulation to Bank Holding Companies ("BHCs") and their nonbanking subsidiaries.[2]

In addition to federal banking law prohibitions, tying arrangements also may violate federal antitrust laws, including Section 3 of the Clayton Act, Section 1 of the Sherman Act, and Section 5 of the Federal Trade Commission Act.[3] Unlike plaintiffs under the antitrust laws, plaintiffs under the BHCA do not have to establish the

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2 12 C.F.R. § 225.4(d).

3 15 U.S.C. §§ 14, 1, 45.

economic power of a bank and specific anticompetitive effects of tying arrangements as a condition to relief.

III. Current Abuses and Rejected Solutions

While there are other federal banking law provisions that impose tying limitations which I will not mention today, it has been represented to me that despite these limitations on tying arrangements, banks do sometimes link credit extensions to an issuer, or credit enhancements to an offering, to use of the bank or its affiliate as underwriter of the offering. The bulk of the tying complaints that I have received involve allegations that banks are unfairly competing for municipal securities underwriting business by tying their credit enhancements to another role such as underwriter. Since these complaints emanate from a variety of sources, I take them seriously, although I am unable to state with certainty that they are valid. I do believe that the majority of banks do not violate the tying limitations. This is an important point that I will return to later in my discussion.

In practice, private actions are rarely, if ever, brought for violations of the tying limitations. In part, this is due to problems of proof; in part, it is due to a reluctance of issuers as customers of banks to alienate potential substantial lenders. Of course, private actions are only available for bank customers and not for bank competitors. Still, the private action remedy is presently available and should be utilized under the appropriate circumstances. For whatever reasons, it historically has not been used.

Also, enforcement actions in this area have rarely been brought by the banking regulators. To date, I am not aware of any cases that have been brought by the bank regulatory agencies in the tying area. Recent press articles indicate that this historical regulatory enforcement inaction may be changing.[4] I can tell you that the staff of the Office of the Comptroller of the Currency ("OCC") has specifically

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4 See, e.g., Stamas, "U.S. Comptroller Probes Charges of Bank Tying On Muni Issues," The Bond Buyer (Sept. 30, 1992), at 1; Holland, "U.S. Probing Alleged Tie-ins In Bond Deals," The American Banker (Oct. 2, 1992), at 1; "Fed Probing Bank Subs?," Corporate Financing Weekly, (Sept. 21, 1992), at 2; Holland," Fed Probing Alleged Ties of Loans to Underwriting," The American Banker (Oct. 13, 1992), at 6; Stamas, "Federal Reserve Board Is Looking at Whether Banks are Linking Loans to Underwriters," The Bond Buyer (Oct. 19, 1992), at 1.

requested that I forward the complaints that I have received in this area to them for investigation. I have forwarded to the OCC the few complaints that I have received where the complainants were prepared to publicly press their complaint, and I have been most impressed with the OCC's interest in pursuing potential tying violations.

I note that the 1991 bank reform bill included strict firewalls designed to bar credit extensions or credit enhancements to issuers of securities underwritten by bank affiliates. For instance, one firewall would have barred a bank from extending credit to or for the benefit of an issuer of securities distributed by a securities affiliate until 90 days after the end of the distribution, unless the bank created an extensive paper trail demonstrating non-tying. Predictably, these firewall provisions were hotly opposed by the banking industry, and, for this and other reasons, the Glass-Steagall reform provisions of the 1991 bill ultimately came to naught.

The rationale behind the 1991 bill's firewall provisions was twofold, to prevent unwise loans, and to prevent unfair competition. A policy to discourage those events appears sound to me, and I was disappointed that a bank reform bill with appropriate firewalls was not enacted. In particular, in my opinion, the 90 day bar provision was a reasonable and an appropriate firewall.

I am of the view that taxpayer guaranteed funds should be walled off from supporting the securities activities of banks or their affiliates. Otherwise, banks and their affiliates will have a substantial advantage in competing for, among other things, underwriting services. This is not only an inappropriate use of the federal deposit insurance system but could ultimately prove detrimental to our capital formation system by perversely stifling competition under the guise of promoting competition.

While I believe that Section 20 subsidiaries have made a positive overall impact by bringing new capital and competition to the market for underwriting services, the offering of artificially easy credit (possibly in amounts larger than a prudent lender could provide, or at artificially low interest rates) could have a negative impact on this market and would also ultimately weaken our financial system. If banks are able to tie extensions of credit to the use of their affiliates' underwriting or other services, the availability of taxpayer-backed deposits would give banks a powerful advantage over independent underwriters lacking access to federally insured funds.[5]

These practices could reduce the quality and efficiency of underwriting services nationally by using indirect federal subsidies to drive out unsubsidized competitors. Even if this practice posed no risk whatsoever to the safety and soundness of banks, and I believe that this practice does pose such a risk, it could significantly distort competition in the capital markets in a way that reduces rather than enhances economic efficiency.

In addition to the damage from unfair competitive practices, there is also the much more pervasive danger, a

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5 Similar points are made in the letter from Chairman Breeden to Chairman Dingell dated October 8, 1992, responding to a request by Chairman Dingell for the views of Chairman Breeden on the problem of bank "tying" of credit and investment banking services. <u>See</u> notes 15 and 18 <u>infra</u>.

very real danger in my opinion, that a banking organization offering such concessionary or "tied" credit and underwriting services might make imprudent loans -- ultimately chargeable to the deposit insurance system -- in order to earn immediately recognizable income in the form of underwriting fees. Clearly, the federal safety net was not designed for this purpose and would only be weakened by such an activity.

IV. Current Commission Authority

Existing general antifraud and anti-manipulation provisions of the federal securities laws do provide the Commission with sufficient authority to address tying abuses in connection with the offer, purchase, or sale of securities. However, these securities laws are not well-designed to address tying in connection with the offer of underwriting or other services. Thus, Commission jurisdiction to propose a regulation to reach tie-ins conditioning the availability of credit on a customer's use of a particular entity's underwriting services is not self evident at the present. It does not appear that the Commission's jurisdiction in this area will be broadened by Congress in the near future.

V. Bank Regulatory Reforms

I wish to change gears at this point to a brief discussion of efforts by bank regulators to achieve financial services industry reform, at least with respect to the issue of firewalls.[6] Since comprehensive legislative reform appears unlikely, the reform that is most likely to occur in the near future, other than scattered partial legislative action, will take place at the regulatory level.

The Board, in a July 1990 release, has proposed modifications to the firewalls between Section 20 subsidiaries of BHCs that underwrite and deal in securities and their affiliates.[7] The Board has also recently revised Regulation Y[8] to permit BHCs to combine brokerage services with investment advisory services.

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6 The Board is also considering adjusting its policy of allowing a bank's securities subsidiary to bring in more than 10% of its revenue from underwriting and dealing in bank-ineligible securities. *See* note 15 *infra*.

7 55 FR 28296 (July 10, 1990).

8 12 CFR 225. *See* 57 FR 41381 (Sept. 10, 1992).

The Board's expansion of BHCs' Section 20 securities underwriting and dealing activities is the principal avenue for bank involvement in the securities markets today, and the Section 20 firewalls play an important role in governing how those activities are conducted. The Board has not yet adopted the proposed modifications to the Section 20 firewalls.[9]

I do wish to mention specifically one of the Board's proposals. The Board has requested comment on whether to ease prohibitions on "cross-marketing," where a bank affiliate of a Section 20 subsidiary acts as agent or engages in marketing activities on behalf of the Section 20 company.[10] With this proposal to ease the prohibitions on "cross-marketing," the Board is placing "substantial reliance" upon the current Section 20 order disclosure requirements, coupled with the provisions in Sections 16 and 21 of the Glass-

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9 See note 9 supra.

10 Currently, banks are permitted to inform customers of the available services of the underwriting subsidiary, and, at the specific request of a customer, to provide information about securities being underwritten by the Section 20 subsidiary.

Steagall Act that prohibit a bank from engaging directly in underwriting and dealing in securities. I am not in a position to determine if this reliance is misplaced.

In adopting the Section 20 firewalls, the Board originally stated that it intended to review from time to time the continued appropriateness of specific firewalls,[11] and it has reduced these firewalls in subsequent orders.[12] The July 1990 release is a further step in reducing these restrictions. It is not clear how far the Board is willing to go in reducing these firewalls; however, in testimony before Congress, Chairman Greenspan stated that he believed that the statutory firewalls contained in Sections 23A and 23B of the Federal Reserve Act[13] by and large offered sufficient

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11 Citicorp, J. P. Morgan & Co. Incorporated, and Bankers Trust New York Corporation, 73 Federal Reserve Bulletin at 473, 499, 504 (1987).

12 See, e.g., J. P. Morgan & Co. Incorporated, The Chase Manhattan Corporation, Bankers Trust New York Corporation, Citicorp, and Security Pacific Corporation, 75 Federal Reserve Bulletin at 192 (1989).

13 12 U.S.C. §§ 371c, 371c-1.

protection for customers and for banks' safety and soundness.[14]

Pursuant to Chairman Greenspan's testimony, with its July 1990 release, the Board may very well be in the process of concluding that the affiliate transaction restrictions of the Federal Reserve Act are adequate to address the potential conflicts of interests and the other potential adverse effects. Obviously this is an area that bears watching for future developments, particularly in light of the tying questions I discussed previously.

VI. Current Solutions

I anticipate that the regulatory reform of the financial services industry that has been conducted by the Board to date will continue. I am not interested in second guessing the Board. The Commission has too many rulemaking problems of its own for me to "armchair quarterback" the Board's decisions. I also do not anticipate any

14 Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System before the Financial Institutions Subcommittee of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, at 28 (April 30, 1991).

comprehensive legislative consensus on this issue in the near future. Thus, if the securities industry, for example, is concerned with the reduction of firewalls with respect to the securities activities of a bank or its affiliates, as I have indicated in the past, it should make that case with the Board.

Current law does give banking regulators the jurisdiction to address bank tying abuses. Tying arrangements in connection with an offer, purchase, or sale of a security may also violate Section 17(a) of the Securities Act, or Sections 9(a), 10(b) and 15(c) of the Exchange Act, and Rule 10b-5 thereunder. While I would support the legislative grant of additional jurisdiction to the Commission in this area, I do not foresee any legislative broadening of Commission jurisdiction in the near future that would enable the Commission to reach bank tying abuses through rulemaking proceedings, inspections, or enforcement actions.[15] However, if the

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15 There remains, however, substantial congressional interest in this issue. Congressman John Dingell, Chairman of the House Energy and Commerce Committee, recently sent a letter to Richard Breeden, Chairman of the Commission, on this subject. This letter alluded to one of my (continued...)

Commission did have the jurisdiction to engage in a rulemaking effort to reach bank tying, any rule promulgated probably should apply to all securities firms and not merely to the securities affiliate of a bank. I mention this latter point since the conflict of interest concerns and anti-competitive problems posed by bank tying are also posed to some extent by tying activity committed by a traditional securities firm. Of course, some important distinctions do exist between bank securities affiliates and traditional securities firms with respect to the tying abuse problem. The major distinctions are that traditional securities firms are not as active in making loans as are banks and, similarly, are not the beneficiary of federal deposit insurance. It has been brought to my attention, though, that tying activity is apparently also

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[15] (...continued)
presentations concerning potential bank tying abuses and requested Chairman Breeden's recommendations to address the problem of bank tying abuses. This letter also indicated that bank tying abuse is "a practice supposedly banned by banking regulations." Chairman Breeden has recently responded by letter to Chairman Dingell. See note 5 supra and note 18 infra. See also 'Lawmakers Ask Why Fed Is Fiddling With Bank's Underwriting Revenue Limits," Securities Week (Sept. 21, 1992), at 4.

present in the non-bank securities industry.[16] In any event, if bank tying is occurring, and there are indications that some such abuses are occurring,[17] the exercise of bank regulatory

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16 As an example of a traditional securities firm's tying activity, some banking institutions have pointed fingers at an investment banking firm that recently served as the underwriter for an initial public offering where a substantial amount of proceeds were used to retire a loan from the investment banking firm. See, e.g., McWilliams & Spiro, "The Fingers Pointed at Shearson," Business Week (Oct. 19, 1992), at 95; "Shearson Promotes Computervision," The New York Times (Oct. 27, 1992), at D5.

17 See Bleakley, "U.S. Banks Lose Corporate Clients to Lenders Abroad," The Wall Street Journal (Sept. 29, 1992), at A2.

"Many banks are refusing to participate in tightly priced, or small-margin, credits because 'they have gotten smarter about their market,' maintains . . . a principal with [a] New York bank consulting firm.

U.S. banks, he says, 'are giving away the unattractive business,' unless they can serve in the agent role where fees are greater for the task of rounding up other banks. Banks also are willing to join in credit lines if they can supply a company's other needs in such areas as cash management, foreign exchange, securities processing and risk management.

'We're willing to use our balance sheet to extend credit when there is a broad base of business,' said . . . head of large corporate lending for [a bank]. Even when credit lines are not drawn down, as is typical when backup lines for a company's commercial paper program are set up, the commitment fees are not high enough to warrant participation unless there's a relationship in other areas, such as private placement fund raising, [he] said."

Id.

See also Dickson, "A Tale of Two Swaps: Role of Remarketer Distinguishes California, New Jersey Deals," The Bond Buyer (Oct. 13, 1992), at 1.

"Officials at one bank. . . said they refused to even bid on [the] $1 billion swap because they did not want to rely on another firm's remarketing effort. . . .

And in another indication of the increasing sensitivity among swap providers to the remarketing of the underlying bonds, market sources said . . . submitted the . . . bid with the stipulation that it be allowed to

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enforcement jurisdiction is one of the solutions. Another answer is, as I have mentioned, the exercise of a private right of action. In my view, the best current solution available to prevent bank tying abuses is to bring such violations to the attention of the bank regulators for appropriate enforcement action.

However, there are other solutions which could be made available as well. Congress could extend the private right of action available to bank customers under the BHCA to bank competitors.[18] Since litigation reform remains a controversial issue in Congress, I do not believe that a congressional consensus on a legislative provision extending a private right action in this manner is likely in the near term. While I also

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17 (...continued)
fire . . . under certain circumstances . . .

In a sampling of opinion from other major municipal swap providers, most said they would not go as far as . . . in automatically rejecting deals that do not include the remarketing feature. . . ."

Id.

18 This remedy was suggested by Chairman Breeden in his letter to Chairman Dingell. See notes 5 and 15 supra. ("However, in view of the fact that the damage that such practices would cause will fall most directly on bank competitors, rather than bank customers, it may be that Congress should consider giving firms that have been damaged by such improper practices the same right bank customers now have to bring actions to enforce the anti-tying laws.")

do not believe that a congressional consensus on comprehensive financial services industry reform is likely either, partial legislative reform may be a different story. For example, legislation permitting interstate banking is more realistically achievable than comprehensive reform legislation. Possibly Congress should consider adding to any such partial legislative reform package the 90 day firewall provision that I mentioned previously. Such a provision becomes even more attractive if the Board were to finalize its proposal to ease prohibitions on "cross-marketing."

At present, though, the best solution available to prevent tying violations remains for the banking regulators to increase their enforcement activity. This appears to be occurring. I believe that most banks currently comply with the law. It appears to me then that it would be in the best interest of the banking industry to press for more aggressive enforcement action in this area, when the facts so warrant, in order to ensure that the majority of banks are not tainted by the activities of a minority. Thus, I challenge the banking industry today to encourage bank regulators to continue their increased enforcement attention in the tying area. I further challenge the industry to bring possible tying violations to the attention of the bank regulators for enforcement consideration. Such industry self-policing appears to be far preferable to the other alternatives that are presently available or that made be made available to prevent such abuses.