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Bank Tying: Current Rules, Current Authority, and Current Solutions

Securities Industry Association
Investment Banking Committee
Washington, D.C.
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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 address the SIA Investment Banking Committee. According to the Commission's Office of Economic Analysis and to preliminary estimates provided by Securities Data Corporation, investment banking appears to have been quite successful thus far in 1992. The underwriting profits for the first three quarters of 1992 are estimated to be a record $5.1 billion, which already surpasses the $5 billion made by Wall Street in the entire 12 months of 1991. The volume of new corporate debt issues continues to reach record levels, while the volume of new municipal issues is on pace to exceed the previous annual high set in 1985. Even though the volume of new equity issues has declined during the course of the year, it remains at near-record levels.

Low interest rates and high price-earning ratios appear to be the driving force behind the continuing large number of new issues brought to market. The low interest rates have made many capital-intensive projects less expensive and have encouraged corporations, municipalities, and individuals with callable debt to refinance.

I note that estimated profits from underwriting corporate debt have also increased because of a rise in high-yield financings. After two years of virtual insignificance, the volume of these issues and the associated profits to securities firms have returned to the highs reached in the 1986-1989 period.

Thus, I congratulate this group collectively on at least a successful first three quarters of 1992. I hope that the remainder of 1992 proves as successful.

It is my understanding that the members of this audience are concerned with regulatory and congressional efforts to reform the financial services industry and, in particular, are concerned with the present and potential

"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 any legislative consensus on this issue will remain elusive. Before I address the subject of regulatory reform efforts in this area, I wish to summarize my understanding of present federal banking law. I will focus on a bank's tying of credit extension to an issuer with the provision of underwriting and related services to the issuer by the bank or any of its affiliates.

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. In addressing this

issue, it is necessary to first discuss the two principal means by which banks are permitted to engage in securities activities.

First, under Section 16 of the Glass-Steagall Act, banks are permitted to underwrite and deal in "bank-eligible" securities (generally U.S. government and municipal general obligation securities). Bank municipal securities activities must be conducted in a "separately identifiable department or division" ("Bank Department"), which is a unit under the supervision of officers designated by the bank's board of directors.

Secondly, under Sections 4(c)(8) and 20 of the Glass-Steagall Act, bank holding companies ("BHCs"), with the prior approval of the Board of Governors of the Federal Reserve System (the "Board"), may establish nonbank securities subsidiaries to engage in underwriting and dealing in "bank-ineligible" securities (corporate equity and debt securities), provided that such subsidiaries are not "engaged principally" in such activities (presently up to 10% of a

subsidiary's gross revenues).[1] Thus, although Section 20 subsidiaries may underwrite and deal in bank ineligible securities, they must underwrite and deal predominantly in bank-eligible securities, including municipal bonds. Bank Departments and Section 20 subsidiaries must register with the Commission as broker-dealers and are thus subject to the Exchange Act and the rules thereunder.[2]

The Bank Holding Company Act (the "BHCA")[3] 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 other service from the bank. This anti-tying provision applies to both Bank Departments and banks affiliated with Section 20 subsidiaries. This provision authorizes the federal banking

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1 See note 12 infra.

2 State-chartered banks that are not members of the Federal Reserve System or subsidiaries of BHCs may establish direct subsidiaries to underwrite and deal in bank ineligible securities. 12 C.F.R. § 337.4. These also must be registered as broker-dealers.

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

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. I will come back to this point later. The Board has extended this tying prohibition by regulation to BHCs and their nonbanking subsidiaries.[4]

Section 16 Bank Departments are required to follow the rules of the Municipal Securities Rulemaking Board ("MSRB"). MSRB rules do not establish specific tying restrictions in connection with a bank's municipal bond underwriting activities. However, there are certain prudential safeguards imposed on bank management and in the regulators' examination process that could reveal questionable interdepartmental bank transactions.[5]

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4 12 C.F.R. § 225.4(d). 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. 15 U.S.C. §§ 14, 1, 45. Unlike plaintiffs under the antitrust laws, plaintiffs under the BHCA do not have to establish the economic power of a bank and specific anticompetitive effects of tying arrangements as a condition to relief.

5 National banks are required to operate in accordance with the principle of "safety and soundness," and examiners may look with special attention on credit arrangements and securities transactions with a single borrower. All records relating to the bank's municipal securities dealer activities must be separately maintained in the Bank Department, and all securities activities must be supervised by Bank Department management assigned

With respect to Section 20 subsidiaries, certain provisions under the Federal Reserve Act[6] prohibit tie-ins and other unfair trade practices in conjunction with affiliated banks. In addition, the Board's Section 20 orders impose a number of additional conditions. Sections 23A and 23B of the Federal Reserve Act, respectively, are intended to prevent misuse of banks' resources and ensure arm's-length transactions between a bank and its nonbank affiliates. However, these provisions generally do not apply to transactions between a bank and its direct nonbank subsidiaries or Bank Departments.[7] Section 20 underwriting subsidiaries are required to maintain separate offices from any affiliated bank. In addition, officer, director, or employee

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specifically to that area. In addition to requiring the compartmentalization of securities activities, MSRB rules require a bank dealer that is both a financial adviser to an issuer and purchaser of a security of the issuer in a negotiated underwriting to terminate the advisory relationship. In competitive issues, MSRB Rule G-23 requires that the dealer bidding on a issue that also is acting as adviser to the issuer must obtain the issuer's express written consent prior to submission of the bid.

6 12 U.S.C. §§ 371c, 371c-1.

7 The FDIC has extended Section 23A restrictions to securities subsidiaries of state nonmember banks. 12 C.F.R. § 337.4(e)(6), (7).

interlocks between an underwriting subsidiary and any of the BHC's bank subsidiaries are prohibited.[8]

The interaffiliate provisions also address competitive concerns between banks and investment banking companies and apply equally to bank eligible and ineligible securities. Section 23B requires transactions between banks and affiliates to be conducted on arm's-length terms. This restriction is intended to prevent banks from discriminating against non-affiliate securities firms in credit transactions. A denial of credit to unaffiliated securities firms must be based on objective criteria and sound business practices and not be intended to create a competitive advantage.[9]

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8 In addition, Section 20 subsidiaries must be BHC subsidiaries and cannot be controlled by any affiliated bank. In some cases, restrictions apply only to bank-ineligible securities.

Lending to issuers for the payment of principal, interest, or dividends on ineligible securities underwritten or sold by securities affiliates is prohibited. To ensure compliance with this provision, any credit extended to an issuer must: (1.) be on substantially different maturities, conditions, terms, and timing from those of the underwritten ineligible security; or (2.) have documentation showing a special purpose; or (3.) involve substantial participation by other lenders. BHC subsidiaries also are prohibited from providing credit facilities that enhance the creditworthiness or marketability of ineligible securities underwritten or distributed by the underwriting affiliate.

9 BHCs and nonbank subsidiaries also may not provide funds to or for the benefit of a securities affiliate without prior notice to and approval by the Board.

III. Current Abuses and Rejected Solutions

Despite these limitations on tying arrangements, I have been advised that banks frequently 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 to date involve allegations that banks are unfairly competing for municipal securities underwriting business by tying their credit enhancements to another role such as underwriter. Since the 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 our banks do not violate the tying limitations.

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 on the part of issuers as customers of banks to alienate 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.

Also, enforcement actions in this area have been rarely brought by the banking regulators. Recent press articles indicate that this historical regulatory enforcement inaction may be changing.[10] I can state with certainty that the staff of the Office of the Comptroller of the Currency ("OCC") has specifically 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 any credit extensions or credit enhancements to issuers of securities underwritten by bank

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10 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.

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 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 proposed firewall provisions was that if a bank could "tie" credit to underwriting or other services, the result may often be a weak loan which turns sour and must be picked up by the federal banking insurance system. Such a policy appears sound to me, and I was disappointed that a bank reform bill with appropriate firewalls was not enacted. I am of the view that taxpayer guaranteed funds should not be used to support 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 strikes me

as not only an inappropriate use of the federal banking insurance system but also as an event that could ultimately prove detrimental to our capital formation system by perversely stifling competition under the guise of promoting competition.

Finally, it should be noted that in 1974 the Commission proposed Rule 10b-20, which would have prohibited broker-dealers from explicitly or implicitly demanding from their customers any payment or consideration in addition to the announced offering price of any security. The proposal was intended to prohibit underwriters from tying the availability of attractive "hot" issues to the purchase of other "sticky" issues. In 1988, the Commission withdrew the rule because of the substantial period of time elapsed since its proposal and the fact that tying arrangements may be reached under existing antifraud and antimanipulative provisions of the federal securities laws. While as a practical matter this may not always be the case, I am not certain that unearthing proposed Rule 10b-20 would be helpful at this time.

Proposed Rule 10b-20 was designed to regulate tying arrangements between certain distribution participants and purchasers of the securities in distribution. Proposed Rule 10b-20 was not directed at potential tying arrangements involving the issuer of the securities and the offering's underwriter. For example, competition by banking institutions for municipal securities underwriting business through the tying of their credit enhancement services to their underwriting services would not have been prohibited by Rule 10b-20 as proposed. Commission jurisdiction to repropose Rule 10b-20 to reach tie-ins conditioning the availability of credit on a customer's use of a particular entity's underwriting services simply does not exist. Current regulatory provisions provide the Commission only with sufficient authority to address tying arrangements in connection with the offer, purchase, or sale of a security and not, for example, in connection with the offer of underwriting services.[11]

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11 Section 17(a) of the Securities Act; Sections 9(a), 10(b), and 15(c) of the Exchange Act.

IV. Regulatory Reforms

I wish to change gears at this point to a discussion of regulatory efforts to achieve financial services industry reform, at least with respect to the issue of firewalls.[12] Since legislative reform appears unlikely, the reform that is most likely to occur in the near future will take place at the regulatory level.

The Board has proposed modifications to the firewalls between Section 20 subsidiaries of BHCs that underwrite and deal in securities and their affiliates.[13] The Board has also recently revised Regulation Y[14] to permit BHCs to combine brokerage services with investment advisory services.

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

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12 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 1 supra.

13 55 FR 28296 (July 10, 1990).

14 12 CFR 225. See 57 FR 41381 (Sept. 10, 1992).

those activities are conducted. The Board has not yet adopted the proposed modifications to the Section 20 firewalls.[15]

I do wish to comment briefly on two of the Board's proposals. First, the Board requested comment on whether the complete prohibition on director, officer, and employee interlocks between a BHC's Section 20 subsidiary and its affiliated banks could be replaced with a general statement requiring that the Section 20 subsidiary not be managed or controlled by its affiliated banks and that there not be a substantial identity of personnel between the entities.

Second, the Board 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.[16] Specifically, the Board raised the possibility of placing

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15 See note 13 supra.

16 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.

"substantial reliance" upon the current Section 20 order disclosure requirements, coupled with the provisions in Sections 16 and 21 of the Glass-Steagall Act that prohibit a bank from engaging directly in underwriting and dealing in securities.[17]

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,[18] and it has reduced these firewalls in subsequent orders.[19] 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

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17 Finally, the Board requested comment on extending the current exemption from the prohibition on the purchase and sale of financial assets between a Section 20 subsidiary and its bank affiliate (currently set forth in Section 20 orders) with respect to U.S. Treasury securities or direct obligations of the Canadian government that are not subject to repurchase or reverse repurchase agreements between the two affiliates. The Board proposed including U.S. government agency securities and U.S. government-sponsored agency securities for which there is a broad and liquid market within the exemption.

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

19 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).

statutory firewalls contained in Sections 23A and 23B of the Federal Reserve Act[20] by and large offered sufficient protection for customers and banks' safety and soundness.[21]

The Board's recent amendments to Regulation Y may shed further light on its views concerning the proposed firewall revisions. The Board issued Regulation Y pursuant to Section 4(c)(8) of the BHCA.[22] That provision provides an exception to the BHCA's prohibition of BHCs' engaging in nonbanking activities or acquiring voting securities of nonbanks. Specifically, by order or by rule, the Board must determine that the activities being conducted are "so closely related to banking or managing or controlling banks as to be a proper incident thereto."

The Board, by order, already has permitted individual BHCs to engage in combined brokerage and investment advisory services. The Regulation Y changes codify

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20 12 U.S.C. §§ 371c, 371c-1.

21 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).

22 12 U.S.C. § 1843(c)(8).

combined brokerage and investment advisory services as a permissible nonbanking activity[23] and in the process eliminate certain restrictions that the Board had previously set forth in its orders.[24]

The Board stated that it did not include most of the restrictions in its previous orders because they already were mandated by other applicable law.[25] Only three sets of

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23 The Regulation Y changes also codify the following financial advisory services: (i) providing financial advice to foreign governments and their municipal agencies; (ii) providing financial and transactional advice to institutional customers with respect to various corporate reorganizations and financing matters; and (iii) providing financial and transactional advice to institutional customers regarding the structuring and arranging of swaps, caps, and similar transactions relating to interest rates, currency exchange rates or prices, and economic and financial indices. "Institutional customers" would include natural persons whose individual net worth exceeds $1,000,000.

24 It should be noted that codifying the Board orders in the rule substantially eases the procedure required for bank holding companies to engage in the activities at issue. Regulation Y originally had only permitted bank holding companies to provide securities brokerage and investment advisory services separately. Regulation Y, 12 CFR 225.25(b)(4), (15) (Jan. 1, 1992). Bank holding companies could seek approval to engage separately in these two activities or to engage only in one of the activities. Prior to engaging in the combined activities, bank holding companies had to apply to the Board for approval. For bank holding companies seeking to engage in the combined activities de novo, a notice period is now substituted for an application procedure, which permits expedited review by the Federal Reserve Banks.

25 The following restrictions were not incorporated in revised Regulation Y: (i) A majority of the brokerage company's board of directors must not be officers or directors of any affiliated bank. (ii) The broker-dealer must hold itself out as a separate and distinct corporation and maintain separate operations from the affiliated banks. (iii) Any back office services provided to the broker-dealer by bank affiliates and research or investment advice purchased from affiliates must be compensated for in accordance with Section 23B of the Federal Reserve Act. (iv) The broker-

restrictions were retained.[26] The Board thus apparently

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dealer must provide notice to its customers that an affiliated bank may be a lender to an issuer of securities. (v) As required by Section 23B of the Federal Reserve Act, no bank affiliated with the broker-dealer may engage in advertising for the broker-dealer stating or suggesting that an affiliated bank is responsible for the broker-dealer's obligations, or enter into any agreement to such effect. (vi) The broker-dealer's offices either must be separate from those of other affiliates or, in the case of offices established in a building in which another affiliate also has offices, be in areas separate from areas utilized by such affiliate. (vii) The broker-dealer may not transmit advisory research or recommendations (other than what it makes available to unaffiliated investor clients or that are non-confidential) to the commercial lending department of any bank affiliate. The broker-dealer may not receive position reports regarding the securities affiliates may hold in inventory. (viii) If the broker-dealer obtains customer lists from affiliates, it must use such lists for general advertising purposes only (such as mass mailings) and not to solicit individual customers of its affiliates. (ix) The broker-dealer may charge fees only for transactions executed for the customer (and not separately for advice).

26 Three sets of restrictions were retained from previous Board orders. First, affiliates are prohibited from providing discretionary investment management services to retail customers, due to the potential for abuse and conflicts of interest in connection with providing such services. The Board reasoned that institutional customers are likely to be financially sophisticated and able to detect potential abuses and conflicts of interest. The Board also stated that BHCs may provide such services to retail customers through a trust company subsidiary or trust department of a bank, where specific fiduciary responsibilities govern the bank or trust company's actions.

Second, the rule continues the requirement in the orders that a full service securities brokerage subsidiary of a BHC provide the specified disclosure items to each customer before providing any brokerage or advisory service, and, in certain cases, again in the customer account statement. The content of the disclosure requirements, as specified in the orders, also is retained generally without modification. The affiliated broker-dealer must prominently disclose that it is not a bank and is separate from an affiliate bank. The broker-dealer also must specify in all customer agreements that it is solely responsible for its contractual obligations and commitments, and that securities sold, offered, or recommended are not insured by the Federal Deposit Insurance Corporation and are not obligations of the bank. Disclosures made prior to providing the services may be given orally, provided that written disclosure is furnished to the customer immediately thereafter.

Third, the rule retains the restriction that prevents a brokerage company from exchanging confidential customer information with any affiliate

concluded that the restrictions retained in Regulation Y, together with federal and state securities laws and federal banking law, particularly the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act, are adequate to address the potential conflicts of interests and other potential adverse effects.

In eliminating from Regulation Y the prohibition of officer and director interlocks and certain cross-marketing limitations, the Board may have signalled its future treatment of these issues in Section 20 orders. Obviously this is an area that bears watching.

V. 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 enough rulemaking problems of its own which do not allow me the latitude to "armchair quarterback" the Board's decisions. I also do not anticipate

without the customer's consent.

any legislative consensus on this issue in the near future. If the securities industry is concerned with the reduction of firewalls with respect to the securities activities of a bank or its affiliates, it should make that case with the Board.

Current law does give banking regulators the jurisdiction to address bank tying abuses. I do not foresee any legislative broadening of Commission jurisdiction in the near future that will enable the Commission to reach bank tying through rulemaking proceedings, inspections, or enforcement actions.[27] As I have indicated, I have referred some of the bank tying complaints that I have received to the OCC. The securities industry should lodge complaints directly with the banking regulators if the circumstances surrounding a particular transaction indicate a violation of the bank tying prohibitions. I challenge the industry today to do so. If bank

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27 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 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." See also 'Lawmakers Ask Why Fed Is Fiddling With Bank's Underwriting Revenue Limits," Securities Week (Sept. 21, 1992), at 4.

tying abuses are occurring, and there are indications that some such abuses are occurring,[28] the exercise of bank regulatory enforcement jurisdiction is one of the solutions. The other answer is, as I mentioned, the exercise of a private right of action. Thus, in my view, the burden is on the securities industry to bring violations of the bank tying limitations to the attention of the bank regulators for appropriate enforcement action or to encourage private actions.

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28 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.

Since there has been some recent public attention focused on potential bank tying abuses, the securities industry has a window of opportunity to "put up or shut up." As I have indicated, I challenge the industry at least to press for more aggressive enforcement action in this area if the facts so warrant.