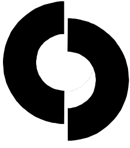

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Conditional Approval #331
November 1999

**DECISION OF THE COMPTROLLER OF THE CURRENCY
ON THE APPLICATION BY
NATIONAL BANK OF COMMERCE, MEMPHIS, TENNESSEE
TO COMMENCE NEW ACTIVITIES
IN AN OPERATING SUBSIDIARY**

I. INTRODUCTION

On May 25, 1999, National Bank of Commerce, Memphis, Tennessee ("Bank") applied to expand the activities of its operating subsidiary, NBC Capital Markets Group, Inc. ("Subsidiary") to engage in various securities activities including underwriting and dealing in corporate bonds, dealing in and privately placing trust preferred securities and buying and selling collateralized mortgage obligations.

The OCC has previously authorized the Subsidiary to underwrite and deal in, to a limited extent, municipal revenue bonds and to conduct securities brokerage services, underwrite and deal in U.S. Government obligations and general obligations of States and their political subdivisions, and buy and sell money market instruments.[1]

The Subsidiary currently is, and will continue to be, a broker-dealer registered with the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 (15 U.S.C. § 78a *et seq.*) and is a member of the National Association of Securities Dealers, Inc. ("NASD"). The Subsidiary, therefore, is subject to the record-keeping and reporting obligations, fiduciary standards, and other requirements of the Securities Exchange Act of 1934, the SEC, and the NASD.

Under the proposal, the Subsidiary would engage in certain underwriting and dealing activities that are not permitted for a national bank to engage in directly. The Subsidiary would engage in the proposed activity in addition to the previously approved activities and would continue to operate within

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[1] *See* Decision of the Comptroller of the Currency on the Application by National Bank of Commerce, Memphis, Tennessee to Commence New Activities in an Operating Subsidiary (October 20, 1998) ("Commerce Decision"), OCC Corporate Decision No. 98-48, *Interpretations and Actions*, Nov. 1998, Vol. 11, No. 11.

the framework of limitations in 12 C.F.R. § 5.34(f) and the conditions set forth in the Commerce Decision. In particular, the Bank has committed that the revenues the Subsidiary would receive from any underwriting and dealing activity not permissible for a national bank would not exceed 25% of the total revenues of the Subsidiary.

Notice of the application, affording interested persons the opportunity to comment on the proposal, has been published, 64 *Federal Register* 31677 (June 11, 1999). The OCC received three comments on the application during the comment period, including two from bank trade associations in support of the application and one from a credit union trade association objecting to approval of the application. Both bank trade associations strongly support approval of the application because they believe that the proposed activities are part of the business of banking and will not violate the Glass-Steagall Act. The credit union trade association objects to approval because it believes national banks would have an unfair competitive advantage over other financial firms as a result of advantages banks derive from the federal safety net.[2] Subsequent to the close of the comment period, the OCC received a comment submitted by the Board of Governors of the Federal Reserve System ("FRB"). The FRB urges the OCC to deny the Bank's application and any other application to allow a national bank to engage through a subsidiary in an activity that is not permissible for a national bank.[3]

Under 12 C.F.R. §5.34(d), the OCC may permit a national bank to conduct an activity through its operating subsidiary that is different from those permissible for the parent national bank, subject to the additional requirements specified in 12 C.F.R. § 5.34(f), provided that the OCC concludes that the activity is part of or incidental to the business of banking or is permitted under other statutory authority. In considering the proposed activity, the OCC considers the particular activity at issue and must weigh: 1) the form and specificity of the restriction applicable to the parent bank; 2) why the restriction applies 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.[4] The OCC's evaluation of these factors will also take into account safety and soundness implications of the activity, the regulatory safeguards that apply to the operating subsidiary and to the activity itself, any conditions that may be imposed in conjunction with an application approval, and any additional undertakings by the bank or the operating subsidiary that address the foregoing factors.[5]

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[2] These concerns are addressed in **Section IV--Safety and Soundness Considerations** of this decision.

[3] The issues raised by the FRB are addressed in **Section III -- Legal Analysis of Proposed Underwriting and Dealing Activities** and **Section IV -- Safety and Soundness Considerations** of this decision.

[4] *See* Legal Opinion from Julie L. Williams, Chief Counsel, to Eugene A. Ludwig, Comptroller of the Currency, "Legal Authority for Revised Operating Subsidiary Regulation," (November 18, 1996) (Op Sub Legal Opinion), at 2.

[5] *See Id.* The OCC has previously determined that underwriting and dealing in municipal revenue bonds is part of the business of banking and therefore authorized for operating subsidiaries under 12 U.S.C. § 24(Seventh). *See* Decision of the Comptroller of the Currency on the Application by Zions First National Bank, Salt Lake City,

The OCC has carefully considered all of the information available to it, including the information and representations provided by the Applicant, and the comments received on the proposal. Based upon this review and for the reasons discussed below, the OCC has concluded that the proposed expansion of activities in the Subsidiary is legally authorized under the above standards and consistent with safe and sound banking practices. Accordingly, for the reasons discussed below, and subject to the conditions specified herein, the Bank's application is approved.

The OCC also notes that the Bank's proposal would be permissible under the standards of the pending Gramm-Leach-Bliley Act ("G-L-B Act"). The Bank meets (and where applicable, all its insured depository institution affiliates meet) the standards set forth in section 121 of the G-L-B Act for a national bank to have a "financial subsidiary" engaged in types of activities that include those proposed by the Bank in the present application. In fact, under the G-L-B Act, the revenue that the Subsidiary may receive from certain underwriting and dealing activity would not be limited to 25% of the Subsidiary's total revenues. Accordingly, at such time as the relevant provisions of the G-L-B Act are effective, the Bank may request the OCC to modify the terms and conditions of this approval to be consistent with the new law.

II. THE BANK'S PROPOSAL

A. Proposed Underwriting and Dealing Activities

Under the proposal the Subsidiary will underwrite and deal in certain securities on a limited basis. Specifically, the Subsidiary will underwrite and deal in corporate bonds that are rated investment grade. The Subsidiary's activities will be limited to participating in underwriting syndicates and transactions will be limited to institutional investors.

The Bank also proposes that the Subsidiary engage in secondary market transactions as a dealer in trust preferred securities issued by unaffiliated bank holding companies. Trust preferred securities are hybrid securities, usually issued through a special purpose subsidiary or trust, that have

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Utah to Commence New Activities in an Operating Subsidiary (December 11, 1997) ("Zions Decision"), OCC Conditional Approval No. 262*, Interpretations and Actions*, Dec. 1997, Vol. 10, No. 12; Commerce Decision, *supra*; Decision of the Comptroller of the Currency on the Application by UMB Bank, N.A., Kansas City, Missouri, to Commence New Activities in an Operating Subsidiary, December 9, 1998 ("UMB Decision"), OCC Conditional Approval No. 297, *Interpretations and Actions*, Jan. 1999, Vol. 12, No. 1; and Decision of the Comptroller of the Currency on the Application by First Tennessee Bank, N.A., Memphis, Tennessee to Establish an Operating Subsidiary, April 12, 1999 ("First Tennessee Decision"), OCC Conditional Approval No. 309, *Interpretations and Actions*, May 1999, Vol. 17, No. 5. The Zions, Commerce, UMB and First Tennessee Decisions are incorporated by reference herein and are collectively referred to herein as the "Revenue Bond Decisions". The OCC also has determined that underwriting and dealing in revenue bonds through an operating subsidiary of a national bank is consistent with section 20 of the Glass-Steagall Act (12 U.S.C. § 377), provided that the entity engaged in the activity derives no more than 25% of its gross revenues from such underwriting and dealing. *See* Revenue Bond Decisions, *supra*.

characteristics of both debt and equity.[6] The OCC has previously concluded that national banks may purchase trust preferred securities as Type III securities.[7]

As noted above, the Bank has committed that the revenues the Subsidiary would receive from any underwriting and dealing activity not permissible for a national bank would not exceed 25% of the total revenues of the Subsidiary.

B. Other Proposed Activities

In addition to the proposed underwriting and dealing activities, the Bank proposes that the Subsidiary privately place trust preferred securities and purchase and sell collateralized mortgage obligations.

The Subsidiary will privately place trust preferred securities on behalf of the issuer in exempt transactions, pursuant to SEC Regulation D (17 C.F.R. § 230.506) and SEC Rule 144A (17 C.F.R. § 230.144A).[8] The Subsidiary will conduct these activities only with qualified institutional buyers, in the case of Rule 144A transactions, or with institutional accredited investors in the case of Regulation D transactions. The transactions will involve both investment grade rated and certain unrated trust preferred securities.[9]

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[6] Also known as capital securities, trust preferred securities are typically issued for a term of thirty years and may be issued as both fixed and floating rate securities. Trust preferred securities are identified by service or trademarked acronyms, depending on the investment bank that serves as the issuer's underwriter, including: MIPS (monthly income preferred shares), QUIPS (quarterly income preferred securities), MIDS (monthly income debt securities), QUICS (quarterly income capital securities), QUIDS (quarterly income debt securities), SKIS (subordinated capital income securities), TOPrS (trust-originated preferred securities), TRUPS (capital trust pass-through securities), TAPs (tax-advantaged preferred securities). *See* PSA, An Investor's Guide to Fixed Rate Capital Securities 4, 5 (1997).

[7] *See* OCC Interpretive Letter No. 777 (April 8, 1997), *reprinted in* [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,204.

[8] The Subsidiary also intends to privately place "securitized" trust preferred securities in transactions pursuant to SEC Regulation D (17 C.F.R. § 230.506) and SEC Rule 144A (17 C.F.R. § 230.144A). The obligations being placed by the Subsidiary would represent interests in a pool of trust preferred securities.

[9] The Subsidiary will effect transactions in unrated trust preferred securities only where it considers the securities to be of comparable quality to that of investment grade rated securities. *See* 12 C.F.R. § 1.3(i).

The Subsidiary also intends to buy and sell collateralized mortgage obligations ("CMOs").[10] The OCC has long permitted national banks and their operating subsidiaries to securitize, buy and sell CMOs and other bank assets.[11] The OCC also has long held that the private placement of securities is a permissible activity for a national bank and its operating subsidiary and does not involve the underwriting, public sale or distribution of securities.[12] Accordingly, the proposed CMO and private placement activities are hereby approved for the Subsidiary based on established OCC precedent.

III. LEGAL ANALYSIS OF PROPOSED UNDERWRITING AND DEALING ACTIVITIES

Introduction and Summary Conclusion

The Supreme Court has long stated that the starting point for any statutory analysis is the language of the statute itself.[13] Since the enactment of the National Bank Act in 1864, section 24(Seventh) has expressly authorized national banks to carry on "the business of banking," including "discounting and negotiating promissory notes" and "other evidences of debt," and to "exercise powers that are incidental thereto." 12 U.S.C. § 24(Seventh). During the latter part of the nineteenth century, and into the twentieth century, national banks relied on this statutory authority to underwrite and deal in both debt and equity securities. Indeed, underwriting and dealing were part of the business of many banks.

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[10] A CMO is a bond, secured by a pool of mortgages or mortgage-related obligations, that typically is issued in a series of classes with each class having an expected maturity different from the loans in the underlying mortgage pool. The OCC views CMOs, in the broadest sense, as an obligation or evidence of indebtedness representing the transfer of an interest in the underlying pool of mortgages or mortgage-related obligations. Letter dated June 18, 1986, from Robert L. Clarke to Senator Alfonse D'Amato ("D'Amato Letter").

[11] *See, e.g.,* Interpretive Letter No. 362 (May 22, 1986), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,532; D'Amato Letter, *supra*.; OCC Interpretive Letter No. 388 (June 16, 1986), *reprinted in* [1988 -1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; *Securities Industry Association v. Clarke*, *supra*.

[12] *See, e.g.,* 12 C.F.R. §§ 5.34(e)(2)(ii)(J) and 5.34(e)(3)(ii)(A); OCC Interpretive Letter No. 463 (December 27, 1988), reprinted in [1988 - 1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,687; OCC Interpretive Letter No. 329 (March 9, 1985), *reprinted in* [1985 - 1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499; OCC No Objection Letter No. 87-4 (May 19, 1987), *reprinted in* [1985 - 1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,033; OCC Interpretive Letter No. 32 (December 9, 1977), *reprinted in* [1978 - 1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,107. *See also Securities Industry Association v. Board of Governors of the Federal Reserve System*, 807 F.2d 1052 (D.C. Cir. 1987), *cert. denied*, 483 U.S. 1005 (1987).

[13] *See Board of Governors of the Federal Reserve System v. Dimension Financial Corp*., 474 U.S. 361, 368 (1986) and *Caminetti v. United States*, 242 U.S. 470, 485 (1917).

In 1927, the McFadden Act limited one aspect of these investment banking activities. The specific language of that Act regulated the extent to which an "association," namely, a national bank, could underwrite and deal in debt securities of any single issuer. The McFadden Act did not change the nature or components of the business of banking, however, nor did it attempt to regulate activities of entities that were related to a national bank. Rather, that Act regulated how a national bank itself could conduct one recognized aspect of the business of banking.

The Glass-Steagall Act in 1933 further regulated the extent to which national banks could engage in investment banking activities and also, for the first time, regulated the investment banking activities allowed for entities that were related to a national bank. Section 16 of the Glass-Steagall Act, while recognizing a national bank's ability to engage in investment banking activities, provided that investment banking functions with respect to certain types of securities could not be undertaken by the "association" -- the national bank itself. But, section 20 of the Act expressly preserved the authority of an "affiliate" of a national bank to conduct investment banking activities involving securities of all types, including bank-ineligible securities, provided the affiliate was not "engaged principally" in underwriting and dealing in bank-ineligible securities. The term "affiliate" was very precisely defined by Congress in the statute and specifically included companies owned or controlled by national banks, *i.e.*, bank subsidiaries.

Thus, although Congress chose to restrict the types of securities in which a national bank could directly underwrite and deal, it specifically allowed underwriting and dealing free from those restrictions in bank affiliates, including subsidiaries, as long as the affiliate is not engaged principally in underwriting or dealing in the type of securities not permitted for the bank itself. This different treatment afforded banks and their affiliates in the Glass-Steagall Act is explicit and unambiguous in the language of the statute itself, and demonstrates that Congress distinguished among the potential risks involved in underwriting and dealing in different types of securities and chose to allow bank "affiliates" to continue to engage in investment banking activities, albeit to a limited extent, with respect to a wider range of securities than permitted for the bank itself.

Accordingly, for the reasons discussed in detail below, the OCC finds that the underwriting and dealing activities proposed to be conducted by the Subsidiary may be permitted for a subsidiary of a national bank. The activities are authorized by section 24(Seventh) of the National Bank Act and, as proposed, are allowed under section 20 of the Glass-Steagall Act.

A. Underwriting and Dealing in Corporate Bonds and Dealing in Trust Preferred Securities are Part of the Business of Banking

The authority to underwrite and deal in debt securities is derived from section 24(Seventh) of the National Bank Act. That section provides that national banks shall have the power:

> [t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing and circulating notes . . . .

12 U.S.C. § 24(Seventh).

National banks relied on this authority to engage in a wide range of investment banking activities, including underwriting and dealing, in the latter part of the nineteenth century and early part of the twentieth century. Underwriting and dealing in debt securities was authorized pursuant to the authority of national banks to "discount and negotiate evidences of debt," and investment banking involving both debt and equity securities was also authorized as part of the business of banking generally.

The Glass-Steagall Act did not redefine the business of banking to exclude investment banking. If anything, the Act recognized that investment banking was an authorized banking function, but then provided that investment banking activities with respect to certain types of securities could not be undertaken directly by the bank, but could be conducted -- subject to certain size restrictions -- by a bank "affiliate."

1. Historical Recognition that Underwriting and Dealing are Part of the Business of Banking

Underwriting and dealing were already considered a customary part of the business of banking by the time the National Banking System was created by President Abraham Lincoln. Indeed, commercial and investment banking have been closely connected from the time banks first appeared in the United States. Commercial banks, from the earliest period, have been major providers of long-term credit to governments, investing their capital in government securities, selling securities and providing long-term loans.[14] Indeed, most of the institutions in the early investment banking business were commercial banks. By the 1830s, a number of leading commercial banks, such as the Bank of the United States of Pennsylvania, the Morris Canal and Banking Company, the Phoenix Bank, and the Bank of the Manhattan Company, developed investment banking as a line of their regular business.[15] Commercial bank involvement in investment banking continued to grow as a result of the immense financing needs of the Civil War and the railroads.

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[14] *See* F. Redlich, *The Molding of American Banking: Men and Ideas, Vol. II* (1951) at 324.

[15] *See* Redlich, *Vol. I, supra* at 50.

With the enactment of the National Currency Act in 1863[16], national banks entered the investment banking business. The First National Bank of New York, for example, sold war bonds during the war, and continued to engage in the buying and selling of government securities after 1865. By 1900 it "was one of the half dozen leading investment banking institutions in the country" and national banks were providing customers with all the services provided by private investment banking houses.[17] That national banks were engaged in investment banking under the authority to conduct the business of banking was widely recognized and acknowledged at the time.

For example, in 1927 the McFadden Act placed quantitative limits on the extent to which national banks could undertake investment banking activities with respect to debt securities of any single issuer. And in 1933, the Glass-Steagall Act replaced those limits with the now familiar limits on investment banking activities involving a wider range of securities. Throughout congressional deliberations on these proposals it was repeatedly recognized and stated that national banks were already engaged in these activities under their existing bank powers. As the House Report relating to the bill that became the McFadden Act noted:

> It is a matter of common knowledge that national banks have been engaged in the investment securities business . . . for a number of years. In this they have proceeded under their incidental corporate powers to conduct the banking business. Section 2(b) recognizes this situation but declares a public policy with reference thereto and thereby regulates these activities.

H.R. Rep. No. 83, 69th Cong., 1st Sess. 2 (1926); Cong. Rec. 2828 (Jan. 27, 1926).[18]

The Supreme Court has also recognized that national banks had the authority to underwrite and deal in securities prior to the Glass-Steagall Act. For example, in *NationsBank v. Variable Annuity Life Insurance Company*, 513 U.S. 251, 258, 115 S.Ct. 810, 814 (1995) ("*VALIC*"), the Court noted that in "limiting" a national bank's authority to buy and sell securities in the McFadden Act, Congress also reaffirmed that the activity was authorized as part of the business of banking. The addition of this limitation on purchasing and selling securities "makes sense only if banks *already had*

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[16] The National Currency Act was renamed the National Bank Act in 1864.

[17] *See* Vincent P. Carosso, *Investment Banking in America: A History* (Harvard University Press, Cambridge 1970) at 23.

[18] The House Report went on to note that while the bill regulated the ability of national banks to invest in securities, it also "[r]ecognizes the right of national banks to continue to engage in the business of buying and selling investment securities." *Id.* at 3-4. *See also* 1924 *Annual Report of the Comptroller of the Currency* at 12 (suggesting legislation which was a forerunner of the McFadden Act's investment securities provision and stating the "provision would make very little change in existing practice, since a great number of national banks now buy and sell investment securities, and the office of the comptroller has raised no objection because this has become a recognized service which a bank must render").

authority to deal in securities, authority presumably encompassed within the 'business of banking' language which dates from 1863." *Id.* Similarly, in *Securities Industry Association v. Comptroller of the Currency*, 479 U.S. 388, 407-408 (1987), the Court noted that "in passing the McFadden Act, Congress recognized and for the first time specifically authorized the practice of national banks' engaging in the buying and selling of investment securities. Prior to 1927, banks had conducted such securities transactions on a widespread . . . basis."

Thus, prior to the enactment of the Glass-Steagall Act in 1933, the authority of national banks to engage in investment banking activities had developed and become established as part of their banking powers. Both the McFadden Act and the Glass-Steagall Act, in effect, recognized and sought to regulate investment banking functions conducted as part of the business of banking. The Glass-Steagall Act further distinguished the potential risks involved in underwriting and dealing in different types of securities and specifically allowed bank "affiliates" to continue to engage in investment banking activities to a limited extent, with respect to a wider range of securities than permitted for the bank itself.

2. Underwriting and Dealing in Corporate Bonds and Dealing in Trust Preferred Securities are Part of the Business of Banking Under Section 24(Seventh)'s Enumerated Power to Discount and Negotiate Promissory Notes and other Evidences of Debt.

Section 24(Seventh) of the National Bank Act expressly authorizes national banks to conduct the business of banking, including "by discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt." 12 U.S.C. § 24(Seventh). Prior to enactment of the McFadden Act and the Glass-Steagall Act, this power was recognized as a legal basis for many of the investment banking activities of national banks.[19] Although the McFadden Act and the Glass-Steagall Act later provided that national banks could not directly conduct investment banking activities with respect to certain types of securities, the Acts did not alter the basic concept of the business of banking or the fact that one specifically identified component of that business was the ability to discount and negotiate promissory notes and other evidences of debt. The Glass-Steagall Act, in fact, specifically preserved, to a limited extent, the ability of a bank-related entity, such as a subsidiary, to engage in this activity with respect to a broader range of debt instruments than allowed for the bank itself.

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[19] *See* Redlich, *Vol. II, supra* at 389 ("The legal basis for investment banking activities of national banks can be found in a clause of the National Currency Act of 1864, section 8 [12 U.S.C. § 24(Seventh)], according to which those banks were authorized to discount and negotiate 'evidences of debt' in general."). *Hearings on the Consolidation of the National Banking Associations, Subcommittee of the Senate Banking and Currency Committee*, S. 1782, 69th Cong., 1st Sess. (1926), at 22. ("The authority is from section 5136 [derived from Act of June 3, 1864, c. 106, § 8, 13 Stat. 101, which was the National Bank Act section codified at 12 U.S.C. § 24(Seventh)] . . . empowering national banks to 'negotiate other evidences of debt'.")

The OCC has previously determined that the authority to discount and negotiate encompasses the power to underwrite and deal in debt securities, such as municipal revenue bonds.[20] Both corporate bonds and trust preferred securities are debt securities representing the long term secured or unsecured debt obligations of the issuing corporation.[21] Thus, like municipal revenue bonds, they qualify as "evidences of debt" within the meaning of 12 U.S.C. §24(Seventh).

As evidences of debt, they may be discounted and negotiated under the authority of 12 U.S.C. § 24(Seventh). The OCC has previously concluded this power to discount and negotiate includes the power to buy and sell as principal.[22] The courts have long held that the term "discount" includes purchases of notes and other evidences of debt.[23] And negotiation is a form of transfer, disposition or sale.[24] Nothing in the sentence authorizing discounting and negotiating limits this authority.[25] Thus, all types of buying and selling are authorized, including the authority to buy and sell as principal. Underwriting and dealing are, in their most basic forms, buying and selling as principal. Accordingly, the Subsidiary has the authority, pursuant to 12 U.S.C. § 24(Seventh), to underwrite and deal in corporate bonds and deal in trust preferred securities.

3. Underwriting and Dealing in Corporate Bonds and Dealing in Trust Preferred Securities are also Part of the General Business of Banking.

Underwriting and dealing in corporate bonds and dealing in trust preferred securities also can be viewed as part of the general business of banking because of the financial nature of the activities and the relationship of the activities to other traditional banking functions. The proposed underwriting and

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[20] *See* Revenue Bond Decisions, *supra*.

[21] Although trust preferred securities have certain characteristics of equity, the OCC has previously concluded that trust preferred securities are, in substance, debt instruments for purposes of national bank investment authority. *See* OCC Interpretive Letter No. 777, *supra*.

[22] *See Revenue Bond Decisions, supra. See also* Op Sub Legal Opinion, *supra*.

[23] *See, e.g., National Bank v. Johnson*, 104 U.S. 271 (1881); *Steward v. Atlantic National Bank*, 27 F.2d 224, 228 (9th Cir. 1928); *Morris v. Third National Bank*, 142 F. 25 (8th Cir. 1905); *Danforth v. National State Bank of Elizabeth*, 48 F. 271 (3d Cir. 1891). *See also* 12A *Words and Phrases* 285-95 (West 1954 and Supp. 1998).

[24] *Black's Law Dictionary* 934 (5th ed. 1979); 28 *Words and Phrases* 768-772 (West 1955 & Supp. 1998).

[25] As noted in this decision, Congress has placed limits upon a national bank's authority to buy and sell debt securities within the bank itself. It has done so not by changing the sentence authorizing discounting and negotiating but by adding additional sentences and by adding other statutes with the effect of excluding certain activities from the scope of activities that had been, and would otherwise be, permissible for the bank itself under the authority of 12 U.S.C. § 24(Seventh). *Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 137 (1984). These exclusions apply only to the bank itself, however, not to its subsidiaries or other affiliates. Congress also limited the activities of subsidiaries and other affiliates, but chose to do so through different means.

dealing activities are similar to commercial lending activities conducted safely and soundly by national banks. As in commercial lending, the role of the operating subsidiary as underwriter of corporate bonds and trust preferred securities is to facilitate the flow of funds to corporations in need of working capital. The activities also are similar to other underwriting and dealing activities conducted by national banks or their operating subsidiaries. Moreover, the activities involve securities that national banks may invest in for their own accounts. Thus, underwriting and dealing in corporate bonds and dealing in trust preferred securities are the functional equivalent of, or logical, incremental extension of activities currently conducted by banks, potentially yielding significant public benefits in the form of increased competition, convenience, and lower cost of financing, and benefiting banks by providing additional sources of revenue. They also involve risks similar in nature to those already assumed by banks.[26]

a. Underwriting and dealing in corporate bonds and dealing in trust preferred securities are the functional equivalent or logical outgrowth of activities currently conducted by national banks.

Underwriting and dealing in corporate bonds and dealing in trust preferred securities are the functional equivalent or a logical extension of commercial lending activities currently being conducted safely and soundly by national banks. Underwriting in corporate bonds is functionally equivalent to or a logical extension of the traditional banking function of providing loans to corporations to finance their working capital needs. In both cases, the Subsidiary is acting as financial intermediary, a "dealer" in capital, facilitating the flow of money and credit among different parts of the economy.[27]

Dealing in trust preferred securities also is functionally equivalent to or a logical outgrowth of permissible commercial lending activities. As noted above, the OCC has previously recognized that an investment in trust preferred securities is functionally equivalent to an investment in the underlying subordinated note. In a basic structure, a parent company issues preferred securities to investors through a special purpose entity, such as a limited partnership or trust. The special purpose entity then purchases a junior subordinated note of the parent with the proceeds of the issuance. This subordinated note is the sole asset of the issuing entity. Thus, an investment in trust preferred securities

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[26] The Supreme Court has held that Section 24(Seventh) is a broad grant of power to engage in the business of banking, including but not limited to the five specifically recited powers and the business of banking as a whole. *See VALIC, supra*. Many activities that are not included in the enumerated powers are also part of the business of banking. Judicial cases reflect three general principles used to determine whether an activity is within the scope of the "business of banking": (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; and (3) does the activity involve risks similar in nature to those already assumed by banks? *See, e.g.*, *Merchants Bank v. State Bank*, 77 U.S. 604 (1871); *M&M Leasing Corp. v. Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978); *American Insurance Association v. Clarke*, 865 F.2d 278, 282 (2d Cir. 1988).

[27] *See* OCC Interpretive Letter No. 494 (Dec. 28, 1989), *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083, at 71,199.

is, in essence, an interest in the underlying note. Accordingly, dealing in trust preferred securities is functionally equivalent or similar to arranging loan participations in commercial loans.

Underwriting and dealing in the proposed securities also involve the same basic functions as underwriting and dealing in bank-eligible securities. For example, for both bank-eligible securities and the proposed securities, the underwriter sets a price at which it believes the securities can be sold to investors at a profit. This requires an analysis of the creditworthiness of the issuer and an assessment of price volatility. Because of their traditional lending activities, banks and their subsidiaries are clearly qualified to perform the credit analysis required in both bank-eligible and the proposed underwritings. The underwriter also is responsible for distributing the securities to investors and generally deals in the issuer's securities by purchasing and selling them for the underwriter's own account. Banks perform similar functions when they underwrite eligible securities. Similarly, acting as a dealer in the proposed debt securities will involve substantially the same analysis as dealing in bank-eligible securities. In both cases, the dealer must evaluate the price risk of the securities held in inventory.

The proposed underwriting and dealing activities also involve functions that are a logical outgrowth of other traditional banking activities. For example, national banks and operating subsidiaries are permitted to directly invest in both corporate bonds and trust preferred securities. The credit analysis required in underwriting corporate bonds involves the same kind of assessment as is required when the bank purchases corporate bonds or trust preferred securities for its own account or makes a direct loan to a corporation. A bank or subsidiary must perform the same credit analysis when advising issuers and assisting them in privately placing their securities.

Thus, the activities involved in underwriting and dealing in corporate bonds and dealing in trust preferred securities are the functional equivalent or a logical extension of underwriting and dealing in bank-eligible securities.

b. Underwriting and dealing in corporate bonds and dealing in trust preferred securities potentially benefit bank customers, including small banks, and increases bank revenues.

The proposed underwriting and dealing activities should produce substantial benefits to the public by increasing competition in the capital markets and by providing greater convenience to investors and borrowers.

The primary corporate bond market is characterized as having relatively few underwriters that serve the needs of mostly large corporate issuers.[28] The entry of the Subsidiary as a new competitor in the corporate bond and capital securities markets may help reduce concentrations and thereby lower customer and financing costs and increase the availability of investment banking services. Small banks

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[28] *See* Fabozzi, Frank J., ed., *The Handbook of Fixed Income Securities*, 4th ed. (Irwin Publishing 1995).

and businesses should particularly benefit through increased access to the capital markets and reductions in borrowing costs. As noted in the application, many smaller banks have not been able to issue trust preferred securities due to the high underwriting costs and lack of investment banker interest in small distributions. Small businesses have faced similar difficulties in accessing the corporate bond market.

Entry of new firms also would increase the number of dealers in corporate bonds and trust preferred securities, which should enhance liquidity in the markets for these securities and thereby increase market efficiency.[29]

Approval of the proposed underwriting and dealing activities should benefit investors by permitting the Subsidiary to offer a wider array of desired financial products and services. Underwriters in the primary corporate debt market generally target large institutional investors when marketing new issuances. As a result, many smaller institutional investors interested in investing in corporate bonds often find their investment opportunities limited or nonexistent as large institutional investors are given the first option on investing in new issuances. The entry of new firms would increase the potential that these smaller institutional investors will access the primary corporate bond market.

National banks also would benefit from the proposed activities. Approval of the proposed underwriting and dealing activities would enable national banks to diversify their activities through operating subsidiaries and generate new sources of revenue. This diversification can have important benefits. Fees and other income from the subsidiaries may enable banks to offset the effects of cyclical downturns in other sectors of the economy.[30] Hence, bank earnings would be less volatile, reducing risks to the bank, and ultimately to the insurance fund. Indeed, the FDIC has testified that allowing a bank to conduct new activities in a bank subsidiary (as opposed to a nonbank subsidiary of a bank holding company) can provide “superior safety and soundness protection” for the bank and the insurance fund.[31] As former FDIC Chairman Helfer stated, conducting new activities in a bank

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[29] The Federal Reserve Board has previously noted that the entry of new dealers in debt and equity securities should enhance liquidity in the markets for those securities. *See* J.P. Morgan & Co. Incorporated, et. al., 75 Federal Reserve Bulletin 192 (1989), *aff'd sub nom. Securities Industry Association v. Board of Governors of the Federal Reserve System*, 900 F.2d 360 (D.C. Cir. 1990).

[30] *See* Testimony of Eugene A. Ludwig, Comptroller of the Currency, Before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce of the U.S. House of Representatives, July 17, 1997, Appendix II “Analysis of the Safety Net Issue” (April 1997) at 12.

[31] *See* Testimony of Donna Tanoue, Chairman, FDIC on Financial Services Modernization Act of 1999, Before the Subcommittee on Banking, Housing, and Urban Affairs of the United States Senate, February 24, 1999.

subsidiary "lowers the probability of bank failure and provides greater protection for the insurance fund" (than if the activities were conducted by holding company subsidiaries).[32]

Stronger institutions with increased profits and asset growth will be better positioned to meet the credit needs in their communities and support the economy as a whole. The proposed activities also can provide an income stream to support the Bank's Community Reinvestment Act (CRA) efforts, thereby increasing the potential pool of resources available to support disadvantaged communities.[33]

Approval of the proposed underwriting and dealing activities also should enhance the role of national banks as financial intermediaries. In recent years, many of the most stable and successful corporate bank customers have turned to the capital markets to meet their financing needs. Allowing bank operating subsidiaries to underwrite and deal in corporate bonds and deal in trust preferred securities will help banks retain or encourage the return of these prime bank customers.

c. The risks associated with underwriting and dealing in corporate bonds and dealing in trust preferred securities are the same risks already assumed by the bank in underwriting, dealing in bank-eligible securities and investing in corporate bonds and trust preferred securities.

The risks an operating subsidiary assumes in underwriting and dealing in corporate bonds and dealing in trust preferred securities are similar to the risks already assumed by the Subsidiary.[34] The primary risks[35] of underwriting, dealing and investing in both bank-eligible and bank-ineligible securities

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[32] *See* Testimony of Ricki Helfer, Chairman, FDIC, on Financial Modernization, Before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997.

[33] The OCC considers the assets of a bank operating subsidiary when evaluating the capacity of the bank to serve its community. *See* OCC Bulletin 97-26, Performance Context (July 3, 1997).

[34] National banks actively engage in holding and trading corporate bonds and trust preferred securities for their own account. This investment activity may actually pose a greater risk of loss than holding such securities as principal in an underwriting or dealing capacity.

[35] Other risks associated with underwriting and dealing in corporate bonds and dealing in trust preferred securities include credit risk, transaction risk, compliance risk, and strategic risk. *See Comptroller's Handbook, Large Bank Supervision, Supervision by Risk* at 18-21. These same risks are associated with underwriting and dealing in bank-eligible securities.

are reputation risk[36] and price risk.[37] The Bank is very experienced in managing these types of risks as a result of its permissible underwriting and dealing activities, and traditional lending functions. Moreover, the Bank has extensive expertise in evaluating the risk characteristics of corporate bonds and trust preferred securities as a result of its direct ability to invest in those investment securities and similar securities for its own account.

B. Section 20 of the Glass-Steagall Act Permits Underwriting and Dealing by a Subsidiary of a National Bank

The Glass-Steagall Act, it is often said, was designed to effect a separation between commercial and investment banking. But as the Second Circuit has noted, "Senator Glass' aspiration to divorce completely commercial banks from their securities affiliates was never attained." [38] This is most clearly demonstrated by the different treatment Congress afforded national banks and their affiliates under the Glass-Steagall Act.[39]

Under section 16 of the Act, "the association," namely the national bank, is precluded from engaging in investment banking functions with respect to various (but not all) types of securities.[40]

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[36] Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution's ability to establish new relationships or services or continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. *See Id.* at 21.

[37] Price risk is the risk to earnings or capital arising from changes in the value of portfolios of financial instruments. This risk arises from market-making, dealing, and position-taking activities in interest rate, foreign exchange, equity, and commodities markets. *See Id.* at 19.

[38] *Securities Industry Association v. Federal Reserve System*, 839 F.2d 47, 59 (2d Cir. 1988), *cert denied*, 486 U.S. 1059, 108 S.Ct. 2830 (1988) ("*Banker's Trust III*").

[39] Indeed, Congress displayed this same precision in the different treatments it applied to other related entities of national banks. For example, holding company affiliates were subject to the same substantive test as other national bank "affiliates," but via a different implementing mechanism. Section 19(e) of the Glass-Steagall Act prevented a company that controlled a national or member bank from voting the stock it owned unless it obtained a voting permit. In order to get a voting permit, the holding company affiliate had to:

> (1) show that it does not own, control, or have any interest in, and is not participating in the management or direction of, any corporation, business trust, association, or other similar organization formed for the purpose of, or engaged principally in, the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail or through syndicate participation, of stocks, bonds, debentures, notes, or other securities of any sort (hereafter referred to as 'securities company'); . . . .

Pub. L. No. 73-66 ch. 89, § 19(e), 48 Stat. 162, 188 (1933), *repealed,* Pub. L. No. 89-485, § 13(c), 80 Stat. 236, 242 (1966). Section 19(e) was later repealed.

[40] Section 5 of the Act applied these restrictions to state-chartered member banks. 12 U.S.C. § 335.

"Affiliates" of national banks, on the other hand, are given a different statutory treatment under section 20 of the Act. That section provides that:

> no member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.[41]

12 U.S.C. § 377. Thus, unlike national banks, their "affiliates" are allowed to engage in investment banking activities with respect to all types of securities, provided the affiliate is not "engaged principally" in investment banking activities with respect to the types of securities in which the bank may not directly underwrite or deal.[42] The term "affiliate" is defined for this purpose to include:

> any corporation, business trust, association, or other similar organization--
>
> (1) Of which a member bank directly or indirectly owns or controls either a majority of the voting shares or more than 50 per centum of the number of shares voted for the election of its directors, trustees, or other persons, exercising similar functions at the preceding election, or controls in any manner the election of a majority of its directors, trustees, or other persons exercising similar functions.

12 U.S.C. § 221a(b)(1).

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[41] The term "dealing" is not included in the language of section 20. The Federal Reserve has interpreted the term "public sale" in section 20 to encompass dealing, however. *See* 73 FED. RES. BULL. 473, 481, 506-07 (1987).

[42] Applying the plain language of section 20, the Federal Reserve has previously permitted other affiliates of member banks, including national banks, to underwrite and deal in securities a national bank would not be permitted to underwrite and deal in. In 1987, the Federal Reserve Board first interpreted section 20 to allow bank affiliates to engage in underwriting and dealing in revenue bonds, commercial paper, mortgage-backed securities and consumer receivable related securities. *See Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation*, 73 FEDERAL RESERVE BULLETIN 473, 487 (1987), *aff'd sub nom.*, *Securities Industry Association v. Board of Governors of the Federal Reserve System*, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059, 108 S.Ct. 2830 (1988); *Chemical New York Corp., Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, Manufacturers Hanover Corp., and Security Pacific Corp.*, 73 FEDERAL RESERVE BULLETIN 731 (1987) (approving underwriting and dealing in consumer receivable related securities after having deferred decision for 60 days in its prior 1987 order). In 1989, the Federal Reserve allowed member bank affiliates to underwrite and deal in all debt and equity securities. *See J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp.*, 75 FEDERAL RESERVE BULLETIN 192 (1989), *aff'd Securities Industry Association v. Board of Governors*, 900 F.2d 360 (D.C. Cir. 1990).

An operating subsidiary is a company that is more than 50% owned or controlled by a national bank.[43] Thus, by applying the literal language of the statute, an operating subsidiary is an "affiliate" for purposes of section 20 of the Glass-Steagall Act. As an "affiliate" of a national bank, an operating subsidiary therefore is able to underwrite and deal in securities of the type not permitted for its parent, provided that the subsidiary is not "engaged principally" in underwriting or dealing functions with respect to those bank-ineligible securities.

The Subsidiary's proposed activities are permissible under this standard. The Federal Reserve has previously determined that an affiliate of a member bank earning 25% or less of its revenue from underwriting and dealing in securities impermissible for a member bank to underwrite and deal in directly, is not "principally engaged" in that activity for purposes of section 20 of the Glass-Steagall Act (12 U.S.C. § 377).[44] The Subsidiary, in this case, has committed that the revenues derived from any underwriting and dealing activity not permissible for a national bank will not exceed 25% of its total revenues. Accordingly, the Subsidiary will not be "engaged principally" in underwriting or dealing in bank-ineligible securities for purposes of section 20 of the Glass-Steagall Act.

In sum, the plain language of the Glass-Steagall Act distinguishes the potential investment banking risks presented by different types of securities and allows subsidiaries of national banks to engage in investment banking functions with respect to types of securities not permitted for the national bank itself. While section 16 prohibits "the association" from underwriting and dealing in certain types of securities, section 20 expressly allows "affiliates" of a bank, including its subsidiaries, to underwrite and deal in a broader range of securities--to a limited extent. Thus, Congress has not prohibited, but rather has expressly enabled, subsidiaries of national banks to engage in a broader range of underwriting and dealing than allowed for the bank directly.[45]

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[43] Under 12 C.F.R. § 5.34, operating subsidiaries are defined 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 . . . ." 12 C.F.R. § 5.34(d)(2).

[44] *See Revenue Test Notice*, *supra*.

[45] In defining the term "affiliate" to include companies owned or controlled by member banks, Congress was well aware that national banks organized and controlled companies engaged in underwriting and dealing. For example, in 1932, while Congress was considering legislation to strengthen the banking system and to deal with banks' involvement in the securities markets, Federal Reserve Board Chairman Eugene Meyer, testifying on companies owned or affiliated with national banks, submitted a chart listing 770 companies that were affiliates of national banks. Of those directly owned by national banks, four were identified as "securities companies". *See Hearings on S.4115 Before the Senate Committee on Banking and Commerce*, 72d Cong., 1st Sess. (1932) at 391-392. *See also Hearings on S. Res. 71 Before a Subcommittee of the Senate Committee on Banking and Currency*, 71st Cong., 3d Sess. (1931); *Hearings on S.Res. 19 Before the Senate Committee on Finance*, 72d Cong., 1st Sess. (1932); *Hearings on S.Res. 84 and S.Res.239 Before a Subcommittee of the Senate Committee on Banking and Commerce*, 72d Cong., 2d Sess.(1933); *Hearings on S.Res. 84 and S.Res. 56 Before the Senate Committee on Banking and Currency*, 73rd Cong., 1st Sess.(1933); *Hearings on S.Res. 84 and S.Res. 97, Senate Committee on*

C. National Banks Are Authorized to Own Operating Subsidiaries Engaged in Activities Not Permissible for the Bank

It is well-settled that national banks may own operating subsidiaries as an incident to being in business.[46] Moreover, as section 20 of the Glass-Steagall Act makes clear, subsidiaries of national banks may legally engage in activities not permitted for the bank itself. The OCC and the courts also have recognized, in various contexts, that limitations that apply to the bank itself do not necessarily apply to its affiliates or subsidiaries.

The OCC's regulation on operating subsidiaries permits an operating subsidiary to engage in activities not permitted for its parent bank as long as the OCC determines that the activities are part of or incidental to the business of banking or otherwise authorized by law and that the limitation applicable to the bank does not apply to the subsidiary.[47] Pursuant to this regulation, the OCC determined that underwriting and dealing in revenue bonds is part of the business of banking and that the limitations on underwriting and dealing in such securities applicable to the bank under section 16 of the Glass-Steagall Act do not apply to an operating subsidiary.[48]

The courts also have recognized that limitations that apply to a bank do not always apply to its affiliates or subsidiaries. In *Board of Governors, FRS v. Investment Company Inst.*, 450 U.S. 46 (1981), the Supreme Court upheld the Federal Reserve's determination that a nonbank subsidiary of a bank holding company could sponsor, organize, control, and act as investment advisor to a closed-end investment company. The Court examined the language, structure, and legislative history of the Glass-Steagall Act and concluded that the activities were permissible for affiliates of banks.[49] In upholding the permissibility of the activities, the Court made the key determination that activities of bank affiliates are governed by section 20 of the Glass-Steagall Act, not sections 16 or 21. Section 20, the Court noted, "does not prohibit bank affiliation with a securities firm unless that firm is 'engaged principally' in

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Banking and Currency, 73rd, Cong., 2d Sess (1934). A 1930 bill, introduced by Senator Carter Glass, also defined "affiliate" to include securities companies owned or controlled by national banks. *See* S. 4723, 71st Cong., 2d Sess. *See also* Op Sub Legal Opinion, *supra,* at 8, 11-12.

[46] *See* Zions Decision, *supra*, at 15-17 for a fuller discussion of this issue.

[47] *See* 12 C.F.R. § 5.34(d).

[48] *See* Zions Decision, *supra*.

[49] The Court also pointed out that the bank itself could engage in the activity. *See* *Id*. at 62.

activities such as underwriting."[50] As a result, the court noted that "bank affiliates may be authorized to engage in certain activities that are prohibited to banks themselves."[51]

Affiliates and operating subsidiaries of national banks may engage in activities different from those permitted for a national bank under certain circumstances. Those activities must still qualify as part of or incidental to the business of banking or be permissible for national banks or their subsidiaries under other statutory authority, however. As explained above, the proposed activities of the Subsidiary are part of the business of banking and are allowed for an operating subsidiary under section 20 of the Glass-Steagall Act. In making this determination, the OCC has weighed the form and specificity of the restriction applicable to the bank, why the restriction applies to the bank, and whether it would frustrate the purpose underlying the restriction on the bank to permit the subsidiary to engage in the proposed activity. For the reasons discussed above, the OCC concludes that the restriction applicable to national banks in section 16 of the Glass-Steagall Act does not apply to operating subsidiaries. By its terms, section 16 only applies to the national bank itself. Congress specifically provided a different standard for affiliates of national banks, including subsidiaries of national banks, in section 20 of the Glass-Steagall Act. Thus, it would not frustrate the purposes of section 16, or the Glass-Steagall Act generally, to permit the Subsidiary to engage in the proposed activity to the extent permitted under section 20. Accordingly, the OCC finds that the activities are legally permissible for an operating subsidiary of a national bank.

IV. SAFETY AND SOUNDNESS CONSIDERATIONS

In reaching its determination to approve the proposed underwriting and dealing activities, the OCC also has carefully considered whether the activities pose an undue risk to the Bank and the Subsidiary or would result in unsafe and unsound banking practices. The OCC believes that, under the conditions and limitations set forth below, the proposed activities present limited risk to the Bank and the Subsidiary and will be conducted in a safe and sound manner.

A. Limited Expansion of Activities

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[50] *Id*. at 64.

[51] *Id*. at 60. *See also Bankers Trust III, supra*; *Securities Industry Association v. Board of Governors, Federal Reserve System*, 847 F. 2d 890 (D.C. Cir. 1988) (both holding that a member bank's affiliate may engage in some securities activities that would be prohibited to the member bank itself). *See also Investment Company Institute v. Federal Deposit Insurance Corp.*, 606 F. Supp. 683 (D.D.C. 1985) (holding that a state nonmember bank could own a securities firm subsidiary even though the bank could not itself engage in the activities of the subsidiary); and *Securities Industry Association v. Federal Home Loan Bank Board*, 588 F. Supp. 749 (D.D.C. 1984) (holding that federal savings and loan associations could indirectly own a corporations engaged in an activity not permissible for the associations).

As noted above, the proposed underwriting and dealing activities represent an incremental expansion of activities already conducted by national banks and this Bank in particular. Moreover, the proposed activities pose comparable risks to national banks as those associated with commercial lending and underwriting, dealing and investing in bank-eligible securities. Accordingly, the OCC has determined that the proposed activities will not result in significant or excessive risk to the Bank or the Subsidiary.

B. Corporate Separateness

In order to minimize any potential that securities underwriting and dealing risk may negatively affect the Bank, the Bank will be insulated, both structurally and operationally, from the Subsidiary.[52] For example, under the OCC's regulation governing operating subsidiaries, 12 C.F.R. § 5.34, there are a number of requirements intended to ensure the Subsidiary's independent legal and corporate existence.[53] Specifically, the Subsidiary is required to: (1) be physically separate and distinct in its operations from the Bank; (2) be held out as a separate and distinct entity from the Bank in its written materials and direct contact with outside parties, with all written materials clearly stating that the Subsidiary is a separate entity from the Bank and the obligations of the Subsidiary are not obligations of the Bank; (3) not have the same name as its parent Bank, and if the Subsidiary has a name similar to its parent Bank, to take appropriate steps to minimize the risk of customer confusion, including clarifying the separate character of the two entities and the extent to which their respective obligations are insured or not insured by the FDIC; (4) maintain separate accounting and corporate records; (5) conduct its operations pursuant to independent policies and procedures that are also intended to inform customers that the Subsidiary is an organization separate from the Bank; (6) contract with the Bank for any services only on terms and conditions substantially comparable to those available to or from independent entities; (7) observe appropriate separate corporate formalities, such as separate board of directors' meetings; (8) maintain a board of directors at least one-third of whom shall not be directors of the Bank and shall have relevant expertise capable of overseeing the Subsidiary's activities; and (9) have internal controls appropriate to manage the financial and operational risks associated with the Subsidiary. These internal controls must also be maintained by the Bank.

In addition to these limitations, section 5.34(f) requires that the Subsidiary be adequately capitalized according to relevant industry measures and maintain capital adequate to support its activities and to cover reasonably expected expenses and losses. When the Subsidiary is engaged in a principal capacity in activities authorized under section 5.34(f), as in this case, certain additional supervisory requirements will protect the financial soundness of the Bank.[54] For example, section

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[52] This separation also is intended to ensure that any advantages associated with the federal safety net insuring bank deposits will not extend to the Subsidiary, a concern expressed by one commenter.

[53] *See* 12 C.F.R. § 5.34(f)(2).

[54] *See* 12 C.F.R. § 5.34(f)(3).

5.34(f) provides that for purposes of determining a bank's regulatory capital adequacy, the bank must deduct from its capital and total assets equity investments made in an operating subsidiary engaged in an activity different from that permitted for the bank, and the subsidiary's assets and liabilities shall not be consolidated with those of the bank. For risk-based capital purposes, 50% of the equity investment is deducted from Tier 1 capital and 50% from Tier 2 capital. In addition, the OCC may require the Bank to calculate its capital on a consolidated basis for purposes of determining whether the Bank is adequately capitalized under 12 C.F.R. Part 6 (prompt corrective action). The regulation also provides that a national bank must be well-capitalized before commencement of the activity. The Bank clearly satisfies this requirement. If the Bank ceases to be well-capitalized for two consecutive quarters, it must submit a plan to the OCC detailing how it will become well-capitalized.

Moreover, transactions between the Bank and the Subsidiary will be subject to the limitations in sections 23A and 23B of the Federal Reserve Act. Under the regulation, the standards of sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c and 371c-1, are made applicable to transactions between a bank and a subsidiary engaged in activities different from those permitted for the bank.[55] The application of these sections will limit the Bank's investments in and extensions of credit to the Subsidiary to 10% of the Bank's capital, require extensions of credit to be fully collateralized, and apply arm's-length safeguards to transactions between the Bank and the Subsidiary. Application of these standards also address concerns regarding inappropriate subsidization by the Bank of its Subsidiary.

In order to avoid customer confusion and minimize reputation risk in the Bank, the Subsidiary also will be required to provide each of its retail customers the same written and oral disclosures, and obtain the same customer acknowledgments, required by the Interagency Statement on Retail Sales of Nondeposit Investment Products. Further, no Bank director, officer, or employee may express an opinion on the corporate bonds or trust preferred securities underwritten or dealt in by the Subsidiary unless he or she notifies the customer of the Subsidiary's role. Together, these disclosures minimize the risk that customers may confuse the activities and obligations of the Subsidiary with those of the Bank.[56]

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[55] *See* 12 C.F.R. § 5.34(f)(3)(ii).

[56] Federal legislation in recent years also has provided the federal banking agencies with additional supervisory tools to address promptly supervisory concerns that may arise in connection with activities engaged in by banks or their subsidiaries. For example, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 provided substantial civil money penalties for national banks engaging in unsafe and unsound banking practices or for violations of conditions imposed in writing in connection with the grant of an application or other request by a national bank. Likewise, the Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub. L. 102-242, Dec. 19, 1991, 105 Stat. 2236), established a framework for prompt corrective action when banks fail to meet specified capital requirements, including the ability of the OCC to require an undercapitalized institution to divest any subsidiary that may pose a significant risk to the parent bank or that is likely to cause a significant dissipation of the institution's assets or earnings. These and other available supervisory actions provide the OCC with a substantial array of tools -- not available until relatively recently -- to address risks presented by national bank operating subsidiaries.

C. Supervision of Subsidiary

The Subsidiary will be subject to comprehensive supervision and functional regulation by securities regulatory authorities. The OCC, as the primary federal banking regulator, will be responsible for ensuring the safe and sound operation of the Bank and full compliance with the regulatory and supervisory conditions applicable to the Bank and the Subsidiary. The OCC has extensive experience and expertise in supervising national banks involved in underwriting, dealing and investing in government securities. Moreover, it is uniquely qualified to assess whether the activities are conducted in a safe and sound manner without undue risk to the Bank.

The Subsidiary will be subject to functional regulation under the Federal securities laws. In particular, the Subsidiary is registered with the SEC as a broker-dealer and will be subject to financial reporting, anti-fraud and financial responsibility rules applicable to broker-dealers. The Subsidiary must comply with the SEC's net capital rule, which imposes capital requirements on broker-dealers that vary with the degree to which a broker-dealer acts as a principal. The Bank represents that the Subsidiary will maintain capital in excess of these requirements. The Subsidiary also will be subject to the rules and regulations of the NASD. These requirements provide further protection against financial losses as a result of the proposed activities.

D. Safety and Soundness Conditions

As detailed above, the Subsidiary and the Bank are subject to a number of conditions and safeguards pursuant to 12 C.F.R. § 5.34(f). That section imposes numerous safeguards that apply to the parent bank and/or the subsidiary when the subsidiary engages in an activity authorized under 12 C.F.R. § 5.34(d), but different from that permitted for the bank. Collectively, these conditions will help to contain risk, reduce potential conflicts of interest, and ensure the safe and sound operation of the parent bank and the subsidiary.

The OCC recognizes that particular activities may give rise to the need for particular safeguards and conditions that are tailored to the activity in question. Accordingly, the OCC has included a number of conditions designed to further minimize the risk of securities underwriting and dealing to the Bank, its customers and the Subsidiary. For example, the Bank is required to establish internal controls to govern its participation in transactions underwritten or arranged by the Subsidiary. In addition, all intra-day extensions of credit by the Bank to the Subsidiary must be consistent with Section 23B of the Federal Reserve Act.

Other supervisory conditions are intended to protect consumers and address potential conflicts of interest. For example, the Bank is prohibited from lending to customers for the purpose of buying securities underwritten by the Subsidiary during the underwriting period. In addition, the Subsidiary is required to make the disclosures required under the Interagency Statement on Nondeposit Investment Products to ensure that customers of the Subsidiary do not confuse the Subsidiary with the Bank.

Bank employees, officers and directors are also prohibited from expressing opinions about securities underwritten by the Subsidiary unless the customer is notified that the Subsidiary is the underwriter.

Several of these conditions are patterned after the Federal Reserve's operating standards applicable to section 20 subsidiaries engaged in underwriting and dealing in securities.[57] These operating standards are tailored to address the risks of affiliation with an insured bank not addressed by other laws.[58]

The OCC will conduct a review of the Subsidiary prior to commencement of the proposed activities to ensure compliance with all supervisory conditions in the Application and the conditions set forth in 12 C.F.R. § 5.34(f).

V. CONCLUSION

For the reasons set forth above, including the representations and commitments made by the Bank and the Subsidiary and their representatives, we find that the proposed expansion of activities in the Subsidiary is legally authorized. Accordingly, this Application is hereby approved subject to following conditions which shall be applicable to the Bank and the Subsidiary, as indicated, in addition to the requirements set forth in 12 C.F.R. § 5.34:

1. The Bank shall adopt policies and procedures, including appropriate limits on exposure, to govern its participation in transactions underwritten or arranged by the Subsidiary. The Bank shall ensure that an independent and thorough credit evaluation has been undertaken in connection with its participation in such transactions, and that adequate documentation of that evaluation is maintained for review by the OCC.

2. The Subsidiary shall provide each of its retail customers the same written and oral disclosures, and obtain the same customer acknowledgments, specified by the Interagency Statement on Retail Sales of Nondeposit Investment Products, and comply fully with the NASD's Rule 2350,

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[57] *See* 62 FEDERAL REGISTER 45295 (August 27, 1997).

[58] *See, e.g.*, 12 C.F.R. § 5.34(f)(2)(iii) and (iv). Standards identical to the Federal Reserve's operating standards already apply to operating subsidiaries of national banks as a result of the conditions and requirements set forth in 12 C.F.R. § 5.34(f). Section 5.34(f) also contains certain requirements that exceed those contained in the new operating standards. For example, a bank that owns a subsidiary engaged in an activity as principal must be well-capitalized both before and after the activity commences and must have a CAMELS composite rating of "1" or "2," a CRA rating of "Outstanding" or "Satisfactory," and must not be subject to a cease and desist order, consent order, formal written agreement, or prompt corrective action order. *See* 12 C.F.R. §§ 5.3(g) and 5.34(f)(3)(iii). In addition, the subsidiary must be adequately capitalized according to relevant industry measures and maintain capital adequate to support its activities and cover reasonably expected expenses. *See* 12 C.F.R. § 5.34(f)(2)(iv).

which specifies requirements applicable to broker-dealers operating on the premises of financial institutions.[59]

3. A director, officer, or employee of the Bank may not express an opinion on the value or the advisability of the purchase or the sale of a bank-ineligible security that he or she knows is being underwritten or dealt in by the Subsidiary unless he or she notifies the customer of the Subsidiary's role.

4. The Bank shall not knowingly extend credit to a customer secured by, or for the purpose of purchasing, any bank-ineligible corporate bond that the Subsidiary is underwriting or has underwritten within the past 30 days, unless: (i) the extension of credit is made pursuant to, and consistent with any conditions imposed in a preexisting line of credit that was not established in contemplation of the underwriting; or (ii) the extension of credit is made in connection with clearing transactions for the Subsidiary.

5. Any intra-day extension of credit by the Bank to the Subsidiary shall be on market terms consistent with section 23B of the Federal Reserve Act.

6. The Bank and the Subsidiary shall submit quarterly to the OCC any FOCUS report filed with the NASD or other self-regulatory organizations, and any additional information required by the OCC to monitor compliance with the representations and commitments made by the Bank and the Subsidiary, these conditions, and the conditions provided in 12 C.F.R. § 5.34(f).

7. In the event that the Subsidiary is required to furnish notice concerning its capitalization to the SEC pursuant to 17 C.F.R. § 240.17a-11, a copy of the notice shall be filed concurrently with the OCC.

8. The Subsidiary's gross revenues derived from any bank ineligible underwriting and dealing shall not exceed 25% of its total gross revenues.

9. Prior to commencing the proposed activity, the OCC will conduct a review of the Subsidiary. Any deficiencies disclosed during this review must be satisfactorily resolved prior to commencing the activity. The Bank should notify the Examiner in Charge to schedule the review.

Please be advised that all conditions of this approval are "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818. As previously noted, at such time as the relevant provisions of the G-L-B Act are

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[59] *See* SEC Release No. 34-39294 (November 4, 1997), 62 F.R. 60542 (November 10, 1997).

effective, the Bank may request the OCC to modify the terms and conditions of this approval to be consistent with the new law.

/s/ 11-03-99

Julie L. Williams Date
Chief Counsel
Application Control Number: 1999-WO-08-0012