



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

**DECISION OF THE COMPTROLLER OF THE CURRENCY
ON THE APPLICATION BY
ZIONS FIRST NATIONAL BANK, SALT LAKE CITY, UTAH
TO COMMENCE NEW ACTIVITIES
IN AN OPERATING SUBSIDIARY**

December 11, 1997

I. INTRODUCTION

On April 8, 1997, Zions First National Bank (“Bank”), Salt Lake City, Utah applied to the Office of the Comptroller of the Currency (“OCC”) pursuant to 12 C.F.R. § 5.34(f) for its operating subsidiary, Zions Investment Securities, Inc. (“Subsidiary”), to commence new activities. The Subsidiary proposes to engage in underwriting, dealing in and investing in securities of states and their political subdivisions. The securities would include: (i) obligations of states and political subdivisions (“general obligation securities”) and (ii) other obligations of states and political subdivisions that do not qualify under the OCC’s current definitions as general obligation securities (hereafter “revenue bonds”).¹ The Subsidiary currently engages in providing brokerage and investment advisory services with respect to corporate equity securities, U.S. government securities, annuities and other securities and investment products. Although the Bank itself is experienced in underwriting and dealing in various government-issued securities, the Subsidiary does not currently underwrite or deal in any securities.

The OCC published notice and request for public comment concerning the Application in the *Federal Register* on April 18, 1997. The OCC received thirteen comments on the Application. The comment letters received by the OCC included three from national banks, three from trade associations (including bank and securities trade associations), one from a consumer advocacy group, four from communities in Utah, one from a federal bank regulatory agency, and one from a federal securities regulatory agency. The majority of comments recommended approval of the Application, noting the benefits, including the lower cost of financing, that local

¹ Section 16 of the Banking Act of 1933 (the “Glass-Steagall Act”), 12 U.S.C. § 24(Seventh), authorizes national banks to underwrite, deal and invest in general obligations and housing, university and dormitory bonds and hold municipal revenue bonds for investment purposes, but that section does not authorize national banks to underwrite or deal in municipal revenue bonds.

governments and taxpayers would enjoy from the increased competition in municipal financing. Most commenters also agreed that the proposed activity is legally permissible for an operating subsidiary of a national bank because it is part of or incidental to the business of banking and is allowable under the Glass-Steagall Act.

The OCC also received four comments in opposition to approval of the Application from the Securities Industry Association (SIA), a securities firm trade association, the Securities and Exchange Commission (SEC), the Board of Governors of the Federal Reserve System (Federal Reserve), and Consumers Union, a consumer advocacy group (collectively “the protestants”). Several of the protestants contend that an operating subsidiary of a national bank should not be permitted to engage in any activity that is not permissible for a national bank. They claim that permitting operating subsidiaries to engage in the proposed securities underwriting and dealing would vitiate the central purpose of the Glass-Steagall Act by allowing national banks to establish subsidiaries to underwrite and deal in securities prohibited for banks. In addition, the SIA objected to the Application on the grounds that the OCC does not have authority under the Bank Holding Company Act to permit an operating subsidiary of a national bank to underwrite and deal in bank-ineligible securities. The SEC expressed concerns regarding its ability to regulate and oversee the Subsidiary’s activities and how the Subsidiary would satisfy certain broker-dealer requirements. The SIA also requested a hearing on the Application prior to a decision by the OCC. This request has been separately addressed by the OCC.²

In addition, as part of its evaluation of the Bank’s Application, OCC staff has conferred with supervisory staff of the National Association of Securities Dealers, Regulation, Inc. (NASDR), the Securities and Exchange Commission (SEC), the Federal Reserve, and the Federal Reserve Bank of New York regarding their supervision of nonbank subsidiaries of bank holding companies (section 20 subsidiaries) engaged in securities underwriting and dealing. None of the agencies noted unique compliance or supervisory problems relating to underwriting and dealing in revenue bonds through section 20 subsidiaries.³ This also is consistent with the Federal Deposit Insurance Corporation’s (FDIC) general experience with the activities of *bona fide* securities subsidiaries of insured nonmember banks.⁴

² The OCC believes that the record on the Application is more than sufficient to permit it to make a fully informed determination on the Application. Accordingly, the OCC decided not to grant the SIA’s request for a hearing. See Letter to Marc E. Lackritz, President, Securities Industry Association from Troy Dixon, Director, Corporate Activity, OCC (November 14, 1997).

³ The Federal Reserve, in fact, recently noted that “the risks of securities underwriting and dealing have in the Board’s experience proven to be manageable in a bank holding company framework, and bank holding companies and banks have successfully undertaken and managed activities posing similar risks for which no firewalls were erected.” See 62 FEDERAL REGISTER 2622, 2623 (January 17, 1997).

⁴ 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.

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.⁵ 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.⁶

The OCC has carefully considered all of the information available to it, including the information and representations provided by the Applicant, and the comments from the public for and against 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.

II. THE BANK'S PROPOSAL

Under the proposal, the Subsidiary will engage in underwriting, dealing in and investing in revenue⁷ and general obligation bonds.⁸ The Subsidiary also will continue to provide brokerage

⁵ 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.

⁶ See *Id.*

⁷ The Subsidiary has proposed to underwrite and deal in revenue bonds that either are rated investment grade or, if not rated, are of sufficiently high credit quality as to warrant, in the judgment of the Subsidiary, an investment grade rating. In determining whether to underwrite and deal in unrated bonds, the Subsidiary will consult with employees of the Bank who are experienced in assessing the credit quality of issuers of non-rated bonds and who are not involved in the underwriting.

⁸ The Subsidiary has committed that the revenues derived from underwriting and dealing in revenue bonds will not exceed 25% of its total revenues. The OCC notes that 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). See *Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities*, 61 FEDERAL REGISTER 68750 (December 30, 1996) ("Revenue Test Notice").

and investment advisory services with respect to corporate equity securities, U.S. government securities, annuities, and other securities, and investment products to its retail customers. In addition, the Subsidiary has proposed to provide brokerage and investment advisory services with respect to revenue bonds it underwrites and deals in. In advising customers with respect to investment in revenue bonds, the Subsidiary has committed that it will inform its customers that it is an underwriter or dealer in such securities. The Subsidiary is registered as a broker-dealer with the SEC and is a member of the NASD.

The Subsidiary does not currently underwrite or deal in any securities. The Bank has significant experience in substantially similar activities, however, and will continue to conduct various securities activities directly. Specifically, for the past 21 years, the Bank has engaged in underwriting and dealing in general obligation bonds and in revenue bonds that are bank eligible (i.e., bonds for housing, university or dormitory purposes) (collectively, “bank-eligible bonds”).⁹ In addition, the Bank underwrites and deals in U.S. government and agency securities including U.S. Treasuries, and obligations issued by the Federal Home Loan Banks, Federal National Mortgage Association, Federal Home Loan Mortgage Association, the Small Business Administration and Student Loan Marketing Association. The Bank also is an experienced primary dealer in government securities and a member of the Government Agency Selling Group. It is the only primary dealer located between Chicago and California.

In addition to its underwriting activities, the Bank provides brokerage and advisory services to its institutional clients, including states and municipalities concerning the issuance of both general obligation and revenue bonds. If the Application is approved, the Bank expects to offer to its institutional customers, solely as agent, the revenue bonds underwritten by the Subsidiary. The Bank has committed that it will fully disclose that it acts solely as agent for its customers and that the Subsidiary is the underwriter or dealer of the securities.

III. LEGAL ANALYSIS

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.¹⁰ Accordingly, that is where we begin. Since the enactment of the National Bank Act in 1864, section 24(Seventh) has expressly authorized national banks to carry

⁹ The Bank has underwritten significant volumes of bank-eligible bonds over the last few years. For example, during 1996 the Bank co-managed the underwriting of over \$330 million aggregate principal amount of “bank-eligible” revenue bonds and managed, co-managed, or participated in the underwriting of over \$5.4 billion aggregate principal amount of general obligation bonds. *See Responses of Zions First National Bank in Connection with Application for Approval* (August 13, 1997).

¹⁰ *See Caminetti v. United States*, 242 U.S. 470, 485 (1917) and *Board of Governors of the Federal Reserve System v. Dimension Financial Corp.*, 474 U.S. 361, 368 (1986).

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 was part of the business of many banks.

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 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 Revenue Bonds is Part of the Business of Banking

The authority to underwrite and deal in revenue bonds 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. The specific legal basis for underwriting and dealing in debt securities was the authority to “discount and negotiate evidences of debt.” 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 is Part of the Business of Banking

Underwriting and dealing was 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, had been major providers of long-term credit to governments, investing their capital in government securities, selling securities and providing long-term loans.¹¹ 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

¹¹ See F. Redlich, *The Molding of American Banking: Men and Ideas, Vol. II* (1951) at 324.

investment banking as a line of their regular business.¹² Commercial bank involvement in investment banking continued to grow as a result of the immense financing needs of the Civil War and the railroads.

With the enactment of the National Currency Act in 1863¹³, 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.¹⁴ 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).¹⁵

¹² See Redlich, *Vol. I, supra* at 50.

¹³ The National Currency Act was renamed the National Bank Act in 1864.

¹⁴ See Vincent P. Carosso, *Investment Banking in America: A History* (Harvard University Press, Cambridge 1970) at 23.

¹⁵ 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”).

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* 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. The Glass-Steagall Act did not redefine the business of banking to exclude investment banking functions. Indeed, both the McFadden Act and the Glass-Steagall Act 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 Revenue Bonds is 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). This authority to discount and negotiate evidences of debt clearly encompasses the power to underwrite and deal in debt securities, such as revenue bonds. First, the term “evidences of debt” includes a debt security such as a revenue bond. A revenue bond reflects the debt obligation of a state or its political subdivision to be repaid from the revenues generated by the project that the bond finances. Thus, a revenue bond represents evidence of debt on the part of the issuer.

Second, the phrase “to discount and negotiate” includes the power to buy and sell as principal. The courts have long held that the term “discount” includes purchases of notes and

other evidences of debt.¹⁶ And negotiation is a form of transfer, disposition or sale.¹⁷ Moreover, the authority to discount and negotiate is not subject to limitation. 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.

Prior to enactment of the McFadden Act and the Glass-Steagall Act, this power served as the legal basis for many of the investment banking activities of national banks.¹⁸ Thus, although the McFadden Act and the Glass-Steagall Act later provided that national banks could not 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.

3. Underwriting and Dealing in Revenue Bonds is also Part of the General Business of Banking.

Underwriting and dealing in revenue bonds is not only authorized by an enumerated power but also can be viewed as part of the general business of banking because of the financial nature of the activity and the relationship of the activity to other traditional banking functions. As noted above, national and state banks have a long tradition of underwriting and dealing in many types of government securities.¹⁹ In addition, national banks have substantial experience and expertise in investing in and analyzing revenue bonds and similar debt instruments for their own accounts. Thus, underwriting and dealing in revenue bonds is the functional equivalent of, or logical,

¹⁶ 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. 1986).

¹⁷ *Black's Law Dictionary* 934 (5th ed. 1979); 28 *Words and Phrases* 758-766 (West 1955 & Supp. 1986).

¹⁸ 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'.")

¹⁹ Nineteen states, including the Bank's home state of Utah (Utah Code Ann. § 7-3-3.2 (1996)), expressly permit state banks to engage directly or through operating subsidiaries in municipal revenue bond underwriting. See "State-authorized Powers -- Municipal Bond Underwriting" in *The Profile of State Chartered Banking* (The Conference of State Bank Supervisors, 1996). The activity is subject to the approval of the bank's primary federal banking regulator. The fact that state banks and their subsidiaries are authorized under state law to engage in revenue bond underwriting is evidence that revenue bond underwriting is part of the business of banking.

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. It also involves risks similar in nature to those already assumed by banks.²⁰

a. Underwriting and dealing in revenue bonds is a functional equivalent or a logical outgrowth of activities currently conducted by national banks.

Underwriting and dealing in revenue bonds is the functional equivalent or a logical extension of the underwriting and dealing activity currently being conducted safely and soundly by national banks. Underwriting involves the bank in its primary function as a financial intermediary, a “dealer” in capital, facilitating the flow of money and credit among different parts of the economy.²¹ The role of a bank as underwriter of revenue bonds is to channel funds of investors to municipalities in need of capital. In that respect, it is similar to the role of banks in lending funds of its depositors to businesses to finance their capital needs.

The proposed underwriting and dealing in municipal revenue bonds also is the functional equivalent or logical outgrowth of a national bank’s authority in Section 16 of the Glass-Steagall Act to underwrite and deal in various types of revenue bonds, including those issued for housing, university or dormitory purposes, as well as municipal general obligation bonds (GOs). 12 U.S.C. § 24(Seventh).²² Functionally, there is no significant difference between underwriting the proposed revenue bonds and the types of revenue bonds enumerated in section 16, and little difference between underwriting the municipal revenue bonds and underwriting general obligation bonds.²³

²⁰ 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).

²¹ *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.

²² Section 16 also authorizes national banks to underwrite and deal in U.S. government and agency securities. 12 U.S.C. § 24(Seventh).

²³ The Federal Reserve has previously determined that underwriting and dealing in municipal revenue bonds is a “natural extension of activities currently conducted by bank, involving little additional risk . . . and potentially yielding significant public benefits in the form of increased competition and convenience and lower cost.” *Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation*, 73 FEDERAL RESERVE BULLETIN

Municipal revenue bonds, like housing, university, dormitory bonds, and GOs, are debt obligations of a state or political subdivision, such as a county, city, town, village or municipal authority, issued for public purposes. In addition, the interest from the bonds, in most cases, is exempt from federal and state income taxation, and all of these types of bonds are subject to some credit, interest rate, and liquidity risk.²⁴

The only significant difference between these bonds is the source of repayment from the issuer. Both municipal revenue bonds and housing, university and dormitory bonds are repaid from the revenues of the facility or project financed by the bonds.²⁵ In contrast, GOs are backed by an issuer's general taxing powers and its full faith and credit. The presence of full faith and credit in a GO is reflected in the pricing of the bond and does not materially alter the nature of the activities involved in underwriting the bonds.

Indeed, underwriting and dealing in the proposed revenue bonds involves the same basic functions as underwriting and dealing in bank-eligible securities.²⁶ For both bank-eligible securities and revenue bonds, 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 issuer²⁷ 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

473, 487 (1987). In the Federal Reserve's view, "definite functional and operational similarities exist between the securities that member banks may underwrite and deal in and . . . municipal revenue [bonds]." *Id.* at 488.

²⁴ The credit risk from the proposed revenue bonds is no different from other types of revenue bonds, such as housing and university bonds. Moreover, although general obligation bonds are often viewed from an investor's perspective as safer than revenue bonds, both GOs and revenue bonds, unlike U.S. government securities, expose the investor to credit risk. The perceived safety of a GO is premised on the fact that it is backed by the taxing authority and full faith and credit of the issuer. Theoretically, this power is unlimited. However, political considerations can and do limit the ability of issuers to use this power.

²⁵ For example, the revenues securing college and university revenue bonds usually include dormitory room rental fees, tuition payments, and sometimes the general assets of the college or university. *See* Frank J. Fabozzi, ed., *The Handbook of Fixed Income Securities*, 5th ed. (Chicago: Irving Professional Publishing, 1997) at 436 and 437.

²⁶ The Federal Reserve has previously determined that "the techniques involved in underwriting bank-eligible securities are the same, or substantially the same, as those that would be involved in conducting [municipal revenue bond] underwriting . . ." *Citicorp/J.P. Morgan & Co. Incorporated/Bankers Trust New York Corporation*, 73 FEDERAL RESERVE BULLETIN 473, 488 (1987).

²⁷ Because revenue bonds, unlike GOs, are not supported by the taxing authority of the State or municipality, the Subsidiary may be required to conduct a more extensive credit analysis and evaluation of the issuer than is required for general obligation bonds. The analysis required is essentially the same, however, as that required for other types of bank-eligible revenue bonds, such as housing-related bonds. Moreover, it is closely analogous to the credit analysis banks perform in their traditional lending activities.

underwriter's own account. Banks perform similar functions when they underwrite eligible securities. Thus, the activities involved in underwriting and dealing in revenue bonds are the functional equivalent or a logical extension of underwriting and dealing in bank-eligible securities.²⁸

b. Underwriting and dealing in revenue bonds potentially benefits local governments and taxpayers and increases bank revenues.

The Bank's proposal to underwrite and deal in revenue bonds through its operating subsidiary would also produce substantial benefits for local governments and taxpayers by providing communities with greater access to the municipal bond market and increasing competition in municipal bond underwriting. As the Bank notes, the number of firms involved in municipal financing has sharply declined over the last decade, decreasing the competition for revenue bond underwritings.

Since 1995, four major securities firms have eliminated their municipal financing businesses.²⁹ Three other major firms had previously left the business or substantially reduced their operations.³⁰ As several communities commenting on the Application noted, this reduction in competition has led to higher financing costs for many public issuers, particularly smaller communities. Indeed, several commenters noted that many communities, particularly smaller communities, no longer have access to the municipal bond market to finance small issuances. The increased competition from having additional participants in municipal bond underwriting should serve to reduce interest rates and underwriting costs for local governments. In addition, taxpayers would benefit from the lower taxes and improved services that lower financing costs and increased access to public financing should yield. Approval of the proposal should also result in greater convenience for municipal customers desiring this form of financing.

In addition, approval of the proposed activity would enable national banks to diversify their activities through operating subsidiaries and generate new sources of revenue. This activities diversification can have important benefits. Fees and other income from the subsidiaries may

²⁸ The proposed underwriting activity also involves functions that are a logical outgrowth of other traditional banking activities. For example, the credit analysis required involves the same kind of assessment as is required when the bank purchases revenue bonds for its own account. In addition, the distribution function is similar to the activity banks perform when they arrange loan syndications.

²⁹ The firms include CS First Boston, Donaldson, Lufkin & Jenrette, Lazard Freres, and Chemical Securities. See "Memorandum in Support of the Application of Zions First National Bank to Commence New Activities Through an Operating Subsidiary," at 19 ("Zions Memorandum").

³⁰ Other major firms have either left the business (Salomon), been largely liquidated (Kidder Peabody) or substantially reduced their operations (Dean Witter). See Zions Memorandum, *supra*, at 19.

enable banks to offset the effects of cyclical downturns in other sectors of the economy.³¹ Hence, bank earnings would be less volatile, reducing risks to the banking system as a whole. As former FDIC Chairman Helfer stated recently, allowing a bank to conduct new activities in a bank 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 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

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

The risks an operating subsidiary assumes in underwriting and dealing in revenue bonds are essentially the same risks as those associated with the permissible activity of underwriting and dealing in bank-eligible securities³⁴ and investing in revenue bonds.³⁵ The primary risks³⁶ of

³¹ 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.

³² Testimony of Ricki Helfer, *supra*, at 23.

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 In order to limit the risks of underwriting and dealing, national banks are subject to a 10% capital limitation per issuer for certain bank-eligible securities, such as housing or dormitory bonds.

³⁵ National banks actively engage in holding and trading revenue bonds for their own account. This activity poses a risk of loss comparable to holding such securities as principal in an underwriting or dealing capacity. See 12 C.F.R. Part 1. In order to limit the risks of underwriting and dealing, national banks are subject to a 10% capital limitation per issuer for certain bank-eligible securities, such as housing or dormitory bonds.

³⁶ Other risks associated with underwriting and dealing in revenue bonds 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. For example, both general obligation underwriting and revenue bond underwriting are subject to the rules of the Municipal Securities Rulemaking Board (MSRB), and the underwriter of both types of bonds is subject to oversight by the National Association of Securities Dealers, Regulation, Inc. (NASDR). Accordingly, the compliance risk associated with revenue bond underwriting is the same as that associated with underwriting general obligations. Similarly, because there are no substantial differences between the bank-eligible underwriting the Bank currently conducts and the proposed underwriting activities, there is no significant new strategic risk associated with the proposed “new line of business.”

underwriting, dealing and investing in both bank-eligible and bank-ineligible securities are reputation risk³⁷ and price risk.³⁸ National banks, and this Bank in particular, are very experienced in managing these types of risks as a result of their permissible underwriting and dealing activities, their permissible investment activities, and their traditional lending functions.³⁹ Moreover, national banks have extensive expertise in evaluating the risk characteristics of revenue bonds as a result of their direct ability to invest in revenue bonds and similar securities for their own account.

B. National Banks are Authorized to Own Operating Subsidiaries as an Incident to the Business of Banking

It is well-settled that national banks may own operating subsidiaries as an incident to being in business.⁴⁰ The OCC, the courts, and Congress have consistently recognized that national banks can own subsidiaries to conduct the business of banking.

The OCC has long recognized the authority of national banks to own subsidiaries. In the 1960s, the OCC first approved the establishment of operating subsidiaries through a series of rulings and regulations governing bank ownership of operating subsidiaries. In 1965, for example, Comptroller of the Currency Saxon permitted a national bank to acquire all of the outstanding stock of a trust company after concluding that 12 U.S.C. § 24(Seventh) allows national banks to “own corporate stock, or interests therein, when such ownership is a proper

³⁷ 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 Comptroller’s Handbook, Large Bank Supervision, Supervision by Risk* at 21.

³⁸ 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 Comptroller’s Handbook, Large Bank Supervision, Supervision by Risk* at 19.

³⁹ As the Federal Reserve noted, in approving this same activity for commonly controlled sister companies of banks in 1987:

The risks associated with underwriting and dealing in any revenue bond, whether eligible or not, are generally a function of the price volatility of the security, as well as the cash flow and viability of the project being financed. These risks are not, in the Board’s view, significantly greater for ineligible revenue bonds than for eligible bonds, given the very close functional similarity between the two kinds of obligations.

Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation, 73 Federal Reserve Bulletin 473, 493 (1987).

⁴⁰ National banks are authorized to engage in activities that are incidental to enumerated powers or the business of banking under section 24(Seventh). *See VALIC, supra*, 513 U.S. at 258, n.2. This authority includes incidental activities necessary to conduct a business so that a bank may engage in activities that are convenient and useful to the conduct of its business, including ownership of operating subsidiaries. *See Op Sub Legal Opinion* at 2-18.

incident to banking.”⁴¹ In 1966, the OCC adopted a regulation, 12 C.F.R. § 7.10 confirming that national banks could own subsidiaries.⁴² The OCC approved 296 applications to establish or perform new activities in operating subsidiaries in 1996. These subsidiaries are engaged in a wide range of banking related activities.

In upholding the authority to own subsidiaries, the OCC has consistently interpreted the limitation on stock purchases added by section 16 of the Glass-Steagall Act in section 24(Seventh) as preventing national banks from undertaking investment banking activities with respect to shares of stock, i.e., engaging in the types of speculative stock purchases that were the object of the Act, not as a bar to the ability of national banks to have subsidiaries or to own stock, where such ownership is “otherwise permitted by law.”⁴³ One such “law” is the powers clause of 12 U.S.C. § 24(Seventh), which was unaffected by the section 16 changes. That clause, as explained above, states that a national bank is expressly authorized to carry on the business of banking and may exercise “all such incidental powers as shall be necessary” to carry on that business. Pursuant to that authority, banks may establish operating subsidiaries to conduct the business of banking.

The courts have consistently upheld the OCC’s position that national banks can own and operate subsidiaries. *See, e.g., VALIC, supra* (a national bank and its operating subsidiary had asked the permission of the OCC to sell annuities, and the Supreme Court held this would be lawful); *Clarke v. Securities Industry Association*, 479 U.S. 388 (1989) (operating subsidiaries of national banks can engage in the securities brokerage business at various nonbank locations); *American Insurance Association v. Clarke*, 865 F.2d 278 (D.C. Cir. 1987) (a national bank’s operating subsidiary can be a municipal bond insurance company).

Congress also has repeatedly recognized the authority of national banks to own subsidiaries through numerous legislative enactments. For example, the changes made to 12 U.S.C. § 24(Seventh) by the McFadden Act in 1927 and the Banking Act of 1933, including the Glass-Steagall Act, confirm that Congress also believed that national banks had the authority to own subsidiaries pursuant to their incidental powers. In each instance, the statute placed limitations on bank subsidiary activities, presupposing the ability of national banks to own and operate subsidiaries, even though such ownership is not expressly identified in the statute.

⁴¹ OCC Letter from Comptroller Saxon (unpublished) (July 30, 1965) (*emphasis added*); *See also* 12 C.F.R. § 7.10 (39 Fed. Reg. 11459 (August 31, 1966)) (explaining the authority of national banks to own subsidiaries); Op Sub Legal Opinion at 15-17.

⁴² *See* 39 FEDERAL REGISTER 11459 (August 31, 1966).

⁴³ That section provides: “Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase [by the bank] of any shares of stock of any corporation.” 12 U.S.C. § 24(Seventh).

The McFadden Act limited the amount a national bank could invest in a corporation that conducted the safe deposit business. The limitation on investment in corporations involved in the safe deposit business makes sense only if banks already had authority to own this type of corporation under 12 U.S.C. § 24(Seventh).⁴⁴ Similarly, in one of many examples from the 1933 Act supporting this proposition, that Act limited the amount a national bank could invest in a bank premises subsidiary corporation, thereby acknowledging the continued lawfulness of the activity.⁴⁵ Indeed, the scope of these provisions would make no sense unless Congress believed that national banks had the authority in the first place to control a company as a subsidiary.⁴⁶

Accordingly, there can be no question that national banks may conduct the business of banking through operating subsidiaries.

⁴⁴ See Op Sub Legal Opinion at 5-6.

⁴⁵ Indeed, the 1933 Act amounted to a comprehensive scheme of recognition and regulation of the ownership by national banks (and state member banks) of subsidiaries and other types of affiliates. Section 5 gave state member banks the same power, but no more, to own corporate stock as was possessed by national banks under the authority of 12 U.S.C. § 24(Seventh). Section 2(b) defined a member bank's affiliate to include a company owned by the bank as a subsidiary. Section 13 imposed capital-based limitations on the amount of stock a member bank could own in affiliates. It also added a new section 23A to the Federal Reserve Act (12 U.S.C. § 371c). The new section imposed qualitative standards and collateral limits on transactions between member banks and their affiliates. Section 14 required a national bank to obtain the OCC's permission in order to invest more than 100 % of its capital funds in the stock of a bank premises corporation. Section 20 allowed a member bank to own the stock of a securities affiliate so long as the company was not engaged principally in the issue, underwriting or distribution of securities. And section 28(a) added a new provision to 12 U.S.C. § 481, authorizing the OCC to examine all of the affiliates of national banks. Together, these provisions clearly presuppose that national banks had the authority to own subsidiaries. See also Op Sub Legal Opinion at 11-14.

⁴⁶ Congress has continued to acknowledge the authority of national banks to own subsidiaries in recent years. For example, the Banking Affiliates Act of 1982, Pub. L. No. 97-320, 96 Stat. 1515-1520, comprehensively revised section 23A of the Federal Reserve Act. In several provisions, the legislation gave subsidiaries of member banks special attention. As now amended, section 23A(a) assumes the authority of national banks and state member banks to own subsidiaries and, in contrast to section 20 of the Glass-Steagall Act, provides that the bank and its subsidiaries will be regulated in the same way, as a unit. Thus, under section 23A, transactions between a bank's subsidiaries and the other affiliates of the bank were made subject to the same controls that apply to direct dealings between the bank itself and those same affiliates. Similarly, in 1987, Congress added a new section 23B to the Federal Reserve Act, placing further restrictions on transactions of member banks and their subsidiaries with their affiliates, Pub. L. No. 100-86, sec. 102(a), 101 Stat. 564-567. The member bank "and its subsidiaries," by virtue of section 23B(a), could henceforth engage in transactions with affiliates only on terms and conditions that were at least as favorable "to such bank or its subsidiary" as those prevailing for comparable transactions in the marketplace or that would be offered to unaffiliated companies. None of these provisions would make any sense unless Congress understood that national banks and state member banks had authority to own subsidiaries. Moreover, these provisions demonstrate that when Congress intended bank subsidiaries to be subject to the same standard that applied to their parent bank, Congress knew how to say so.

C. 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.”⁴⁷ This is most clearly demonstrated by the different treatment Congress afforded national banks and their affiliates under the Glass-Steagall Act.⁴⁸

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.⁴⁹ “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.⁵⁰

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

⁴⁷ *Securities Industry Association v. Federal Reserve System*, 839 F.2d 47, 59 (2d Cir. 1988).

⁴⁸ 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.

⁴⁹ Section 5 of the Act applied these restrictions to state-chartered member banks. 12 U.S.C. § 335.

⁵⁰ 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).

which the bank may not directly underwrite or deal.⁵¹ 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).

An operating subsidiary is a company that is more than 50% owned or controlled by a national bank.⁵² 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

⁵¹ Applying the plain language of section 20, the Federal Reserve has previously permitted 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).

⁵² 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).

20 of the Glass-Steagall Act (12 U.S.C. § 377).⁵³ The Subsidiary, in this case, has committed that the revenues derived from its proposed revenue bond underwriting and dealing activities 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, it would not frustrate the purposes of the Glass-Steagall Act to permit revenue bond underwriting and dealing in a subsidiary of a national bank.⁵⁴

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

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.

Most recently, the OCC revised its regulation on operating subsidiaries to permit 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

⁵³ See *Revenue Test Notice, supra*.

⁵⁴ 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 Banking and Currency*, 73rd, Cong., 2d Sess (1934). See *Hearings on S. 4115, supra*, at 391-392. 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. (*emphasis added*). See also Op Sub Legal Opinion, *supra*, at 8, 11-12.

authorized by law and that the limitation applicable to the bank does not apply to the subsidiary.⁵⁵ The new regulation is intended to clarify the OCC's position regarding whether the operating subsidiaries are subject to the same federal laws as apply to national banks. In the past, the OCC had generally taken a position that operating subsidiaries were subject to the same laws as national banks. Nevertheless, over the years, the OCC has made numerous exceptions to this policy when deemed appropriate in the circumstances, and has allowed subsidiaries to engage in banking and incidental-to-banking activities even though their parent bank could not engage in those activities directly.

For example, a letter from Deputy Comptroller DeShazo, dated October 25, 1967, permitted a Pennsylvania national bank to acquire up to 100% of the common stock of a commercial finance company headquartered in New York City where it conducted the bulk of its business. The approval was codified in Paragraph 7376 of the Comptroller's rulings (the operating subsidiary ruling). Nothing was said about any geographical problem or branching issue under 12 U.S.C. § 36, even though the bank could not be located in New York. The statement was made that "the operations of the finance company will *in general* be subject to the same laws and regulations as it is now after acquisition by the bank." (*Emphasis added*).

In addition, a January 1968 letter signed by Deputy Comptroller Watson held a mortgage company subsidiary's borrowing would be treated as being independent from the parent national bank's borrowings. This avoided a problem under the then-applicable capital limitations imposed on national bank borrowings by 12 U.S.C. § 82. The mortgage company also was allowed to buy real estate for its own future development purposes, and to make loans to finance a development tract on terms that would be impossible for the parent national bank under 12 U.S.C. §§ 84 and 371. The Watson letter explained why in this concluding statement:

a [controlled subsidiary corporation of a national bank] is a separate, legal entity, apart from its parent corporation, operating under its own charter and articles of incorporation with corporate power and authority to own property and to carry on its business. Accordingly, the Commerce Mortgage Company may pursue such activities which are consistent with its doing business as a mortgage servicing corporation.

More recently, operating subsidiaries have been permitted to act as a general partner in various types of business enterprises, despite the Supreme Court's holding in *Merchants National Bank v. Wehrmann*, 202 U.S. 295 (1906), that it is *ultra vires* for a national bank to take on the unlimited liability of a general partner in a partnership.⁵⁶ The OCC reasoned in these cases that an

⁵⁵ Three commenters objected to the application on the grounds that national bank subsidiaries should not be permitted to engage in any activity prohibited for the bank itself.

⁵⁶ See, e.g., Interpretive Letter No. 541 (Feb. 6, 1991), *reprinted in* [1990-91 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83, 253 (affirming an earlier letter which permitted an operating subsidiary to act as general partner in a commodity pool); Interpretive Letter No. 423 (April 11, 1988), *reprinted in* [1988-89 Transfer

operating subsidiary could lawfully be a general partner because the unlimited partner liability would be cut off at the level of the subsidiary and not flow through to the parent bank, thereby addressing the issue that concerned the Court in the *Wehrmann* case.

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.⁵⁷ 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 activities such as underwriting."⁵⁸ As a result, the court noted that "bank affiliates may be authorized to engage in certain activities that are prohibited to banks themselves."⁵⁹

In *Investment Company Institute v. Federal Deposit Insurance Corp.*, 606 F. Supp. 683 (D.D.C. 1985) the district court upheld a regulation issued by the FDIC to "govern the manner in which nonmember state banks can arrange to own subsidiaries . . . engaged in aspects of the securities business, particularly underwriting various types of securities,"⁶⁰ The court held 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. The case hinged on the scope of section 21 of the Glass-Steagall Act, which prohibits insured non-member state banks from engaging directly in a full-scale securities business.⁶¹ The plaintiffs argued that the restrictions of section 21 also

Binder] Fed. Banking L. Rep. (CCH) ¶ 85, 647 (operating subsidiary can act as managing general partner in a venture formed to invest in real estate mortgage-related assets); and Interpretive Letter No. 289 (May 15, 1984), *reprinted in* [1983-84 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85, 453 (approving an operating subsidiary to act as general partner of a partnership formed to establish ATMs).

⁵⁷ The Court also pointed out that the bank itself could engage in the activity. *See Id.* at 62.

⁵⁸ *Id.* at 64.

⁵⁹ *Id.* at 60. *See also SIA v. Board of Governors, Federal Reserve System*, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059, 108 S. Ct. 2830; *SIA 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).

⁶⁰ *Id.* at 684.

⁶¹ 12 U.S.C. § 378. The Supreme Court has found that Sections 21 and 16 "seek to draw the same line" and that section 21 cannot be read to prohibit what section 16 permits. *SIA v. Board of Governors*, 468 U.S. 137, 149 (1984); *See also Board of Governors v. Investment Company Institute*, 450 U.S. 46, 63 (1981); *SIA v. Board of Governors*, 807 F.2d 1052, 1057 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005, 107 S.Ct. 3228 (1987).

included subsidiaries of a bank and that subsidiaries should be treated as “alter egos” of their parent bank. The court rejected the effort to include the subsidiary within the limitations applicable to its parent under section 21, finding no Congressional intent to apply that section to an entity separate from a bank, even one that the bank controlled.

In *Securities Industry Association v. Federal Home Loan Bank Board*, 588 F. Supp. 749 (D.D.C. 1984) (*SIA v. Bank Board*), the Federal Home Loan Bank Board (“Bank Board”) had permitted several federal savings and loan associations to own service corporations which, in turn, owned out-of-state subsidiaries engaged in securities brokerage and investment advisory activities. These subsidiaries of service corporations were partially owned by investors that were not S&Ls. The applicable statute, section 5(c)(4)(B) of the Home Owner’s Loan Act (“HOLA”), permitted federal S&Ls to invest in service corporations, but required that the corporation be organized under the laws of the state in which the home office of the S&L is located, and that its stock be available for purchase only by S&Ls in that state. No mention of, or provision for, subsidiaries of service corporations was contained in the statute.

The parties to the lawsuit agreed as to the material facts, that the federal S&Ls in question could not themselves engage in the securities brokerage and investment advisory activities, nor could they directly own the out-of-state jointly-owned subsidiaries which were engaged in this business. The court nevertheless held that the federal S&Ls’ service corporations could own those subsidiaries. It observed that “[e]xcept in unusual circumstances,” courts will not disregard the separate identities of a parent and its subsidiary, even a wholly-owned subsidiary.⁶² Such separate existence will not be disregarded “merely because the corporate arrangement allows an affiliate or subsidiary to engage in activities which an affiliated or parent corporation is statutorily prohibited from doing.”⁶³

The court accepted the Bank Board’s ruling that the activities of the service corporations’ subsidiaries were “reasonably related to the activities” of federal S&Ls.⁶⁴ It also observed that the Board “must be permitted to adapt the regulatory structure of HOLA to the changing needs of the economy” and that the Board’s determination with respect to the S&Ls’ service corporations was “consistent with HOLA.”⁶⁵

⁶² *SIA v. Bank Board*, *supra*, 588 F.Supp. at 754-55, citing *Labadie Coal Co. v. Black*, 672 F.2d 92, 96 (D.C. Cir. 1982); and *Quinn v. Butz*, 510 F.2d 743, 759 (D.C. Cir. 1975).

⁶³ *Id.* at 755, citing *Board of Governors, FRS v. Investment Company Inst.*, 450 U.S. 46 (1981).

⁶⁴ *Id.* at 754.

⁶⁵ *Id.* See also *Rettig v. Arlington Hgts. Fed. Sav. & Loan Ass’n*, 405 F. Supp. 819, 824 (N.D. Ill, E.D. 1975) (Subsidiaries of federal S&Ls can engage in the insurance agency business even though the parent S&Ls cannot engage in the business themselves).

In conclusion, affiliates and operating subsidiaries of national banks may engage in activities different from those permitted for a national bank under certain circumstances. However, 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. As explained above, the proposed activities of the Subsidiary clearly 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 20.⁶⁶ 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 municipal revenue bond 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

As noted above, the proposed municipal revenue bond activities represent an incremental expansion of activities already conducted by national banks and this Bank in particular.⁶⁷ The revenue bonds which the Subsidiary proposes to underwrite and deal in are substantially equivalent to revenue bonds national banks are permitted to underwrite, deal, and invest in under

⁶⁶ The OCC notes that it submitted a report to Congress on its revisions to 12 C.F.R. Part 5, which includes the regulation governing operating subsidiaries, as required under the Small Business Regulatory Enforcement Fairness Act of 1996 ("1996 Act"), Pub. Law 104-121 (1996). The regulation, as noted above, provides that an operating subsidiary of a national bank may engage in activities different from that permitted for its parent bank as long as the activities are part of the business of banking or are otherwise authorized by law. Congress took no action, as is authorized under the 1996 Act, to negate the effectiveness of that regulation.

⁶⁷ In 1982, Federal Reserve Board Governor J. Charles Partee testified that the Federal Reserve favors granting banks the authority to underwrite and deal in most state and government revenue bonds, noting that the activity is a "natural extension of activities already being done by banks." See Statement of J. Charles Partee, Member, Board of Governors of the Federal Reserve System before the Senate Banking Committee, February, 1982.

section 16 of the Glass-Steagall Act.⁶⁸ Moreover, the proposed activities pose comparable risks to national banks as those associated with underwriting, dealing and investing in bank-eligible securities. These risks are mitigated by the Bank's substantial experience and expertise as a municipal securities dealer. The OCC notes that many of the same individuals now associated with the Bank's government securities activities will be employed by the Subsidiary. Moreover, as noted above, other regulators that have experience with bank affiliates engaged in the proposed types of activities indicated that they have not had significant or unusual compliance or supervisory concerns with those affiliates. 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. 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.⁶⁹ 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

⁶⁸ The Federal Reserve has previously determined that municipal revenue bond underwriting and dealing is "substantially similar to operations safely and soundly being conducted presently by member banks [and] would not result in significant or excessive risk." See *Citicorp, J.P. Morgan & Co. Incorporated/Bankers Trust Corporation*, 73 Federal Reserve Bulletin 473, 493 (1987).

⁶⁹ See 12 C.F.R. § 5.34(f)(2).

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.⁷⁰ For example, section 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.⁷¹ The application of these sections will limit the Bank's subsequent 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. The arm's-length standards also address concerns regarding inappropriate subsidization by the Bank of its Subsidiary.

In addition, 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 revenue bonds underwritten or dealt in by the Subsidiary unless he or she notifies the customer of the Subsidiary's role. The Bank also has committed to disclose its relationship with the Subsidiary to its customers when it acts as agent in the sale of securities underwritten or dealt in by the Subsidiary. Together, these disclosures minimize the risk that customers may confuse the activities and obligations of the Subsidiary with those of the Bank.⁷²

⁷⁰ See 12 C.F.R. § 5.34(f)(3).

⁷¹ See 12 C.F.R. § 5.34(f)(3)(ii).

⁷² 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

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.

In addition, the Subsidiary will be subject to functional regulation under the Federal securities laws.⁷³ 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.⁷⁴ 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 and

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.

⁷³ When the OCC proposed revisions to its regulation governing operating subsidiaries, the Securities and Exchange Commission did not object, but requested OCC confirmation that: (1) securities activities conducted in operating subsidiaries would be subject to regulation under the Federal securities laws, and (2) the OCC's regulation would not allow activities previously not permitted for a bank itself to be shifted from an operating subsidiary to the bank. In the final rule, the OCC confirmed that operating subsidiaries that conduct securities activities are fully subject to the Federal securities laws and that the new rule would not be used to authorize national banks to directly conduct activities not previously permitted for national banks. See 61 FEDERAL REGISTER at 60351, n. 1.

⁷⁴ In its comment letter, the SEC expressed concern that aspects of the Bank's proposal may not comply with certain regulatory requirements under the Securities Exchange Act of 1934. The Bank and the Subsidiary have committed to comply with all applicable federal securities laws and regulations, including the SEC's financial responsibility regulations. The OCC notes that the Subsidiary must notify and obtain the approval of the NASD prior to commencing the proposed activities. Through that process, the NASD reviews the proposal to assure compliance with the federal securities laws. Another concern expressed by the SEC related to the extent to which securities regulatory and self-regulatory authorities will be able to supervise the Subsidiary and to examine, investigate and, if necessary, discipline the Bank for activities related to the Subsidiary's operation. As noted at the outset of this section, the Subsidiary will be subject to full functional regulation under the federal securities laws, and the SEC does have the authority to examine, investigate, and if necessary, discipline the Bank for activities in connection with the Subsidiary's revenue bond activities. The OCC will, of course, cooperate with the SEC and appropriate self-regulatory authorities in connection with their oversight of the Subsidiary and any connected activities of the Bank.

MSRB. 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 also 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.

In addition, 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 new operating standards applicable to section 20 subsidiaries engaged in underwriting and dealing in securities. The Federal Reserve recently eliminated many of the conditions it formerly applied to section 20 subsidiaries engaged in underwriting and dealing and consolidated the remaining restrictions in a series of operating standards.⁷⁵ These new operating standards are tailored to address the risks of affiliation with an insured bank not addressed by other laws.⁷⁶

⁷⁵ See 62 FEDERAL REGISTER 45295 (August 27, 1997).

⁷⁶ 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 CAMEL 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

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. ADDITIONAL REGULATORY AND POLICY REVIEWS

A. Bank Holding Company Act

As the administrator of national banks, the OCC has broad authority under 12 U.S.C. § 24(Seventh) to determine the permissible activities of national banks and their subsidiaries. One commenter asserts, however, that this authority does not extend to subsidiaries of banks that propose to engage in activities such as underwriting and dealing in securities.⁷⁷ The commenter contends that the Bank Holding Company Act (“BHCA”) provides the exclusive means by which bank holding company affiliates, including subsidiaries of banks, can engage in such activities. Specifically, the commenter asserts that the Subsidiary must apply under section 4(c)(8) of the Bank Holding Company Act⁷⁸ for approval from the Federal Reserve to engage in the proposed activities.

The courts have specifically held, however, that the BHCA does not govern the permissible activities of banks or their subsidiaries. In *Independent Insurance Agents of America, Inc. v. Board of Governors of the Federal Reserve System*, 890 F.2d 1275 (2d Cir. 1989) (*Merchants II*), cert. denied, 498 U.S. 810 (1990), the Second Circuit upheld a Federal Reserve Board order concluding that the BHCA’s activity restrictions did not apply to the activity of a bank subsidiary of a bank holding company.⁷⁹

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).

⁷⁷ The commenter also contends that the OCC does not have authority under section 93a of the National Bank Act to permit a national bank to engage in ineligible securities activities through an operating subsidiary, because section 93a provides that the OCC may not issue rules and regulations concerning the securities activities of national banks under the Glass-Steagall Act. This Application would not confer authority on national banks (or their operating subsidiaries) that they do not have under existing law, however. As explained in this decision, the proposed activity is part of the business of banking under 12 U.S.C. §24(Seventh) and is allowed under section 20 of the Glass-Steagall Act. Section 93a is simply inapplicable, and the OCC is not prohibited by section 93a from approving the proposed transaction.

⁷⁸ Section 4(c)(8) of the BHCA authorizes the Federal Reserve to approve the acquisition and retention by a bank holding company of shares of a company engaged in activities that are “so closely related to banking . . . as to be a proper incident thereto.” 12 U.S.C. §1843(c)(8).

⁷⁹ The Eighth Circuit, in *Norwest Bank Minnesota, N.A. v. Sween Corporation, et. al.*, 1997 U.S. App. LEXIS 16602 (8th Cir. 1997), recently followed the reasoning in *Merchants II* in a case involving a dispute between a national bank and a company advised by the bank. The company refused to pay the bank an agreed upon advisory fee for its services contending, among other things, that the bank could not collect the fee for its services because it

Shortly thereafter, in *Citicorp v. Board of Governors of the Federal Reserve System*, 936 F.2d 66 (2nd Cir. 1991), *cert. denied*, 502 U.S. 1031 (1992), the same court vacated a Federal Reserve Board order that required a state bank owned by a bank holding company to terminate certain activities conducted through the state bank's subsidiary. The court applied the reasoning of *Merchants II*, concluding that "once the BHCA has been construed to leave the regulation of a holding company's subsidiary banks to their chartering authorities, the Act cannot sensibly be interpreted to reimpose the authority of the Fed on a generation-skipping basis to regulate the subsidiary's subsidiary."⁸⁰ It therefore held that the BHCA does not extend to the subsidiary of a holding company's bank subsidiary.⁸¹ The activities of the bank's subsidiary in question were, according to the court, appropriately the responsibility of the bank's chartering authority to address.⁸²

Accordingly, the Subsidiary is not required to obtain approval under section 4(c)(8) of the BHCA to engage in the proposed activities.

B. Consumer Protection Issues

In addition to the safeguards and conditions discussed above, the extensive regulatory scheme presently governing the Subsidiary's and Bank's municipal securities activities will provide additional protection for purchasers of the proposed general obligation securities and revenue bonds. The Subsidiary already has registered with the SEC as a broker-dealer and is a member of the NASD. Consequently, the Subsidiary's brokerage activities are subject to federal securities law and NASDR and SEC oversight. As a registered broker-dealer, the Subsidiary's underwriting of municipal securities and its sales of those securities also will be fully subject to federal securities law.

The Subsidiary's employees who broker municipal securities products to retail customers are registered as General Securities Representatives with the NASDR pursuant to federal

did not have prior approval from the Federal Reserve under the BHCA to engage in advisory services. The court held that the BHCA, and the Federal Reserve's regulation interpreting the BHCA (12 C.F.R. § 225.21(a)), do not apply to a bank subsidiary of a bank holding company.

⁸⁰ *Citicorp v. Federal Reserve*, *supra*, at 68.

⁸¹ Although the case involved a state bank, the court's reasoning would apply equally to national banks.

⁸² Furthermore, section (4)(c)(5) of the Bank Holding Company Act, 12 U.S.C. § 1843(c)(5), would expressly exempt the Bank's operating subsidiary from any applicable restrictions in the BHCA. Section (4)(c)(5) provides that the investment restrictions contained in section 4 of the Act do not apply to "shares which are of the kinds and amounts eligible for investment by national banking associations under section 24 of the National Bank Act." As explained in this decision, section 24 of the National Bank Act provides authority for national banks to invest in an operating subsidiary engaged in the business of banking. Thus, the plain language of the BHCA expressly preserves the authority of the Bank to own shares in the operating subsidiary as authorized in the National Bank Act.

securities law requirements.⁸³ To be registered as a General Securities Representative, one must pass an examination that tests for adequate product and regulatory knowledge of the securities being recommended and sold.⁸⁴

Because banks are not “brokers” or “dealers” under the Exchange Act,⁸⁵ and thus not subject to certain provisions of the federal securities laws, one commenter has stated that the Bank would avoid essential investor protection rules if the Bank, rather than the Subsidiary, sold the revenue bonds. However, the Bank’s municipal securities activities are subject to the same comprehensive regulatory scheme as other registered municipal securities dealers. That regulatory scheme affords the bank customers with important protections.⁸⁶ While the Bank is not a general securities broker-dealer, the Bank is registered as a municipal securities dealer under the Exchange Act.⁸⁷ Consequently, the Bank’s municipal securities activities are subject to the rules of the MSRB.⁸⁸

These rules include extensive consumer protection provisions, such as suitability requirements (MSRB Rule G-19), price and commission limits (MSRB Rule G-30), disclosures in connection with new issues (MSRB Rule G-32), employee qualification requirements (MSRB Rules G-2 and G-3), and recordkeeping requirements (MSRB Rule G-8). In addition, the Bank’s securities activities are subject to federal securities law antifraud provisions.⁸⁹

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

⁸³ See Section 15B(b)(2)(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-4(b)(2)(a) (“Exchange Act”); MSRB Rule G-3 (sets forth qualification requirements, including testing, that a person associated with a municipal securities broker or dealer must meet).

⁸⁴ See Series 7 Examination.

⁸⁵ See Section 3(a)(4) and (5) of the Exchange Act, 15 U.S.C. § 78c(a)(4) and (5).

⁸⁶ The Bank is also a registered government securities dealer, subjecting the Bank to an additional, parallel regulatory scheme. See Sections 3(a)(44) and 15C of the Exchange Act, 15 U.S.C. §§ 78c(a)(44) and 78o-5.

⁸⁷ See Sections 3(a)(30) and 15B(a)(1) of the Exchange Act; 15 U.S.C. §§ 78c(a)(30) and 78o-4(a)(1).

⁸⁸ See MSRB Rule G-1 (defines a “separately identifiable department or division of a bank” and the municipal securities dealer activities that must take place there).

⁸⁹ See Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5.

subject to the following conditions which shall be applicable to the Bank and the Subsidiary, as indicated, in addition to the conditions and requirements set forth in 12 C.F.R. § 5.34(f):

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.
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 revenue 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 underwriting and dealing in revenue bonds 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 its EIC 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.

Julie L. Williams
Chief Counsel

Date

Application Control Number: 97-WO-08-0003