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Tearing Down the Wall Between Banking and Commerce: An Evaluation of the Federal Reserve Board's Implementation of the New Standard for Permissible Non-Banking Activities

BY SHAWN A. BAILEY*

I. INTRODUCTION

For the majority of the twentieth century, a steep barrier existed between commercial banking activities and other types of financial activities. On November 12, 1999, the United States Congress lifted this barrier by passing the Gramm-Leach-Bliley Financial Modernization Act' (the "GLB Act"). The primary stated purpose of this Act was to "enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers."2

Prior to the enactment of the GLB Act, bank holding companies3 and national banks4 could only engage in limited non-banking activities. Before

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2 Id.
3 A bank holding company is an "[e]ntity controlling one or more commercial banks." DICTIONARY OF BANKING TERMS 45 (4th ed. 2000).
4 A national bank is a "[c]ommercial bank chartered by the COMPTROLLER OF THE CURRENCY, an agency of the U.S. Treasury Department." Id. at 306.
the passage of the GLB Act, the provisions of the Glass-Steagall Act ("Glass-Steagall") explicitly restricted the ability of national banks to deal in, purchase, or underwrite securities\(^5\) and it limited forays into the securities industry by bank holding companies by disallowing affiliations between bank holding companies and entities that were "engaged principally" in securities underwriting or sales.\(^6\) For those activities that were not expressly forbidden by Glass-Steagall proscriptions, financial institutions had yet another set of hoops through which to jump before they could engage in non-banking activities. Bank holding companies were only permitted to engage in those non-banking activities that were "so closely related to banking or managing or controlling banks as to be a proper incident thereto."\(^7\) National banks were similarly restricted in their non-banking activities and were only empowered in this capacity to exercise "all such incidental powers as shall be necessary to carry on the business of banking."\(^8\) Believing that these standards were "not well adapted to the changes taking place in the financial services industry"\(^9\) and that "developments in technology, globalization of financial services, and changes in the capital markets have rendered the laws governing financial services unsuitable and outdated in many respects,"\(^10\) Congress set out to redefine the standards by which banks could engage in non-banking activities.

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\(^8\) 12 U.S.C. § 24. State-chartered banks are subject to similar constraints. See, e.g., N.Y. BANKING LAW § 96 (McKinney 2002) ("Every bank and every trust company shall . . . have the following powers: 1. To discount, purchase and negotiate promissory notes, drafts, bills of exchange, other evidences of debt, . . . and exercise all such incidental powers as shall be necessary to carry on the business of banking."). The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") imposes a limitation on these powers for state banks, however. Under FDICIA, state-chartered banks that have FDIC deposit insurance (effectively almost every state-chartered bank) may not engage as a principal in any type of activity that is not permissible for a national bank unless (1) the FDIC determines that the activity would not pose any significant risk to the deposit insurance funds; and (2) the State bank is in compliance with applicable capital standards. 12 U.S.C. § 1831a(a)(1) (2002).

\(^10\) Id.
This Note will examine the new standard for permissible non-banking activities and how it compares with the standard in existence prior to the enactment of the GLB Act. After providing a brief overview of the new framework created by this legislation, this Note will set out the parameters of the old standard followed by a more detailed discussion of the new standard and subsequent clarifications made by the regulatory bodies charged with administering these statutory provisions, some of which were made at the urging of commentators within the financial industry. A side-by-side evaluation of these two regimes will identify the changes brought about by the new standard and will discuss the manner in which the new standard has been used to foster growth and competition within the financial services industry in the United States.

II. OVERVIEW OF THE NEW FRAMEWORK FOR PERMISSIBLE NON-BANKING ACTIVITIES

The GLB Act changed the old framework for permissible non-banking activities by amending 12 U.S.C. § 1843(c)(8) [Section 4(c)(8) of the Bank Holding Company Act of 1956] to freeze the definition of new activities as "so closely related to banking" and permissible for bank holding companies as of November 12, 1999. In addition, the GLB Act created a new entity—the financial holding company—and defined its powers by adding subsection (k)(1) to the Bank Holding Company Act, which permits financial holding companies to engage in any activity that is considered "financial in nature or incidental to such financial activity" or "complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally." The determination as to whether an activity conducted by a financial holding company meets one of these criteria is made by the Board of Governors of the Federal Reserve (the "Board"), which is the primary regulator of all bank holding companies and financial holding companies.

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11 See discussion infra Part II.
12 See discussion infra Part III.
13 See discussion infra Part IV.A.
14 See discussion infra Parts IV.B, V.
17 Id. § 1843(k)(1)(A) (2002).
18 Id. § 1843(k)(1)(B).
19 Id. § 1843(k)(1).
20 Cf. id. §§ 1841(a)(2)(C), (a)(5)(D) (outlining various capacities in which the Board serves to regulate bank holding companies).
The GLB Act also expanded the ability of national banks to conduct non-banking activities by adding 12 U.S.C. § 24a, which allows national banks to control or hold an interest in financial subsidiaries that engage in “activities that are financial in nature or incidental to a financial activity.” Auspiciously missing is the ability of national banks to declare an activity “complementary” and thus permissible, as the Board is empowered to do. This omission reflects a policy judgment that these activities may not pose excessive risk within the framework of a more diversified financial holding company, but that they pose too much risk to be operated through a national bank subsidiary. The Secretary of the Treasury regulates national banks through the Office of the Comptroller of the Currency (the “OCC”) and has the ability to determine whether or not a non-banking activity falls within the ambit of the new standard. Operating subsidiaries of national banks generally may engage in the same activities allowed for financial holding companies; however, the GLB Act has defined several activities permitted for financial holding companies that are not permitted for subsidiaries of national banks: insurance or annuity underwriting, developing or investing in real estate, merchant banking, and insurance portfolio investing. This differentiation is apparently the result of a compromise between the Board and the OCC, which was based on the belief that certain financial activities were “too risky to be placed in a financial subsidiary of a bank.” Notably, the GLB Act did include a sunset provision, which will take effect on November 12, 2004, and will allow the Board of Governors of the Federal Reserve and the Secretary of the Treasury to adopt rules jointly permitting merchant banking activities for national bank subsidiaries.

The Board must notify the Secretary of the Treasury prior to declaring a new non-banking activity to be “financial in nature” or “incidental” to a financial activity, and the Secretary has the ability to block the approval

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22 Id. § 1 (2002).
23 Id. § 24a(a)(2)(B)(i).
24 Id. § 24a(a)(2)(B)(ii).
25 Id. § 24a(a)(2)(B)(iii).
26 Id.
of the Board within thirty days of receiving notice from the Board.\textsuperscript{30} Similar provisions apply to the Secretary of the Treasury with regard to approval of non-banking activities for national banks, vesting the Board with veto powers over the Secretary's findings.\textsuperscript{31} Effectively, both the Secretary of the Treasury and the Board have the ability to hold a gun to each other's head in determining whether or not a specific activity is "financial in nature" or "incidental." In the final analysis, however, the Board is most likely to be the ultimate authority on what constitutes a permissible non-banking activity.\textsuperscript{32} Many remain cynical as to the actual weight behind these "consultation" provisions. \textit{American Banker}, a leading trade journal in the banking industry, reported that "[a]lthough some Fed determinations are subject to 'consultation' with the Treasury Department, that obligation is not much of a real restriction. The Fed has been slugging it out with Treasury and its [OCC] for years, and the Fed almost always has come out the winner."\textsuperscript{33}

III. THE PRE-GLB ACT REGIME: "SO CLOSELY RELATED"

The parameters of the standard for permissible non-banking activities according to the Board, under both current and prior law, have been codified in the regulations promulgated under the Bank Holding Company Act.\textsuperscript{34} Those non-banking activities that have been designated as permissible by the Board under the "so closely related" standard (and which

\textsuperscript{30} \textit{Id.} §§ 1843(k)(2)(A)(ii), 24a(b)(1)(B)(ii)(II).
\textsuperscript{31} \textit{Id.} §§ 1843(k)(2)(B), 24a(b)(1)(B).
\textsuperscript{32} The House Conference Report on the GLB Act stated that:
[i]he Board has primary jurisdiction for determining what activities are financial in nature, incidental to financial in nature, or complementary.
\textsuperscript{34} See, \textit{e.g.}, MICHAEL P. MALLOY, \textit{BANK REGULATION} 186 (1999).
continue to limit bank holding companies that have not elected to become financial holding companies) are found at Section 225.28 of Title 12 of the Code of Federal Regulations.\textsuperscript{35} Michael P. Malloy, Professor of Law at McGeorge School of Law at the University of the Pacific, commenting on the usefulness of such a list, stated that “[a]lthough the inclusion of a particular activity in the list creates certain procedural advantages in the processing of a notice, it does not predetermine the outcome of a notice. The public benefits of the proposed activity, outweighing its possible adverse affects [sic], must still be demonstrated on a case-by-case basis.”\textsuperscript{36} The need for case-by-case analysis was created by the 1970 Amendments to the Bank Holding Company Act, which added a “public benefits” balancing test to the calculus of whether or not a non-banking activity is permissible.\textsuperscript{37} This test was an attempt to create the “necessary flexibility to allow bank holding companies to meet adequately the financial service needs of the country and to insure that the activities of these companies do not result in harm to the public from decreased competition.”\textsuperscript{38} Thus, while the inclusion of a list of predetermined closely-related activities in the regulations helped to clarify the standard, the regulations were not conclusive as to whether an activity would be permitted for any particular bank holding company.

The 1970 Amendments transformed the “so closely related” standard into a two-part test: 1) is the activity “so closely related to banking,” and, if so; 2) do the benefits of allowing a bank to undertake the activity override the adverse effects that allowing a bank to engage in that activity might create?\textsuperscript{39} As to the first part of the test, the Court of Appeals for the District of Columbia characterized it as “a question that asks only whether the activities in question are generally of a kind that Congress, having concluded that ‘banking and commerce should remain separate,’ forbade bank holding companies to engage in, without regard to the merits of such engagement in a particular case.”\textsuperscript{40} The origin of the “so closely related” standard is in the original Bank Holding Company Act of 1956.\textsuperscript{41} The legislative history of this Act does not explain the exact meaning of this

\textsuperscript{35} 12 C.F.R. § 225.28 (2002).
\textsuperscript{36} MALLOY, supra note 34, at 187.
\textsuperscript{38} Id. at 5533.
\textsuperscript{39} Indep. Bankers Ass’n v. Bd. of Governors, 516 F.2d 1206, 1215 (D.C. Cir. 1975).
\textsuperscript{40} Nat’l Courier Ass’n v. Bd. of Governors, 516 F.2d 1229, 1233 (D.C. Cir. 1975) (footnote omitted).
\textsuperscript{41} Id. at 1236.
rather, it appears that the framers of this legislation recognized that any standard would have to be flexible. The Senate report on this legislation stated:

In the opinion of [the Committee on Banking and Currency], certain activities of a financial, fiduciary, or insurance nature are obviously so closely related to banking as to require no divestment by a bank holding company. . . . However, there are many other activities of a financial, fiduciary, or insurance nature which cannot be determined to be closely related to banking without a careful examination of the particular type of business carried on under such activity. For this reason [the Committee on Banking and Currency] deems it advisable to provide a forum before an appropriate Federal authority in which decisions concerning the relationship of such activities to banking can be determined in each case on its merits.43

Accordingly, the “so closely related” standard appears to have been intended as a starting point for evaluation as to whether an activity should be permitted; it does not seem to be a bright-line test in and of itself.

In construing this standard in a case involving a contest of a Board determination that certain courier services were “so closely related” to banking and thus permissible, the Court of Appeals for the District of Columbia decided that the Court “owe[s] considerable deference to the Board’s judgment that a particular activity is ‘closely related to banking.’ Rather than define that term with any precision, therefore, we simply require that the Board go about making its ‘closely related’ decision in a reasoned fashion consistent with the legislative intent.”44 The Court went on to articulate that in making a determination as to whether an activity is permissible, the Board may not be arbitrary or capricious and must show some kind of connection between the activity and the business of banking.45 This connection, the Court stated, could be shown in one of three ways:

1. Banks generally have in fact provided the proposed services.
2. Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed service.

42 Id.
44 Nat’l Courier Ass’n, 516 F.2d at 1237.
45 Id.
3. Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.\textsuperscript{46}

While these guidelines added a degree of clarity to the calculus of whether or not an activity qualifies as “so closely related” to banking, the standard remained vague. The Supreme Court took notice of the reaction of the Board to the guidelines enumerated in the \textit{National Courier} decision, stating:

The Board has recognized, however, that [these] guidelines do not provide the exclusive basis for finding that an activity is “closely related” to banking, and has stated that it will consider “any . . . factor that an applicant may advance to demonstrate a reasonable or close connection or relationship of the activity to banking.”\textsuperscript{47}

Because of this vagueness, the Board is able to exercise considerable discretion in determining what activities are permissible for bank holding companies.\textsuperscript{48} While this flexibility allowed the Board to “fashion paths around . . . impediments”\textsuperscript{49} caused by the pre-GLB Act statutory framework, it was deemed to be “no substitute for the establishment of fundamental policy by Congress.”\textsuperscript{50} Thus, the passage of the GLB Act swept away the old statutory framework and replaced it with a new, more expansive standard. The implementation of this new standard remains in the hands of the Board, however, and the Board will play an important role in determining precisely what Congress’ fundamental policies were and how they should best be given effect.

\section*{IV. THE GLB ACT: “FINANCIAL IN NATURE,” “INCIDENTAL,” OR “COMPLEMENTARY” TO BANKING}

\subsection*{A. Fundamental Changes Brought About by the Shift in the Standard}

1. \textit{Leveling the Playing Field for Smaller Bank Holding Companies}

As a starting point, the new standard for permissible non-banking activities was intended by Congress to be broader than the prior “so closely

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\textsuperscript{46} \textit{Id.}
\textsuperscript{48} \textit{Id.} at 214.
\textsuperscript{49} S. REP. NO. 106-44, at 5 (1999).
\textsuperscript{50} \textit{Id.}
related” standard. In defining a list of permissible activities as “financial in nature,” Congress included all activities that, prior to the enactment of the GLB Act, had been determined by the Board to have been “so closely related” to banking. The most obvious expansion from the pre-GLB Act era was the declaration of insurance underwriting and securities dealing as permissible activities. This change resulted in part from the repeal of the earlier Glass-Steagall provisions that restricted these types of affiliations between banks and securities firms. However, the ability to engage in limited securities activities had been in place prior to the enactment of the GLB Act through the use of “Section 20 subsidiaries” that engaged in both “bank-eligible” securities underwriting (typically government-issued or guaranteed securities) and “bank-ineligible” securities underwriting.

51 Id. at 6.
52 12 U.S.C. § 1843(k)(4)(F) (2002). The Board has included by regulation those activities defined as “so closely related to banking” (either by 12 C.F.R. § 225.28 (2002) or by order, as of November 12, 1999) or “usual in connection with the transaction of banking abroad,” (as of November 11, 1999) which are permissible for bank holding companies, as permissible for financial holding companies. 12 C.F.R. § 225.86(a)-(b) (2002).

Activities permitted by regulation as “so closely related to banking” include: providing administrative and other services to mutual funds, owning shares of a securities exchange, acting as certification authority of digital signatures, and real estate title abstracting. Id. § 225.86(a). Activities permitted as “usual in connection with banking abroad” include: providing management consulting services, operating a travel agency, and organizing and sponsoring a mutual fund under certain conditions. Id. § 225.86(b).
54 Id. § 1843(k)(4)(E).
56 See MALLOY, supra note 34, at 188.
Through this loophole, large bank holding companies such as J.P. Morgan & Co., Inc., Citicorp, and Bankers Trust New York Corporation were able to engage in securities underwriting activities in which Federal Reserve member banks could not engage.\(^5\)

As the Board, over time, increased the amount of permissible securities underwriting as a percentage of the gross revenues of a bank holding company subsidiary, commercial banks increasingly acquired investment banks to exploit this loophole.\(^7\) The removal of the restrictions placed on bank holding companies by Glass-Steagall leveled the playing field, allowing smaller bank holding companies to engage in the same activities previously limited to their larger competitors. By defining securities and insurance underwriting as “financial in nature” in the GLB Act itself, Congress expressly signaled that it was comfortable with allowing bank holding companies to engage in these types of activities, just as they could before Depression-era legislation, like Glass-Steagall, was passed into law. In addition, the removal of the Glass-Steagall prohibitions and the Board regulations that accompanied them corrected the inequitable situation whereby banks could acquire brokers but brokers could not acquire banks.\(^5\)

The removal of the explicit “public benefits” test, which the 1970 Amendments added, when Section 1843(c)(8) was amended by the GLB Act, was somewhat more subtle.\(^6\) In lieu of such a balancing test for financial holding companies, Congress provided regulators with “factors to be considered” in determining whether or not an activity is permissible as “financial in nature” or “incidental to a financial activity.”\(^6\) These guidelines include the types of public benefits listed in the 1970 version of


\(^{58}\) See Blumenthal, *supra* note 33, at 12.

\(^{59}\) *Id.*

\(^{60}\) The 1970 Amendments stated that the Board, in considering whether an activity is permissible, shall consider its public benefits, including “greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.” 12 U.S.C. § 1843(c)(8)(2002).

\(^{61}\) *Id.* § 1843(k)(3).
Section 1843(c)(8), but expand on them significantly by specifically addressing issues relating to technology and physical security issues. The most important function of this change is to merge an expanded version of the "public benefits" test into the determination of whether or not an activity is "financial in nature" or "incidental to a financial activity." Under the prior scheme, an activity could be defined as "so closely related" to banking and be permitted for one bank holding company to undertake, but the same activity could be deemed impermissible for another bank holding company to undertake because the particular circumstances of that second bank holding company led to a different balance of adverse effects and public benefits. By folding a determination that the benefits of an activity outweigh its adverse effects into the decision to deem an activity "financial in nature" or "incidental to a financial activity," Congress created a unitary test. Once an activity is deemed permissible, either by the GLB Act itself or by regulations promulgated under its authority, a financial holding company may engage in that activity without having to obtain prior approval from the Board.

This analysis not only levels the playing field by treating all financial holding companies equally, but also reduces the administrative burden for financial holding companies who previously had to obtain regulatory approval before engaging in a non-banking activity, regardless of whether it was previously permitted for another holding company. Under the new regulatory regime, all a financial holding company must do is notify the Board, in writing, of its engagement in a non-banking activity within thirty days of either commencing the activity in question or acquiring control of a company engaging in that activity. According to William J. Sweet, a partner with Skadden, Arps, Slate, Meagher & Flom, this after-the-fact notification should make financial holding companies more nimble and competitive. Notable, however, is that this improvement only applies to

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62 Id.
63 Id.
64 The Court of Appeals for the District of Columbia recognized the case-by-case nature of the "public benefits" test, stating that the test is "one which normally must be resolved upon specific facts. . . . Naturally the conclusion that the non-banking activity of one bank holding company would be anticompetitive or threaten "unsound banking practices" may not hold for a different bank holding company under different circumstances." Nat'l Courier Ass'n v. Bd. of Governors, 516 F.2d 1229, 1233 (D.C. Cir. 1975).
66 Id. § 1843(k)(6)(A); 12 C.F.R. § 225.87(a) (2002).
67 Dean Anason, Fed to Approve 100 'Holding Company' Applications, AM. BANKER, Mar. 10, 2000, at 1.
activities that have been defined previously as "financial in nature" or "incidental to a financial activity." Activities that are defined as "complementary to a financial activity" are still subject to a case-by-case review before a financial holding company may engage in the proposed activity. In addition, bank holding companies that have not made an effective election to become financial holding companies continue to be subject to a case-by-case public benefits review, just as they were before the passage of the GLB Act.

2. Umbrella Regulation by the Federal Reserve Board

Before a bank holding company may engage in expanded financial activities permitted under the new standard, it must meet certain requirements. First, all of the depository institution subsidiaries of the bank holding company must be "well-capitalized" and "well-managed." The Board has maintained that it has the authority to restrict the activities of subsidiaries of financial holding companies based on these criteria, even though these subsidiaries may engage in businesses such as insurance underwriting or securities broker-dealer activities that are already subject to functional regulation. In commenting on the Board’s interim rule concerning the manner in which a company elects to be a financial holding company, financial services industry leaders criticized the position of the Board and claimed that the Board lacks the regulatory authority to make judgments about the managerial staff or capital sufficiency of a subsidiary that is already subject to oversight by regulators with authority over a particular business. While it modified the language reserving authority to restrict the activities of financial holding companies when it adopted the final rule, the Board refused to change its position. Responding to these allegations, the Board stated:

Section 8 of the [Bank Holding Company] Act, section 8 of the Federal Deposit Insurance Act, and other applicable statutes long have given the

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69 Id. § 1843(j)(2)(A). In certain circumstances, a bank holding company may qualify for automatic approval without being subject to a public benefits review, including that the bank holding company and its lead depository institution are well-capitalized and well-managed and the proposed activity has already been deemed permissible either by statute, regulation or order. Id. § 1843(j)(3)-(4).
70 Id. § 1843(l)(1)(A).
71 Id. § 1843(l)(1)(B).
73 Id.
Board supervisory authority to restrict the conduct of bank holding companies where necessary or appropriate to protect the safety and soundness of depository institutions or otherwise further the purpose of Federal banking laws. Although the GLB Act amended several of these provisions, it did not limit the general applicability of the Board’s supervisory power over bank holding companies that become financial holding companies. Therefore, the final rule continues to provide that the Board may take appropriate supervisory action against a [financial holding company] if the Board believes that the company does not have the appropriate financial and managerial resources to commence or conduct an activity, make an acquisition, or retain ownership of a company, or the Board believes such action is appropriate to enforce applicable Federal law. 74

In maintaining this position, the Board holds considerable authority not only in allowing a bank holding company to make its election to become a financial holding company, but also to supervise its activities once it becomes a financial holding company and engages in permitted activities.

Bank holding companies were always subject to Board regulation, even prior to the passage of the GLB Act. The umbrella regulation of the GLB Act, however, will enable the Board to be yet another regulatory body with which securities firms (who already answer to the Securities & Exchange Commission as well as state regulators) and insurance firms (who already answer to state insurance regulators) must deal if they merge with a financial holding company—a prospect at which many large insurance and securities firms have balked. 75 Peter Wallison, a former general counsel to the Treasury Department, has opined that "'[v]ery few companies have wanted, or will want, to let the Fed determine what businesses they can enter' . . . 'The [GLB Act's] requirement that companies that control banks engage only in activities that the Fed defines as "financial in nature" is its fatal flaw.'" 76


75 See Rob Garver, Reality Has Discouraged Bank-Insurer Merger Deals, AM. BANKER, Feb. 20, 2001, at 6 (quoting Peter Wallison, a former Treasury Department general counsel, who is now a resident fellow at the American Enterprise Institute).

76 Barbara A. Rehm, In Focus: Critics Show Impatience with Fed’s Implementation of G-L-B, AM. BANKER, Nov. 19, 2001, at 1. As Samuel J. Baptista, Morgan Stanley’s lead lobbyist, characterized some non-banks’ concerns, becoming a financial holding company is like entering “the roach motel. . . . Once you enter,
Federal Reserve Vice Chairman Roger W. Ferguson, Jr. emphasized that the financial holding company structure requires an agency to assess overall risk, regardless of the risks present in each separate subsidiary. In a speech to the National Association of Urban Bankers in San Francisco in May 2000, Mr. Ferguson stated that “[e]ven if individual subsidiaries are considered to be financially strong and well-managed by bank, thrift, or functional regulators, their risk profiles may change when they are amalgamated into a consolidated organization.”

Attempting to assuage the concerns of the financial services industry about what this type of regulation might entail, Mr. Ferguson pledged that in fulfilling its role as “umbrella regulator,” the Board will use information obtained by financial holding company subsidiaries’ functional regulators as much as possible and may conduct joint examinations with these functional regulators to minimize the burden of Board regulation. Mr. Ferguson stressed that “[u]mbrella supervision is not intended to impose bank-like supervision on financial holding companies as a whole, or on either regulated or non-regulated non-bank subsidiaries of financial holding companies.”

In addition to the well-capitalized and well-managed criteria for electing financial holding company status, the Board requires that a bank holding company file a declaration with the Board stating that the bank holding company elects to become a financial holding company to engage in activities that were previously not permitted for bank holding companies, along with a certification that the company is well-capitalized and well-managed. Once a company has successfully obtained financial holding company status, it may still be prevented from engaging in expanded activities or acquiring control of a company engaging in such activities if any insured depository institution subsidiary of the financial holding company received less than a “satisfactory” rating at its most recent Community Reinvestment Act examination. This requirement does not

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78 Id.

79 Id.


apply, however, to acquisitions of merchant banking or insurance portfolio investments.82

B. The Board’s Interpretations of the New Standard

1. Activities That Are “Financial in Nature” or “Incidental to a Financial Activity”

a. Merchant Banking Limitations

Section 4(k)(4) of the Bank Holding Company Act was amended by the GLB Act to define nine categories of activities that are permissible as being “financial in nature,” one of the most significant of which is merchant banking.83 Bank holding companies were permitted to engage in limited amounts of merchant banking activities prior to the enactment of the GLB Act, much as they were able to engage in securities underwriting on a limited basis. For instance, under the Bank Holding Company Act, bank holding companies themselves are allowed to invest in not more than five percent of any class of voting shares (or 24.9% of total equity) of a company, or in as much as forty-nine percent of a company through subsidiaries (such as small business investment companies, or SBICs) that meet certain government criteria.84 Large bank holding companies, such as Chase Manhattan Corp., Citigroup, Inc., Bank of America Corp., FleetBoston Financial Corp., and Wells Fargo & Co., used this ability to pursue sizeable and active venture capital businesses.85 For example, in

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84 Id. § 1843(k)(4)(H).
86 See Jathon Sapsford, Fed to Make Banks Boost Capital to Cover Venture-Investing Risks, WALL ST. J., Mar. 14, 2000, at A4. See also 12 U.S.C. § 1843(c)(6). A financial holding company may acquire more than five percent of any class of voting shares of a company that is not engaged exclusively in activities that are financial in nature, incidental, or otherwise permissible for a financial holding company only if: (1) the acquired company is “substantially engaged” in permitted activities; (2) the acquiring financial holding company complies with all applicable notice requirements; and (3) the acquired company terminates or divests all activities that are not permitted within two years of the financial holding company’s acquisition of more than five percent of its voting shares. 12 C.F.R. § 225.85(a)(3)(i)(A)-(C) (2002).
87 Sapsford, supra note 86.
1999, Chase’s venture capital unit, Chase Capital Partners, had $2.5 billion in revenue, which translated into $1.3 billion in profits for Chase.\textsuperscript{88}

In enacting the GLB Act, Congress chose not to limit merchant banking activities of financial holding companies expressly by statute. Rather, the GLB Act included a provision that authorized the Board and the Secretary of the Treasury to promulgate regulations that govern the extent of permissible merchant banking activities for financial holding companies.\textsuperscript{89} Pursuant to this authority, the Board and the Secretary issued interim rules that defined the types of merchant banking investments that financial holding companies could make,\textsuperscript{90} limited the ability of a financial holding company to manage or operate a portfolio company,\textsuperscript{91} and set the permissible holding period for merchant banking investments at ten years.\textsuperscript{92} Most significantly, these regulations established aggregate thresholds below which financial holding companies could make merchant banking investments without Board review: the lesser of six billion dollars or thirty percent of a financial holding company’s Tier 1 capital, or the lesser of four billion dollars or twenty percent for private equity fund investments.\textsuperscript{93} At the same time, the Board and the Secretary issued a capital proposal that would require financial holding companies to take a capital charge of fifty cents of Tier 1 capital for every dollar of merchant capital investment they made in order to compensate for the risk of loss inherent in merchant banking investments.\textsuperscript{94}

These proposals drew a significant amount of criticism from financial services industry leaders, lawmakers, and regulators. Banks maintained that they already set aside sufficient reserves to compensate for the risks inherent in merchant banking activities.\textsuperscript{95} For instance, large banks such as Chase Manhattan already reserved capital equal to fifty percent of their merchant banking investments prior to the issuance of the initial capital proposal.\textsuperscript{96} Other critics claimed that the cap on merchant banking invest-

\textsuperscript{88} Id.
\textsuperscript{89} 12 U.S.C. § 1843(k)(7).
\textsuperscript{91} Bank Holding Companies and Change in Bank Control, 65 Fed. Reg. at 16,460, 16,473.
\textsuperscript{92} Id. at 16,474.
\textsuperscript{93} Id. at 16,475.
\textsuperscript{94} Id. at 16,480.
\textsuperscript{96} Id.
ments was too restrictive and contradicted the intent of the GLB Act to promote merchant banking by financial holding companies.97 As a result, the Board and the Secretary made significant revisions before issuing a final rule in January 2001, which removed the six billion dollar threshold on the aggregate amount of permitted investments.98 In February 2001, the Board and the Secretary jointly proposed a revised capital charge that cut the previous charge by more than one-half and introduced a sliding scale with a top charge of twenty-five cents on the dollar for merchant banking investments in excess of twenty-five percent of Tier 1 capital.99 In January 2002, after receiving comments on the capital charge proposal, the Board and the Secretary issued a final capital charge rule that is substantially similar to the proposed rule.100 Effective April 1, 2002, this final rule incorporated the sliding scale for capital charges as proposed101 and caused the expiration of the aggregate threshold for merchant banking investments,102 which had been set at thirty percent of the financial holding company’s Tier 1 capital with no dollar cap.103

100 Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Nonfinancial Equity Investments, 67 Fed. Reg. 3784, 3786 (Jan. 25, 2002).
101 The sliding scale is as follows: for merchant banking investments (including those made through SBICs) having an aggregate adjusted carrying value of less than fifteen percent of the Tier 1 capital held by all of the depository institutions controlled by the financial holding company, a capital charge of eight percent of Tier 1 capital would be required on all investments not made through SBICs. If aggregate merchant banking investments (including SBIC investments) exceed fifteen percent but are less than twenty-five percent of the organization’s Tier 1 capital, a twelve percent capital charge would be required on the adjusted carrying value of investments made over the fifteen percent threshold. For aggregate investments equaling twenty-five percent or more of the organization’s Tier 1 capital, a twenty-five percent capital charge would be required on the adjusted carrying value of investments made over the twenty-five percent threshold. 12 C.F.R. pt. 225, app. A (2002).
102 Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Nonfinancial Equity Investments, 67 Fed. Reg. at 3786. See 12 C.F.R. § 225.174(c)(e) (sunset automatically upon issuance of a final rule regarding appropriate capital charges for merchant banking investments.)
103 12 C.F.R. § 225.174(a)(1).
In crafting the final rule on merchant banking activities and the revised capital charge proposal, the Board and Secretary of the Treasury demonstrated that they would be receptive to the concerns of the financial services industry. H. Rodgin Cohen, chairman and senior partner of New York law firm Sullivan & Cromwell, noted that "[t]here is no question that the Federal Reserve has clearly listened to the concerns of the industry. They have really made an effort to meet those concerns because the reduction for the capital charge is significant." Contentious issues remained even after the issuance of the final merchant banking rules and interim capital charge proposal, such as whether or not capital charges would apply retroactively to private equity investments made prior to enactment of the GLB Act. The Board and the Secretary, however, once again showed their receptiveness to commenters' concerns in the final capital charge rule, which applied the new capital charges only to investments made on or after March 13, 2000 (the date on which financial holding companies' authority to make merchant banking investments became effective). For those who feared that the Board would negate the gains in financial services industry modernization made by the GLB Act, the willingness of the Board and the Secretary to work with the industry to arrive at a workable compromise is an encouraging sign.

b. General Rules for New Activities

As discussed above, the GLB Act itself identified a number of activities that are permissible as "financial in nature." Additional authority was granted to the Board to define further what activities are "financial in nature" or "incidental to a financial activity" by order or regulation. The GLB Act, however, limited this authority to certain categories of activities: "(i) Lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities. (ii) Providing any device or other instrumentality for transferring money or other financial assets. (iii) Arranging, effecting, or facilitating financial transactions for the account

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108 Id. § 1843(k)(5)(A).
of third parties." Pursuant to this authority, the Board set forth an interim rule that defines these three categories of activities as “financial in nature” or “incidental to a financial activity” when conducted pursuant to Board approval. The staff of the Board commented on this definition, stating:

These three categories encompass a wide range of activities. Included in these categories are some activities in which financial holding companies and national banks and their financial subsidiaries are already permitted to engage. . . . The categories were intended, however, to allow financial holding companies and financial subsidiaries to engage in activities that were not otherwise permitted for these companies.

Given the broad scope of the statutory language, the Board has opted to create a mechanism by which financial holding companies and their subsidiaries may file requests for approval of non-banking activities that have not previously been defined as “financial in nature” or “incidental to a financial activity,” rather than expressly define what would make a proposed activity “financial in nature” or “incidental to a financial activity.” This request procedure places the onus on the applicant to not only specifically describe the activity and how it would be conducted, but also to provide information as to how the proposed activity falls into one of the three categories defined in the statute. The Board will then evaluate the request, taking into account the factors that it otherwise is directed by statute to consider whenever it must determine whether an activity is “financial in nature” or “incidental to a financial activity.”

In addition, once the Board has determined that a particular activity is “financial in nature” or “incidental,” a procedure exists through which a financial holding company may request an advisory opinion from the Board as to whether a specific proposed activity of the financial holding company

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109 Id. § 1843(k)(5)(B).
112 Id.
113 12 C.F.R. § 225.86(e)(4)(i).
114 Id. § 225.86(e)(4)(ii).
115 Id. § 225.86(e)(3). The factors to be considered are listed at 12 U.S.C. § 1843(k)(3) (2002) and generally relate to the purposes of the GLB Act, changes in the financial services marketplace and technology, and whether the activity is necessary or appropriate to enable a financial holding company to compete effectively in the financial services industry, efficiently deliver financial services, and offer customers cutting-edge technological means for using financial services.
falls within the scope of the activity previously permitted.\(^\text{116}\) This process does not include the Secretary of the Treasury, as does the rulemaking process for defining new categories of permitted activities.\(^\text{117}\) As such, the advisory opinion loophole may serve as a vehicle to enable the Board to expand the scope of permitted activities without having to consult with the Secretary of the Treasury.

c. Board Definitions for Specific Activities

Although a mechanism exists for requests from parties wishing to engage in a particular activity, the Board maintains the ability to determine whether or not a particular activity is “financial in nature” or “incidental to a financial activity” on its own accord. To date, the Board has only exercised this authority to define one type of activity as permissible: acting as a finder.\(^\text{118}\) The Board defined “acting as a finder” as “bringing together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate.”\(^\text{119}\) In keeping with the focus of the GLB Act on technology and its place in the financial services industry, the Board included the following activities in its definition of finder services: “[h]osting an electronic marketplace on the financial holding company’s Internet web site by providing hypertext or similar links to the web sites of third party buyers or sellers;”\(^\text{120}\) hosting on the financial holding company’s servers the web site of a buyer or seller that provides information about that buyer or seller, its products and services, and the ability to place bids, offers or orders (or confirmation thereof);\(^\text{121}\) hosting the web site of a government or government agency that describes the services or benefits provided by that entity, assists people in completing applications for such services or benefits, and transmits the application to the government or government agency;\(^\text{122}\) and operating a web site that gives multiple buyers and sellers the ability to exchange information about products or services they wish to buy or sell, locate interested parties, aggregate orders, and enter into transactions between

\(^\text{116}\) 12 C.F.R. § 225.88(e) (2002).
\(^\text{117}\) See supra notes 29 & 30 and accompanying text.
\(^\text{118}\) 12 C.F.R. § 225.86(d)(1).
\(^\text{119}\) Id.
\(^\text{120}\) Id. § 225.86(d)(1)(ii)(A).
\(^\text{121}\) Id. § 225.86(d)(1)(ii)(B)(1).
\(^\text{122}\) Id. § 225.86(d)(1)(ii)(B)(2).
themselves (i.e., the buyer and seller, not the financial holding company that hosts the web site). Under this last provision, a financial holding company would be permitted to operate an auction-type web site—something that certainly was never contemplated when the Bank Holding Company Act was enacted in 1956, but is nonetheless quite a leap from the days when an activity had to be "so closely related" to banking.

While it has not issued any further formal rules defining other activities as permissible under the grant of authority in Section 1843(k)(5), the Board issued proposals for public comment that would recognize real estate brokerage and management services as "financial in nature" or "incidental to a financial activity" and would expand the range of data processing services that a financial holding company could provide as "complementary to a financial activity." The proposal regarding real estate brokerage and management services garnered considerable public comment, and as a result, the deadline for public comment was extended from March 2, 2001 to May 1, 2001. More recently, the Board and the Secretary of the Treasury delayed issuing any final rule on the real estate brokerage proposal until 2003 due to the strong lobby against the proposal by real estate agents.

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123 Id. § 225.86(d)(1)(ii)(C).
125 Bank Holding Companies and Change in Bank Control, 65 Fed. Reg. 80,384 (Dec. 21, 2000).
126 Bank Holding Companies and Change in Bank Control Financial Subsidiaries, 66 Fed. Reg. 12,440 (Feb. 27, 2001). See Dean Anason, DC Speaks: Realtor Group Fighting to Keep Banks Off Its Turf, AM. BANKER, June 8, 2001, at 4:

The Fed and Treasury received nearly 75,000 comment letters, and an estimated 90% to 95% of them were from real estate agents criticizing the plan. Fed officials said the agency got 42,040 letters, more than double the record prompted by the ill-fated "know your customer" anti-money-laundering plan that was withdrawn two [now more than three] years ago.

Id.

2. Activities That Are "Complementary to a Financial Activity"

The proposal relating to data processing is the only instance in which the Board addressed what it would consider to be a "complementary" activity. This type of permissible activity is the exclusive province of the Board and financial holding companies, since the provisions relating to national banks do not include "complementary" activities as permissible for national banks or their subsidiaries.\textsuperscript{128} In allowing the Board to define what constitutes a "complementary" activity, the GLB Act constrains the authority of the Board by limiting permissible activities to those that the Board determines do "not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."\textsuperscript{129} The Board stated that in order to be considered "complementary," an activity must "in some way complement or enhance a financial activity or there must be a relationship or connection between the complementary activity and a financial activity."\textsuperscript{130} As to the intended use of this authority, the Board acknowledged that:

The authority to engage in complementary activities was included as a mechanism for allowing some amount of commercial or nonfinancial activities so long as there is a connection between the complementary activity and a financial activity conducted by the [financial holding company] and the activity does not pose unacceptable risks to the safety and soundness of the [financial holding company], its banks or the banking system. At the same time, Congress rejected the invitation to allow depository institutions to affiliate in an unrestricted manner with commercial companies and determined not to permit [financial holding companies] to engage in a basket of purely commercial activities that have no connection to financial activities.\textsuperscript{131}

Thus, "complementary" activities stand at the outermost fringes of permissible activities, where the lines between banking and commerce blur.

The Board proposal for expanded data processing activities is evidence of how far the Board is willing to go. Under the "so closely related"

\textsuperscript{130} Bank Holding Companies and Change in Bank Control, 65 Fed. Reg. at, 80,385.
\textsuperscript{131} Id.
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standard, bank holding companies had been permitted to “engage in processing financial, economic and banking data (and providing limited amounts of general purpose data processing hardware).” These activities were not restricted as to the type of data processed, as long as revenues from processing nonfinancial data did not exceed thirty percent of the total data processing revenues of the company. The proposal not only seeks to increase the allowable level of nonfinancial data processing from thirty percent to forty-nine percent, but also to allow financial holding companies to engage in data storage (of both financial and nonfinancial data), general data processing, (including data transmission hardware, software, advice, and facilities) and provision of electronic information portal services. This last activity is defined by the Board to include “providing on-line search engines . . . , bulletin boards, newsgroup services . . . , ‘chat’ rooms, Internet web sites or portals that contain links to other web sites, and aggregation services . . . This activity would also include acting as an Internet Service Provider.” While the Board states that in granting this authority it expects that financial holding companies will offer these services in order to market and provide financial products and services, it acknowledges that this type of activity will require investment in companies “engaged in some degree of commercial activities.” In order to keep financial holding companies from exploiting this opportunity to the detriment of the safety and soundness of the financial holding company, the Board proposes that the carrying value of investments in data storage, general data processing, and electronic information portal services should be limited to five percent of the holding company’s Tier 1 capital.

132 Id. See also Ass’n of Data Proc. Serv. Orgs., Inc. v. Bd. of Governors, 745 F.2d 677 (D.C. Cir. 1984) (upholding the Board’s permission for banks to provide data processing services and to supply hardware in data processing packages to customers, provided that profits from manufacturing data processing hardware do not exceed thirty percent of the package, as a proper exercise of the Board’s authority under the “incidental” standard of the Bank Holding Company Act).

133 Bank Holding Companies and Change in Bank Control, 65 Fed. Reg. at 80,385.

134 Id.

135 Id. at 80,386.

136 Id.

137 Id.

138 Id.
V. \textbf{How Will the New Standard \linebreak \hspace{2cm} Shape the Future of the Banking Industry?}

The Board has always had considerable discretion in determining what activities would be permitted for bank holding companies. The standards by which these activities have been deemed permissible are less bright-line tests and more "jumping-off points" for Board analysis. While the GLB Act has served to streamline and simplify the process by which activities are permitted, it also has served to grant the Board even broader authority than it held in the past. In many ways the playing field has been leveled, giving smaller holding companies the ability to engage in activities that were previously allowed to only the largest financial service providers—evidenced by the fact that the vast majority of the approximately six hundred companies who have filed for financial holding company status are smaller regional companies.\textsuperscript{139} At the same time, the field has been widened considerably. It is true that the Internet and electronic commerce are integral parts of the American economy, and the GLB Act was intended to allow financial holding companies the ability to make the most of those channels.

If the Board's interpretations of its authority under the GLB Act serve as any prediction, it appears that there will not be many activities in which a financial holding company will not be able to engage as long as the activities are framed as at least tangential to a financial activity. Concurrently, however, the Board has shown that it is committed to maintaining separation between banking and commerce—as is demonstrated by its tough yet flexible stance on merchant banking investments. Further, the Board is now more focused on Tier 1 capital levels as a safety and soundness measure, shifting away from percent-of-revenue thresholds for permissible activities. Taken together, these indications seem to signal that the Board will use its new powers to allow financial institutions to get further away from core banking activities as long as those operations are balanced by sufficient capital to ensure that the risks that expanded activities bring to the institution as a whole are borne by the institution itself, rather than by the federal deposit insurance funds and taxpayers.

Reflecting on the effect that the GLB Act has had on the financial services industry in the first two years after its enactment, one of the authors of the Act, Representative Jim Leach, surmised that:

\textsuperscript{139} As of June 28, 2002, 609 companies had made effective financial holding company elections. List \textit{at} http://www.federalreserve.gov/generalinfo/Fhc (updated periodically).
The goal of Gramm-Leach-Bliley was to create the most competitive and the most stable environment for a financial market to function. In that sense, it represented a change, but not a revolution; a change that was consistent with the direction of markets. If the change had been inconsistent, it would have thrown sand in the gears of finance and commerce. Instead, (Gramm-Leach-Bliley) is intended to be a grease rather than friction.\(^{140}\)

The new standard, as it has been interpreted, has enabled bank holding companies to expand the scope of their services to meet the financial needs of the twenty-first century consumer. Enhanced competition—getting top-of-the-line products into the hands of consumers at lower costs—is the purpose of this Act. The interpretations that the Board has adopted to date appear to have kept this purpose in mind. That being the case, the Board will most likely continue to use the new standard for permissible non-banking activities to allow bank holding companies and their affiliates to engage in less conventional banking services as long as the Board believes that the overall safety and soundness of the financial holding company is not threatened. In making this determination, the Board's assumed role as "umbrella regulator" will be critical. To what extent will the Board rely on functional regulators to make assessments of affiliates that engage in securities or insurance activities in formulating the overall risk profile of a financial holding company who wishes to engage in unconventional activities? This presents a possible stumbling block to further expansion of permissible activities under the GLB Act, but as technology continues to enable financial holding companies to offer new and innovative products, it is likely that regulatory turf wars will take a back seat to the insatiable demands of the American consumer.

VI. CONCLUSION

Whether or not the end result of the GLB Act will be to improve competition and the provision of cutting-edge services in the financial service industry remains to be seen. By enacting the GLB Act and its change in the standard for permissible activities, Congress has placed the future of the American financial services industry into the Board’s hands. While its authority is broad, the expansion in permissible activities made to date appears to have kept in mind the safety and soundness concerns

absent in the era that led to the collapse of the American financial services industry during the Great Depression. With the enactment and implementation of the GLB Act, financial services legislation has come full-circle in the United States. It seems certain that the Board will use its discretion to allow financial institutions to push the envelope in providing new products and services to consumers as long as these institutions appear capable of bearing the additional risks these activities pose. As long as the Board continues to exercise its authority, mindful of the failures that made Glass-Steagall necessary in the first place, the legacy of the GLB Act should be one of unparalleled prosperity for the American economy well into the twenty-first century.