Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Conditional Approval #309
May 1999

DECISION OF THE COMPTROLLER OF THE CURRENCY ON THE APPLICATION BY FIRST TENNESSEE BANK, N.A., MEMPHIS, TENNESSEE TO ESTABLISH AN OPERATING SUBSIDIARY

April 12, 1999

I. INTRODUCTION AND SUMMARY OF PROPOSAL

On February 24, 1999, First Tennessee Bank, N.A., Memphis, Tennessee ("Bank") applied to the Office of the Comptroller of the Currency ("OCC") pursuant to 12 C.F.R. §§5.34(d) and (f) to establish an operating subsidiary, First Tennessee Securities Corporation ("Subsidiary"), to engage, to a limited extent, in underwriting and dealing activities with respect to municipal revenue bonds, and to engage in certain bank permissible activities described herein. The Subsidiary would be a wholly-owned subsidiary of the Bank.

The OCC has previously determined that underwriting and dealing in revenue bonds is part of the business of banking and therefore authorized for operating subsidiaries under 12 U.S.C. § 24(Seventh).[1] The OCC also has determined that underwriting and dealing in revenue bonds through an operating subsidiary of a national bank is consistent with section 20 of the Glass-Steagall Act (12

[1] *See* 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) ("Zions Decision"), OCC Conditional Approval No. 262, *Interpretations and Actions*, Dec. 1997, Vol. 10, No. 12; Decision of the Comptroller of the Currency on the Application by National Bank of Commerce, Memphis, Tennessee to Commence New Activities in an Operating Subsidiary (October 20, 1998) ("Commerce Decision"); and Decision of the Comptroller of the Currency on the Application by UMB Bank, N.A., Kansas City, Missouri, to Commence New Activities in an Operating Subsidiary, December 9, 1998 ("UMB Decision"). The Zions, Commerce, and UMB Decisions are incorporated by reference herein and are collectively referred to herein as the "Revenue Bond Decisions".

U.S.C. § 377), provided that the entity engaged in the activity derives no more than 25% of its gross revenues from such underwriting and dealing.[2]

The Bank has committed that the Subsidiary will not derive more than 25% of its total gross revenue from its proposed revenue bond underwriting and dealing activities. In addition, the Bank has committed that the Subsidiary will conduct its underwriting and dealing activities subject to the conditions and limitations established by the OCC in 12 C.F.R. 5.34(f) and in prior OCC decisions conditionally approving revenue bond underwriting and dealing through an operating subsidiary.[3]

Accordingly, on the basis of the record and for the reasons discussed below, the OCC has determined, subject to the conditions specified herein, that the application should be, and hereby is, approved.

II. THE BANK'S PROPOSAL

A. Revenue Bond Activities

Under the proposal, the Subsidiary will engage in underwriting and dealing, to a limited extent, in municipal revenue bonds.[4] The Subsidiary will be a self-clearing broker-dealer registered with the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 (15 U.S.C. § 78a *et seq.*) and a member of the National Association of Securities Dealers, Inc. ("NASD"). The Subsidiary, therefore, will be subject to the record-keeping and reporting obligations, fiduciary standards, and other requirements of the Securities Exchange Act of 1934, the SEC, and the NASD.

The Bank has significant experience in underwriting and dealing in general obligation bonds and will continue to underwrite and deal in those securities. First Tennessee Capital Markets ("FTCM"), a division of the Bank, is currently engaged in a broad range of securities activities, including underwriting and dealing in bank-eligible securities, private placement activities, brokerage activities, portfolio analysis, tax planning, and loan securitization to institutional clients worldwide.[5] Initially, personnel from

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

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

[4] 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.

[5] The Bank will offer revenue bonds underwritten by the Subsidiary to its customers, as agent, or in secondary market transactions, as riskless principal. The OCC has previously determined that brokerage activities conducted as a riskless principal are authorized for national banks pursuant to 12 U.S.C. § 24(Seventh). *See* OCC

FTCM will provide the primary disciplines and much of the experience necessary to conduct the proposed revenue bond activities and the other proposed activities. These individuals will either transfer to the Subsidiary or become dual employees of the Subsidiary and the Bank.

B. Other Proposed Activities

In addition to the proposed revenue bond activities, the Bank proposes that the Subsidiary conduct the following activities:

1. Arranging commercial mortgage loans for the Bank and outside customers, including long-term, fixed rate commercial real estate loans extended by life insurance companies and securitizing such loans ("Commercial Mortgage Loan Activities")[6];

2. Engaging in private placements of corporate debt securities, trust preferred securities, and leases, including structuring, documenting, and placing fixed rate secured and unsecured term debt, fixed rate subordinated debt, and fixed rate mezzanine debt for commercial customers, as well as engaging in large lease transactions and loan syndications and participations ("Private Placement Activities")[7];

Interpretive Letter No. 371 (June 13, 1986), *reprinted in* [1986-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,541 (1986). The Bank has committed that it will fully disclose in agency and riskless principal transactions that the subsidiary is the underwriter and dealer of the securities.

[6] The OCC has previously determined that national banks and their operating subsidiaries may act as an intermediary to arrange for commercial real estate financing. *See* 12 C.F.R. §5.34(e)(2)(ii)(J); Interpretive Letter No. 271 (September 21, 1983); and Interpretive Letter No. 387 (June 22, 1987). In addition, national banks and their operating subsidiaries may securitize and sell assets, including interests in certain commercial loans. *See, e.g.*, Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612 and *Securities Industry Association v. Clarke*, 885 F.2d 1034 (2d Cir. 1988), *cert. denied* 493 U.S. 1070 (1990); No Objection Letter No. 87-9 (December 16, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,038 (securitized commercial loans originated by bank).

[7] The OCC has previously determined that the private placement of securities as agent for the issuer is a permissible activity for a national bank and its operating subsidiary and does not involve the underwriting, public sale or distribution of securities. *See* 12 C.F.R. §§ 5.34(e)(2)(ii)(J) and 5.34(e)(3)(ii)(A)*;* OCC Trust Interpretation 256 (1990); Interpretive Letter No. 463 (1988); Interpretive Letter No. 435 (1988); Interpretive Letter No. 416 (1988). *See also Securities Industry Association v. Board of Governors of the Federal Reserve System*, 807 F.2d 1052 (D.C. Cir. 1987) *cert. denied*, 483 U.S. 1005 (1987). In addition, the OCC has determined that brokerage activity conducted as a riskless principal is authorized for national banks and does not violate the Glass-Steagall Act restrictions on bank underwriting and dealing. Interpretive Letter No. 371 (June 13, 1986) *reprinted in* [1985-1987 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 85,541.

3. Providing advisory services in connection with mergers and acquisitions activities, including valuations, acquisitions, and sales such as the acquisition or marketing of branches for financial institutions ("Mergers and Acquisitions Activities")[8];

4. Buying and selling all types of securities on an agency or "riskless principal" basis ("Brokerage Activities")[9];

5. Engaging as principal in investing and trading activities in bank eligible securities ("Investing and Trading Activities")[10];

6. Advising, structuring, arranging and executing transactions, as agent or principal, with respect to derivative instruments ("Derivative Activities")[11];

7. Underwriting, dealing, trading, investing and public finance activities in bank eligible securities, including securities of states and political subdivisions thereof which meet the definition of general obligation securities as defined by the OCC ("GO Underwriting and Dealing Activities")[12]; and

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[8] National banks and their operating subsidiaries may provide financial and strategic advisory services to their customers, including those related to recapitalizations, mergers, acquisitions, and other means of establishing or expanding business operations. *See* 12 C.F.R. §5.34(e)(2)(ii)(J). *See also* Conditional Approval Letter No. 221 (December 4, 1996). In particular, national banks and their subsidiaries may engage in certain additional functions when providing financial counseling or acting as a "finder" including giving advice on the financing a sale or acquisition. *See* Letter from Judith A. Walter, Senior Deputy Comptroller (July 17, 1986); Interpretive Letter No. 137 (December 27, 1979) *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,218.

[9] National banks and their operating subsidiaries may provide brokerage services, related securities credit, advisory services, and administrative services as part of or incidental to the business of banking. *See* 12 C.F.R. §5.34(e)(3)(ii)(A); Interpretive Letter No. 647 (April 15, 1994); Interpretive Letter No. 622 (April 9, 1993); Interpretive Letter No. 494 (December 20, 1989); *Securities Industry Association v. Comptroller of the Currency*, 577 F. Supp. 252 (D.D.C. 1983). Section 16 of the Glass-Steagall Act specifically recognizes such activities as permissible for national banks. 12 U.S.C. §24(Seventh). The OCC has previously determined that authorized brokerage services include buying and selling securities in the secondary market as "riskless principal." *See* Interpretive Letter No. 375 (September 25, 1986) *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 85,545.

[10] A national bank or its operating subsidiary may purchase for its own account "investment securities" under limitations prescribed by the OCC in 12 C.F.R. Part 1. *See* 12 U.S.C. §24(Seventh).

[11] National banks and their operating subsidiaries may advise, structure, arrange, and execute transactions, as agent or principal, in connection with interest rate, basis rate, currency, currency coupon, and cash-settled commodity, commodity price index, equity and equity index swaps, and other related derivative products. *See* 12 C.F.R. §5.34(e)(3)(ii)(E).

[12] National banks and their operating subsidiaries may underwrite, deal, and invest in certain bank-eligible securities including obligations of the United States and general obligations of any State or political subdivision and certain specified quasi-government guaranteed obligations enumerated in 12 U.S.C. §24(Seventh). 12 U.S.C.

8. Securitizing and selling pools of consumer-receivable loans, including credit card loans, auto loans, home equity lines of credit, and 1-4 family residential mortgages, and buying and selling securitized assets ("Asset Backed Activities")[13].

Because these activities are permissible for a national bank to engage in directly, no further legal analysis is required herein. Accordingly, the proposed bank permissible activities are approved.

III. DISCUSSION AND LEGAL ANALYSIS OF PROPOSED MUNICIPAL REVENUE BOND ACTIVITIES

Introduction and Summary Conclusion

The Supreme Court has long-stated that the starting point for any statutory analysis is the language of the statute itself.[14] Accordingly, that is where we begin. Since the enactment of the National Currency Act in 1863, section 24(Seventh) has expressly authorized national banks to carry on "the business of banking," including "discounting and negotiating promissory notes" and "other evidences of debt," and to "exercise powers that are incidental thereto." 12 U.S.C. § 24(Seventh). During the latter part of the nineteenth century, and into the twentieth century, national banks relied on this statutory authority to underwrite and deal in both debt and equity securities. Indeed, underwriting and dealing 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

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§24(Seventh). National banks and their operating subsidiaries also may advise state and local governments on financing projects and assist them in the marketing of their securities. *Id*. 12 C.F.R. §5.34(e)(2)(ii)(I); Interpretive Letter No. 122 (August 1, 1979) *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,203. In addition, a national bank or its operating subsidiary may purchase for its own account "investment securities" under limitations prescribed by the OCC in 12 C.F.R. Part 1. 12 U.S.C. 24(Seventh).

[13] National banks and their operating subsidiaries may securitize and sell assets and buy and sell obligations representing interests in a pool of loans. *See, e.g.,* Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612 and *Securities Industry Association v. Clarke*, 885 F.2d 1034 (2d Cir. 1988), *cert. denied* 493 U.S. 1070 (1990). *See also* Interpretive Letter No. 585 (June 8, 1992), *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,406 (securitized motor vehicle retail installment sales contracts purchased from automobile dealers); Interpretive Letter No. 540 (December 12, 1990), *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,252 (securitized credit card receivables originated by bank or purchased from others); No Objection Letter No. 87-9 (December 16, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,038 (securitized commercial loans originated by bank).

[14] *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).

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 revenue bond activities proposed to be conducted by the Subsidiary may be permitted for a subsidiary of a national bank. The revenue bond 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.[15] 12 U.S.C. § 24(Seventh). National banks relied on this authority to engage

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[15] 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).

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 express statutory authority to "discount and negotiate evidences of debt."[16] 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.[17] Indeed, most of the institutions in the early investment banking business were commercial banks. With the enactment of the National Currency Act in 1863[18], national banks entered the investment banking business. The First National Bank of New York, for example, sold war bonds during the Civil 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.[19] 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

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[16] We note that Congress recently considered legislation on financial modernization that would have explicitly permitted national banks to underwrite municipal revenue bonds directly in the bank as well as in a subsidiary. *See* H.R. 10, 105th Cong. 2d Sess. (1998).

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

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

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

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.[20]

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."[21]

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.

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[20] 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). 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").

[21] *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."

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). The OCC has previously determined that this enumerated power clearly encompasses the power to underwrite and deal in debt securities, such as revenue bonds.[22]

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.[23] 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.[24] In addition, national banks have substantial experience and expertise in investing in and

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[22] *See* Zions Decision, *supra* and Commerce Decision, *supra*.

[23] *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'.").

[24] Nineteen states 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

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, 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.[25]

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.[26] 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).[27] Functionally, there is no significant difference between underwriting the proposed revenue bonds and

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authorized under state law to engage in revenue bond underwriting is evidence that revenue bond underwriting is part of the business of banking.

[25] 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).

[26] *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.

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

the types of revenue bonds enumerated in section 16, and little difference between underwriting the municipal revenue bonds and underwriting general obligation bonds.[28]

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.[29]

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.[30] 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 involve the same basic functions as underwriting and dealing in bank-eligible securities.[31] 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

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[28] The Federal Reserve has previously determined that underwriting and dealing in municipal revenue bonds is a "natural extension of activities currently conducted by banks, 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 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.

[29] 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.

[30] 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.

[31] 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).

a profit. This requires an analysis of the creditworthiness of the issuer [32] and an assessment of price volatility. Because of their traditional lending activities, banks and their subsidiaries are clearly qualified to perform the credit analysis required in both bank-eligible and the proposed underwritings. The underwriter also is responsible for distributing the securities to investors and generally deals in the issuer's securities by purchasing and selling them for the underwriter's own account. Banks perform similar functions when they underwrite eligible securities. 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.[33]

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. There has been a substantial decrease in competition in municipal revenue bonds underwriting and dealing, resulting in higher costs for many municipalities, particularly small communities most in need of such financing. The Bank believes that the Subsidiary's entrance into this field will result in increased competition. Increased competition, in turn, should result in cost savings to municipalities, resulting in increased benefits to taxpayers through lower taxes or increased services. In addition, the Bank believes that permitting the Subsidiary to engage in the revenue bond activity may provide alternative sources of financing for smaller municipalities that are unable to obtain such financing currently. Approval of the proposal should also result in greater convenience for municipal customers desiring this form of financing.

In addition, approval of this activity would enable national banks to diversify their activities through operating subsidiaries and generate new sources of revenue. Activity diversification can have important benefits. Fees and other income from the subsidiaries may enable banks to offset the effects of cyclical downturns in other sectors of the economy.[34] Hence, bank earnings would be less volatile,

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[32] 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.

[33] 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.

[34] *See* Testimony of Julie L. Williams, Acting Comptroller of the Currency, Before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, June 25, 1998, at pp. 2-4 ("Bank subsidiaries provide a

reducing risks to the banking system as a whole. As former FDIC Chairman Helfer stated, 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).[35]

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.[36]

c. The risks associated with underwriting and dealing in revenue bonds are the same risks already assumed by the bank in underwriting and 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 securities[37] and investing in revenue bonds.[38] The primary risks[39] of underwriting, dealing

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means for prudent diversification of bank activities and income"). *See also* 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.

[35] Testimony of Ricki Helfer, *supra*, at 23. *See also* Ricki Tigert Helfer, William M. Isaac, and L. William Seidman, *Ex-FDIC Chiefs Unanimously Favor the Op-Sub Structure*, THE AMERICAN BANKER, Sept. 2, 1998.

[36] 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).

[37] 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.

[38] 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.

[39] 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

and investing in both bank-eligible and bank-ineligible securities are reputation risk[40] and price risk.[41] National banks 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.[42] 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. Section 20 of the Glass-Steagall Act Permits Underwriting and Dealing by a Subsidiary of a National Bank

The OCC has previously concluded that section 20 of the Glass-Steagall Act would permit underwriting and dealing in revenue bonds by an operating subsidiary of a national bank, notwithstanding the Glass-Steagall Act's prohibition on such underwriting by national banks.[43] National banks and operating subsidiaries are afforded a different statutory treatment under the Glass-Steagall Act. 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.[44] Under section 20 of the Act, on the other hand, "affiliates" of national banks are allowed to engage in investment banking activities with respect to all types of securities, provided the affiliate is not "engaged

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proposed "new line of business."

[40] 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.

[41] 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.

[42] 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).

[43] *See* 12 U.S.C. § 377, Zions Decision, *supra* and Commerce Decision, *supra*.

[44] *See* 12 U.S.C. § 24(Seventh).

principally" in underwriting or dealing in securities in which the bank may not directly underwrite or deal. [45]

The term "affiliate" is defined for purposes of section 20 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 includes a company that is more than 50% owned or controlled by a national bank.[46] 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.

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[45] 12 U.S.C. § 377. 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).

[46] 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). The Bank, in this case, owns 80% of the capital stock of the Subsidiary.

The Subsidiary's proposed activities are permissible under this standard. The Federal Reserve has previously determined that an affiliate of a member bank earning 25% or less of its revenue from underwriting and dealing in securities impermissible for a member bank to underwrite and deal in directly, is not "principally engaged" in that activity for purposes of section 20 of the Glass-Steagall Act (12 U.S.C. § 377).[47] 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 gross 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.

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

It is well-settled that national banks may own operating subsidiaries as an incident to being in business.[48] Moreover, as section 20 of the Glass-Steagall Act makes clear, subsidiaries of national banks may legally engage in activities not permitted for the bank itself. The OCC and the courts also have recognized, in various contexts, that limitations that apply to the bank itself do not necessarily apply to its affiliates or subsidiaries.

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 authorized by law and that the limitation applicable to the bank does not apply to the subsidiary.[49] Pursuant to this regulation, the OCC determined that underwriting and dealing in revenue bonds is part of the business of banking and that the limitations on underwriting and dealing in such securities applicable to the bank under section 16 of the Glass-Steagall Act do not apply to an operating subsidiary.[50]

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-

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[47] *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*").

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

[49] *See* 12 C.F.R. § 5.34(d).

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

Steagall Act and concluded that the activities were permissible for affiliates of banks.[51] 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."[52] As a result, the court noted that "bank affiliates may be authorized to engage in certain activities that are prohibited to banks themselves."[53]

In conclusion, affiliates and operating subsidiaries of national banks may engage in activities different from those permitted for a national bank under certain circumstances. Those activities must still qualify as part of or incidental to the business of banking or be permissible for national banks or their subsidiaries under other statutory authority, however. As explained above, the proposed activities of the Subsidiary 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. 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

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

[52] *Id*. at 64.

[53] *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). *See also Investment Company Institute v. Federal Deposit Insurance Corp.*, 606 F. Supp. 683 (D.D.C. 1985) (holding that a state nonmember bank could own a securities firm subsidiary even though the bank could not itself engage in the activities of the subsidiary); *Securities Industry Association v. Federal Home Loan Bank Board*, 588 F. Supp. 749 (D.D.C. 1984) (holding that federal savings and loan associations could indirectly own a corporations engaged in an activity not permissible for the associations).

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.[54] 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 section 16 of the Glass-Steagall Act.[55] Moreover, the proposed activities pose comparable risks to national banks as those associated with underwriting, dealing and investing in bank-eligible securities. Accordingly, the OCC has determined that the proposed activities will not result in significant or excessive risk to the Bank or the Subsidiary.

B. Corporate Separateness

In order to minimize any potential that securities underwriting and dealing risk may negatively affect the Bank, the Bank will be insulated, both structurally and operationally, from the Subsidiary. There are a number of requirements intended to ensure the Subsidiary's independent legal and corporate existence under the OCC's regulation governing operating subsidiaries. [56]

In addition, section 5.34(f) requires that the Subsidiary be adequately capitalized according to relevant industry measures and maintain capital adequate to support its activities and to cover reasonably expected expenses and losses. When the Subsidiary is engaged in a principal capacity in activities authorized under section 5.34(f), as in this case, certain additional supervisory requirements will protect the financial soundness of the Bank.[57] 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

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[54] 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.

[55] 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).

[56] *See* 12 C.F.R. § 5.34(f)(2).

[57] *See* 12 C.F.R. § 5.34(f)(3).

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.[58] 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. These disclosures minimize the risk that customers may confuse the activities and obligations of the Subsidiary with those of the Bank.[59]

C. Supervision of Subsidiary

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

[59] 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 (Pub. L. 101-73, Aug. 9, 1989, 103 Stat. 183) provided substantial civil money penalties for national banks engaging in unsafe and unsound banking practices or for violations of conditions imposed in writing in connection with the grant of an application or other request by a national bank. Likewise, the Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub. L. 102-242, Dec. 19, 1991, 105 Stat. 2236), established a framework for prompt corrective action when banks fail to meet specified capital requirements, including the ability of the OCC to require an undercapitalized institution to divest any subsidiary that may pose a significant risk to the parent bank or that is likely to cause a significant dissipation of the institution's assets or earnings. These and other available supervisory actions provide the OCC with a substantial array of tools -- not available until relatively recently -- to address risks presented by national bank operating subsidiaries.

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 and municipal 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.[60] In particular, the Subsidiary is registered with the SEC as a broker-dealer and will be subject to financial reporting, anti-fraud and financial responsibility rules applicable to broker-dealers. The Subsidiary must comply with the SEC's net capital rule, which imposes capital requirements on broker-dealers that vary with the degree to which a broker-dealer acts as a principal. The Bank represents that the Subsidiary will maintain capital in excess of these requirements. The Subsidiary also will be subject to the rules and regulations of the NASD and the Municipal Securities Rulemaking Board. 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 requirements 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 requirements 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 to the Bank, its customers, and the Subsidiary associated with underwriting and dealing in securities. 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.

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[60] 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.

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 and for thirty days thereafter. 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.[61] These new operating standards are tailored to address the risks of affiliation with an insured bank not addressed by other laws.[62]

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

V. CONCLUSION

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

1. The Bank shall adopt policies and procedures, including appropriate limits on exposure, to govern its participation in transactions underwritten or arranged by the Subsidiary. The Bank shall ensure that an independent and thorough credit evaluation has been undertaken in

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

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

connection with its participation in such transactions, and that adequate documentation of that evaluation is maintained for review by the OCC.

2. The Subsidiary shall provide each of its retail customers the same written and oral disclosures, and obtain the same customer acknowledgments, specified by the Interagency Statement on Retail Sales of Nondeposit Investment Products, and comply fully with the NASD's Rule 2350, which specifies requirements applicable to broker-dealers operating on the premises of financial institutions.[63]

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

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

commencing the activity. The Bank should notify the Examiner in Charge to schedule the review.

Please be advised that all conditions of this approval are "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818.

/s/ 04-12-99

Julie L. Williams Date
Chief Counsel

Application Control Number: 1999-WO-08-0006