SIMPSON THACHER

THE GRAMM-LEACH-BLILEY ACT

SIMPSON THACHER & BARTLETT LLP

NOVEMBER 17, 1999

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INTRODUCTION

On November 12, 1999, President Clinton signed the "Gramm-Leach-Bliley Act" ("GLBA") into law. With the enactment of GLBA, Congress has finally achieved a goal that has eluded it for nearly 20 years: the formal elimination of the increasingly ineffectual barriers separating commercial banking, investment banking and insurance. GLBA also achieves the secondary goal of rationalizing, at least to some degree, the regulatory structure for the financial services industry in the United States.

GLBA permits a full range of financial services—from insurance and banking to securities underwriting, investment management and merchant banking—to be conducted under a common holding company. GLBA does not permit "universal banking," as that concept is known in Europe and elsewhere, in the sense that banks in the United States will not have significantly greater authority to offer non-banking products and services directly than they do today (and, in the case of insurance underwriting and real estate activities, will have less authority). Instead, GLBA contemplates the formation of groups of affiliated financial services companies, each regulated by its own "functional regulator": the Securities and Exchange Commission (the "SEC"), in the case of a securities firm, a state insurance commissioner, in the case of an insurance company, state or federal bank regulators, in the case of a depository institution, and so forth. The holding company for all these affiliated financial services companies will be supervised and regulated by the Board of Governors of the Federal Reserve System (the "Federal Reserve").

GLBA is unlikely, in the near term, to result in fundamental changes in the structure of the financial services industry in the United States. Innovative regulatory interpretations over the past two decades have already permitted banking organizations to underwrite and deal in securities, to manage investment companies and sell their shares, to act as an insurance agent and even to affiliate (at least on a temporary basis) with an insurance underwriter. GLBA will, however, provide an unchallengeable statutory basis for these activities and eliminate the structural oddities that had resulted from these regulatory interpretations (such as the requirement that insurance agency activities be conducted through a bank office in a small town rather than through a bank holding company, or that a bank holding company hire an independent "distributor" for its mutual funds). GLBA will also significantly reduce the role of the most innovative regulators of recent years, the Comptroller of the Currency (the "OCC") and the Office of Thrift Supervision (the "OTS"), as participants in the continuing financial modernization process.

The two most significant structural changes made by GLBA are to permit affiliations between banks and insurance companies and to expand the scope of authorized merchant banking activities for bank holding companies. Prior to GLBA, banks and bank holding companies were generally not permitted to underwrite insurance (other than the limited category of credit life insurance). As a result of GLBA, banks will be permitted to affiliate under a common holding company with life, property/casualty and other insurance companies. Given the low profitability of much of the insurance industry today and the volatility of operating results (particularly in the property/casualty lines), industry observers generally do not expect a wave of insurance acquisitions by bank holding companies following the enactment of GLBA. Rather, the focus for the near term by banking organizations is likely to be on enhanced product distribution arrangements and further acquisitions of insurance agencies. There may be a greater level of activity in the reverse direction — insurance companies acquiring banks — because GLBA permits insurance companies to become bank holding companies notwithstanding most state insurance law restrictions. As a result, large insurance companies may be able to relever some of their excess capital by investing it in a subsidiary depository institution.

The provisions of GLBA dealing with merchant banking activities are likely to be of greater significance to many banking organizations, at least in the near term. Merchant banking has become a highly profitable and growing business for many banking organizations. These activities, however, have been conducted under complicated rules and ownership limitations established by the Federal Reserve to prevent banking organizations from acquiring or exercising "control" (as defined very broadly by the Federal Reserve) over commercial companies. GLBA gives financial holding companies broad authority to acquire control of any company, either as principal or as manager or general partner of an investment fund, as part of their merchant banking activities. These provisions of GLBA, which do not contain any size or volume limitations on a financial holding company's merchant banking activities, should have the effect of leveling the playing field between banking organizations and traditional merchant banks and significantly expanding the merchant banking operations of many banking organizations.

Except for these provisions relating to merchant banking activities, however, GLBA actually increases the existing legal separation between banking and commerce in the United States. Companies which become financial holding companies are given limited grandfather rights to continue their non-financial activities for up to 15 years after the enactment of GLBA, after which time all non-financial activities must be divested or terminated. More importantly, the exemption that permitted unitary savings and loan holding companies to engage in non-financial activities is repealed by GLBA for companies that had not acquired a thrift or filed an application with the OTS to form or acquire a thrift on or prior to May 4, 1999. As a result, commercial companies (such as Wal-Mart) will no longer have any viable means to provide financial services to their customers through an affiliated depository institution.

On the surface, GLBA appears to provide a more rational regulatory structure. The disorderly competition among the Federal Reserve, the OCC, the Federal Deposit Insurance Corporation (the "FDIC") and the OTS to determine what activities depository institutions should be engaged in and through what structures has been ended by, in effect, requiring financial activities other than traditional banking activities to be conducted through holding company affiliates and by leaving determinations regarding new activities up to the Federal

Reserve. The perceived unfairness of allowing some securities and insurance activities to be conducted in banks free of SEC and state insurance regulation is addressed by creating significant incentives for banks to move their securities activities into registered broker-dealer subsidiaries and affiliates and clarifying the authority of the SEC and state insurance regulators to regulate these activities regardless of the legal entity in which they are conducted. However, "functional" regulation is based on a sometimes illusory distinction between securities, banking and insurance products and services. Functional regulation in the short run means that functionally similar products and services may be subject to different capital, risk management and disclosure requirements, ensuring the continuation of regulatory arbitrage. Functional regulation is also at odds with, and under GLBA, subordinated to, the concept of the Federal Reserve as the "umbrella" regulator. In the long run, it is possible that either the Federal Reserve will be the ubiquitous regulator, or the regulatory structure will need to be realigned so that it is based on regulatory objectives, with, for example, the Federal Reserve focused on systemic risk, the SEC focused on efficient markets, and another regulator focused on disclosure to investors.

The significant provisions of GLBA are described in greater detail below. While major portions of the legislation became effective upon enactment, the most important provisions—such as those in Title I permitting affiliations of banks, securities firms and insurance companies—will not become effective until 120 days after the date of enactment. During this period, the Federal Reserve is expected to adopt implementing regulations. In addition, the OCC is required to adopt implementing regulations within 270 days after the enactment of GLBA for national banks to engage in financial and incidental activities through operating subsidiaries. These regulations, when issued, will be the subject of a subsequent memorandum.

Any questions concerning this memorandum generally or the provisions of GLBA relating to depository institutions should be directed to Lee Meyerson (212-455-3675), Gary Rice (212-455-7345) or John Walker (212-455-7365). Questions regarding insurance matters may be directed to Steve DeLott (212-455-3426), and questions regarding investment company matters may be directed to Cynthia Cobden (212-455-7744) or David Wohl (212-455-7937).

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I. FINANCIAL HOLDING COMPANIES

The centerpiece of GLBA is a series of amendments to the Bank Holding Company Act of 1956 (the "BHC Act") and other statutes that will permit a "financial holding company" to acquire or retain companies that engage in insurance, banking, securities underwriting and dealing, merchant banking and other financial activities. These amendments take effect 120 days after enactment.

A. Becoming a Financial Holding Company

1. Status as a Bank Holding Company or Non-U.S. Bank

Only a bank holding company or a non-U.S. bank that has a branch or agency in the United States may elect to become a financial holding company. GLBA did not alter Section 3 of the BHC Act, and a company that wishes to become a bank holding company by acquiring or establishing a "bank" will be required to apply to the Federal Reserve and demonstrate that it meets the applicable financial and managerial standards. The definition of the term "bank" is also unchanged: institutions that are FDIC insured or that both accept demand deposits and make commercial loans are "banks", with certain existing exceptions (such as those for thrifts and credit card banks). The process of obtaining Federal Reserve approval to become a bank holding company is likely to remain time consuming.

A non-U.S. bank that has a branch or agency in the United States is also eligible to become a financial holding company. GLBA did not alter Section 7 of the International Banking Act of 1978, as amended (the "IBA"), which requires a non-U.S. bank to obtain the approval of the Federal Reserve prior to establishing an office in the United States. For non-U.S. banks that are seeking approval to establish their first branch or agency, this process is also likely to remain time consuming.

2. "Well Capitalized" and "Well Managed"

A bank holding company that meets the following criteria may become a financial holding company by filing a declaration to that effect with the Federal Reserve and certifying that those criteria are met.

First, all of its depository institution subsidiaries must be "well capitalized". It is important to note that the holding company itself need not be "well capitalized". Under the BHC Act, a depository institution is "well capitalized" if it is "well capitalized" for purposes of the prompt corrective action provisions in the Federal Deposit Insurance Act: it has a tier 1 risk-based capital ratio of at least 6%, a total risk-based capital ratio of at least 10%, a leverage ratio of at least 5%, and it is not subject to any formal supervisory action. Second, all of its depository institution subsidiaries must be "well managed". A depository institution is "well managed" if it has received a CAMEL composite rating of 1 or 2 (or an equivalent rating under an equivalent rating system) in its most recent supervisory examination or subsequent review and at least a "satisfactory" rating for management, if such a rating is given. In the case of an existing bank holding company, it will be possible to determine on the effective date of GLBA whether it meets both of these standards.

GLBA provides that the Federal Reserve shall apply to non-U.S. banks that have a branch or agency in the United States and that wish to become financial holding companies standards that are "comparable" to the "well managed" and "well capitalized" standards that apply to U.S. depository institutions, giving "due regard to the principle of national treatment and equality of competitive opportunity." Because the provisions pursuant to which bank holding companies become financial holding companies do not exclude non-U.S. banks, in our view non-U.S. banks that are bank holding companies would be treated in the same way as other bank holding companies: as long as their U.S. depository institution subsidiaries satisfy the relevant tests, such non-U.S. banks could become financial holding companies.

In the case of non-U.S. banks that are not bank holding companies, the "well capitalized" and "well managed" standards are to be applied to the non-U.S. bank itself. A non-U.S. bank that has a tier 1 risk-based capital ratio of at least 6% and a total risk-based capital ratio of at least 10%, calculated under home country rules adopted pursuant to the BIS guidelines or pursuant to the Federal Reserve's risk-based capital rules, will be viewed as "well capitalized" for purposes of attaining financial holding company status. The Federal Reserve is not likely to require non-U.S. banks to satisfy the leverage ratio requirement. For non-U.S. banks that are near to but not quite at these levels, particularly if they satisfy the 6% tier 1 risk-based capital requirement, the Federal Reserve is likely to be receptive to arguments that, in view of the banks' asset quality, they should be regarded as well capitalized. However, this will require an application and a determination by the Federal Reserve.

With regard to the "well managed" standard, the Federal Reserve is likely to take the same approach that it now uses in determining whether non-U.S. banks may use the expedited procedures for making nonbank acquisitions, which is to require that the U.S. operations of the non-U.S. bank have received a rating of 1 or 2 (derived from the Summary of Condition) at the most recent annual assessment.

3. "Satisfactory" CRA Rating

A bank holding company cannot become a financial holding company unless all of its subsidiary insured depository institutions have received CRA ratings of "satisfactory" or better in their most recent examinations. Depository institutions acquired by the financial holding company within twelve months prior to the date on which the election is filed will be excluded from this test even if they have less than a satisfactory CRA rating as long as the financial holding company has submitted a plan to the applicable Federal banking agency to improve the acquired depository institution's CRA rating and the Federal banking agency has accepted such plan.

In addition, GLBA provides that a financial holding company may not commence any new financial activity or activity incidental thereto, or acquire any company engaged in such financial or incidental activities (other than investments made in connection with previously commenced merchant banking and insurance company portfolio investment activities described below), if any insured depository institution subsidiary of such financial holding company has received a rating of less than satisfactory in its last CRA examination. A similar restriction applies to insured depository institutions that conduct financial activities and activities incidental thereto through financial subsidiaries in the event such institution receives less than a satisfactory CRA examination rating.

The GLBA Conference Report indicates that the foregoing restrictions are to be based solely on the results of the relevant institutions' most recent CRA examination and will terminate as soon as all the relevant depository institutions have restored their CRA ratings to satisfactory or better. The Conference Report also emphasizes that these provisions of GLBA do not authorize any regulatory agency to require the divestiture of any company acquired by the financial holding company or bank prior to the time it failed to comply with the minimum CRA requirements, or to limit in any way any activity engaged in by the financial holding company or bank at the time such noncompliance began. In contrast, as discussed below, the Federal Reserve is given express power under GLBA to order divestitures in the case of financial holding companies that cease to be well capitalized and well managed and the OCC is given comparable powers with respect to national banks that engage in financial activities through operating subsidiaries.

4. The Decision to Become a Financial Holding Company

a. Bank Holding Companies and Non-U.S. Banks. It seems likely that most if not all bank holding companies and non-U.S. banks that qualify will elect to become financial holding companies. This status will enable them to engage in a much broader range of financial activities than is now permitted and to make acquisitions of non-depository institutions without prior Federal Reserve approval. For a bank holding company that meets the standards for becoming a financial holding company, there is no reason not to elect such status.

A non-U.S. bank that operates a U.S. securities affiliate pursuant to the grandfather provisions of the IBA is required to give up those grandfather rights if it becomes a financial holding company. Because a financial holding company will be permitted to engage in all the activities of a grandfathered securities company, including underwriting and dealing activities (without any revenue limitation) and broader merchant banking activities than are permissible for such grandfathered companies, the loss of grandfather rights should not be meaningful. Moreover, the Federal Reserve is authorized to terminate such grandfather rights of a non-U.S. bank if, after two years from the enactment of GLBA, the non-U.S. bank has not elected to become a financial holding company. Non-U.S. banks are not required by GLBA to give up the right, contained in Section 2(h)(2) of the BHC Act, to retain certain affiliations with non-U.S. commercial and industrial companies that have operations in the United States.

Bank holding companies and non-U.S. banks that do not qualify for or choose not to elect financial holding company status will be permitted to continue to engage in activities that have been approved by the Federal Reserve pursuant to Section 4(c)(8) of the BHC Act prior to the enactment of GLBA, but not in any newly authorized financial activities. This means, for example, that such banking organizations will not be permitted to engage in insurance agency activities (other than through a bank subsidiary) or insurance underwriting activities. Such organizations will also continue to be subject to the narrow restrictions imposed on merchant banking activities prior to the adoption of GLBA. Although securities underwriting and dealing activities will be permissible, such activities will be subject to the same conditions that applied prior to GLBA unless the Federal Reserve removes those conditions, which include: ineligible revenue limitations, operating conditions, and a prohibition on distributing mutual fund shares.

b. Investment Banks and Insurance Companies. It is less clear to what extent investment banks and insurance companies will choose to acquire a "bank" and become a financial holding company. Prior to the enactment of GLBA, such companies could combine insurance, securities and merchant banking activities. Investment banks and insurance companies have been (and, if they do not elect to become financial holding companies, will remain) subject to relatively little regulation at the holding company level and few restrictions on affiliated activities. Financial holding company status brings with it the Federal Reserve as the "umbrella" regulator and consolidated minimum capital requirements. Notwithstanding the functional regulation theme that runs through GLBA, the Federal Reserve is likely to take its role as umbrella regulator seriously.

c. Nonfinancial Companies. Another cost of becoming a financial holding company is the requirement to curtail and ultimately divest nonfinancial activities. GLBA permits a company that is not a bank holding company or a non-U.S. bank and that is engaged in commercial activities to become a financial holding company and to continue to engage in impermissible commercial activities on a grandfathered basis during the ten-year period beginning on the date of enactment of GLBA (with the Federal Reserve having the authority to extend this period by up to an additional five years). [1] These grandfathered activities are subject to the following limitations:

- only activities in which the company was engaged on September 30, 1999 can be grandfathered;

[1] GLBA contains an exception for companies that are not bank holding companies or non-U.S. banks and that were engaged as of September 30, 1999 in trading, sales and investments in commodities and underlying physical properties that were not permissible activities for bank holding companies on such date. This exception permits such a company to continue such activities indefinitely as long as the aggregate amount of assets related to such activities does not exceed 5% of its consolidated assets (or such higher percentage as the Federal Reserve may permit).

- the company must be "predominantly engaged in financial activities" — meaning that the company's annual consolidated gross revenues from financial and incidental activities represent at least 85% of the company's annual consolidated gross revenues (excluding, in each case, revenues from subsidiary depository institutions); a similar test must also be met on an ongoing basis after the company becomes a financial holding company;

- the company may not expand the grandfathered activities through acquisitions of other companies or businesses engaged in non-financial activities;[2] and

- any depository institution controlled by the financial holding company will be prohibited from engaging in cross-marketing activities with an affiliate which is engaged in the grandfathered activities and will be prohibited from engaging in any "covered transactions" (for purposes of Sections 23A and 23B of the Federal Reserve Act) with that affiliate.

In addition, GLBA does not repeal Section 4(a)(2) of the BHC Act, which provides a company that becomes a bank holding company with a period of at least two years to conform its activities to the BHC Act. This is the provision utilized by Travelers Group to acquire Citicorp. A company that cannot satisfy the "predominately financial" test for becoming a financial holding company could acquire a bank holding company pursuant to Section 4(a)(2) and ultimately become a financial holding company. However, if the company is predominately commercial or industrial, the Federal Reserve is unlikely to be receptive to requests to extend the two year conformance period contained in Section 4(a)(2) for the three additional years that the Federal Reserve has the power to grant.

d. Alternative Ways to Own Depository Institutions. Companies that are not bank holding companies or non-U.S. banks, in considering whether to become financial holding companies, must weigh the costs of more intrusive holding company regulation and termination of nonfinancial activities against the benefits of acquiring a depository institution that comes within the definition of "bank" in the BHC Act. It is not necessary to acquire a "bank" to offer commercial loans. Nor is it necessary to acquire a "bank" to engage in credit

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[2] GLBA contains an exception to this provision for the benefit of a single company, which authorizes a financial holding company that owns both a broadcast station and an insurance company to acquire additional companies engaged in non-financial or incidental activities unless and until the financial holding company is acquired by or becomes affiliated with one of the five largest U.S. bank holding companies.

card activities because credit card banks continue to be excluded from the BHC Act definition of "bank".[3]

A nonfinancial company that owns a "nonbank bank" retains its grandfather right to operate such bank. These banks are sometimes referred to as "CEBA banks" because they were grandfathered when the Competitive Equality Banking Act of 1987 amended the BHC Act definition of "bank". GLBA liberalizes the restrictions that such banks operate under in several ways. In particular, such banks are no longer subject to cross-marketing restrictions and are not limited to the activities in which they were engaged in 1987. However, such banks continue to be subject to the basic restriction that they cannot offer both demand deposits and commercial loans.

Another way to offer certain depository institution services without acquiring a "bank" is to own a thrift institution. A company that acquired or chartered (or filed an application to acquire or charter) an insured thrift institution on or before May 4, 1999 is permitted to retain the thrift without having any restrictions placed on the activities in which the company may engage through other subsidiaries. In fact, if a financial services company (such as an investment bank or insurance company) is willing to terminate any nonfinancial activities in which it may be engaged, it can still acquire an insured thrift institution, in which case it would be subject to the somewhat less burdensome regulations of the OTS rather than those of the Federal Reserve.[4] However, the thrift institution charter has limitations: in general, the deposits that can be raised, either directly by the thrift or through cross-marketing by affiliates, for the most part must be invested by the thrift in credit card receivables, mortgage-related assets, consumer loans and similar assets in order to satisfy the "qualified thrift lender" test (which is not changed by GLBA). In addition, commercial loans generally may not constitute more than 10% of the assets of the thrift.

B. Remaining a Financial Holding Company

GLBA requires each financial holding company to continue to meet the well capitalized and well managed tests in order to continue engaging in the full range of financial and incidental activities permitted by GLBA. If the Federal Reserve determines that a financial holding company (other than one that engages only in the non-banking activities currently permitted by Section 4(c)(8) of the BHC Act) no longer satisfies the well capitalized and well managed tests, it will be required to enter into an agreement within 45 days with the Federal

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3 The exception from the definition of "bank" that exists for banks that engage "only in credit card operations" is expanded by GLBA to allow such banks to hold non-U.S. banks that do not engage in activities in the United States but the business of which outside the United States is need limited to credit card operations.

4 For example, the OTS does not impose minimum consolidated capital requirements on holding companies.

Reserve to correct these conditions. If the conditions are not corrected within 180 days after the Federal Reserve first notified the financial holding company of its failure to meet the well capitalized or well managed tests, the Federal Reserve may require the financial holding company to either divest any depository institution subsidiaries it controls or cease to engage in any financial or incidental activity that is not permissible for bank holding companies under Section 4(c)(8) of the BHC Act. GLBA permits the financial holding company to elect which of the two alternative courses of action it will pursue, and also permits the Federal Reserve to extend the 180 day cure period indefinitely if the Federal Reserve in its discretion determines such extensions to be appropriate.

C. Activities Authorized for Financial Holding Companies

1. Financial Activities

GLBA adds a new subsection (k) to Section 4 of the BHC Act. This subsection authorizes financial holding companies to engage in activities, either directly or through subsidiaries, that are "financial in nature" or incidental to a financial activity. GLBA contains a list of activities that are predefined as "financial activities". The list includes all types of insurance, securities, merchant banking, investment advisory, and lending activities.[5] GLBA also permits the Federal Reserve and the Treasury Department jointly to expand the list of financial activities, as described below.

a. Insurance Activities. Prior to GLBA, Section 4(c)(8) of the BHC Act prohibited the Federal Reserve from authorizing bank holding companies to engage in insurance underwriting and insurance agency activities, with a few very limited exceptions which the Federal Reserve did not interpret as broadly as the OCC. New Section 4(k) allows financial holding companies and their nonbank subsidiaries to engage in all types of insurance activities, including health insurance and annuities.

b. Securities Activities. GLBA repeals Section 20 and Section 32 of the Glass-Steagall Act, which prohibited banks from being affiliated with and having interlocks with companies that are principally engaged in underwriting, dealing or issuing securities. Pursuant to Section 4(k) of the BHC Act, financial holding companies will be permitted, either directly or through subsidiaries, to underwrite and deal in any type of securities, without any limitations on the revenue derived from such activities.

The restrictions that the Federal Reserve imposed on controlling mutual funds, which derived from the Federal Reserve's view that such companies are principally engaged in issuing

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5 GLBA does not expand the types of leasing activities that may be engaged in by a financial holding company: such leases must still be in "nonoperating" leases in the sense that the financial holding company is not permitted to service, repair or manage the leased property.

securities, are also repealed. Financial holding companies will be permitted to have interlocks with, sponsor, control and distribute the shares of all types of mutual funds.

c. Merchant Banking Activities. One of the most significant changes made by GLBA is the expansion of authorized merchant banking powers for financial holding companies. Merchant banking has become a substantial and highly profitable business for many U.S. bank holding companies. However, these activities have had to operate under a number of constraints as a result of BHC Act limitations on acquiring more than 5% of any class of voting shares of a nonfinancial company and Federal Reserve interpretations that prohibit a bank holding company from acquiring control of such companies by holding substantial amounts of nonvoting equity or other means. In order to ensure that a bank holding company's merchant banking investments are completely passive and do not constitute an indirect way of engaging in an otherwise impermissible business, the Federal Reserve has typically limited these types of investments to 5% or less of any class of voting stock and less than 25% of the total equity of the portfolio company; restricted officer and director interlocks; prohibited referral and cross-marketing arrangements with any of the bank holding company's other subsidiaries; and restricted the manner in which such investments could be sold.

The Federal Reserve's Regulation K permits bank holding companies and Edge Act subsidiaries of banks to make investments in up to 19.9% of the voting shares and 40% of the equity of a company that is not engaged in business in the United States. However, in a global economy the exclusion of companies with U.S. activities increasingly undermined the utility of this Regulation K investment authority.

Bank holding companies have also been prohibited from engaging in real estate investment activities, except to the extent such investments could be made under the 5% voting and 24.9% total equity restrictions.

GLBA by its terms would eliminate all of these restrictions. It expressly permits financial holding companies to acquire and hold, either as principal or on behalf of third parties (for example, as manager or general partner of or investment advisor to an investment fund) or otherwise, debt or equity securities or other ownership interests in another company, regardless of the business in which that other company is engaged, and to exercise control over that other company, subject to the following conditions:

- the securities or ownership interests in the portfolio company are not held by a depository institution or a subsidiary of a depository institution unless banks in the future become authorized to conduct merchant banking activities through their operating subsidiaries (see "Part II—Banks and Their Subsidiaries", below);

- the securities or ownership interests in the portfolio company are acquired and held either by a securities subsidiary of the financial holding company or one of its affiliates, or by a registered investment advisor to an insurance company or one of its affiliates, as part of a bona fide underwriting or merchant or investment banking activity, including activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment;

- the securities or ownership interests are held for such period of time as is appropriate "to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability" of such merchant banking activities; and

- during the period that the financial holding company holds such securities or ownership interests, the financial holding company "does not routinely manage or operate [the portfolio company] except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition".

GLBA also contains a similar exception permitting insurance companies engaged predominantly in underwriting life, accident and health or property/casualty insurance (other than credit-related insurance) or annuities, to make portfolio investments to the extent permitted by applicable state law for such insurance companies and subject to similar restrictions as described above for merchant banking investments by financial holding companies, except that the insurance company investment authority does not place any time limits on how long an investment may be held.

Although GLBA provides that the merchant banking activities described above are financial in nature and may be engaged in by financial holding companies without the need for further Federal Reserve action or approval, GLBA does authorize the Federal Reserve and the Treasury Department to jointly issue implementing regulations with respect to such activities, including limitations on transactions between depository institutions and affiliated portfolio companies. In addition, GLBA prohibits cross-marketing arrangements between a depository institution and any affiliate held as a merchant banking or insurance company portfolio investment, with a limited exception for statement inserts and Internet websites involving companies held as insurance company portfolio investments if, among other things, the Federal Reserve determines that the arrangement is in the public interest, does not undermine the separation of banking and commerce, and is consistent with the safety and soundness of depository institutions.

GLBA also amends Sections 23A and 23B of the Federal Reserve Act (which, among other things, restrict extensions of credit and other covered transactions between a bank and its affiliates) to create a rebuttable presumption that a company held as a merchant banking or insurance company portfolio investment is an affiliate of the financial holding company and its depository institution subsidiaries if the holding company owns 15% or more of the portfolio company's equity capital. This provision will also cover merchant banking investments held by a national bank through its financial subsidiaries if such activities are permitted in the future.[6] (Under Sections 23A and 23B as currently in effect, the threshold for being an affiliate is generally ownership of 25% of any class of the subject company's voting stock.) These amendments to Sections 23A and 23B permit the companies involved to provide information to the Federal Reserve that rebuts this presumption of control, and it is possible that the Federal Reserve will permit rebuttals of control based on the same non-control commitments (often referred to as the "Crown commitments") that it currently accepts to rebut a presumption of control under the BHC Act.

d. Activities Usual in Connection with Banking Abroad. The enumerated financial activities in Section 4(k) include engaging in the United States in all activities that the Federal Reserve has determined to be usual in connection with banking or other financial operations abroad. This list of activities, which is codified at 12 C.F.R. §211.5(d), primarily consists of activities that already are authorized by other provisions in Section 4(k). However, the list does include travel agency activities, which are not included in Section 4(k).

Data processing and management consulting activities also appear on the list. The restrictions that apply to data processing and management consulting activities when conducted pursuant to Section 4(c)(8) are not included in Section 211.5(d) of Regulation K. Although this suggests that Regulation K (and now Section 4(k)) permits a broader range of data processing and management consulting activities than had been permitted pursuant to Section 4(c)(8), the Federal Reserve staff recently interpreted the Regulation K provision authorizing data processing activities conducted abroad to be subject to the same restrictions as apply in the United States. Presumably, the staff will also narrowly interpret the management consulting activities that are permitted by Section 211.5(d).

2. Future Determinations that Activities are Financial in Nature

In addition to the authorized financial activities specified above, the Federal Reserve may determine, either by order or regulation, that other activities are financial in nature or incidental to such financial activities and therefore permissible for financial holding companies. Before doing so, the Federal Reserve must notify and consult with the Treasury Department. The Federal Reserve will not be permitted to approve the proposed activity if the Treasury Department notifies the Federal Reserve that in Treasury's view the proposed activity is not financial in nature or incidental to financial activities or is not otherwise permissible. GLBA also provides a procedure for the Treasury Department to propose to the Federal Reserve that a

6 The Regulation K investment provisions remain in place. Financial holding companies may still prefer to make investments pursuant to Regulation K (for investments that are consistent with the restrictions contained in Regulation K) rather than pursuant to the merchant banking power of Section 4(k) of the BHC Act because Regulation K investments can be indirectly made by a bank and a bank can make loans to companies in which it has made an investment pursuant to Regulation K without regard to the restrictions of Section 23A of the Federal Reserve Act.

proposed activity be determined by the Federal Reserve to be financial in nature or incidental thereto. The Federal Reserve would then have a specified period of time (generally 30 days) to determine whether or not to approve the activity proposed by Treasury.

Although these procedures could theoretically result in a stalemate between the Federal Reserve and the Treasury Department over expanded financial services powers, the Conference Report expresses the intent of the Conferees that the two agencies "will establish a consultative process that will negate the need for either agency to veto a proposal of the other agency".

GLBA also requires the Federal Reserve to define the extent to which the following activities are financial in nature or incidental thereto and therefore permissible for financial holding companies to engage in:

- lending, exchanging, transferring, investing for others or safeguarding financial assets other than money or securities;

- providing means for transferring money or other financial assets; and

- arranging, effecting or facilitating financial transactions for the account of third parties.

GLBA does not specify any time period within which the Federal Reserve is required to issue these definitions.

GLBA also does not specifically enumerate any standards by which activities are determined to be financial in nature or incidental thereto. It does direct the Federal Reserve, however, to take technological and competitive factors, among others, into account in making any such determination.[7]

3. Complementary Activities

Financial holding companies may also engage in activities that the Federal Reserve determines to be "complementary" to a financial activity as long as the complementary activity "does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally." This provision does not appear to require that the Federal Reserve notify or obtain the concurrence of the Treasury Department before approving a new activity.

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7 These factors include: the purposes of GLBA and the BHC Act; changes or reasonably expected changes in the marketplace in which financial holding companies compete; changes or reasonably expected changes in the technology for delivering financial services; and whether such activity is necessary or appropriate to allow a financial holding company to compete effectively with other financial service providers, efficiently deliver information and services that are financial in nature through the use of technological means, or offer customers any available or emerging technological means for using financial services.

D. Procedures for Acquisitions and De Novo Activities

One of the most significant changes made by GLBA to the BHC Act is the elimination of any requirement of prior approval from or prior notice to the Federal Reserve for a financial holding company to acquire another company engaged in permissible financial or incidental activities, or for a financial holding company to begin such activities on a *de novo* basis. Prior approval from the Federal Reserve will still be required for a financial holding company to acquire a bank or a savings association or for a company to become a bank holding company by acquiring a bank. The process for obtaining these approvals will remain unchanged from current law.

For any other acquisition or commencement of a *de novo* activity which is a permitted financial activity (either because it is designated as such in GLBA or because the Federal Reserve has approved it as such by order or regulation), a financial holding company is only required to give notice to the Federal Reserve of such action within 30 days *after* consummating such acquisition or commencing such activity. This approach reflects the theory of "functional regulation" that runs throughout GLBA. Responsibility for approving the acquisition of regulated companies or the commencement of regulated activities is placed with the principal regulator of those activities.

Because many types of financial holding company acquisitions will no longer be subject to prior review by a federal banking agency with responsibility for considering the antitrust effects of a transaction, the Federal Trade Commission is given broadened authority to review acquisitions by financial holding companies to the extent they involve the acquisition of non-depository operations or otherwise are not subject to prior Federal Reserve review. GLBA amends the Hart-Scott-Rodino provisions of the Clayton Act to provide that the portion of an acquisition which is being consummated under new Section 4(k) of the BHC Act, and which does not require prior approval from the Federal Reserve under Sections 3 or 4 of the BHC Act, will be subject to the pre-merger filing and review procedures of the Hart-Scott-Rodino Act.

Procedurally, this will mean that financial holding companies will need for the first time to make Hart-Scott-Rodino filings, including in situations where they are acquiring companies with both banking and nonbanking operations. For example, a financial holding company seeking to acquire another financial holding company or bank holding company would need to file an application with the Federal Reserve to acquire the target's subsidiary banks and would also need to make a Hart-Scott-Rodino filing with the Federal Trade Commission with respect to the target's non-banking subsidiaries that engage in financial activities permissible under new Section 4(k) of the BHC Act (unless the acquirer chose to seek prior Federal Reserve approval to acquire such non-banking subsidiaries under Section 4(c)(8)).

E. Functional Regulation and the Federal Reserve as "Umbrella Regulator"

GLBA contains extensive provisions implementing the concept of functional regulation — that is, that similar activities should be regulated by the same regulator with expertise in the area, regardless of the legal entity in which the activities are conducted. This applies both in allocating responsibility for supervising different companies within a financial holding company structure and in supervising different activities within the same company (such as securities and insurance activities within a bank).

1. Umbrella Supervision by the Federal Reserve

Under GLBA, the Federal Reserve is designated as the "umbrella" supervisor of financial holding companies. In that capacity, the Federal Reserve has authority to supervise and examine each financial holding company and its subsidiaries and to require the filing of reports regarding their businesses, operations and financial condition. However, in the case of "functionally regulated subsidiaries", the Federal Reserve is generally required to defer to examinations conducted by and reports provided to the functional regulators of such subsidiaries unless, among other things, the Federal Reserve concludes that any such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution or is not in compliance with other laws that the Federal Reserve has specific jurisdiction to enforce.

For these purposes, a "functionally regulated subsidiary" generally means a subsidiary which is not a depository institution and which is:

- a broker-dealer registered as such under the Securities Exchange Act of 1934 (the "1934 Act"), which would be regulated primarily by the SEC;
- a registered investment advisor, which would be regulated primarily by either the SEC or a state securities commission, depending on its type of registration;
- an investment company registered under the Investment Company Act of 1940 (the "1940 Act"), which would be regulated primarily by the SEC;
- an insurance company, which would be primarily regulated, as to its insurance activities, by applicable state insurance regulators; or
- an entity subject to regulation by the Commodity Futures Trading Commission.

GLBA also adds a new section to the BHC Act that prohibits the Federal Reserve from issuing regulations or orders or taking other actions, directly or indirectly, with respect to the functionally regulated subsidiaries of a bank holding company unless the Federal Reserve determines that such action is necessary to address material risks to an affiliated depository institution or to the domestic or international payments system and that such risks cannot be effectively addressed by action with respect to the affiliated depository institution itself.

In addition, GLBA imposes similar restrictions on the ability of the applicable federal regulator of a depository institution to examine, require reports from or (as described below) impose capital requirements on or require capital infusions from a functionally regulated subsidiary of a depository institution.

2. Capital Adequacy Rules

One key issue that GLBA raises is the extent to which the Federal Reserve will be able to effectively mandate capital levels for functionally regulated subsidiaries by virtue of its role as umbrella supervisor for financial holding companies. Since all financial holding companies will also be bank holding companies they would, under current regulations, be subject to the Federal Reserve's consolidated risk-based and leverage capital guidelines. This would have the indirect effect of setting minimum capital levels for all of the financial holding company's consolidated subsidiaries unless the Federal Reserve acts to modify the existing guidelines.

GLBA specifically prohibits the Federal Reserve from acting to impose any capital adequacy rules on a functionally regulated subsidiary that is:

- in compliance with the applicable capital requirements of its federal regulatory authority or state insurance authority;
- properly registered as an investment advisor under the Investment Advisers Act of 1940 (the "Advisers Act") or with a state; or
- licensed as an insurance agent with the appropriate state insurance authority.

However, GLBA only addresses in a limited way the Federal Reserve's ability to set consolidated capital rules that indirectly affect functionally regulated subsidiaries. GLBA provides that in setting capital adequacy guidelines for bank holding companies, the Federal Reserve may not take into account the activities, operations or investments of an affiliated registered investment company unless either (i) the investment company is itself a bank holding company or (ii) the bank holding company owns 25% or more of the investment company's shares and such shares have a market value of more than $1 million. GLBA is otherwise silent on the issue of how the Federal Reserve's consolidated capital rules should treat activities by functionally regulated subsidiaries, although in the spirit of functional regulation the Federal Reserve should modify its capital rules to exclude such subsidiaries to the extent they are subject to their own capital adequacy rules. On this point, the Conference Report does not provide much support. It only states:

> The Conferees intend that the [Federal Reserve] Board be flexible in its application of holding company consolidated capital standards for the leverage requirement and the timing of the asset calculations to [financial holding companies] of which the predominant regulated subsidiary is a broker-dealer.

> The Conferees intend that, to the extent the [Federal Reserve] Board deems feasible and consistent with the overall financial condition and activities of the holding company, the capital requirements for such holding companies be consistent with the capital standards applied by the SEC to the broker-dealer, which accounts for the predominant amount of assets and activities of the holding company.

3. Limitation on the Source of Strength Doctrine

For many years the Federal Reserve has taken the position that a bank holding company must serve as a source of financial and managerial strength to its subsidiary depository institutions and be prepared to provide funds to those subsidiaries if they need it, even if such actions are not otherwise in the holding company's best interests. Pursuant to this doctrine, the Federal Reserve has on a number of occasions ordered bank holding companies to inject additional capital into their subsidiary banks in order to strengthen the financial condition of those banks during times of financial difficulties.

Because GLBA permits companies that are regulated by regulators other than the Federal Reserve to become financial holding companies, it contains provisions restricting the Federal Reserve's authority to take action under the source of strength doctrine without the approval of other applicable regulatory authorities. GLBA prohibits the Federal Reserve from ordering a bank holding company to provide funds or other assets (either directly or from an affiliate) to a subsidiary depository institution if:

- the bank holding company or such affiliate is an insurance company, registered broker-dealer, registered investment company or registered investment advisor; and

- the functional regulator for the bank holding company or such affiliate (*e.g.*, a state insurance commissioner or the SEC) objects to such action on the grounds that it would have a material adverse effect on the financial condition of the functionally regulated company.

If the Federal Reserve is blocked from ordering such action, it may require the bank holding company to divest the subsidiary depository institution with 180 days, and may impose operating restrictions pending such divestiture.

4. Loan Loss Reserves

GLBA also contains a brief provision mandating that the SEC must consult and coordinate with the appropriate federal banking agency before taking any action or rendering any opinion relating to the adequacy of loan loss reserves of any insured depository institution or holding company. This provision was inserted as a result of the well publicized disagreement between the SEC and the federal banking agencies over the levels of loan loss reserves maintained by SunTrust and certain other bank holding companies.

II. Banks and Their Subsidiaries

A. Activities of Financial Subsidiaries of Banks

One of the key compromises that allowed the passage of GLBA relates to the ability of national banks to engage in financial activities through "financial subsidiaries" even if such activities are not permissible for the bank itself. The Federal Reserve firmly held the position that such activities were inherently riskier and should be conducted only in holding company subsidiaries in order to avoid extending the federal "safety net" of deposit insurance. The Treasury Department argued that permitting national banks to conduct these activities through subsidiaries would give banks greater flexibility to structure their operations in the most efficient manner and would not expose the deposit insurance funds to significant additional risk if adequate safeguards were imposed. Ultimately, Federal Reserve Chairman Greenspan and Treasury Secretary Summers were able to negotiate a somewhat complicated compromise that enabled the legislation to move forward.

1. Powers of a Financial Subsidiary

As set forth in GLBA, the compromise permits a national bank to control, or hold an interest in, a subsidiary (referred to as a "financial subsidiary") which engages only in financial activities or activities that are incidental to financial activities, or which are otherwise permissible for national banks. It is significant to note that, unlike current law, GLBA does not require that a national bank own any minimum percentage of a financial subsidiary's voting stock as long as the subsidiary is controlled by one or more insured depository institutions.

Financial activities are defined to include any financial or incidental activities that are authorized for financial holding companies — subject to certain exceptions described below — as well as activities that the Secretary of the Treasury determines to be financial in nature or incidental thereto. The procedures for the Secretary to make this determination mirror those by which the Federal Reserve may determine that an activity is permissible for financial holding companies, including giving the Federal Reserve a veto power over the Treasury Department's ability to expand the list of permissible activities for financial subsidiaries of national banks.

As part of the compromise between the Federal Reserve and the Treasury Department, GLBA specifically prohibits national bank financial subsidiaries from engaging in the following financial activities as principal, even though they are permissible for financial holding companies:

- insurance or tax-deferred annuities (other than insurance that national banks were permitted to underwrite as of January 1, 1999, and title insurance to the extent permitted by other provisions of GLBA; see "Bank Insurance Activities", below);

- real estate development or real estate investment activities (unless otherwise expressly authorized by law); and

- merchant banking or insurance company portfolio investments (unless the Federal Reserve and the Treasury Department jointly decide, at the end of the five-year period beginning on the date of enactment of GLBA, to adopt rules permitting national banks to engage in these activities through their financial subsidiaries).

2. Requirements for Establishing a Financial Subsidiary

In order to engage in financial or incidental activities through a financial subsidiary, a national bank must meet the following conditions:

- it, and each of its affiliated depository institutions, must be well capitalized and well managed (which terms have the same meaning as in the financial holding company context, discussed in Part I.A. above);

- the aggregate consolidated total assets of all financial subsidiaries of the national bank do not exceed the lesser of (i) 45% of the consolidated total assets of the parent bank, and (ii) $50 billion (subject to adjustment pursuant to an indexing mechanism that is to be jointly established by the Secretary of the Treasury and the Federal Reserve by regulation);

- if the national bank is one of the fifty largest insured banks in the United States (based on consolidated total assets as of the end of the preceding calendar year), it must have at least one series of "eligible debt" that is rated within the three highest investment grade rating categories by a nationally recognized statistical rating organization; and

- if the national bank is one of the second fifty largest insured banks in the United States (based on consolidated total assets as of the end of the preceding calendar year), it must either satisfy the "eligible debt" requirement noted above or else satisfy such other comparable criteria as the Federal Reserve and the Secretary of the Treasury may jointly establish by regulation.

For purposes of these tests, "eligible debt" is defined to mean unsecured, long-term debt that is not supported by any form of credit enhancement, including a guarantee or standby letter of credit, and that is not held in whole or in any significant part by any affiliate, officer, director, principal shareholder or employee of the bank or any other person acting on behalf of or with funds from the bank or an affiliate of the bank. A national bank that fails to meet the eligible-debt requirement after establishing a financial subsidiary will be prohibited from making any additional equity investments in the financial subsidiary (including, for this purpose, acquiring any debt of the financial subsidiary that qualifies as regulatory capital for it, such as subordinated debt issued by a registered broker-dealer subsidiary). The eligible-debt requirement will not apply to any national bank whose financial subsidiaries engage in financial and incidental activities solely as agent and not as principal.

Each national bank that engages in financial and incidental activities through a financial subsidiary will also be required to meet the same CRA requirements that a financial holding company is required to meet under the BHC Act (discussed in Part I.A. above). Failure by the bank or any of its affiliated depository institutions to maintain a satisfactory or better CRA rating would have the same consequences as a similar failure by a financial holding company: the commencement of new financial activities, and the acquisition of companies engaged in financial and incidental activities, would be prohibited, but existing financial and incidental activities could continue unimpaired.

Likewise, a national bank that fails to remain well capitalized and well managed (or fails to maintain the required safety and soundness firewalls described below), will be subject to similar requirements as a financial holding company would be to cure the default within prescribed cure periods or divest its financial subsidiaries.

3. Capital, Funding and Other Restrictions

In order to insulate the parent national bank against the presumed greater risk of non-banking financial activities and also ensure that subsidiaries of national banks are not able to engage in financial activities on more favorable terms than nonbank subsidiaries of financial holding companies, GLBA requires that financial subsidiaries be separately capitalized and funded and comply with certain procedural safeguards.

GLBA mandates that a national bank which has an investment in a financial subsidiary must, for purposes of calculating the bank's capital adequacy ratios:

- □ treat the financial subsidiary as an unconsolidated subsidiary (that is, generally account for it using the equity method); and
- □ deduct from both the parent bank's assets and its tangible equity the full amount of the bank's equity investment in the financial subsidiary, including all retained earnings of the financial subsidiary.

GLBA also requires that any published financial statements of the parent national bank present separate financial information for the bank calculated on the basis described above as well as in accordance with generally accepted accounting principles.

In addition, GLBA amends Sections 23A and 23B of the Federal Reserve Act to add new sections restricting transactions between banks and their financial subsidiaries. These amendments treat all financial subsidiaries of a bank as affiliates, rather than subsidiaries, so that loans and extensions of credit by the bank to the financial subsidiary, purchases of assets from the financial subsidiary by the bank, and other "covered transactions" (as currently defined in Section 23A) between the bank and the financial subsidiary are subject to the restrictions of Sections 23A and 23B. GLBA broadens these restrictions to also specify that

- any purchase of, or investment in, the securities of a financial subsidiary by a bank's affiliates will be treated as a direct purchase or investment by the bank itself; and

- the Federal Reserve may determine to treat any extension of credit to a financial subsidiary by a bank's affiliates as a direct extension of credit by the bank itself.

The effect of these provisions is to place a bank financial subsidiary at a disadvantage compared to a subsidiary of a financial holding company, since the latter will not be subject to any limitations on funding or other transactions with its non-depository affiliates.

For purposes of calculating the volume limitation on covered transactions between a bank and its financial subsidiaries, GLBA eliminates the current limitation of 10% of the bank's capital stock and surplus on transactions with any single financial subsidiary of the bank but retains the limitation that the aggregate amount of covered transactions between the bank and all of its affiliates, including its financial subsidiaries, may not exceed 20% of the bank's capital stock and surplus.

Finally, GLBA requires that national banks that have interests in financial subsidiaries must establish certain safety and soundness firewalls between the bank and its financial subsidiaries. GLBA does not mandate any specific set of procedures or policies, but instead places the responsibility on the bank for developing and implementing procedures and policies that

- identify and manage financial and operational risks within the bank and the financial subsidiary so as to adequately protect the bank from such risks; and

- preserve the separate corporate identity and limited liability of the bank from its financial subsidiaries.

4. Operating Subsidiaries

National banks are permitted to conduct through an operating subsidiary any activities in which the bank is permitted to engage directly. For example, a national bank may form an operating subsidiary to engage in mortgage banking operations. The national bank is not required to deduct its investment in an operating subsidiary for purposes of calculating the bank's capital ratios, nor is it required to treat such a subsidiary as an "affiliate" for purposes of Section 23A.

5. State Chartered Banks

The provisions described above are designed to permit national banks to engage in financial and incidental activities through financial subsidiaries. GLBA also amends the Federal Deposit Insurance Act to permit state-chartered, FDIC-insured banks to exercise comparable powers. In order to exercise these powers, the state chartered bank and each of its affiliated depository institutions must be well capitalized (after giving effect to any required capital deductions for investments in financial subsidiaries). In addition, the state-chartered bank must comply with the same capital deduction and financial disclosure rules, safety and soundness firewalls, and amendments to Sections 23A and 23B of the Federal Reserve Act as a national bank. GLBA does not, however, require that the state-chartered bank comply with the other requirements for investing in a financial subsidiary that would apply to a national bank, including being "well managed", having a satisfactory or better CRA rating, or having an outstanding issue of "eligible debt"; nor does GLBA place any limitation of the aggregate amounts that a state-chartered bank may invest in its financial subsidiaries.

If a national bank may only engage in an activity through a financial subsidiary, then a state-chartered bank may only conduct that activity through a financial subsidiary. The FDIC has authorized state chartered banks to conduct certain activities through subsidiaries that now may be conducted by a national bank only through a financial subsidiary. An example is underwriting and dealing in securities. GLBA contains a grandfathering clause that will permit state-chartered banks to retain their interests in such subsidiaries without treating or qualifying such subsidiaries as financial subsidiaries.

The FDIC retains its power to authorize state chartered banks to conduct activities through subsidiaries that a national bank is not permitted to undertake in an financial subsidiary. The most notable example is real estate investment and development.

The authority of a state-chartered bank to engage in financial and incidental activities will also depend upon whether the state in which it is chartered authorizes such activities. Many states have granted "wild card" authority to banks chartered in their states that permits them to engage in any activity authorized for national banks, without the need for any further regulatory or legislative action.

B. Bank Insurance Activities

Over the past decade, the OCC has substantially expanded the range of insurance activities that national banks may engage in, generally by means of issuing new and innovative interpretations of very old statutes. These interpretive positions have frequently been the subject of lengthy lawsuits involving the OCC, state insurance commissioners and the banks seeking to use the new powers authorized by the OCC. The OCC has usually (but not always) prevailed in its interpretive positions because of the general policy followed by U.S. federal courts of giving deference to administrative agencies in the interpretation of statutes they are charged with enforcing. As described below, GLBA contains a series of compromise provisions that resolve most of the ongoing conflicts between the OCC and the various state insurance regulators. These provisions, among other things:

- freeze the insurance powers of national banks to those granted as of January 1, 1999;
- pre-empt all state laws that have the purpose or effect of prohibiting affiliations between banking organizations and insurance companies;
- allocate principal responsibility for supervising and regulating bank insurance activities to the applicable state insurance authorities, as long as such powers are not exercised in a manner that discriminates against depository institutions and their affiliates;
- provide for expedited resolution of disputes that may arise between state insurance regulators and the OCC regarding bank insurance activities, and eliminate any presumption in favor of the OCC in resolving those disputes; and
- provide a safe-harbor for 13 types of regulations that states may adopt without being challenged as discriminatory against depository institutions and their affiliates.

1. Insurance Underwriting

GLBA prohibits national banks and their subsidiaries from underwriting any insurance other than certain grandfathered insurance products that national banks were authorized to underwrite by the OCC as of January 1, 1999 (including credit life, health, disability and property damage insurance; municipal bond and similar financial guaranty insurance; and mortgage insurance) and which had not been overturned by a court (for example, "retirement" CDs and crop insurance). The grandfathering provision expressly excludes, however, both tax-deferred annuities and, as described below, title insurance. In order to prevent evasions of these prohibitions, GLBA also prohibits national banks and their subsidiaries from providing insurance or reinsurance outside the United States that insures, indemnifies or guarantees insurance products provided in the United States or that indemnifies an insurance company with regard to insurance products provided in the United States.

In addition, GLBA generally gives state insurance regulators the authority to determine what products constitute insurance products and accordingly may not be underwritten by national banks and their subsidiaries. For this purpose, the determination of what constitutes an insurance product is made on a state-by-state basis and is deemed to include (i) any product that was regulated as insurance in the relevant state as of January 1, 1999, (ii) any product that is first offered after January 1, 1999 and that the relevant state insurance regulator determines to be insurance because the product insures, guarantees or indemnifies against certain specified types of risks, and (iii) tax-deferred annuities. GLBA also contains a list of general types of bank products and services that state insurance regulators cannot designate as insurance. The list includes: deposits; loans and other extensions of credit; trust and fiduciary services; certain types of derivatives and similar instruments that are treated as "qualified financial contracts" under the Federal Deposit Insurance Act; and financial guarantees (other than those which would be treated at least in part as insurance under the Internal Revenue Code).

2. Insurance Agency Activities

GLBA generally preempts all state laws and regulations that prevent or significantly interfere with the ability of a depository institution or its affiliates to engage in insurance sales on an agency basis or to otherwise engage in sales solicitations or cross-marketing activities. In this respect, GLBA codifies the decision of the U.S. Supreme Court in *Barnett Bank of Marion County N.A. v. Nelson*, 517 U.S. 25 (1996). GLBA does permit individual states to adopt laws and regulations that specifically relate to insurance activities of depository institutions as long as they fall within one of thirteen enumerated safe-harbors. These include prohibitions on tying an extension of credit to the purchase of insurance from an affiliate; privacy restrictions on the use of health and other insurance claims information of customers; restrictions on misleading advertising; and requirements relating to the maintenance of separate books and records. These provisions also permit the states to prohibit the payment of referral fees to unlicensed personnel (such as bank branch personnel), unless the referral "does not include a discussion of specific insurance policy terms and conditions."

3. Title Insurance

GLBA generally prohibits national banks from (i) engaging in the underwriting of title insurance; or (ii) selling title insurance as agent in any state other than in a state that expressly permits (i.e., not merely by virtue of a "wildcard" provision) state banks to do so. There is a grandfather provision that covers national banks and their subsidiaries which were engaged in title insurance activities prior to the date of enactment of GLBA. However, the grandfather provision does not permit the underwriting of title insurance by a national bank or its subsidiary when the bank has an affiliate (other than a subsidiary) that underwrites any type of insurance. Moreover, if the national bank has a subsidiary that underwrites insurance, and has no affiliate (other than a subsidiary) that underwrites insurance, the bank may not itself directly underwrite title insurance.

4. Mandatory State Licensing

GLBA specifically prohibits any person from engaging in the business of insurance in any state, either as principal or agent, unless licensed by that state in accordance with the local laws. The only limitation imposed by GLBA is that these laws cannot discriminate against depository institutions or their affiliates.

GLBA specifically provides that the insurance brokerage activities of national banks and other depository institutions will be subject to functional regulation by the applicable state insurance regulators. Accordingly, banks and bank personnel engaged in insurance brokerage and other insurance activities will need to comply with all state licensing and sales practice requirements of the states they do business in unless those laws discriminate against depository institutions and their affiliates. This is generally consistent with the position the OCC had previously taken on preemption of state laws governing insurance agency activities (see OCC Advisory Letter 96-8, "Guidance to National Banks on Insurance and Annuity Sales Activities").

5. New Federal Consumer Protection Regulations

GLBA requires the Federal banking agencies to jointly adopt, within one year after the enactment of GLBA, consumer protection regulations relating to the sale of insurance by depository institutions and, if the agencies deem appropriate, depository institution subsidiaries. These regulations are to cover: sales practices involving illegal tying practices; adequate disclosure of the uninsured status and investment risk of insurance products; appropriate standards for physically segregating deposit-taking facilities from insurance production facilities; standards for paying referral fees to depository branch personnel (which generally are to be limited to a "one-time nominal fee of a fixed dollar amount for each referral" and not be dependent on whether the referral results in a transaction); and qualification and licensing requirements. In addition, GLBA requires the Federal banking agencies to jointly establish a "consumer complaint mechanism" to receive and resolve complaints regarding violations of the foregoing regulations.

GLBA provides a somewhat complicated preemption scheme in the event of inconsistencies between the foregoing Federal regulations and comparable provisions of state law. Normally, if a state has laws or regulations relating to retail insurance sales that cover the same matters as the Federal regulations, the state laws will control. If the Federal banking agencies jointly determine that their regulations are more protective of consumers than those of the state, the Federal banking agencies may preempt the comparable state provision by giving notice to the state. The state may then override the Federal preemption if it chooses by adopting legislation to that effect within three years.

6. Resolution of State/Federal Regulatory Disputes

GLBA provides that in the case of any conflict between a state insurance regulator and a federal banking regulator regarding insurance issues, either regulator may seek an expedited judicial review by filing a petition with the United States Court of Appeals, either in the circuit in which the state is located or in the District of Columbia Circuit. The Court of Appeals is required to render a judgment within 60 days after a petition is filed, unless all parties agree to an extension. The Court is further required to evaluate the questions presented "without unequal deference" to either regulator — thereby eliminating one of the key advantages that the OCC has historically had in litigation relating to bank insurance powers.

C. Banks and Investment Companies

GLBA contains provisions that expand the role banks may play in the field of investment management and also increase the regulatory burden on those banks that engage in investment management activities. GLBA makes several important changes to the laws regarding the interaction between banks and investment companies registered under the 1940 Act. GLBA also amends the Advisers Act, to, among other things, require the registration with the SEC of banks that act as investment advisers. Finally, GLBA clarifies the definition of bank common trust funds under the Federal securities laws. The effective date for these changes is 18 months after the date of enactment of GLBA.

1. Investment Company Distributors and Sponsorship

GLBA repeals Section 20 of the Glass-Steagall Act, which prohibited banks from controlling companies that are principally engaged in issuing securities (such as open-end investment companies). Because the Federal Reserve historically viewed an investment company's distributor or underwriter as controlling the investment company, Section 20 effectively prohibited a bank or its affiliate from acting as an investment company distributor or underwriter of a "proprietary mutual fund". The Federal Reserve also did not permit securities underwriting affiliates of banks to distribute shares of any mutual fund. The repeal of Section 20 therefore permits a underwriting affiliates of banks to act as a distributor or underwriter of investment company securities. In addition, GLBA has eliminated the restrictions on a bank sponsoring an investment company, as well as the prohibition against bank affiliates serving as investment company directors and officers. The effect of these amendments is to permit banks and their affiliates to take a more active role in the formation, business and governance of investment companies.

2. Investment Company Custodians

GLBA grants the SEC the authority to adopt rules and issue orders prescribing the conditions under which a bank (or its affiliate) may serve as custodian for a registered investment company with which the bank is affiliated.[8] Currently, a bank may serve as

8 The SEC's rulemaking authority is conditioned on its consulting with and taking into consideration the views of the various Federal banking agencies. A similar amendment would permit the SEC to adopt rules allowing a bank which is an affiliate of a principal underwriter for, or depositor of, a registered unit investment trust to serve as trustee or custodian for that trust.

custodian for an affiliated investment company, but that relationship is subject to the restrictions contained in Rule 17f-2 issued by the SEC under the 1940 Act, including the requirement that the investment company's accountants conduct at least three audits (two of them without notice) of the investment company's securities each year and file the results with the SEC. This has generally made it impractical for a bank to act as custodian for an affiliated investment company.

3. Loans to Investment Companies

GLBA also addresses the issue of whether a bank can lend money to an affiliated investment company by amending Section 17(a) of the 1940 Act to state that an affiliate may not loan money or other property to a registered investment company in contravention of such rules or orders as the SEC (after consultation with and taking into consideration the views of the various Federal banking agencies) may adopt or issue. The effect of this change is to make it clear that such lending will be permitted under prescribed SEC guidelines.

4. Independent Directors

In addition, GLBA amends the 1940 Act by revising the standard by which a broker, dealer or lender (or an affiliate thereof) will be considered an "interested person" of an investment company. The scope of this provision has important consequences for the qualification of individuals as "disinterested directors." Previously, any broker or dealer registered under the Securities Exchange Act of 1934, as amended (the "1934 Act") (or an affiliate thereof) was considered an "interested person" of an investment company under the 1940 Act. Therefore, an officer of any broker or dealer generally would be ineligible to serve as a disinterested director of an investment company unless the requirements of Rule 2a19-1 under the 1940 Act were met. [9] Under GLBA, this broad statutory language has been replaced by a more specific provision (similar to Rule 2a19-1) that states that an interested person of an investment company includes any person (or any affiliated person of that person) that, at any time during the preceding 6-month period, has (i) executed any portfolio transactions for, (ii)

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[9] Rule 2a19-1 provides that a director of a registered investment company will not be considered an interested person of that investment company (or of the investment company's investment adviser or principal underwriter) solely because that director is a broker, dealer or an affiliate thereof, provided that (i) the broker or dealer does not execute any portfolio transactions for the investment company's complex, engage in any principal transactions with the complex or distribute shares for the complex for at least six months prior to the time the director is to be considered disinterested and for the period the director is to be considered disinterested, (ii) the investment company's board of directors determines that the investment company and its shareholders will not be adversely affected if the broker or dealer does not execute any portfolio transactions for the investment company, engage in any principal transactions with the investment company or distribute shares for the investment company and (iii) no more than a minority of the disinterested directors of the investment company are brokers, dealers or affiliates thereof.

engaged in any principal transactions with, (iii) distributed shares for or (iv) loaned money or other property to:

- the investment company;
- any other investment company having the same investment adviser or principal underwriter as the investment company in question or holding itself out to investors as a related investment company for purposes of investment or investment services; or
- any account over which the investment company's investment adviser has brokerage placement discretion or borrowing authority.

There are some important differences between the new statutory language and the SEC's position under Rule 2a19-1. First, the statutory language is broader than the rule in that GLBA covers entities that lend to investment companies. Also, under GLBA the investment company's board of directors is not required to make a finding that the company and its shareholders will not be harmed if the investment company does not transact business with the broker or dealer. Finally, GLBA does not require directors who are affiliates of brokers or dealers to make up only a minority of the disinterested directors.

5. Required Disclaimer

Codifying an existing SEC interpretive position, GLBA requires investment companies that are advised by or sold through a bank to prominently disclose that an investment in the investment company is not insured by the FDIC or any other government agency. GLBA gives the SEC the authority to adopt rules prescribing the manner in which this disclosure should be made. GLBA also explicitly prohibits all investment companies from making statements that the investment company or its securities have been insured by the FDIC or that investment company shares are guaranteed by or are otherwise obligations of any bank or insured depository institution.

6. Disqualification

GLBA adds banks to the list of entities that may be prohibited from serving as investment advisers or principal underwriters for registered investment companies if they have engaged in certain types of misconduct.

7. Registration and Regulation Under the Advisers Act

GLBA's most important modification to the Advisers Act is its elimination of the exclusion from the definition of "investment adviser" (and therefore the exclusion from the registration and substantive requirements of the Advisers Act) previously provided for banks. Under GLBA, banks and bank holding companies will be considered "investment advisers" subject to the Advisers Act to the extent they serve or act as an investment adviser to a registered investment company. However, if in the case of a bank such services or actions are performed through a "separately identifiable department or division of the bank," only that department or division, and not the bank itself, will be deemed an investment adviser. GLBA defines a "separately identifiable department or division" of a bank as a unit:

- that is under the direct supervision of an officer or officers designated by the board of directors of the bank as being responsible for the day-to-day conduct of the bank's investment adviser activities for one or more investment companies, including the supervision of all bank employees engaged in the performance of such activities; and

- for which all the records relating to its investment adviser activities are separately maintained in or extractable from such unit's own facilities or the facilities of the bank, and such records are so maintained or otherwise accessible as to permit independent examinations and enforcement by the SEC of the Advisers Act, the 1940 Act and the rules and regulations promulgated thereunder.

The effect of this change is to subject banks (or their investment advisory divisions) to the regulatory requirements and liabilities of the Advisers Act. This will likely increase the costs associated with a bank's investment management activities. In addition, it is unclear whether GLBA's concept of a "separately identifiable department or division" is practical, and whether such a concept is sufficient to shield the non-investment advisory portions of a bank from liability under the Advisers Act.

The Advisers Act has also been amended to add a provision promoting interagency consultation. Under the amendment, the appropriate Federal banking agency and the SEC, as the case may be, must provide the other, upon request, the results of any examination or report with respect to the investment advisory activities of any bank holding company, bank or separately identifiable department or division of a bank that is registered under the Advisers Act. However, neither the SEC nor the federal banking agencies may generally be compelled to disclose publicly any such information.

8. Bank Common Trust Funds

Common trust funds are popular vehicles for banks to pool assets for which they serve as trustees or executors for investment purposes. GLBA expands upon and clarifies the definition of these funds for purposes of the Federal securities laws by stating that a common trust fund is excluded from the definition of "investment company" under the 1940 Act if it is maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator or guardian and if:

- such fund is employed by the bank solely as an aid to the administration of trusts, estates or other accounts created and maintained for a fiduciary purpose;

- interests in such fund are not advertised or offered for sale to the general public, except in connection with the ordinary advertising of the bank's fiduciary services; and

- fees and expenses charged by such fund are not in contravention of fiduciary principles established under applicable Federal or state law.

A bank that maintains a common trust fund that is excluded from the definition of "investment company" would not be required to register under the Advisers Act because such registration is only required with respect to banks that advise registered investment companies.

GLBA makes conforming amendments to the Securities Act of 1933, as amended (the "1933 Act"), to state that interests in common trust funds that are excluded from the definition of "investment company" under the 1940 Act are exempt from the registration requirements of the 1933 Act. Likewise, GLBA amends the 1934 Act to state that interests in common trust funds that are excluded from the definition of "investment company" under the 1940 Act are considered "exempted securities" under the 1934 Act.

D. Elimination of the Broker/Dealer Exemption for Banks

Under current law, the definitions of "broker" and "dealer" in the 1934 Act exclude banks. As a result, banks (and U.S. branches and agencies of non-U.S. banks) have historically been able to conduct securities operations without registering with the SEC or any industry self-regulatory organization ("SRO") and without complying with their net capital rules or similar requirements.

GLBA eliminates this exemption so that securities activities conducted by banks (and U.S. branches and agencies of non-U.S. banks) will be subject to SEC and industry SRO supervision and regulation as if they were conducted in a separate subsidiary and the personnel involved in those activities must comply with applicable licensing and registration requirements. This change takes effect 18 months after the effective date of GLBA.

In order to reduce the disruption caused by these changes, GLBA provides a list of activities in which banks have traditionally engaged which banks may continue to engage in without being deemed to be a broker or dealer under the 1934 Act. These activities include the following:

- arrangements with third party registered broker/dealers to provide securities services to the bank's customers (for example, space leasing arrangements), subject to a number of restrictions specified in GLBA;

- □ trust activities, where the compensation is chiefly based on an annual fee, a percentage of assets under management fee or a capped or flat per order processing fee equal to the bank's actual execution costs, or some combination of such fees;

- □ transactions in commercial paper, bankers acceptances, exempted securities or Brady bonds;

- □ certain unsolicited transactions as part of a bank's transfer agency activities with respect to employee benefit, dividend reinvestment and similar stock purchase plans;

- □ sweep accounts for the bank's deposit customers where the funds are swept into no-load money market mutual funds;

- □ transactions for affiliates (other than affiliates that are registered broker/dealers or are engaged in merchant banking activities);

- □ private placements and exempted small offerings of securities in primary offerings, as long as the bank either

  - — from and after the first anniversary of enactment of GLBA, is not affiliated with a broker/dealer that has been registered for more than one year and that engages in dealing, market making or underwriting (other than of exempted securities), or

  - — is not affiliated with a broker or dealer and does not effect primary offerings (other than of government or municipal securities) in an aggregate amount that exceeds 25% of its capital;

- □ safekeeping and custody activities (including securities lending and borrowing transactions), as long as the bank is not acting as a carrying broker for another broker or dealer;

- □ transactions in "identified banking products" (which are discussed in detail below);

- □ transactions in municipal securities; and

- □ a *de minimus* number of transactions (fewer than 500 transactions per year).

In addition, GLBA provides that a bank will not be considered to be a dealer if it engages in the following activities (in addition to the activities described above):

- purchases or sales of securities for investment purposes for the bank's own account or for trust or other fiduciary accounts; and

- asset-backed transactions involving the securitization of obligations primarily originated by the bank or one of its affiliates (other than an affiliated broker/dealer), or by a syndicate of banks of which the bank is a member, if the obligations consist of mortgages or consumer receivables.

As a related matter, GLBA requires the NASD and other registered securities associations to create a special limited qualification category for associated persons of broker/dealers who effect sales as part of primary offerings done as private placements or as exempt small offerings. Any bank employee who was engaged in such activities during the six month period preceding enactment of GLBA will be eligible for qualification in such category without testing. This will permit bank employees to continue effecting private placements without interruption even if their employer is required to register as a broker/dealer as a result of GLBA.

As stated above, GLBA permits banks to continue effecting transactions in "identified banking products" without being required to register with the SEC as a broker or dealer. Identified banking products are defined to include the following:

- deposit accounts, certificates of deposit and similar instruments;

- bankers acceptances;

- letters of credit issued or loans made by a bank;

- participations in loans that the bank or an affiliate of the bank (other than an affiliated broker/dealer) funds, participates in or owns that are sold to either

  - "qualified investors" (a new term that covers categories of investors similar to those that would be qualified institutional buyers under the SEC's Rule 144A or "qualified purchasers" under Section 3(c)(7) of the 1940 Act); or

  - other sophisticated high net worth investors who are given the opportunity to review and assess material information, including information regarding the borrower's creditworthiness, and who "have the capability to evaluate the information available, as determined under generally applicable banking standards or guidelines"; and

- swaps, other than equity swaps sold directly to a person who is not a "qualified investor".

Finally, GLBA creates a new set of procedures that the SEC must comply with if in the future it decides that a particular instrument or product which was not regulated as a security prior to the enactment of GLBA should be regulated as a security. Because treating this new product (referred to in GLBA as a "new hybrid product") as a security would, as a result of GLBA, prevent banks from effecting transactions in the new product other than through a licensed broker/dealer, the SEC will be required to go through the following rule-making exercise before requiring banks to register as broker/dealers for this purpose or bringing an enforcement action against a bank for failure to so register.

First, the SEC will be required to consult with the Federal Reserve and consider the Federal Reserve's views as to, among other things, the appropriateness under the banking laws of regulating the new hybrid product and the impact of the proposed rule on the banking industry. If the SEC promulgates a regulation treating a new hybrid product as a security, the Federal Reserve may challenge it by bringing an action in the U.S. Court of Appeals for the D.C. Circuit. The filing of the action will act as an automatic stay of the SEC's regulation pending a judicial resolution of the proceeding. Any third party may also seek judicial review of the SEC's regulation. GLBA provides that in the judicial proceedings, neither the SEC nor the Federal Reserve will be entitled to judicial deference to their views.

III. Other Provisions Affecting Insurance Companies

As a general matter, GLBA reaffirms the validity of the McCarran-Ferguson Act and the primacy of the states in regulating the business of insurance. However, GLBA also contains a number of provisions that significantly affect the regulatory powers of state insurance commissioners in connection with mergers and corporate reorganizations. Some of these provisions are designed to facilitate mergers of insurance companies with banking organizations; others were added by insurance industry lobbying groups to facilitate mutual-to-stock conversions and the formation of mutual holding companies that has been obstructed by particular states over recent years.

A. Acquisitions of Insurance Companies

GLBA generally preempts all state anti-affiliation laws that would prevent or significantly interfere with the ability of an insurance company to acquire or affiliate with a banking organization or to become a financial holding company by acquiring a bank. In addition, GLBA preempts all state laws that limit the amount that an insurance company may invest in the voting stock of a depository institution unless such laws permit voting stock investments of up to at least 5% of a domestic insurer's admitted assets.

As discussed above, the principle of functional regulation embodied in GLBA contemplates that acquisitions of state-regulated insurance companies by financial holding companies be reviewed and approved by the applicable state insurance department, not the Federal Reserve, and that the state may not discriminate against depository institutions in acting on such applications. GLBA states that a state insurance commissioner is to act on an application relating to an acquisition of an insurance company by a financial holding company, or similar affiliation transaction, during the 60-day period preceding the consummation date of the transaction— language that does not take into consideration the date that the relevant applications are filed with the commissioner. The Conference Report contains more sensible wording, requiring the commissioner to act within 60 days of receiving notice of the proposed affiliation.

B. Demutualizations and Mutual Holding Companies

GLBA contains several provisions designed to limit the ability of individual state insurance commissioners to restrict mutual-to-stock conversions and the formation of mutual holding companies. For example, GLBA prohibits the insurance commissioners of any state, other than the converting insurer's state of domicile, from reviewing, approving or disapproving an insurer's demutualization or mutual holding company plan. As a result, GLBA preempts state statutes such as New York's which requires all New York-licensed mutual life insurers (regardless of state of domicile) to submit their demutualization plans to the New York Superintendent of Insurance for his consideration of its fairness to New York policyholders.

GLBA also contains broad provisions to permit mutual insurers that are domiciled in states that do not have laws setting "reasonable terms and conditions" for the formation of mutual holding companies to redomesticate to states that do permit such formations.[10] The redomesticating insurer's certificate of authority, agents' appointments and licenses, rates, approvals "and other items that a licensed state allows" and that are in existence immediately prior to the redomestication will remain in full force and effect upon the redomestication, if the insurer remains duly qualified to transact business in the state. All outstanding insurance policies and annuity contracts also will remain in full force and effect and need not be endorsed to indicate the new domicile unless so required by state law. A redomesticating insurer may use existing policy forms until new forms are approved (if so required). In order for a mutual insurer to redomesticate and reorganize as a mutual holding company, the state insurance regulator of the transferee state must determine that the plan of reorganization meets certain requirements, including the requirement that officers and directors of the insurer may not

10 The following states and the District of Columbia have enacted mutual holding company laws: California, Florida, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Minnesota, Mississippi (for property/casualty insurers), Missouri (for life insurers), Nebraska, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont and Wisconsin. In addition, mutual holding company bills are pending in Georgia, Indiana, Maryland, New Jersey (for life insurers) and New York (for life insurers).

receive stock options or stock grants in the company for a period of six months following an initial public offering.[11]

State laws generally prohibit an insurer from redomesticating without the permission of the transferor state. [12] All such laws are preempted by GLBA. In addition, any state law that has the effect of "impeding the activities of, taking any action against, or applying any provision of law or regulation to" any insurer because the insurer plans to redomesticate or has redomesticated is preempted by GLBA. Moreover, if any state takes action against the license of such an insurer because of the redomestication, GLBA exempts the insurer from many of the insurance laws of that state, including the licensing requirement.

C. Federal Registration of Insurance Agents

GLBA provides that unless a majority of states have enacted, within three years of the date of enactment of GLBA, either (i) uniform insurance agent licensing requirements or (ii) agent reciprocity laws, a National Association of Registered Agents and Brokers ("NARAB") will be established. To satisfy the uniformity test, the states must establish uniform criteria regarding personal qualifications, residence, education, experience, training, continuing education and methods to ensure that consumers are purchasing suitable insurance products. To satisfy the reciprocity test, the states must license any agent who is licensed in his or her home state (so long as the home state also grants reciprocity), if the agent simply provides a copy of the agency application filed with the home state and pays a licensing fee.

The National Association of Insurance Commissioners (the "NAIC") is charged with making the determination at the end of the three-year period following enactment of GLBA as to whether the requisite uniformity or reciprocity has been achieved. In addition, if at any time the uniformity or reciprocity no longer exists, NARAB would be established two years after the date on which such uniformity or reciprocity ceases to exist, unless the requisite uniformity or reciprocity is again satisfied before the expiration of such two-year period. If NARAB is established, it would be a non-profit corporation subject to the supervision of the NAIC (at least initially), and would not be an agent or instrumentality of the federal government. The bylaws and rules of NARAB (and any amendments thereto) would be subject to approval by the NAIC.

Generally, any state-licensed agent would be eligible to become a member of NARAB. NARAB may establish its own membership criteria, including standards for personal qualifications, education, training and experience. Significantly, a NARAB member would be automatically entitled to licensure in each state for which the member pays the requisite fees

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11 Only a few of the states that have enacted mutual holding company laws currently have this prohibition in their statute: Kentucky, Massachusetts, Oregon, South Carolina and Wisconsin (one-year prohibition).

12 *See* NAIC Redomestication Model Bill, Section 2.

and, where applicable, complies with bonding requirements. Any state law, regulation or other action directed against an insurance agent related to his or her membership in NARAB is preempted by GLBA.

The Board of Directors of NARAB would be composed of seven members appointed by the NAIC. If within two years from the date of enactment of GLBA, the NAIC has not appointed the initial seven members of the Board of Directors, the initial Board of Directors would consist of the state insurance commissioners of the seven states with the greatest total dollar amount of commercial-lines insurance. NARAB would have the authority to: issue uniform insurance agency applications; establish a central clearinghouse through which members may apply for licenses in multiple states; and establish or utilize a national database for the collection of regulatory information concerning the activities of insurance agents.

If after two years from the date these provisions of GLBA are to take effect (*i.e.*, five years after the date of enactment of GLBA): (i) at least a majority of the states representing at least 50% of total U.S. commercial-lines insurance premiums[13] have not satisfied the uniformity or reciprocity requirements discussed above; or (ii) the NAIC has not approved NARAB's bylaws, is unable to operate or supervise NARAB, or NARAB is not conducting its activities as required under GLBA, then the President of the United States will assume oversight of NARAB.

D. Rental Car Agency Insurance Activities

GLBA contains a brief subtitle which provides that, for a period of three years beginning on the date of enactment of GLBA, it will be presumed that no state law imposes any licensing, appointment, or education requirements on car rental agents who solicit the sale of insurance in connection with car rentals. This subtitle does not affect: (i) state statutes; (ii) the prospective application of any court judgment interpreting any state statute; or (iii) the prospective application of any state regulation or other statutorily authorized interpretation or action which, in any such case, "by its specific terms, expressly regulates or exempts from regulation" car rental agents who solicit the sale of insurance in connection with car rentals.

IV. UNITARY SAVINGS AND LOAN HOLDING COMPANIES

Prior to GLBA, a company that controlled only one savings association (other than a savings association that was acquired with FDIC assistance because it failed or was failing) could engage in any type of business, whether financial or not. Companies engaged in a broad variety of non-financial businesses, ranging from automobile manufacturing to funeral homes,

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[13] As noted above, for NARAB not to come into existence, a majority of states must have enacted uniform or reciprocal agent licensing laws within three years of the date of enactment. However, for the NAIC to retain oversight over NARAB, there is the additional requirement that those states representing 50% of total U.S. commercial-lines insurance premiums must have enacted such laws within an additional two years.

used this provision to acquire and operate a savings association and thereby be "unitary savings and loan holding companies".

GLBA eliminates this exception on a prospective basis. The statute provides that a company which acquires control of a savings association after May 4, 1999 (unless it had filed an application to do so on or prior to that date) may not engage in any activities other than those that are closely related to banking and therefore permissible for bank holding companies under Section 4(c)(8) of the BHC Act, financial and incidental activities which are permissible for financial holding companies under the new Section 4(k) of the BHC Act, and certain other financial activities that are permissible for multiple savings and loan holding companies under the Home Owners' Loan Act. GLBA retains the current two year grace period for a company to divest its impermissible non-financial businesses after it acquires a savings association.

In addition, GLBA provides that this grandfather right is not transferable, so that any company that subsequently acquires a grandfathered unitary savings and loan holding company will be restricted to the financial activities described above. However, GLBA does not limit a thrift institution that is held pursuant to such grandfather rights to the activities in which it was engaged at the time of the enactment of GLBA. For example, in recent years many companies have established federal savings banks solely to engage in trust activities. GLBA does not prevent those companies from expanding the activities of such federal savings banks to the full panoply of activities that are permissible for federal savings banks under the Home Owners' Loan Act.

V. PRIVACY

Some of the most controversial provisions of GLBA relate to the restrictions and disclosure obligations it imposes on financial institutions with respect to the use and sharing of their customers' personal information. For purposes of these provisions of GLBA, a "financial institution" is defined to include any institution which engages in financial activities of the types described in new Section 4(k) of the BHC Act, as added by GLBA. U.S. branches and agencies of foreign banks are also included. All such financial institutions will be subject to these privacy provisions, whether or not they are affiliated with a financial holding company. Enforcement and rulemaking authority under these provisions is assigned to the functional regulator in the case of regulated entities and to the Federal Trade Commission in all other cases.

GLBA requires that, at the time of establishing a customer relationship with a consumer (defined as an individual who obtains financial products or services to be used primarily for personal, family or household purposes) and not less frequently than annually during the customer relationship, each financial institution must disclose to the customer:

the policies and practices of the institution with respect to disclosing nonpublic personal information to affiliates and non-affiliated third parties, including the categories of information that may be disclosed and the institution's practices with regard to nonpublic information of former customers;

- the categories of persons to whom such nonpublic personal information may be disclosed;
- the categories of nonpublic personal information that are collected by the financial institution;
- the policies the institution maintains to protect the confidentiality and security of nonpublic personal information; and
- its procedures for an individual to opt out of the institution's practice of disclosing nonpublic personal information to non-affiliated third parties, as described below.

GLBA provides that a financial institution may not disclose nonpublic personal information to a non-affiliated third party unless such financial institution clearly and conspicuously discloses to the consumer, in writing or as provided in regulations issued by that institution's governing agency, that the information may be disclosed, the consumer is given the opportunity to opt out of the disclosure before any such disclosure occurs, and the consumer is informed as to how to opt out. "Nonpublic personal information" is broadly defined as personally identifiable financial information provided by a consumer, resulting from any transaction with or performed for the consumer or otherwise obtained by the financial institution, or any list, description or grouping of consumers derived using any nonpublic personal information, but does not include publicly available information, or any list derived solely by use of publicly available information.

GLBA provides several significant exceptions to the "opt out" provisions. A financial institution is permitted to disclose nonpublic personal information to non-affiliated third parties in order for them to perform services for or functions on behalf of the financial institution, including marketing of the financial institution's own products or services. The exception also allows a financial institution to provide nonpublic personal information to a non-affiliated third party to market financial products or services offered pursuant to joint agreements between two or more financial institutions, so long as the institutions do not disclose the information to unaffiliated third parties in violation of GLBA (that is, without giving the customer prior notice of such proposed disclosure and the opportunity to opt out). However, information disclosed to the non-affiliated third parties may not include account or access numbers. Other exceptions to the opt-out requirements permit a financial institution to disclose nonpublic personal information to non-affiliated third parties to service its accounts, provide information to rating agencies, to a consumer reporting agency in accordance with the Fair Credit Reporting Act, in connection with asset securitizations, or in connection with the proposed or actual sale, merger or transfer of assets of the institution.

Finally, GLBA provides that it will not supersede state law to the extent that state law affords greater protection to individuals than is provided under GLBA, as determined by the Federal Trade Commission.

VI. COMMUNITY REINVESTMENT ACT MATTERS

Some of the other highly controversial issues in GLBA relate to CRA matters. In addition to the issue of whether a financial holding company can engage in new financial activities if its subsidiary depository institutions do not have and maintain a satisfactory or better CRA rating (see "Part I — Financial Holding Companies", above), GLBA also deals with two issues that were of particular concern to Senator Gramm: disclosure of agreements between banking organizations and CRA activist groups, and reducing the CRA compliance burden on small banks.

A. CRA "Sunshine Requirements"

GLBA requires that any agreement entered into six months or more after the enactment of GLBA between a depository institution or its affiliate and a nongovernmental party in order to fulfill CRA requirements must be disclosed in its entirety to the appropriate Federal banking agency and to the public by each party to the agreement. CRA agreements entered into before the end of the six-month period beginning on the date of enactment of GLBA are not subject to these reporting requirements.

A depository institution or its affiliate must report at least once a year to the appropriate Federal banking agency such information as may be required by the agency relating to payments, fees, loans made to or received by any party to the CRA agreement, aggregate data on loans, investments, and services provided by each party to its community under such CRA agreement, and such other matters as determined by regulation.

The nongovernmental entity or person that is the other party to the CRA agreement must provide at least once a year to the appropriate Federal banking agency an accounting of the funds received pursuant to each CRA agreement during the preceding 12 months. Such accounting shall include a detailed itemized list of the uses to which such funds have been put, including compensation, administrative expenses, travel, entertainment, consulting and professional fees, and such other expense categories as determined by the appropriate Federal banking agency.

For purposes of these provisions, a CRA agreement is defined as any of the following: (i) any written agreement or understanding made pursuant to, or in connection with, the fulfillment of CRA obligations that provides for cash payments, grants, or other consideration with a value in excess of $10,000, or for loans with an aggregate principal amount in excess of $50,000, annually; or (ii) a group of substantively related contracts with an aggregate value of cash payments, grants, or other consideration in excess of $10,000, or with an aggregate amount of loan principal in excess of $50,000, annually. GLBA excludes the following from the definition of CRA agreement: (ii) individual mortgage loans; (ii) specific contracts or commitments for loans or extensions of credit to individuals, businesses, farms or other entities, if the funds are loaned at rates not substantially below market and no re-lending of the borrowed funds to other parties is intended; and (iii) agreements entered into between a depository institution or its affiliate and a nongovernmental entity or person that has not commented on, testified about, or contacted the institution with respect to CRA.

Whether a particular agreement is deemed to be made in fulfillment of CRA requirements and thus subject to these disclosure rules depends on a list to be developed by each appropriate Federal banking agency of factors that materially affect such agency's decision to approve or disapprove a deposit facility, or to assign a CRA rating to a depository institution.

Material willful failure to comply with the foregoing disclosure requirements by persons other than depository institutions or their affiliates will result in the unenforceability of a CRA agreement, after the offending party has been given notice and a reasonable period of time to perform or comply. Moreover, if funds or resources received under a CRA agreement are diverted for personal financial gain in conflict with the purposes of such agreement, the appropriate Federal banking agency may force the offending party to disgorge such funds and/or prohibit the offending party from participating in any CRA agreement for a period not to exceed 10 years.

GLBA indicates that in preparing implementing regulations for these provisions, the Federal banking agencies are to minimize the regulatory burden on the reporting parties, including by permitting the use of existing reporting and auditing requirements and practices of the reporting parties. The Conference Report states that reporting parties should be able to fulfill the annual requirements to account for the use of funds by submitting annual audited financial statements or Federal income tax returns. Inadvertent or de minimus reporting errors are not to subject the filing party to any penalty.

GLBA does not provide any Federal banking agency with authority to enforce the provisions of any CRA agreement.

B. CRA Examinations of Small Banks

GLBA amends the CRA to provide for less frequent CRA examinations of small banks. Any financial institution with aggregate assets of not more than $250,000,000 shall be subject to routine examination under CRA according to the following schedule: not more than once every 60 months for an institution that received an "outstanding" rating at its most recent examination; not more than once every 48 months for an institution that received a "satisfactory" rating at its most recent examination; and as deemed necessary by the appropriate Federal banking agency for an institution that received a rating of less than "satisfactory" at its most recent examination.

This alternative timetable for CRA examination of small institutions is subject to two exceptions. First, a financial institution will remain subject to examination, regardless of its previous rating, in connection with an application for a deposit facility (which is defined for this purpose as the application for a charter, deposit insurance, the establishment of a branch, the relocation of an office, a merger or acquisition transaction, or certain acquisitions of shares or assets in a regulated financial institution). Second, the appropriate Federal banking agency will have the discretion to conduct more or less frequent examinations for reasonable cause under such circumstances as determined by the agency.

VII. MISCELLANEOUS

A. Municipal Bond Underwriting by National Banks

GLBA gives national banks the power to underwrite, deal in and purchase for investment purposes, without limit, all types of state and local obligations, including limited obligation bonds, revenue bonds and industrial development bonds. In order to exercise this power, the national bank must be well capitalized under applicable regulations.

B. ATM Fees

GLBA amends the Electronic Fund Transfer Act to require the Federal Reserve to issue regulations mandating certain disclosures at ATMs. The regulations will require every ATM operator that charges a fee for transactions initiated by a person who does not have an account with the operator to:

- post a notice prominently on the ATM to the effect that fees will be imposed; and
- display a notice on the ATM's screen, or on a piece of paper generated by the ATM, disclosing the imposition and the amount of the fee. Such disclosure must occur after the customer initiates a transaction but before the customer is irrevocably committed to completing the transaction.

There is a grace period through December 31, 2004 from the on-screen (or paper) disclosure requirements for ATMs that lack the technical capability to display or produce such information.

C. Treatment of Swaps Under Section 23A

GLBA requires the Federal Reserve to adopt, within 18 months after the enactment of GLBA, new rules under Section 23A of the Federal Reserve Act that will treat credit exposures arising from derivative transactions and intraday extensions of credit between banks and their affiliates as "covered transactions".

D. Treatment of Branches and Agencies of Non-U.S. Banks Under Section 23A

Section 114 of GLBA authorizes the Federal Reserve to impose restrictions on transactions between U.S. branches and agencies of non-U.S. banks and any affiliate in the United States of such banks if the Federal Reserve determines that such restrictions are necessary to avoid, among other things, unfair competition. There is precedent for this in the Federal Reserve imposing Section 23A on transactions between U.S. branches and agencies of non-U.S. banks and their Section 20 affiliates. Non-U.S. banks accepted this as a condition for obtaining approval to establish a Section 20 affiliate. Presumably, Section 114 gives the authority for the Federal Reserve to impose such a restriction in recognition of the fact that, because financial holding companies will not need to apply to the Federal Reserve for permission to engage in financial activities, the Federal Reserve otherwise would not have an opportunity to impose such a condition. Although there is some concern that the Federal Reserve will use this authority to impose Section 23A on transactions between the parent non-U.S. bank and its U.S. affiliates, that does not appear to be authorized by Section 114; nor is it consistent with past Federal Reserve practice.

E. SEC Supervision of Investment Bank Holding Companies

GLBA permits a holding company that controls a broker/dealer and that does not control a "bank" (other than a CEBA bank), and that is not a non-U.S. bank that has a branch in the United States, to elect to be supervised at the holding company level by the SEC. The SEC would be authorized to require reports and conduct examinations of the holding company. The Conference Report notes that GLBA does not authorize the SEC to regulate the capital levels of the holding company. The purpose of this provision is to enable U.S. investment banks that do not wish to become financial holding companies but that do wish to acquire banks outside of the United States to satisfy the requirements of the non-U.S. supervisors of such banks that the investment banks be subject to "comprehensive supervision on a consolidated basis" (the same standard that the Federal Reserve applies to non-U.S. banks that apply to open offices in the United States).

F. Study of Subordinated Debt

GLBA requires the Federal banking agencies to conduct a number of studies regarding various aspects of the U.S. financial services industry and regulatory framework. One of the more significant is a joint study that the Federal Reserve and the Treasury Department are required to complete within 18 months as to the benefits of requiring large insured depository institutions and holding companies to issue subordinated debt as part of their capital structure. Current capital regulations permit, but do not require, the issuance of subordinated debt for this purpose.

Since individual Governors of the Federal Reserve Board and others have recently indicated that they believe that issuing subordinated debt is a good way to impose market discipline on depository institutions (on the theory that the interests of subordinated debt holders are most closely aligned with the interests of the FDIC), it is quite possible that some requirement for the mandatory issuance of subordinated debt will result from the study.