

Some New Developments in Bank Securities Regulation

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A. If It Walks like a Duck, and If It Quacks like a Duck, It is a Barift

Soon after the passage of the Garn-St Germain Depository Institutions Act in 1982 (“Garn-St Germain”), thrifts began to seek to be treated as a “bank” for purposes of the Federal securities laws. At the time, the cause celebre was acting as a securities broker, so thrifts sought to enjoy the exemption that a “bank” then had from the definitions of “broker” and “dealer” under the Securities Exchange Act of 1934 (“Exchange Act”). In 1983, the SEC issued a release asking a number of questions about whether a thrift should be treated as a bank,¹ and no further

¹ Investment Company Act Release No. 13666, [1983-1984 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶83,462 (December 12, 1983). The SEC sought public comment on whether it should propose one or more of the following: (i) to adopt rules that would exempt certain thrifts from the definition of “investment adviser” in the Investment Advisers Act of 1940 (“Advisers Act”), and common and collective trust funds maintained by a thrift from the registration requirements of the Investment Company Act of 1940 (“Investment Company Act”) and the Securities Act of 1933 (“1933 Act”), and from the registration, reporting, and proxy requirements of the Exchange Act; (ii) to adopt rules defining the term “bank” in the Investment Company Act, the Advisers Act, and Sections 3(a)(12) and 12(g)(2)(H) of the Exchange Act to include thrifts which perform specified functions substantially equivalent to those performed by banks; (iii) to adopt an interpretation of the term “bank” for purposes of the Investment Company Act, the Advisers Act, the 1933 Act, and the Exchange Act that would include thrifts which perform certain functions; and (iv) to develop a legislative proposal to amend the Exchange Act, the Investment Company Act, and the Advisers Act to include thrifts within the definitions of “bank” in such Acts, at least for certain purposes. It concluded that the SEC should not, by administrative interpretation through no-action letters, without notice and opportunity for comment, eliminate the distinction that Congress appears to have drawn in the Federal securities laws between banks and thrift institutions. The SEC then discussed the scope of its rulemaking authority, and asked commentators to focus specifically on: (a) whether in view of their expanded powers, thrifts can meet the definitional prerequisites of the term “bank” as defined in the Exchange Act, the Investment Company Act, and the Advisers Act; (b) if certain thrifts can meet the statutory elements of the definition of the term “bank,” how should the SEC clarify their status under the Federal securities laws; (c) whether in taking action on any of the alternatives discussed above, there are significant investor protection or public interest concerns that should be considered by the SEC; (d) the costs to thrifts of maintaining common trust funds and collective investment trusts subject to the registration, reporting and proxy requirements of the Federal securities laws; (e) the costs to thrifts of establishing a corporate subsidiary to engage in the trust business, the advisory business, or both; and (f) whether SEC action to implement any of the alternatives discussed above would create regulatory disparities that would be unjustified.

action was taken. Meanwhile, culminating in the famous no-action letter issued to Chubb,² most thrifts were able to avoid registration as a securities broker or a dealer by engaging in networking activities where another, fully-licensed broker-dealer, engaged in brokerage activities on the premises of the thrift institution.

Somewhat under the radar screen, thrifts had previously been given the power to engage in trust activities in Section 403 of the Depository Institutions Deregulation and Monetary Control Act of 1980, which amended Section 5 of the Home Owners' Loan Act of 1933 to authorize the Federal Home Loan Bank Board ("FHLBB") to grant trust powers to Federal savings and loan associations and to issue regulations regarding the proper exercise of trust powers.³ Thereafter, FHLBB proposed regulations,⁴ which closely paralleled the Comptroller of the Currency's Regulation 9,⁵ and adopted them.⁶ FHLBB also noted at that time that it did not have jurisdictional parity with the other Federal bank regulatory agencies respecting the Federal securities laws, *i.e.*, a thrift was not a "bank," and directed its staff to prepare a legislative proposal for this purpose. To the author's knowledge, no such legislative proposal surfaced during the legislative process that produced Garn-St Germain. In November 1989, the Office of Thrift Supervision ("OTS"), as regulatory successor to FHLBB, re-promulgated the trust rules without substantive change or renumbering.⁷

Beginning in the mid-1990s, OTS began reporting that certain thrifts were engaging in trust activities, which suggested that those thrifts were effecting transactions for the account of others [acting as a broker], sponsoring common trust funds and collective investment funds [investment companies unless excluded], and giving investment advice [acting as an investment adviser] apparently without registration under either the Exchange Act, the Investment Company

² Chubb Securities Corp., SEC No-Action Letter, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,829 (Nov. 24, 1993).

³ Pub. L. No. 96-221, §403, 94 Stat. 132 (codified at 12 U.S.C. §1464(n)).

⁴ 45 Fed. Reg. 57728 (1980).

⁵ 12 C.F.R. §9.1 et seq. (2006).

⁶ FHLBB adopted its regulations in December 1980, 45 Fed. Reg. 82164 (Dec. 15, 1980), 45 Fed. Reg. 82162 (Jan. 1, 1981), reproduced at 12 C.F.R. §§550, 571.15.

⁷ 54 Fed. Reg. 49411 (Nov. 30, 1989). In December 1997, OTS issued a final rule revising its fiduciary powers regulation. 62 Fed. Reg. 3 (Dec. 30, 1997), Fed. Banking L. Rep. (CCH) ¶91-112. The proposed ruling appears at 62 Fed. Reg. 39477. Specifically, OTS significantly rewrote its prior regulation in "plain English" style, and incorporated significant interpretive guidance. The final rule also codifies the existing policy statement regarding the applicability of OTS's fiduciary powers regulation to the fiduciary activities of state-chartered thrifts that previously appeared at 12 C.F.R. §571.15 (2006).

Act, or the Advisers Act. Needless to say, a situation where an entire industry is out of compliance is very unsatisfactory for all concerned.⁸

Next came Section 223 of the Gramm-Leach-Bliley Act in November 1999, which somewhat inexplicably changed the long-standing definition of “bank” in the Investment Company Act; that definition had been substantially identical to the definition of “bank” in the 1933 Act, Exchange Act, and Advisers Act. In a new twist, however, the new definition of “bank” provided by Section 223 solely for purposes of the Investment Company Act has at its core the definition of “depository institution” in the Federal Deposit Insurance Act, which includes thrifts.⁹ Section 223 had appeared in many of the previous versions dating back to the early 1990s of what would become the Gramm-Leach-Bliley Act, and had been routinely supported in Congressional testimony by various representatives of the SEC. Nonetheless, the anecdotal evidence suggests that the SEC staff was surprised to discover that the new definition of “bank” has the practical effect of allowing thrift-sponsored common trust funds and collective investment trust funds to rely on Sections 3(c)(3) and 3(c)(11) of the Investment Company Act. This left thrifts in an anomalous and asymmetrical position: their brokerage activities were not subject to the Exchange Act by virtue of the Chubb no-action letter and its successor provisions in Section 3(a)(4)(B)(i) of the Exchange Act and their collective investment vehicles were not subject to the Investment Company Act, but their investment advisory activities were fully subject to the Advisers Act.

In Spring 2001, the OTS began pursuing legislative and administrative channels to address what it considered to be unequal treatment accorded to thrifts under the Exchange Act and Advisers Act.¹⁰ In April 2004, the SEC proposed a new rule that would have exempted certain thrift trust activities from the Advisers Act, and would have exempted certain common trust funds and collective investment funds from the Exchange Act.¹¹ The comment letters were very critical of the Advisers Act proposal.¹²

⁸ To the author’s knowledge, the SEC has not brought an enforcement case against a thrift for violation of the 1933 Act, Exchange Act, Investment Company Act, or Advisers Act solely with respect to the status of its trust activities under those statutes, a remarkable act of forbearance.

⁹ Section 223 amends the definition of “bank” in Section 2(a)(5)(A) of the 1940 Act to refer to the definition of “depository institution (as defined in section 3[c] of the Federal Deposit Insurance Act) or a branch or an agency of a foreign bank (as such terms are defined in section 1(b) of the International Banking Act of 1978).”

¹⁰ “OTS Wants Registration Exemption Parity for Thrifts,” Trust Letter, May 2001, at 9.

¹¹ Investment Advisers Act Release No. 2232 (April 30, 2004).

¹² “Exception for Thrift Advisory Services Poorly Conceived or Not Enough, Critics Say,” 83 BNA Banking Rep. 119 (July 19, 2004); “ABA Urges Full Registration Exception for Thrifts,” Trust Letter, August 2004, at 5; “Belated SEC Plan Probably Won’t Satisfy Thrifts,” American Banker, April 28, 2004, at 2.

It should come as no surprise, then, that giving thrifts parity with banks has been a perennial candidate for adoption in the various “reg relief” bills that have been considered by Congress in recent years. In Spring 2006, the Senate passed S. 2856, The Financial Services Regulatory Relief Act of 2006. Section 401 of S. 2856 provided, essentially, that a thrift would be treated like a bank for purposes of the Exchange Act and the Advisers Act. On September 30, 2006, the House passed its version of S. 2856 without making any changes to Section 401. As a result, when the President signed this legislation on October 13th, thrifts achieved parity with banks under the Federal securities laws, ending an amazing 26 year-journey to become a barift.

B. SEC Regulation B: May It Rest in Peace

The Gramm-Leach-Bliley Act was signed into law by President on November 11, 1999. Title II of the Gramm-Leach-Bliley Act became effective on May 12, 2001, eighteen months later. On the day before it was to become effective, the SEC adopted Interim Final Rules interpreting the new “push-out” provisions of Title II that would give the SEC functional regulation over bank broker and dealer activities.¹³ Because the Interim Final Rules had been issued without notice and opportunity for comment, the SEC immediately suspended their effectiveness so that comments could be submitted. The comments from the banking industry were uniformly critical, and the comment letter from the four Federal banking agencies was notable for its suggestion that, in interpreting the “push-out” provisions, the SEC staff had acted in “bad faith.” In testimony that summer before the House Financial Services Committee, Acting SEC Chairman Laura Unger promised that the SEC would propose changes to the Interim Final Rules that would be acceptable to the banking industry and four Federal banking agencies, and that there would be a substantial period granted before the revised rules would become effective even after they were finally adopted. In spring 2004, the SEC published Regulation B,¹⁴ and was again greeted by uniformly negative comments from the banking industry and four Federal banking agencies. With something close to a stalemate in hand, the Financial Services Committee in the House floated the concept of requiring joint rulemaking between the SEC and the four Federal banking agencies.¹⁵ Fourteen of the twenty Senators serving on the Senate Banking Committee wrote to the SEC urging substantial revisions to Regulation B.¹⁶

Fast forward to spring 2006 when the Senate passed S. 2856. Section 101 of S. 2856 would have nullified any rules adopted by the SEC to implement the “push-out” provisions of Title II, and would have required the SEC to engage in a joint rulemaking with the four Federal banking agencies within 180 days of the enactment of S. 2856. On September 30, 2006, the

¹³ Securities Exchange Act Release No. 44291 (May 11, 2001).

¹⁴ Securities Exchange Act Release No. 49879 (June 17, 2004).

¹⁵ “House Panel May Force Rulemaking On Reg B Between Bank Agencies, SEC,” 37 BNA Sec. Reg. & L. Rep. 1369 (August 15, 2005).

¹⁶ “SEC Delays Compliance on Push-Out Rule; Fourteen From Senate Banking Urge Rewrite,” 84 BNA Banking Rep. 480 (March 14, 2005).

House passed its version of S. 2856 and changed Section 101 to require the SEC to jointly propose with the Federal Reserve Board, in consultation with the three other Federal banking agencies, a rule implementing the “push-out” provisions of Title II.¹⁷ As a result, when the President signed this legislation on October 13th, almost seven years from the day when the Gramm-Leach-Bliley Act was signed into law, it put an end to a very sad and embarrassing chapter in the history of functional regulation of financial services. To quote SEC Chairman Christopher Cox in a speech before the Financial Services Roundtable Annual Meeting on September 21, 2006, “All in all, the seven-year stretch from enactment of Gramm-Leach-Bliley until today is a disappointing record of indecision and inaction.” Interestingly, Commissioner Cox also stated: “I fully intend to complete work on a proposed rulemaking this year, and I expect a final rule to be completed within six months.” Given where things now stand, that is a truly ambitious schedule and it would be a genuinely remarkable achievement.

¹⁷ On September 29, 2006, the SEC issued Press Release 2006-169 announcing a timetable for enactment of the successor to Regulation B, and issued an order extending the exemption from the definition of “broker” until January 15, 2007. Securities Exchange Act Release No. 54544 (September 29, 2006).