

DEPARTMENT OF THE TREASURY

OFFICE OF THE COMPTROLLER OF THE CURRENCY

12 CFR Part 5

12 CFR Part 12

[Docket No.]

RULES, POLICIES AND PROCEDURES FOR CORPORATE ACTIVITIES
RECORDKEEPING AND CONFIRMATION REQUIREMENTS FOR SECURITIES TRANSACTIONS

Brokerage Activities to be Conducted in an Operating Subsidiary.

AGENCY: Office of the Comptroller of the Currency; Treasury

ACTION: Notice of proposed rulemaking.

SUMMARY: The Office of the Comptroller of the Currency ("Office") is proposing a rule, to be codified in 12 C.F.R. § 5.52, that sets forth the circumstances in which brokerage activities of national banks should be conducted in operating subsidiaries of such banks. The circumstances are, first, the provision of certain securities brokerage services and, second, receipt of transaction-related fees for brokerage activities conducted on behalf of trust, managing agency or other accounts to which the bank provides investment advice. Alternatively,

covered activities could be conducted in nonbank subsidiaries of bank holding company affiliates, consistent with the requirements of the Bank Holding Company Act and Regulation Y under that act.

Under the proposal, national banks could continue to conduct many types of brokerage activities within a department of the bank. This includes national banks publicly soliciting customers for so-called "limited purpose" discount brokerage services provided in conjunction with registered broker-dealers.

The rule is intended to provide this Office with a more efficient means of supervising and examining national banks that engage in brokerage activities. Covered banks' brokerage activities would be subject to supervision and examination by this Office under the banking laws. Brokerage activities conducted in operating subsidiaries of national banks or in a nonbank subsidiaries of bank holding companies would be subject to the broker-dealer requirements of the Securities Exchange Act of 1934 ("Exchange Act").

A companion amendment to 12 C.F.R. Part 12 is also being proposed. In particular, an addition would be made to section 12.6 that addresses development of written policies and procedures for national banks that effect transactions in securities for customers. To aid bank examination and to ensure proper conduct, a new paragraph would be added requiring written policies and procedures regarding bank brokerage activities.

DATE: Written comments must be submitted on or before (45 days after date of publication in the FEDERAL REGISTER).

ADDRESSEES: Comments should be directed to: Docket No. [], Communications Division, 3rd Floor, Office of the Comptroller of the Currency, 490 L'Enfant Plaza East, S.W., Washington, D. C. 20219, Attention: Marie France. Comments will be available for public inspection and photocopying.

FOR FURTHER INFORMATION CONTACT: Lisa J. Lintecum, Investment Securities Division, Office of the Comptroller of the Currency, (202) 447-1164, or Linda Gottfried, Attorney, Securities & Corporate Practices Division, Office of the Comptroller of the Currency, (202) 447-1954.

SUPPLEMENTARY INFORMATION:

Background

In recent years, fundamental changes in the marketplace for financial services have caused an increasing number of national banks to offer securities related services to their customers. The elimination, in May 1975, of fixed minimum commission rates charged by brokers, 1/ has made it economically feasible for banks, which traditionally have provided securities execution services, to offer a wider range of brokerage services to their

1/ See Rule 19b-3 under the Securities Exchange Act of 1934 ("Exchange Act"), 17 CFR § 240.19b-3.

customers. Increased provision of brokerage services by banks represents a natural growth of a traditional banking service and is consistent with the general evolution of the market place for financial services.

Brokerage services provided by banks varies, reflecting, in part, differences in their financial markets. Community-oriented banks serve almost exclusively a retail market and discount brokerage services may be one of several financial services provided their customers. Other banks, including many regional and money-center banks, offer a wide range of financial services to the public and through established correspondent relationships. Those banks may provide brokerage services on either a wholesale basis to correspondent banks or directly to retail customers.

Discount brokerage services are generally being provided by banks in conjunction with brokers registered under the Exchange Act. Typically, the clearing broker enters into a contract to perform various brokerage functions for the bank, including opening customer accounts, holding customer funds and securities, making margin loans, confirming customer transactions and preparing and maintaining the business records necessary for operating a brokerage business in accordance with accepted industry standards. In such arrangements, the bank usually has responsibilities for marketing and promoting the brokerage service. The bank may provide account applications which, when completed by the customer, are forwarded by the bank to the

clearing broker. While bank employees may answer questions concerning the brokerage services, customer questions concerning trading and their accounts are handled directly by the clearing broker. Banks are compensated for those services, typically a fixed percentage of commissions charged by the clearing broker. Banks performing in this capacity are sometimes referred to as "limited purpose" introducing brokers. 2/

Other banks have established themselves directly in the retail market for brokerage services through a separate corporate entity, such as an operating subsidiary. In the case of national banks, this Office has approved several applications to provide discount brokerage services to customers through an operating subsidiary of the national bank. 3/ A national bank operating

2/ This is similar to the activities engaged in by certain nonbank financial institutions that are participating in "networking" arrangements with registered clearing brokers without that financial institution registering as a broker pursuant to Section 15 of the Exchange Act. Such arrangements have been the subject of a number of SEC staff "no-action" letters. See, e.g., letter dated July 8, 1982, from Jeffrey L. Steele to Savings Association Investment Securities, Inc.

3/ Under this Office's regulations, a national bank may, with the prior approval of the Comptroller of the Currency, engage in activities which are a part of the business of banking or incidental thereto by means of an operating subsidiary. In order to qualify as an operating subsidiary, the parent bank must own at least 80 percent of the voting stock of the subsidiary. See 12 CFR § 5.34, as amended, 48 Fed. Reg. 48454 (Oct. 19, 1983). For a further discussion of bank discount brokerage services, see, e.g., Decision of the Comptroller of the Currency Establishing an Operating Subsidiary to be Known as Security Pacific Discount Brokerage Services, Inc. (Aug. 26, 1982). In at least

subsidiary is subject to all provisions of federal banking law applicable to the operations of the bank. 4/ The operating subsidiary is also subject to examination and supervision by this Office in the same manner and to the same extent as the bank. 5/

As an alternative to the operating subsidiary model, brokerage services are being offered through nonbank subsidiaries of bank holding companies. 6/ Those subsidiaries are subject to the provisions of section 4(c)(8) of the Bank Holding Company Act of 1956, as amended, 7/ and section 225.25(b)(15) of Regulation Y, adopted by the Board of Governors of the Federal Reserve System ("Board") under that Act. 8/ They are subject to examination by the Board under the Bank Holding Company Act. They are also

3/ (continued)

one instance, the Office has approved an operating subsidiary to provide investment advisory services at a national bank with a separate operating subsidiary furnishing discount brokerage. See Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice (Sept. 2, 1983).

4/ See 12 CFR § 5.34(d)(2).

5/ See 12 CFR § 5.34(d)(3).

6/ See, e.g., Order of the Board of Governors of the Federal Reserve System Approving the Acquisition of Charles Schwab & Co, Inc. by BankAmerica Corporation, 69 Fed. Res. Bull. 105 (1983).

7/ 12 U.S.C. § 1843(c)(8).

8/ 12 C.F.R. § 225.25(b)(15), as amended, 49 Fed. Reg. 828 (Jan 5, 1984).

subject to examination by this Office as an affiliate of a national bank. 9/

In addition, bank operating subsidiaries and affiliates engaged in the brokerage business which are registered under Section 15(a) of the Exchange Act 10/ are subject to the provisions of the Exchange Act applicable to brokers. As such, the subsidiary and affiliate can be examined by the SEC or the relevant securities industry "self-regulatory organization," 11/ such as the New York Stock Exchange ("NYSE") or the National Association of Securities Dealers, Inc. ("NASD").

Coordinated Regulatory Scheme

Provision of brokerage services in national bank operating subsidiaries and holding company affiliates has provided the Office with an opportunity to evaluate the advantages of a coordinated approach to the regulation of bank brokerage activities. The Office believes this approach, under certain circumstances, provides a more efficient means of exercising its supervisory responsibilities under the banking laws.

9/ 12 U.S.C. §§ 161, 481.

10/ 15 U.S.C. § 78o(a).

11/ Under section 3(a)(26) of the Exchange Act, a "self-regulatory organization" includes any "national securities exchange," or any "registered securities association" 15 U.S.C. § 78c(a)(26).

The concept of coordinated regulatory responsibility is not new, either to the banking industry or the securities industry. By establishing the Federal Financial Institutions Examination Council, Congress required a coordinated approach to matters of mutual regulatory interest. In addition, this Office and the FDIC have recently announced a cooperative examination program for national banks, intended to meet their needs for coordination, communication and cooperation in carrying out their complementary responsibilities. 12/ Another example is the recent approval by this Office of an operating subsidiary to underwrite credit life insurance. The subsidiary will be regulated jointly by this Office and state insurance authorities. 13/

Within the securities industry, under the Exchange Act regulatory scheme for brokers and dealers, the SEC and designated self-regulatory organizations have developed a coordinated system for allocating regulatory responsibility among self-regulatory organizations having common members. 14/ For example, under the SEC's program, when a broker is a member of the NASD and an exchange, the primary regulatory responsibility is vested in one of the two self-regulatory organizations.

12/ See Comptroller of the Currency-Federal Deposit Insurance Corporation, Joint News Release (December 13, 1983).

13/ [Current] Fed. Banking L. Rep (CCH) ¶ 99,806.

14/ See Rules 17d-1 and 17d-2 under the Exchange Act, 17 C.F.R. §§240.17d-1 and 17d-2.

Finally, the Exchange Act's regulatory scheme provides, in different ways, for coordinated regulatory responsibilities among the SEC and federal banking agencies with respect to municipal securities dealers 15/, as well as clearing agencies and transfer agents. 16/

On the basis of its preliminary evaluation, the Office believes that, to carry out its responsibilities under the banking laws in the most efficient manner and to promote continued public confidence in an evolving financial system, banks which engage in certain brokerage activities should conduct their activity in either an operating subsidiary of the bank or an affiliated nonbank subsidiary of its bank holding company. Among other things, activities covered by this rule would be subject to requirements designed specifically to ensure the operational integrity of the brokerage operations and to protect customers. Of course, brokerage activities and non-brokerage activities conducted in operating subsidiaries remain subject to 12 C.F.R. § 5.34(d)(2)(i).

15/ See Section 15B of the Exchange Act, 15 U.S.C. 78-2.

16/ See Section 17A of the Exchange Act, 15 U.S.C. 78q-1.

Activities Covered by the Rule

The rule, to be set forth in 12 C.F.R. § 5.52, would apply to two separate categories of bank brokerage activities. The first category involves banks that provide brokerage services under certain circumstances. See proposed 12 C.F.R. § 5.52(d)(1). The second category involves banks that receive transaction related fees for brokerage activities conducted for trust, managing agency and other accounts to which the bank provides investment advice. See proposed 12 C.F.R. § 5.52(d)(2).

I. Brokerage Services

With respect to the first category of brokerage activities, a bank must first be deemed to be providing a "brokerage service." That term is defined in proposed 12 C.F.R. § 5.52(c)(1), to mean effecting transactions in securities for the account of customers and receiving compensation for that service. Banks offering brokerage services may not ultimately be involved in the execution of customer transactions, e.g., on a national securities exchange or in the over-the-counter market. However, to the extent that banks are involved in opening customer brokerage accounts or in transmitting orders to a broker that ultimately executes securities transactions for customers, such banks would be deemed to be effecting transactions in securities.

Since the rule is intended to ensure appropriate regulation of retail brokerage services, certain types of transactions in securities effected by banks, as agent, would be expressly excluded from the definition of "brokerage service." First, transactions effected by a bank, as agent, in municipal securities are excluded. See proposed 12 C.F.R. § 5.52(c)(1)(A)(i). Transactions in municipal securities by bank municipal securities dealers are subject to the regulatory scheme provided by Section 15B of the Exchange Act, including rules of the Municipal Securities Rulemaking Board.

Second, transactions effected by a bank, as agent, in U.S. government or federal agency securities are excluded from the definition of brokerage service. See proposed 12 C.F.R. § 5.52(c)(1)(A)(ii). Bank transactions in such securities generally are not conducted for retail customers.

Third, transactions effected by a bank for the investment portfolio of affiliated banks are excluded from the definition of brokerage service. See proposed 12 C.F.R. § 5.52(c)(1)(A)(iii). Such transactions are not within the intended scope of the rule.

Fourth, there would be an exclusion for sweep account transactions between a customer's deposit account and money market funds or other types of investment companies. See proposed 12 C.F.R. § 5.52(c)(1)(A)(iv). Sweep arrangements

typically involve money market funds that are registered pursuant to the Investment Company Act of 1940. Distribution of interests in such funds are conducted through a broker or dealer registered pursuant to the Exchange Act. Bank involvement in such arrangements usually includes providing administrative and shareholder services to participating customers.

Fifth, there would be an exclusion for banks with respect to transactions effected as part of dividend reinvestment services and employee stock purchase plans. See proposed 12 C.F.R. § 5.52(c)(1)(A)(v). These services are not within the intended reach of the rule.

Sixth, there would be an exclusion for banks that average less than 200 securities transactions per year for customers over the prior three calendar year period, exclusive of transactions in U.S. Government and federal agency obligations. See proposed 12 C.F.R. § 5.52(c)(1)(A)(vi). The volume of such transactions is insignificant and corresponds to an exemption from certain requirements of 12 C.F.R. Part 12.

Critical Conditions. The rule would apply to bank brokerage services only if certain conditions exist. As a preliminary matter, banks would not be subject to the rule unless they solicit brokerage business either (i) publicly, through advertisements or otherwise; or (ii) from other banks, through correspondent relationships or otherwise. In addition, banks

would not be subject to the rule unless they are either (i) making margin loans to customers of the brokerage services, or (ii) holding customer securities, unless the bank introduces transactions on a fully disclosed basis to a registered broker and promptly forwards securities to or from customers. The latter two conditions generally are not present in brokerage services currently being provided by the vast majority of all national banks. Those banks function as a so-called "limited purpose" introducing brokers, and could continue to offer their services within the bank.

Margin Lending. The proposed rule is intended to cover situations in which the bank extends or maintains credit to or for a retail brokerage customer as part of its brokerage business. See proposed 12 C.F.R. § 5.52(d)(1)(A). Credit extended to a customer for the purpose of effecting transactions in securities would not be covered by the rule, if such customer effects the transaction through someone other than the bank extending the credit.

The intended effect of this provision is to assure that the margin lending function conducted as part of a brokerage business be subject to the initial margin requirements applicable to brokers under the Exchange Act, and to the margin maintenance requirements applicable by virtue of membership in one of the securities industry self-regulatory organizations, such as the NASD or NYSE. Thus, covered bank brokerage activities would be

subject to the initial margin requirements of Regulation T 17/ rather than Regulation U. 18/ Those requirements are administered by the Board pursuant to Section 7 of the Exchange Act. 19/ In addition, such activities would be subject to the margin maintenance requirements adopted by self-regulatory organizations. 20/

Holding Customer Securities

The proposed rule is also intended to apply to situations in which the bank, in connection with the operation of its brokerage business (either at a retail or wholesale level), holds customer securities. See proposed 12 C.F.R. § 5.52(d)(1)(B). However, banks would be excluded from the rules if the bank (i) introduces all transactions and accounts of customers to a registered broker, who carries such accounts on a fully disclosed basis and (ii) "promptly forwards" all securities of customers received in connection with such service to the appropriate parties. The "promptly forwards" criterion would be satisfied if the bank

17/ 12 C.F.R. Part 220.

18/ 12 C.F.R. Part 221.

19/ 15 U.S.C. §78g.

20/ See, e.g., NYSE Rule 431; Art. III, Sec. 30 NASD Rules of Fair Practice.

establishes and maintains a system providing for the forwarding of securities no later than noon of the next business day after receipt of such securities. Effecting prompt forwarding of securities would not be required prior to the settlement date of a transaction.

II. Transaction Related Fees

The second category of brokerage activity that would be covered by the rule relates to transactions effected on behalf of trust, managing agency and other accounts to which the bank provides investment advice. See proposed 12 C.F.R. § 5.52(d)(2). As a preliminary matter, banks, in effecting transactions on behalf of fiduciary accounts, must assure themselves that all applicable fiduciary standards are met. To the extent that it is permissible under fiduciary requirements to receive a fee for effecting transactions on behalf of fiduciary accounts, those transactions would have to be conducted in an operating subsidiary. This Office, in Trust Banking Circular 23, dated October 4, 1983, clarified its position regarding the permissibility of national banks making purchases of securities for trust accounts which they administer through a discount brokerage affiliate. For the purpose of this rule proposal, a bank would not be deemed to receive a "fee" if a charge imposed by a bank in fiduciary accounts only covered the cost of effecting the transaction. As discussed in the Trust Banking Circular, receipt of a transaction related fee by a discount

broker affiliate must be based on specific authorization in the appropriate governing instrument or local law. In addition, where all beneficiaries of a particular fiduciary account are ascertained and competent, those beneficiaries may authorize bank receipt of transaction related fees.

Written Policies and Procedures

The Office is also proposing a requirement that national banks adopt written policies and procedures designed to ensure compliance with proposed section 5.52. See proposed 12 C.F.R. 12.6(e). As proposed, every national bank that effects transactions in securities for customers would have to establish such policies and procedures. These banks already maintain written policies and procedures concerning other aspects of their brokerage activities pursuant to 12 C.F.R. § 12.6(a)-(d). In addition, these banks are already subject to recordkeeping and confirmation provisions of 12 C.F.R. Part 12. The written policies and procedures requirement would further facilitate this Office's examination of bank brokerage activities.

Special Studies

This Office believes that the impact of its proposal, if adopted, will not be sufficient to warrant either a regulatory impact analysis or a regulatory flexibility analysis. Those conclusions are based on the following reasoning.

A stratified random sample of nearly 500 national banks was recently surveyed to determine the nature and extent of their discount brokerage services. Within each of six districts, the survey reached five percent of the banks with assets less than \$300 million, 50 percent of the banks with assets between \$300 million and \$1 billion and all banks with assets \$1 billion and over. The five percent sample reached 217 banks, the 50 percent sample 104 banks and the 100 percent sample 159 banks. There was a 100 percent response rate and 55 percent reported offering discount brokerage services. Among the banks sampled, seven percent of the smallest, 17 percent of the middle and 19 percent of the largest size class offered discount brokerage services in a department of the bank that, without modification, would have to be placed in a subsidiary or holding company affiliate. In brief those banks indicated that they were offering margin loans, securities safekeeping or both as a part of their discount brokerage service.

If those ancillary services were abandoned or modified in accordance with the provisions of the proposed rule, banks could continue offering discount brokerage without incurring the expense of transferring it to a separate corporate entity. Exercise of either option would have a negligible impact on bank earnings and would maintain banks as a vital competitive force in this segment of the financial services marketplace. Those who choose to shift the operation out of the bank could face a one-time charge usually associated with incorporation of a

business. That expense would not be met by banks that are members of a holding company that already has a subsidiary offering discount brokerage.

In light of the survey results and the considerations outlined above, the Office has concluded that its proposal will not have a significant economic impact upon a substantial number of small banks. The same reasoning underlies the conclusion that this is not a major rule as defined by Executive Order 12291.

List of Subjects

For Part 5 - National banks, administrative practice and procedure. For Part 12 - National banks, customers' securities transactions.

Accordingly, the Comptroller of the Currency proposes to amend 12 C.F.R. Part 5 and 12 C.F.R. Part 12 as follows:

1. A new section 5.52 is added to read as follows:

§ 5.52 Bank brokerage services.

(a) Authority. The provisions of this section are issued pursuant to 12 U.S.C. §§ 1 et seq, 24(Seventh), 92a and 93a.

(b) Policy. The Office has determined that, to facilitate the more efficient exercise of its supervisory and examining responsibilities under the banking laws, 12 U.S.C. §§ 1 et seq., certain national bank brokerage activities should be conducted in operating subsidiaries of such banks, subject to the prior approval of this Office pursuant to the provisions of 12 C.F.R. § 5.34. Securities brokerage activities not covered by this section may be conducted by national banks in a department of the bank. To the extent that the brokerage activities of national bank subsidiaries of bank holding companies are subject to this section those activities can be conducted by the national bank in an operating subsidiary or by the bank holding company in a non-bank subsidiary subject to the requirements of the Bank Holding Company Act of 1956, as amended, and Regulation Y thereunder.

(c) Definitions. For the purpose of this section:

(1) A bank is deemed to be providing a "brokerage service" if such bank:

(A) effects transactions in securities for the account of customers, except where such transactions consist of (i) agency transactions in municipal securities; (ii) agency transactions in U.S. government or federal agency securities; (iii) transactions effected for the investment portfolio of affiliated banks; (iv) transactions effected as part of a program for the investment or reinvestment of bank deposit account funds

into any investment company registered pursuant to the Investment Company Act of 1940, so long as the interests in such investment company are distributed by a broker or dealer registered pursuant to the Securities Exchange Act of 1934; (v) transactions effected as part of a dividend reinvestment plan or employee stock purchase plan; or (vi) average less than 200 securities transactions per year for customers over the prior three calendar year period, exclusive of transactions in U.S. Government and federal agency obligations; and

(B) receives any compensation for effecting such transactions, including but not limited to, receipt of a commission (or any portion thereof) from any person, including any clearing broker involved in effecting the transaction.

(2) The term "retail brokerage customer" shall mean any person from whom, or on whose behalf, a bank in connection with its brokerage business has received, acquired or holds funds or securities for the account of such person, but does not include a broker or dealer.

(3) A bank is deemed to "promptly forward" all securities within the meaning of this section if the bank establishes and maintains a system to provide for the forwarding of securities to or from customers no later than noon of the next business day after the receipt of such securities, provided, however, that such prompt forwarding shall not be required to be effected prior to the settlement date for such transaction.

(4) The term "security" shall have the same meaning set forth in Section 12.2(e) of this title.

(d) Conditions which require brokerage activities to be conducted within an operating subsidiary. Securities brokerage activities of a national bank shall be conducted in an operating subsidiary of such bank, subject to 12 C.F.R. §5.34, if the bank:

(1) provides brokerage services (i) publicly through advertisements or otherwise or (ii) for other banks, through a correspondent relationship or otherwise; and either:

(A) extends credit to or maintains credit for retail brokerage customers with respect to the purchase or sale of securities effected through the bank, or

(B) holds retail brokerage customers' securities, unless the bank (i) introduces and forwards all transactions and accounts of customers to a broker registered pursuant to the Securities Exchange Act of 1934 who carries such accounts on a fully disclosed basis and (ii) promptly forwards all securities of such customers received in connection with its brokerage service; or

(2) receives a transaction related fee for brokerage activities conducted on behalf of any trust, managing agency or other accounts to which the bank provides investment advice.

* * * * *

2. A new subsection (e) of section 12.6 would be added to read as follows:

(e) Assignment of responsibility for supervision of all bank officers and employees who participate in, or have responsibility for, effecting transactions in securities for customers to ensure compliance with 12 C.F.R. § 5.52.

Date: 2/15/84 C.T. Conover
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Comptroller of the Currency