November 28, 1989

To: Steve Harris

From: Sharon Heaton

Re: Recent Section 20 Decision by the Federal Reserve

On November 22, 1989, the Federal Reserve Board approved an application by J.P. Morgan & Company Incorporated to act, through a subsidiary, as an agent in the private placement of all types of securities and to buy and sell securities on the order of clients as a "riskless principal." A copy of this decision is attached. On October 30, 1989, the Board approved a similar application by Bankers Trust. Bankers Trust New York Corporation, 75 Fed. Res. Bull. --- (Order dated October 30, 1989). For reasons discussed in the Bankers Trust decision, these activities are not deemed underwriting or dealing in securities; therefore, revenue derived from these activities are not attributed to the 10 percent limitation on a securities subsidiary's participation in "ineligible securities activities."

In the November 22 decision, the Board noted that Morgan did not agree to comply with all the conditions agreed to by Bankers Trust. As a result, Morgan may extend credit at either the bank holding company or subsidiary level to a customer knowing that the loan would be used to pay principal or interest on securities placed by Morgan's section 20 subsidiary. In addition, Morgan may purchase for its own account, or the account of its nonbank subsidiaries, securities being placed by its section 20 subsidiary.

Specifically, Morgan proposed to have its affiliate banks extend credit to an issuer whose debt securities were placed by the section 20 subsidiary where the "proceeds" (presumably the loan) would be used to pay the principal amount of the securities at maturity. Morgan argued that such transactions may be appropriate if, at the time the securities mature, the issuer would find it more advantageous to obtain financing from the bank rather than reissue the securities. The Board determined that such extensions of credit were appropriate provided: (1) there is at least 3 years between the placement of the securities by the section 20 subsidiary and the extension of credit by the bank; (2) the extension of credit meets prudent and objective standards; and (3) the banks or other affiliates that extend such credit maintain detailed documentation. With these conditions, the Board believed that Section 23B of the Federal Reserve Act (requiring that inter-company transactions be at arms-length) and the examination process would be adequate protection against conflicts of interests and imprudent banking practices.

Morgan also proposed that its securities subsidiary be permitted to place securities with its parent holding company or nonbank affiliates. The Board observed that banks currently place securities with parent holding companies and nonbank affiliates. Noting that such activities have not led to supervisory problems, the Board determined that securities subsidiaries could similarly

place securities provided that: (1) affiliated banks do not purchase such securities; (2) parent holding companies and their nonbank subsidiaries purchase no more than 50 percent of any one issue being placed by the securities subsidiary; and (3) the parent holding company establish internal policies, procedures and limitation regarding the amount of securities of any particular issue placed by the securities subsidiary, individually and in the aggregate.

I believe that both firewalls waived by the Board in the Morgan decision were included in S.1886, the Glass-Steagall reform bill considered by the Senate in 1987-88. In its early decisions, the Board indicated that it would adopt the Senate approved firewalls; this may be the first time the Board has dropped these protections. In addition, I have informally heard that the Board is about to decide securities applications filed by several foreign entities regulated as bank holding companies in the U.S. It is expected that the Board will significantly modify the conditions imposed upon these entities. Conversely, the Board has been considering the appropriate restrictions to be imposed on the overseas securities activities of domestic bank holding companies; here again, the Board is expected to remove many of the conditions upon which bank holding companies currently operate.

Attachment