proposed information collection, along with an analysis of comments and recommendations received, will be submitted to the Board for final approval under OMB delegated authority. Comments are invited on the following:

a. Whether the proposed collection of information is necessary for the proper performance of the Federal Reserve's functions; including whether the information has practical utility;

b. The accuracy of the Federal Reserve's estimate of the burden of the proposed information collection, including the validity of the methodology and assumptions used;

c. Ways to enhance the quality, utility, and clarity of the information to be collected; and

d. Ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology.

DATES: Comments must be submitted on or before February 28, 1997.

ADDRESSES: Comments, which should refer to the OMB control number (or Agency form number in the case of a new information collection that has not yet been assigned an OMB number), should be addressed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, DC 20551, or delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, N.W. Comments received may be inspected in room M-P-500 between 9:00 a.m. and 5:00 p.m., except as provided in section 261.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8(a).

A copy of the comments may also be submitted to the OMB desk officer for the Board: Alexander T. Hunt, Office of Information and Regulatory Affairs, Office of Management and Budget, New Executive Office Building, Room 3208, Washington, DC 20503.

FOR FURTHER INFORMATION CONTACT: A copy of the proposed form and instructions, the Paperwork Reduction Act Submission (OMB 83-I), supporting statement, and other documents that will be placed into OMB's public docket files once approved may be requested from the agency clearance officer, whose name appears below.

Mary M. McLaughlin, Federal Reserve Board Clearance Officer (202-452-3829), Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, DC 20551. Telecommunications Device for the Deaf (TDD) users may contact Dorothea Thompson (202-452-3544), Board of Governors of the Federal Reserve System, Washington, DC 20551.

Proposal to approve under OMB delegated authority the extension, with revision, of the following report:

1. Report title: Application for Employment with the Board of Governors of the Federal Reserve System (''Application'')
Agency form number: FR 28
OMB control number: 7100-0181
Frequency: on occasion
Reporters: applicants for employment with the Board
Annual reporting hours: 8,500
Estimated average hours per response: 1.0
Number of respondents: 8,500
Small businesses are not affected.

General description of report: This information collection is required to obtain or retain a benefit (12 U.S.C. 244 and 248(1)) and is given confidential treatment under the Privacy Act (5 U.S.C. 552(a)) and the Freedom of Information Act (5 U.S.C. 552(b)(2) and b(6)).

Abstract: The Federal Reserve Board proposes to extend the Application, with revisions, for three years. The purpose of the Application is to collect information to determine the qualifications, suitability, and availability of applicants for employment with the Board. The Application asks about education, training, employment, and other information covering the period since the Applicant left high school.

The proposed revisions include substantively revising several items. There are no proposed deletions. The Board further proposes revising text to comply with current law, to reflect changes in societal language preferences, and to reflect changes in the Board's *Rules Regarding Equal Opportunity*.

Board of Governors of the Federal Reserve System, December 24, 1996

William W. Wiles,

Secretary of the Board.

[FR Doc. 96–33163 Filed 12–27–96; 8:45am]

BILLING CODE 6210–01–F

[Docket No. R-0841]

Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board is increasing from 10 percent to 25 percent the amount of total revenue that a nonbank subsidiary of a bank holding company (a so-called section 20 subsidiary) may derive from underwriting and dealing in securities that a member bank may not underwrite or deal in. The revenue limit is designed to ensure that a section 20 subsidiary will not be engaged principally in underwriting and dealing in such securities in violation of section 20 of the Glass-Steagall Act. Based on its experience supervising these subsidiaries and developments in the securities markets since the revenue limitation was adopted in 1987, the Board has concluded that a company earning 25 percent or less of its revenue from underwriting and dealing would not be engaged principally in that activity for purposes of section 20.

EFFECTIVE DATE: March 6, 1997.

FOR FURTHER INFORMATION CONTACT: Gregory A. Baer, Managing Senior Counsel (202/452-3236), Thomas M. Corsi, Senior Attorney (202/452-3275), Legal Division; Michael J. Schoenfeld, Senior Securities Regulation Analyst (202/452-2781), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

I. Background

Section 20 of the Glass-Steagall Act provides that a member bank of the Federal Reserve System may not be affiliated with a company that is ''engaged principally'' in underwriting and dealing in securities. [1] In 1987, the Board first interpreted that phrase to allow bank affiliates to engage in underwriting and dealing in bank-ineligible securities—that is, those securities that a member bank would not be permitted to underwrite or deal in—when the Board approved applications by three bank holding companies to underwrite and deal in commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer-receivable-related securities (hereafter, ''tier-one securities''). [2] In

[1] 12 U.S.C. 377.

[2] *Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp.,* 73 Federal Reserve Bulletin 473 (1987) (hereafter, *1987 Order*), *aff'd, Securities Industry Ass'n* v. *Board of Governors,* 839 F.2d 47,

1989, the Board allowed five bank holding companies to underwrite and deal in all debt and equity securities (hereafter, ''tier-two securities''). [3]

Currently, forty-one subsidiaries of bank holding companies are authorized to engage in underwriting and dealing activities that are not authorized for a member bank. Fifteen of these so-called section 20 subsidiaries have authority to underwrite and deal in tier-one securities pursuant to the *1987 Order.* Pursuant to the *1989 Order,* twenty-three section 20 subsidiaries have authority to underwrite and deal in all tier-two securities, and three may underwrite and deal in all debt securities.

The Board has established a revenue test to determine whether a company is ''engaged principally'' in underwriting and dealing for purposes of section 20. The revenue test provides that a section 20 subsidiary may not derive more than 10 percent of its total revenue from underwriting and dealing in bank-ineligible securities. The Board arrived at this revenue test through a series of interpretive steps, in a series of orders.

The Board interpreted the meaning of ''engaged principally'' in its 1987 order allowing Bankers Trust New York Corporation to engage in private placement of commercial paper. [4] Having satisfied itself that the ''engaged principally'' language of section 20 must allow some level of underwriting and dealing, [5] the Board was required to choose between two alternative meanings of ''principal.'' The first meanings of ''principal,'' advocated by the applicant, included definitions such as ''chief,'' ''main,'' or ''largest,'' and translated into allowing underwriting and dealing to constitute up to 50 percent of the section 20 subsidiary's business or, alternatively, to constitute anything other than its largest business (collectively, the ''largest activity interpretation''). The second meaning included definitions such as ''primary,'' ''substantial,'' ''leading,'' ''important,'' or ''outstanding'' and translated into a stricter limitation on underwriting and dealing—that is, allowing underwriting and dealing subject to a limit somewhat lower than 49 percent of the applicants' business. [6] Based on the purposes and legislative history of Glass-Steagall Act, the Board chose the latter interpretation. [7]

The Board further found in the *Bankers Trust* order that the best measure of the underwriting and dealing activity for purposes of section 20 was the gross revenue derived from that activity. [8] The *Bankers Trust* order found that a company deriving less than five percent of revenue would be in compliance with section 20, but did not attempt to identify the maximum percentage of revenue permitted by the statute.

Finally, in its *1987 Order,* the Board translated its interpretation of ''engaged principally'' into a quantitative limit on the amount of gross revenue that could permissibly be derived from underwriting and dealing. The Board found that underwriting and dealing in bank-ineligible securities would not be a ''substantial'' activity for a section 20 subsidiary if the gross revenue derived from that activity did not exceed 5 to 10 percent of the total gross revenue of the subsidiary. [9] As a prudential matter, the Board initially limited ineligible revenue to 5 percent of total revenue in order to gain experience in supervising such subsidiaries. In 1989, the Board allowed section 20 subsidiaries to increase their underwriting and dealing revenue to 10 percent of total revenue. [10]

No changes were made to the revenue test in subsequent orders until, in January 1993, the Board allowed section 20 subsidiaries to use an alternative revenue test that was indexed to account for changes in interest rates since 1989. [11] The Board found that historically unusual changes in the level and structure of interest rates had distorted the revenue test as a measure of the relative importance of ineligible securities activity in a manner that was not anticipated when the 10 percent limit was adopted in 1989. In particular, the Board found that because bank-eligible securities (such as U.S. government securities) tended to be shorter term than ineligible securities, an increase in the steepness of the yield curve had caused the revenue earned by at least some section 20 subsidiaries from holding eligible securities to decline in relation to ineligible revenue, even as the relative proportion of eligible and ineligible securities activities being conducted by these subsidiaries remained unchanged. [12] Five section 20 subsidiaries are currently operating under this indexed test; use of the test has not been more widespread because the systems necessary to administer it are expensive and complicated.

II. Proposed Change to Revenue Limit

On July 31, 1996, the Board proposed to maintain the revenue measure but increase the revenue limit from 10 percent of total revenue to 25 percent. [13] The Board based this proposed increase on the experience it has gained through supervision of the section 20 subsidiaries over a nine-year period. The Board stated its belief that the limitation of 10 percent of total revenue it adopted in 1987, without benefit of this experience, had unduly restricted the underwriting and dealing activity of section 20 subsidiaries. The Board noted that changes in the product mix that section 20 subsidiaries are permitted to offer and developments in the securities markets had affected the relationship between revenue and activity since 1987.

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66 (2d Cir.), *cert. denied,* 486 U.S. 1059 (1988) (hereafter, *Citicorp); Chemical New York Corp., Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, Manufacturers Hanover Corp., and Security Pacific Corp.,* 73 Federal Reserve Bulletin 731 (1987) (approving underwriting and dealing in consumer-receivable-related securities, after having deferred decision for 60 days in its *1987 Order*).

[3] *J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp.,* 75 Federal Reserve Bulletin 192 (1989) (hereafter *1989 Order), aff'd, Securities Industries Ass'n* v. *Board of Governors,* 900 F.2d 360 (D.C. Cir. 1990) (hereafter, *SIA II*).

[4] *Bankers Trust New York Corporation,* 73 Federal Reserve Bulletin 138 (1987) (hereafter, *Bankers Trust*).

[5] *Bankers Trust* order at 141; *1987 Order* at 474.

[6] *Bankers Trust* order at 140–42; *see also 1987 Order* at 477–78, 482–83.

[7] *Bankers Trust* order at 142.

[8] *Bankers Trust* order at 145; *1987 Order* at 483–485. In terms of what revenue to consider, the Board ruled that securities that a member bank was authorized to underwrite under section 16 of the Glass-Steagall Act (for example, U.S. government securities) were not covered by the prohibition of section 20; accordingly, the Board decided that revenue derived from underwriting and dealing in such securities should not count as underwriting and dealing for purposes of section 20. Rather, only revenue earned on ''ineligible securities''—those that a member bank could not underwrite or deal in—was counted toward the section 20 limit. *1987 Order* at 478; *Citicorp,* 839 F.2d at 62.

The Board also established a test based on the company's share of the market in a particular security, but this market share test was subsequently struck down by the Second Circuit. The court of appeals held that ''by using the term 'engaged principally,' Congress indicated that its principal anxiety was over the perceived risk to bank solvency resulting from their over-involvement in securities activity. A market share limitation simply does not further reduce this congressional worry.'' *Citicorp,* 839 F.2d at 68.

[9] *1987 Order* at 485.

[10] 75 FR 751 (1989).

[11] *Order Approving Modifications to the Section 20 Orders,* 79 Federal Reserve Bulletin 226 (1993) (hereafter, *1993 Modification Order*).

[12] *1993 Modification Order* at 228. Under the indexed revenue test, current interest and dividend revenue from eligible and ineligible activities for each quarter are increased or decreased by an adjustment factor provided by the Board. The adjustment factors, which are calculated for securities of varying durations, represent the ratio of interest rates on Treasury securities in the most recent quarter to those in September 1989. Section 20 subsidiaries may use the adjustment factors to ''index'' actual interest and dividend revenue based upon the average duration of their eligible and ineligible securities portfolios.

[13] 61 FR 40643 (August 5, 1996).

III. General Summary of Comments

The Board received 42 public comments: 26 from banks, bank holding companies and their trade groups; three from securities firms and one of their trade groups; and the remainder from members of Congress, a community group, a think tank, the Conference of State Bank Supervisors, and individuals. Thirty-four commenters favored the proposal, and eight opposed. The banking industry comments generally supported the proposal, and the securities industry comments generally opposed. The remaining comments were mixed.

Several banking industry commenters asked the Board to raise the revenue limit higher than 25 percent, generally to 49 percent. Several banking industry commenters also asked the Board to supplement the revenue test with an asset-based test or a sales volume test.

The securities industry commenters argued that comprehensive reform of the financial services industry is necessary and can be accomplished only through legislative action. The Securities Industry Association (SIA) expressed concern that if the Board were to increase the revenue limit to 25 percent, banks and bank affiliates would have little or no incentive to support a financial services modernization bill, because they would have received by rule much of the relief they would have sought in legislation.[14] Securities industry commenters also argued that securities, insurance, and other financial services firms would be placed at a competitive disadvantage with banks.

Several commenters opposed the increase in the limits on the grounds that the Board had previously rejected in its *1987 Order* any percentage limit greater than 10 percent. Commenters also stated that a level of ineligible securities activity giving rise to 25 percent of revenue must be considered ''substantial'' and therefore to constitute being principally engaged in that activity.

The SIA argued that a 25 percent limit as a measure of ''substantial'' was inconsistent with other laws that establish presumptions on a percentage basis, including the Bank Holding Company Act and regulations of the Board and the other banking agencies. The SIA also argued that raising the revenue limit to 25 percent could well render section 20 meaningless by permitting affiliations between member banks and the largest investment banks in the country, and would thus be contrary to the intent of Congress in enacting the Glass-Steagall Act to divorce commercial and investment banking.

A community group argued that allowing bank holding companies to expand further into securities underwriting without increased scrutiny under the Community Reinvestment Act would result in further neglect by banks and bank holding companies of the credit needs of low- and moderate-income neighborhoods and households and small businesses. The commenter argued that banks affiliated with section 20 subsidiaries have closed branches and reduced services to the public, and therefore that the operation of section 20 subsidiaries has had adverse effects on the public. The commenter argued that one of the problems that Congress meant to address with the Glass-Steagall Act was the diversion of financial resources in the banking system to the securities markets—a diversion that allowed and encouraged speculation in the securities markets and removed such funds from use in the retail banking business. Finally, the commenter argued that allowing expanded securities underwriting and dealing could undermine confidence in U.S. banks during declines in the securities markets.

The Board received five comment letters from members of Congress. Four Representatives supported the Board's proposal, and one opposed it.

IV. Final Order

A. Introduction

Interpreting section 20 is a difficult task. The language of the statute is ''intrinsically ambiguous,''[15] and further inquiry into the legislative history is therefore necessary to interpret it. As the Board noted in its *1987 Order,* this inquiry ''requires application of a statute adopted over 50 years ago in very different circumstances to a financial services marketplace that technology and other competitive forces have altered in a manner and to an extent never envisioned by the enacting Congress.''[16] Furthermore, although the general purpose of the Glass-Steagall Act was to divorce commercial and investment banking, the express language of section 20 clearly allows some level of investment banking for bank affiliates.[17]

Although a few commenters criticized the Board for preempting the Congress by reviewing its section 20 orders, the Board has in fact delayed a review of its section 20 orders in the hope that Congressional action would make such a review unnecessary. The Board continues to believe that reform of the laws governing this nation's financial services is needed in order to ensure that our nation's financial system remains innovative and competitive and provides services to customers at the lowest possible cost. The Board does not believe that an increase in the revenue limit detracts from the need for comprehensive reform and does not intend for this step to substitute for such reform. Rather, the Board is exercising its statutory responsibility to administer section 20 in light of significant changes to the securities markets in the years since the Board first analyzed its terms.

Summary

After considering the comments received, the Board has decided to adopt the proposal and amend its section 20 orders to allow up to 25 percent of total revenue to be earned from underwriting and dealing in bank-ineligible securities. The Board has concluded that a 25 percent revenue limit is consistent with section 4(c)(8) of the Bank Holding Company Act and section 20 of the Glass-Steagall Act.

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[14] Seven members of the SIA wrote separately to dissent from its views. The commenters noted that the association had recently supported other, non-comprehensive legislative reform of financial services regulation.

[15] *Citicorp,* 839 F.2d at 63; *cf. Board of Governors v. Agnew,* 329 U.S. 441, 446 (1947) (the related term ''primarily engaged'' is susceptible to a range of ''accepted and common meanings'').

[16] *1987 Order* at 475.

[17] The premise for this divorce was that the affiliation of commercial banking had yielded abuses that had to be corrected. *See generally Investment Company Instit. v. Camp,* 401 U.S. 617, 629-34 (1970) (discussing legislative history). However, recent research indicates that this premise may have been inaccurate. *See* James S. Ang and Terry Richardson, *The Underwriting Experience of Commercial Bank Affiliates Prior to the Glass-Steagall Act: A Reexamination of Evidence for Passage of the Act,* 18 J. Banking and Finance 351, 385 (1994) (''We have found no evidence that bonds underwritten by the security affiliates of commercial banks as a group [from 1926-1934] were in *any* way inferior to the bonds underwritten by investment banks. . . . Bank affiliate issue default rates were lower, *ex ante* yields were lower, *ex post* prices were higher and yield/price relation no different than investment bank issues.''); Randall S. Kroszner and Raghuram G. Rajan, *Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933,* 84 Amer. Econ. Rev. 810, 829 (''Not only did bank affiliates underwrite higher-quality issues [from 1921-29], but also we find that the affiliate-underwritten issues performed better than comparable issues underwritten by independent investment banks.''); George J. Benston, *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered* 41 (1990) (''The evidence from the pre-Glass-Steagall period is totally inconsistent with the belief that banks' securities activities or investments caused them to fail or caused the financial system to collapse.'').

C. Glass-Steagall Act Analysis

Based on its nine years of experience supervising section 20 subsidiaries, the Board has concluded that a company whose ineligible revenue approaches 10 percent of total revenue is neither engaged principally, nor on the verge of being engaged principally, in underwriting and dealing for purposes of section 20. The Board has decided that a section 20 subsidiary will not be engaged principally in such activities so long as ineligible revenue does not exceed 25 percent of total revenue.

In reaching this decision, the Board has not revisited its decisions, beginning with its *Bankers Trust* order in 1987, that the ''engaged principally'' standard of section 20 must be interpreted as ''substantial'' or ''primary,'' rather than as ''chief'' or ''main'' or ''largest.'' The Board did not propose such a reinterpretation. Similarly, the Board has not revisited its use of revenue as the appropriate measure of business activity.

The Board has reviewed, however, its decision in the *1987 Order* that underwriting and dealing in bank-ineligible securities would be a ''substantial activity'' of a section 20 subsidiary if such underwriting and dealing generated more than 10 percent of the section 20 subsidiary's total revenue. The Board has concluded that the 10 percent revenue limit unduly restricts the underwriting and dealing activity of section 20 subsidiaries to a level that falls short of ''principal engagement'' for purposes of section 20. This conclusion is based on the Board's experience with the section 20 subsidiaries through the process of examination and supervision. The conclusion is also supported by identifiable changes in the relationship between gross revenue and underwriting and dealing activity since the Board's *1987 Order.*

First, a given level of activity in underwriting and dealing in tier-two securities pursuant to the *1989 Order* generally yields substantially higher revenue than an equivalent level of activity in underwriting and dealing in tier-one securities pursuant to the *1987 Order.* Underwriting fees for tier-two securities are significantly larger than fees for tier-one securities, particularly with respect to equity securities and non-investment-grade debt securities. [18] Similarly, bid/offer spreads on many corporate bonds and other tier-two securities are significantly wider than the spreads on tier-one securities. Put another way, the Board has concluded that (all else being equal) a company that maintained a constant level of underwriting and dealing activity over the past nine years but shifted its product mix to include tier-two securities would have seen a significant increase in ineligible revenue.

Commenters confirmed this experience. One large bank holding company noted that since receiving approval in late 1994 to engage in corporate debt and equity activities, it had earned ''an ever increasing level of revenue derived from ineligible securities underwriting and dealing activities without a corresponding percentage increase in the number or size of the transactions involving ineligible securities. The factor primarily responsible for this revenue increase is . . . the revenues generated by corporate—particularly high yield—debt activities. The same level of corporate debt activity as a percentage of total transactions yields greater ineligible revenues than a comparable number of transactions involving commercial paper or municipal revenue bonds.''

Second, a converse trend has developed with respect to eligible revenue, where market changes have reduced the eligible revenue derived from a given level of activity. Most notably, increased competition in brokerage services has diminished revenue as a function of activity. [19] Lower commissions have required companies to increase volume in order to maintain a given level of eligible revenue. This market change particularly affects any company with a large retail investor base—generally those operating under the 1987 Order—that wishes to engage in any significant level of ineligible securities activities, as it must generally rely on brokerage activities in order to generate eligible revenue. In contrast, the overwhelming majority of companies operating under the 1989 Order have an institutional investor base and generate eligible revenue through underwriting and dealing in bank-eligible securities.

Finally, relative securities returns have varied over the years, changing the mix of eligible and ineligible revenue. As noted above, interest rate changes have reduced eligible interest revenue relative to ineligible interest revenue. For the great majority of companies that have elected not to use the indexed revenue test, these interest rate changes have continued to skew their reported ratio of ineligible to total revenue, though to a far lesser extent since a recent clarification to the revenue limit, which stated that interest earned on most investment-grade debt securities is treated as eligible income. [20] In addition, short term interest rates have on balance declined over the period, and equity prices have trended higher. Therefore, companies with tier-two powers who are engaged in equity securities activity may well have seen an increase in their ratio of ineligible revenue to total revenue.

Commenters supported this conclusion. Seven bank holding company commenters and two bank trade associations specifically noted that these developments had affected their institutions or members. None of the commenters opposed to an increase in the revenue limit disputed the Board's analysis. [21]

The Board recognizes that one reason underwriting and dealing spreads are higher for some activities than for others is to compensate for risk. The risks of holding high-yield bonds in inventory, for example, are higher than the risks of holding commercial paper, which is short-term and generally issued by a highly rated company and backed by a bank line of credit. However, in the Board's experience, as confirmed by the commenters, these wider spreads have resulted in higher revenue even after accounting for losses attributable to pricing, credit or other risks. [22] In the Board's experience, the ability to earn these higher profits derives from financial innovation in structuring transactions, ability to foresee shifting public needs gained from an experienced sales force, research on the

[18] *See, e.g., Investment Dealer's Digest* 12 (Feb. 19, 1996); *Investment Dealer's Digest* 19 (February 15, 1988).

[19] *See, e.g., The Economist* 9 (April 15, 1995) (''Commissions on listed securities as a percentage of the value of trade in these instruments have fallen from 70-90 basis points in the early 1980s to below 40 basis points. Even for over-the-counter trading . . . returns have fallen from 80-90 basis points to around 20 basis points.'')

[20] 61 FR 48953 (1996).

[21] One commenter stated that the Board was precluded from changing its view that ineligible revenue in excess of 10 percent would violate section 20 because once the Board had made a reasonable interpretation of a statute, and that interpretation was affirmed by a court, the Board may not thereafter adopt a position inconsistent with that interpretation. This statement is incorrect as a matter of law. *See, e.g., Smiley v. Citibank (South Dakota), N.A.,* 116 S.Ct. 1730, 1734 (1996) (agency may reverse an earlier position and receive judicial deference so long as the change is not ''sudden and unexplained''). As demonstrated above, the Board's amendment to the revenue limit is based on nine years of experience supervising section 20 subsidiaries and identifiable market and regulatory developments since the initial interpretation.

[22] The same point can be made with respect to the indexed revenue test, which took into account an increase in the steepness of the yield curve. Such a change in the shape of the yield curve may be caused by a rise in expected future interest rates, with no increase in interest rate risk.

issuer that is credited by the market, the ability to use marketing expertise to avoid losses, and accuracy in pricing.[23] Each of these skills yields greater rewards with respect to tier-two securities than tier-one securities, as tier-two securities generally trade in thinner markets where the frequency of trading is lower, the number of intermediaries smaller, and therefore the ability to gain a competitive advantage is greater.

Although the point was not raised by the commenters, the Board recognizes that these market and regulatory developments may have affected each section 20 subsidiary differently, depending on the products it offers and the duration of its interest rate-sensitive assets. However, the Board continues to believe that only a single revenue limit should govern.[24] Any standard that attempted to reflect the characteristics of each security approved for a section 20 subsidiary would be unworkable. Determination of compliance on a case-by-case basis would appear to be the only alternative to a quantitative test. The Board is concerned that such a practice could lead to substantial uncertainty among section 20 subsidiaries as well as the potential for inconsistent interpretations of the statute among section 20 subsidiaries and examiners. Therefore, the Board continues to prefer to use a single, bright-line standard.

Although not disputing the Board's analysis, one commenter stated that any amount of activity rising to 25 percent of total activity was by definition ''substantial'' and therefore inconsistent with the Glass-Steagall Act. The Board disagrees. The Board has used a ''substantial activity'' test as a way of determining whether a section 20 subsidiary is ''engaged principally'' in underwriting and dealing. This reading is consistent with the general interpretation of ''principal'' as meaning ''primary,'' ''substantial,'' ''leading,'' important,'' or ''outstanding''[25] and with the definition of substantial as ''an essential part, point or feature.''[26] The Board believes that an activity that represents less than 25 percent of a firm's total activity—or, put another way, where 75 percent of the firm's activity is in other areas—is not per se a ''principal,'' ''primary,'' ''substantial,'' ''leading,'' ''important,'' outstanding,'' or ''essential'' part of that firm's activity.

The Board notes that its decision is consistent with an interpretation of a parallel statute. As several commenters noted, the New York State Banking Department has taken the position that a company would not be ''engaged principally'' in underwriting and dealing for purposes of New York State's ''little Glass-Steagall Act''—which contains the same ''engaged principally'' standard as section 20—if underwriting and dealing was 25 percent or less of its total business activities.[27]

Several commenters urged the Board to adopt a greater increase in the revenue limit—to 50 percent or, in one case, 33 percent—on the grounds that such an increase would be consistent with safety and soundness and not pose risks to banks affiliated with a section 20 subsidiary. The Board notes, however, that although safety and soundness is clearly a relevant factor under the Bank Holding Company Act, the Board has limited authority to interpret section 20 based on whether underwriting and dealing activities can be conducted consistent with safety and soundness. Congress itself has decided when a company's risks of underwriting and dealing are too great to allow affiliation with a bank: whenever they constitute a principal activity of that company. Thus, even if the Board were to find that affiliation posed minimal risks, that finding would not allow the Board to raise the section 20 revenue limit to 100 percent. Nor would a finding that affiliation poses extreme risks allow the Board to lower the section 20 revenue limit to zero (though the Bank Holding Company Act, discussed below, could).

Commenters raised two objections to the proposed increase in the revenue limit based on the volume of underwriting and dealing that it would allow. One commenter stated that even under a 10 percent revenue limit, several section 20 subsidiaries were among the largest underwriters in the United States and that therefore an increase in the limit was unjustified. The Board notes that in its *1987 Order* first authorizing the establishment of a section 20 subsidiary, it required that underwriting and dealing in each security not exceed 5 percent of the total domestic underwriting and dealing in that security. As noted above, this market share test was struck down by the Second Circuit as unsupported by the language, legislative history, and purposes of the Glass-Steagall Act.

Other commenters argued that if the threshold for the revenue test were increased from 10 percent to 25 percent, then banks would be permitted to affiliate with the nation's largest investment banks, contrary to the express purpose of section 20 of the Glass-Steagall Act.[28] This argument is basically a restatement of the market share test. The relevant question for purposes of interpreting the Glass-Steagall Act is whether the Board's interpretation would have allowed banks to affiliate with the securities affiliates of the 1920s and 1930s[29] or companies engaged in activities similar to those affiliates, not whether it would allow banks to affiliate with the investment banks of today. Although data are sketchy, the Board believes that securities firms deriving more than 25 percent of their income from underwriting and dealing in securities were common in the pre-Glass-Steagall period, and thus that the revenue limit the Board is adopting today is consistent with the purposes of the Act.[30] The

[23] *See generally* Ernest Bloch, Inside Investment Banking (2d ed. 1989); 81-104. 248-73; Kenneth Garbade, Securities Markets 473-74, 493-97 (1982).

[24] In *Citicorp,* the petitioner argued that because the Board's interpretation of section 20 necessitated regulation, it a fortiori contravened the Act. The court of appeals rejected this argument, ''The Board's interpretation is one that attempts to walk the line that Congress laid down.'' 839 F.2d at 66.

[25] *Bankers Trust* order at 141-42.

[26] *The Shorter Oxford English Dictionary,* 2172 (3d ed. 1973), *cited in Citicorp,* 839 F.2d at 64.

[27] See Letter from Jill Considine, Superintendent of Banks, New York State Banking Department, to Morgan Guaranty Trust Company and Bankers Trust Company (Dec. 23, 1986). Although one commenter argued that a 25 percent limit is inconsistent with percentage limits established in other banking statutes and regulations, those statutes do not rest on an interpretation of the phrase ''engaged principally.'' Moreover, the most prominent example cited by the commenter, the presumption of control in the Bank Holding Company Act, is consistent with a 25 percent revenue limit, as it establishes a presumption of control over a bank holding company based on ownership of 25 percent or more of the company's securities. *See* 12 U.S.C. 1841(a)(2). The difference between a test of ''25 percent or less'' (under section 20) and a test of ''less than 25 percent'' (under the Bank Holding Company Act) is infinitesimal.

[28] Similarly, although one commenter argued that a 25 percent revenue limit could allow underwriting and dealing to be the first or second largest activity in the section 20 subsidiary, the Board believes that the relationship to total revenue, not the relationship to other activities, is controlling.

[29] By the time of the enactment of Glass-Steagall, the major securities affiliates of banks had been dissolved. W. Nelson Peach, *The Security Affiliates of National Banks* 158 (1941). Thus, the Glass-Steagall Act was aimed at preventing a recurrence of earlier abuses—most particularly, those leading up to the stock market crash of 1929—rather than at conditions prevailing at the time of its passage.

[30] *See, e.g., Agnew,* 329 U.S. at 445 (finding that in 1943 one of the nation's leading underwriters, Eastman, Dillon & Co., earned between 26 percent and 40 percent of its revenue by underwriting securities). A description of the nation's two largest securities affiliates by an observer of the time appears to indicate that they derived revenue substantially in excess of 25 percent of its revenue from underwriting and dealing. ''The volume of securities originated and distributed by [the National City Company, a securities affiliate of National City Bank,] was so large that it was necessary to have a separate vice-president in charge of securities issued by industrial

Board notes that while the largest section 20 subsidiaries currently derive substantial eligible revenue from the U.S. Treasury market, the federal government was running a budgetary surplus in the pre-Glass-Steagall period, and the outstanding federal debt and therefore the market for government securities were small.[31] Thus, most securities affiliates of that period could not have derived substantial eligible revenue from underwriting and dealing in government securities.

Second, although not relevant to the statutory interpretation, the Board is not convinced that a 25 percent revenue limit would allow unlimited affiliation between banks and investment banks for purposes of section 20. Adverse commenters provided no data to support their assertion that it would. The Board has reviewed the publicly available financial information for a sample of the largest investment banks, and it is not apparent that they would be in compliance with a 25 percent revenue limit. [32]

D. Bank Holding Company Act Analysis.

In its *1987 Order* and *1989 Order,* the Board concluded that the applicants' proposed underwriting and dealing activities were closely related to banking and could be expected to result in significant benefits to the public in the form of increased competition, greater convenience to customers, increased efficiency and maintenance of domestic and international competitiveness.[33] The Board's experience in supervising section 20 subsidiaries has borne out this conclusion, and the Board has now concluded that a further increase in the revenue limit to 25 percent would extend these benefits.[34] Numerous commenters stressed that an increase in the revenue limit would allow section 20 subsidiaries to operate more efficiently and compete more effectively domestically and globally. Such competition should benefit both institutional and individual customers by increasing customer choice and lowering prices. Furthermore, commenters indicated that a higher limit would facilitate the creation of new section 20 subsidiaries, thereby increasing competition.

The Board has also concluded, as it had in its original orders, that an increase in the revenue limit will not cause any adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices that would outweigh the projected public benefits.[35] Accordingly, these benefits will not come at an increased risk to the safety and soundness or reputation of the nation's banks or to the federal safety net. Bank holding companies have demonstrated over the past nine years that they are able to manage the risks of investment banking, and section 20 subsidiaries operate as separately capitalized subsidiaries of a bank holding company, outside the control of any affiliated bank and therefore outside the protections of the federal safety net.[36] Section 20 subsidiaries must register as broker-dealers and remain subject to the capital regulations of the Securities Exchange Commission.

Protection against unfair competition and undue concentration of resources is provided by the antitrust laws and special anti-tying restrictions applicable only to banks,[37] which prohibit a bank from using its products to require or induce customers to use the products of its securities affiliate. A section 20 subsidiary is also subject to the consumer protection and anti-fraud provisions of the Securities Exchange Acts of 1933 and 1934.[38] In the Board's experience, competition in the securities markets remains vibrant.

The Community Reinvestment Act does not provide for consideration of a bank's community lending performance in deciding whether a nonbanking activity is permissible under section 4 of the Bank Holding Company Act or in deciding what level of underwriting and dealing activity is permitted by section 20 of the Glass-Steagall Act. In any event, the Board believes that expanded securities activities by bank holding companies will not adversely affect low- and moderate-income neighborhoods and households or small businesses. At least one study has shown that section 20 subsidiaries bring a larger proportion of smaller-sized issues and lower-credit-rated new issues of non-financial firms to market than do independent investment banks.[39] Although banks affiliated with section 20 subsidiaries have closed branches since 1987, particularly over the past few years, these closings are intrinsic to the consolidation that is occurring in the banking industry. Commenters provided no evidence that a bank with a securities affiliate is more likely to close branches than a like-sized bank without one.[40] More importantly, the number of branch offices nationwide has increased each year between 1987 and 1995, and the population per branch has declined each year.[41] Finally, regardless of the activities of its nonbanking affiliates, a bank's record for lending continues to be subject to review and rating under the Community Reinvestment Act.

V. Indexed Revenue Test

In conjunction with today's order, the Board is eliminating its alternative indexed revenue test, which as noted

corporations, a vice-president in charge of municipal securities, a vice-president in charge of railroad securities, a vice-president in charge of foreign work, a vice-president in charge of accounting and treasury work, and a vice president in charge of the selling organization.'' *See* Peach at 94. Similarly, from 1917 to 1927, the securities affiliate of Chase National Bank of New York, Chase Securities Corporation, ''was identified only with major issues of bonds, offering such bonds at wholesale without public notice.'' *Id.* at 96.

[31] *See* Robert J. Gordon, *The American Business Cycle: Continuity and Change* 382 (1986); Benjamin M. Friedman, *The Changing Roles of Debt and Equity in Financing U.S. Capital Formation* 96, Table 6.2 (1982).

[32] Determining the ineligible revenue of independent investment banks is difficult because they do not segregate ineligible revenue from eligible revenue in their annual reports or the FOCUS reports that they file with the Securities Exchange Commission. For example, an investment bank may report a given figure for interest and dividends earned on securities without a separate breakdown of what percentage of that amount was earned from government securities, and many of the largest firms are primary dealers in government securities.

[33] *See 1987 Order* at 489-90; *1989 Order* at 200–02.

[34] The Board reached the same conclusion when it reviewed its section 20 orders in 1994. *See* 59 FR 35516–35517 (1994).

[35] *Accord 1987 Order* at 490–502; *1989 Order* at 202–10. Two commenters disagreed with this analysis, pointing to recent claims made against Bankers Trust Corporation regarding derivatives trading, an NASD action against Citicorp for failing to ensure that brokers complied with continuing education requirements, and the Board's 1996 enforcement action against Swiss Bank Corporation for violating the revenue limit. The Board has concluded that these isolated incidents are not sufficient to question the safety and soundness of underwriting and dealing generally. Moreover, the Citicorp and Swiss Bank actions were compliance issues that did not result in losses to either the section 20 subsidiary or an affiliated bank, or in any other safety and soundness problems. While Bankers Trust did suffer from abuses in its derivatives activities, these were bank-eligible activities that were conducted at the bank as well as the section 20 subsidiary. The section 20 revenue limit does not constrain this activity.

[36] The federal safety net includes deposit insurance, access to the Federal Reserve's discount window, and access to the payments system.

[37] 12 U.S.C. 1972(1).

[38] 15 U.S.C. 77a-77z; 15 U.S.C. 78a-78ll.

[39] Amar Gande, Manju Puri, et al., *Bank Underwriting of Debt Securities: Modern Evidence,* in *Bank Structure and Competition* 651 (1996) (working paper).

[40] *Cf. A Review and Evaluation of Federal Margin Regulations: A Study by the Staff of the Board of Governors of the Federal Reserve System* (December 1984) (concluding that concerns that securities credit diverts funds from more productive uses are unfounded).

[41] *See* Stephen A. Rhoades, *Bank Mergers and Industrywide Structure, 1980–94: Staff Study of Board of Governors of the Federal Reserve System* 25 (1996); Myron L. Kwast, *United States Banking Consolidation: Current Trends and Issues* Table 3 (1996) (paper presented to OECD).

above is indexed to account for changes in interest rates since 1989. The Board has concluded that distortion of the revenue limit from interest rate fluctuations has been addressed by today's increase in the revenue limit and by the recent clarification of the revenue limit, which stated that interest earned on most investment-grade debt securities is treated as eligible income.

VI. Section 32 of the Glass-Steagall Act

Also in conjunction with today's order, the Board intends to interpret section 32 of the Glass-Steagall Act generally to prohibit interlocks between a bank and any company that derives more than 25 percent of its total revenue from underwriting and dealing in bank-ineligible securities. Section 32 prohibits personnel interlocks between a member bank and any company ''primarily engaged'' in underwriting and dealing in securities.[42] Since 1987, the Board has interpreted ''engaged principally'' under section 20 and ''primarily engaged'' under section 32 consistently.[43] The Board and the courts have noted that section 20 should be interpreted at least as strictly as section 32 because ''the dangers resulting from affiliation are arguably greater than those resulting only from personnel interlocks.''[44]

The Board has not, however, measured compliance with section 32 and section 20 in the same manner, relying on a more qualitative analysis for purposes of section 32. This difference is largely attributable to the fact, as noted above, that the Board does not gather detailed revenue information from securities companies other than section 20 subsidiaries. Furthermore, while the Board must continuously monitor compliance with section 20, and is thus in need of a bright-line test, inquiries under section 32 are infrequent.

Thus, in 1958, the Board established a nine-part guideline for determining compliance with section 32 that included ''the dollar volume of business of the kinds described in section 32 engaged in by the firm or organization'' and ''the percentage ratio of such dollar volume to the dollar volume of the firm's total business.'' However, the Board did not establish a revenue or dollar volume limit. A subsequent staff letter noted that ''the Board generally has determined that a securities firm, which [sic] receives 10 percent of its gross income from section 32 business, is 'primarily engaged' within the meaning of [section 32],'' and the Board in its *1987 Order* noted that the Board had developed a ''general guideline'' to that effect. The Board has never, however, imposed a specific limitation in order to enforce compliance with section 32, and has found firms deriving more than 10 percent of their revenue from underwriting and dealing not to be primarily engaged. Nor has the Board ever reviewed the appropriateness of its 10 percent guideline since its apparent adoption in the 1950s, despite significant developments in the securities markets since that time.

In light of those developments and the Board's action on the section 20 revenue limit, the Board will generally find a securities firm to be primarily engaged in underwriting and dealing for purposes of section 32 when more than 25 percent of its total revenue derives from underwriting and dealing in bank-ineligible securities.

By order of the Board of Governors of the Federal Reserve System, December 20, 1996.

William W. Wiles,

Secretary of the Board.

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[42] 12 U.S.C. 78.

[43] *Bankers Trust* order at 142. The Board relied on the Supreme Court's interpretation of section 32 in *Agnew* in determining that ''engaged principally'' denotes substantial activity as opposed to the largest activity. However, the *Agnew* Court did not translate its interpretation of ''primarily engaged'' into a limitation on revenue or any other test of business activity.

[44] *Citicorp* at 67.

Formations of, Acquisitions by, and Mergers of Bank Holding Companies

The companies listed in this notice have applied to the Board for approval, pursuant to the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*) (BHC Act), Regulation Y (12 CFR Part 225), and all other applicable statutes and regulations to become a bank holding company and/or to acquire the assets or the ownership of, control of, or the power to vote shares of a bank or bank holding company and all of the banks and nonbanking companies owned by the bank holding company, including the companies listed below.

The applications listed below, as well as other related filings required by the Board, are available for immediate inspection at the Federal Reserve Bank indicated. Once the application has been accepted for processing, it will also be available for inspection at the offices of the Board of Governors. Interested persons may express their views in writing on the standards enumerated in the BHC Act (12 U.S.C. 1842(c)). If the proposal also involves the acquisition of a nonbanking company, the review also includes whether the acquisition of the nonbanking company complies with the standards in section 4 of the BHC Act, including whether the acquisition of the nonbanking company can ''reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices'' (12 U.S.C. 1843). Any request for a hearing must be accompanied by a statement of the reasons a written presentation would not suffice in lieu of a hearing, identifying specifically any questions of fact that are in dispute, summarizing the evidence that would be presented at a hearing, and indicating how the party commenting would be aggrieved by approval of the proposal. Unless otherwise noted, nonbanking activities will be conducted throughout the United States.

Unless otherwise noted, comments regarding each of these applications must be received at the Reserve Bank indicated or the offices of the Board of Governors not later than January 22, 1997.

A. Federal Reserve Bank of Cleveland (R. Chris Moore, Senior Vice President) 1455 East Sixth Street, Cleveland, Ohio 44101:

1. FJSB Bancshares, Inc., Fort Jennings, Ohio; to become a bank holding company by acquiring 100 percent of the voting shares of The Fort Jennings State Bank, Fort Jennings, Ohio.

B. Federal Reserve Bank of St. Louis (Randall C. Sumner, Vice President) 411 Locust Street, St. Louis, Missouri 63166:

1. Waterfield Bank Corp., Indianapolis, Indiana; to become a bank holding company by acquiring 100 percent of the voting shares of First National Bank of Mitchell, Mitchell, Indiana.

Board of Governors of the Federal Reserve System, December 23, 1996.

Jennifer J. Johnson,

Deputy Secretary of the Board.

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Formations of, Acquisitions by, and Mergers of Bank Holding Companies

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