Approved: _____
Date March 16, 2000

MINUTES OF THE SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE.

The meeting was called to order by Chairperson Senator Don Steffes at 9:00 a.m. on March 14 , 2000 in Room 234-N of the Capitol.

All members were present except:

Committee staff present: Dr. William Wolff, Legislative Research
Ken Wilke, Office of Revisor of Statutes
Nikki Feuerborn, Committee Secretary

Conferees appearing before the committee: Judy Stork, Deputy Bank Commissioner
Steve Handke, Community Bankers Association
Chuck Stones, Kansas Bankers Association

Others attending: (See Attached)

Hearing on SB 2676–Board of directors, banks and trust companies

Judy Stork, Deputy Bank Commissioner, explained the current legislation which requires state-chartered bank and trust companies to hold their annual meetings during the first 120 days of each calendar year (Attachment 1). This is problematic when state-chartered banks and sister banks with national charters attempt to schedule such meetings according to statute. The Bank Commissioner issued Special Order 1996-2 in 1996 which allowed more operational flexibility. They are now requesting the Special Order be made part of the statutes to provide efficiencies and savings for those banking groups with a mix of state and national banks. This would be helpful as banks and trust companies would not have to look beyond the statutes for such information.

Lynn Nelson, State Bank Commissioner, presented Committee members with a Summary of the Gramm-Leach-Bliley Act–Financial Modernization (Attachment 2) The Act does three fundamental things:

- Permits commercial banks to affiliate with investment banks
- Permits companies that own commercial banks to engage in any type of financial activity
- Allows subsidiaries of banks to engage in a broad range of financial activities that are not permitted for banks themselves

Personnel from the Office of the State Bank Commissioner have personally informed each Committee member of the main topics of the Act and how it can possibly impact the Kansas financial and insurance communities. The privacy issue of how much information i.e. health, is exchanged in companies in which insurance and financial business occurs was discussed. The confidentiality laws refer to forbidding of such an information exchange between companies, not within companies. Commissioner Nelson provided a brief explanation of the new financial subsidiary powers including whether a state chartered bank can already engage in the activity, either directly or through a subsidiary structure (Attachment 3). He then presented an amendment which would create in the Kansas banking code a new section regarding the activities of a financial subsidiary thereby allowing the same privileges as those of nationally chartered banks (Attachment 4).

Chuck Stones pointed out that a national bank can buy an insurance company immediately without seeking permission. A Kansas chartered bank cannot legally do this. This definitely puts a state chartered bank at a disadvantage without the adoption of the proposed amendment. Such an amendment would also make the state-chartered bank entirely responsible for their own privacy issues.

Commissioner Nelson and Deputy Commissioner Stork pointed out the availability of the "wildcard" statute which allows the Commissioner to issue Special Orders addressing all banks but requires that each bank

individually contact the Commissioner with a request for prior approval before taking action. This would allow the Bank Commissioner to act promptly should the request for such action arise.

The Committee discussed the wisdom of waiting to see how this Act will actually impact the financial community in the next few months and the advisability of requesting an interim study to explore the possibilities of the long-range effects of the Act. The Committee expressed their confidence in Commissioner Nelson's judgment in issuing Special Orders. It was pointed out the Legislature would be in Session in a few months to review the Order and pass subsequent legislation.

Senator Steffes closed the Hearing on **HB 2676.**

Hearing and Action on HB 2754–Banks and trust companies, holding of real estate

Steve Handke, Community Bankers Association, explained the difficulty of dealing with current legislation which requires banks to sell or orderly dispose of unneeded real estate within a stated time frame i.e. when does the beginning point of the seven-year holding period begin? (Attachment 5). This is especially a problem for expansion of banks in small towns due to property not coming up for sale very often, banks changing locations and being unable to sell property where they were once located e.g. drive-in banks. When the time period is up, the banks are forced to charge the asset off the bank's books which can cause a serious distortion of the bank's general ledger.

Judy Stork, Deputy Bank Commissioner, explained that the proposed legislation which allows flexibility in dealing with their "other real estate owned" category of assets would still be under the auspices of the Bank Commissioner. He could disallow the retention of such property if it was determined it was acquired for speculative purposes.

Chuck Stones, Kansas Bankers Association, also provided testimony in support of the proposed changes (Attachment 6).

Chairman Steffes declared the Hearing closed on **HB 2754.**

Senator Biggs moved the bill be reported favorably. Motion was seconded by Senator Praeger. Motion carried.

Senator Feleciano moved the minutes of March 8 and 9 be approved as corrected regarding the passage of Substitute SB 600. Motion was seconded by Senator Brownlee. Motion carried.

The meeting was adjourned at 10:00 a.m. The next meeting is scheduled for March 15.

SENATE FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE
GUEST LIST
DATE: 3-14-00

NAME	REPRESENTING
Chuck Stones	KBA
Jennifer Crow	Federico Consulting
George Barbee	CBA
Pat Morris	KAIA
Franklin W. Nelson	OSBC
Judi Stork	OSBC
Steve Handke	Union St Bank/CBA
Matt Goddard	HCBA
Laurie Ann Lower	KAHP

STATE OF KANSAS
BILL GRAVES
GOVERNOR

Franklin W. Nelson
Bank Commissioner

Judi M. Stork
Deputy Bank Commissioner

Sonya L. Allen
General Counsel

Kevin C. Glendening
Acting Deputy Commissioner
Consumer and Mortgage Lending

OFFICE OF THE
STATE BANK COMMISSIONER

SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE

March 14, 2000

Mr. Chairman and Members of the Committee:

My name is Judi Stork. I am the Deputy Commissioner for the Division of Banking. I am here today in support o House Bill 2676, which amends K.S.A. 9-1114. This statute currently states that a bank or trust company shal hold its annual meeting during the first 120 days of each calendar year. In April of 1996, it came to our attentior that this requirement was causing problems with scheduling of annual meetings by affiliated bank groups consisting of state-chartered banks and sister banks with national charters. These bank groups wanted to have the operational flexibility of holding annual meetings of all sister banks on the same day, but were restricted ir designating a date for the meeting due to the requirement in K.S.A. 9-1114. Therefore the Commissioner pursuant to the "wildcard authority" granted by K.S.A. 9-1715, issued a Special Order which allowed state chartered banks and trust companies to hold their annual meetings on any date specified in the bank's or trus company's bylaws. Issuance of the Order provided for operational efficiencies, resulting in cost savings to those banking groups with a mix of state and national banks, and restored the balance of equality in the laws governing state and national banks. The proposed language in HB 2676 mirrors that found in the National Bank Act at 12 U.S.C. §71 and §75.

We are requesting the statute be amended to reflect the authority previously granted to banks and trus companies by Special Order 1996-2. The amendment is intended to clean up the regulatory structure, so tha banks and trust companies will no longer need to look beyond the statute to the Special Order for guidance regarding holding their annual meetings. If this change is made in the statute, the Special Order will no longer be necessary, and will be revoked.

Senate Financial Institutions & Insurance
Date 3/14/00
Attachment
1

AMERICAN BANKERS ASSOCIATION

FINANCIAL MODERNIZATION: THE GRAMM-LEACH-BLILEY ACT

SUMMARY

Prepared by COVINGTON & BURLING

November 12, 1999

AMERICAN BANKERS ASSOCIATION®

World-Class Solutions, Leadership and Advocacy 1875-2000

Senate Financial Institutions & Insurance
Date 3/14/00
Attachment 2

EXECUTIVE SUMMARY

The Gramm-Leach-Bliley Act (the "Act") was signed by the President and enacted into law on November 12, 1999.[1] This landmark financial services reform legislation is the culmination of legislative initiatives mounted by the ABA and others in eight of the last ten Congresses. It is also a ratification of the successful efforts by the ABA and its members to expand, through the regulatory process and the courts, the range of business opportunities for commercial banking organizations. ABA helped craft nearly every significant part of the Act that affects the banking industry, and strongly supports the new law.

The Act does three fundamental things:

- ***It repeals key provisions of the 66-year old Glass Steagall Act to permit commercial banks to affiliate with investment banks.***
- ***It substantially modifies the 43-year old Bank Holding Company Act of 1956 to permit companies that own commercial banks to engage in any type of financial activity.***
- ***It allows subsidiaries of banks to engage in a broad range of financial activities that are not permitted for banks themselves.***

The result is that banks of all sizes will be able to offer their customers a wide range of financial products and services without the costly restraints of outdated laws (*e.g.*, the "town of 5000" provision). In addition, banking companies and other types of financial companies—securities, insurance, and financial technology companies, for example—will be able to combine much more readily.

Although the provisions authorizing the combination of banking and financial activities are the core of the new law, the Act includes many other important provisions. For example, the Act eliminates the authority of commercial companies to acquire thrift institutions through the unitary thrift holding company vehicle. The Act also includes important new provisions regarding the privacy of customer information; increased access by community banks to the Federal Home Loan Bank System; and significant changes to the requirements imposed by the Community Reinvestment Act.

This summary of the Act is divided into the following eight sections:

I. **"*Financial Holding Companies*" and "*Financial Subsidiaries*."** This section describes the new types of regulated entities that are authorized to engage in the broad new range of financial activities. A "financial holding company," which can engage in ***all*** of the Act's newly-authorized activities, is simply a bank holding company whose depository institutions are well-capitalized, well-managed, and CRA-rated "satisfactory" or better. A "financial subsidiary," which can engage in ***most*** of the newly-authorized activities, is a direct subsidiary of a bank that satisfies the same conditions as the FHC—plus several others.

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[1] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999). *See also* H.R. Conf. Rep. No. 434, 106th Cong., 1st Sess. (1999).

II. ***Newly-Authorized Activities.*** This section describes the most important of the newly-permissible financial activities for financial holding companies, *i.e.*, ***securities, insurance, merchant banking/equity investment, "financial in nature,"*** **and** ***"complementary" activities***. The "merchant banking" provisions are especially significant because they will allow a financial holding company to make a controlling investment in ***any*** kind of company, financial or commercial. As a group, these new powers allow a banking organization to engage in virtually every type of activity currently recognized as financial, and provide substantial discretion to the Federal Reserve and Treasury Department to authorize new activities as "financial," or as "incidental" or "complementary" to a financial activity.

III. ***Unitary Thrift Holding Company Restrictions.*** This section describes the Act's termination of the ability of commercial companies to acquire thrifts through unitary thrift holding companies. Existing commercial unitary thrift holding companies are grandfathered (as of May 4, 1999), but such companies may not sell their thrifts to any other *commercial* company.

IV. ***Federal Home Loan Bank System Reforms.*** This section summarizes the Act's significant changes to laws governing the Federal Home Loan Bank System. It focuses on those provisions that dramatically increase the access of community banks and thrifts to the System, which will create a whole new source of low-cost liquidity for these institutions.

V. ***Privacy.*** This section summarizes the Act's four new requirements, which apply equally to ***all*** financial institutions, regarding the sharing of customer information with others. Each financial institution must: (1) establish and annually disclose a ***privacy policy***; (2) provide customers ***the right to opt-out*** of having their information shared with ***nonaffiliated third parties*** (subject to many significant exceptions); (3) ***not*** share customer account numbers with nonaffiliated third parties; and (4) abide by regulatory standards to protect the security and integrity of customer information.

VI. ***Community Reinvestment Act Provisions.*** This section explains the three controversial CRA provisions that nearly prevented the legislation from passing: (1) the provision establishing "satisfactory" CRA ratings as a condition for engaging in the Act's new activities; (2) the "sunshine" provision requiring disclosure of CRA agreements between financial institutions and third parties; and (3) the provision establishing a lengthened CRA exam cycle for community banks and thrifts.

VII. ***Other Regulatory Provisions.*** This section summarizes other key regulatory provisions in the Act affecting banks and financial institutions, including the Federal Reserve's "umbrella" supervisory authority over financial holding companies; provisions affecting foreign banks; limitations on the states' ability to establish regulations that discriminate against banking organizations; revisions to federal antitrust authority affecting financial holding companies; ATM disclosure provisions; and elimination of the "Special Reserve" of the Savings Association Insurance Fund.

VIII. ***Effective Dates.*** The last section sets forth the effective dates for key provisions of the Act. This includes the 120-day delayed effective date for the financial holding company and financial subsidiary sections of the Act. During this period, the Federal Reserve and other regulators will likely issue regulations that interpret key provisions of the Act (such as the "merchant banking" provision).

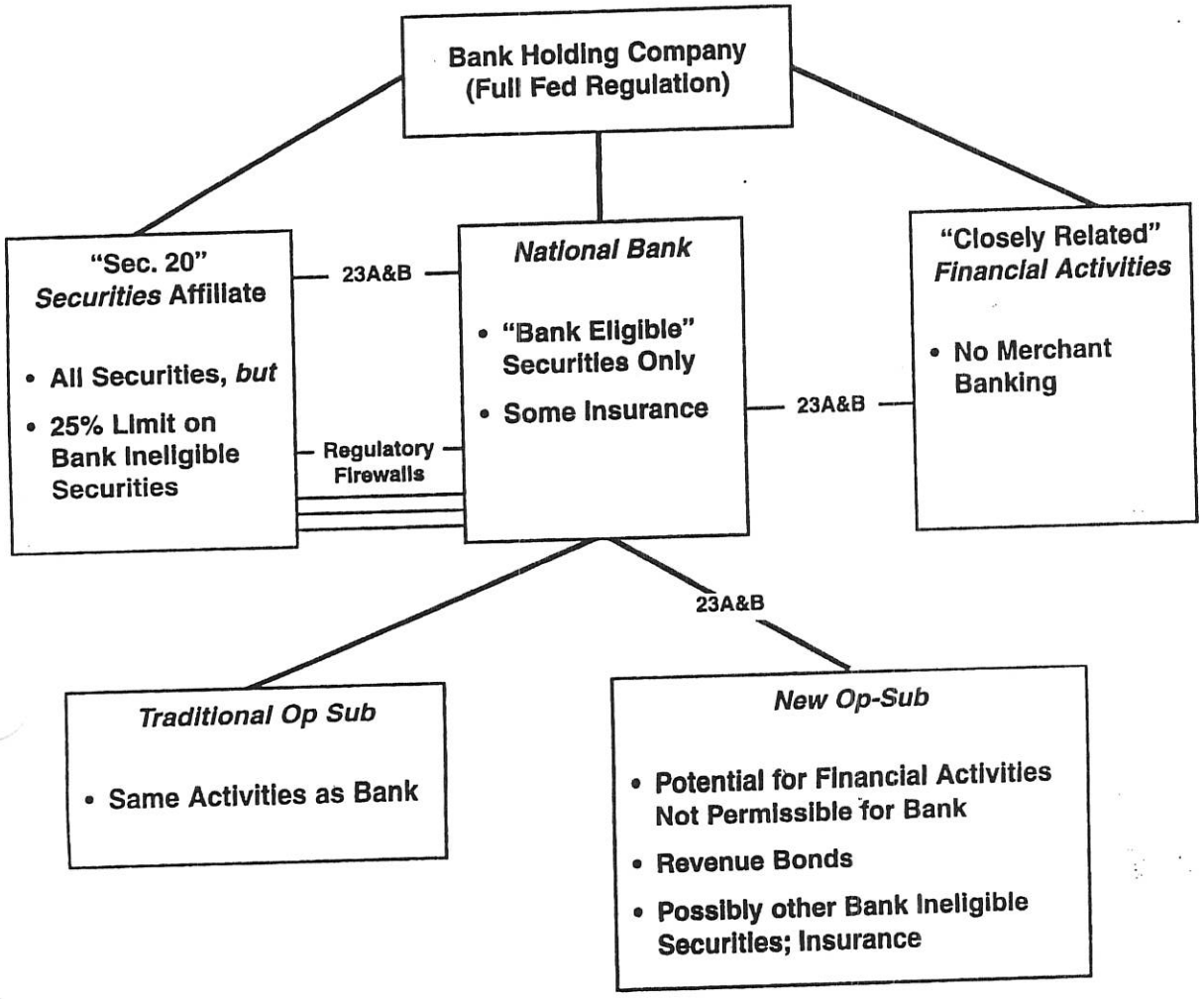
Appendices. Finally, the summary includes several important appendices that explain in more detail the Act's securities regulation provisions, insurance regulation provisions, and privacy provisions.

Where appropriate, charts have been included in this summary to help visualize and explain the Act's reforms. Chart 1 summarizes the permissible affiliations of banks under the law pre-dating the Act. Using that chart as a baseline, Chart 2 shows the new activities and affiliations permitted by the Act, with newly-permissible affiliations and activities shown in blue, and new restrictions shown in red.

CHART 1

LAW *BEFORE* GRAMM-LEACH-BLILEY ACT

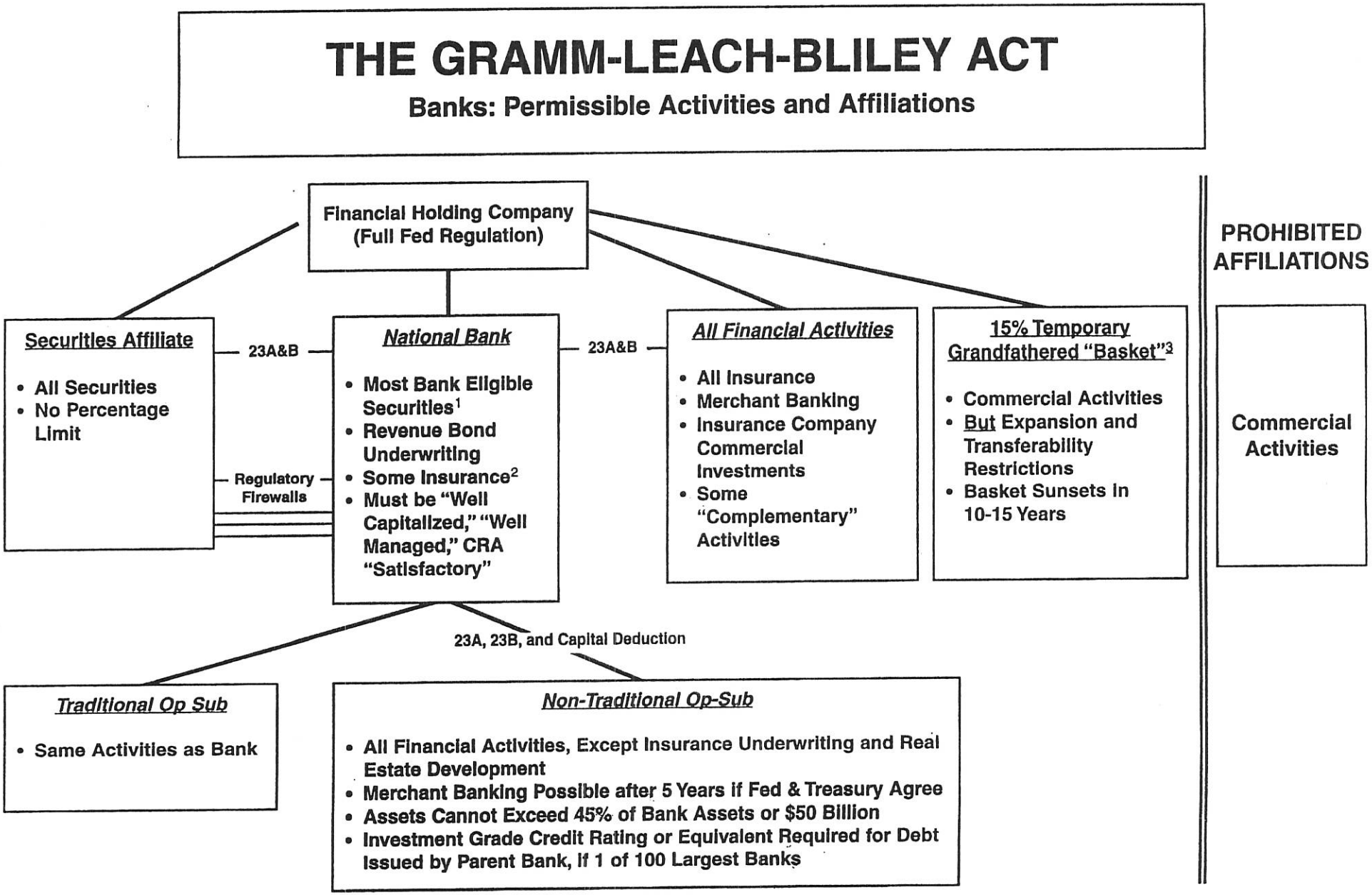
Banks: Permissible Activities and Affiliations



PROHIBITED AFFILIATIONS

Most Insurance Activities	Other Financial Activities	Commercial Activities

CHART 2



[1]Some bank eligible securities activities and some banking products would be "pushed out" (or exposed to push-out) from bank.
[2]Insurance underwriting is generally prohibited.
[3]Applies to newly-formed FHCs. Annual gross revenues from FHCs commercial activities may not exceed 15% of FHC's gross revenues (excluding depository institution revenue).

I. "FINANCIAL HOLDING COMPANIES" AND "FINANCIAL SUBSIDIARIES"

The Act provides two new vehicles that a banking organization can use to engage in new types of financial activities or affiliate with new types of financial companies. The first and most flexible vehicle is a "financial holding company," which allows new activities to be conducted through a holding company affiliate regulated by the Federal Reserve Board. The second is a "financial subsidiary" (a new type of bank "operating subsidiary"), which allows new activities to be conducted through a subsidiary of a bank regulated by that bank's regulator. Both new regulatory entities are described below.

A. Financial Holding Companies

The Act amends the Bank Holding Company Act to authorize a new kind of bank holding company called a "financial holding company" (or "FHC"). As noted, the FHC is the primary vehicle through which a banking organization may engage in *any* type of financial activity, including any type of insurance or securities activity, or become affiliated with *any* type of financial company. The FHC is also the primary vehicle through which a nonbanking financial company (*e.g.*, a securities or insurance company) may purchase a bank.

An FHC is simply a bank holding company that satisfies and continues to satisfy certain new regulatory requirements. A bank holding company that satisfies these new requirements may elect to become an FHC in order to engage in the broad new range of financial activities permitted under the Act. But it also may elect not to become an FHC if it wants merely to engage in the types of activities in which bank holding companies are permitted to engage under existing law.[2]

Thus, in most ways an FHC is subject to the same regulation as other bank holding companies, including reporting, examination, supervision, and consolidated capital requirements imposed by the Federal Reserve Board ("Federal Reserve"). Set forth below, however, are the ways in which an FHC will be regulated *differently* than other bank holding companies, including (1) the conditions it must satisfy to be an FHC; and (2) the reduced requirements regarding notice and prior approval that will apply when the company commences new activities or new affiliations.

1. Regulatory Conditions for FHCs

In order to be a financial holding company that can engage in the new financial activities authorized by the Act, a bank holding company's subsidiary depository institutions must all be:

- ***Well capitalized***
- ***Well managed***
- ***Rated "satisfactory" or better in their most recent Community Reinvestment Act examinations***

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[2] However, a bank holding company that chooses not to become an FHC may engage only in the nonbanking activities permitted under §4(c)(8) of the BHCA as of the date of enactment of the Act.

2-7

The bank holding company must also file a certification with the Federal Reserve that it meets the "well-capitalized" and "well-managed" requirements before it can engage in any of the newly-authorized activities.[3]

An FHC that does not continue to satisfy any of these three conditions will become subject to restrictions, which differ depending on the condition that is violated. If the Federal Reserve determines that any of the FHC's depository institutions is either not well capitalized or not well managed, then it must give notice of that determination to the FHC. Until the FHC restores its institutions to compliance, the Federal Reserve has broad discretion to limit (or not limit) the conduct or activities of the FHC as it deems appropriate. In addition, if compliance is not restored within 180 days, then the Federal Reserve may even require the FHC to divest its depository institutions.

If any of the FHC's depository institutions fails to satisfy the CRA rating requirement, then the restrictions are different. Until all such institutions are restored to at least "satisfactory" CRA ratings, the FHC may not engage in any *additional* activities of the kind that are newly permissible under the Act, including any new affiliation with any company engaged in such activities. However, existing activities and affiliations are unaffected, and there is no authority provided for divestiture as a remedy for this type of violation.

2. Only After-the-Fact Notice Required for New Activities

Unlike other bank holding companies, an FHC does not need to file an application for the prior approval of the Federal Reserve to engage in a nonbanking financial activity or to acquire a company engaged in a *nonbanking* financial activity.[4] Instead, it only needs to file an after-the-fact notice with the Federal Reserve within 30 days of engaging in the activity or making the acquisition. This elimination of the application-and-prior-approval process will significantly reduce the regulatory burden for bank holding companies.

B. Financial Subsidiaries

The Act provides banks with the alternative of using a subsidiary of the bank rather than an FHC as the vehicle for conducting new financial activities. The Act accomplishes this by amending the National Bank Act to authorize a national bank to own or invest in a new type of subsidiary called a "financial subsidiary." As discussed below, a state bank is permitted to establish such a subsidiary as well (if otherwise authorized to do so by that state's law). The most important difference between the FHC and the financial subsidiary is that the latter, as described below, is prohibited from engaging in certain financial activities as "principal." However, a financial subsidiary may engage in the *sale* of any financial product (*i.e.*, agency activities) without geographic limitation.

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[3] "Well capitalized" has the same meaning as in section 38 of the Federal Deposit Insurance Act, and "well managed" means an institution that has received at least a "satisfactory" composite examination rating, with a rating of at least "satisfactory" for management and for compliance (if such a rating has been given).

[4] The Federal Reserve's prior approval continues to be required for acquisitions of banks and bank holding companies.

1. Regulatory Conditions for "Financial Subsidiaries"

The same conditions apply for establishing a financial subsidiary as for establishing an FHC—plus several others. These conditions are different for national and state banks.

a. Conditions for National Banks

Like an FHC, in order for a national bank to own or invest in a financial subsidiary that engages in new financial activities, the bank and all of its affiliated depository institutions must be "well capitalized," "well managed," and rated "satisfactory" or better in their most recent Community Reinvestment Act examinations. But unlike an FHC, the following additional conditions apply:

- The consolidated assets of the national bank's financial subsidiaries must not exceed $50 billion or 45% of the bank's consolidated assets, whichever is less.
- If the bank is among the 100 largest in the United States, its long-term debt must receive one of the top three investment grade ratings.[5]
- The bank must receive *prior approval* from the OCC to engage in any of the newly-authorized activities.

In addition to these conditions, a national bank must satisfy certain safety and soundness "firewall" requirements to ensure that the financial subsidiary is truly separate from its parent bank:

- The bank's equity investment in a financial subsidiary must be deducted from the bank's capital in applying regulatory capital adequacy standards.
- The bank must have risk management procedures in place to protect it from risks relating to the financial subsidiary and to preserve the separate corporate identity and limited liability of the bank.
- The financial subsidiary generally must be treated as if it were a nonbank affiliate for purposes of the affiliate-transaction rules (Sections 23A and 23B) and the anti-tying rules (Section 106).

b. Conditions for State Banks

The Act makes clear that a state bank also will be eligible to own or invest in a financial subsidiary, if the bank can do so under state law. Many state banks have such authority already, and many will obtain such authority through their state "wild card" statutes because of the newly-authorized authority for national banks to own such subsidiaries. ("Wild card" statutes allow state banks to engage in activities authorized for national banks to ensure competitive equity between the two types of charters.)

The Act imposes federal conditions on such ownership by state banks that are similar, but not identical, to the conditions imposed on a national bank's ownership of a financial subsidiary. Specifically, a state bank is subject to the "well capitalized," CRA rating, and safety and soundness firewall requirements that apply to a national bank. But a state bank is *not* sub-

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[5] This requirement does not apply to a financial subsidiary that engages only in activities as agent, such as insurance agency activities. In the case of the banks ranked 51-100, a different but comparable criterion may apply, if agreed to jointly by Treasury and the Federal Reserve.

ject to the statutory "well managed" requirement or to the investment-grade debt rating requirement that apply to national banks.[6] In addition, a financial subsidiary of a state bank does not appear to be treated as if it were a holding company affiliate for purposes of the anti-tying rules.

c. Joint Ventures

A financial subsidiary can be jointly owned by two or more depository institutions and by other parties. A company can qualify as a financial subsidiary if it is controlled (*e.g.*, at least 25%-owned) by one or more insured depository institutions. A financial subsidiary thus can be a vehicle for a joint venture among depository institutions and with one or more non-depository-institution parties.

2. Permissible Activities of "Financial Subsidiaries"

In general, a financial subsidiary can engage in any of the Act's newly-authorized activities for FHCs, including *all* financial activities as agent (such as insurance sales) and some financial activities as principal (such as securities underwriting). However, a financial subsidiary may *not* engage in the following four activities:

(1) ***Insurance underwriting.***
(2) ***Real estate development or investment.***
(3) ***"Merchant banking."*** But the Treasury and the Federal Reserve can jointly decide, five years after enactment of the Act, to authorize financial subsidiaries to conduct merchant banking activities.
(4) ***"Complementary activities,"*** which, as described below, are nonfinancial activities approved by the Federal Reserve as complementary to a financial activity.

A financial subsidiary also can engage in any activity that is permissible for a national bank to conduct directly. However, a national bank still can conduct such bank-permissible activities through a subsidiary that is *not* a financial subsidiary (*i.e.*, a traditional "operating subsidiary"), which is not subject to the special requirements summarized above.

Finally, unlike previous versions of the legislation, there is no requirement that a national bank be part of an FHC in order to engage in new activities through a financial subsidiary. As a result, if a banking organization does not seek to engage in the four types of activities described above, it does not need to have a holding company and be regulated under the Bank Holding Company Act. It may instead operate as a bank with financial subsidiaries (provided all other conditions for owning a financial subsidiary are satisfied).

II. NEWLY-AUTHORIZED ACTIVITIES

A financial holding company may engage in any type of financial activity that was permissible for a bank holding company to engage in before the enactment of the Act. In addition,

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[6] Existing regulations of the Federal Deposit Insurance Corporation ("FDIC") do provide that a state bank must satisfy the same "well managed" requirement in order for its subsidiary to engage in any activity as principal that is not permissible for a subsidiary of a national bank. However, since a financial subsidiary of a national bank is now permitted to engage in new activities as principal (e.g., securities underwriting), it is unclear whether the FDIC regulation would require a state bank to satisfy the well-managed requirement in order for its subsidiary to engage in such principal activities.

an FHC may engage in virtually any other type of financial activity. And under limited circumstances, an FHC even may be authorized to engage in certain *non*financial activities. The Act sets forth in detail the types of new activities that are permissible for an FHC. The most important of these activities are as follows:

- **All Securities Underwriting and Dealing Activities**
- **All Insurance Underwriting and Sales Activities**
- **Merchant Banking/Equity Investment Activities**
- **Future "Financial in Nature" and Incidental Activities**
- **"Complementary" Nonfinancial Activities**

Set forth below is a description of each of these newly-authorized activities, including a summary of restrictions that may apply in connection with each.

A. All Securities Underwriting and Dealing Activities

The Act authorizes both an FHC and an operating subsidiary to engage in all securities activities, including all securities underwriting and dealing activities, without artificial limits. The particular newly-authorized activities are described below. This description is followed by a summary of the securities "functional regulation" provisions, which will subject some existing bank securities and investment company activities to regulation by the Securities and Exchange Commission (SEC).

1. Newly-Authorized Securities Activities

a. Bank Affiliations with Full Service Securities Underwriters

The Act repeals section 20 of the Glass Steagall Act and expressly authorizes an FHC to underwrite, deal in, or make a market in securities. These provisions remove the 25 percent "gross revenue limit" that currently restricts the underwriting and dealing activities of an affiliate of a bank. The result is that an FHC or a financial subsidiary may own a full service securities broker-dealer. [7]

b. Removal of Prohibition on Interlocks

The Act, by repealing section 32 of the Glass Steagall Act, eliminates the prohibition on director, officer, and employee interlocks between a bank and any affiliated or unaffiliated securities firm that is primarily engaged in securities underwriting activities that are not permissible for banks to engage in directly ("bank ineligible" securities activities). However, the Act also provides the Federal Reserve with broad authority to impose "prudential safeguards" on relationships or transactions between a bank and its affiliates, which could include interlock restrictions. (The OCC and the FDIC are provided similar authority with respect to transactions between a national or state bank and its subsidiaries.)

c. Bank Authority to Underwrite/Deal in Municipal Revenue Bonds

The Act authorizes a national bank to underwrite and deal directly in municipal revenue bonds, so long as the bank is well capitalized. This new authority applies to all national banks,

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[7] It is unclear whether the gross revenue limit would be removed for a "Section 20" affiliate of a bank holding company that elects *not* to become an FHC. Although section 20 of the Glass Steagall Act is repealed, it appears that the Federal Reserve would have to modify its section 20 orders to remove the existing 25 percent limit.

regardless of whether the bank is part of an FHC, and thus could prove especially useful to community banking organizations that choose not to become FHCs or own securities broker-dealers.

d. Authority to Underwrite/Distribute Investment Company Shares

Before enactment of the Act, the Federal Reserve had never permitted a Section 20 broker-dealer affiliate of a bank to serve as the underwriter or distributor of an investment company's shares. By permitting a broker-dealer affiliate of an FHC to underwrite and deal in securities generally, the Act also makes it permissible for such an affiliate to underwrite and distribute investment company shares.

2. New Restrictions on Bank Securities Activities

a. SEC Broker-Dealer Regulation of Bank Securities Activities

Existing law permits banks to engage directly in a limited range of securities brokerage and dealing activities—so-called "bank eligible" securities activities. Before enactment of the Act, the securities laws had expressly exempted a bank from all SEC broker-dealer regulation, even where the bank engaged in bank eligible securities activities. The SEC has long argued that all securities activities should be conducted only by securities broker-dealers that are "functionally regulated" by the SEC. The agency has supported legislation that would repeal the blanket securities law exemption applicable to banks and therefore "push out" of the bank to an SEC-regulated broker-dealer any securities activity or any banking activity that could be characterized as a "securities" activity.

The Act attempts to address the SEC's concern by repealing the broad exemption for all banking activities. At the same time, it replaces the blanket exemption with a series of specific exemptions that apply to specific bank activities that could involve securities brokerage or dealing. Taken as a whole, the Act's lengthy list of specific exemptions covers nearly all existing bank securities activities—other than direct retail brokerage—and very likely many future banking activities as well. As a result, few direct banking activities will actually be pushed out of the bank or even exposed to push-out as a result of the Act's changes.

Nevertheless, because bank activities will remain exempt from push-out only if they fall within the new statutory exemptions, it will be important for banks to understand the specific details and contours of these exemptions. Moreover, the Act requires each of the federal banking agencies to establish recordkeeping requirements for banks so that their compliance with the specific terms of the exemptions may be determined.

Attached to this summary as Appendix A is a list of the Act's exemptions from push-out, with a brief explanation of each exemption. Among the most significant are the exemptions for securities activities that a bank conducts in connection with trust and fiduciary functions, swap transactions, safekeeping and custody, and "networking" activities. In addition, a *de minimis* "basket" provision applies to exempt *any* brokerage transaction if the bank conducts no more than 500 such transactions each year, and the transactions are not conducted by a bank employee that is a "dual employee" of a broker or dealer.

Taken together, the *de minimis*, trust, and "networking" exemptions will protect from push-out virtually all securities activities currently engaged in by community banks.

b. SEC Regulation of Bank Investment Company Activities

Again as the result of SEC requests, the Act makes some changes to the regulation of bank investment company activities, which are listed in Appendix B at the end of this summary. It is not anticipated that any of these changes will significantly increase the regulatory burden on banking organizations engaged in investment company activities. Among the more significant changes are the requirement that a bank that provides investment advice to a registered investment company register as an investment adviser, enhanced SEC authority over bank custodians of investment companies, and codification of the SEC's "no action" letters regarding common trust funds. The Act also permits thrift institutions, for the first time, to offer common trust funds (and collective funds) subject to the same exemptions from the federal securities laws that apply to commercial banks that offer such investment vehicles.

B. All Insurance Underwriting and Sales Activities

The Act's insurance provisions were the result of a fierce political debate between the banking and insurance industries. As a result, it is not surprising that the provisions themselves are exceptionally lengthy and complex. Nevertheless, taken as a whole, these provisions distill to two fundamental points. First, a banking organization is now authorized to engage in ***all*** types of insurance activities, which means that a bank may affiliate with any type of insurance company or agency. Second, despite their complexity, the Act's extensive set of provisions relating to the regulation of the insurance activities of banking organizations (including national banks and financial subsidiaries) will allow these organizations to engage in these activities ***without*** undue regulatory restrictions.

Set forth below is a description of the newly-authorized insurance activities and the new scheme of federal and state regulation.

1. Newly-Authorized Insurance Activities

The Act generally grants both FHCs and their affiliates extensive new authority to engage in insurance sales and underwriting activities. (The one exception is the new, prospective limits that the Act imposes on the ability of national banks and their subsidiaries to provide "insurance" as principal.) The sales and underwriting provisions are discussed separately below.

a. Insurance Sales Activities

FHC affiliates. The Act expressly authorizes an affiliate of an FHC to sell insurance as agent or broker. Thus, the Act removes pre-existing restrictions on the sale of insurance by nonbank affiliates of bank holding companies, and gives such affiliates of FHCs full insurance sales authority *without product or geographic limitations*.

National banks. The Act does not directly alter the authority of a national bank to sell insurance pursuant to Section 92 of the National Bank Act, the so-called "town of 5000" provision, or to sell annuities pursuant to Section 24 (Seventh) of the National Bank Act.

Financial subsidiaries. The Act does, however, give a national bank new authority to engage in insurance sales through a financial subsidiary. As already noted, a financial subsidiary is permitted to engage in the same full range of insurance agency and brokerage activities that an FHC affiliate may undertake. Thus, a national bank financial subsidiary may also engage in the sale of insurance without product or geographic limitations (which, as a practical matter, eliminates the "town of 5000" constraints for any national bank that chooses to sell insurance through such a subsidiary).

Title insurance sales. The Act authorizes a financial subsidiary of a national bank to sell title insurance without geographic limit. But the Act generally prohibits a national bank itself from selling title insurance. However, this prohibition is subject to two important exceptions: (1) in a state where a state bank is allowed to sell title insurance, a national bank may likewise sell title insurance in the state to the same extent, in the same manner, and under the same restrictions as a state bank; and (2) where a national bank or its subsidiary (*i.e.*, a traditional operating subsidiary) was lawfully engaged in the title insurance sales activities prior to enactment of the Act, that national bank or subsidiary may continue the same title insurance sales activities.

b. Insurance Underwriting Activities

FHC affiliates. The Act expressly authorizes an FHC affiliate to engage in all insurance underwriting activities. The Act thus removes the barrier that the Bank Holding Company Act had long imposed on the affiliation of banks and full-line insurance underwriters, including underwriters of property, casualty, and life insurance, as well as underwriters of title insurance and annuities.

National banks and subsidiaries. At the same time, the Act effectively bars a national bank and its subsidiaries (including a financial subsidiary) from undertaking any new forms of insurance underwriting activities in the future.

First, the Act expressly excludes both insurance and annuity underwriting from the powers of the new financial subsidiaries authorized for a national bank.

Second, the Act generally prohibits a national bank and its subsidiaries (that is, traditional operating subsidiaries) from providing as principal any "insurance" product that national banks were not lawfully providing (or had not been authorized by the OCC to provide) as principal as of January 1, 1999.[8] (This prospective approach to prohibiting insurance underwriting activities by national banks and their subsidiaries, of course, protects the banks' ability to continue long-permitted activities such as the underwriting of credit-related insurance.) Also, for purposes of this national bank insurance underwriting prohibition, the Act includes a complex definition of "insurance" that is designed to ensure that any new bank product that is developed after January 1, 1999, and that is in fact a new form of a traditional banking product (for example, a deposit product, a loan or other form of extension of credit, or a fiduciary product) is not foreclosed to banks simply because state insurance regulators might deem the product to be a form of insurance if offered by an insurance company.

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[8] The Act's prohibition on insurance underwriting by national banks and their subsidiaries includes underwriting activities conducted off-shore where the products are offered in the United States.

Title insurance and annuity underwriting. Finally, the Act includes express prohibitions on the underwriting of both annuities and title insurance by a national bank and its subsidiaries. The only exception to these prohibitions is for title insurance underwriting activities in which a national bank or its subsidiary was engaged prior to enactment of the Act.

2. Regulation of Insurance Activities

The Act includes extensive and exceptionally complex provisions relating to the federal and state regulation of insurance activities of banking organizations. Some of these provisions call for the federal banking agencies to issue a limited range of federal consumer protection regulations. Other provisions establish a limited number of "safe harbors" under which states may impose limited regulation on the insurance sales activities of banking organizations.

Of most significance, however, are the provisions that *expand* the federal preemption of state regulations affecting these organizations. While national banks had enjoyed the preemption resulting from the Supreme Court's *Barnett* decision, that same preemption (except with respect to the "safe harbors" for insurance sales regulation) is now extended in varying degrees to *subsidiaries of banks, FHC affiliates of banks,* and *even state-chartered banks and thrifts*. The net result is a significant set of federal limits on states' ability to regulate the insurance activities of ***any*** type of banking entity. These limits include important restrictions on state regulation that ***discriminates against*** or has a ***substantially adverse effect*** on such entities.

Because of the complexity of these rules, a separate and detailed summary of the Bank Insurance Regulation provisions is attached as Appendix C. This Appendix explains the scope and effect of the Act's new scheme for such regulation.

C. Merchant Banking/Equity Investment Activities

In addition to the newly-authorized securities and insurance activities, perhaps the most significant new activity authorized by the Act is the new "merchant banking" or equity investment power.

Before enactment of the Act, a banking organization was substantially limited in its ability to make an equity investment, including a "controlling" equity investment, in any company engaged in activities that were not "closely related to banking." At the same time, a securities or insurance firm was free to make such a "merchant banking" or "private equity" investment in virtually any kind of financial or nonfinancial company. Such investments have often proved to be highly profitable.

Recognizing that these investment activities are "financial in nature," the Act substantially expands the authority of a banking organization to make a "controlling" equity investment in any kind of company, including a nonfinancial company. Only an FHC may engage in these merchant banking activities, at least for the first five years after the date of enactment. After that time, a financial subsidiary of a bank may also be permitted to engage in such activities, but only if the Federal Reserve and the Treasury agree.

Set forth below is a description of the two types of equity investment activities newly authorized by the Act for an FHC: (1) general equity investment activities; and (2) insurance company equity investment activities.

1. General Equity Investment Activities

An FHC may make a controlling investment in the shares, assets, or ownership interests of any entity, subject to five conditions:

(1) The investment is not made by a depository institution subsidiary of the FHC, or by a subsidiary of a depository institution.
(2) The FHC owns a "securities affiliate."[9] But the investment need not be made by that securities affiliate.[10]
(3) The investment is made as part of a ***"bona fide underwriting or merchant or investment banking activity***, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment."[11]
(4) The investment is ***"held for a period of time to enable the sale or disposition thereof on a reasonable basis*** consistent with the financial viability of the [bona fide underwriting or merchant or investment banking activity]."[12]
(5) The FHC does not ***"routinely manage or operate"*** the entity in which the investment is made, "except as may be required to obtain a reasonable return on investment upon sale or disposition."[13]

These five vaguely-worded conditions for engaging in equity investment activities do not appear difficult for an FHC to satisfy, which would mean that an FHC has broad leeway to invest in any type of company or entity. However, before the FHC provisions become effective on March 11, 2000, the Federal Reserve plans to issue regulations implementing new section 4(k) of the Bank Holding Company Act ("BHCA"), of which the merchant banking provision is a part. In addition, the Act specifically provides the Federal Reserve and the Treasury Department with broad discretion to jointly issue regulations on the merchant banking provision, and these regulations may also be issued before the March 11 effective date. As a result, the actual scope of an FHC's merchant banking authority will depend very much on regulations that interpret the provision's exceptionally broad and vague terms.

2. Insurance Company Equity Investment Activities

In addition to its general equity investment authority, an FHC may also make a controlling equity investment through an insurance company owned by the FHC, if the "investment is made in the ordinary course of business of such insurance company in accordance with relevant State law governing such investments." Unlike the general equity investment authority described above, the insurance company equity investment authority includes no "holding peri-

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9 "Securities affiliate" is not defined, which is one of the issues that will be addressed by Federal Reserve regulations that will be issued before the effective date of this provision in early 2000.

10 The Act also provides that an FHC *without* a securities affiliate can exercise the new authority if it owns a registered investment adviser that is affiliated with an insurance company and provides investment advice to an insurance company.

11 These broad terms are undefined, and the use of the word "including" suggests that the "appreciation/resale" requirement need not always apply.

12 No specific time limit is imposed on this holding period.

13 The "routinely manage" language is not defined, and the exception appears quite broad.

od" condition. But like the general equity investment authority, the insurance company equity investment authority does prohibit the FHC from "routinely managing or operating" the entity in which the investment is made, "except as may be required to obtain a reasonable return on investment upon sale or disposition."

3. Other Restrictions on Equity Investment Activities

The Act imposes two other restrictions on the equity investment activities of an FHC. First, a depository institution controlled by an FHC may not cross market the products or services of a company in which the FHC has made an equity investment (a "portfolio company"), and *vice versa.* However, with respect to insurance company equity investments, it is possible that this restriction may not apply to marketing provided through "statement stuffers" or Internet websites if the Federal Reserve determines the arrangement to be in the public interest. Moreover, the Act does not restrict a *nonbank affiliate* of an FHC and a portfolio company from cross marketing each other's products.

Second, an investment made pursuant to the Act's merchant banking or insurance company equity investment authority will very likely be a "controlling investment." This would make the portfolio company an "affiliate" of a depository institution for purposes of Sections 23A and 23B of the Federal Reserve Act. Indeed, the Act establishes a rebuttable presumption that an FHC's merchant banking or insurance company equity investment comprising 15 percent or more of an entity's equity capital will make that entity an affiliate. The result is that a depository institution's credit and asset purchase transactions with such an "affiliate" will be subject to the "covered transaction" restrictions of Sections 23A and 23B of the, Federal Reserve Act, including quantitative limits, collateral requirements, and the "arm's length" transaction standard.

D. Future "Financial in Nature" and Incidental Activities

As described above, the Act expressly authorizes an FHC to engage in all activities in which a bank holding company was permitted to engage as of the date of enactment, including activities that previously could only be conducted outside the United States under Regulation K,[14] *plus* all securities activities, all insurance activities, and a broad new range of equity investment activities. Taken together, these express authorizations permit an FHC to engage in virtually all activities that are currently recognized as *financial.*

In addition to these currently-recognized financial activities, the Act authorizes an FHC to engage in any future activity that the Federal Reserve determines, by regulation or order, to be "financial in nature or incidental to such financial activity." This authority to permit new financial activities is considerably broader than the Federal Reserve's comparable authority before the enactment of the Act, which had only extended to a new activity that was "so closely related to banking as to be a proper incident thereto."

One specific aspect of this new authority is that the Federal Reserve is directed to define the extent to which three types of activities are "financial in nature":

(1) Lending, exchanging, and engaging in certain other transactions with financial assets *other than* money or securities;

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[14] For example, travel agency activities, because they had previously been authorized under Regulation K, are a permissible type of "financial" activity for an FHC.

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(2) Providing any device or instrumentality for transferring money or other financial assets; or

(3) Arranging, effecting, or facilitating financial transactions for the account of third parties.

It is expected that the Federal Reserve will begin interpreting these provisions in rules that are to be issued during the four-month period between the date of enactment and the effective date, which is March 11, 2000. While it is unclear how the Federal Reserve will exercise this specific new authority, it could very well determine, for example, that real estate brokerage activities are permissible as "effecting financial transactions for the account of third parties."[15]

Apart from its authority with respect to these three specified activities, the Federal Reserve has broad discretion to determine that other types of activities are "financial in nature or incidental to such activity." In making such a determination, the Federal Reserve is directed to consider a number of factors, and these factors appear to encourage the agency to be especially flexible regarding the ability of an FHC to engage in new financial "e-commerce" activities. Among the specific factors to be considered by the Federal Reserve are:

- Changes or reasonably expected changes in the marketplace in which FHCs compete or ***the technology for delivering financial services;*** and
- Whether the proposed activity is necessary or appropriate to allow an FHC to—
  - ➢ Compete effectively with any company seeking to provide financial services;
  - ➢ Efficiently deliver information and services that are financial in nature ***through the use of technology, including applications involving systems for data transmission or financial transactions;*** and
  - ➢ Offer customers any available or ***emerging technological means for using financial services*** or for the document imaging of data.

The Act provides the Treasury Department with the right to veto any Federal Reserve determination that a new activity is "financial in nature or incidental to such activity." Likewise, the Federal Reserve has the right to veto any similar determination made by the Treasury Department that a new activity to be engaged in by a financial subsidiary of a bank is "financial in nature or incidental to such activity."

E. "Complementary" Nonfinancial Activities

Finally, in addition to the newly-authorized *financial* activities described above, the Act authorizes an FHC to engage in certain *nonfinancial* activities. Specifically, an FHC may engage in a nonfinancial activity, or acquire a company engaged in a nonfinancial activity, if the Federal Reserve determines by regulation or order that the activity:

(1) Is "complementary" to a financial activity; and

(2) Does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

Given the Federal Reserve's past skepticism regarding proposals to allow bank holding companies to engage in new types of activities, especially nonfinancial activities, it is unclear the extent to which this potential new authority will prove significant. Nevertheless, it is con-

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[15] The Treasury Department has identical authority to make similar determinations for financial subsidiaries.

ceivable that, sometime in the future, the following types of activities could be authorized as either "financial in nature," "incidental," or "complementary": real estate management; physical commodity trading; leasing on an operating basis rather than a "net" basis; and accounting or auditing services.

III. UNITARY THRIFT HOLDING COMPANIES

As described above, the Act substantially expands the ability of a bank to affiliate with any *financial* company. But, with limited exceptions, the Act also confirms the longstanding prohibition on a bank affiliating with a *commercial* company. Recognizing that thrift institutions have become much more like banks, the Act removes the authority of a thrift institution to become affiliated with a commercial company.

Specifically, the Act flatly prohibits a commercial company from acquiring a thrift institution through the "unitary thrift holding company" vehicle. The retroactive effective date of the prohibition is May 4, 1999.

The Act "grandfathers" any commercial company that was a unitary thrift holding company as of the retroactive effective date, or had an application pending at the Office of Thrift Supervision to become a unitary thrift holding company as of that date. But the grandfather rights are limited: a grandfathered unitary thrift holding company may not sell or otherwise transfer control of its thrift institution to another *commercial* company. Instead, it may only transfer control to a *financial* company.[16]

Thus, with limited exceptions, banks and thrifts are treated equally for the future: both may affiliate with financial companies, but neither may affiliate with commercial companies.

While the Act eliminates the authority of a commercial company to acquire a thrift, it does nothing to prevent a *financial* company from being a unitary thrift holding company. That is, a financial company may still own or acquire a single thrift institution and engage in all the activities that are permissible for an FHC—but without *becoming* an FHC. As under pre-existing law, such a company would be a financial unitary thrift holding company that is regulated at the holding company level by the OTS, not the Federal Reserve.

Charts 3 and 4 show the Act's changes to the regulatory structure of unitary thrift holding companies.

IV. FEDERAL HOME LOAN BANK SYSTEM REFORMS

The Act contains a number of significant changes to the Federal Home Loan Bank System. These changes modify the regulatory and enforcement powers of the Federal Housing Finance Board, which is the regulator of the individual Federal Home Loan Banks ("FHLBanks"). They also reduce the regulatory burden on the FHLBanks by altering their corporate governance structure, providing them with more corporate freedom, and modifying their capital requirements. The changes that are of most interest to the banking industry, however,

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[16] For these purposes, a financial company means an FHC or any company that is engaged in activities that are permissible for either an FHC or for a savings and loan holding company that is not a unitary thrift holding company.

are those that will significantly increase depository institution access to the Bank System, especially for community banks and thrifts.

A. Expanded Types of Eligible Collateral

The Act creates a new type of FHLBank member called a Community Financial Institution or "CFI," which is a community bank or thrift with less than $500 million in assets (to be adjusted for inflation). Unlike other member institutions, a CFI may now pledge small business and agricultural loans (or securities representing a whole interest in such loans) as collateral for FHLBank advances. The effect of this change alone is dramatic: it is estimated to increase the amount of community banks' eligible collateral for advances by *over $400 billion*, which will provide a significant new source of low-cost liquidity.

B. Relaxed Membership Requirements

The Act also permits a Community Financial Institution to join the FHLBank System without satisfying the requirement, which applies to all other institutions, that at least 10 percent of the institution's assets consist of housing-related loans. This means that many more community banks—that is, those that are not significantly engaged in home mortgage lending—will have increased access to the low-cost funding provided by the FHLBank System. Again, the effect of this change is dramatic—it is estimated that over 2,500 community banks—most of them rural—have now become eligible for System membership.

C. Elimination of QTL-Related Restrictions

The Act also abolishes a number of restrictions that had applied to a member institution that did not comply with the Qualified Thrift Lender (or "QTL") test, including the more onerous stock purchase requirements; the ability to obtain advances only for housing-related purposes; the 30 percent limit on total advances to non-QTL members; and certain restrictions that applied to non-QTL thrifts.

D. Other Significant Changes

Effective six months after enactment, the Act makes FHLBank membership *voluntary* for all member institutions. This is a significant change for federally-chartered thrift institutions, which had formerly been obligated to subscribe.

Another significant change to the FHLBank System is the establishment of a new capital standard. The Act effectively sets a new minimum total capital-to-assets requirement of 4 percent for each FHLBank. (The requirement is technically 5 percent, but attribution rules for a certain category of FHLBank stock effectively lower the requirement to 4 percent.)

Finally, with respect to corporate governance of the FHLBanks, the Act equalizes the terms of elected and appointed board members to three years each. It also requires that an FHLBank chairman and vice chairman be elected by the FHLBank's board, rather than being appointed by the Federal Housing Finance Board in Washington. These changes should significantly increase the local control of FHLBanks by its member institutions.

CHART 3

LAW *BEFORE* GRAMM-LEACH-BLILEY ACT

Thrifts: Permissible Activities and Affiliations

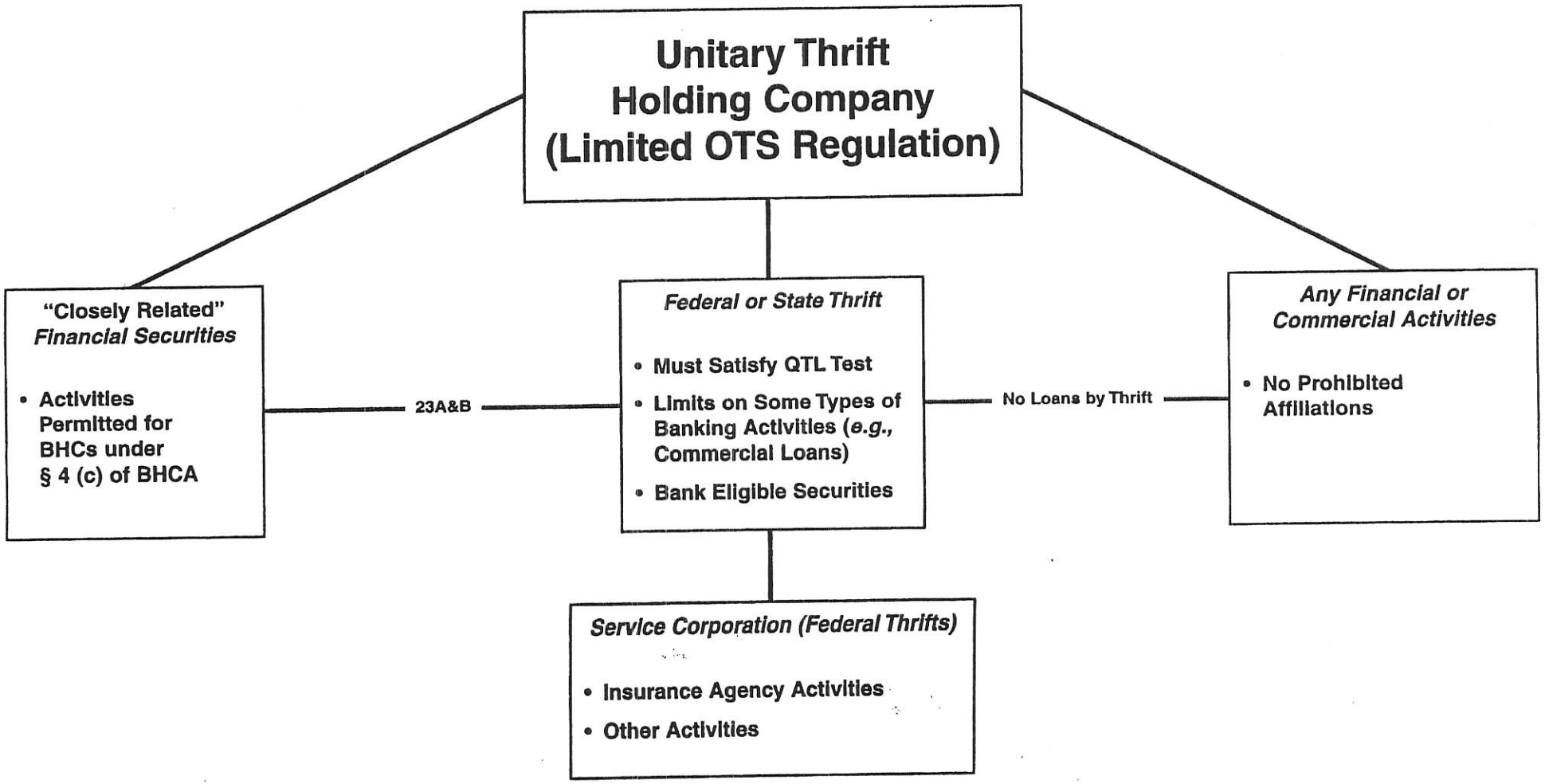
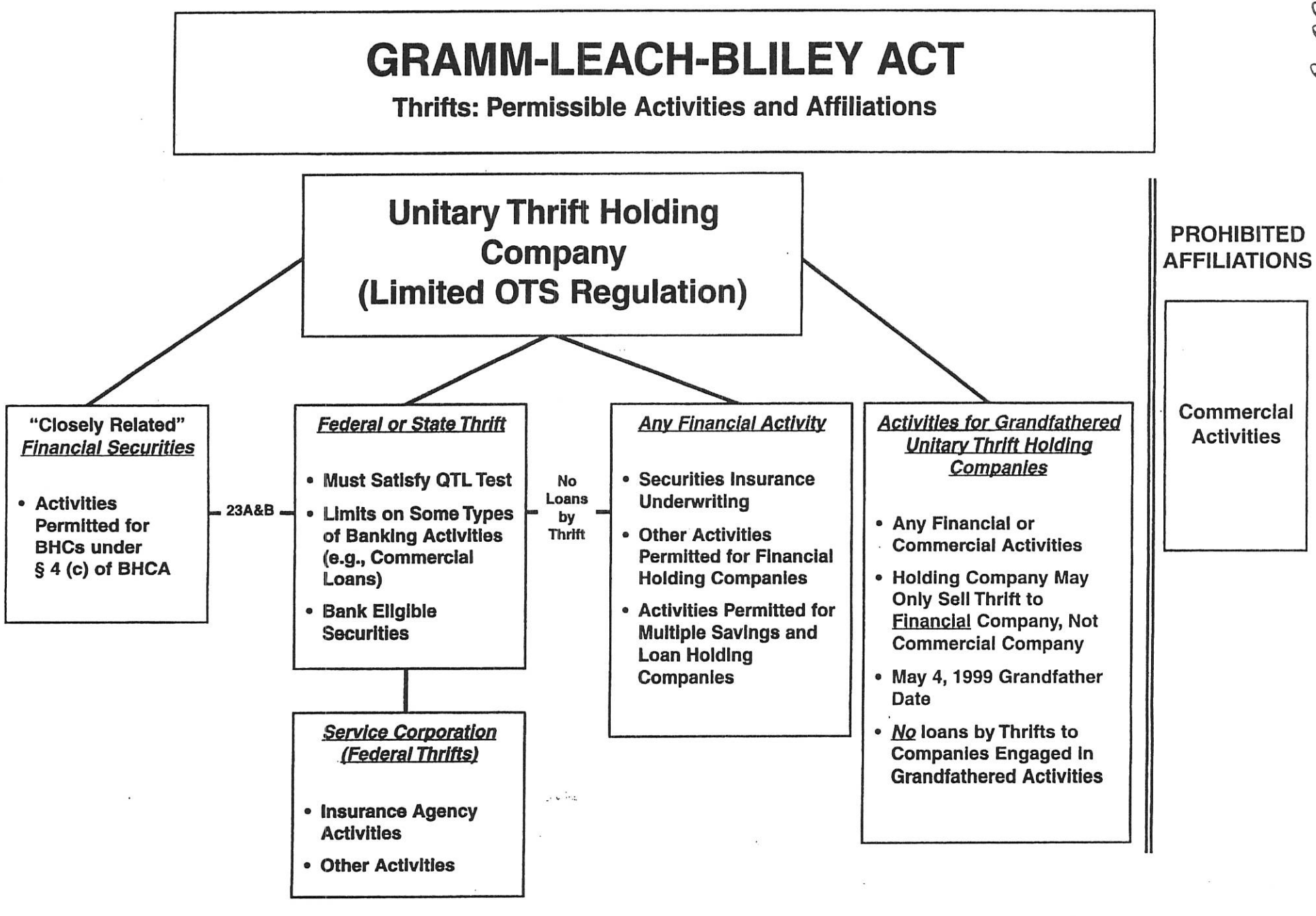


CHART 4


GRAMM-LEACH-BLILEY ACT
Thrifts: Permissible Activities and Affiliations
Unitary Thrift Holding Company (Limited OTS Regulation)
"Closely Related" Financial Securities
• Activities Permitted for BHCs under § 4 (c) of BHCA
23A&B
Federal or State Thrift
• Must Satisfy QTL Test
• Limits on Some Types of Banking Activities (e.g., Commercial Loans)
• Bank Eligible Securities
Service Corporation (Federal Thrifts)
• Insurance Agency Activities
• Other Activities
No Loans by Thrift
Any Financial Activity
• Securities Insurance Underwriting
• Other Activities Permitted for Financial Holding Companies
• Activities Permitted for Multiple Savings and Loan Holding Companies
Activities for Grandfathered Unitary Thrift Holding Companies
• Any Financial or Commercial Activities
• Holding Company May Only Sell Thrift to Financial Company, Not Commercial Company
• May 4, 1999 Grandfather Date
• No loans by Thrifts to Companies Engaged in Grandfathered Activities
PROHIBITED AFFILIATIONS
Commercial Activities

V. PRIVACY

The Act significantly expands a customer's ability to protect the privacy of information provided to any kind of financial institution, including banks, securities firms, insurance companies, thrifts, and credit unions—as well as any other institution "the business of which" is engaging in activities permitted for an FHC, *even if it is not itself an FHC.*[17] Federal and state financial privacy laws in effect before enactment of the Act, especially the Fair Credit Reporting Act ("FCRA"), had already provided a significant level of consumer privacy protection. But the Act's prospect of accelerated cross-industry mergers, coupled with technological advances that make all forms of information more readily accessible, prompted a controversial debate in Congress about imposing especially far-reaching privacy restrictions on financial institutions.

In the end, the Act's provisions strike a balance between the heightened concerns of consumers for certain kinds of privacy protections, and the legitimate need of financial institutions to share information, especially among affiliates, for the benefit of consumers. The Act's provisions do not extend as far as consumer groups had advocated, but they do provide more significant privacy protections for customers of financial institutions than apply to customers in virtually any other industry in the country. And while these new provisions impose new regulatory obligations on financial institutions, the burden will not be nearly as great as would have been the case with other provisions that Congress narrowly rejected.

The Act subjects a financial institution to four new requirements regarding the nonpublic personal information of a consumer. The financial institution must:

(1) Establish and disclose annually its privacy policy.

(2) Afford consumers the right to "opt out" of disclosures to non-affiliated third parties, subject to a number of significant exceptions.

- ***No opt-out applies with respect to disclosures to <u>affiliates.</u>***

(3) <u>Not</u> disclose account information to third-party marketers.

(4) Abide by regulatory standards to protect the security and confidentiality of consumer information.

In addition to these four new obligations, the Act prohibits the practice of "pretext calling" in which someone fraudulently obtains or causes the disclosure of customer information from a financial institution by fraudulent or deceptive means. These and other privacy provisions in the Act are explained in more detail in Appendix D.

VI. COMMUNITY REINVESTMENT ACT PROVISIONS

The controversial subject of CRA came close to derailing efforts to enact this legislation. In the end, agreement was reached on three significant categories of provisions relating to

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[17] This definition has significant consequences. For example, because travel agency activities are now a permissible activity for FHCs, presumably travel agencies will now be "financial institutions" that are subject to the new privacy obligations. Likewise, there will now be a "ratcheting effect": any time the Federal Reserve authorizes a new activity as permissible for an FHC, a company engaged in that business will become a "financial institution" subject to the Act's privacy obligations even if the company is not part of an FHC. Thus, if the Federal Reserve were to authorize FHCs to engage in real estate brokerage, all realtors would become subject to the Act's new privacy obligations.

CRA: (A) CRA requirements that must be met by companies and banks that seek to utilize the expanded powers authorized under the Act; (B) regulatory relief from CRA examinations for smaller banks; and (C) disclosure of CRA agreements.[18]

A. CRA Eligibility Requirements

As noted above, a CRA eligibility requirement applies to any company that wishes to become a financial holding company and thereby exercise the expanded powers that the Act makes available. To become an FHC, all of the company's subsidiary depository institutions must have "satisfactory" or better CRA ratings. A limited one-year exception is provided for recently acquired affiliate institutions if a plan to improve the acquired institution's CRA rating has been accepted by the institution's federal regulator. Similarly, when a bank wishes to exercise expanded powers by acquiring or investing in a financial subsidiary, the bank and all of its depository institution affiliates must have "satisfactory" or better CRA ratings.

What happens if the CRA rating of one of these depository institutions subsequently falls below the "satisfactory" level? This was a subject of major controversy during the legislative process. As also noted above, the Act provides that in such a situation the FHC is barred from acquiring control of additional companies or commencing new activities pursuant to the new powers authorized by the Act, but is not required to divest companies previously acquired or limit activities already being conducted. A national bank owning a financial subsidiary would be subjected to similar restrictions.

B. CRA Regulatory Relief

The Act provides significant regulatory relief to smaller community banks and thrifts—those with aggregate assets of $250 million or less. The Act directs that those institutions ordinarily shall not be subjected to CRA examinations more often than once every *five* years if the institution's last CRA rating was "outstanding," and no more often than once every *four* years if the last CRA rating was "satisfactory." This general standard does not preclude the regulatory agency from conducting a CRA examination in connection with an application by the institution for a "deposit facility" (*e.g.*, an application to acquire another depository institution or to establish additional branches) or in other circumstances for reasonable cause.

C. Disclosure of CRA Agreements

The Act includes provisions requiring public disclosure of CRA agreements between banking organizations and community groups or other private parties. Under the Act, an agreement is potentially subject to this disclosure requirement if it is made by a depository institution pursuant to or in connection with CRA and provides for payments or grants of more than $10,000 annually or loans of more than $50,000 annually. Exceptions are provided for individual mortgage loans, for loans at approximately market rates that are not intended for re-lending, and for agreements with persons or entities that have not submitted CRA comments or other-

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[18] The Act also provides for two different studies of CRA: one by the Federal Reserve focusing on the default and delinquency rates and the profitability of loans made in conformity with CRA (due March 15, 2000); and one by the Treasury focusing on the extent to which the Act results in adequate services being provided as intended by CRA, including services in low- and moderate-income neighborhoods and for persons of modest means ("baseline" report due March 15, 2000; final report due two years after the date of enactment of the Act).

wise contacted the institution about CRA. The Act directs the federal banking agencies to issue regulations that, among other things, define the scope of agreements to which these new disclosure rules apply, as well as the exceptions to these rules. The agencies are also directed to limit the burden of these rules on the parties to the agreements, including banks and thrifts.

Financial institutions that enter into agreements covered by the disclosure requirement must report annually to their federal regulator on the amount of payments, fees, or loans made to or received from the other parties. They also must report aggregate data on loans, investments, and services provided in the relevant community by each party pursuant to the agreement.

In addition, the community group or other non-depository-institution parties to the agreement must provide a detailed annual accounting of the use of funds received pursuant to the agreement. If such a party willfully and materially fails to comply with any of these requirements, the relevant federal bank regulator can declare the agreement unenforceable. The regulators also can require the disgorgement of funds diverted under a CRA agreement for personal gain.

However, the regulators are not given any new authority to enforce private CRA agreements.

VII. OTHER SIGNIFICANT REGULATORY PROVISIONS

In addition to the provisions described, the Act includes several important miscellaneous provisions that are significant for the banking industry. These include (A) changes to the scope of the Federal Reserve's supervisory authority; (B) provisions affecting foreign banks; (C) new federal limits on state regulation of banking organization activities *other than insurance*; (D) revisions to the authority of the antitrust agencies prompted by the new authority for FHCs; (E) ATM notice provisions; and (F) elimination of the "Special Reserve" of the Savings Association Insurance Fund. Each of these provisions is discussed below.

A. Federal Reserve Supervisory Authority

Because of its authority to engage in all financial activities, an FHC may very well own a variety of financial companies that are "functionally regulated" by different financial regulators, *e.g.*, a national bank regulated by the OCC; a broker-dealer or investment adviser regulated by the SEC; or an insurance company regulated by a state insurance regulator. As is the case with bank holding companies generally, the Act firmly establishes the Federal Reserve as the regulator of the consolidated FHC owning these entities (sometimes referred to as the role of "umbrella supervisor"). But the Act also limits, to some extent, the Federal Reserve's authority over entities that are functionally regulated by other regulators (the so-called "Fed Lite" provisions).

Specifically, the Act directs the Federal Reserve, in discharging its function as umbrella supervisor, to rely to the maximum extent possible on examinations and reports prepared by functional regulators, publicly reported information, and reports filed with other regulators (*e.g.*, the SEC or state insurance regulators). The Federal Reserve is also prohibited from applying any capital standard directly to any functionally regulated affiliate that is already in compliance with the capital requirements of its functional regulator (such as a securities broker-dealer affiliate that satisfies the SEC's "net capital" rule).

Notwithstanding these general limitations, the Federal Reserve retains broad regulatory authority to examine and require reports from any affiliate of an FHC. In addition, with limited exceptions, the Act does not affect the Federal Reserve's authority to establish consolidated capital requirements for an FHC, which would take into account at the holding company level the assets held by functionally regulated subsidiaries of the FHC.

B. Provisions Affecting Foreign Banks

A foreign bank operating in the United States may elect to be treated as an FHC in order to engage in the Act's newly-authorized activities. As discussed below, several issues may arise in connection with such an election.

1. Capital and Management Requirements

Most foreign banks operate in the U.S. through branches, agencies, or commercial lending companies. The standards are not clear for determining whether such an organization satisfies the "well capitalized" and "well managed" requirements for treatment as an FHC. The Act directs the Federal Reserve to apply "comparable capital and management standards" as apply to domestic banks, but how this phrase will be implemented is uncertain. Resolving this uncertainty has been identified as a top priority by the Federal Reserve in the regulations that it plans to issue before this part of the Act becomes effective in March of 2000.[19]

2. Authority to Engage in Nonconforming Activities

Subject to limitations and conditions in Regulation K, so-called "qualifying foreign banking organizations" ("QFBOs") have the authority to engage outside the United States and indirectly in the United States in activities that are not permitted for domestic bank holding companies, including nonfinancial activities. A QFBO that elects to be treated as an FHC maintains its ability to engage in these nonfinancial activities to the same extent as it had been permitted to do so before passage of the Act.

Some foreign banks currently have authority to engage in "grandfathered" activities under the International Banking Act. If such a foreign bank elects to be treated as an FHC, it forfeits its right to engage in grandfathered *financial* activities that are permissible for an FHC. In addition, even if it does not elect to be treated as an FHC, the Federal Reserve has the discretion after two years to impose restrictions on any grandfathered financial activity that is also permissible for an FHC. Such restrictions are to be comparable to those imposed on an FHC that conducts such activities.

There is no change, however, to the authority of a foreign bank to engage in grandfathered *nonfinancial* activities; it may continue to exercise such authority whether or not it elects to be treated as an FHC.

3. Prudential Safeguards

The Act expressly provides the Federal Reserve with the authority to impose "restrictions or requirements on relationships or transactions" between a branch, agency, or commercial

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[19] The CRA-rating requirement for FHCs is less of an issue for foreign banking organizations because CRA applies only to depository institutions that are federally insured, and most foreign bank operations in the U.S. are not federally insured.

lending company of a foreign bank in the United States and any affiliate in the United States. This is comparable to the authority that the federal banking regulators are provided with respect to relationships or transactions between domestic banks and their affiliates.

Before enactment of the Act, the Federal Reserve had imposed such safeguards—most notably the limitations of Sections 23A and 23B of the Federal Reserve Act—on transactions between a foreign branch or agency and its "Section 20" securities underwriting affiliate. But it had not imposed such safeguards on transactions between a branch or agency and any other type of U.S. affiliate.

It is unclear whether and to what extent the Federal Reserve will exercise its express new authority under the Act with respect to transactions between branches or agencies and their affiliates, *i.e.,* whether it will be limited to transactions involving securities affiliates or will be applied more broadly.

C. New Federal Limitations on State Regulation of *Non*-Insurance Activities

The Act provides for the first time limited federal protection from abusive state regulation of *non*-insurance activities that the Act authorizes for depository institutions and their subsidiaries and affiliates. In essence, state regulation of such non-insurance activities is subject to the same limitations that the Act imposes on state regulation of federally authorized insurance underwriting activities (*see* Appendix C). Thus, for example, state regulation of lending activities authorized by the Act for nonbank affiliates is preempted to the extent that such state regulation does one or more of the following:

- ***Distinguishes adversely by its terms between entities engaged in such lending activities that are affiliates of depository institutions, and other entities or persons engaged in the same lending activities.***
- ***Impacts the affiliates engaged in such lending activities in a manner that is "substantially more adverse" than it impacts other entities or persons engaged in the same lending activities.***
- ***Effectively prevents such affiliates from engaging in such lending activities.***
- ***Conflicts with the Act's intent to permit the affiliation of depository institutions and nonbank entities engaged in such lending activities.***

These new general federal limitations on state regulation of *non*-insurance activities are a significant and positive development for all depository institutions and their affiliates given that, historically, only national banks and federal thrifts have been able to invoke the protection of federal law with respect to their authorized activities.

D. Revised Antitrust Agency Authority

The Act includes several provisions that revise the authority of the federal antitrust authorities—that is, the FTC and the Department of Justice—in light of the new financial holding company structure authorized by the Act.

1. Interagency Data Sharing

The Act generally authorizes the federal banking agencies to provide to the Department of Justice and the FTC any information in the agencies' possession, including bank examination reports, that the Department or the FTC deem necessary in connection with their antitrust

review of bank or holding company acquisitions or mergers or any holding company acquisition of a nonbank subsidiary. The Act thus eliminates doubts that previously have existed regarding the banking agencies' authority to share information with the antitrust agencies.[20]

2. FTC Authority over Bank Subsidiaries and Affiliates

Under current law, the FTC is prohibited from enforcing the Federal Trade Commission Act against banks (and also savings associations). The Act makes clear that this exemption from FTC authority does not extend to any nonbank entity that is a subsidiary or affiliate of a bank.

3. Hart-Scott-Rodino Amendments

Before enactment of the Act, transactions subject to Federal Reserve approval under Section 3 of the Bank Holding Company Act were exempt from review under the Hart-Scott-Rodino Act. The same was true of transactions subject to Federal Reserve Board approval under Section 4 of the BHCA so long as certain informational submissions were made. The Act amends both these exemptions to make clear that they do *not* apply (and Hart-Scott-Rodino review is therefore required) with respect to any portion of a transaction that (a) is subject to the new financial activities authority which the Act adds as Section 4(k) of the BHCA, and (b) does not require agency approval under either Section 3 or Section 4 of the BHCA.[21]

E. ATM Provisions

The Act amends the Electronic Funds Transfer Act ("EFTA") to require operators of automated teller machines ("ATMs") to disclose fees charged for ATM "host transfer services." Such services are ones that require an ATM owner to conduct an "electronic funds transfer" under the EFTA in connection with the customer's transaction.

An ATM fee notice must be posted on the machine in a conspicuous location. The Act further requires that an ATM notify a customer that a fee will be charged and allow the customer to cancel the transaction before it is completed and the fee assessed. This notice and option to cancel must appear on the screen of the ATM, or on a printed receipt discharged from the ATM before the transaction is completed. The Act allows until December 31, 2004, for ATM owners to implement ATM technology that satisfies the Act's notice and right-to-cancel requirements.

F. Elimination of SAIF Reserve

Finally, the Act frees nearly $1 billion contained in the federal deposit insurance fund for thrifts (*i.e.*, the Savings Association Insurance Fund or "SAIF"). These funds had been part

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[20] The Act also specifies that any information shared be kept confidential; that before any shared information is disclosed to a third party by the Department or the FTC, the agency that provided the information must be notified in writing and afforded an opportunity to oppose or limit the disclosure; and that the sharing of information does not affect any claim of privilege to which the information is otherwise subject. And the Act expressly extends these same protections to any information shared by one federal banking agency with another federal banking agency, and to any information shared by a federal banking agency with any state agency or authority.

[21] The Act provides for Federal Reserve Board notification to the FTC (as well as the Department of Justice) when the Board approves a bank or holding company acquisition that includes the acquisition of a nonbanking company, including the expanded nonbank authority provided for FHCs. This amendment does not give the FTC any new authority over bank acquisitions, but is designed to ensure that the FTC has more of an opportunity to exercise its existing but little-used authority over nonbank acquisitions by banking companies.

of the general reserves of the SAIF until 1996, when Congress segregated them into a "Special Reserve" within the SAIF that (1) was difficult to access to pay for thrift failures; and (2) could not be counted towards the SAIF's overall "designated reserve ratio," which affects the level of deposit insurance premiums assessed on thrifts. By eliminating the Special Reserve, the Act returns the funds to SAIF's general reserves, which greatly increases the cushion available in that fund to offset the costs of potential thrift failures.

VIII. KEY EFFECTIVE DATES

Title I -Affiliations

- **Establishment of "Financial Holding Companies."**—120 days after date of enactment (March 11, 2000). The Federal Reserve will issue regulations in the interim that will interpret key provisions of the Act as they relate to financial holding companies.
- **Establishment of "Financial Subsidiaries."**—No sooner than 120 days after date of enactment (March 11, 2000). OCC "implementing" regulations must be in place 270 days after enactment (August 8, 2000), but will likely be issued within the 120-day period.
- **Certain Regulation of Insurance Activities (§104)**—Date of enactment (November 12, 1999).

Title II—Securities

- **SEC Regulation of Bank Securities Activities ("Push-Outs") and Bank Investment Company Activities**—18 months after date of enactment (May 12, 2001).
- **Other Securities Provisions**—Date of enactment (November 12, 1999).

Title III—Insurance Regulation

- **Regulation of Insurance Activities of Banking Organizations**—Date of enactment (November 12, 1999).

Title IV—Unitary Thrift Holding Companies

- **Elimination of Commercial Company Affiliations**—Retroactive to May 4, 1999.

Title V—Privacy

- **General Requirements for Disclosure of Nonpublic Personal Information**—Generally, six months after regulations are issued, and regulations must be issued six months after date of enactment (May 12, 2000)—but regulators may prescribe a later effective date.
- **Fraudulent Access to Financial Information**—Date of enactment (November 12, 1999).
- **Amendments to Fair Credit Reporting Act**—Date of enactment (November 12, 1999).

Title VI—Federal Home Loan Bank System Reforms

- **Relaxed Requirements for Membership and Increased Access to Advances**—Date of enactment (November 12, 1999).
- **Voluntary Membership for Federal Thrifts.**—Six months after date of enactment (May 12, 2000).

Title VII—Miscellaneous Regulatory Provisions

- **CRA Disclosure Provisions**—Applies to all CRA agreements entered into 6 months after date of enactment (May 12, 2000).
- **CRA Small Bank Regulatory Relief**—Date of enactment (November 12, 1999).
- **ATM Fee Disclosure Requirements**—Date of enactment, but operators have until December 31, 2004 to adopt technology for "right-to-cancel" option.

APPENDIX A

BANKING ACTIVITIES EXEMPT FROM SEC BROKER-DEALER REGULATION

("Push-Out" Exemptions)

- **"Networking" brokerage.** Exempts certain support services provided by bank employees to third party brokers in connection with securities sales to bank customers.
- **Trust and fiduciary brokerage and dealing.** Generally exempts transactions provided in a bank's trust or fiduciary capacity, subject to restrictions on advertising and limits on some types of fee arrangements.
- **Government securities brokerage and dealing.** Exempts transactions in bank eligible securities, including newly bank eligible municipal revenue bonds.
- **Stock purchase plan brokerage.** Generally exempts transactions that a bank effects as stock transfer agent for employee benefit plans, dividend reinvestment plans, and "issuer" plans, if the bank does not solicit transactions or provide investment advice.
- **Safekeeping and custody brokerage.** Generally exempts such customary bank activities as general safekeeping and custody, securities clearing and settling, securities lending and borrowing, securities pledging, and custodial or administrative services for individual retirement accounts and other employee benefit plans.
- **Dealing in certain asset-backed securities.** Exempts a bank's underwriting of or dealing in securities backed by assets "predominantly originated" by the bank, a non-broker-dealer affiliate of the bank, or a syndicate of which the bank is a member. The exemption does not apply unless the securities are provided only to sophisticated investors ("qualified investors").[22]
- **Certain private placement brokerage.** Exempts a bank's private placement activities as agent if the bank is ***not*** affiliated with a broker-dealer that engages in underwriting or dealing in bank ineligible securities. The amount of an individual private placement may also be limited to 25 percent of the bank's capital.
- **Brokerage and dealing in "identified banking products."** Exempts transactions involving the following specific banking products in order to prevent their being characterized as "securities" subject to push-out: ***deposits; bankers acceptances; bank letters of credit; bank loans; loan participations*** provided to "qualified investors" (and in some circumstances to other types of investors); and ***swap agreements***, as discussed next.

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[22] A "qualified investor" generally includes regulated entities and governments. It also includes corporations and individuals with more than $10 million in discretionary investments ($25 million when used in connection with the swaps exemption).

- **Brokerage and dealing in swap agreements.** Exempts all swap agreements from push-out, including "credit and equity swaps, with one exception: any equity swap that is sold "directly" to a non-"qualified investor."[23]
- **Brokerage and dealing in certain new hybrid bank/securities products.** Establishes possible exemption for a new type of hybrid bank/securities product developed by a bank after the date of enactment, even if the SEC deems it to be a "security," if the Federal Reserve Board asks a court to determine that the product would be more appropriately regulated as a banking product, and the court agrees.[24]
- ***De Minimis* annual brokerage (500 transactions or fewer).** Exempts up to 500 brokerage transactions annually for each bank, so long as the bank transactions are not conducted by bank employees who are also employees of a broker-dealer. Will be especially useful to community banks that conduct "accommodation brokerage" for their customers.
- **"Sweep" account and affiliate brokerage.** Exempts "sweep account" transactions for no-load money market mutual funds, and brokerage for an affiliate, unless the affiliate is a broker-dealer or a company in which an FHC has made a merchant banking investment.

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[23] The word "directly" was added as an effort to ensure that a bank could issue an equity swap that was ultimately sold to a non-qualified investor, so long as the actual sale to the investor was made indirectly through a registered broker-dealer.

[24] Under the circumstances described, the product could not be pushed out of the bank pending the court's final determination.

APPENDIX B

SEC REGULATION OF BANK INVESTMENT COMPANY ACTIVITIES

- **Bank investment adviser registration.** A bank that acts as an investment adviser to a *registered* investment company must register as an SEC-regulated investment adviser. This registration may be made by a separately identifiable department or division of the bank (a "SIDD"), rather than have the entire bank register.
- **Common trust funds for banks.** Codifying SEC "no-action" letters, bank common trust funds will continue to be exempt from the federal securities laws if: (1) the fund is employed by the bank solely as an aid to the administration of accounts created and maintained for a fiduciary purpose; (2) the funds are not advertised or offered for sale to the general public, except in connection with the ordinary advertising of the bank's fiduciary services; and (3) the fees and expenses charged by such fund are not in contravention of fiduciary principles under applicable federal or state law.
- **Common trust funds for thrifts.** The exemption from registration for bank common and collective pooled funds under sections 3(c)(3) and 3(c)(11) of the Investment Company Act is expanded to include common and collective pooled funds offered by thrift institutions. Thus, thrifts may now offer such investment vehicles exempt from registration under the securities laws to the same extent as banks.
- **Independent directors.** The Act expands the definition of "interested persons," *i.e.*, persons unable to fill "independent" director seats on the board of an investment company. The expanded definition includes persons who are employed by entities that have bank-like relationships with the investment company, such as lending money to the investment company or executing portfolio transactions for the investment company.
- **Bank holding company personnel as directors.** Before enactment of the Act, a majority of an investment company's board of directors could not consist of officers, directors, or employees of a *bank*. The Act expands that prohibition to include officers, directors, or employees of a *bank holding company*.
- **Bank custodians.** Enhanced SEC authority over a bank serving as custodian for an affiliated registered management company or unit investment trust.
- **Affiliate lending.** Enhanced SEC authority over bank lending to an affiliated investment company.
- **Required disclosures.** Enhanced SEC authority to require disclosures that mutual funds advised by or sold through a bank are not federally insured.

APPENDIX C

FEDERAL AND STATE REGULATION OF INSURANCE ACTIVITIES OF BANKING ORGANIZATIONS

This appendix discusses the Act's extensive provisions relating to both federal and state regulation of insurance activities of banking organizations.

B. Federal Regulation of Insurance Activities

1. General Requirements

Within one year after enactment, the Act requires the federal banking agencies to promulgate jointly new federal consumer protection regulations that will apply to the advertising and sale of any insurance product (1) by any bank or other depository institution, (2) on the premises of any such institution, or (3) on behalf of any such institution. The federal banking agencies are also required to determine the extent to which these new regulations will apply to the insurance sales activities of subsidiaries of depository institutions.

The types of consumer protections to be imposed by these new regulations, which are not expected to be unduly burdensome, include disclosures and prohibitions on activities in which banks are already prohibited from engaging (such as tying and coercion). Attachment 1 is a list of the consumer protection provisions to be included in the regulations.

The consumer protection regulations do not limit the authority of federal securities regulators, including the SEC. In addition, the Act specifies that the federal banking agencies' consumer protection regulations are *not* preemptive of any inconsistent state insurance laws or regulations except to the extent that (a) the federal banking agencies jointly determine that the protection afforded for customers by the federal consumer protection regulations is "greater" than the protection afforded by a state's laws or regulations, and (b) the state, after receipt of notice from the federal banking agencies, does not adopt legislation to override the preemptive effect of the federal regulations within three years from the date of the notice.

2. Federal Judicial Review of Federal-State Insurance Disputes

The Act prescribes a new set of procedures and a new standard of judicial review for disputes between a federal regulators and a state insurance regulator with respect to "insurance issues," including whether state insurance regulations are preempted by federal law. Specifically, the Act provides for direct review of such insurance disputes in the United States Courts of Appeals on an expedited basis. The Court of Appeals is directed to decide the matter based on its review of "the merits of all questions presented under State and Federal Law, . . . *without unequal deference.*" This statutorily prescribed standard of judicial review is intended

to preclude the application in such cases of the *Chevron* rule of substantial judicial deference to an expert federal agency's interpretation of a federal statute for which the agency has primary responsibility (*e.g.*, the OCC's interpretation of the National Bank Act).

These new procedures and this new standard of judicial review are *not* applicable to disputes over matters other than "insurance issues." Nor are they applicable in context of *private* challenges to rulings of the OCC or other federal regulators or to private disputes with state insurance regulators that relate to "insurance issues."

C. State Regulation of Insurance Activities

1. State Insurance Licensing and Regulation

The Act expressly provides that any person engaged in the business of insurance in a state as either principal or agent must comply with the state's licensure requirements. The Act likewise prescribes that the insurance activities of any person shall be "functionally regulated" by the states.[25]

These provisions are generally intended to make clear that all entities and individuals, including banks, bank affiliates, and their personnel, are subject to state insurance licensing and regulation with respect to any insurance sales or underwriting activities in which they are engaged in a state.[26] At the same time, however, these provisions are expressly subject to the federal limitations on state regulation of bank and bank affiliate insurance activities that are described below. Importantly, these federal limitations include both overrides of state anti-affiliation laws and prohibitions on discriminatory state regulation.

2. Federal Limitations on State Regulation of Insurance *Affiliations*

The Act expressly provides that no state may "prevent or restrict" a bank or other depository institution from being affiliated with any other entity or person engaged in insurance activities as authorized by the Act or any other provision of federal law. Thus, for example, a state may not bar an FHC from owning both an insurance underwriter and a bank in accordance with the authority granted by the Act.

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[25] The Act also includes a new federally sponsored regime designed to achieve uniformity in state licensure and education requirements for entities and individuals engaged in insurance sales activities.

[26] Indeed, the Act's "functional regulation" provision includes an express reference to national banks' insurance sales authority under Section 92 of the National Bank Act, leaving no doubt as to Congress' intent to subject national banks as well as other depository institutions to functional state regulation of their insurance sales activities.

The Act's prohibition on state restrictions on insurance affiliations is, however, subject to certain limitations. For example, the Act makes clear that the prohibition does not prevent an insurer's state of domicile from exercising approval authority under applicable state law over a proposed acquisition of the insurer by an FHC, so long as the state acts within 60 days and its action does not have the effect of discriminating against a depository institution or its affiliate. Likewise, other states in which the insurer operates are permitted to request and collect information on the proposed acquisition so long as they also act within 60 days and are not discriminatory in their actions. And the insurer's state of domicile may require the acquiror to maintain or restore the insurer's capital in accordance with generally applicable state standards, while *any* state may, on a non-discriminatory basis, restrict changes in the ownership of insurers that have converted from mutual to stock form.[27]

3. Federal Limitations on State Regulation of Insurance *Sales*

The Act includes a complex set of provisions relating to state regulation of insurance sales activities by banking organizations. As described below, these provisions do essentially three things: (a) generally codify the existing standard for federal preemption of state laws regulating the insurance sales activities of national banks, *and extend that standard to the insurance sales activities of other types of depository institutions and affiliates of depository institution;* (b) establish "safe harbors" from federal preemption for certain specified forms of state insurance sales regulation; and (c) prescribe additional federal rules affecting state insurance regulation that differ depending on whether such state regulation was adopted prior to or on or after September 3, 1998.

a. General Standard of Federal Preemption

The Act generally prescribes that no state, by statute, regulation, or other form of action, may "prevent or significantly interfere with" the ability of any depository institution, or any affiliate thereof (including subsidiaries of national banks), to engage in any insurance sales, solicitation or cross-marketing activity. The Act makes clear that it thus intends to incorporate the preemption standard set forth in the Supreme Court's landmark *Barnett* decision. Indeed, the Act further provides that nothing in its provisions relating to state insurance regulation is to be construed "to limit the applicability of" the *Barnett* decision, except in the case of the specific state "safe harbors" described below.

The *Barnett* decision itself dealt only with preemption of state regulation restricting national bank insurance sales activities. The Act now extends the reach of that preemptive standard to provide federal protection for the insurance sales activities of (1) non-federal (*i.e.*, state-chartered) depository institutions; (2) subsidiaries of depository institutions; and (3) affiliates of

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[27] The Act includes a separate provision specifically restricting state authority to interfere with the ability of an insurer, or its affiliate, to become an FHC or acquire a depository institution, or generally to limit the amount an insurer may invest directly or indirectly in a depository institution.

depository institutions. *This extension is an extremely important expansion of federal preemption in relation to state regulation of the insurance sales activities of banks and their affiliates.*

b. State "Safe Harbors"

While generally expanding the reach of the *Barnett* preemption standard, the Act also provides states with certain specified "safe harbors" for state insurance sales regulations. Any state insurance sales regulation that falls within one of these "safe harbors" (including any state regulation that is "substantially the same as but no more burdensome or restrictive") is exempt from preemption under the Act's provisions. Attachment 2 is a list of these safe harbors.

c. Additional Federal Rules Regarding State Regulation

The Act also prescribes certain *additional* federal rules relating to state insurance sales regulation that differ depending on whether the relevant state law or regulation was adopted prior to September 3, 1998, or on or after that date.

First, the Act provides that, where state regulation of insurance sales activity was *adopted prior to September 3, 1998* (and the state regulation also does not fall within one of the "safe harbors" for state insurance sales regulation described above[28]), such state regulation is not subject to judicial review under the special "*without unequal deference*" standard that the Act generally prescribes for "insurance issue" disputes between federal regulators and state insurance regulators. As a result, in the case of state insurance regulation adopted prior to September 3, 1998, even disputes between federal and state regulators will be subject to judicial review under the *Chevron* standard of substantial judicial deference to the expert federal agency (so long as the state regulation is not within one of the "safe harbors").

Second, the Act prescribes a new set of federal standards that state regulation of insurance sales activities (that is not within one of the "safe harbors") must satisfy *in addition* to the general *Barnett* preemption standard codified in the Act. These new federal insurance standards apply, however, only to state insurance sales regulations *adopted on or after September 3, 1998.* The new federal standards ("the New Federal Insurance Standards") preempt any form of state regulation of insurance sales activities that are federally authorized for depository institutions or their affiliates to the extent that the state regulation does one or more of the following:

- Distinguishes adversely by its terms between depository institutions or their affiliates and other entities or persons engaged in insurance activities.

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[28] If the state regulation falls within one of the Act's "safe harbors," such regulation is protected from federal preemption and is not intended to be subject to significant judicial challenge.

- Affects depository institutions or their affiliates in a manner that is "substantially more adverse" than its effect on other entities or persons engaged in insurance activities.
- Effectively prevents a depository institution or its affiliate from engaging in federally authorized insurance activities.
- Conflicts with the Act's intent to permit the affiliation of depository institutions and entities or persons engaged in insurance activities.

d. Federal Limitations on State Regulation of Insurance *Underwriting*

Finally the Act imposes federal limitations on state regulation of the insurance underwriting activities of depository institutions and affiliates that are authorized by the Act. But the Act's limitations on such state underwriting regulation are much narrower than the limitations that the Act imposes with respect to state regulation of insurance sales activities. Indeed, under the Act, state insurance underwriting regulation is preempted *only* to the extent that such regulation violates one or more of the New Federal Insurance Standards discussed immediately above.[29]

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[29] The Act's savings provisions for state laws and regulations generally relating to securities regulation, corporate governance, and state antitrust enforcement are also applicable in the insurance underwriting context. See note to Attachment 2.

APPENDIX C—ATTACHMENT 1

FEDERAL CONSUMER PROTECTION REGULATIONS FOR BANK INSURANCE SALES

The federal consumer protection regulations for bank insurance sales issued by the federal banking agencies will include the following:

- **Anti-tying.** Prohibitions on tying and coercion, with respect to the sale of insurance in connection with extensions of credit, that would violate the anti-tying provisions of the Bank Holding Company Act Amendments of 1970.
- **Disclosures.** Required disclosures that insurance products are not FDIC insured, involve investment risk in the case of variable products, and need not be purchased from a bank in order to obtain an extension of credit.
- **Customer acknowledgment.** Required consumer acknowledgement of receipt of the disclosures.
- **Prohibition on misrepresentations.** Prohibitions on any misrepresentation that could mislead consumers with regard to the fact that insurance products are not FDIC insured, that variable products involve investment risk, or that approval of an extension of credit may not be conditioned on purchase of insurance from the bank making such extension.
- **Physical separation.** Required physical separation of deposit-acceptance activities from insurance sales activities "to the extent practicable."
- **Referral fees.** Standards permitting tellers and others who accept deposits to refer customers to insurance sales personnel only if the teller or other employee receives for the referral no more than a "one-time nominal fee" of a fixed dollar amount that does not depend on whether the referral results in a sale.

APPENDIX C—ATTACHMENT 2

"SAFE HARBORS": STATE INSURANCE SALES REGULATION OF BANKS AND AFFILIATES THAT WILL BE SHIELDED FROM FEDERAL PREEMPTION

1. **Anti-competitive denial of insurance.** A prohibition on a depository institution or any affiliate rejecting an insurance policy required in connection with a loan solely because the issurer of the policy is not affiliated with the depository institution or an affiliate.
2. **Separate handling charges.** A prohibition on a depository institution or any affiliate requiring a debtor, insurer, insurance agent or broker to pay a separate handling charge for insurance required in connection with a loan or another traditional banking product unless such charge would also be required if the depository institution or affiliate were providing the insurance.
3. **Misrepresentation.** A prohibition on the use by a depository institution or affiliate of misleading advertising that would cause a person to believe that the federal government or a state government guarantees, or is a source of payment on, any insurance product sold by the institution or affiliate.
4. **Licensing.** A prohibition on the payment or receipt of commissions or brokerage fees (or other valuable consideration) for services as an insurance agent or broker unless the recipient is validly licensed under applicable state law (except that services as an insurance agent do not include merely making customer referrals to a licensed insurance agent or broker).
5. **Unlicensed referral fees.** A prohibition on any unlicensed individual being paid or receiving any compensation for the referral of an insurance customer based on the purchase of insurance by the customer.
6. **Disclosure of customer information.** A prohibition on the release of a customer's insurance information (including information regarding the premiums, terms, or conditions of the customer's coverage) to any person other than a director, officer, employee, agent, or affiliate of a depository institution, for the purpose of selling insurance, without the customer's express consent (except that such a prohibition may not bar transfers to unaffiliated insurers in connection with transfers of insurance in force, transfers in mergers or acquisitions, and transfers otherwise authorized by state or federal law).
7. **Disclosure of health information.** A prohibition on the use of health information obtained from a customer's insurance records (other than for activities as a licensed agent or broker) without the customer's express consent.
8. **Anti-tying.** A prohibition on conditioning an extension of credit, the lease or sale of property, or the furnishing of services (or fixing or varying the consideration for any of the foregoing) on a customer obtaining insurance from a depository institution or its affiliate or from a particular insurer, agent or broker (except that such a prohibition may not prevent a depository institution or its affiliate from engaging in any activity that would not violate the anti-tying provisions of the Bank Holding Company Act Amendments of 1970 or from advising a customer either that insurance is required in order to obtain an extension of credit or that insurance is available from the depository institution or an affiliate).

9. **Anti-tying disclosure.** A requirement that when a depository institution or an affiliate offers insurance (including required insurance) to a customer who is applying for an extension of credit from the depository institution or an affiliate, the customer be provided a written notice advising that the credit decision and the credit terms will not be affected by the customer's choice of insurance provider (except that the depository institution may impose reasonable requirements regarding the insurer's creditworthiness and the scope of insurance coverage).
10. **Disclosures on deposit insurance.** A requirement that prior to the sale of insurance by a depository institution or its affiliate, the customer be given, "in writing, where practicable," a clear disclosure indicating that the insurance policy is not a deposit; is not FDIC insured; is not guaranteed by the depository institution or any affiliate; and, where appropriate, involves investment risk.
11. **Separation of documents for credit and insurance.** Requirements that when a customer obtains both insurance (other than credit insurance or flood insurance) and credit from a depository institution or any affiliate (or any person selling insurance on their premises), the credit and insurance transactions be completed through separate documents.
12. **Separation of credit from insurance premiums.** Requirements that when a customer obtains both insurance (other than credit insurance or flood insurance) and credit from a depository institution or any affiliate (or any person selling insurance on their premises), the insurance premiums not be included in the credit transaction without the customer's express written consent.
13. **Separate books and records.** A requirement that depository institutions and their affiliates maintain separate books and records with respect to insurance transactions and that such books and records be made available to appropriate state insurance regulators for inspection upon reasonable notice.[30]

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[30] In addition to these "safe harbors" for state insurance sales regulation, the Act includes separate savings provisions to protect from federal preemption under the codified and expanded *Barnett* standard state laws and regulations that relate generally to state securities regulation, corporate governance, and state antitrust enforcement. The savings provisions for state laws and regulations relating to corporate governance and state antitrust enforcement are subject to the limitation that such state laws and regulations may not be inconsistent with the Act's purpose to authorize affiliations covered by the Act and to remove barriers to such affiliations.

APPENDIX D

DETAILED SUMMARY OF PRIVACY PROVISIONS

This appendix describes in more detail the Act's requirements regarding (A) the disclosure of nonpublic personal information of financial institution consumers; and (B) the prohibition on fraudulent access to such information.

A. Disclosure of Nonpublic Personal Information

As described below, a financial institution is subject to four new requirements regarding the nonpublic personal information of a consumer. For these purposes, a "consumer" means an individual who obtains financial products or services from a financial institution primarily for personal, family, or household purposes; it does not include any corporate entity or any individual or corporate business customer. "Nonpublic personal information" generally means personally identifiable financial information obtained by any means, other than publicly available information.

1. Annual Disclosure of Privacy Policy

The Act's first privacy obligation for financial institutions is the requirement to establish and disclose a privacy policy.

General requirement. A financial institution must clearly and conspicuously disclose to each of its consumers its policies and practices for the protection and disclosure of nonpublic personal information.

Contents of disclosure.[31] Among other things, the disclosure must include the categories of information that are collected and the financial institution's policy and practices regarding—

- Disclosure of nonpublic personal information to ***both*** nonaffiliated third parties ***and affiliates.***
- Disclosure of nonpublic personal information of persons who are no longer customers.
- Protection of the confidentiality and security of nonpublic personal information.

Timing and form of disclosure. The disclosure must be made at the beginning of a financial institution's relationship with the consumer, and at least once each year thereafter as long as the relationship with the consumer continues. The disclosure must be in writing, electronic form, or other form prescribed by implementing regulations.

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[31] The Act's provisions regarding the contents of the disclosure are both redundant and confusing. This confusion will likely be resolved by the implementing regulations.

2. Customer "Opt-Out" of Disclosures to Third Parties

The Act's second basic privacy obligation for financial institutions is the requirement that a consumer be afforded the right to prevent the disclosure of nonpublic personal information to a nonaffiliated third party—commonly referred to as the right to "opt out."

General requirement. A financial institution may not disclose nonpublic personal information to a "nonaffiliated third party" unless—

- The financial institution clearly and conspicuously discloses to the consumer that such information may be disclosed to the third party;
- The consumer is given the opportunity to direct that the information not be disclosed to the third party (the right to "opt out"); and
- The consumer is given an explanation of how to exercise the opt-out.

The financial institution does *not* have to provide the right to opt out when the information is provided to an *affiliate,* as opposed to a nonaffiliated third party. In addition, "nonaffiliated third party" is defined as an entity that is not under common control with the financial institution; a "joint employee" is not a nonaffiliated third party. As a result, the opt-out need not be provided if the financial institution provides the information to its employee who happens also to be an employee of a nonaffiliated third party.

Timing and form of disclosure. The consumer must be given the right to opt out *before* nonpublic personal information is initially disclosed to a nonaffiliated third party. And as with the privacy policy disclosure, the opt-out disclosure must be in writing, electronic form, or other form prescribed by implementing regulations.

Limits on re-disclosure of information. A nonaffiliated third party that receives nonpublic personal information from a financial institution may not re-disclose that information to any other nonaffiliated third party, unless it would have been lawful for the financial institution to make that disclosure in the first instance. The Federal Trade Commission ("FTC") is provided the authority to enforce the privacy restrictions in the Act that apply to non-financial institutions, which includes the re-disclosure restrictions that apply to a nonaffiliated third party that is not a financial institution.

Exceptions. There are many important exceptions to the opt-out requirement, the most significant of which are listed in Attachment 1 attached to this Appendix. For example, the opt-out does not apply where a financial institution discloses information to a nonaffiliated third party to market the financial institution's own products. The opt-out also does not apply where the disclosure is made to market financial products or services offered pursuant to joint agreements between two or more financial institutions. Community banks, in particular, should be able to take advantage of this "joint agreement" exception when partnering with other financial companies to sell securities or insurance.

Other exceptions to the opt-out requirement are intended to address situations, among others, where: it would not be practical to provide the opt-out (*e.g.,* where the sharing is done to produce a consolidated customer statement from affiliated companies); an opt-out would not be expected by the consumer (*e.g.,* where the sharing is necessary to complete a transaction or service the customer's account); or the information sharing would serve an equally important public policy as protecting the customer's privacy (*e.g.,* to comply with a regulatory investigation). As a group, these exceptions address fundamental concerns that had been raised by the financial services industry concerning the practical problems associated with an opt-out.

3. Prohibition on Disclosure of Account Information

The Act's third privacy requirement for financial institutions is a prohibition: A financial institution may not disclose an account number "or similar form of access number or access code" for a credit card account, deposit account, or transaction account of a consumer to any nonaffiliated party for use in telemarketing, direct mail marketing, or other marketing through electronic mail to the consumer. There is only one statutory exception to the prohibition, which applies to disclosures to a credit bureau. However, additional exceptions may be established by regulation.[32]

This prohibition does not apply to disclosures to an affiliate. As a result, the Act does not prevent the use of an account number either in a financial institution's own marketing, or in the marketing of the financial institution's products by an affiliate.

4. Regulatory Standards to Protect Security and Confidentiality

The Act's fourth privacy requirement for financial institutions derives from a vague provision that "it is the policy of the Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information." Although this provision is worded quite broadly, its actual effect is unclear because it is stated merely as a "policy of the Congress" and appears not to impose any specific restrictions.

A related provision does, however, require each financial institution regulator, "in furtherance of the policy," to establish appropriate "standards" relating to safeguards to (1) ensure the security and confidentiality of customer records; (2) protect against any anticipated threats to the security of such records; and (3) to protect against unauthorized access to such records that could result in substantial harm or inconvenience to the customer. These proposed standards seem directed toward the physical security and integrity of customer records, which appears to be considerably narrower than the subject matter of the "Congressional policy" that it purports to implement. Moreover, the use of the term "standards," rather than "rules or regulations," suggests that the regulatory agencies are to provide generalized guidance rather than detailed regulatory prescriptions.

5. Rulemaking and Enforcement

The Act requires the federal banking agencies, the National Credit Union Administration, the SEC, the Treasury Department, and the FTC *each* to prescribe regulations to implement the new privacy obligations for the institutions or persons under their respective jurisdictions. (As noted previously, the FTC will have jurisdiction over any institution or person that is subject to the privacy provisions but is not otherwise regulated as a "financial institution.") While these agencies are supposed to consult with one another to assure as much similarity in the regulations as possible, they may in fact issue quite different versions of such regulations—which would mean that quite different privacy rules could apply to different subsidiaries (*e.g.*, bank, insurance, and securities subsidiaries) owned by a single FHC. The agencies listed above, along with state insurance regulators, are to enforce the statute and implementing regulations.

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[32] The Act's legislative history indicates that, in granting regulatory exceptions, the regulators may consider it consistent with the purposes of the privacy provisions to permit the disclosure of customer account numbers in an encrypted form where the disclosure is expressly authorized by the customer and is necessary to service a transaction expressly authorized by the customer.

6. FCRA Rulemaking Authority

The Act eliminates the prohibition on the FTC and the federal banking agencies from issuing regulations under the FCRA, and in fact directs the federal banking agencies to jointly prescribe "such regulations as are necessary to carry out the purposes of the [FCRA]" (with the Federal Reserve prescribing regulations for bank holding companies). The Act also removes restrictions on the federal banking agencies' conducting examinations regarding FCRA compliance. Finally, the Act states that, with the exception of the provisions just mentioned, none of its new privacy provisions is intended to change the manner in which the FCRA applies to financial institutions. This means that FCRA requirements that had applied before the enactment of the Act, such as the disclosures required when a consumer's credit application information is shared with an affiliate, will continue to apply as before.

7. Relation Between Federal and State Laws

The Act generally provides that the new federal privacy provisions will preempt only those state laws that are inconsistent with the federal laws. The exception is that such preemption will not apply if the state law provides *greater* privacy protection than the federal law, as determined by the FTC.

B. Fraudulent Access to Financial Information

The final privacy provision in the Act applies not to financial institutions, but to any person who fraudulently obtains or causes the disclosure of customer information from a financial institution by fraudulent or deceptive means. The Act makes such fraudulent access a federal crime, punishable by up to five years' imprisonment. The Act also provides the FTC and financial regulatory agencies with administrative enforcement power. This provision in the Act is aimed squarely at the abusive practice of "pretext calling," in which someone misrepresents the identity of the person requesting the information or otherwise misleads an institution or customer into making an unwitting disclosure of customer information. Although the prohibition applies directly to the conduct of the persons who seek fraudulent access, the Act directs the financial regulatory agencies to revise existing regulations and guidelines to ensure that financial institutions under their jurisdiction have policies, procedures, and controls in place to prevent, deter, and detect fraudulent access to customer information.

APPENDIX D—ATTACHMENT 1

DISCLOSURES NOT SUBJECT TO "OPT-OUT" REQUIREMENT

A financial institution may make the following types of disclosures of nonpublic personal information of a consumer to a nonaffiliated third party ***without*** providing the consumer the right to "opt out" of the disclosure:

- **Marketing certain financial products.** Disclosures to perform services on behalf of the financial institution, *including*—
  - ➢ Marketing of the financial institution's own products or services, and
  - ➢ Marketing of financial products or services offered pursuant to joint agreements between two or more financial institutions.

These exceptions apply only if the financial institution fully discloses to the consumer the providing of the information to the third party, and the third party agrees by contract to maintain the confidentiality of the information. *Community banks, in particular, should be able to take advantage of the "joint agreement" exception when partnering with other financial companies to sell securities or insurance.*

- **Necessary for transaction.** Disclosures that are "necessary to effect, administer, or enforce a transaction"—
  - ➢ In connection with servicing or processing a financial product or service requested or authorized by the consumer.
  - ➢ In connection with maintaining or servicing the customer's account with the financial institution, or with another entity as part of a private label credit card program or other extension of credit on behalf of such entity.
  - ➢ In connection with a proposed or actual securitization, secondary market sale (including sales of servicing rights), or similar transaction related to a transaction of the consumer.
  - ➢ Requested or authorized by the consumer.

For purposes of these exceptions, "necessary to effect, administer, or enforce" is defined broadly to include disclosures that are required or are the "usual, appropriate, or acceptable method" to—

- ➢ Carry out a transaction, record or service or maintain the consumer's account, or administer benefits or claims related to a consumer transaction;
- ➢ Provide the consumer with a confirmation or other record of a transaction or information on the value of a financial service or product;
- ➢ Accrue bonuses associated with a transaction;
- ➢ Enforce the rights of the financial institution in carrying out a financial transaction;
- ➢ Engage in a range of activities related to providing insurance or reinsurance; or
- ➢ Provide authorization, settlement, billing, processing, clearing, transferring, reconciling, or collection of amounts charged, debited, or otherwise paid using a check, debit or credit card, or other payment means.

- **Consent.** Disclosures made with the consent or at the direction of the consumer.
- **Customer protection.** Disclosures to protect the confidentiality or security of the customer's information.
- **Antifraud.** Disclosures to protect against fraud, unauthorized transactions, etc.
- **Dispute resolution.** Disclosures for "required institutional risk control," or for resolving customer disputes or inquiries.
- **Beneficial or fiduciary interests.** Disclosures to persons holding a legal or beneficial interest relating to the consumer, or to persons acting in a fiduciary or representative capacity on behalf of the consumer.
- **Rating agencies.** Disclosures to provide information to rating agencies, insurance rate advisory organizations, guaranty funds or agencies, and persons assessing compliance with industry standards.
- **Attorneys, accountants, and auditors.** Disclosures to any of these service providers.
- **Law enforcement.** Disclosures to law enforcement agencies, other agencies, or self-regulatory organizations if specifically permitted or required under other provisions of law.
- **Public safety investigation.** Disclosure for an investigation involving public safety.
- **Credit bureaus.** Disclosures to a consumer reporting agency in accordance with the FCRA, or from a consumer report reported by a consumer reporting agency.
- **Sale or merger.** Disclosures made in connection with a proposed or actual sale or merger of all or a portion of a business, if the disclosure of the nonpublic personal information concerns solely consumers of such business or unit.
- **Legal requirements, judicial process, or regulatory compliance.** Disclosures to comply with federal, state, or local law; comply with regulatory investigations; respond to judicial process; or comply with examination or related requirements.
- **Regulatory exceptions.** In addition to these statutory exceptions, additional exceptions may be provided by regulation to permit other types of disclosures without the opt-out.

Explanation of New Financial Subsidiary Powers

Below each provision is a very brief explanation, including whether a state chartered bank can already engage in the activity, either directly or through a subsidiary structure.

New Section _____. Activities of a financial subsidiary. A financial subsidiary formed pursuant to K.S.A. 9-1101 (29) may engage in the following activities:

(a) Lending, exchanging, transferring, investing for others, or safeguarding money or securities;
(State banks can do this now, either in the bank or the bank's trust department.)

(b) Acting as agent or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, death, or providing annuities as agent or broker, subject to the requirements of Chapter 40 of the Kansas statutes and the authority of the insurance commissioner;
(State banks can do this now pursuant to Special Order 1990-2. However, there is a geographic restriction of towns of 5,000 or less. Subsection (b) would authorize a state bank to sell insurance from any location through a financial subsidiary.)

(c) Providing financial, investment, or economic advisory services, including advising an investment company as defined in section 3 of the Investment Company Act, 15 U.S.C. § 80a-3;
(State banks can provide investment advice through a wholly-owned subsidiary formed pursuant to K.S.A. 9-1101 (21). In addition, state banks can provide financial advice/planning services through a bank service corporation formed pursuant to K.S.A. 9-1123 et seq. However, both of these other types of subsidiaries require the bank or a group of banks, in the case of a bank service corporation, to have full ownership of the subsidiary. The financial subsidiary concept allows non-bank owners, so long as a bank "controls" the financial subsidiary.)

(d) Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;
(This provision would allow a state bank to bundle its mortgage loans, for example, and sell interests in the pool.)

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(e) Underwriting, dealing in, or making a market in securities;
(K.S.A. 9-1101 (21) authorizes a state bank to form a wholly-owned subsidiary which engages in the following securities activities:
selling or distributing stocks, bonds, debentures, notes mutual funds and other securities (b) issuing and underwriting municipal bonds; organizing and operating mutual funds; acting as a securities broker-dealer.
Subsection (e) is broader than the current state bank powers. It would allow a state bank to invest in a financial subsidiary that assumes the risk of buying a new issue of securities from the issuing corporation or governmental entity and reselling them to the public, either directly or through dealers. This is the concept of "investment banking" An investment banker is defined in Rosenberg's Dictionary of Banking as "the middleman between the corporation issuing new securities and the public. The usual practice is for one or more investment bankers to buy outright from a corporation a new issue of stocks or bonds. The group forms a syndicate to sell the securities to individuals and institutions. The investment banker is the underwriter of the issue.")

(f) Engaging in any activity that the Board of Governors of the Federal Reserve System has determined, by order or regulation in effect on November 12, 1999, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto, subject to the same terms and conditions contained in the order or regulation in effect on November 12, 1999.
(State banks can do this now by forming a bank service corporation pursuant to K.S.A. 9-1123 et seq. However, ownership of a bank service corporation is limited to bank owners. The financial subsidiary concept allows non-bank owners, so long as a bank "controls" the financial subsidiary.)

(g) Engaging in any other activities that are permissible for the bank to conduct directly.
(State banks can do this now pursuant to Special Order 1996-4. However, that Special Order requires 80% ownership by the bank. The financial subsidiary concept would only require "control")

It is important to note what the list of authorized activities for a financial subsidiary does not include:

*The general business of real estate development or real estate investment

*Underwriting insurance

*Merchant banking

Amend onto 2000 HB 2676 in the Senate FI&I Committee:

Add to K.S.A. 9-1101:

(29) with prior approval of the commissioner, to control a financial subsidiary or hold an interest in a financial subsidiary controlled by one or more depository institutions, that engages in any of the activities listed in new section __ of the Kansas Statutes. Provided, that the total investment in all financial subsidiaries by any bank shall not exceed 45% of the bank's total assets. As used in this paragraph, control means:

(A) directly or indirectly owning, controlling or having power to vote 25% or more of any class of the voting shares of a financial subsidiary;

(B) controlling in any manner the election of a majority of the directors or trustees of the financial subsidiary; or

(C) otherwise directly or indirectly exercising a controlling influence over the management or policies of the financial subsidiary, as determined by the commissioner.

Then create a new section in the Banking Code as follows:

New Section _____. Activities of a financial subsidiary. A financial subsidiary formed pursuant to K.S.A. 9-1101 (29) may engage in the following activities:

(a) Lending, exchanging, transferring, investing for others, or safeguarding money or securities;

(b) Acting as agent or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, death, or providing annuities as agent or broker;

(c) Providing financial, investment, or economic advisory services, including advising an investment company as defined in section 3 of the Investment Company Act, 15 U.S.C. § 80a-3;

(d) Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;

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(e) Underwriting, dealing in, or making a market in securities;

(f) Engaging in any activity that the Board of Governors of the Federal Reserve System has determined, by order or regulation in effect on November 12, 1999, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto, subject to the same terms and conditions contained in the order or regulation in effect on November 12, 1999.

(g) Engaging in any other activities that are permissible for the bank to conduct directly.

Community Bankers Association of Kansas

Directed By The Members We Serve

Senate Committee on Financial Institutions & Insurance

Regarding HB 2754

March 14, 2000
Kansas Legislature

Presented by
Steve Handke
Community Bankers Association of Kansas

Good morning. My name is Steve Handke and I serve as CEO of the Union State Bank of Everest. Everest is a small town of 300 people located in northeast Kansas. Our bank has served the area residents of Atchison and Brown counties since 1902. Today I'm representing the Community Bankers Association of Kansas as a member of our State Legislative Committee. The Community Bankers Association is a statewide association composed of approximately 150 member banks that believe in community-based banking.

Thank you Mr. Chairman for the opportunity to appear before your Committee. House Bill 2754 makes a technical change in K.S.A 9-1102 (a)(2), which governs the real estate Kansas banks are allowed to hold.

K.S.A. 9-1102 was enacted in 1947 and a predecessor law can be traced back to 1897. Since 1947, the statute remained intact until it was amended in 1975 to its present form.

The present language contained in (a)(2) was added in the Senate Committee, and further amended in conference committee near the end of the 1975 session. Because of banks' difficulties in complying with a rigidly defined holding period, the inflexibility of the law has caused some problems over the years. These problems have been accentuated in recent years with our industry's movement in Kansas toward branch banking with multiple locations.

The operational problem with 9-1102(a)(2) is the defined beginning point of the seven-year holding period that a bank has to dispose of unneeded real estate. This beginning point in the current statute is set out as the date of acquisition. This language makes it virtually impossible for a bank to orderly dispose of a property that has been used for banking purposes for a number of years. In my testimony today, I am using just a few examples of the many times and different situations this section of K.S.A. 9-1102 has caused assets to be unnecessarily charged off of financial records.

The St. Marys State Bank is a good example of the difficulty in complying with the current statute. The bank had operated a drive up branch facility on real estate it had owned for more than seven (7) years. When management decided to relocate the facility, there was an immediate violation triggered by its date of acquisition. The only alternative available under the current statute was a forced sale of the property or charging the asset off the bank's books. In this case the book value of the facilities was substantial and a charge off would cause a serious distortion of the bank's general ledger. It certainly is not consistent with GAAP accounting principal to charge off a valuable asset

(Over)

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The technical change offered in House Bill 2754 would have remedied this problem by allowing the bank management a period of 7 years from the date they decided to close the existing facility, or in essence the date the purpose of the facility changed.

Not only does the current statute cause compliance problems on sale of existing bank facilities, it also causes problems with state-chartered banks and their ability to purchase real estate for potential new locations. As Kansas banks more fully develop the branch-banking marketplace, they have a much different need in acquiring real estate for potential building sites than in 1975 when this statute was enacted. In 1975 one bank meant one location. This is vastly different that our branching interstate market place in Kansas today. A need for acquiring potential building sites is especially true in small communities, like Everest, where banks may only have the opportunity once every 10 years to purchase a choice site for an additional location.

Our bank encountered this type of difficulty with the statute when the board decided to expand the main facility. The bank had been land-locked on a corner location and shared a common wall with an adjoining building whose owner who was unwilling to sell at any reasonable price. Because of the unlikely possibility of ever purchasing the adjoining building, the bank had purchased a set of lots as a potential new building site. When the owner of the adjoining building decided to sell his building, the bank purchase it and expanded into the new building. This created a violation of the statute on the lots owned for a future building. As in the first example, this violation was triggered because the bank had owned the lots for more than seven (7) years. Again the proposed bill would have given the bank seven years <u>after</u> the change in intent to dispose of the lots, and not created the immediate violation.

The third and final industry example I would like to share is a situation that developed with the First Option Bank of Osawatomie. Gregg Lewis, President of the Bank recalled the problem as follows,

"The bank bought about 12-14 acres in 1992 and used approximately three (3) acres for a new bank building. There is a small creek and wooded area directly behind which runs east to west through the entire property. The bank tried selling the remaining 10.85 acres, but anyone that was interested kept running into snags when the city manager told them they would have to spend a fortune rerouting the water flow. One of the bank's competitors had done just that, about a quarter of a mile east of our location. It cost them over $250,000 in dirt work alone.

"First Option Bank eventually sold three acres of the best property to a group doing a retirement facility and (I) think the remaining property is pretty worthless with the city's requirements on drainage. At this point, the bank doesn't know what they can do with the property." *[end quote]*

This is an industry example of a bank not being able to buy the precise tract of real estate that it needed. As a result, it had to buy larger tract to obtain the desired location. The current statute makes it difficult to resolve such situations.

In conclusion, we ask you to report House Bill 2754 favorably. This small change will make the statute more operationally consistent with the current banking marketplace in Kansas.

Thank you for your time and consideration. Are there any questions?

Kansas Bankers Association

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3-14-00

TO: Senate Financial Institutions and Insurance Committee
FROM: Chuck Stones

RE: HB 2754

Mr. Chair and Members of the Committee:

The Kansas Bankers Association appreciates the opportunity to appear before you in support of HB 2754.

HB 2754 would give additional flexibility to banks in dealing with their "other real estate owned" category of assets. We feel that this added flexibility might help a bank caught in the bounds of the current law avoid taking an unnecessary loss.

We urge your support of HB 2754.

Senate Financial Institutions & Insurance
Date 3/14/00
Attachment
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