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February 16, 2001

By Hand and Via Electronic Mail

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Proposal and Interim Rule Regarding Activities of Financial Holding Companies, Docket Nos. R-1092, R-1094

Dear Ms. Johnson:

The Securities Industry Association ("SIA")[1] welcomes the opportunity to comment on the following proposal and interim rule of the Board of Governors of the Federal Reserve System ("Board"):

- Proposal to permit a greater amount of nonfinancial data processing activities and allow financial holding companies ("FHCs"), as an activity that is complementary to financial activity under the Gramm-Leach-Bliley Act ("GLB Act"), to invest in companies engaged in certain types of data storage, general data processing and data transmission services and electronic information portal services.

- Interim rule defining three categories of activities under section 4(k)(5) of the Bank Holding Company Act as financial in nature or incidental to a financial activity.

[1] The Securities Industry Association brings together the shared interests of more than 740 securities firms throughout North America to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates more than $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about SIA is available at our Internet web site, http://www.sia.com.)

SIA commends the Board for its efforts, evidenced by these and other recently released proposals, to attempt to broaden the range of activities that are permissible for FHCs. We support the effort to increase the number of permissible activities for FHCs but have concerns about the restrictiveness of this proposal. SIA believes that -- as more and more FHCs come into existence with affiliates engaged in securities, banking and insurance activities -- such institutions should be able to diversify their activities to the broadest extent possible to meet the needs of their customers and to compete effectively. To that end, the GLB Act clearly contemplates that the list of financial activities will expand to include new activities in order to keep pace with changes in the marketplace and technology. Consequently, Congress vested the Board with broad authority to add new activities to the list of approved financial activities.

While we support the Board's effort to allow FHCs to engage in a broader range of data processing, data storage, and other related activities, we think the proposal incorporates too many restrictions. This proposed rule, as well as other recent proposals of the Board, create a highly complex series of proscriptions for FHCs that are not within the spirit of the GLB Act to loosen the restrictions on FHCs to engage in a wide range of activities. Instead, this proposal establishes a rigid formula that must be rigorously followed in order to take advantage of these newly authorized activities.

Proposal to Allow a Greater Amount of Non-Financial Data Processing Activities, and to Allow Investments in Companies Engaged in Certain Types of Data Storage and other Related Activities

The proposal amends the Board's Regulation Y to permit all bank holding companies to conduct a greater amount of nonfinancial data processing in connection with processing financial data. The Board also proposes to allow FHCs, as an activity that is complementary to financial activities, to own companies engaged in certain types of data storage, Internet and portal hosting activities and advisory activities involving data processing if the business of those companies involves providing financial data processing or other financial products and services. Investment in these activities is limited to an aggregate of 5 percent of a FHCs Tier 1 capital. Lastly, the proposal seeks comment on whether financial holding companies should be permitted to make investments in companies engaged in developing new technologies related to the sale of financial products and services, companies that provide communication links for the delivery of financial products, and companies that engage in the electronic sale and delivery of products and services.

We support the Board's proposal to increase the amount of revenue that bank holding companies may derive from nonfinancial data processing from 30 to 49 percent of their revenues. However, we think that the 49 percent limitation need not apply to financial holding companies, and that broader nonfinancial data processing is authorized under the GLB Act. Because financial holding company activities need not be limited by the "closely related to banking" standard, but instead can be authorized by the broader "financial in nature" or "incidental" standard, we think the GLB Act authorizes FHCs to conduct nonfinancial data processing beyond the 49 percent threshold. Processing financial data is clearly a financial in nature activity, and processing nonfinancial data

should be determined to be activity that is incidental to a financial activity. Because of the tight link between processing financial and nonfinancial data, there is enough basis to find that processing nonfinancial data is an activity incidental to a financial activity. The Board has already acknowledged that processing nonfinancial data is in many cases "operationally and functionally indistinguishable from processing financial data." FHCs should not be subject to this limit because as the lines between financial and nonfinancial data become harder to distinguish this revenue limit will become more difficult and costly to monitor. Furthermore, rigid revenue limitations create business and pricing distortions in the data processing services provided by FHCs, while non-FHC providers for these services are not constrained by these inefficiencies. The only restriction that should be placed on FHCs with respect to processing nonfinancial data is that they be engaged to some extent in financial data processing.

If the Board is unwilling to approve providing nonfinancial data processing as an incidental activity, we suggest that 49 percent test be applied in a way that allows FHCs flexibility in meeting the revenue test. Fluctuations in revenues due to ups and downs in business cycles and the economy make it difficult to predict revenue streams with precision quarter to quarter. Thus, the revenue test should be applied in a manner that takes into account the unexpected turns in revenue streams and that does not disrupt normal business operations.

We also support the Board's proposal to allow financial holding companies, to own companies engaged in certain types of data storage, general data processing and data transmission services and electronic information portal services. However, we disagree with designation of all of these activities as "complementary" to related financial activities and the aggregate investment cap of 5 percent of Tier 1 capital that is being placed on these activities. Clearly, at a minimum, conducting data storage should be considered a financial in nature activity and not a complementary activity. Data storage, in which an institution acts as a custodian of files is almost identical in kind to the "safekeeping and custody" services that banks have traditionally provided. A financial institution would be performing the same function, and providing the same kinds of service by providing data storage as it does for providing safe deposit boxes. Therefore, data storage should be considered to be an activity that is financial in nature or incidental to a financial activity, and not subject to the 5 percent cap. The only restriction that should be placed on data storage is that the company acting as custodian provide services for financial data.

We also believe that data imaging and retrieval should be designated as financial in nature or, at a minimum, as incidental activities, and part of overall data storage or processing. As noted by the Board in footnote 3 of the Release, the GLB Act explicitly mandates that one of the factors the Board consider in determining whether an activity is financial in nature or incidental to a financial activity is whether the activity is necessary to offer customers technological means for the "document imaging of data." Document imaging is just another step in the process of document storage and retrieval. Providers of data processing services necessarily combine data storage and and retrieval as part of an integrated data processing service. Data is collected, stored, and retrieved from

storage for processing and returned to storage. Any artificial limitations on the provision of integrated front-to-back data processing solutions puts FHCs at a significant competitive disadvantage relative to other providers of these services.

We also think the restrictions on general data processing and data transmission services go too far. FHCs should be permitted to engage in a full range of data processing activities. Many data processing, storage and information retrieval activities are truly "hybrid" activities that inextricably intertwine pure financial activities with activities that are "incidental" and "complementary" thereto. As the Internet and electronic commerce become increasingly important parts of the financial marketplace and economy, FHCs should have the ability to engage in a full range of e-commerce and data processing activities. The proposal requires that companies engaged in these activities derive 20 percent of their total revenues from financial institutions or from processing financial data. The 20 percent requirement seems to be an arbitrary figure that is not a useful barometer of what is a commercial activity. By permitting institutions to conduct nonfinancial data processing, the Board has already recognized the close connection of these types of activities to a financial activity. Moreover, it will be very difficult for FHCs to determine with any certainty whether a company derives 20 percent of its revenue from providing data processing services to depository institutions or processing financial data or the sale of other financial products and services. The amount of a company's revenue from these defined activities could fluctuate from quarter to quarter and year to year, and could go above 20 percent unbeknownst to the financial institution. Compliance with the 20 percent requirement is further complicated because it is not entirely clear what would be considered to "financial products and services".

In addition, we think the provision of web and portal hosting services not be limited as complementary activities because such services are only a new technological alternative for the delivery of financial services and information.

We also have many concerns about the requirement that investments in the three categories of activities be limited to 5 percent to the FHCs Tier 1 capital. While we understand the Board's intent to limit the potential risk to the safety and soundness of a FHC, this 5 percent cap appears to be totally arbitrary, and raises many questions. Will this 5 percent cap apply to all activities that are heretofore defined as complementary, or will it just apply to three categories of activities enumerated in the present proposal? The ability of FHCs to take advantage of the complimentary activities would certainly be limited if all complementary activities -- those in this rule and all future authorized activities -- are limited to 5 percent of Tier 1. If this were the case, an FHC that had invested up to 5 percent of Tier 1 in any of these three activities, would not be able to invest in any new complimentary activities that are authorized. Moreover, the application of a capital test would be difficult where an FHC invests in a company that provides integrated services, such as financial and nonfinancial data processing, storing, imaging and retrieval, and some of these services have been determined to be financial in nature whereas others are complementary activities. We also have questions as to how the 5 percent limit will be monitored. For instance, how will investments be treated that start out under 5 percent, but grow to more than 5 percent through appreciation? For these

reasons, we think the 5 percent cap is arbitrary, and quite low if it is to apply to all complimentary activities.

We recommend that the Board not apply the 60-day prior notice requirement to each investment made under any of the complementary activities. The Board should consider a one-time notice by FHCs for similar types of investments or a shorter notification period per investment.

The Board is also requesting comment on whether it should permit FHCs to make noncontrolling investments in companies engaged in developing new technologies, providing communications links or selling products electronically. Under its proposal, the Board would permit FHCs to invest in up to 25 percent of the voting stock of companies engaged in these activities and engage in cross-marketing activities with these companies. The only restrictions would be that the FHC does not exercise control and that another group own more shares of the company than the FHC. We fully support allowing FHCs to make such investments. However, we recommend that any calculation of voting shares for purposes of determining control appropriately account for the options and warrants that typically make up the capital structure of these companies. SIA believes that these kinds of investments are essential to permitting FHCs to advance with changes in technology and the marketplace, and to compete with other sectors that will be venturing into financial services.

We also recommend that the Board consider as financial, incidental or, at a minimum, complementary activities certain new technologies that are used by financial institutions internally or as mechanisms to deliver financial services or information to customers. Some of the technologies needed by financial institutions are not available in the market and may be developed by the financial institutions themselves, sometimes in partnership with a technology company. Institutions may find it cost effective or necessary from a competitive perspective to offer their customers access to, or use of, these technologies along with the financial services or information provided.

Interim Rule to Define Activities under section 4(k)(5) of the Bank Holding Company Act

The interim rule issued by the Board and Department of the Treasury finds three categories of activities defined by the GLB Act (and listed in section 4(k)(5) of the Bank Holding Company Act and section 5136A(b)(3) of the Revised Statutes) to be financial in nature, and creates a procedure by which requests may be made to define particular activities within one of the three categories. The three activities are: i.) lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities; ii.) providing any device or other instrumentality for transferring money or other financial assets; and iii.) arranging, effecting or facilitating financial transactions for the account of third parties.

The agencies have solicited comment regarding what particular activities should be defined to be within the three categories, and what other types of assets should also be considered financial assets.

We suggest deeming transactions in the overlying commodity or asset of derivative transactions as financial transactions. This would allow financial institutions for derivative transactions that settle other than in cash to be involved in the settlement of the overlying commodity or asset. Allowing financial institutions to be involved in the settlement of these transactions would create greater efficiencies, lower costs and expedite settlement time.

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SIA believes that the GLB Act's provision for the activities of FHCs to advance with changes in technology and the marketplace is essential to the future of the financial services industry. The ability to adapt and innovate will determine which financial institutions are competitors in the increasingly global economy. Expanding the list of permissible activities also will accord with the intent of Congress to ensure a vigorous financial industry and will allow financial institutions to diversify their customer offerings and become the financial supermarkets envisioned by the GLB Act. All of this will benefit consumers by providing them with more choices at lower costs.

If we can provide any further information, please contact Alan E. Sorcher at (202) 296-9410.

Sincerely,

James E. Reilly
Chair
Holding Company Committee