

**Securities Industry Association**

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William W. Wiles
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: : Comments on the Releases Entitled: (1) "Review of Restrictions on Director and Employee Interlocks, Cross-Marketing Activities and the Purchase and Sale of Financial Assets" (Docket No. R-0701); and (2) "Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities" (Docket No. R-0932)

Dear Mr. Wiles:

I. INTRODUCTION AND PURPOSE

The Securities Industry Association ("SIA") ¹ appreciates this opportunity to comment on the recent proposals contained in the two releases by the Board of Governors of the Federal Reserve System (the "Board") entitled: (1) "Review of Restrictions on Director and Employee Interlocks, Cross-Marketing Activities and the Purchase and Sale of Financial Assets" (the "Firewalls Release"); and (2) "Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities" (the "Revenue Calculation Release"). SIA respectfully submits that the Board should consider these proposals -- along with the proposal to raise from 10% to 25% the revenue limit applicable to bank-ineligible activities of subsidiaries of bank holding companies engaged in underwriting and dealing in securities ² -- in the context of achieving a comprehensive restructuring and modernization of the United States financial services industry.

SIA believes that several of the Board's proposals, in the absence of such comprehensive restructuring, could provide bank holding companies, and their affiliated securities firms, with substantial competitive advantages over other securities firms, and over other financial services firms affiliated with securities firms

(such as holding companies that own a limited purpose bank and a securities firm). As a result, the adoption of these proposals could have the unintended consequence of preventing or significantly delaying the enactment of legislation or the adoption of rules that would comprehensively restructure the financial services industry, by interfering with the ability of Congress or the Board to reach the consensus within the financial community necessary to enact such legislation or adopt such rules. Accordingly, SIA respectfully requests that the Board defer taking any action on certain of its proposals until either Congress or the Board is able to address the fundamental competitive issues presented by the Glass-Steagall Act on a comprehensive basis.

II. CONTEXT: THE NEED FOR COMPREHENSIVE FINANCIAL SERVICES MODERNIZATION LEGISLATION OR RULEMAKING

SIA believes that comprehensive reform and modernization of the financial services industry by Congress is the only means by which banks and securities firms (as well as insurance companies and other financial services providers) will be able to compete and affiliate on a fair and rational basis. As the Board is aware, the potential advantages of permitting such competition and affiliations, with appropriate firewalls and other safeguards, include greater diversification for and financial strength of financial institutions, greater opportunities for product development, greater competition in the United States financial services market, and increased international competitiveness for United States financial services firms. The ultimate beneficiary of these advantages would be the financial services consumer, who would have available more and better products and services at a lower cost.

As the Board also is aware, several financial services modernization legislative proposals recently have been advanced. During this term, Congressman Leach proposed such legislation, which advanced quite far in the legislative process. Many members of the financial services community supported that legislation in varying degrees. SIA supported many aspects of the legislation, and actively worked with Congressman Leach and others to address SIA's remaining concerns with the legislation by proposing modifications intended to assure a level playing field, functional regulation and a full "two-way" street. In addition, Senator D'Amato and Congressman Baker previously had developed and introduced an alternative legislative approach to financial services modernization, which was re-introduced this term in both the Senate and the House (although little other action was taken on that legislation during this term).

This term's legislative efforts were distinguished from prior attempts to comprehensively modernize the financial services industry by the wide-spread industry participation and support in the legislative process. For example, in a precedent-setting effort, a number of financial trade groups that historically have been Glass-Steagall adversaries successfully worked as a group to develop comprehensive financial services modernization legislation. Specifically, the Alliance for Financial

Services Modernization -- an industry group consisting of the American Bankers Association (the "ABA"), ABA Securities Association, American Financial Services Association, America's Community Bankers, Bankers Roundtable, Consumer Bankers Association, Financial Services Council, Investment Company Institute and SIA -- developed a proposal for comprehensive financial services modernization legislation, the broad terms of which generally were supported by the Alliance members.

In contrast to comprehensive financial services modernization, piecemeal increases by bank regulators in the securities powers of banks and bank holding companies -- such as eliminating firewalls -- are not long-term solutions to the complicated competitive issues caused by the now-antiquated statutes regulating the financial services industry. Rather, as the recent efforts to craft broadly acceptable financial services modernization legislation demonstrates, such modernization involves weighing legitimate and competing interests of many members of the financial services community, not just the interests of banks and bank holding companies. Eliminating certain firewalls between banks and their securities affiliates could provide such securities affiliates with a competitive advantage over other securities firms, such as the ability to cross-market products with affiliated banks, and in effect to receive inexpensive credit or other financing from affiliated banks. However, no corresponding benefit would be provided to competing securities firms that are not affiliated with banks.

SIA is greatly concerned that piecemeal increases in the securities powers of banks and bank holding companies, whether by the Board or other Federal banking regulators, could have the unintended consequence of significantly reducing the chances for comprehensive financial services modernization. As the Board is aware, to date the difficulty Congress has faced in enacting such legislation has been that certain institutions prefer the competitive advantages under existing rules while keeping other institutions constrained. Any part of the financial services industry that achieves major regulatory advantages over other industry participants also will correspondingly be disinclined to support comprehensive legislative reform. While regulatory advantages may serve short-term competitive interests, they will have a deleterious impact on the long-term competitiveness of the United States financial services industry as a whole, including on banks and bank holding companies. Such regulatory advantages could, in turn, significantly disadvantage the U.S. consumer, who will not receive the benefits that comprehensive financial services modernization would bring.

SIA also believes that the Board should not view its mandate, as do some Federal regulators, as advancing the interests of one narrow set of members of the financial services community. Rather, because of its unique regulatory roles, the Board should view the impact of its actions in light of the effects those actions would have on the financial services industry, and on the American economy, as a whole. As a matter of policy and fairness, the Board should not view its mandate to regulate bank holding companies as a mandate to put their specific (even if legitimate) interests ahead of the interests of the rest of the financial services community.

Further, there is no compelling need for the Board at this time to take piecemeal actions (such as eliminating firewalls) that could jeopardize comprehensive financial services modernization, or provide a competitive advantage to only one segment of the financial services community. As the Board is aware, banks and bank holding companies already have a significant ability to engage in securities and insurance activities -- even though securities firms and insurance companies cannot engage in commercial banking activities. As a result, banks and bank holding companies already can and do obtain significant revenues from these securities and insurance activities (as well as from their bank-eligible securities underwriting and dealing activities, and their offshore underwriting and dealing activities). Thus, the historic argument that banks and bank holding companies should be permitted to engage in greater securities activities to provide greater financial diversification simply is not compelling. And, most significantly, it appears that the Board's proposals largely are intended to advantage bank holding companies and their securities affiliates, rather than the ultimate consumers of financial services and financial products. SIA believes that the Board's proposals would not advantage consumers. By providing competitive advantages to bank holding companies and their affiliates that are not available to other securities and financial services firms, the Board's actions actually could have the effect of decreasing competition -- particularly in smaller markets served principally by regional firms.

SIA is aware that securities affiliates of banks currently are constrained in the revenues they may receive from underwriting and dealing in bank-ineligible securities. This too, presents significant competitive issues. However, the appropriate method for addressing this and other competitive disparities is not for the Board to unilaterally increase the securities powers of banks and their affiliates. Rather, the Board's efforts should focus on assuring functional regulation and a full "two-way" street for all members of the financial services community, and on preventing the direct and indirect use of deposit insurance to finance securities and insurance activities. If banks can affiliate with smaller securities firms, securities firms should be able to affiliate with smaller banks. And, a securities firm that chooses to affiliate with a bank should not become subject to the full panoply of regulation as a bank holding company, when that firm's principal activities already are subject to comprehensive regulation by its principal regulators (such as the Securities and Exchange Commission and the Commodity Futures Trading Commission).

As recent legislative activities demonstrate, comprehensive financial services modernization can be achieved only if a broad segment of the financial services industry, and a broad segment of the relevant Federal and State regulators, work together to reach reasonable compromises on many difficult issues. The Board's efforts in achieving financial services modernization therefore should be focused (to the extent permissible under federal law) on attempting to assemble and work with such a broad-based coalition, rather than seeking to unilaterally expand the powers of bank holding companies.

Finally, SIA notes that the Board is proposing changes to prudential limitations established in its Section 20 Orders, which were issued pursuant to Section 4 of the Bank Holding Company Act and the Board's Regulation Y. SIA therefore submits that the Board, in its consideration of the proposed changes, should consider the factors contained in the Board's Regulation Y that must be applied by the Board to proposals to engage in nonbanking activities ³ -- i.e., whether the proposed changes can reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, and gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices). In view of the limited record currently before the Board, SIA believes that the Board has no basis upon which to make these determinations. Further, it appears that the Board's Releases do not request comment on these issues, and it therefore is unlikely that the Board will have a sufficient record on which to make such determinations following its review of those comments.

III. COMMENTS ON THE PROPOSALS IN THE FIREWALLS RELEASE

The Firewalls Release proposes the elimination or modification of three of the "prudential limitations" (i.e., firewalls) governing non-bank subsidiaries ("Section 20 Subsidiaries") of bank holding companies that engage in bank-ineligible securities underwriting or dealing activities: (1) the prohibition on director, officer and employee interlocks between a Section 20 Subsidiary and its affiliated banks or thrifts (the "Interlock Restriction"); (2) the restriction on a bank or thrift acting as agent for, or engaging in marketing activities on behalf of, an affiliated Section 20 Subsidiary (the "Cross-Marketing Restriction"); and (3) the restriction on the purchase and sale of financial assets between a Section 20 Subsidiary and its affiliated bank or thrift (the "Financial Assets Restriction"). For the reasons discussed below, SIA does not object to the modification of the Interlock Restriction, because SIA does not believe that the modification of the restriction will present unfair competitive advantages to Section 20 Subsidiaries. SIA respectfully requests, however, that the Board defer action on the Cross-Marketing and Financial Assets Restrictions, each of which could provide Section 20 Subsidiaries with significant competitive advantages over other securities firms, until securities firms other than Section 20 Subsidiaries can affiliate with banks and enjoy the same advantages as the Board proposes to extend to Section 20 Subsidiaries.

A. The Interlock Restriction

The Board in effect makes three proposals with respect to the Interlock Restriction:

1. Eliminate the restriction entirely.

2. With respect to directors, prohibit a majority of the board of directors of a Section 20 Subsidiary from being composed of directors, officers or employees of affiliated banks and thrifts, and prohibit a majority of the board of directors of a bank

or thrift from being composed of directors, officers or employees of an affiliated Section 20 Subsidiary.

3. With respect to officers and employees, prohibit interlocks only with the senior executive officers of the Section 20 Subsidiary.

SIA respectfully suggests that the Board consider modifying the Interlock Restrictions as suggested in items number 2 and 3, at least initially. After the Board has gained sufficient experience with any issues that may arise as a result of such modifications, the Board could consider eliminating all or part of the remaining Restrictions, if appropriate.

B. The Cross-Marketing Restriction

The Board proposes to eliminate the restriction that prohibits a bank or thrift affiliate of a Section 20 Subsidiary from acting as agent for, or engaging in marketing activities on behalf of, the Section 20 Subsidiary. The Board notes in this regard that "the Interagency Statement on Retail Sales of Nondeposit Investment Products may be a more narrowly tailored and less burdensome method of protecting against customer confusion as to whether the customer is dealing with a Section 20 Subsidiary or an affiliated bank or thrift."

As previously mentioned, SIA respectfully requests the Board to defer action on eliminating or modifying the Cross-Marketing Restriction, until securities firms that are not Section 20 Subsidiaries can affiliate with banks, and thus will not be competitively disadvantaged by the Board's action. SIA is aware that safety and soundness and investor protection concerns -- rather than competition between Section 20 Subsidiaries and other securities firms -- were the paramount issues causing the Board to impose the various firewalls. Nonetheless, the Cross-Marketing Restriction has at least partially maintained a level of competitive fairness between Section 20 Subsidiaries and other securities firms by limiting a Section 20 Subsidiary's ability to market its products and services through its affiliated bank's retail branch system -- an opportunity not available to other securities firms. For that reason, and for the reasons previously discussed, SIA believes that it would be inappropriate for the Board to ignore the competitive advantages that removal of the Cross-Marketing Restriction would give to bank holding companies and their securities affiliates, as well as the potential of undermining the ability of Congress, the Board and others comprehensively to reform and modernization financial services regulation.

C. The Financial Assets Restriction

The Board proposes to modify the Financial Assets Restriction, which generally prohibits a bank or a thrift from purchasing financial assets from, or selling financial assets to, an affiliated Section 20 Subsidiary. An existing exception to this Restriction allows the purchase or sale of U.S. Treasury securities or direct

obligations of the Canadian federal government at market terms, provided they are not subject to repurchase or reverse repurchase agreements between the underwriting subsidiary and its bank or thrift affiliates. The Board proposes to expand this exception to include the purchase and sale of any assets with a sufficiently broad and liquid market to ensure that the transaction is on market terms and that the bank is not incurring credit or liquidity risk through the purchase of assets.

SIA is concerned that, notwithstanding the protections built into the proposed amendment of the Financial Assets Restriction, this proposal could provide a competitive advantage to Section 20 Subsidiaries over other securities firms. Among other things, SIA is concerned that terms like "sufficiently broad and liquid market" and "market terms" are so vague as in practice to permit banks to sell financial assets to, or purchase such assets from, affiliated Section 20 Subsidiaries on terms or under conditions that would not be available to other securities firms, in effect subsidizing the activities of their affiliated Section 20 Subsidiaries. SIA also is concerned that banks could provide affiliated Section 20 Subsidiaries with access to certain financial assets either earlier than, or in amounts greater than, would be available to other securities firms. This could be the case, for example, with certain types of government, asset-backed and other bank-eligible securities.

Again, while the types of competitive concerns identified above were not the central reasons for adopting the Financial Assets Restriction, SIA respectfully submits that the Board should consider those concerns in connection with determining whether, and when, to modify that Restriction.

Also, it would be inappropriate for the Board to eliminate the Financial Assets Restriction until it first has sought and obtained the views and suggestions of the Securities and Exchange Commission concerning the potential for abuse that the elimination of that Restriction could cause.

IV. COMMENTS ON THE PROPOSAL IN THE REVENUE CALCULATION RELEASE

The Revenue Calculation Release proposes, for purposes of Section 20 of the Glass-Steagall Act, to permit a Section 20 Subsidiary to treat interest earned on debt securities that a member bank may hold for its own account as revenue not derived from underwriting or dealing in bank-ineligible securities.

SIA respectfully suggests that the Board should defer action on this proposal. The Revenue Calculation Release does not set forth any information as to what effect this would have on the level of permissible bank-ineligible underwriting or dealing activities of a Section 20 Subsidiary. Similarly, the Release does not address the possibility that the proposal could permit Section 20 Subsidiaries to manipulate their revenue in such a way as to increase their ineligible-securities underwriting and dealing activities. The Board should not take any action on this proposal -- or on any

other proposal -- until these and related factual issues have been fully examined by the Board, and the results of that examination included in a notice requesting public comment on the proposal.

Respectfully Submitted,

Marc E. Lackritz
President

Footnotes:

1 The Securities Industry Association brings together the shared interests of more than 730 securities firms throughout North America to accomplish common goals. SIA members -- including investment banks, broker-dealers, specialists, and mutual fund companies -- are active in all markets and in all phases of corporate and public finance. In the United States, SIA members collectively account for approximately 90 percent, or \$100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans.

2 See Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities (Docket No. R-0841). SIA anticipates submitting a separate comment letter to the Board discussing SIA's additional views on the proposal in this release.

3 See 12 C.F.R. 225.24.

For more information, please contact [Steve Judge](#) or [Josie Storrs](#).