been raised as to whether this treatment is appropriate for interest earned on debt securities that a member bank is authorized to hold. Under the Glass-Steagall Act, a member bank is expressly authorized to purchase and sell for its own account ''investment securities,'' which generally include investment grade corporate debt and certain municipal revenue securities.[4] The Board is aware that pursuant to this authority many banks hold for their own account a significant amount of investment grade debt securities. In addition, many banks buy and sell these securities on a relatively frequent basis as part of managing their investment portfolio. In recognition of this activity, changes to accounting rules were made at the end of 1993 to establish separate accounting treatment for bank portfolio securities that are ''available for sale'' and not intended to be held to maturity.[5]

In view of the above, the Board is proposing to clarify that interest earned on the types of debt securities that a member bank may hold for its own account is not treated as revenue from underwriting or dealing in ineligible securities for purposes of section 20. The Board believes a distinction can be made between the interest earned by a section 20 subsidiary from holding these kinds of securities and the profit made from underwriting or reselling them. The profit or loss a section 20 subsidiary earns on the resale of investment grade ineligible debt securities the subsidiary holds in inventory more closely approximates the revenue that should be attributed to performing the functions of dealing in or underwriting securities, the critical element of which is the actual offering and sale of the instruments involved.[6]

On the other hand, the interest the subsidiary earns on investment grade ineligible debt securities while it holds them in inventory more closely represents the revenue that can be attributed to holding the securities as a member bank may do.[7] Thus, the Board believes that it is reasonable to conclude that interest revenue derived from holding the kinds of debt securities a member bank may hold should not be treated as revenue from underwriting or dealing in securities. The proposed clarification would apply only to interest derived from those types of debt securities that a member bank may hold for its own account, but not underwrite or deal in.

By order of the Board of Governors of the Federal Reserve System, July 31, 1996.

William W. Wiles,

*Secretary of the Board.*

[FR Doc. 96–19865 Filed 8–2–96; 8:45am]

**BILLING CODE 6210–01–P**

Engaged in Bank-Ineligible Securities Underwriting and Dealing, Form FR Y–20. Schedule SUD–I, Line Item 5 (December 1994) (FR Y–20 Instructions). See also ''Structuring Bank-Eligible and Bank-Ineligible Transactions'' in FR Y–20 Instructions.

[4] 12 U.S.C. 24 Seventh, 335; 12 CFR 1.3. Member banks may not purchase any non-investment grade debt securities or equity securities for their own account.

[5] Statement of Financial Accounting Standards No. 115.

[6] For purposes of the section 20 revenue limitation, the Board has viewed ''public sale'' to include the activity of dealing in securities—the process of buying and reselling to the public specific securities as part of an ongoing, regular business. *E.g., Citicorp, supra,* 73 Federal Reserve Bulletin at 506–08. The term ''underwriting'' generally refers to the process by which new issues of securities are offered and sold to the public. *E.g., Securities Industry Ass'n* v. *Board of Governors,* 807 F.2d 1052, 1062–66 (D.C. Cir. 1986), *cert. denied,* 483 U.S. 1005 (1987).

[7] This distinction is further reflected in the current reporting requirements for section 20 subsidiaries and in Generally Accepted Accounting Principles for bank holding companies, which prescribe that interest revenue be reported separately from gains or losses on securities owned. FR Y–20 Instructions, Statement of Income, Schedule SUD–I, Line Items 2, 5); Securities and Exchange Commission FOCUS Report (Form X–17A–5 Part II) and instructions thereto. Generally Accepted Accounting Principles incorporate the format of the FOCUS Report.

**[Docket No. R–0841]**

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

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Notice; request for comments.

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

**DATES:** Comments must be received by September 30, 1996.

**ADDRESSES:** Comments, which should refer to Docket No. R–0841, may be mailed to the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551, to the attention of Mr. William Wiles, Secretary. Comments addressed to the attention of Mr. Wiles may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in room MP–500 between 9 a.m. and 5 p.m. weekdays, except as provided in section 261.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

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

**SUPPLEMENTARY INFORMATION:**

### Background

Section 20 of the Glass-Steagall Act provides that a member bank may not be affiliated with a company that is ''engaged principally'' in underwriting and dealing in securities.[1] In 1987, the Board first allowed bank affiliates to engage in underwriting and dealing in bank-ineligible securities—that is, those securities that a member bank would not be permitted to underwrite or deal in—when the Board approved an application by three bank holding companies to underwrite and deal in commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer-receivable-related securities.[2] In 1989, the Board allowed five section 20 subsidiaries to underwrite and deal in all debt and equity securities, subject to more rigorous firewalls.[3]

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

[2] *Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp.,* 73 Federal Reserve Bulletin 473 (1987), *aff'd, Securities Industry Ass'n* v. *Board of Governors,* 839 F.2d 47 (2d Cir.), *cert. denied,* 486 U.S. 1059 (1988) (hereafter ''*1987 Order*'').

[3] *J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp,* and

Continued

Currently, thirty-nine nonbank subsidiaries of bank holding companies are authorized to engage in underwriting and dealing activities that are not authorized for a member bank. Fourteen of these so-called section 20 subsidiaries have authority to underwrite and deal in commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer receivable related securities. Twenty-two section 20 subsidiaries have authority to underwrite and deal in all debt and equity securities, and three may underwrite and deal in all debt securities. Over the past nine years, the Board has had substantial experience in supervising the activities and operations of those companies. In the Board's experience, the section 20 subsidiaries have operated in a safe and sound manner without adverse effects on their affiliated banks or the public, and have provided additional competition in the securities markets.

As a condition of its 1987 order approving underwriting and dealing in a section 20 subsidiary, the Board established a revenue test to ensure compliance with the ''engaged principally'' standard of section 20. The Board arrived at a revenue test through a series of interpretive steps. First, the Board determined that a bank affiliate would be ''engaged principally'' in underwriting and dealing only if underwriting and dealing were a ''substantial line of business activity for the affiliate.'' [4] The Board further found that the best measure of the underwriting and dealing activity of a section 20 subsidiary was the gross revenue derived from that activity.[5] In terms of what revenue to consider, the Board ruled that securities that a member bank was authorized to underwrite under section 16 of the Glass-Steagall Act (for example, U.S. government securities) were not covered by the prohibition of section 20; accordingly, the Board decided that revenue derived from underwriting and dealing in such securities should not count in determining whether a section 20 subsidiary's level of underwriting and dealing activity was ''substantial'' for purposes of the statute. Rather, only revenue earned on ''ineligible securities''—those that a member bank could not underwrite or deal in—was counted toward the section 20 limit.

Finally, the Board found that underwriting and dealing in ineligible securities would not be a ''substantial'' activity for a section 20 subsidiary if the gross revenue derived from that activity did not exceed 5 to 10 percent of the total gross revenues of the subsidiary. (As a prudential matter, the Board initially limited ineligible revenue to 5 percent of total revenue in order to gain experience in supervising such companies. In 1989, the Board raised the limit to 10 percent.)

No changes were made to the revenue test in subsequent orders until, in January 1993, the Board allowed section 20 subsidiaries to use an alternative revenue test that was indexed to account for changes in interest rates since 1989.[6] The Board found that historically unusual changes in the level and structure of interest rates had distorted the revenue test as a measure of the relative importance of ineligible securities activity in a manner that was not anticipated when the 10 percent limit was adopted in 1989. In particular, the Board found that because bank-eligible securities (such as U.S. government securities) tended to be shorter term than ineligible securities, an increase in the steepness of the yield curve had caused the revenue earned by at least some section 20 subsidiaries from holding eligible securities to decline in relation to ineligible revenue, even as the relative proportion of eligible and ineligible securities activities being conducted by these subsidiaries remained unchanged.[7] Five section 20 subsidiaries are currently operating under this indexed test.

At the same time it proposed the indexed revenue test, the Board sought comment on use of an asset-based measure as an alternative to the existing gross revenue measure, and in July 1994 sought comment on both the asset-based measure (for a second time) and a sales volume measure.[8] As the courts have recognized, ''the relative significance of the firm's activities could be measured in various ways—dollar volume, number of transactions, strategic significance, and so on.'' [9]

The Board has recently received petitions from trade groups and others urging the Board to increase the revenue limit to at least 25 percent of total revenue. Petitioners argue that the Board could justify a higher revenue limit either by reinterpreting ''engaged principally'' more consistently with the ordinary meaning of ''principal''—that is, to include only the largest or majority activity—or by finding that a higher level of revenue does not yield a level of activity that is substantial.

Proposed Change to Revenue Limit

The Board is proposing to maintain the revenue test but increase the revenue limit from 10 percent of total revenue to 25 percent. The Board seeks comment on whether this amended revenue test would be an appropriate gauge of underwriting and dealing activity for purposes of section 20. The Board is concerned that a test based on assets or sales volume would not yield benefits—in terms of greater accuracy, ease of administration, or immunity from manipulation—that would justify the costs of converting compliance systems to a new test.

The Board is proposing to increase the revenue limit based on its supervision of the section 20 subsidiaries over a nine-year period. Based on this experience, the Board now believes that the limitation of 10 percent of total revenue it adopted in 1987, without benefit of this experience, unduly restricted the underwriting and dealing activity of section 20 subsidiaries to a level that fell short, and continues to fall short, of substantial activity and principal engagement for purposes of section 20.

Furthermore, the Board believes that changes in the product mix that section 20 subsidiaries are permitted to offer and developments in the securities markets have affected the relationship between revenue and activity. When the Board initially adopted a 5–10 percent of total revenue test for underwriting and dealing in investment-grade commercial paper, municipal revenue bonds, mortgage-backed securities and

*Security Pacific Corp.*, 75 Federal Reserve Bulletin 192 (1989) (hereafter ''*1989 Order*'').

[4] *Bankers Trust New York Corp.*, 73 Federal Reserve Bulletin 138, 142 (1987); *1987 Order* at 481–483.

[5] *1987 Order* at 483–485.

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

[7] *1993 Modification Order* at 228. Under the indexed revenue test, current interest and dividend revenues from eligible and ineligible activities for each quarter are increased or decreased by an adjustment factor provided by the Board. The adjustment factors, which are calculated for securities of varying durations, represent the ratio of interest rates on Treasury securities in the most recent quarter to those in September 1989. Section 20 subsidiaries use the adjustment factors to ''index'' actual interest and dividend revenues based upon the average duration of their eligible and ineligible securities portfolios.

[8] 59 FR 35,516 (1994).

[9] *Securities Industry Ass'n* v. *Board of Governors of the Federal Reserve System* 847 F.2d 890, 894 (D.C. Cir. 1988). For example, the New York State Banking Department has interpreted its ''little Glass-Steagall Act,'' which contains the same ''engaged principally'' language as section 20, to allow a securities affiliate of a bank to have up to 25 percent of its business activity consist of underwriting and dealing. New York originally measured activity using an asset test but has more recently employed a revenue test. See Letter from Deputy Superintendent Barrantes to Paul L. Lee (May 4, 1988).

consumer receivable related securities, the Board concluded that a ''substantial'' level of engagement in those activities would generally yield revenues of greater than 10 percent of total revenue. Since initially establishing a revenue limit of 10 percent, the Board has expanded significantly the types of underwriting and dealing activities in which a section 20 subsidiary may engage, most notably in the 1989 Order allowing section 20 subsidiaries to underwrite all types of debt and equity securities. Nevertheless, the Board has not until now reexamined its assumption about what level of revenue corresponds to a substantial level of engagement in the types of ineligible securities activities permitted a section 20 subsidiary.

In fact, the Board's experience shows that the relationship between gross revenue and underwriting and dealing activity is not the same for corporate debt securities and other securities approved in the 1989 Order as it was for securities approved in the 1987 Order. A given level of activity in corporate debt and equity underwriting and dealing yields substantially higher revenue than an equivalent amount of activity in underwriting and dealing in investment-grade commercial paper, municipal revenue bonds, mortgage-backed securities, and consumer receivable related securities. For example, bid/offer spreads on many corporate bonds and other securities authorized for dealing in the 1989 Order are significantly wider than the spreads on the securities authorized for dealing in the 1987 Order. Similarly, underwriting fees for those securities authorized in the 1987 Order are significantly smaller than fees for those securities authorized in the 1989 Order, particularly with respect to equity securities and non-investment grade debt securities.[10] Put another way, the Board believes that (all things being equal) a company that maintained a constant level of activity over the past nine years, but shifted its product mix from those authorized by the 1987 Order to those authorized by the 1989 Order, would have seen a significant increase in ineligible revenue.

A converse trend appears to have developed with respect to eligible revenue, where market changes appear to have reduced the eligible revenue derived from a given level of activity. As noted above, to varying degrees over the years, prior interest rate changes have reduced eligible interest revenue relative to ineligible interest revenue for the majority of companies that have elected not to use the indexed revenue test. More importantly, with respect to eligible revenue derived from other sources, most notably brokerage services, increased competition has diminished revenue as a function of activity.[11] Lower commissions have required companies to increase volume in order to maintain a given level of eligible revenue.

In sum, the Board believes that a section 20 subsidiary company that (1) Maintained a steady level of both bank-eligible and ineligible securities activity since 1987, and (2) updated its product mix to include what the Board has interpreted the Bank Holding Company Act to allow, would have seen its the ratio of ineligible to total revenue more than double.

Finally, the Board believes that this increase in the revenue limit would not give rise to the potential dangers to commercial banks from general underwriting activities that motivated the Congress to enact the Glass-Steagall Act, or the more general dangers of affiliation that motivated the Congress to enact the Bank Holding Company Act. The Board has now had considerable experience supervising these companies, and believes that they have operated in a safe and sound manner. Particularly given the safeguards of the examination and reporting process and increased emphasis on internal risk management, the Board believes that allowing a section 20 subsidiary to increase to 25 percent the amount of revenue it derives from underwriting and dealing in ineligible securities would not pose significant risk to an affiliated bank.

By order of the Board of Governors of the Federal Reserve System, July 31, 1996.

William W. Wiles,

*Secretary of the Board.*

[FR Doc. 96–19866 Filed 8–2–96; 8:45 am]

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

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

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

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

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

Unless otherwise noted, comments regarding each of these applications must be received at the Reserve Bank indicated or the offices of the Board of Governors not later than August 29, 1996.

A. Federal Reserve Bank of Chicago (James A. Bluemle, Vice President) 230 South LaSalle Street, Chicago, Illinois 60690:

*1. Lewis Management Company*, Morris, Illinois; to become a bank holding company by acquiring 19.82 percent of the voting shares of Illinois Valley Bancorp, Inc., Morris, Illinois, and thereby indirectly acquire Grundy County National Bank, Morris, Illinois.

*2. TDI Financial Corporation*, Chicago, Illinois; to become a bank holding company by acquiring 100 percent of the voting shares of Security Chicago Corporation, Chicago, Illinois,