

October 29, 1999

THE GRAMM-LEACH-BLILEY FINANCIAL SERVICES MODERNIZATION ACT,
S. 900, 106TH CONG. (1999)

On October 22, 1999, United States Senator Phil Gramm confidently stated that the Gramm-Leach-Bliley Financial Services Modernization Act, S. 900, 106th Cong. (1999), “will become law because it will pass both houses of Congress by large margins and will be signed by the President.” Senator Gramm spoke after the approval of a compromise bill by a joint conference committee of the United States House of Representatives and Senate that had convened beginning in September to reconcile two different versions of legislation passed to overhaul regulation of the financial services industry. The bill had been most recently delayed while Clinton Administration officials and key Republican lawmakers tried to reach agreement on the effect of the proposed legislation on the Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901 *et seq.* (“CRA”).¹ Congress and the White House have now reached an agreement, and the resulting legislation will break down the barriers that have separated the banking, securities and insurance industries since the 1930s and placed U.S. companies in those industries at a competitive disadvantage with their international counterparts. The adopted legislation is also expected to spur significant merger activity within the financial industry. The joint conference committee has not yet reported the legislation. Although the language of the legislation has been completed, disagreement currently exists over wording in the accompanying joint conference committee report, which will explain how the bill should be interpreted.

In general, the legislation will repeal the provisions of the Glass-Steagall Act that restrict the ability of banks and securities underwriters to affiliate with one another. Within the framework of the Bank Holding Company Act, the bill will allow for the affiliation of a wider range of financial services providers, including commercial banks, insurance underwriters and merchant banks. Banks, securities firms and insurance companies will be able to affiliate with one another within a single bank holding company structure. Bank holding companies will be allowed to engage in activities determined to be “financial in nature or incidental to such financial activities,” which represents a significantly broader standard than the “closely related to banking” standard that currently delineates the permissible activities of bank holding companies.

¹ The CRA requires the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Comptroller of the Currency and certain other federal financial supervisory agencies to use their “authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions.” 12 U.S.C. § 2901(b). Enforcement of the CRA is accomplished through its requirement that federal supervisory agencies assess CRA compliance by a particular financial institution whenever that institution makes an “application for a deposit facility,” which includes applications for a bank charter, federal deposit insurance, a branch or similar facility, a merger or an acquisition.

In addition, the bill will allow national banks² to engage through subsidiaries in a wider range of financial services than had been permitted previously. For instance, national banks will be able to underwrite securities through their operating subsidiaries, although they still will not be able to underwrite insurance.

HISTORY OF THE LEGISLATION

In 1998, the House passed the Financial Services Act of 1998, H.R. 10, 105th Cong. (1998) (the “1998 Act”); however, the Senate failed to pass the 1998 Act because several senators objected to, among other things, the 1998 Act’s expansion of the application of the CRA. On January 1, 1999, Representative James A. Leach reintroduced the Financial Services Act of 1999, H.R. 10, 106th Cong. (1999). The House Committee on Banking and Financial Services, as well as the House Committee on Commerce, held hearings on H.R. 10 and reported the bill to the full House. See H.R. Rep. No. 106-74 (1999). On July 1, the House passed H.R. 10 by a vote of 343-86.

While H.R. 10 was being debated by the House Commerce Committee and House Banking Committee, on April 28, 1999, Senator Phil Gramm introduced to the Senate the Financial Services Modernization Act of 1999, S. 900, 106th Cong. (1999), along with a report from the Senate Committee on Banking, Housing, and Urban Affairs. See S. Rep. No. 106-44 (1999). The Senate, on May 6, 1999, passed S. 900 by a 54-44 vote, and on July 20, the House considered and passed S. 900, but only after amending it by inserting the entire text of H.R. 10.

Following the passage of the bill, the House and Senate formed a joint conference committee to iron out the differences between H.R. 10 and S. 900. The House/Senate Conference Committee on H.R. 10 and S. 900 (the “Joint Committee”) convened on September 23, 1999 and has just finished drafting a version of the bill acceptable to both chambers and the President, now known as the Gramm-Leach-Bliley Financial Services Modernization Act, S. 900, 106th Cong. (1999) (the “Gramm-Leach Act” or the “Act”).

Initially, the most difficult sticking point with the new legislation was how to regulate the “one-stop financial companies” that would be created as a result of the new legislation. The Clinton Administration had insisted that the Treasury Department’s Office of the Comptroller of the Currency (the primary regulator of national banks) should have significant authority to approve new powers and activities for national banks and their subsidiaries. Republican lawmakers favored requiring all new activities to be undertaken only through holding company affiliates (entities under common control with banks, but not banks themselves or their

² Although the bill speaks only to national banks, the interplay of Federal statutes governing the activities of state-chartered banks and those banks’ own state banking laws will probably result, ultimately, in parity of treatment between national banks and state-chartered banks.

subsidiaries) with ultimate oversight vested in the Federal Reserve Board. After a protracted regulatory turf war, on October 13, Secretary of the Treasury Lawrence Summers and Federal Reserve Board Chairman Alan Greenspan reached a compromise whereby each regulator will exercise its authority in this area in consultation with the other. In addition, President Clinton had threatened to veto the measure if it failed to protect consumer privacy or weakened the CRA. The Gramm-Leach Act appears to have placated the President with respect to both issues.

KEY PROVISIONS

The Gramm-Leach Act will repeal those portions of the Banking Act of 1933 (the “Glass-Steagall Act”) and the Bank Holding Company Act of 1956 (the “BHC Act”) that limit the securities and insurance activities of bank holding companies and their non-bank affiliates. Set forth below is a summary of the key provisions of the Gramm-Leach Act, as such provisions have been agreed to as of October 29, 1999.

TITLE I – FACILITATING AFFILIATION AMONG BANKS, SECURITIES FIRMS, AND INSURANCE COMPANIES

1. The Act repeals the provisions of the Glass-Steagall Act that restrict the ability of banks and securities underwriters to affiliate with one another.
2. The Act creates a new category of bank holding company (a “financial holding company” or “FHC”) under the BHC Act.
 - An FHC may directly engage in (or acquire and retain the shares of any company engaged in) a statutorily provided list of financial activities, including insurance and securities underwriting, merchant banking activities, and insurance company portfolio investment activities.
 - An FHC may also directly engage in (or acquire and retain the shares of any company engaged in) any other activities that the Federal Reserve, in consultation with the Secretary of the Treasury, determines to be “financial in nature or incidental to a financial activity” or “complementary to financial activities.”
 - For a bank holding company to become an FHC, it must file a self-executing declaration with the Federal Reserve Board stating that all of its insured depository institution subsidiaries are “well-capitalized” (i.e., maintain leverage capital of at least 5%, Tier I risk-based capital of at least 6%, and total risk-based capital of at least 10%) and “well-managed” (i.e., have at least a composite rating of 1 or 2, with a rating for the management component of at least 2, on its most recent examination under the Uniform Financial Institutions Rating System) and have at least a “satisfactory” rating under the CRA.
 - The Act provides for the regulation of FHCs by the Federal Reserve Board as the

“umbrella regulator,” with functional regulation of banks, merchant banks and insurance companies in the structure, respectively, by the appropriate bank regulator (including the Treasury Department’s Comptroller of the Currency (OCC), the Federal Deposit Insurance Corp. (FDIC), and the appropriate state banking department), the Securities and Exchange Commission (SEC), and the appropriate state insurance regulator.

3. If any insured depository institution or insured depository institution affiliate of an FHC received less than a satisfactory rating in its most recent CRA exam, the appropriate Federal banking agency may not approve any additional new activities or acquisitions under the authorities granted under the legislation.
4. Although the Act will preempt state laws regulating affiliations between bank and insurance entities, it will allow states to continue to regulate insurance as long as they do not prevent or restrict bank insurance activities or affiliations between banks and insurance firms.
5. The Act provides that a bank holding company organized as a mutual holding company will be regulated on terms and subject to the same limitations as any other bank holding company.
6. The Act allows national banks to conduct certain new financial activities, including the underwriting of securities, through their own subsidiaries (so-called “financial subsidiaries”) and not just through holding company affiliates.
 - In addition, after five years, a financial subsidiary could engage in merchant banking activities if jointly approved by the Federal Reserve and Treasury Department.
 - Financial subsidiaries will not be permitted to engage in insurance underwriting or real estate development. Those activities will be required to be conducted through holding company affiliates.
 - To engage in the permitted financial activities through operating subsidiaries, national banks will have to satisfy several conditions. These conditions act as financial safeguards to protect the FDIC’s deposit insurance fund. The total assets of all financial subsidiaries may not exceed 45% of the parent bank’s assets or \$50 billion, whichever is less. The national bank must be “well-capitalized” and “well-managed.” A national bank that is among the 50 largest FDIC-insured banks in the United States must have an issue of outstanding third-party, unsecured, long-term debt that is rated in one of the three highest rating categories by an independent rating agency. A national bank that is among the largest 100 FDIC-insured banks in the United States, but not in the top 50, must meet either the rating requirement described above or a comparable test jointly agreed to by the Federal Reserve Board and the Treasury. No rating requirement will apply to national banks that are not among the 100 largest FDIC-insured banks.
 - The Act permits national banks (and their subsidiaries) to underwrite municipal revenue bonds.

- The Act provides for national treatment for foreign banks wanting to engage in the new financial activities authorized under the Act.
7. The Act ensures that appropriate antitrust review is conducted for new financial combinations allowed under the Act.

TITLE II – FUNCTIONAL REGULATION

1. The Act establishes functional regulation of bank securities activities by narrowing significantly the complete exemptions banks have had from broker-dealer and investment adviser regulation under the Federal securities laws. The new, more limited, exemptions are substantially confined to the following bank activities: trust, safekeeping, and custodial activities; shareholder and employee benefit plan activities; operation of sweep accounts; private placement activities (under certain conditions); self-directed IRAs; and third-party networking arrangements to offer brokerage services to bank customers.
2. The Act provides for the SEC and the Federal Reserve Board to determine jointly which products are “securities” and must be pushed out of the bank and into a securities affiliate regulated by the SEC. The Act generally permits banks to continue to offer most traditional bank products, however.

TITLE III – INSURANCE

1. The Act establishes what types of insurance products national banks and bank subsidiaries may provide. For instance, it prohibits national banks not currently engaged in underwriting or sale of title insurance from commencing that activity, but national bank subsidiaries are permitted to sell all types of insurance including title insurance.

TITLE IV – UNITARY SAVINGS AND LOAN HOLDING COMPANIES

1. The Act provides that new “commercial” unitary thrift holding companies (holding companies that have been permitted to own a single thrift institution despite being engaged directly or indirectly in significant commercial or industrial businesses) may not be organized after May 4, 1999.
2. The Act provides that existing unitary thrift holding companies may be sold only to financial companies, not commercial ones.

TITLE V – PRIVACY

1. The Act makes it a crime for a person to obtain customer information from a financial institution under false pretenses.
2. The Act requires depository institutions to advise their customers of their privacy policies at the establishment of the business relationship and not less than annually thereafter.
3. Customers may prohibit their financial institutions from disclosing nonpublic personal information to third parties with certain exceptions.
4. The bank regulatory agencies are directed to study whether current laws relating to disclosure adequately protect customers' privacy.
5. Financial institutions and insurance companies are barred from disclosing customer account numbers or access codes to unaffiliated third parties for telemarketing or other direct marketing purposes.
6. Federal and state regulators are directed to establish comprehensive standards for ensuring the security and confidentiality of consumers' personal information.
7. The Act accords supremacy to state laws that give consumers greater privacy protections than the provisions in federal law.

TITLE VI – FEDERAL HOME LOAN BANK SYSTEM MODERNIZATION

1. The Act includes the "Federal Home Loan Bank System Modernization Act of 1999," which, among other things, removes the requirement that federally-chartered thrifts be members of the Federal Home Loan Bank System and permits smaller thrifts to obtain FHLB System advances to finance agricultural and small business loans.

TITLE VII – OTHER PROVISIONS

1. The Act requires ATM operators who impose a fee for use of an ATM by a noncustomer to post a notice on the machine and on the screen of the amount of the fee.
2. The Act requires full public disclosure of CRA agreements by banks and community organizations. Each party to a CRA agreement must make a public report each year on how the money and other resources involved in the agreement were used.

3. The Act gives small banks and thrifts (those with no more than \$250 million in assets) some regulatory relief from CRA. Those that received an “outstanding” rating at their most recent CRA exam will not receive a routine CRA exam more often than once every 5 years. Those that received a “satisfactory” rating at their most recent CRA exam will not receive a routine CRA exam more often than once every 4 years.
4. Clarifies that nothing in the legislation repeals any provision of the CRA.

If you would like more information regarding the Gramm-Leach Act, H.R. 10, S. 900, or the House and Senate committee reports, please contact Bill Bates in King & Spalding’s New York office (telephone: 212/556-2240; e-mail: wbates@kslaw.com) or Bill Baxley in King & Spalding’s Atlanta office (telephone: 404/572-3580; e-mail: bbaxley@kslaw.com), co-heads of King & Spalding’s M&A Practice Group.

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