WILMER, CUTLER & PICKERING

Financial Institutions Group Newsletter

FEBRUARY 26, 2003

NEW CONTOURS OF BANK SECURITIES ACTIVITIES: Dealer "Push-Out" Rules and Underwriting by Foreign Banks

The Securities and Exchange Commission ("SEC") and the Federal Reserve Board ("Board") took separate regulatory actions earlier this month that are of importance to many banks and their broker-dealer affiliates. Specifically, the SEC issued long-awaited rules clarifying exemptions for certain bank activities from the definition of "dealer" in the Securities Exchange Act of 1934 ("Exchange Act"). The Board meanwhile issued an interpretation clarifying that foreign banks wishing to underwrite securities that are distributed in the United States must have authority to do so under the Bank Holding Company Act ("BHC Act"). This Newsletter examines each new regulatory action in turn.

I. Bank Exemptions from the Exchange Act's Definition of "Dealer"

On February 14, 2003, the SEC adopted final rules that allow banks to engage in certain activities without having to register as securities dealers under the Exchange Act.[1] As described further below, these rules exempt banks that engage in a limited number of riskless principal and certain asset-backed transactions from the Exchange Act's definition of "dealer." The rules also create an exemption for bank securities lending activities from both the "dealer" and "broker" definitions of the Exchange Act.

A. Background

In 1999, the Gramm-Leach-Bliley Act ("GLB Act") eliminated the blanket exemption that banks (and the U.S. branches and agencies of foreign banks) had enjoyed from the definitions of "broker" and "dealer" under the Exchange Act and other federal securities laws. The GLB Act effectively required banks to "push out" most of their securities brokerage and dealing activities to SEC-registered broker-dealers by a compliance deadline of May 12, 2001.

The GLB Act exempted certain traditional banking activities from the general push-out requirements; specifically, the Act allowed banks to engage in 11 "excepted" brokerage activities and four dealing activities without having to register as broker-dealers with the SEC. The four "dealer" exemptions are as follows:

1. *Investment, Trustee and Fiduciary Transactions.* A bank may buy and sell securities for its own investment purposes and for accounts over which it acts in a trustee and fiduciary capacity;

2. *Exempted Securities.* A bank may buy and sell commercial paper, banker's acceptances, exempted securities, certain Canadian government obligations and Brady bonds;

3. *Identified Banking Products.* A bank may buy and sell certain "identified banking products," which include, among others, deposits and CDs, loans and letters of credit, loan participations sold to certain "qualified investors" or other sophisticated persons, and swaps sold to qualified investors;[2] and

---

1 *See* Exch. Act Rel. No. 47,364 (Feb. 14, 2003) ("Adopting Release"). Pursuant to Exchange Act Rule 15a-9, savings associations and savings banks are exempted from the definition of "dealer" under the Exchange Act under the same terms as "banks." Thus, for purposes of the discussion of bank dealer exemptions in this Newsletter, the term "bank" is intended to include banks, savings banks, and savings associations, as well as the U.S. branches and agencies of foreign banks.

2 The term "qualified investor" was defined in the GLB Act and is codified at Section 3(a)(54) of the Exchange Act to include investment companies, banks, small business investment companies, any state-sponsored employee benefit plan, institutional trusts, market intermediaries, and natural persons, corporations, or partnerships that own and invest on a discretionary basis more than $25 million. Under several of the GLB Act's "broker" and "dealer" exceptions, securities may only be sold by banks to qualified investors.

4. *Asset-Backed Transactions.* A bank may issue or sell asset-backed securities to qualified investors, provided that the underlying assets are predominantly originated by the bank, a bank affiliate that is not a broker-dealer, or (if the assets are mortgage or consumer-related obligations) a syndicate of banks of which the bank is a member.[3]

The scope of many of the GLB Act's bank "broker" and "dealer" exemptions is unclear and, on May 11, 2001, the SEC adopted interim final rules designed to provide clarity to and guidance regarding the parameters of these exemptions.[4] The SEC's interim rules were not well received; they sparked intense opposition from not only the banking industry but also federal banking regulators, which charged that the SEC had misread the GLB Act and overstepped its statutory authority under that Act. In response, the SEC issued a series of orders delaying the date for compliance with the GLB Act's push-out provisions and decided to modify its approach to the push-out requirements.

On November 5, 2002, the SEC issued proposed amendments generally applicable to the less complex – and, therefore, less controversial – bank "dealer" interim rules.[5] In so doing, the SEC decided to leave for another day the far more difficult bank "broker" exemptions.[6]

The SEC's final rules adopt with some modifications the proposed amendments issued in November. The final rules are designed to clarify one of the four GLB Act bank "dealer" exemptions – the one that applies to asset-backed transactions. In these rules, the SEC also provides a "dealer" exemption for riskless principal transactions and an exemption from the definition of both "broker" and "dealer" for bank securities lending activities. In addition, the SEC has delayed the effective date of the new rules for one year and extended an exemption from Section 29(b) liability for banks.

B. The Asset-Backed Transactions Exemption

As noted above, the GLB Act's asset-backed transactions exception to the definition of "dealer" allows a bank to issue or sell to qualified investors, through a grantor trust or other separate entity, "securities backed by or representing an interest in notes, drafts, acceptances, loans, leases, receivables, other obligations (other than securities of which the bank is not the issuer), or pools of any of these obligations predominantly originated" by the bank, an affiliate of the bank other than a broker-dealer, or (if the obligations are mortgage or consumer-related receivables) a syndicate in which the bank is a member.[7]

A number of the terms in this statutory exception required clarification, which is what one of the SEC's final rules provides. New Exchange Act Rule 3b-18 clarifies, for example, that a bank loan may be "originated" by a bank or an affiliate (and thus sold under the exception) even if the bank did not make and fund the loan when the obligation was initially created. Under the rule, a bank may regard itself as originator of obligations created by auto dealers, mortgage companies, and others so long as (1) the obligation conforms to the bank's underwriting standards or is on documentation prepared by the bank, and (2) the bank funds the obligation within six months of when it was created.

Rule 3b-18 also defines "predominantly originated" for purposes of the exemption. To meet the predominantly originated test, at least 85% of the obligations (as measured by the value of the obligations) underlying the securities issued and sold by a bank must have been originated by the bank or its non-broker-dealer affiliates, or a syndicate of which the bank is a member.

The rule further makes clear that, to be considered a member of a syndicate, the individual bank must originate obligations. Under the rule, when a syndicate of banks issues asset-backed securities through a grantor trust or other separate entity, each bank selling the securities, and, thus, acting as a dealer in the transaction, must have originated at least 10% of the value of the pool of obligations backing the securities.

3 As the SEC notes in the Adopting Release, under the GLB Act, resolution of the question of whether a bank's activities cause it to be a securities "dealer" under the Exchange Act requires a two-step analysis. First, a bank (like all other securities market participants) needs to consider where its activities fall under the traditional "trader" vs. "dealer" distinction that the SEC has drawn under the Exchange Act. If the bank's activities are those of a "dealer," then the bank needs to consider whether its activities fit within one or more of the bank-specific exemptions.

4 *See* Exch. Act Rel. No. 44,291 (May 11, 2001), 66 Fed. Reg. 27,760 (May 18, 2001). For a discussion of the interim final rules, *see* "Securities Law Developments: SEC Issues Interpretive Rules on the GLB 'Push-Out' Requirements for Banks" avail. at www.wilmer.com/docs/news_items/ACFFA76.pdf.

5 Exch. Act Rel. No. 46,745 (Oct. 31, 2002), 67 Fed. Reg. 67,495 (Nov. 5, 2002).

6 From informal conversations with SEC staff, it appears unlikely that proposed "broker" rules will be issued before May 2003, when the current SEC exemption from the GLB Act's broker push-out requirements expire. Accordingly, it seems likely that the SEC will issue another extension to this push-out requirement.

7 *See* Exchange Act Section 3(a)(5)(C)(iii).

C. Riskless Principal Exemption

The GLB Act created a *de minimis* exception to the bank "broker" push-out requirement. Under the Act, a bank would not be considered a "broker" if it engaged in 500 or fewer brokerage transactions a year (that were not covered by one of the other exemptions provided in the statute).[8]

Questions arose as to whether banks could rely on that exception to engage in riskless principal transactions. The SEC adopted new Exchange Act Rule 3a5-1 to make clear that riskless principal, as well as brokerage transactions, qualify under the annual 500-transaction limit.[9] (Of course, until the broker push-out rules become effective, all 500 of the allotted transactions under the *de minimis* exemption can be used for riskless principal transactions.)

The rule also clarifies that both legs of a riskless principal transaction may be counted as a single transaction for purposes of the *de minimis* limit. Because the SEC takes the view that riskless principal transactions are a dealer activity (rather than brokerage or agency activity, which is the position of the bank regulators), the SEC adopted this riskless principal rule as an exemption from the "dealer" push-out requirements.

D. Securities Lending Exemption

The GLB Act contains an exception to the "broker" push-out requirements that permits those banks that offer safekeeping and custody services to engage in securities lending and borrowing transactions. The SEC believed that this exemption – since it is confined to custodial banks, and only applies to the Exchange Act's definition of "broker" (but not "dealer") – created uncertainty for banks that engage in securities lending without having custody of the underlying securities and in situations where banks' activities might meet the definition of "dealer" under the federal securities laws.

As a consequence, the SEC adopted new Rule 15a-11 to exempt banks that engage in securities lending transactions from the Exchange Act's definitions of "broker" and "dealer." The rule allows banks to engage in securities lending whether operating with or without custody of the securities; the rule also permits banks to act in an agency capacity or as a "conduit" lender. (A bank acts as a conduit lender if it borrows [or loans] securities as principal for its own account and contemporaneously loans [or borrows] the securities as principal for its own account.)

When it originally proposed this rule in November 2002, the SEC limited the exemption to securities lending transactions between banks and qualified investors. The final rule modifies this approach in two ways. First, the final rule allows banks to enter into securities lending transactions with parties that they "reasonably believe" to be qualified investors. Second, banks may engage in securities lending transactions with pension plans that have $25 million in investments and are managed on a discretionary basis, even if these plans do not meet the qualified investor test.

E. Delayed Effective Date and Exemption from Section 29 Liability

Concurrent with the release of the final "dealer" rules, the SEC extended the date for compliance with the "dealer" provisions of the rules until September 30, 2003.[10] Some commenters had urged the SEC to delay the effective date of these rules until the "broker" push-out rules are also finalized; the SEC rejected that approach, saying that implementing these rules first will give banks needed certainty with respect to their riskless principal transactions and afford banks some experience in identifying securities transactions that may or may not meet the various exemptions before the broker exemptions come into force.

The SEC also extended a previously adopted exemption from rescission liability under the Exchange Act.[11] To explain, Section 29(b) of the Exchange Act provides that any contract made in violation of the Act or rules adopted thereunder "shall be void as regards the rights of any person ... who made or engaged in the performance of any such contract." Amended Rule 15a-8 provides an exemption for contracts entered into by a bank before March 31, 2005, from being considered void or voidable because the bank that is a party to the contract violated the registration requirements of the Exchange Act based solely on the bank's status as a dealer when the contract was created. This exemption is designed to give banks time to comply with the new rules and to alleviate their concern that technical violations of the dealer push-out requirements will trigger Section 29(b)'s rescission liability.

8 Exchange Act Section 3(a)(4)(B)(xi).

9 *See* Exchange Act Rule 3a5-1. "Riskless principal" transactions are generally described as trades in which, after receiving an order to buy (or sell) from a customer, the broker-dealer purchases (or sells) the security from (or to) another person in a contemporaneous offsetting transaction. *See* Exchange Act Rule 10b-10(a)(2)(ii)(A).

10 *See* Exch. Act Rel. No. 47,366 (Feb. 13, 2003).

11 *See* Exchange Act Rule 15a-8.

II. Board Interpretation Regarding Foreign Banks' Securities Underwriting

On February 19, 2003, the Board published in the Federal Register a new interpretation regarding the authority of foreign banks to underwrite securities to be distributed in the United States.[12] The interpretation is designed to clarify the scope of restrictions on underwriting activities by foreign banks with U.S. branches, agencies, and commercial lending companies.

A. Background

According to the new interpretation, the Board has discovered that a number of foreign banks that are subject to the BHC Act are becoming members of underwriting syndicates for securities that are registered and intended to be distributed in the United States. The underwriting obligation and risk is assumed by a non-U.S. office or affiliate of the foreign bank; the U.S. offices or affiliates of the participating bank act as liaison with the U.S. issuer, prepare documentation, and/or provide other support services in connection with the underwriting.

Foreign banks have taken the position that they are not engaged in underwriting in the United States for purposes of U.S. banking and securities laws because any underwriting obligation is booked outside the United States and because the foreign bank does not distribute any of the securities in the United States (or elsewhere, for that matter). That is, in the view of these foreign banks, participating in an underwriting syndicate should not be viewed as a securities dealer activity subject to U.S. regulation, so long as the foreign bank is not actually allocating the underwritten securities to investors. It is unlikely that the foreign banks have consulted the SEC prior to taking such a position. Under the prevailing SEC staff's interpretation, serving as an underwriter in a U.S. offering likely would trigger the broker-dealer status, regardless of the extent of actual involvement in the marketing and sales process.[13]

B. Permissible Scope of Underwriting under the BHC Act

The Board's interpretation clarifies that a foreign bank with a U.S. branch, agency, or commercial lending company that participates in underwriting activities with respect to securities that are to be distributed in the United States is considered to be conducting an activity in this country for purposes of U.S. banking laws. As a result, that bank must have authority under the BHC Act to provide such services in the United States. This means that a foreign bank engaged in this underwriting conduct either must elect to become a financial holding company under section 4(l) of the BHC Act[14] or must have authority to engage in securities underwriting under section 4(c)(8) of the Act.[15]

* * *

If you would like further information regarding or a copy of the new SEC rules or the Board interpretation, please contact:

Brandon Becker	+1 (202) 663-6979 (Brandon.Becker@wilmer.com)
Martin E. Lybecker	+1 (202) 663-6240 (Martin.Lybecker@wilmer.com)
Soo J. Yim	+1 (202) 663-6958 (Soo.Yim@wilmer.com)
Satish M. Kini	+1 (202) 663-6482 (Satish.Kini@wilmer.com)
Jerome Roche	+1 (202) 663-6870 (Jerome.Roche@wilmer.com)

12 68 Fed. Reg. 7898 (Feb. 19, 2003).

13 *See, e.g.*, Acqua Wellington North America Equities Fund, Ltd., SEC No-Action Letter (Oct. 11, 2001).

14 12 U.S.C. § 1843(l)(3); *accord* 12 C.F.R. 225.90 (Board implementing Regulation Y).

15 12 U.S.C. § 1843(c)(8).

James E. Anderson	+1 (202) 663-6180	Simon Firth	+44 (20) 7872-1036	Eric Mogilnicki	+1 (202) 663-6410
Philip D. Anker	+1 (202) 663-6613	Franca Harris Gutierrez	+1 (202) 663-6557	Bruce Newman	+1 (212) 230-8835
Gregory A. Baer	+1 (202) 663-6859	Wilhelm Hartung	+44 (20) 7872-1075	David Ogden	+1 (202) 663-6440
Robert G. Bagnall	+1 (202) 663 6974	Stephen R. Heifetz	+1 (202) 663-6558	Alix Prentice	+44 (20) 7872-1064
Ursula Bass	+1 (202) 663-6203	Michael Hershaft	+1 (202) 663-6427	Matthew P. Previn	+1 (212) 230-8878
Brandon Becker	+1 (202) 663-6979	Kirk Jensen	+1 (202) 663-6182	Victoria Schonfeld	+1 (212) 230-8874
Clare D. Bracewell	+1 (202) 663-6944	Satish M. Kini	+1 (202) 663-6482	Jessica E. Singer	+1 (202) 663-6133
Russell J. Bruemmer	+1 (202) 663-6804	Michael D. Leffel	+1 (202) 663-6784	Marianne K. Smythe	+1 (202) 663-6711
J. Beckwith Burr	+1 (202) 663-6695	Christopher Lipsett	+1 (212) 230-8880	Daniel H. Squire	+1 (202) 663-6060
David M. Capps	+44 (20) 7872-1080	David A. Luigs	+1 (202) 663-6451	Natacha Steimer	+1 (202) 663-6534
Matthew Chambers	+1 (202) 663-6591	Martin E. Lybecker	+1 (202) 663-6240	Todd Stern	+1 (202) 663-6940
David S. Cohen	+1 (202) 663-6925	James H. Mann	+1 (212) 230-8843	Manley Williams	+1 (202) 663-6595
Ricardo R. Delfin	+1 (202) 663-6912	David Medine	+1 (202) 663-6220	Soo J. Yim	+1 (202) 663-6958