United States General Accounting Office

GAO

Report to Congressional Requesters

September 1995

BANKS' SECURITIES ACTIVITIES

Oversight Differs Depending on Activity and Regulator

GAO/GGD-95-214

GAO United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-259498

September 21, 1995

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

The Honorable Edward J. Markey
Ranking Minority Member
Subcommittee on Telecommunications
and Finance
Committee on Commerce
House of Representatives

This report presents the results of our review of federal banking regulators' oversight of banks' securities activities. You requested that we report on the extent to which banks have expanded into securities activities. You also asked us to evaluate the status of federal banking regulators' programs for examining and enforcing compliance with regulatory safeguards intended to separate insured banking activities from securities activities and protect securities investors from unfair practices. This report recommends actions to improve bank regulators' oversight of bank securities activities.

As agreed with you, unless you publicly release its contents earlier, we plan no further distribution of this report until 5 days from its issue date. At that time, we will provide copies to interested Members of Congress, appropriate committees, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the National Association of Securities Dealers, other interested parties, and the public.

Major contributors to this report are listed in appendix X. If you have any questions, please call me at (202) 512-8678.

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

Numerous U.S. banks and bank holding companies are expanding into securities activities, including retail securities brokerage services (acting as an agent for buyers and sellers of securities), securities underwriting (publicly distributing new issues of securities), and securities dealing (trading securities as a principal in the secondary market). These securities activities can provide greater diversification and additional income for banks, a more competitive securities industry, and added convenience for bank customers. They may also pose additional risks to banks and new challenges to regulators.

The adequacy of regulatory oversight of banks' securities activities concerned the Ranking Minority Member of the House Committee on Commerce and the Ranking Minority Member of the Subcommittee on Telecommunications and Finance, House Committee on Commerce. They asked GAO to

- determine the extent to which banks provide securities brokerage services and how these services are regulated;
- evaluate the completeness and results of Federal Reserve inspections of bank holding company subsidiaries that the agency authorizes to underwrite and deal in securities; and
- evaluate the Federal Deposit Insurance Corporation's (FDIC) regulation of bank subsidiaries that can underwrite and deal in securities.

Background

Congress passed the Glass-Steagall Act in 1933 in reaction to the banking crisis of the Great Depression. The act generally prohibits banks from underwriting and dealing in securities, except for "bank-eligible" securities. These are limited to securities offered and backed by the federal government and federally sponsored agencies, and certain state and local government securities. As banks have sought to expand their product lines, federal regulators have provided banks, through affiliated firms, limited authority to underwrite and deal in "bank-ineligible" securities. Banks subject to Glass-Steagall provisions may be chartered and regulated by one or more federal and state regulators. National banks are chartered and regulated by the Office of the Comptroller of the Currency (OCC). State-chartered and regulated banks are also regulated federally by the Federal Reserve if they choose to join the Federal Reserve System (FRS). If they do not join FRS, they are regulated by FDIC because they are federally insured. The Federal Reserve also regulates all bank holding companies.

In addition to restricting activities within banks, Section 20 of the Glass-Steagall Act prohibits FRS-member banks, including all national banks, from affiliating with firms "principally engaged" in underwriting ineligible securities. The Federal Reserve interprets Section 20 of the act to allow bank holding companies to establish subsidiaries engaged in securities underwriting and dealing, as long as the subsidiary generates no more than 10 percent of its gross revenue from ineligible securities. The subsidiary's activities must also be considered closely related to banking. Bank holding companies must obtain Federal Reserve approval to establish underwriting and dealing subsidiaries, which are known as "Section 20 subsidiaries."

In November 1994, OCC proposed to revise its rules so that subsidiaries of approved national banks could engage in activities impermissible for the parent bank, possibly including underwriting and dealing in ineligible securities. OCC is considering comments on the proposal.

The Glass-Steagall Act does not prohibit subsidiaries of state-chartered non-FRS-member banks from engaging in securities activities. In 1984, FDIC issued regulations setting out conditions under which "bona fide subsidiaries" of these banks may underwrite ineligible securities.

The Glass-Steagall Act also does not restrict bank securities brokerage activities, which may take place either within a bank or an affiliate. Generally, a firm that provides securities brokerage services (known as a broker-dealer) must register with and be regulated by the Securities and Exchange Commission (SEC). Banks, however, are exempted from SEC registration. Consequently, brokerage services provided directly by a bank are not subject to scrutiny by federal securities regulators. The bank exemption does not apply to separately incorporated bank affiliates.

Generally, bank regulators supervise banking organizations to ensure their safety and soundness and compliance with banking laws. As part of their supervision, the regulators are to ensure that the banking organizations, including banks' securities affiliates, are adequately capitalized and comply with certain operating conditions and restrictions called "firewalls." Among other things, firewalls help insulate banks from credit relationships and intercompany transactions that pose risks to bank safety and soundness or potential conflicts of interest.

Securities regulators examine and monitor the activities of broker-dealers for compliance with securities laws and regulations, including net capital rules. Much of this regulation is done through self-regulatory organizations (SROS) such as the National Association of Securities Dealers (NASD), which enforce rules of fair practice among their members. SEC evaluates the quality of SRO oversight in enforcing compliance with federal securities laws, including provisions related to preventing fraudulent and manipulative practices and protecting investors from such practices.

Results in Brief

About 22 percent of U.S. banks offered securities brokerage services to their customers in 1994. SEC and NASD regulated the securities activities of 88 percent of these 2,400 banks because they provided these services through registered broker-dealers or through third-party arrangements with registered broker-dealers. However, 287 banks provided these services on bank premises exclusively through bank employees. These bank-direct brokerage operations were subject to regulation by federal bank regulators and were exempted from regulation by SEC and NASD. GAO found that federal bank regulators did not always review bank-direct brokerage operations as part of routine bank examinations. However, in 1994 bank regulators jointly issued new guidance and examination procedures that placed increased emphasis on such reviews.

Because some bank securities activities are overseen by securities regulators while others are overseen by bank regulators, the potential exists for inconsistent oversight of these activities. This potential for inconsistent oversight has not been much of a problem so far, because most banks provide securities services in affiliates that are regulated primarily by securities regulators. While the regulators have coordinated their exams, among other things, providing consistent securities oversight, no matter where in an organization these activities are done, would be enhanced by increased cooperation, coordination, and sharing of regulatory expertise among bank and securities regulators.

As of November 1994, the Federal Reserve had 35 Section 20 securities subsidiaries to examine for compliance with firewall requirements. GAO found that FRS examiners usually met their inspection schedules, addressed the inspection objectives and procedures outlined in FRS guidance, and, in general, comprehensively reviewed or tested for compliance with applicable firewalls. However, GAO found a few cases where full compliance with all firewalls could not be assured or was not documented. Specifically, for 2 of the 14 subsidiary examinations that GAO reviewed, neither Federal Reserve examiners nor the bank internal auditors, whose work the examiners can rely upon, had reviewed or tested all applicable firewall procedures. Also, in two of the four FRS districts GAO visited, examiners had not always provided sufficient documentation to determine whether they had reviewed or tested applicable firewall procedures, especially when examiners relied on internal auditors.

Unlike the Federal Reserve, FDIC had no centralized program to oversee the activities of the bona fide securities subsidiaries of state-chartered banks, and did not know how many such subsidiaries were actually operating. FDIC also had not fully prepared its examiners to examine securities activities because it had not provided training and had no examination guidelines. In some cases, FDIC examiners were confused about when subsidiaries needed to obtain the bona fide designation. As a result, FDIC had little assurance about the risks these subsidiaries' activities pose to affiliated banks.

GAO's Analysis

Bank Securities Brokerage Activities Raise Regulatory Issues

About 2,400 banks—22 percent of nearly 11,100 banks nationwide—offered retail securities brokerage services, according to the results of GAO's survey of banks. Of those 2,400 banks, most (88 percent) provided the services through registered brokerage subsidiaries or through arrangements with nonaffiliated registered securities broker-dealers. The remaining 287 banks, about 12 percent, provided direct brokerage services. According to survey responses, these banks had limited their services to discount brokerage, in which the employees of these banks took customers' orders but did not make buy and sell recommendations.

Because the securities laws exempt banks from SEC registration and regulation, the securities activities of the 287 banks that GAO estimated provide direct brokerage services are regulated by bank regulators. GAO's review of regulatory examinations of 40 of these banks, completed during 1992 through mid-1994, showed that bank regulators had not reviewed the brokerage operations of 29, or 72 percent, of the sampled banks.

Bank regulators have since taken steps intended to improve the oversight of banks' direct brokerage operations. In 1994, bank regulators issued a joint policy statement to banks on the sale of nondeposit investment products, such as mutual funds, stocks, and bonds. Each regulator also issued examination guidance for reviews of bank-direct brokerage operations.

Bank and securities regulators have also acted to coordinate examinations of most bank brokerage activities, but other regulatory issues need to be addressed to ensure consistent regulation of all bank brokerage activities. In January 1995, all three banking regulators and NASD reached a formal agreement to coordinate examinations of bank-affiliated broker-dealers and share examination findings and workpapers. However, this agreement did not address bank-direct brokerage operations because they are not subject to SEC and NASD regulation. Also, bank and securities regulators' guidance and proposed rules under which bank brokerages are expected to operate are not consistent, and not all regulatory procedures used by securities regulators are available to bank regulators. The lack of consistent regulatory standards for bank-related and nonbank-related brokerages could result in confused investors, ambiguous sales practice standards, and inconsistent oversight of sales representatives.

Bank regulators have provided new guidance and examination procedures and are working to improve their oversight of bank-direct brokerage operations. Nevertheless, providing consistent securities oversight, no matter where in an organization these activities are done, would be enhanced by ongoing cooperation, coordination, and sharing of regulatory expertise among bank and securities regulators.

Federal Reserve Inspections Usually Assess Compliance With All Applicable Firewalls

The Federal Reserve's policy is to inspect the firewall procedures of underwriting subsidiaries either before approving their underwriting and dealing activities or during initial inspections after approval, depending upon the type of underwriting powers sought. Approved subsidiaries underwrote $59 billion of securities in 1993. As of November 1994, 35 subsidiaries were operating with Federal Reserve approval to underwrite and deal in certain bank-ineligible securities.

Federal Reserve examiners may rely upon annual reviews by the bank holding company internal auditors to assess subsidiaries' compliance with firewall requirements. The examiners may also do their own annual evaluations of firewall compliance by subsidiaries during bank holding company inspections. The Federal Reserve is also to routinely monitor the activities and financial status of the subsidiaries.

Although the Federal Reserve's inspections GAO reviewed usually addressed all applicable firewalls, in two instances Federal Reserve examiners and bank holding company internal auditors did not review all applicable firewalls. For example, in a 1993 inspection of a large underwriting subsidiary, neither Federal Reserve examiners nor internal auditors reviewed firewalls that restricted credit extensions to the underwriting subsidiary and its clients and customers or that prohibited intercompany transactions and transfers of assets between the subsidiary and affiliated insured banks. The Federal Reserve inspections also did not always document the extent to which examiners or internal auditors had tested firewalls. For example, in GAO's review of the annual inspections of six subsidiaries, examiners said they relied on the internal auditors' review and tests and did some selective review and tests themselves, but the review and testing was not always documented in workpapers. In these instances, inspection supervisors' reviews would have been needed to ensure that all firewalls were examined and work was properly documented in work papers.

The Federal Reserve has imposed few sanctions for firewall noncompliance. However, it has acted to correct identified compliance-related deficiencies through inspection close-out meetings with bank officials and required correspondence from the banks on actions taken to correct deficiencies.

FDIC Had No Program to Assess Risks Posed by Securities Activities

FDIC requires state-chartered non-FRS-member banks that establish or acquire bona fide subsidiaries to underwrite and deal in securities to file notices with FDIC regional directors. FDIC then is to examine the parent banking organizations and the subsidiaries for compliance with FDIC regulations.

Unlike the Federal Reserve, FDIC has no centralized system to oversee the securities activities of bank subsidiaries. Such a system could help FDIC to identify banks that own operating subsidiaries and assess the subsidiaries' financial condition, compliance with firewall restrictions, and the overall risks the subsidiaries might pose to insured banks and the Bank Insurance Fund. FDIC could not provide accurate data on the number of banks that were using authority granted under FDIC regulations.

FDIC officials said that underwriting and dealing in securities were more common among larger banking organizations than among the state-chartered nonmember banks it supervises. FDIC officials said that examiners could identify any bona fide subsidiaries that should be subject to its regulatory provisions through the examination process. However, in 3 of 13 examinations GAO reviewed, FDIC examiners were confused about the applicability of these provisions and had to seek a legal determination from the FDIC regional headquarters about a subsidiary's status. As of September 1994, FDIC had no formal examiner training program that focused on oversight of securities activities of state nonmember banks and their subsidiaries.

Without a program to identify and routinely review the securities activities and the financial condition and performance of bank securities subsidiaries that are under FDIC's jurisdiction, FDIC cannot fully assess the risks the underwriting and dealing activities of bank subsidiaries pose to insured banks and the Bank Insurance Fund.

Recommendations

GAO is making the following recommendations:

- The Federal Reserve, FDIC, OCC, SEC, and NASD should work together to develop and implement an approach for regulating bank-direct securities activities that provides consistent and effective standards for investor protection, while ensuring bank safety and soundness.
- The Chairman of the Board of Governors of the Federal Reserve System should ensure that either Federal Reserve examiners or internal auditors review and test all applicable firewalls at least once annually and appropriately document the work performed.
- The Chairman of FDIC should establish a program to identify and routinely review the securities activities and the financial condition and performance of bona fide subsidiaries under FDIC's jurisdiction to assess the overall risks posed by the activities on federally insured banks and ensure compliance with firewalls. The program should provide FDIC examiners guidance and training on how to examine bank and bank subsidiary securities activities.

Agency Comments

The Federal Reserve, FDIC, OCC, SEC, and NASD provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2, 3, and 4. The bank regulators commented that they have already begun efforts to coordinate regulation of bank brokerage activities with securities regulators. The securities regulators agreed to participate in cooperative efforts but believe that a system of functional regulation, in which each entity is regulated according to the particular activities that it undertakes, would provide a more effective and efficient regulatory structure.

The Federal Reserve commented that it would promptly address GAO's findings on firewall compliance. It intends to reiterate to examiners the need to fully inspect and document Section 20 companies' compliance with firewalls.

FDIC disagreed with GAO over the benefits of centralized monitoring of the securities activities and financial performance of bona fide subsidiaries of insured banks. FDIC commented that a centralized program would create a burdensome reporting process while supervision of those institutions would still fall on regional personnel. FDIC said that it is considering the scope and type of examiner training necessary for bank securities activities.

FDIC also disagreed with GAO over the need for a program to assess the risks securities activities of bona fide subsidiaries may pose to insured banks and ensure compliance with regulatory firewalls. It said that such a program would create a burdensome reporting process.

GAO disagrees with FDIC's views. GAO believes that as a regulator of federally insured banks, FDIC is responsible for knowing of and supervising activities that may pose risks to those banks. A program to identify and monitor the securities activities of those banks' securities subsidiaries could improve FDIC's oversight immediately at little extra cost. Also, because FDIC already requires banks to notify it of subsidiaries' securities activities and has regional supervision programs in place and because securities subsidiaries' financial data are available from reports required by securities SROs, a centralized program should not impose added regulatory or reporting burden on banks.

Contents

Chapter 4 FDIC Was Unable to Assess Risks to Federally Insured Banks Posed by Securities Activities of Bank Subsidiaries

Appendixes

Tables

Figures

Abbreviations

BIF	Bank Insurance Fund
CRD	Central Registration Depository
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FRS	Federal Reserve System
NASD	National Association of Securities Dealers
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation
SRO	self-regulatory organization

Introduction

Since the mid-1980s, banks have been expanding into securities activities by providing retail brokerage services—buying and selling securities for customers, which may involve making buy and sell recommendations—and underwriting and dealing in securities.[1] These securities activities can provide additional income for banks and convenience for bank customers, and they can foster a more competitive securities industry. However, without proper management, including internal controls, and appropriate regulatory oversight, banking organizations that conduct such securities activities may be subject to a heightened risk of financial losses that, if large enough, could undermine public trust in the banking system. Also, without proper oversight of the securities activities, investors may not be adequately protected from fraudulent and unfair sales practices. As a result of concerns of and issues raised by the Ranking Minority Member of the House Committee on Commerce and the Ranking Minority Member of the Subcommittee on Telecommunications and Finance, House Committee on Commerce, about the expansion of banks into securities activities, we reviewed federal bank regulators' procedures and processes for examination and supervision of bank securities activities.

Background

Banks' expansion into securities activities presents legal and financial risks to federally insured banks. How these risks are managed and overseen depends on how the banks are chartered and regulated and on how they are organized to do business. It also depends on the securities activities the banks undertake, which may be limited by federal law and regulation.

Securities Activities Can Pose Legal and Financial Risks to Insured Banks

Generally, the types and degree of risk that securities activities present to banking organizations vary by type of activity. Discount brokerage activities, in which the broker only takes orders and executes trades for customers who make their own investment decisions, pose little risk. Full-service brokerage activities, in which the broker also provides investment recommendations, can pose legal and financial risk, because the broker—including, for example, a federally insured bank whose employees provide investment advice—can be held liable for a customer's financial losses if those losses result from fraudulent or unsuitable investment recommendations. Underwriting and dealing activities generally pose greater financial risk because the underwriter or dealer

[1] Underwriting is the public distribution of new issues of securities; dealing refers to the business of holding oneself out to the public as being willing to make a secondary market in a security by offering to buy and sell securities as principal.

may incur losses in the principal amount (face value) of securities being underwritten or held.

Banks Are Chartered and Regulated by Federal and State Authorities

A bank's power to engage in securities activities comes from the government authority that charters the bank. In the case of a national bank, the chartering authority is the Office of the Comptroller of the Currency (OCC). OCC, as the primary regulator, establishes the regulations under which national banks operate. State authorities charter state banks. A state bank's authority to engage in securities activities is established by the state banking agency and governed by state law.

Two other federal agencies also have bank regulatory responsibilities.[2] The Board of Governors of the Federal Reserve System is the primary federal regulator of bank holding companies[3] and those state-chartered banks that choose to become members of the Federal Reserve System (FRS). The Federal Deposit Insurance Corporation (FDIC) is the primary federal regulator of state-chartered banks that have federally insured deposits and are not members of the Federal Reserve System. FDIC also administers the Bank Insurance Fund (BIF), which provides deposit insurance for banks. Because of this role, FDIC has back-up regulatory authority over all insured banks.

The primary goal of federal bank regulators is to work toward improving and maintaining the safety and soundness of banks to help safeguard the financial system and protect depositors and other customers. Regulators adopt policies and regulations and examine the banks under their jurisdiction for soundness and compliance with these policies and regulations. The Federal Reserve also inspects bank holding companies to ascertain their financial strength and to determine the consequences of

[2]The Office of Thrift Supervision and the National Credit Union Administration also regulate depository institutions, respectively, thrifts and credit unions. Their activities were not within the scope of our work because it was limited to securities activities of commercial banks.

[3]A bank holding company is a company that controls one or more banks. A company controls a bank if it owns, controls, or has power to vote 25 percent or more of the voting stock of a bank, controls the election of a majority of the bank's directors, or exercises a controlling influence over the bank's management or policies. A bank holding company structure allows nonbank subsidiaries to engage in a variety of nonbanking activities that are considered closely related to banking functions.

The largest bank in a bank holding company is typically referred to as the lead bank and often holds most of the company's assets. Although the Federal Reserve is responsible for inspecting all bank holding companies, OCC or FDIC, respectively, would be responsible for regulating the lead bank if it is a nationally chartered bank or a state-chartered bank that is not a member of the Federal Reserve System.

transactions between the parent bank holding company, its nonbanking subsidiaries, and the subsidiary banks.

Bank and Securities Regulators Oversee Various Bank Securities Activities

Bank regulators and securities regulators both play a role in regulating the securities activities of banks; the specific roles they play depend on both the activities and the way banks organize those activities. Brokerage services, for example, may be regulated by bank or securities regulators depending upon the method the bank uses to provide these services. Also, both bank regulators and securities regulators are responsible for overseeing various aspects of the underwriting and dealing activities of banking organization subsidiaries.

The Securities Act of 1933 and the Securities Exchange Act of 1934 are the basis for securities regulation in the United States. Under the 1934 act, firms engaged in brokering or dealing securities, including bank securities affiliates, must register as broker-dealers.[4] The Securities and Exchange Commission (SEC) is the federal agency responsible for securities regulation. SEC achieves its mission, in part, through self-regulatory organizations (SROs) like the National Association of Securities Dealers (NASD) and the New York Stock Exchange.[5]

Basically, SEC and SROs adopt rules and regulations that the broker-dealers must follow to protect securities investors and provide for the maintenance of fair and orderly markets. Securities rules and regulations require companies providing brokerage services to have adequate capital to protect investors from the losses of broker-dealers. Such companies are also required to implement procedures to protect investors from unfair sales practices. The inability of registered broker-dealers to meet obligations to retail customers—that is, to restore the funds in retail

[4]Broker-dealers combine the function of brokers and dealers. Brokers are agents who handle public orders to buy and sell securities. Dealers are principals who buy and sell securities for their own accounts and at their own risk.

[5]We have reported in the past on SEC and SRO regulation of the securities industry and broker-dealers in general, which include registered securities affiliates of banking organizations. In those reports we recommended various actions needed to improve regulatory oversight of securities markets and broker-dealers and better protect investors. See, for example, Securities Industry: Strengthening Sales Practice Oversight (GAO/GGD-91-52, Apr. 25, 1991); Securities Investor Protection: The Regulatory Framework Has Minimized SIPC's Losses (GAO/GGD-92-109, Sep. 28, 1992); Penny Stocks: Regulatory Actions to Reduce Potential for Fraud and Abuse (GAO/GGD-93-59, Feb. 3, 1993); and Securities Markets: Actions Needed to Better Protect Investors Against Unscrupulous Brokers (GAO/GGD-94-208, Sep. 14, 1994).

customers' accounts if the broker-dealers go out of business—is insured against by the Securities Investor Protection Corporation (SIPC).[6]

Securities regulators examine and monitor the broker-dealers' activities for compliance with securities laws and regulations. SEC also evaluates the quality of SRO oversight in enforcing compliance with federal securities laws and SRO rules, including provisions related to preventing fraudulent and manipulative practices and protecting investors from such practices.

Brokerage Activities May Be Regulated by Securities or Bank Regulators

As shown in table 1.1, securities regulators are responsible for regulating a bank's brokerage services when a bank provides these services to its customers through (1) a registered securities brokerage affiliate; or (2) an arrangement with an unaffiliated registered third-party broker-dealer, whether the services are provided on or off bank premises. When these services are provided on the bank's premises by bank employees or through a bank affiliate, bank regulators may examine the brokerage activities. Bank regulators have no direct authority over unaffiliated, third-party broker-dealers, even when they operate on bank premises. However, the federal banking agencies' "Interagency Statement on Retail Sales of Nondeposit Investment Products," February 15, 1994, requires that a bank's agreement with a third-party broker-dealer authorize the appropriate banking agency to have access to all records of the third-party broker as are necessary or appropriate to evaluate whether the third-party broker is complying with the terms of its agreement. Bank regulators generally address safety and soundness concerns and compliance with applicable laws, regulations, and supervisory guidance, while securities regulators generally address investor protection concerns and compliance with securities laws and regulations.

Banks that exclusively use their own employees, rather than an affiliated company, to provide securities brokerage services to retail customers are exempt from registration and regulation as broker-dealers under the 1934 securities exchange act. The exemption means that these activities are outside the normal securities regulatory framework. However, the antifraud provisions of the federal securities laws still apply. Further, banking regulations require banks providing such direct securities brokerage services to keep records and provide customers confirmations of securities transactions. Also, the securities brokerage activities of these

[6]SIPC, a private, nonprofit membership corporation established by Congress in 1970, provides certain financial protections to the customers of failed U.S. broker-dealers. In 1992 we reported that SIPC had been successful at protecting investors and noted that SIPC's success was derived from SEC's and SROs' diligent oversight of the securities industry. See Securities Investor Protection: The Regulatory Framework Has Minimized SIPC's Losses (GAO/GGD-92-109, Sep. 28, 1992).

banks are not SIPC-insured, unless the bank customers are also identified as customers of an SEC-registered broker-dealer through which the bank places customers' orders for execution.

Table 1.1: Bank Methods of Providing Retail Brokerage Services and Resulting Regulatory Responsibilities

Method	Regulatory responsibility
Off bank premises, either through registered securities brokerage affiliate or an arrangement with an unaffiliated registered third-party broker-dealer.	Securities regulators. Bank regulators also can examine activities of bank affiliates.
On bank premises through a registered securities brokerage affiliate.	Bank and securities regulators.
On bank premises through a third-party arrangement with an unaffiliated registered broker-dealer.	Securities regulators. Bank regulators have no direct authority over unaffiliated broker-dealers. A bank's agreement with an unaffiliated broker-dealer is required to provide regulators access to records of the unaffiliated broker-dealer.
On bank premises through bank's own employees.	Bank regulators.

Source: GAO Analysis

Affiliates That Underwrite and Deal in Securities Are Regulated by Both Bank and Securities Regulators

Banking organizations' securities underwriting and dealing activities are subject to regulation by both bank and securities regulators. Bank regulations require that a bank holding company and its subsidiaries that underwrite and deal in securities meet certain financial conditions and have regulatory limitations called firewalls in place and functioning to protect insured banks and bank customers from any possible losses of an underwriting affiliate. Bank regulators examine the underwriting subsidiaries for both their overall financial condition and compliance with firewalls. Securities regulators oversee and examine the same subsidiaries for compliance with securities laws and SEC and SRO regulations and rules.

Firewalls are policies and procedures that separate the activities of banks from their affiliated companies that underwrite and deal in securities. These devices are meant to insulate insured banks from any possible losses of the underwriting affiliate. Firewalls also serve to minimize conflicts of interest.

Banks Are Not Prohibited From Providing Retail Brokerage Services

Banks have never been prohibited by federal law or regulation from providing customers with retail securities brokerage services and associated investment advisory services. Nevertheless, bank retail brokerages did not become common until after the mid-1980s, when OCC issued a statement that generally granted national banks approval to provide retail brokerage services. The Federal Reserve also issued a statement approving bank holding companies' provision of retail brokerage services.

After these statements were issued, banks began to request and receive approval from the regulators to provide retail brokerage services. At the time of our review, banks' retail securities brokerage services included the buying and selling of securities, such as stocks, bonds, and mutual funds, which bank regulators refer to as "nondeposit investment products."

Banking Organizations Can Underwrite and Deal in Securities Only Under Certain Conditions

The Banking Act of 1933, commonly known as the Glass-Steagall Act, restricts banks and bank-affiliated companies in many underwriting and dealing activities. The act allows banks and companies affiliated with a bank[7] to underwrite and deal in certain types of securities known as bank-eligible securities. These include U.S. government and federally sponsored agency securities and general obligation bonds of states and municipalities. Underwriting and dealing in other types of securities—known as bank-ineligible securities—are subject to specific restrictions.

The Glass-Steagall Act was enacted in reaction to the banking crisis of the Great Depression, during which many banks failed and customers lost confidence in the banking system. Basically, the act separates commercial and investment banking in an effort to enhance the safety and soundness of commercial banking and protect bank customers from potential conflict-of-interest abuses and other inequities.[8] The Glass-Steagall Act prohibits banks from underwriting and dealing in bank-ineligible securities—that is, municipal revenue bonds, private mortgage-backed securities, commercial paper, asset-backed securities, and corporate equity and debt securities (stocks and bonds). More specifically:

- Section 16 of the act prohibits a national bank from underwriting and dealing in bank-ineligible securities.

[7]A bank becomes affiliated with a securities underwriting firm when (1) the company that owns the bank also owns the securities firm, (2) the securities firm owns the bank, or (3) the securities firm is a subsidiary of the bank.

[8]An example of an inequity that could result if banks were allowed unrestricted securities activities would be banks' favoring loan requests of customers and clients of their securities business over those of other bank customers.

- Section 20 of the act prohibits a Federal Reserve member bank from becoming affiliated with any company that is "principally engaged" in the underwriting, sale, or distribution of bank-ineligible securities.
- Section 21 of the act prohibits any person or company engaged in the business of underwriting, selling, and distributing bank-ineligible securities from engaging in the business of receiving deposits.
- Section 32 of the act governs interlocking relationships by prohibiting directors, officers, or employees of member banks from serving as directors, officers, or employees of any institution primarily engaged in underwriting and dealing in securities.

The Federal Reserve Act subjects state-chartered banks that belong to the Federal Reserve System to the same underwriting and dealing restrictions as national banks. Although Section 21 of the Glass-Steagall Act in effect prohibits state-chartered banks that are not FRS members from directly underwriting and dealing, they are not subject to Glass-Steagall restrictions on affiliations and, if not prohibited by state law, may affiliate with securities firms. However, bank holding companies that own state nonmember banks must obtain the Federal Reserve's approval under the Bank Holding Company Act before acquiring any underwriting subsidiary.

Until recently, OCC interpreted the restrictions on national bank securities activities to apply to both banks and any subsidiary of the bank. OCC, however, changed this interpretation in November 1994, when it submitted a proposal to revise its rules governing corporate applications. The proposal would set up a process for OCC to consider applications from individual national banks to pursue new activities, including securities underwriting, through establishment of operating subsidiaries. OCC formerly prohibited bank subsidiaries from activities impermissible for the parent banks. According to OCC, applications would be considered on a case-by-case basis. OCC is considering comments on the proposal.

Section 20 Subsidiaries

In addition to restricting activities within banks, Section 20 of the Glass-Steagall Act prohibits Federal Reserve member banks—all national banks and state banks that choose to become members—from affiliating with an institution principally engaged in underwriting securities. The Federal Reserve interprets the prohibition to allow banks owned by holding companies to affiliate with institutions engaged in securities underwriting and dealing so long as the activity involving bank-ineligible securities generates 10 percent or less of the affiliate's gross revenue. The 10-percent threshold signifies that the bank-ineligible activity is not a principal activity of the institution. The companies that the Federal

Reserve has approved to underwrite and deal in bank-ineligible securities are known as Section 20 subsidiaries. Generally, the principal business of these subsidiaries is underwriting and dealing in bank-eligible securities.

Other financial and operating conditions must also be met before a Section 20 subsidiary may be established by a bank holding company. As described in further detail in chapter 3, the company must meet the following criteria:

- It must be adequately capitalized.
- It must be approved for such activities by the Federal Reserve Board.
- It must register with SEC as a broker-dealer and be a member in good standing of NASD.
- It must comply with certain operating conditions and firewalls.

Bona Fide Subsidiaries

Although Section 21 of the Glass-Steagall Act has the effect of prohibiting a state-chartered non-FRS-member bank from underwriting securities, the prohibition does not extend to the bank's subsidiaries. In 1984, FDIC issued regulations[9] setting out conditions under which insured state banks that are not Federal Reserve members can establish subsidiaries to engage in the sale, distribution, and underwriting of bank-ineligible securities. These subsidiaries are known as bona fide subsidiaries.

Unlike the Federal Reserve, FDIC does not require non-FRS-member banks to obtain advance approval from FDIC headquarters to establish bona fide subsidiaries. However, any nonmember bank that wants to establish such subsidiaries is required to notify the Regional FDIC director of its intentions. Otherwise, bona fide subsidiaries must meet conditions similar to those required of Section 20 subsidiaries. As discussed in further detail in chapter 4, the company must meet the following criteria:

- It must be adequately capitalized.
- It must register with SEC as a broker-dealer and be a member in good standing of NASD.
- It must comply with operating conditions and restrictions that are similar to the firewalls that the Federal Reserve requires of bank holding company subsidiaries.

[9] 12 CFR Section 337.4.

Objectives, Scope, and Methodology

As a result of the requesters' concerns and issues raised about the regulation of banking organizations' expansion into securities brokerage, underwriting, and dealing activities, we reviewed (1) bank regulators' procedures and processes for examining and supervising banks that provide brokerage services directly by bank employees and (2) banking organizations' securities underwriting and dealing activities. Our objectives were to assess

- the extent to which banks provide securities brokerage services and how these services are regulated;
- the Federal Reserve's supervision of bank holding company subsidiaries that the agency authorizes to underwrite and deal in securities, including the completeness and results of its inspections; and
- FDIC's regulation of bona fide subsidiaries that underwrite and deal in securities.

We also sought to provide information on training available to bank examiners on brokerage and other securities activities.

The scope of our work was limited to banking organizations' securities activities that are subject to Federal Reserve, OCC, and FDIC regulation. We have reported in the past on SEC and SROs' regulation of the securities industry and broker-dealers in general, which include registered securities subsidiaries of banking organizations. This report does not address other bank securities activities, including banks' holding securities as proprietary investments, which they can trade; banks' management of trusts or serving as investment advisers to mutual funds; and banks' activities as registered government and municipal securities dealers. Also, it was not within the scope of our work to determine comparative degrees of risk associated with different types of investment products or the various banking and nonbanking activities that banks might engage in.

We obtained information on regulatory programs from officials of federal bank regulatory agencies, reviewed agency documents and examination files, and surveyed a sample of banks. To evaluate bank regulators' oversight of bank-direct brokerage operations we obtained from OCC, the Federal Reserve, and FDIC, respectively, guidance for examining brokerage operations and nonbanking activities of national, state FRS-member and state non-FRS-member banks and bank subsidiaries. We reviewed regulatory examinations of banks identified as having bank-direct brokerage operations to determine if the brokerage operations were examined as directed by the guidance. We identified banks that provided brokerage services directly by the bank from our survey of banks' securities and mutual fund activities (see ch. 2).

We obtained information on the Federal Reserve's supervision of underwriting subsidiaries of bank holding companies from Federal Reserve officials. We reviewed the two most recently completed inspections, usually from 1992 and 1993, of the underwriting subsidiaries in four Federal Reserve Districts—Chicago, New York, Richmond, and San Francisco—to determine if the inspections were conducted as directed by Federal Reserve guidance on the inspection of nonbank subsidiaries engaged in underwriting and dealing. The four districts were selected because they provided a mix of banking organizations and subsidiaries, including money center banks, large regional organizations, and foreign-owned subsidiaries. They also were located near our headquarters and regional offices.

We obtained information on regulation of securities activities conducted by national banks and their securities affiliates from OCC officials. We also reviewed examinations and interviewed examiners of national banks affiliated with underwriting subsidiaries to determine if their examinations included procedures to review prohibited interaffiliate transactions between a national bank and an underwriting affiliate.

We obtained information on regulation of nonmember state-chartered banks' securities activities from FDIC officials. In addition to our review of bank-direct brokerage operations, we also reviewed and selected recent examinations of banks identified by FDIC as having bona fide subsidiaries meeting the criteria for underwriting and dealing in securities.

The three bank regulators also provided us information related to the training of bank examiners on banks' securities activities.

To develop information on the extent to which banks are providing brokerage services to retail customers and how those services are being provided, we surveyed a stratified random sample of 2,233 banks that is projectable to a nationwide universe of about 11,100 commercial banks. Our survey sample, described in appendix VIII, included Federal Reserve member, nationally chartered, and state-chartered banks of varying sizes. We conducted the survey because data on banks' securities activities that are compiled by bank regulators and industry groups did not capture the information we sought on banks' involvement in securities brokerage and mutual fund activities.

Our work was performed at the Board of Governors of the Federal Reserve System, OCC, and FDIC in Washington, D.C.; in the Federal Reserve's Chicago, New York, Richmond, and San Francisco districts; and in OCC's and FDIC's Atlanta, Chicago, New York, and San Francisco regions. We conducted our audit work between May 1993 and September 1994 in accordance with generally accepted government audit standards. We obtained comments on a draft of the report from the Federal Reserve, FDIC, OCC, SEC, and NASD. Their comments are presented and evaluated in chapters 2, 3, and 4 and are reprinted in appendixes III, IV, V, VI, and VII.

Banks' Securities Brokerage Activities Raise Regulatory Issues

Our survey of banks showed that the securities activities of most banks are regulated by SEC. The survey also showed that an estimated 287, about 12 percent, of the estimated 2,400 banks that provide securities brokerage services provide those services on bank premises, exclusively through bank employees. We refer to these as bank-direct brokerage operations. Because banks are exempt from securities regulation, as noted in chapter 1, the securities brokerage activities of these banks are regulated by bank regulators. In the past, bank regulators did not always review the bank-direct brokerage operations as part of bank examinations, but they issued new guidance and examination procedures in 1994 that have increased emphasis on such reviews. Nevertheless, exempting the securities activities of these banks from securities regulation results in parallel, though different, regulatory systems for the same activity.

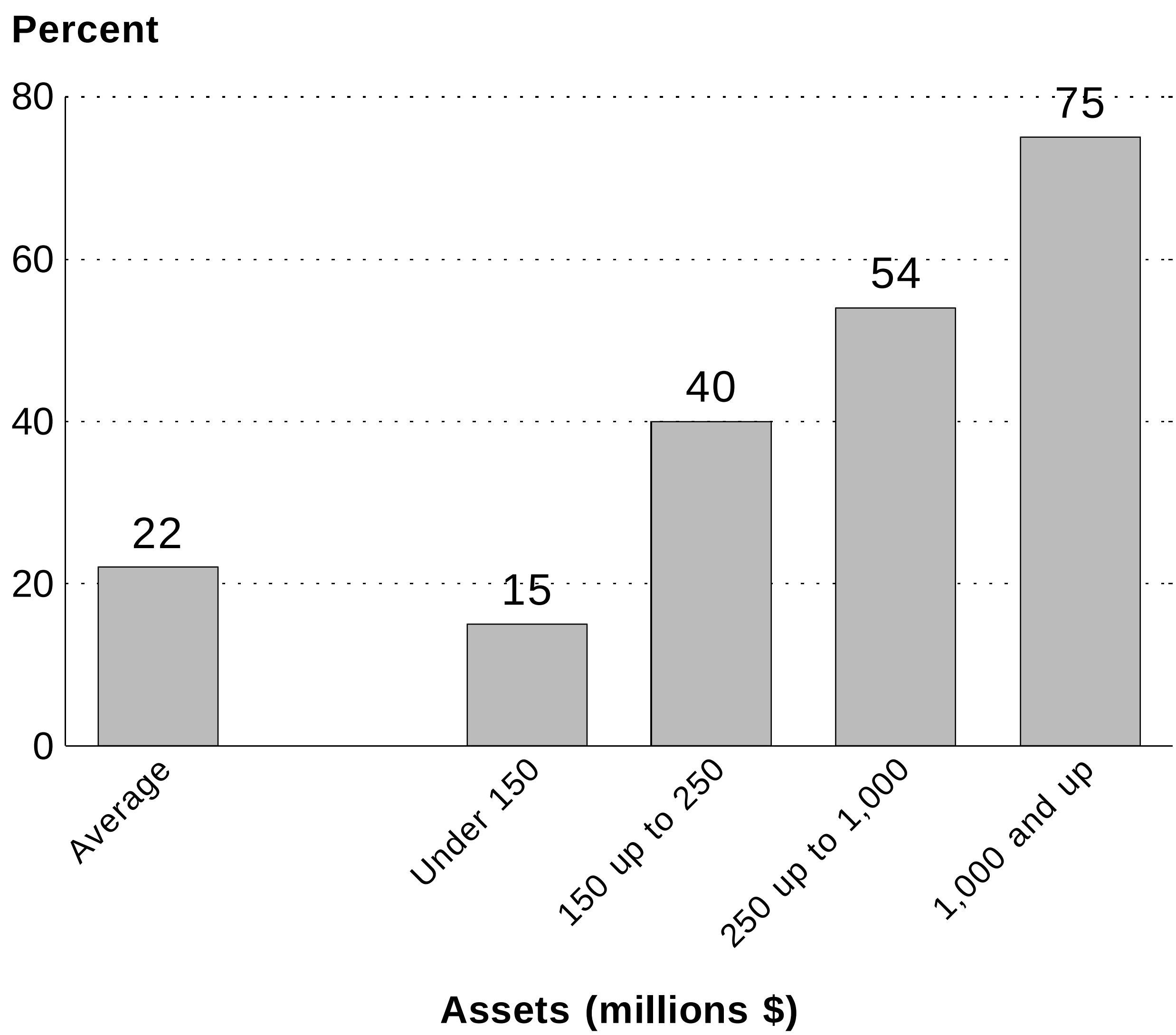
Many Banks Provide Retail Securities Brokerage Services

To determine the number of banks providing bank-direct and other brokerage services and to gather data about the nature of services provided, we surveyed a sample of over 2,200 banks nationwide. Appendixes VIII and IX provide technical information about the survey and the questionnaire we used.

On the basis of the results of our survey, we estimate that about 2,400 banks offered retail securities brokerage services as of June 1994. This represents about 22 percent of the 11,084 banks that we estimated were in the United States at the time of our survey.[1] Figures 2.1 through 2.3 show by size, type, and region the percent of all banks that offered brokerage services. For example, figure 2.1 shows that the larger the bank, the greater the likelihood that it provided securities brokerage services to retail customers.

[1]The sampling errors for the weighted estimates from our survey are no more than plus or minus 5 percent unless otherwise noted. The number of banks shown differs from the number, 11,210, shown in app. VIII, table VIII.1, because we estimated 126 banks in the original population were ineligible for our survey because they had ceased to operate as financial institutions.

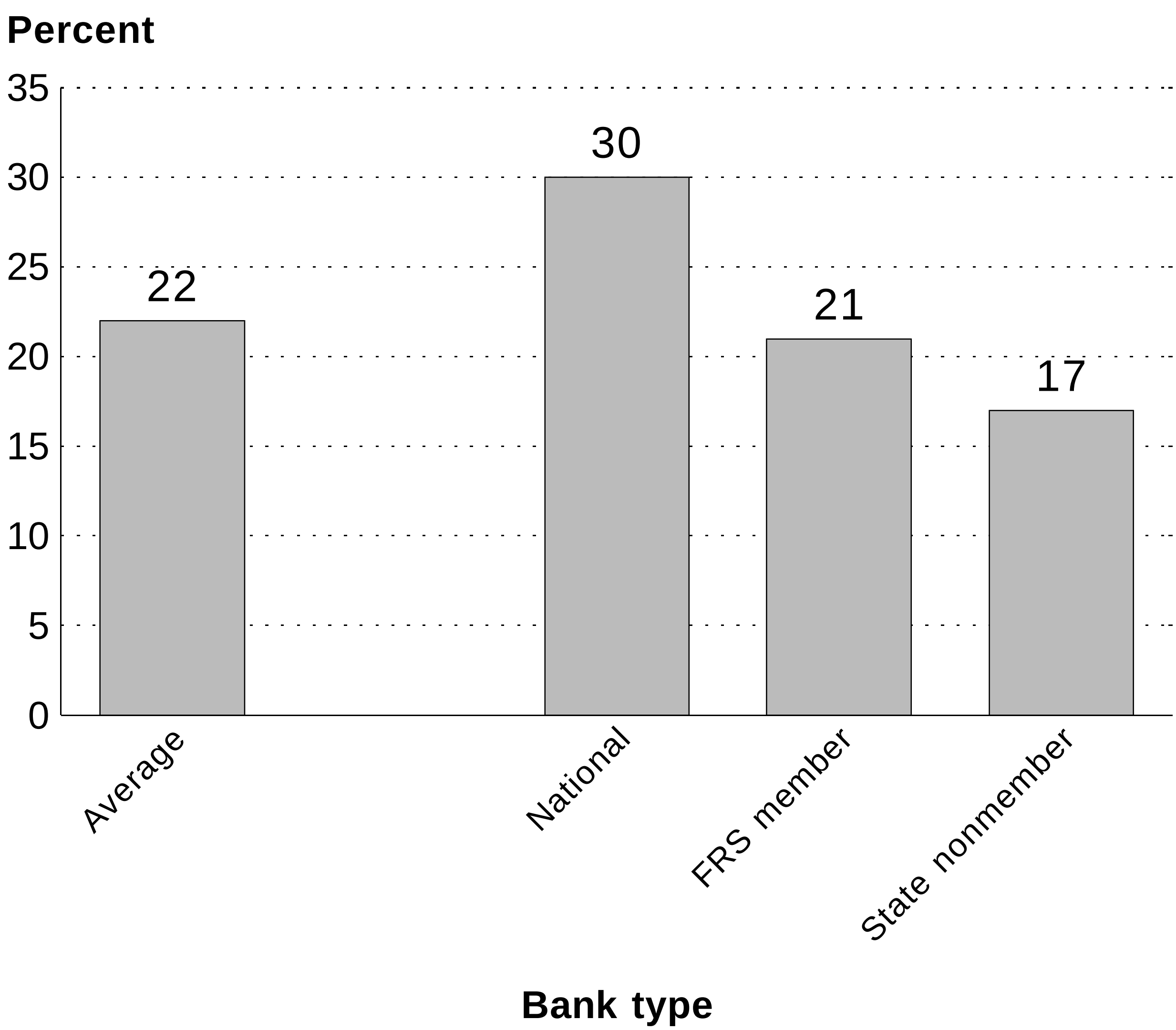
Figure 2.1: Estimated Percent of All Banks and Banks in Each Size Category Offering Retail Securities Brokerage Services



Source: GAO survey.

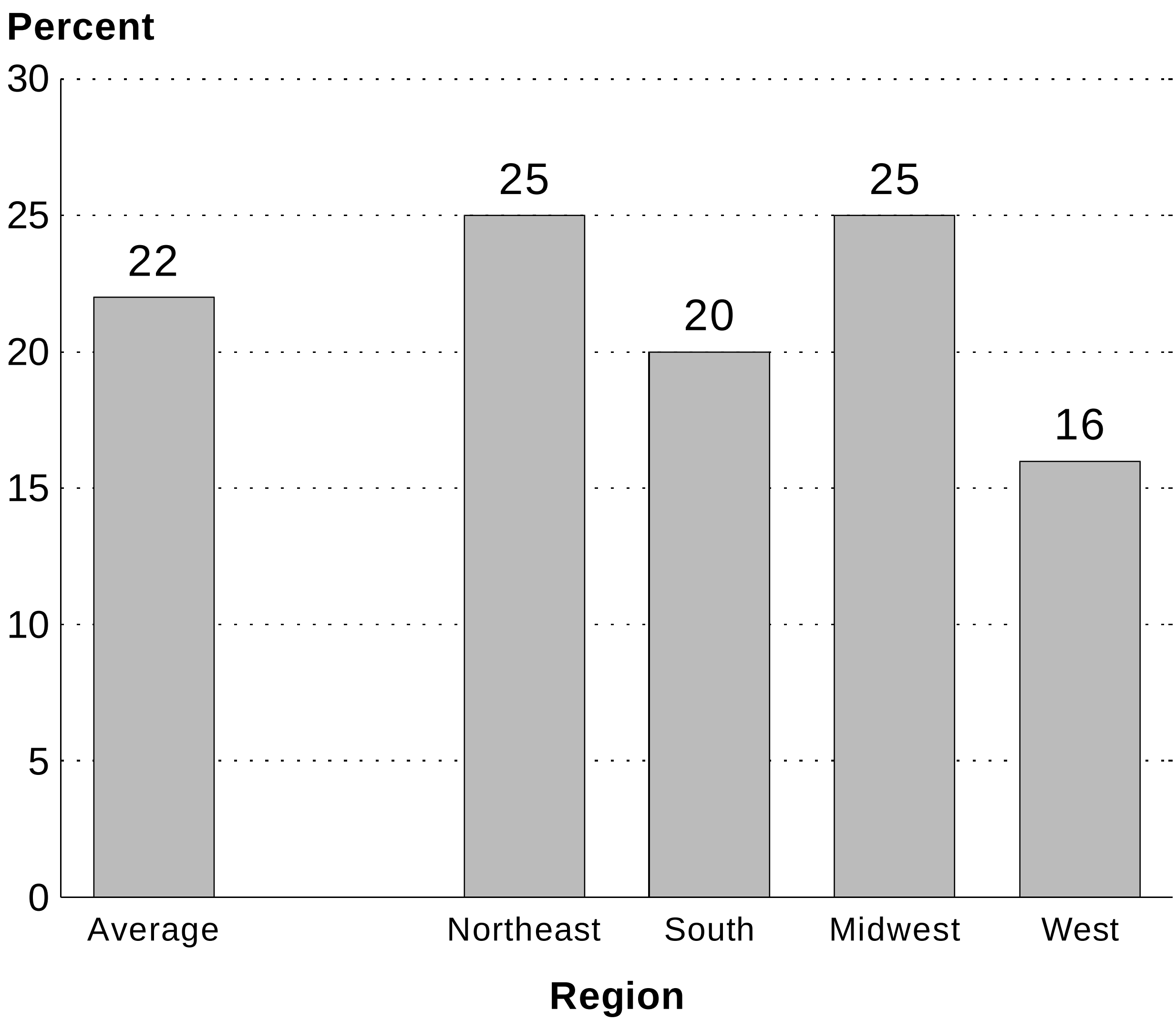
Figures 2.2 and 2.3 show the percentages of banks by type and region of the United States that provide securities brokerage services.

Figure 2.2: Estimated Percent of All Banks and Banks of Each Type Offering Retail Securities Brokerage Service



Source: GAO survey.

Figure 2.3: Estimated Percent of All Banks and Banks in Each Region Offering Retail Securities Brokerage Services

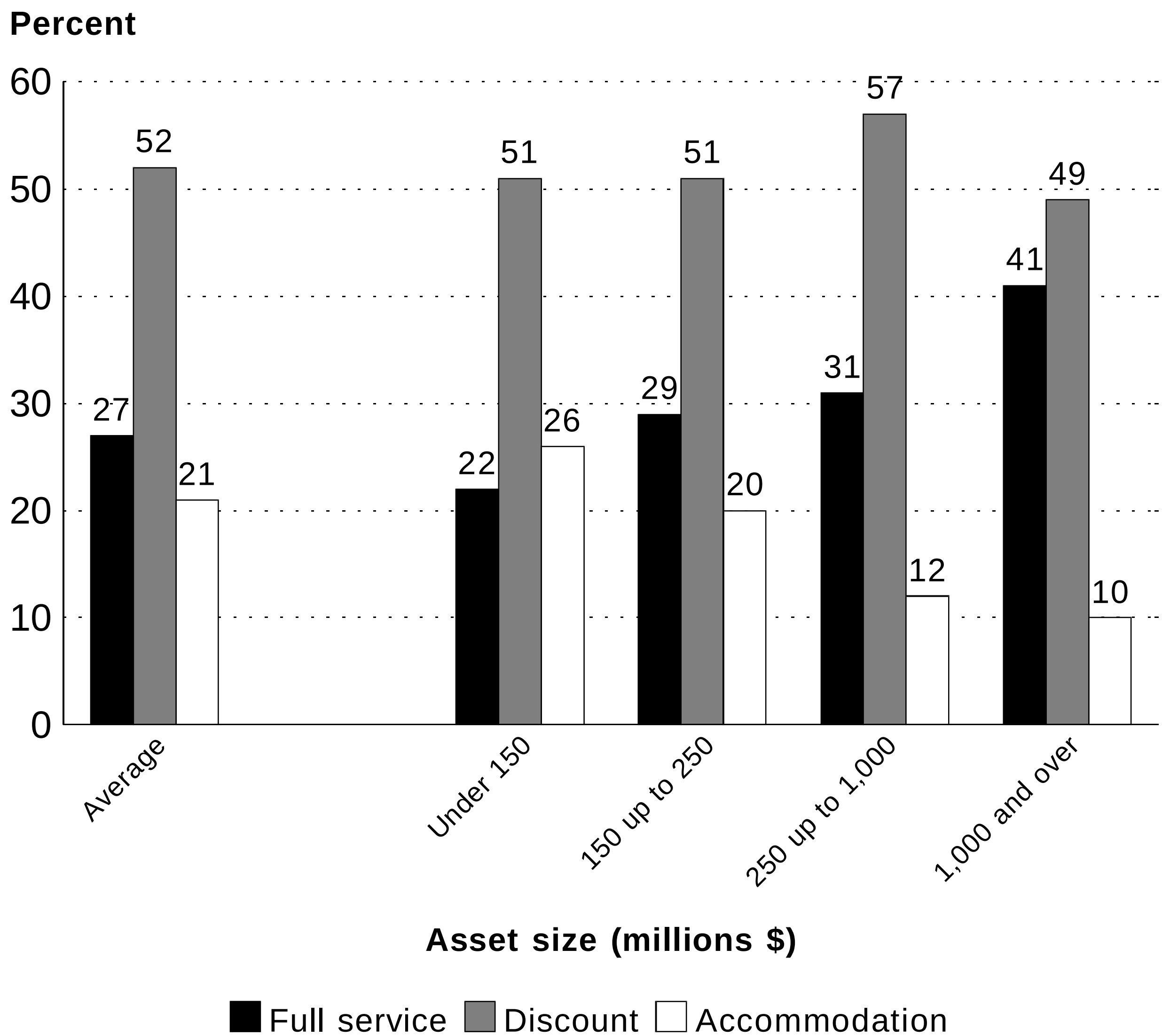


Source: GAO survey.

Of the estimated 2,400 banks that offered retail securities brokerage services, 27 percent provided full-service brokerage services, 52 percent provided discount brokerage services, and 21 percent provided accommodation brokerage services.[2] Except for banks operating in the West, we found similar patterns in the type of securities brokerage services banks offered by size, type of bank, and regional location, as shown in figures 2.4 through 2.6. We also found that larger banks and banks operating in the West were more likely to offer full-service retail brokerage services.

[2] In our survey of banks, we defined full-service brokerage as offering investment advice and/or buy and sell recommendations in conjunction with executing customer buy and sell orders, discount brokerage as acting solely as an agent in executing customer buy and sell orders, and accommodation brokerage as placing buy and sell orders as a service only when requested by a customer or to facilitate other transactions.

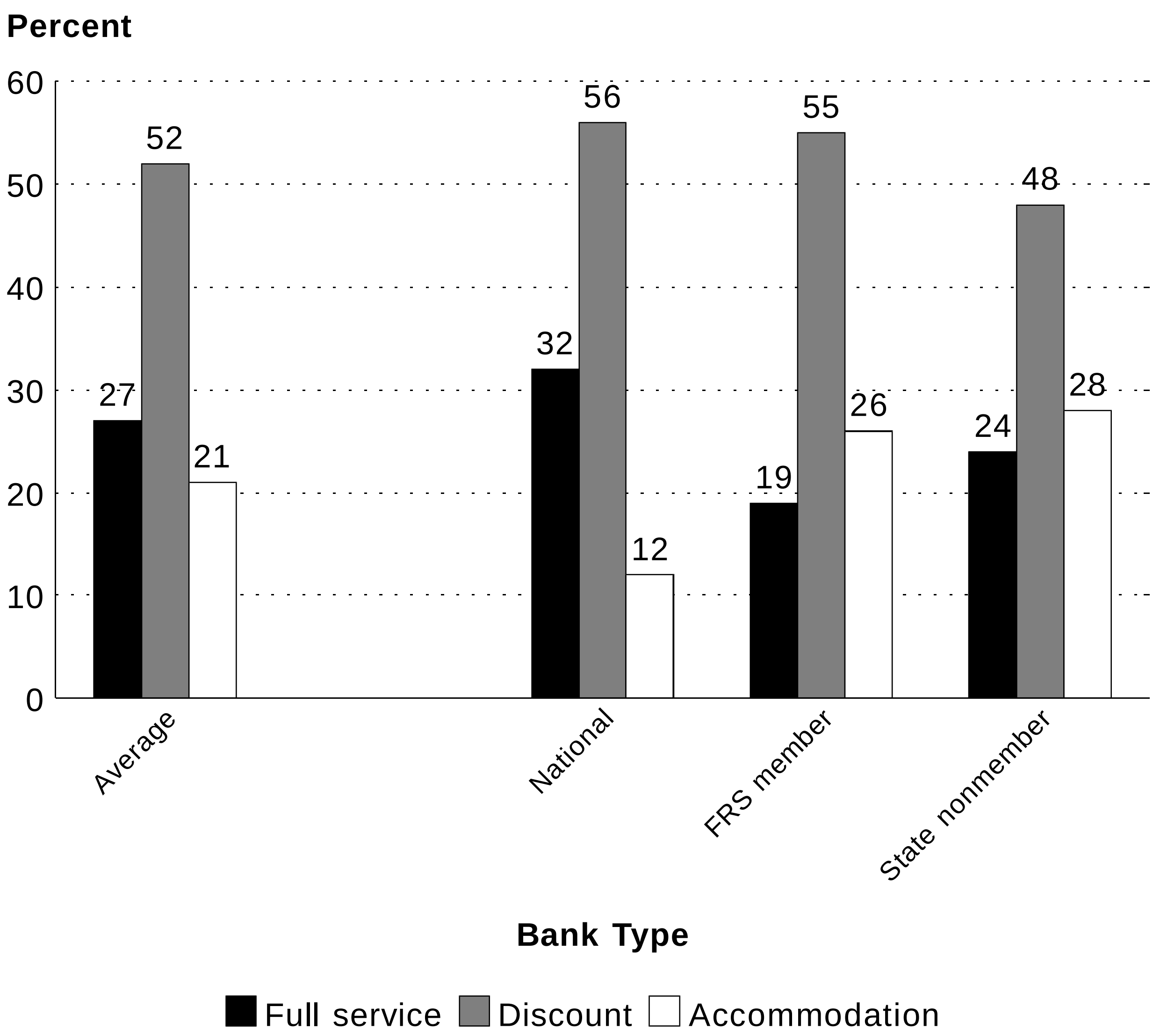
Figure 2.4: Type of Brokerage Services Offered by Banks That Provide Securities Services in Each Size Category



Note: Percentages may not add to 100 percent bacause of rounding.

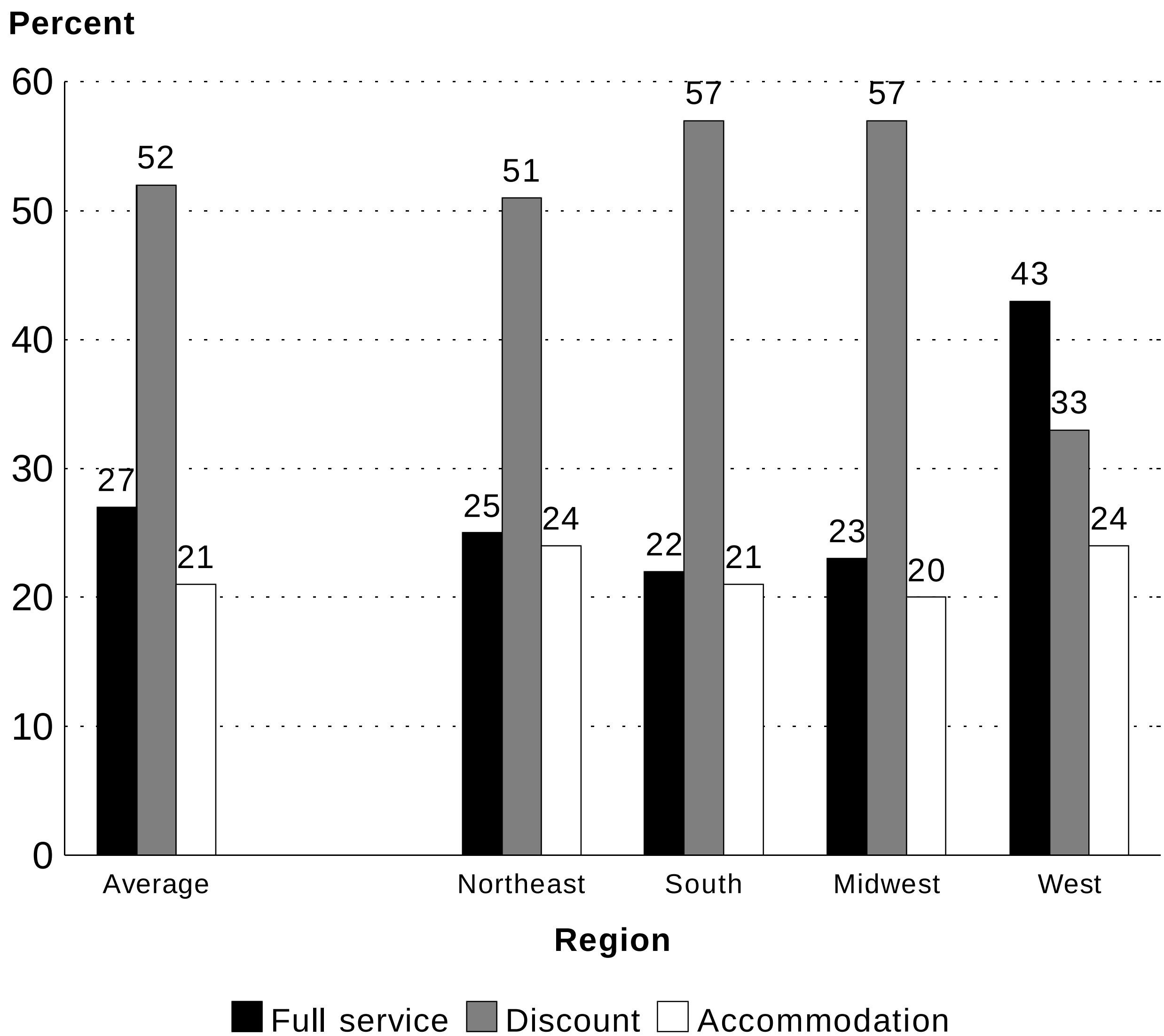
Source: GAO survey.

Figure 2.5: Type of Brokerage Services Offered by Banks That Provide Securities Services by Type of Bank



Source: GAO survey.

Figure 2.6: Type of Brokerage Services Offered by Banks That Provide Securities Services by Region



Source: GAO survey.

Most Bank Brokerage Services Were Provided Through Subsidiaries and Third-Party Arrangements

As table 2.1 shows, 12 percent of the banks that offered securities brokerage services (287 banks, or about 3 percent of banks nationwide) provided only bank-direct brokerage services. The remaining 88 percent of banks that provided securities brokerage services did so through an SEC-registered securities broker-dealer. Securities brokerage services at some of these banks were provided in a variety of ways. As a result, some banks responding to our survey provided multiple responses to describe securities brokerage services. Table 2.1 shows the various ways in which banks provide securities brokerage services to retail customers.

Table 2.1: How Banks Provide Retail Securities Brokerage Services to Their Customers

Multiple responses allowed

Services provided	Bank responses (percent)
Customer orders taken directly by employees of the bank only	12
Through a leasing or networking agreement[a] with a registered broker-dealer	35
Bank employee referral of customers to registered broker-dealers and/or other arrangements involving a registered broker-dealer	39
Through registered affiliate or subsidiary broker-dealer	42
Using dual employees[b] of the bank and a registered broker-dealer	44

[a]A leasing or networking agreement is an arrangement between a bank and a registered broker-dealer to offer brokerage services to customers on bank premises. These arrangements can involve either affiliated or unaffiliated broker-dealer firms.

[b]An arrangement in which a registered broker-dealer uses bank employees and premises to sell securities and in return makes a monthly payment to the bank. The dual employees can be paid incentive bonuses in addition to a fixed salary.

Source: GAO survey.

To validate questionnaire responses and determine how banks handle brokerage transactions, we contacted all 46 banks that responded to our survey by April 15, 1994, indicating that they provided bank-direct brokerage services. Officials of six banks said their employees either referred customers directly to an unaffiliated registered broker-dealer or provided brokerage services through a registered broker-dealer subsidiary. Officials of the remaining 40 banks confirmed that they provided bank-direct brokerage services—that is, services at the bank premises and exclusively through bank employees. According to officials from these 40 banks, designated bank employees take customer-initiated orders to buy or sell investment products, which the bank refers to unaffiliated registered broker-dealers for execution and confirmation.

After April 15, 1994, 25 additional banks responded to our survey and indicated that they provided bank-direct brokerage services. The size, type, and location of these additional banks appeared similar to the characteristics of the 40 banks we had identified earlier as providing bank-direct brokerage services. We did not gather additional information on how these 25 additional banks handled their retail securities brokerage operations because we had no reason to expect their responses would be different from the responses we received from the initial 46.

Follow-up discussions with the 40 banks that provided bank-direct brokerage services indicated that most were not handling large volumes of brokerage transactions. Officials of 16 of those banks said that they processed fewer than 10 transactions per month, 14 said 10 to 25 per month, and 10 said more than 25 per month. An official from 1 of the 40 banks said the bank also offered investment advice to retail customers. However, the investment advice was offered only to retail customers interested in the bank's mutual fund sales program. The official from this particular bank said the bank also operated a separate brokerage unit to provide discount brokerage services to customers interested in buying or selling other securities products, such as stocks, bonds, and U.S. Treasury securities.

Bank Regulators Are Working to Improve Reviews of Bank-Direct Brokerage Operations

Bank regulators' responsibilities for examining bank-direct brokerage operations are defined by regulations and supervisory guidance. Before 1994, under the old guidance, bank regulators did few examinations of bank-direct brokerage operations. In 1994, federal bank regulators issued new joint guidance and examination procedures for brokerage operations on bank premises. It is too early too tell how frequently examinations will be done or how effective bank examiners will be at examining brokerage operations under the new guidance and examination procedures. Examination of brokerages traditionally has been the responsibility of securities regulators. Further, not all bank examiners are trained to examine bank securities activities.

Before 1994, Bank Regulators Did Few Examinations of Bank-Direct Brokerage Operations

Bank regulators' responsibilities to monitor banks activities, including bank-direct brokerage activities, although not explicitly stated, are defined generally by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) (P.L. 102-242). The act, as amended in 1994, requires federal bank regulatory agencies to perform a full-scope, on-site examination at least once a year for each insured depository institution with assets greater than $250 million.[3] The purpose of these examinations is to ensure that effective internal controls are in place and operating as intended to protect the safety and soundness of the bank. The examinations are to cover all factors relevant to the safe and sound operation of the bank—including nonbanking activities conducted on bank premises, such as bank-direct brokerage services. However, federal securities regulators told us that bank regulatory oversight is not equivalent to oversight by securities regulators because federal banking statutes and regulations do not comprehensively address sales practice issues, nor do they impose an explicit duty to supervise bank securities sales personnel. In addition, they said bank securities customers have no formal avenue of redress for complaints.

Regulatory responsibilities related to bank-direct brokerage activities are further defined by guidance that each bank regulator has issued on nonbanking activities, including securities brokerage activities. During 1993, each of the three bank regulators individually issued agency guidance that instructed examiners to focus on the sale of nondeposit investment products on bank premises as part of routine bank examinations.[4]

Despite the requirements of FDICIA and existing agency guidance, many bank-direct brokerages were not reviewed during on-site examinations completed in the period 1992 through mid-1994. The results of our review of examinations completed in that period showed that 28 (72 percent) of 39 bank-direct brokerages that should have been reviewed were not. (We excluded one FDIC-regulated bank from this analysis because it responded that it provided minimal accommodation brokerage services.) Because these bank-direct brokerages are exempt from SEC and NASD regulation and they were not reviewed by bank regulators, they were operating without any federal oversight. Table 2.2 shows the number of bank-direct brokerages, out of the 40 we reviewed, that bank regulators have examined.

[3]State regulatory examinations can be substituted in alternate years for state-chartered banks, and longer examination periods—18 months—can be used for banks with less than $250 million in assets that previous examinations have shown to be well-capitalized and well-managed.

[4]FRB notice to Officers-in-Charge of Supervision at each federal reserve bank on the separation of mutual fund sales activities from insured deposit-taking activities (June 17, 1993) (SR 93-35 (FIS)); OCC Banking Circular 274, issued July 19, 1993 (NR 93-77); FDIC Statement on State Nonmember Bank Sales of Mutual Funds and Annuities, issued October 8, 1993 (FIL-71-93).

Table 2.2: Bank-Direct Brokerage Operations Examined by Bank Regulators in the Period 1992 Through Mid-1994

Bank regulators	Banks with bank-direct brokerage operations	Banks with examinations that included a review of bank-direct brokerage operations
FDIC	18	3
Federal Reserve	4	1
OCC	17	8
Total	**39**	**12**

Source: GAO analysis.

Bank Regulators Have Issued New Guidance on Bank-Direct Brokerage Operations

Banking regulators recently took steps to improve their oversight of bank-direct brokerage operations. On February 15, 1994, federal bank regulators issued a joint policy statement on the sale of nondeposit investment products on the premises of insured banking institutions. This new guidance addresses investor protection issues, such as sales practices and suitability,[5] use of information about customers, and consumer disclosure and advertising requirements for the retail sale of mutual funds and other securities products on bank premises. The new guidance applies to retail recommendations and sales of nondeposit investment products made by (1) employees of a banking organization, (2) employees of an affiliated or unaffiliated third party operating on the premises of the banking organization, and (3) sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral. The purpose of the guidance is to minimize the possibility of customer confusion and to safeguard the institution from liability under antifraud provisions of the federal securities laws.

The Federal Reserve, FDIC, and OCC have taken steps to review for compliance with this guidance as part of their routine safety-and-soundness examinations. Although the new guidance does not have the same force as a federal statute or bank regulation, federal bank regulators have informed the various banking organizations under their jurisdiction that, as appropriate, a review for compliance with the joint agency guidance will be included in routine bank examinations. For example, OCC said that it directed examiners to include a review of nondeposit investment product sales activities in all bank safety and soundness examinations. All three bank regulators have developed

[5]Suitability refers to the matching of customer financial means and investment objectives with a suitable product.

detailed examination procedures for their examiners to use in reviewing securities sales activities of banks during routine examinations. The examination procedures address investor protection concerns, such as advertising, suitability of investments recommended, and sales practices.

Information on Training Provided to Bank Examiners for Oversight of Bank Securities Activities

FDICIA requires federal bank agencies to periodically review and provide training to their examiners to ensure frequent, objective, and thorough examinations of federally insured banking institutions. The Federal Reserve, FDIC, and OCC provide bank examiners with guidance on overseeing bank securities activities. Bank examiners at the Federal Reserve and OCC also receive formal training that addresses oversight of bank and bank subsidiaries' securities activities, including the joint agency guidance. However, as of September 1994, FDIC had no formal examiner training program that focused on oversight of securities activities of state nonmember banks and their subsidiaries.

The Federal Reserve and OCC Provide Examiner Training on Bank Securities Activities

Federal Reserve examiners may receive training related to bank securities activities through specialized seminars and training courses. For example, Federal Reserve examiners can attend a securities market seminar. This 2- to 3-day seminar covers relevant securities and banking laws governing bank securities activities as well as retail securities brokerage activities within the bank. Seminar topics include inequitable and unfair sales practices, insider trading, customer account recordkeeping and confirmation requirements, firewall requirements (discussed in chapters 3 and 4), SEC and SRO oversight functions, and other related topics. In addition, the Federal Reserve recently developed an examiner training course on the joint regulatory guidance on retail sale of nondeposit investment products in the bank.

OCC examiners receive specialized training through conferences, seminars, and courses. In December 1992, OCC offered examiners a conference that included a session on risks banks take in selling mutual funds and annuities. This conference included a discussion of suitability issues.[6] In September 1993, OCC offered examiners a 3-day seminar on bank sales of mutual funds and nondeposit investment products. In addition, OCC's 1993 course catalog also lists various examiner training opportunities related to bank securities activities. An OCC Capital Markets Expert Seminar covered

[6]Consistent with NASD's Rules of Fair Practice, bank regulators expect banks to determine whether a product being recommended is an appropriate investment for the customer. Banks are instructed to ensure that any salesperson involved in bank-related sales obtains sufficient information from a customer to enable the salesperson to make a judgment about the suitability of any recommendations to the customer.

a range of capital markets topics, including bank dealer, trading, and retail brokerage activities. Another OCC course covered fundamental concepts and terminology of the securities business. It explained the processes and procedures used in issuing, transferring, and regulating securities and presented an overview of securities industry operations and the basic industry components. A course entitled "Bank Securities Dealers" was designed to enable OCC examiners to identify potentially unsafe and unsound practices for sales of municipal securities. Another OCC examiner course focused on the potential effects of transactions between banks and affiliates and related organizations. According to OCC, training relevant to examining bank securities activities was also provided in each of its six district offices and those examiners, in turn, provided the training to examiners in other offices across the country.

FDIC Provides No Formal Examiner Training on Bank Securities Activities

FDIC provided no extended formal training to its examiners on oversight of bank securities brokerage and underwriting activities. FDIC's examiner training on these subjects was limited to briefings on changes in regulations, a lecture on bank relationships with broker-dealers, and on-the-job examiner training. FDIC officials said that FDIC's primary focus is to oversee the safety and soundness of banks—not the sales practices of bank securities subsidiaries, which are subject to oversight by securities industry regulators. However, FDIC is responsible for regulatory oversight of bank-direct brokerage activities of banks under FDIC's jurisdiction. Such brokerages are exempt from oversight of securities regulators.

In April 1994, FDIC provided examiners with specific examination procedures for examinations of bank-direct brokerage activities; however, the agency provides no similar guidance for examinations related to securities underwriting activities. In the absence of such aids and a formal training program, FDIC examiners are instructed to use FDIC's regulation for bona fide subsidiaries as guidance, along with their professional judgment, in examining banking organizations for compliance with the FDIC firewall provisions that apply to bank securities underwriting activities. FDIC officials said that despite the lack of formal training programs to address bank securities underwriting and brokerage activities, they were confident that their examiners could assess the impact of banks' securities activities on the safety and soundness of state nonmember banks.

Bank and Securities Regulators Can Cooperate to Make Oversight of Bank-Direct Brokerage Operations More Consistent

Under the current regulatory structure, either bank or securities regulators may oversee the securities activities of banks, depending on how banks organize the activities. Therefore, to ensure that customers who invest in securities are treated fairly, bank and securities regulators must work closely together to share information, coordinate rules, and provide consistent examinations. Otherwise, securities investors can be exposed to inconsistent sales practices by sales representatives having different levels of training and experience. Although bank and securities regulators have cooperated well on some activities, other opportunities for cooperation exist that could provide more consistent regulation of bank securities activities.

On occasion bank and securities regulators have worked together. For example, during 1994 bank regulators sought the assistance of SEC and NASD officials and examiners in developing new guidance and in developing and pilot-testing examination procedures. Also during 1994, the Federal Reserve and NASD agreed to coordinate examinations of bank brokerage affiliates. In January 1995, all three banking regulators and NASD reached a formal agreement to coordinate examination schedules of bank-affiliated broker-dealers and share examination findings and workpapers. Further, securities regulators and bank regulators told us that they are discussing various proposals to extend securities industry qualifications testing and registration to bank employees who are engaged in bank-direct securities activities. The testing and registration process is to be backed by examination, enforcement, and disciplinary functions designed to be identical to those in place for the securities industry. Bank and securities regulators expect to resolve this issue within the next several months. SEC has also contacted the bank regulators to propose development of a common approach to eliminating the payment of referral fees to nonregistered employees of financial institutions.

Despite such cooperative efforts, differences in approaches to and procedures for regulating bank brokerage operations persist. For example, the interagency guidance sets forth standards for registered broker-dealers that differ, in some respects, from federal securities laws and regulations. These differences were highlighted when, in December 1994, NASD released for comment proposed rules governing securities broker-dealers operating on bank premises. The proposed NASD rules prohibit the payment of referral fees by the broker-dealer to nonregistered bank employees. Referral fees are permitted by the interagency guidance, provided that they are one-time nominal fees of a fixed-dollar amount and not contingent on the referral resulting in a transaction. The proposed rules also place stricter controls than the interagency guidance on the broker's use of confidential bank customer financial information, such as certificate of deposit maturity dates and balances, for soliciting sales of securities. Also, the proposed NASD rules place stricter limits on the use of bank logos in advertising materials for securities than the interagency guidance.

NASD's proposed rules have generated controversy in the banking industry. According to the financial press, some bankers have complained that the rules hold bank brokerages to standards that are higher than for nonbank brokerages. For example, they note that, unlike bank brokerages, nonbank brokerages are not required to disclose that mutual funds are not federally insured. An NASD official responded that when a customer deals with a brokerage in a bank, that brokerage has a higher responsibility to ensure that the customer understands the risk involved in investing in securities as compared to savings accounts or certificates of deposit. According to NASD, its proposed rules[7] seek consistent treatment of affiliated and networking (third-party) broker-dealers. Further, NASD said the banking guidelines established by the Interagency Statement do not have the force and effect of law and cannot support disciplinary actions against broker-dealers. Both the Interagency Statement and the proposed NASD rules, however, require written acknowledgement of the disclosure of risks associated with investment products sold in banks. The Interagency Statement is more comprehensive in that it also requires oral disclosure at any sales presentation or offering of investment advice.

Additional cooperative efforts among bank and securities regulators could help make regulation more uniform and consistent by making information and regulatory procedures used by securities regulators available to bank regulators. For example, NASD and state securities regulators maintain the Central Registration Depository (CRD), a database containing background and disciplinary information on broker-dealers and individual sales representatives.[8] In our September 1994 report and testimony before the congressional oversight committee[9] we recognized that the CRD information, after system design limitations are corrected, could be a useful regulatory tool for controlling the migration of unscrupulous

[7]NASD's proposed rules will be held open for further notice and comment when they are submitted to SEC for approval.

[8]Originally established as a centralized broker licensing and SRO registration system, CRD is now also used by regulators and the industry to help oversee brokers' activities.

[9]Securities Markets: Actions Needed To Better Protect Investors Against Unscrupulous Brokers (GAO/GGD-94-208, Sep. 14, 1994); and Securities Markets: Actions Needed To Better Protect Investors Against Unscrupulous Brokers (GAO/T-GGD-94-190, Sep. 14, 1994).

persons among sectors of the financial services industry. We recommended that SEC, the Treasury Department, and other regulators work together to increase disclosure of the CRD information among the various regulators of financial services. Those regulators have begun actions to increase disclosure.[10] According to the Federal Reserve, banking and securities regulators are developing a proposal that would include developing a CRD recordkeeping system for bank sales personnel.

Bank and Securities Regulators Have Differing Views on How Banks' Securities Activities Should Be Regulated

Although bank and securities regulators have cooperated to develop guidance and related examination procedures for banks offering brokerage services, the same regulators have been at odds about whether the current regulatory structure is adequate to protect investors. Securities regulators are concerned that the current regulatory structure for oversight of bank securities activities has not kept pace with changes in the market and may not be adequate to protect investors. In particular, the securities regulators have questioned the continued exemption of banks from SEC registration and regulation. They argue that the exemptions subject banks to weaker regulatory standards than broker-dealers. For example, in congressional hearings SEC officials stated that banking regulation has traditionally focused on the safety and soundness of the banking system and the protection of depositors as opposed to protection of securities investors. The securities regulators and securities industry representatives have stated that Congress should reassess the current regulatory structure in light of banks' expansion into securities activities and develop a system of functional regulation in which the securities regulators would be responsible for regulating all securities activities, including those of banks.[11]

In contrast, bank regulators and banking industry representatives have stated that measures that they have taken to strengthen oversight of securities activities provide adequate protection to customers who choose to invest through their banks. They also said that reforming the regulatory structure as advocated by SEC would create a duplicative and burdensome regulatory environment for banks. Banking industry representatives have testified that functional regulation should be considered only in connection with comprehensive reform of banking regulation, including

[10]Bank regulators currently have access to CRD but as currently structured, CRD does not include bank employees engaged in bank-direct sales of securities.

[11]The concept of functional regulation calls for regulation according to function rather than according to the entity performing the function. Hence, under functional regulation SEC would be responsible for regulation and oversight of all securities broker-dealer and related activities of banks, and banking regulators would be precluded from examining these activities.

repeal of Glass-Steagall Act provisions that limit banks' securities activities.

Conclusions

Clearly, banking and securities activities are no longer separate as envisioned by 1930s legislation because banks have become more involved in providing their customers with securities services. The regulatory system, which was also designed in the 1930s, has not been adjusted to reflect the changed activities. Because banks are exempt from SEC registration and regulation, banking organizations can chose how to organize their securities brokerage activities, and depending on that organization, how they are regulated. For example, banks can choose to sell securities directly and be subject to oversight by banking regulators but not by securities regulators. If these activities are to be regulated, then bank regulators must include them in their regulatory scheme and examinations. Under the current regulatory structure the same type of securities activities can be overseen by different regulators depending on how banks organize their securities activities.

The potential for inconsistent oversight has not been much of a problem so far because most banks provide securities services in subsidiaries that are regulated primarily by securities regulators. Further, for the 3 percent of banks nationwide that offer brokerage services that are exempt from regulation by securities regulators, bank regulators have provided new guidance and examination procedures and are working to improve their oversight. Nevertheless, providing consistent securities oversight, no matter where in an organization these activities are done, would be enhanced by increased cooperation, coordination, and sharing of regulatory expertise among bank and securities regulators. Although bank and securities regulators have shown that they can cooperate on oversight of securities sales on bank premises, as we have indicated, issues requiring further coordination remain. By working more closely together bank and securities regulators could help ensure that both safety and soundness and investor protection concerns are appropriately addressed in regulatory requirements and examinations of bank-direct brokerage activities, but without added regulatory burden.

Recommendation

We recommend that the heads of the Federal Reserve, FDIC, OCC, SEC, and NASD require their respective staffs to work together to develop and implement an approach for regulating bank-direct securities activities that provides consistent and effective standards for investor protection while ensuring bank safety and soundness.

Agency Comments and Our Evaluation

FDIC

FDIC commented that although its procedures were not flawless in the period covered by our review, the results shown in table 2.2 on bank-direct brokerages examined by bank regulators may be misleading. In preparing detailed comments, FDIC reviewed our analysis and said it found a different picture of its regulatory oversight from that indicated by the numbers presented. FDIC polled its regions and found that three, rather than two, of the banks' brokerage activities were examined. This additional examination was completed after the period of our survey. We now include it in table 2.2 as being examined. FDIC stated that many of the banks are not involved in retail sales of nondeposit investment products except to accommodate customer requests. FDIC also said that the remainder of those banks conduct a brokerage activity only through a third-party vendor.

We cannot explain why the securities brokerage activities of banks as reported by FDIC would differ from information we obtained directly from the banks we surveyed, unless the banks changed how they provided brokerage services between the time of our survey and the time they were last contacted by FDIC examiners. Nineteen FDIC-regulated banks responded to our survey that they provided brokerage services to customers directly by bank employees. We later called each of those banks to validate their responses. Eighteen of those banks responded that they provide discount brokerages services by bank employees. One bank responded that it provided minimal accommodation brokerage services. We have dropped it from the table 2.2 analysis in our final report.

FDIC commented that its efforts have been directed at eliminating customer confusion concerning investment products sold by banks. It said it is working closely with other federal regulators to develop and implement an improved and coordinated approach to supervising securities activities and would continue to work with SEC and NASD to harmonize rules.

FDIC commented that it has supervisory responsibility over few banking organizations with securities activities that would require extensive specialized examiner training. However, it is considering the type and scope of examiner training necessary.

Federal Reserve

The Federal Reserve agreed with our recommendation that bank and securities regulators work together to develop and implement an approach for regulating bank-direct securities activities. The Federal Reserve said that it has been pursuing a number of efforts to coordinate supervision of bank securities activities with securities regulators. It also said that its joint efforts with securities regulators are resulting in a supervisory program for bank-direct sales activities that is analogous to, and consistent with, broker-dealer regulation. Among these, the Federal Reserve noted banking regulators' efforts to make securities regulators' professional qualification examinations available to bank sales personnel. The Federal Reserve also noted that the banking regulators have proposed coordinated rulemaking by the banking regulators, including developing a comprehensive central registration depository type recordkeeping system for bank sales personnel.

OCC

OCC commented that our recommendation is consistent with actions it has already undertaken to improve oversight of banks' securities brokerage activities through better coordination and cooperation with securities regulators.

OCC disagreed with our discussion of the additional risks to banks that are associated with securities activities. We did not study the comparative risks of various banking and nonbanking activities. Nevertheless, securities activities can pose risks to banking organizations, just as they can to securities firms. When federally insured banks can be affected by such risks, measures should be taken to insulate those banks from losses incurred by the securities activities.

OCC stated that it directed examiners to include a review of nondeposit investment product sales activities in all bank safety and soundness examinations. The examinations are to be done with statutory frequency—every 12 to 18 months, depending on bank size and condition. OCC expects that by the end of 1995, all national banks that are engaged in bank-direct brokerage operations will have had at least one such examination.

SEC

SEC commented that it, the federal banking regulators, and NASD have worked hard together but that interagency cooperation to regulate banks' securities activities is not enough. It advocated a system of functional regulation, in which each entity is regulated according to the particular activity that it undertakes. SEC stated that functional regulation would be a more efficient and responsible use of both taxpayer dollars and bank capital. SEC emphasized the importance of ensuring that the applicable regulatory scheme provides equal protection for all investors and reduces regulatory costs. This, SEC commented, in turn, would ensure that competition is based on market performance, rather than on arbitrary differences in regulation. SEC commented that our report appears to encourage a system of duplicative regulation, which it strongly disagrees with.

We believe that in the present regulatory environment, in which bank-affiliated securities activities are regulated primarily by securities regulators and bank-direct activities are regulated by bank regulators, cooperation and coordination by regulators is a practical means of sharing regulatory expertise and achieving consistent investor protection. Without financial system reform and restructuring, which could include both functional and consolidated regulatory systems as a means to efficient and comprehensive regulation, cooperation and coordination is the only way to achieve consistent investor protection. Under a system of functional regulation, cooperation and coordination among regulators would still be needed to avoid duplication and coverage gaps and share information and examination results.

NASD

NASD commented that it is a strong advocate of functional regulation as the long-term solution to establishing an effective regulatory structure that spans the securities activities of banks and broker-dealers. However, NASD stated that it was willing to support our recommendation that the regulators cooperate by sharing its advertising and sales practice policies and procedures and experience and expertise in securities examinations with the bank regulators and assisting in bank examiner training.

Federal Reserve Inspections Usually Assess Compliance With All Applicable Firewalls

As of November 1994, the number of Section 20 subsidiaries in operation was 35. The total gross revenues of all Section 20 subsidiaries was about $10 billion in 1993, which was about 8 percent of total 1993 gross revenues for the securities industry. The Federal Reserve has prescribed firewalls to protect insured affiliated banks from risks associated with the Section 20 subsidiaries' securities activities. Federal Reserve examiners are to inspect those Section 20 subsidiaries that seek to underwrite and deal in corporate securities before they begin operations to ensure that they are capable of complying with prescribed firewalls. For all other Section 20 subsidiaries, the first annual inspection is to include a detailed examination of compliance with applicable firewalls. All subsidiaries are then to be inspected annually to assess their financial condition and to determine their compliance with firewalls and the limits on the amount of their business in bank-ineligible securities.

We found that the Federal Reserve has generally maintained its annual inspection cycle during the last 2 years and that the Federal Reserve has taken steps to correct deficiencies identified by the inspections. However, we also found that some firewalls were not examined, and documentation available in some examination files was inadequate for determining whether appropriate firewall inspections had occurred. Thus, although the Federal Reserve in general comprehensively reviewed or tested for compliance with all firewalls, there were a few cases in which full compliance with all firewalls could not be assured.

Section 20 Subsidiaries' Securities Activities Have Grown

As mentioned in chapter 1, the Federal Reserve allows bank holding companies to establish Section 20 subsidiaries, which engage in limited amounts of underwriting and dealing in bank-ineligible securities (no more than 10 percent of the subsidiary's gross revenue can be derived from such activities). The Federal Reserve has approved bank-ineligible securities for Section 20 activities over time, starting in 1987. The initial Federal Reserve order of April 30, 1987, approved applications of Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp. to engage in limited underwriting and dealing in municipal revenue bonds, mortgage-related securities, and commercial paper. Later that year, the Federal Reserve issued an order approving the underwriting of asset-backed securities.[1] The activities approved in 1987 are referred to as "1987 powers" of Section 20

[1]These are bonds or notes backed by loans or accounts receivable originated by banks, credit card companies, or other providers of credit. Typically, the originator of the loan or account receivable paper, such as for automobile loans and credit card receivables, sells the paper to a special trust, which repackages it as securities. The securities are then underwritten by brokerage firms, which reoffer them to the public.

subsidiaries. In 1989, the Federal Reserve extended the powers for certain Section 20 subsidiaries to underwriting and dealing in corporate debt and equity securities—referred to as "1989 powers."

As of November 1994, 35 Section 20 subsidiaries were operating under Federal Reserve approval. As shown in table 3.1, 17 of those subsidiaries operated under 1987 powers, 14 operated under both 1987 and 1989 powers, and 4 had 1987 and 1989 corporate-debt-only powers. Twelve of the 35 Section 20 subsidiaries were foreign-owned.

The volume of activity among Section 20 subsidiaries in bank-ineligible securities has grown rapidly in recent years even though their share of revenues in the securities industry has declined. In 1990, the volume of bank-ineligible securities underwritten by Section 20 subsidiaries was about $27.8 billion.[2] According to Federal Reserve records, the volume of bank-ineligible securities underwritten by Section 20 subsidiaries in 1993 was about $58.6 billion, a 110-percent increase over 1990's volume. The total gross revenues of the Section 20 subsidiaries increased by 57 percent from about $6.4 billion for 1990 to about $10.0 billion for 1993. However, according to SEC data, the total gross revenues of Section 20 subsidiaries as a percent of the total for the securities industry declined from 10.1 percent for 1990 to 7.8 percent for 1993. As of the end of 1993, Section 20 subsidiaries held 13.6 percent of the total securities industry assets.

The top 10 Section 20 subsidiaries in terms of revenue production during 1993 included J.P. Morgan Securities, Greenwich Capital Markets, BT Securities, Citicorp Securities, Barclays Capital, Chase Manhattan Securities, Sanwa-BGK Securities, Chemical Securities, Deutsche Bank Securities, and NationsBanc Capital Markets. The Section 20 subsidiaries and their parent organizations are also shown in table 3.1.

[2]Our report, Bank Powers: Bank Holding Company Securities Subsidiaries' Market Activities Update (GAO/GGD-91-131, Sep. 20, 1991), provided information on the market activities of Section 20 subsidiaries. From the amount shown for the value of securities underwritten we excluded the amount of commercial paper underwritten by the Section 20 subsidiaries in 1990 to make the total amount consistent with data reported to the Board for 1993. The Board did not include commercial paper, because issues are frequently rolled over and reissued several times during a year.

Table 3.1: Section 20 Subsidiaries' Securities Powers and Parent Organizations as of November 1994

Section 20 subsidiary	Parent organization
1987 and 1989 Corporate debt and equity powers	
BA Securities, Inc.	BankAmerica Corp.
BT Securities Corp.	Bankers Trust N.Y. Corp.
Chase Securities Inc.	Chase Manhattan Corp.
Chemical Securities Inc.	Chemical Banking Corp.
Deutsche Bank Securities Corp.	Deutsche Bank AG[a]
Harris Nesbitt Thomson Securities, Inc.	Bankmont Financial Corp.[a]
Hopper Soliday and Co., Inc.	Dauphin Deposit Corp.
J.P. Morgan Securities Inc.	J.P. Morgan and Co., Inc.
NationsBanc Capital Markets, Inc	NationsBanc Corp.
RBC Dominion Securities Corp.	Royal Bank of Canada[a]
Republic N.Y. Securities Corp.	Republic New York Corp.[a]
ScotiaMcleod (USA) Inc.	The Bank of Nova Scotia[a]
Toronto Dominion Securities (USA) Inc.	Toronto-Dominion Bank[a]
Woody Gundy Corp.	The Canadian Imperial Bank of Commerce[a]
1987 and 1989 Corporate debt powers	
Barclays Capital Corp.	Barclays Bank PLC[a]
Citicorp Securities Inc.	Citicorp
First of America Securities, Inc.	First of America Bank Corp.
First Chicago Capital Markets, Inc.	First Chicago Corp.
1987 Powers	
ABN AMRO Securities (USA) Inc.	ABN AMRO North America, Inc.[a]
Banc One Capital Corp.	Bank One Corp.
Bank South Securities Corp.	Bank South Corp.
Barnett Securities, Inc.	Barnett Banks Inc.
DKB Securities Corp.	The Dai-Ichi Kangyo Bank, Ltd.[a]
First Union Securities, Inc.	First Union Corp.
Fleet Securities, Inc.	Fleet Financial Group, Inc.
Greenwich Capital Markets, Inc.	The Long-Term Credit Bank of Japan[a]
Huntington Capital Corp.	Huntington Bancshares, Inc.
Liberty Investment Services, Inc.	Liberty National Bancorp, Inc.
National City Investments Corp.	National City Corp.
Norwest Investment Services	Norwest Corp.
PNC Securities Corp.	PNC Bank Corp.
Sanwa-BGK Securities Co., L.P.	The Sanwa Bank Ltd.[a]
SouthTrust Securities Inc.	SouthTrust Corp.
SunTrust Capital Markets	SunTrust Banks, Inc.
Synovus Securities, Inc.	Synovus Financial Corp.

(Table notes on next page)

[a]Foreign-owned corporation.

Source: Federal Reserve Board.

The Federal Reserve Has Prescribed Firewalls to Protect Banks and Requires Section 20 Subsidiaries to Have Internal Controls

Both the Federal Reserve and banking organizations that seek to establish Section 20 subsidiaries are to provide safeguards to insulate banks from subsidiaries' securities activities. To protect affiliated insured banks and the parent banking organization from risks associated with Section 20 subsidiaries' underwriting and dealing activities, the Federal Reserve has prescribed various firewalls. The banking organizations that establish Section 20 subsidiaries are also to have internal controls in place to ensure compliance with the firewalls and to manage attendant business risks.

Firewalls Provide Important Protection for Insured Bank Affiliates

As discussed briefly in chapter 1, Section 20 subsidiaries are subject to various limitations on their activities and operating conditions, which are called firewalls. These limitations and operating conditions are intended to insulate affiliated banks from risks associated with the ineligible securities underwriting and dealing activities and minimize conflicts of interest. The firewalls

- define the method a banking organization with a Section 20 subsidiary should use to calculate its capital so that investments and loans to the subsidiary are not counted toward the consolidated capital of the bank holding company;
- limit credit extensions that the bank affiliate may make to the Section 20 subsidiary and its clients and customers;
- require separate offices for the Section 20 subsidiary and limit employees, officers, and directors from serving in the same capacity for both the Section 20 subsidiary and an affiliated bank.
- require disclosures of the nature of the Section 20 subsidiary's business and its relationship with the banking affiliates, including disclosing to customers that the subsidiary is an organization separate from any affiliated bank and that securities recommended, offered, or sold by the subsidiary are not bank deposits and are not insured by FDIC;
- restrict a banking affiliate from offering investment advice regarding securities underwritten or dealt in by the Section 20 subsidiary unless the customer is notified of the affiliate's involvement;

- restrict extensions of credit and purchases of assets that would shift risk to insured institutions and prevent any unfair competitive advantage to bank-affiliated securities firms; and
- restrict the exchange of nonpublic customer information between banking affiliates and the Section 20 subsidiary.

For each Section 20 subsidiary, the specific firewalls that apply vary according to the powers of the subsidiary and whether the subsidiary is foreign-owned. All of the firewalls are published in the Federal Reserve's Bank Holding Company Supervision Manual. (See app. I for a list of the Federal Reserves's detailed firewall conditions.) In addition to meeting the firewall conditions, applicants seeking expanded 1989 powers to underwrite and deal in corporate debt and equity securities are required to establish the necessary managerial and operational infrastructure before receiving Federal Reserve approval for these activities.

The original Federal Reserve orders giving banks approval to underwrite and deal in securities document the rationale and importance of the establishment and operations of firewalls. The firewalls that prohibit extensions of credit, for example, are considered important for the following reasons:

- They preclude banking affiliates from making loans to depositors to purchase securities underwritten by a Section 20 subsidiary and thus seek to ensure that affiliates grant credit in a sound and impartial manner.
- They restrict banking subsidiaries from making unwise loans to improve the financial condition of the companies or organizations whose securities are underwritten or dealt in by an affiliated underwriting subsidiary, either to assist in marketing the securities or to prevent the customers of the underwriting subsidiary from incurring losses on securities sold by the subsidiary.
- They prohibit loans or other transactions between banking subsidiaries and underwriting subsidiaries to cover any financial losses sustained by the underwriting subsidiaries.
- They prohibit banks from purchasing low-quality assets from the underwriting subsidiary or providing the underwriting subsidiary with credit on preferential terms. (Such transactions are prohibited by Sections 23A and 23B of the Federal Reserve Act.)

Firewalls that insulate the underwriting subsidiaries from banking subsidiaries by requiring separate operations—including separate officers, directors, and employees—are important to avoid any conflicts of interest and prevent loss of public trust in the banking subsidiary should the underwriting subsidiary sustain financial losses.

Subsidiaries Are Directed to Establish Internal Controls for Compliance With Firewalls and Other Requirements

The Federal Reserve generally requires Section 20 subsidiaries to have internal controls in place. For example, Federal Reserve inspection guidance for Section 20 subsidiaries seeking 1989 powers directs examiners to confirm that the subsidiaries have (1) internal control procedures to ensure compliance with the Federal Reserve's firewalls; (2) written underwriting and trading position limits; (3) procedures for managing syndicate (group) underwritings; and (4) procedures for segregation of duties, control over data entry, and hiring competent employees.

The banking organizations we met with use a variety of such policies, procedures, and control mechanisms. According to information we obtained from three banking organizations, the controls used generally were in the form of written policies and procedures, staff training and awareness activities, and internal audit functions. Also, procedures to ensure compliance with regulations included compliance manuals, routine memoranda on securities underwritten and associated restrictions on credit relationships, separation of duties, supervision of employees, surveillance systems, compliance reviews, and internal audits. Those Section 20 subsidiaries also had policies and procedures to prevent insider trading and prevent affiliates from engaging in impermissible credit or investment activities and "tie-in" arrangements. (Tie-in or tying arrangements involve an agreement to provide a customer one service on the condition that he or she also obtain other services. This practice is considered anticompetitive and is generally prohibited by the Bank Holding Company Act, section 106(b).) To restrict insider trading and impermissible credit or investment activities, the subsidiaries issued "watch lists" and "restricted lists." To make employees aware of regulatory provisions prohibiting tie-in arrangements and the banks' antitying policies, the subsidiaries used compliance guidelines, memoranda, and training.

Officials of the three banking organizations also said that they had employee training programs that included reviews of regulatory compliance requirements. Officials of one banking organization said that the organization's compliance manual is reviewed with employees, and insider trading and antitying policies are highlighted. Officials of another bank holding company said that all new hires were trained on securities laws and regulations as well as provisions on firewalls and antitying. Officials of another banking organization said it provided employees ongoing regulatory compliance training, and it required all employees to read compliance regulations annually and certify that they are familiar with and will comply with controls and provisions governing the bank's securities activities. According to Federal Reserve officials, such internal controls and training programs are common among the bank holding companies that the Federal Reserve has approved to underwrite and deal in bank-ineligible securities. However, a detailed review of private sector banking organizations' internal control systems was beyond the scope of our work, and we cannot comment on the effectiveness of those controls.

Both Federal Reserve and Securities Regulators Are to Examine Section 20 Subsidiaries

Section 20 subsidiaries are to be examined by both the Federal Reserve and by securities regulators, but for different purposes. The Federal Reserve focuses on compliance with the firewalls and with the 10-percent limit on the subsidiaries' business in bank-ineligible securities. Securities regulators examine the subsidiaries for compliance with securities laws and SEC and SRO regulations and rules. Both the Federal Reserve and securities regulators examine the Section 20 subsidiaries' financial condition; however, according to Federal Reserve officials, the scope and objectives of the examinations differ. The officials said that securities regulators examine financial records to check for compliance with net capital requirements for broker-dealers.[3] They said Federal Reserve examiners verify data reported to the Federal Reserve on the subsidiaries' financial performance[4] and focus on any adverse effects of the subsidiaries' operations on the consolidated bank holding company and its depository institution affiliates.

Federal Reserve Inspections Focus on Compliance With Firewalls and Operating Conditions

The Federal Reserve's guidance on inspections of Section 20 subsidiaries outlines four types of inspections of the subsidiaries: firewall condition inspections, infrastructure reviews, annual inspections, and supplemental inspections. The timing and purposes of these inspections are described in table 3.2.

[3]Net capital requirements are set forth in SEC Rule 15c3-1.

[4]Section 20 subsidiaries report quarterly on Form FR Y-20, Financial Statements for a Bank Holding Company Subsidiary Engaged in Ineligible Securities Underwriting and Dealing. The FR Y-20 data are considered as confidential pursuant to section (b)(4) of the Freedom of Information Act, 5 U.S.C. 552(b)(4).

Table 3.2: Federal Reserve Inspections of Section 20 Subsidiaries

Type of inspection	Time of inspection	Scope of inspection
Firewall condition inspection	Initial inspection for compliance with firewalls and operating conditions applicable to 1987 powers.	All of the Section 20 subsidiary's policies and operating procedures.
Infrastructure review	Before approval for 1989 powers, regardless of whether the applicant is seeking initial powers or has been approved for 1987 powers.	Reviews of management, SRO examination results, internal controls, computer and accounting systems, and internal audit and other areas. Examiners are to (1) review and confirm that management is qualified to direct and supervise securities underwriting and dealing activities and knowledgeable about associated risks and marketing techniques; (2) review the latest SRO examination to determine compliance with securities laws and regulations; (3) review internal controls to ensure that appropriate controls are in place; (4) review computer and accounting systems to determine whether the systems can process and account for the relevant securities activities; and (5) evaluate the internal audit program and auditors' qualifications and determine the adequacy of the internal audit function, recordkeeping, and accounting and computer systems.
Annual inspection	Annual.	Evaluations of compliance with the applicable firewalls and the 10 percent revenue limitation, and assessments of the subsidiaries' financial condition. In conducting annual inspections, Federal Reserve examiners rely on the work of the subsidiary's internal auditor and focus on (1) assessing changes in subsidiary operations that may have affected applicable firewalls and (2) verifying that deficiencies found by internal and any external audits have been corrected. The annual inspection procedures emphasize that a strong internal audit department will ordinarily review and test internal controls. This minimizes the need for Federal Reserve examiners to engage in extensive review and testing of controls.

(continued)

Type of inspection	Time of inspection	Scope of inspection
Supplemental inspections	Random or targeted.	Testing of the firewalls in instances where a Section 20 subsidiary has a poor compliance record or has not been subject to substantial internal audits.

Source: GAO Analysis of the Federal Reserve's Inspection Guidance.

Additional controls over Section 20 subsidiaries are provided by mandatory financial reporting, the Federal Reserve's centralized monitoring of inspection results and the underwriting activities of the subsidiaries, and regulation by securities industry regulators. In 1990, the Federal Reserve instituted a program requiring Section 20 subsidiaries to file quarterly reports on balance sheet, income, stockholders' equity, and other data on their underwriting activities. These data are to be submitted on reporting Form FR Y-20. The Federal Reserve uses these data to monitor compliance with the Federal Reserve's 10 percent revenue test and the financial status and underwriting activities of the Section 20 subsidiaries. Before FR Y-20 reporting was started, the Federal Reserve used copies of FOCUS Reports (Financial and Operational Combined Uniform Single Report) filed with securities industry Self-Regulatory Organizations (SROs) and other quarterly reports to monitor compliance with the 10 percent revenue test and the financial condition of Section 20 subsidiaries. Staff at Federal Reserve headquarters also monitor the results of the Federal Reserve districts' inspections of the Section 20 subsidiaries.

Securities Regulators Examine for Compliance With Securities Laws and Regulations

Section 20 subsidiaries are also required to register with SEC and join an SRO. The currently approved Section 20 subsidiaries are members of NASD or the New York Stock Exchange. The SROs regulate and examine the Section 20 subsidiaries' compliance with securities laws and regulations, SRO rules of fair practice, and their implementation of procedures designed to restrict opportunities for insider trading.[5] While banking organizations should have controls in place to prohibit the sharing of confidential information, the Section 20 subsidiaries' compliance with the insider

[5]These procedures, required by the Insider Trading and Securities Fraud Enforcement Act of 1988, P.L. 100-704, are intended to prevent nonpublic information acquired in one capacity from being used in another—for example, between a financial organization's varied activities, such as underwriting and trading and investment research and advice. NASD and NYSE have jointly developed guidelines for the securities industry to restrict insider trading.

trading provisions is primarily under SEC, NASD, and other SRO oversight, rather than the bank regulators.[6]

Subsidiaries Generally Were Inspected Annually

Information on the timing of the Federal Reserve's inspections of Section 20 subsidiaries showed that Federal Reserve examiners generally inspected the Section 20 subsidiaries annually. The information provided to us by Federal Reserve officials showed that the Federal Reserve annually inspected 30 of the 31 Section 20 subsidiaries that were active at the end of 1992 and 1993. One subsidiary was not inspected; although Federal Reserve officials could not provide a reason for this, they said they had made the district bank aware that the Section 20 subsidiary should be inspected annually.

However, in the period from 1989 through 1993, a total of nine of the Section 20 firms were not examined annually as required. According to Federal Reserve officials, annual inspections were delayed for a variety of reasons. The officials said delays in inspections of foreign-owned subsidiaries occurred due to a 1991 reorganization of the Federal Reserve's New York District inspection staff. In that reorganization, the officials said, two separate units were formed—one to inspect domestic firms and the other to inspect foreign-owned firms. According to the officials, as a result of the reorganization, no foreign-owned subsidiaries were inspected in 1991, but such scheduling delays have not been repeated. According to the Federal Reserve officials, other inspections were delayed because some districts were slow in implementing Section 20 inspection programs. One Section 20 subsidiary initially was not inspected because, although approved in 1990 for 1989 powers, it had not completed an internal audit program and was not actually allowed to begin underwriting and dealing activities until 1991.

We also interviewed bank examiners with OCC, the primary regulator of national banks. These examiners are responsible for examining national banks that are subsidiaries of the same parent bank holding company as a Section 20 subsidiary. The national bank examiners said that their examinations consider the operations of Section 20 subsidiaries only to the extent that they might affect the safety and soundness of the national banks. The examiners said they are concerned with the bank's overall risk exposure and the bank's efforts to measure and manage risk levels, and

[6]We reported on SROs' adoption of insider trading provisions in Securities Markets: Clearly Defined "Chinese Wall" Standards Have Been Issued (GAO/GGD-91-115, Aug. 21, 1991).

they leave the detailed reviews of the Section 20 subsidiaries to the Federal Reserve and securities regulators.

Some Federal Reserve Inspections Relied on Internal Audits and Did Not Always Assess Compliance With All Firewalls

Our review of the Federal Reserve's inspections of 14 Section 20 subsidiaries located in the Chicago, New York, Richmond, and San Francisco Federal Reserve districts showed that the Federal Reserve usually conducted detailed reviews of the subsidiaries. The district examiners conducted the required infrastructure reviews of subsidiaries seeking powers to underwrite corporate equity and debt securities. The results of our analysis of four infrastructure reviews completed during 1993 showed that those reviews generally were complete and addressed all conditions listed in the Federal Reserve's guidance. As noted on page 55, the Federal Reserve also completed annual firewall inspections of 30 of 31 approved underwriting subsidiaries.

We also analyzed annual and special firewall inspections completed in 1992 and 1993 for all 14 Section 20 subsidiaries. The approach taken on the annual inspections varied among districts. The Richmond and San Francisco Federal Reserve Banks generally conducted independent reviews and, as applicable, tested the firewall conditions. The Chicago and New York Banks—especially the New York bank, in whose district the largest number of Section 20 subsidiaries are located—relied more on the banking organizations' internal auditors' assessments of compliance with the firewall conditions. For example, our review of the Federal Reserve's annual inspections of six Section 20 subsidiaries in the New York district found that the examiners relied, in all six cases, on the internal auditors' review and testing of the firewalls.

Although Federal Reserve examiners said that they did some selective review of policies and procedures and testing of the firewalls, we found that such review and testing were not always documented in the inspection workpapers. In addition, the workpapers did not always include documents showing the scope and methodology of the internal auditors' review and testing of firewalls. In a 1993 report on the Federal Reserve's bank holding company inspections, we noted that the quality of Federal Reserve workpapers was inconsistent, and the Federal Reserve Manual did not provide guidance on workpaper preparation.[7] We also recommended that the Federal Reserve improve workpaper documentation of its bank holding company inspections. In response to

[7]Bank Examination Quality: FRB Examinations and Inspections Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-13, Feb. 16, 1993).

those recommendations, the Federal Reserve said that those workpapers would be subject to standards similar to the agency's new standards for workpapers in commercial bank examinations, which the Federal Reserve was testing as of September 1994. The Federal Reserve's standardized commercial bank work documentation program is intended to provide a consistent format for documenting the tasks performed on each examination. The Federal Reserve's commercial bank examination standards also provide a format for examiners to follow in reviewing the work of internal auditors, including determining the adequacy of internal auditors' testing methods.

In our review of the Federal Reserve's inspections of the Section 20 subsidiaries, we found two instances in which neither Federal Reserve examiners nor the internal auditors reviewed for compliance with certain firewalls. More specifically, we found the following:

- In the 1993 inspection of one of the larger Section 20 subsidiaries, neither the Federal Reserve examiner nor the internal auditors reviewed firewalls that restricted credit extensions to the underwriting subsidiary and its clients and customers, prohibited interlocking directorates, required disclosure of the subsidiary's relationship to the parent organization, and prohibited intercompany transactions and transfers of assets between the Section 20 subsidiary and affiliated insured banks. In this case, the examiner said that he relied on an internal audit that was the same one he relied on in the prior year's inspection. The Federal Reserve examiners said that they used spot-checks and walk-throughs to review these items, and those reviews may not have been documented in workpapers.
- In another inspection, neither the Federal Reserve examiner nor the internal auditor reviewed firewalls that restrict the sale of securities underwritten by the Section 20 subsidiary to other subsidiaries of the same bank holding company and restrict any asset sales to affiliated banks.

It is important that these firewalls be checked to ensure that they are in place and functioning properly to restrict conflicts of interest, risky credit relationships, and illegal intercompany transactions[8] and reciprocal arrangements. In these instances, inspection supervisors' reviews would have been needed to ensure that all firewalls were examined and work was properly documented in workpapers.

[8]We earlier reported that during bank holding company inspections Federal Reserve examiners did not adequately assess risks from intercompany transactions. See GAO/AFMD-93-13, Feb. 16, 1993, pp. 45-46.

Federal Reserve officials said that it allowed the districts to use their own discretion in deciding how much to rely on the work of internal auditors. Such discretion is allowed because it is a practical approach to covering all Section 20 subsidiaries. Otherwise, the districts would not be able to cover all of the bank holding companies and their subsidiaries if Federal Reserve examiners themselves did extensive testing of every regulatory requirement. This would be especially true for the New York district, which has the highest number of Section 20 subsidiaries (13).

Federal Reserve Inspections Seek to Correct Deficiencies and Avert Problems

The Federal Reserve, as well as the other federal bank regulators, can impose any of several informal and formal enforcement actions on banks that operate in an unsafe or unsound manner or fail to comply with laws and regulations. Informal enforcement actions include

- meeting with bank officers and boards of directors to obtain agreement on improvements needed,
- requiring banks to issue commitment letters to the regulators specifying corrective actions that need to be taken,
- requiring bank boards of directors to issue resolutions specifying corrective actions, and
- requiring a memorandum of understanding between regulators and bank officers on actions that will be taken.

Formal enforcement actions include formal written agreements; orders to cease and desist; assessments of civil money penalties; and orders for removal, prohibition, or suspension of individuals from bank operations.[9]

According to Federal Reserve officials, the Federal Reserve has taken few enforcement actions against Section 20 subsidiaries for firewall noncompliance. Since the 1987 order that first approved Section 20 subsidiaries, two enforcement actions have been taken, one formal and one informal, both during 1994. On December 5, 1994, the Federal Reserve Bank of New York executed a Written Agreement with a bank holding company, its affiliated bank, and its Section 20 subsidiary not to engage in any violation of Section 23A of the Federal Reserve Act or any of the Federal Reserve's firewalls. As a result of a 1994 inspection, at the Federal Reserve's request a Section 20 subsidiary adopted a board of directors resolution that restricted the subsidiary's underwriting and dealing in ineligible securities and required various corrective measures.

[9]The bank regulatory enforcement process is described in detail in our report Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, April 15, 1991, pp.17-19).

According to Federal Reserve officials, the Federal Reserve has taken few enforcement actions because the Federal Reserve emphasizes corrective measures, rather than enforcement actions, to ensure that Section 20 firms have appropriately functioning internal control and internal audit procedures in place. Under this approach, Federal Reserve officials said, potential problems are discovered and corrected as part of the inspection process before they become serious enough to warrant an enforcement action. However, Federal Reserve officials said they will take enforcement actions if their examiners discover (1) an incidence of serious noncompliance with laws, regulations, or supervisory guidance relative to a Section 20 subsidiary; (2) repeat offenses; or (3) an unwillingness to correct voluntarily noted deficiencies or violations.

Even though the Federal Reserve's inspections have not resulted in many enforcement actions, our review of Federal Reserve inspection reports showed that the Federal Reserve's annual firewall inspection efforts have identified deficiencies and potential problems. In 15 out of 31 of the most recent inspections completed during 1992 or 1993, Federal Reserve examiners noted deficiencies. These deficiencies included, among others, a lack of internal audits for a newly established Section 20 subsidiary and failure to account for and adhere to technical rules related to calculation of the amounts of ineligible versus eligible revenues. According to Federal Reserve officials, such deficiencies are discussed with bank officials in inspection close-out meetings. Following these meetings, Federal Reserve officials said they require the subsidiaries' management to respond in writing within 60 days about the actions that the subsidiary will take to correct such deficiencies. The officials also said that the Federal Reserve would consider taking a formal or informal enforcement action, as appropriate, if no response were received or the next inspection showed that the subsidiary had failed to correct the deficiency.

Conclusions

The Federal Reserve's inspections of Section 20 subsidiaries were usually done on schedule and assessed compliance with applicable firewalls. Federal Reserve examiners or bank holding company internal auditors usually reviewed and tested for compliance with all applicable firewalls. However, the Federal Reserve's monitoring for firewall compliance is not complete unless Federal Reserve examiners or internal auditors review all applicable firewalls and unless Federal Reserve examiners review the completeness of the internal audit and document the audit's scope, methodology, and results. Reliable monitoring of and compliance with firewalls help ensure that banking organizations—including federally insured banks—are not engaging in unwise or unduly risky transactions with the underwriting subsidiaries, their clients, or their customers.

In cases where documentation of the work performed by examiners and internal auditors is not sufficient, the Federal Reserve cannot attest to the completeness of its firewall inspections or to the general level of compliance with firewalls. Also, without sufficient documentation we cannot fully conclude that the Federal Reserve's inspections are complete and effective, that the Federal Reserve has a basis for reliance on bank holding company internal auditors, or comment on the general level of compliance with the Federal Reserve's firewalls. The Federal Reserve's proposed development of a standardized workpaper format for bank holding company inspections that is similar to the format that it has developed and is testing for commercial bank examinations could provide adequate documentation of the work performed by Federal Reserve examiners and internal auditors if applied to the Section 20 subsidiary segments of the bank holding company inspections. However, those instances where firewall reviews are not being performed will not be remedied by implementation of documentation procedures.

Recommendations

We recommend that the Chairman of the Board of Governors of the Federal Reserve System ensure that either Federal Reserve examiners or internal auditors review and test all applicable firewalls at least once annually and document in inspection workpapers the work performed by Federal Reserve examiners or bank holding company internal auditors. Federal Reserve workpapers should document Federal Reserve examiners' testing of the work of internal auditors as a basis for reliance on internal audit.

Agency Comments and Our Evaluation

The Federal Reserve said that it would promptly address our findings related to firewall compliance. It intends to reiterate for examiners the Federal Reserve's long-standing policy to inspect and fully document Section 20 companies' compliance with all applicable firewall conditions. In addition, it will instruct examiners that when they rely on the reports of internal auditors, their workpapers must explicitly cross-reference the auditors' documentation of testing for compliance with each firewall.

The Federal Reserve also noted that in recent months additional enhancements have been made to its supervisory program to facilitate oversight of Section 20 companies' regulatory compliance. According to the Federal Reserve these include (1) the addition of another full-time, experienced staff member to its Section 20 oversight group; and (2) the preparation of a quarterly profile of the operations of each Section 20 company, including any violations of, or weaknesses in, controls relative to firewall conditions and the status of any supervisory follow-up actions and corrective measures.

The Federal Reserve also commented on three instances that we cited in the draft report of examiners or internal auditors failing to review for compliance with certain firewalls and instances where examiners' review and testing of firewalls were not always documented. The Federal Reserve said that those instances were either minor or not completely accurate. Federal Reserve staff reviewed each of the instances cited to provide additional detail.

- In the first instance, Federal Reserve staff found that the examiners felt justified in their reliance on the same internal audit for two consecutive inspections. This was because of the examiners' confidence in the company's strong program of quarterly firewall testing, history of consistent compliance, and the high quality of its internal audit programs. We could not review private banking organizations' compliance and internal audit programs and cannot comment on their quality. However, we believe that relying on the same internal audit for two consecutive inspections of firewall compliance does not provide continued assurance of compliance with firewalls.
- In the second instance, Federal Reserve staff found that internal auditors failed to review compliance with a firewall restricting sales of securities underwritten by the Section 20 company to affiliates because of a recent merger. In that case Federal Reserve staff found that the examiners verified compliance with this firewall. However, we did not see this work and the results documented in the inspection workpaper files that we reviewed. The Federal Reserve staff also noted that the Section 20 company in question, at the time of the inspection, was operating under the Federal Reserve Board's 1987 Order and was not subject to the firewall governing asset sales. According to our reading of the Federal Reserve's Bank Holding Company Supervision Manual, Section 2185.0, page 28, the 1987 Order did contain a firewall governing asset sales.
- In the third instance, Federal Reserve staff found that a firewall prohibiting reciprocal arrangements was not tested because the Section 20 company in question did about 98 percent of its business in government securities, which are not subject to firewalls. This company was involved only as a minor participant in underwritings of ineligible securities. This

information was not apparent from inspection workpapers and was not provided to us at the time of our review. We have dropped this example from the final report.

FDIC Was Unable to Assess Risks to Federally Insured Banks Posed by Securities Activities of Bank Subsidiaries

Under FDIC regulation and supervision federally insured state-chartered nonmember banks under its jurisdiction can establish or acquire bona fide subsidiaries to underwrite and deal in securities—activities not permissible for banks. However, the agency has not fully prepared its examiners to examine these activities and does not have other procedures for monitoring the subsidiaries' activities. As a result, FDIC has no systematic way of knowing the extent to which bank subsidiaries are engaged in securities activities that pose risks to nonmember banks or ensuring that any such risks are minimized.

Bona Fide and Section 20 Subsidiary Firewalls Share the Same Purpose

As discussed in chapter 1, bona fide subsidiaries are subject to operating conditions and firewalls required under FDIC Rules and Regulations, Section 337.4. The purpose of these requirements, like the requirements that Section 20 subsidiaries must meet, is to ensure the safety and soundness of bank affiliates of the bona fide subsidiaries and protect consumers from conflict-of-interest abuses and other inequities. Generally, Section 337.4 contains the following provisions:

- The bona fide subsidiary must be adequately capitalized.
- The bona fide subsidiary must be physically separate from the bank with separate offices, separate accounting and other records, and separate employees and officers.
- Bona fide subsidiaries' underwriting and dealing activities are limited to (1) "investment quality" debt and equity securities that are rated in the top four rating categories by a nationally recognized rating service or have equivalent characteristics, or (2) underwriting of investment companies whose holdings are primarily investment quality securities or obligations of the U.S. government and its agencies or money market instruments.[1]
- The nature of the bona fide subsidiary's business and its relationship with the banking affiliates, including that the subsidiary is a separate organization from the bank and that investments recommended, offered, or sold by the subsidiary are not bank deposits and are not insured by FDIC, must be disclosed to customers.
- Credit extensions that the bank affiliate may make to the bona fide subsidiary and its clients and customers are limited.
- Banks are prohibited from purchasing as fiduciary any securities underwritten or dealt by the bona fide subsidiary.
- Banks are prohibited from transacting business through a trust department with a bona fide subsidiary on terms that appear preferential

[1]This restriction does not apply to subsidiaries that are members in good standing with NASD and have been in continuous operation for at least 5 years.

when compared to similar transactions with unaffiliated securities companies.

- Banks are prohibited from conditioning any loan or extension of credit on the requirement that the bona fide subsidiary underwrite or distribute a company's securities.

Like the Federal Reserve, FDIC seeks to ensure that subsidiaries engaged in underwriting and dealing in bank-ineligible securities are insulated from bank affiliates by mandating separate operations—including separate officers and employees. Also similar to the Federal Reserve, the FDIC Regulation requires that an insured nonmember bank's direct investment in a securities subsidiary not be counted toward the bank's capital. FDIC expects bona fide subsidiaries to establish the necessary managerial and operational infrastructure before beginning operations. A more detailed account of the Section 337.4 provisions that apply to bona fide subsidiaries is presented in appendix II.

FDIC Requires Notification of Banks' Affiliation With Bona Fide Subsidiaries

The Federal Reserve examines a Section 20 subsidiary before it is approved to underwrite and deal in corporate equity and debt securities. In contrast, FDIC requires only that a nonmember bank notify the agency when it establishes or acquires a bona fide subsidiary. Section 337.4, rather than an FDIC action of approval, authorizes bona fide subsidiaries to underwrite and deal in certain corporate equity and debt securities. A nonmember bank is to notify the FDIC regional director of its intention to establish a bona fide subsidiary 60 days before the subsidiary is to begin operations and again within 10 days after it begins operations.

FDIC makes no effort to ensure through an on-site examination that bona fide subsidiaries commence securities underwriting and dealing activities in compliance with Section 337.4 operating conditions and firewalls. FDIC requires compliance with the Section 337.4 provisions at the time that a bona fide subsidiary begins operations. However, as a matter of policy, after receiving the notification FDIC reviews the bank's compliance at the next scheduled FDIC examination of the bank. Under certain conditions, this policy could allow a bona fide subsidiary to operate for many months before it is examined for compliance with Section 337.4 requirements. For banks subject only to FDIC examinations, a newly established bona fide subsidiary could operate for nearly a year before an examination. For banks that are subject to annual examinations alternating between FDIC and state regulators, such subsidiaries might operate without FDIC oversight for a longer period.[2] According to FDIC officials, FDIC has not established any procedure for approving state nonmember banks' establishment of bona fide subsidiaries because doing so would be burdensome on the banks.

FDIC Does Not Know How Many Banks Have Established Bona Fide Subsidiaries

From among the more than 6,000 banks the agency supervised, FDIC could neither provide an accurate count of the number of banks that had established or acquired bona fide subsidiaries nor identify all such subsidiaries. In response to our request for a list of banks with bona fide subsidiaries, FDIC polled its regions and identified 80 such banks. In our review of examination files for 13 of these banks, we found that none were engaged in underwriting and dealing in bank-ineligible securities.[3] In fact, only 5 of the 13 banks had actually established or acquired bona fide subsidiaries. Of those five subsidiaries, three provided full-service brokerage services; the remaining two provided only discount brokerage services (which did not require bona fide subsidiary status). Of the remaining eight banks that had not established bona fide subsidiaries, one provided full-service brokerage services (so it should have obtained bona fide subsidiary status), five provided only discount brokerage services, and two provided no brokerage services.[4]

FDIC officials later told us that the initial listing of 80 banks was inaccurate, and they were unable to provide us with any other data on banks with bona fide subsidiaries engaged in underwriting and dealing in bank-ineligible securities. The officials said that examiners have several ways of identifying banks and subsidiaries that should be examined for compliance with Section 337.4: (1) through the notices filed by banks to FDIC regional directors, (2) from information obtained from the banks in response to a preexamination entry letter, (3) from survey questionnaires responded to by bank officers, (4) from listings of bank affiliates and subsidiaries, and (5) from examiners' own visual examination of the banking organizations' activities. According to the officials, very few nonmember banks have established bona fide subsidiaries for the purpose of underwriting and dealing in bank-ineligible securities. The FDIC officials said that underwriting and dealing in securities are more common among

[2]The FDIC Improvement Act allows examination requirements to be met by state examinations in alternating years if the federal regulator deems this appropriate.

[3]The 13 banks were located in FDIC's Atlanta, Chicago, New York, and San Francisco regions.

[4]As noted in chapter 1, the Glass-Steagall Act does not prohibit banks from providing discount and full-service brokerage services.

larger banking organizations than the state-chartered nonmember banks FDIC supervises.

Some Examiners Were Uncertain About Examining Bona Fide Subsidiaries

FDIC examination guidance directs examiners to review the activities of bank subsidiaries and their compliance with firewalls.[5] During examinations of nonmember banks, FDIC examiners are also to determine that the activities of bank subsidiaries do not endanger the safety and soundness of the parent institution. When applicable, FDIC examiners are to review for compliance with Section 337.4 provisions. Although such subsidiaries are also subject to SEC and NASD examination, possible impacts on the safety and soundness of affiliated banks and compliance with firewalls to protect those banks are not within the scope of the SEC and NASD examinations.

In our review of FDIC examinations, we found instances of uncertainty among examiners about whether the Section 337.4 provisions applied to the subsidiary being examined. On two examinations—one in FDIC's Atlanta region and one in the San Francisco region—examiners did not know if the Section 337.4 provisions applied to the organization being examined and had to obtain determinations from FDIC regional legal counsels of whether the regulation applied. In another instance—in the Chicago region—a bank subsidiary that was providing full-service brokerage services was not examined for compliance with the regulation because the examiners believed that it did not apply to full-service brokerage activities.

The uncertainty examiners experienced regarding the applicability of Section 337.4 provisions is understandable. FDIC has no process for approving the securities activities of individual banks; thus, going into examinations FDIC examiners do not know which banks should be examined for compliance with Section 337.4. Further, FDIC's requirement that full-service brokerage subsidiaries be bona fide subsidiaries and comply with Section 337.4 provisions does not appear in FDIC's examination guidance. Section 337.4 requires only that activities prohibited by the Glass-Steagall Act, namely underwriting and dealing, be conducted in a bona fide subsidiary. The uncertainty that follows from this condition might be minimized by additional examiner guidance. As noted in chapter 2, FDIC examiners are not provided formal training on bank

[5]Securities subsidiaries of nonmember banks, including bona fide subsidiaries, are also subject to NASD examinations, which focus on investor protection issues, such as net capital position, trading practices, and sales practices, rather than on any effect that the subsidiary might have on the safety and soundness of the parent banking institution.

securities activities. Also, FDIC has no detailed examination procedures for examiners to follow in examining for compliance with Section 337.4. According to FDIC officials, no specific examination procedures are needed because Section 337.4 "speaks for itself" and serves as adequate examination guidance.

FDIC relies on the examination process as a means of monitoring the activities of bona fide subsidiaries. However, FDIC has no reliable means of knowing which banks and subsidiaries should be examined for compliance with Section 337.4, nor has it provided clear examination guidance or specialized training to enable FDIC examiners to conduct efficient and effective compliance examinations of bona fide subsidiaries.

FDIC Has No Reliable Way to Monitor Securities Activities of Non-Federal Reserve Member Banks

FDIC delegates all oversight of the bona fide subsidiaries to its regions. FDIC does not maintain centralized data on nonmember banks that have established or acquired bona fide subsidiaries, the volume of bank subsidiaries underwriting and dealing activities, the financial condition of the subsidiaries, or the subsidiaries' compliance with FDIC firewalls. This information would be relevant to monitoring possible risks to federally insured banks and any possible effect on the FDIC-administered Bank Insurance Fund.

The effects of FDIC's lack of centralized oversight of the securities activities of nonmember banks were exemplified by the results of our effort to obtain information about those activities. FDIC could not provide a count of banks that had established bona fide subsidiaries or even identify any such subsidiaries. This inability to provide information is most troublesome, as it bears on FDIC's ability to monitor the safety and soundness of banks under its jurisdiction that operate bona fide subsidiaries.

Conclusions

Federal banking regulators with supervisory responsibility for bank subsidiaries that engage in securities underwriting and dealing activities have a clear responsibility to adequately monitor the subsidiaries' activities in order to assess and minimize risks such activities may pose to federally insured banks. FDIC's policies on compliance monitoring and examination guidance and training, and the lack of systematic oversight, do not enable the agency to fulfill its responsibility to ensure that risks securities activities pose to nonmember banks are minimized.

Perhaps FDIC officials are correct in their perception that very few nonmember banks have engaged in underwriting and dealing in securities as permitted by FDIC regulations. If so, FDIC probably does not need to establish a program to monitor bona fide subsidiaries of the same magnitude as the program the Federal Reserve uses to monitor Section 20 subsidiaries. However, to ensure the safety and soundness of insured parent banks, FDIC at least should be capable of (1) identifying which of the banks it supervises have established bona fide subsidiaries, (2) monitoring and maintaining information on the size of those subsidiaries' underwriting and dealing activities and their capital adequacy positions, and (3) ensuring that the subsidiaries have controls in place and functioning to ensure compliance with firewalls.

Recommendation

We recommend that the Chairman, FDIC, establish a program to identify and routinely review the securities activities and the financial condition and performance of bona fide subsidiaries under FDIC's jurisdiction to assess the overall risks posed by the activities on federally insured banks and ensure compliance with firewalls. The program should provide FDIC examiners guidance and training on how to examine bank and bank subsidiary securities activities.

Agency Comments and Our Evaluation

FDIC disagreed with our recommendation that it establish a program to identify and routinely review the financial condition and performance of bona fide subsidiaries, assess risks posed by the subsidiaries' securities activities, and ensure compliance with firewalls. It believes that its decentralized approach has provided effective supervision and minimized risks to insured banks. It commented that because the range of permissible bank securities activities is subject to change over time, centralized reporting would only identify which banks had a bona fide subsidiary at some point in time. FDIC also said that supervision of those institutions would still fall to regional personnel. FDIC noted that bank securities subsidiaries also fall under the supervisory umbrella of SEC and NASD. FDIC said that rather than create a burdensome reporting process, it prefers to deal with bank subsidiaries' securities activities on a case-by-case basis. However, FDIC also commented that as the number of banks engaged in securities activities and the variety of such activities increase, it is considering various ways to improve its oversight of institution and systemic developments and issues.

We disagree with FDIC's view that changes in the range of permissible bank securities activities make monitoring those activities difficult and thereby justify its not systematically monitoring those activities. We believe that as a regulator of federally insured banks, FDIC is responsible for knowing of and supervising activities that may pose risks to those banks. We believe a centrally administered program to identify and monitor the securities activities and financial performance of institutions could improve FDIC's oversight of nonmember banks' securities activities immediately at little extra cost. For example, the centrally administered Federal Reserve program requires minimal staff resources—until recently, it required only one full-time analyst. With FDIC having few banking organizations with securities activities to oversee, a centrally administered program would likely require only a part-time responsibility for one headquarters staff position. Also, because FDIC already requires banks to notify it of subsidiaries' securities activities and has regional supervision programs in place, a centralized program should not require added regulatory burden on nonmember banks. Such a program, through regional examiners, would rely on the results of securities regulators' examinations to alert FDIC of conditions that might affect bank safety and soundness and not encourage duplicative examinations. Additional reporting burden would also not be a concern because securities subsidiaries' financial data are available from the FOCUS reports required by securities SROs.

Federal Reserve Board Firewalls

This Appendix Lists (1) the Firewall Requirements the Federal Reserve Established in Its 1987 and 1989 Orders Approving Bank Holding Company Subsidiaries to Underwrite and Deal in Bank-Ineligible Securities and (2) Firewall Requirements the Federal Reserve Modified for Underwriting Subsidiaries of Foreign Banks.

	Firewall applicable		
Firewall category/firewall description	**1987 Powers**	**1989 Powers**	**Foreign-owned**
Types of securities to be underwritten			
1. Section 20 subsidiary may underwrite and deal only in the following four ineligible securities: municipal revenue bonds, mortgage-related securities, commercial paper, and consumer-receivable-related (asset-backed) securities.	•	•	•
2. Section 20 subsidiary may underwrite and deal in corporate debt and equity.		•	•
Capital investment and adequacy			
3(a). Parent is required to deduct from its consolidated capital any investment it makes in the Section 20 subsidiary that is treated as capital in the Section 20 subsidiary.	•	•	
3(b). Foreign parent bank should meet Basle Accord risk-based capital standards.			•
4. Parent will also deduct from its regulatory capital any credit it or a nonbank subsidiary extends directly or indirectly to the Section 20 subsidiary unless the extension of credit is fully secured by U.S. Treasury Securities or other marketable securities and is collateralized in the same manner and to the same extent as would be required under Section 23A(c) of the Federal Reserve Act if the credit extension was made by a member bank.		•	•
5(a). Parent and its nonbank subsidiaries will not, directly or indirectly, provide any funds to, or for the benefit of, the Section 20 subsidiary, whether in the form of capital, secured or unsecured extensions of credit, or transfer of assets, without prior notice to and approval by the Board.		•	•
5(b). A Section 20 subsidiary may not be funded by an applicant's U.S. bank, thrift, branch, or agency. A foreign bank may invest in or lend to a Section 20 subsidiary as though foreign bank was a bank holding company.		•	•
6. Before commencing new activities, parent must submit to the Board acceptable plans to raise additional capital or demonstrate that it is strongly capitalized and will remain so after making the capital adjustments authorized or required by the Board's order.		•	
7. Section 20 subsidiary will maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses.	•	•	•
Credit extensions to customers of underwriting subsidiary			
8(a). Parent and its subsidiaries will not extend credit that may be viewed as enhancing credit worthiness or marketability of an ineligible security issue underwritten by the Section 20 subsidiary.	•	•	•
8(b). Section 20 subsidiary will not underwrite or distribute ineligible securities if it knows that an affiliate, foreign or domestic, is providing credit enhancements.			•
9. Parent and its non-Section 20 subsidiaries will not knowingly extend to a customer credit directly or indirectly secured by, or for the purpose of purchasing, any ineligible security that the Section 20 subsidiary underwrites during the underwriting period or for 30 days thereafter; or to purchase from the Section 20 subsidiary any ineligible security in which it makes a market.	•	•	•
10(a). Parent and its subsidiaries may not make loans to issuers of ineligible securities underwritten by the Section 20 subsidiary for purpose of payment of principal, interest, or dividends on such securities. To ensure compliance, any credit lines extended to an issuer by a bank affiliate shall provide for different timing, terms, conditions, and maturities from ineligible securities being underwritten.	•	•	•

(continued)

Firewall category/firewall description	Firewall applicable: 1987 Powers	Firewall applicable: 1989 Powers	Firewall applicable: Foreign-owned
11. Parent will adopt appropriate procedures to assure that any credit extensions by it or any of its subsidiaries to issuers of ineligible securities underwritten or dealt in by the Section 20 are on an arm's length basis for purposes other than payment of principal, interest, or dividends on such securities.	•	•	•
12. In any transaction involving the Section 20 subsidiary, thrift subsidiaries will observe the limitations of Sections 23A and 23B of the Federal Reserve Act as if the thrifts were banks.	[a]	•	•
13. Requirements relating to credit extensions to issuers noted in items 8-12 above will also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds.	•	•	•
14. Parent will cause its U.S. bank subsidiaries to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in financing transactions underwritten or arranged by the Section 20 subsidiary.		•	•
15. Parent and its U.S. subsidiaries will establish appropriate policies, procedures, and limitations regarding exposure of the holding company on a consolidated basis to any single customer whose securities are underwritten or dealt in by the Section 20 subsidiary.		•	•
Limitations to maintain separateness of underwriting affiliate's activity			
16(a). No officer, director, or employee interlocks are permitted between the Section 20 and any bank subsidiaries of the holding company. Section 20 will have separate offices from any affiliated bank.	•	•	
16(b). No interlocks except one officer of branch may act as a director of section 20 subsidiary. The Section 20 will have offices separate from any affiliated bank.			•
Disclosure by underwriting subsidiary			
17(a). Section 20 subsidiary will provide special disclosure statement describing difference between the Section 20 subsidiary and its U.S. bank affiliates, pointing out that an affiliated bank could be a lender to an issuer and referring the customer to the disclosure document for details. Statement will state that securities sold, offered, or recommended by the Section 20 subsidiary are not deposits, are not insured by FDIC or FSLIC, are not guaranteed by bank affiliate, and are not an obligation or responsibility of the bank. Section 20 will disclose any material lending relationship between issuer and bank affiliate, and in every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.	•	•	•
Marketing activities on behalf of underwriting subsidiary			
18. Section 20 subsidiary and affiliated U.S. bank will not engage in advertising or enter into an agreement stating or suggesting that an affiliated bank is responsible in any way for the Section 20's obligations.	•	•	•
19(a). U.S. bank affiliates of the Section 20 will not act as agent for, or engage in marketing activities on behalf of, the Section 20. In this regard, prospectuses and sales literature relating to securities being underwritten or dealt in by the Section 20 subsidiary may not be distributed by bank and may not be made available to the public at bank affiliate office, unless specifically requested by a customer.	•	•	•
Investment advice by bank and thrift affiliates and conflicts of interest			
20. U.S. bank affiliates may not express opinion on the value or the advisability of purchase or sale of ineligible securities underwritten or dealt in by the Section 20 subsidiary unless the bank affiliate notifies the customer that the Section 20 subsidiary is underwriting, making a market, distributing, or dealing in the security.	•	•	•

(continued)

Firewall category/firewall description	Firewall applicable: 1987 Powers	Firewall applicable: 1989 Powers	Firewall applicable: Foreign-owned
21. Parent and its U.S. bank, thrift, trust, or investment advisory subsidiary will not purchase, as a trustee or in any other fiduciary capacity, for accounts over which they have investment discretion ineligible securities (a) under- written by the Section 20 subsidiary as lead underwriter or syndicate member during period of underwriting or selling syndicate, and for 60-day period after termination; (b) from the Section 20 if it makes a market in that security, unless such purchase is specifically authorized.	•	•	•
Extensions of credit and purchases and sales of assets/conflicts of interest			
22. Parent and its non-Section 20 subsidiaries will not: (a) purchase, as principal, ineligible securities that are underwritten by the Section 20 subsidiary during underwriting period and for 60 days after close of underwriting period or (b) purchase from the Section 20 subsidiary any ineligible securities in which the Section 20 subsidiary makes a market.	•	•	•
23. Section 20 subsidiary may not underwrite or deal in ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliate, except for: (a) securities of affiliates if rated by a nonaffiliated, nationally recognized rating organization or are issued or guaranteed by FNMA, FHLMC or GNMA,[b] or represent interests in such obligations; and (b) grantor trusts or special purpose corporations created to facilitate underwriting of securities backed by residential mortgages originated by a nonaffiliated lender.	•	•	•
24(a). Parent will ensure that no U.S. bank subsidiary will, directly or indirectly, extend credit in any manner to the Section 20 subsidiary; or issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of the Section 20 subsidiary.		•	•
24(b). This prohibition does not apply to an extension of credit by a bank to the Section 20 subsidiary that is incidental to the provision of clearing services by the bank to the Section 20 subsidiary with respect to securities of the U.S. or its agencies, if the credit extension is fully secured by such securities, is on market terms, and is repaid on the same calendar day.		•	•
25(a). All purchases and sales of assets between U.S. bank affiliates and Section 20 subsidiary (or third parties in which the Section 20 is participant, or has financial interest, or acts as an agent or broker or receives a fee for its services) will be at arm's length and on terms no less stringent than those applicable to unrelated third parties and will not involve low-quality securities, as defined in Section 23A of the Federal Reserve Act.	•	•	
25(b). U.S. bank subsidiary will not, directly or indirectly, for its own account, purchase or sell financial assets of the Section 20 subsidiary. This limitation does not apply to the purchase and sale of U.S. Treasury securities that are not subject to repurchase or reverse repurchase agreements between the Section 20 subsidiary and bank affiliate.		•	•
Limitations on transfers of information to address possible unfair competition			
26. U.S. bank affiliates may not disclose to the Section 20 subsidiary, and vice versa, any nonpublic customer information, including an evaluation of credit worthiness of an issuer or other customer of that bank or Section 20 subsidiary, without customer consent.	•	•	•
Reports			
27. Parent will submit quarterly to the Federal Reserve FOCUS reports filed with NASD or other SROs and detailed information on the Section 20's underwriting activity broken out by eligible and ineligible securities.	•	•	•
Transfer of activities and formation of subsidiaries of an underwriting subsidiary to engage in underwriting and dealing			
28. Pursuant to Regulation Y, corporate reorganization of the Section 20 subsidiary may not be consummated without prior Board approval.	•	•	•

(continued)

Firewall category/firewall description	Firewall applicable		
	1987 Powers	1989 Powers	Foreign-owned
Limitations on reciprocal arrangements and discriminatory treatment			
29(a). Parent and its subsidiaries may not, directly or indirectly, enter into any reciprocal arrangement with another holding company for purposes of evading Board requirements.		•	•
29(b). U.S. bank affiliates of Section 20 subsidiary will not, directly or indirectly, (a) acting alone or with others, extend or deny credit or services, or vary terms or conditions, if the effect would be to treat an unaffiliated securities firm less favorably than the Section 20, unless the extension or denial is based on objective criteria and is consistent with sound business practices; (b) extend or deny credit or services or vary terms or conditions with intent of creating a competitive advantage for the Section 20.	[c]	•	•
Requirement for supervisory review before commencement of activities			
30. Parent may not commence proposed debt and equity securities underwriting and dealing activities until the Board has determined that policies and procedures have been established to ensure compliance with this Order's requirements, including computer, audit, and accounting systems, internal risk management controls, and operational and managerial infrastructure.		•	•

Legend
• = Firewall applicable

[a]Sections 23A and 23B of the Federal Reserve Act were made applicable to thrifts in 1989 by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

[b]FNMA refers to Federal National Mortgage Association; FHLMC refers to Federal Home Loan Mortgage Corporation; GNMA refers to Government National Mortgage Association.

[c]Although 1987 firewalls did not include tying restrictions, Section 20 subsidiaries operating with 1987 powers are not exempt from tying prohibitions contained in section 106(b) of the Bank Holding Company Act Amendments of 1970 and Federal Reserve Regulation Y (12 C.F.R. 225.7).

Source: GAO analysis of Federal Reserve information.

FDIC Bona Fide Subsidiary Provisions and Firewalls

FDIC regulation 337.4 requires that a subsidiary of an insured nonmember bank that conducts securities activities not authorized for a bank under sections 16 and 21 of the Glass-Steagall Act

(1) is adequately capitalized;

(2) is physically separate and distinct in its operations from the operation of the bank;

(3) maintains separate accounting and other corporate records;

(4) observes separate formalities, such as board of directors' meetings;

(5) maintains separate employees who are compensated by the subsidiary;

(6) shares no common officers with the bank;

(7) has a board of directors that is composed of a majority of persons who are neither directors nor officers of the bank; and

(8) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is an organization separate from the bank and that investments recommended, offered, or sold by the subsidiary are not bank deposits, are not insured by FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

Bona fide subsidiaries are required to register with the Securities and Exchange Commission as broker-dealers and be members in good standing of the National Association of Securities Dealers.

Bona fide subsidiaries' underwriting activities are limited to underwriting of investment quality debt and equity securities and underwriting of investment companies with not more than 25 percent of their investments in other than investment quality securities or obligations of the United States Government and its agencies, bank certificates of deposit, bankers acceptances, and other bank money instruments, short-term corporate debt instruments, and other similar investments normally associated with a money market fund.

An insured nonmember bank that has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities, or acts as an investment advisor to any investment company shall not:

(1) Purchase in its discretion as fiduciary, cofiduciary, or managing agent any security currently distributed, currently underwritten, or issued by its "bona fide" subsidiary or an investment company advised by that subsidiary, unless where allowed by regulation.

(2) Transact business through its trust department with its subsidiary unless the transactions are at least comparable to transactions with an unaffiliated securities company or a securities company that is not a subsidiary of the bank.

(3) Extend credit or make any loan directly or indirectly to any company the stocks, bonds, debentures, notes, or other securities of which are currently underwritten or distributed by its subsidiary or affiliate of the bank unless the company's stocks, bonds, debentures, notes, or other securities that are underwritten or distributed qualify as investment quality debt or equity securities.

(4) Extend credit or make any loan directly or indirectly to any investment company whose shares are currently underwritten or distributed by the "bona fide" subsidiary of the bank.

(5) Extend credit or make any loan where the purpose of the extension of credit or loan is to acquire any stock, bond, debenture, note, or other security underwritten by the bank's subsidiary or an investment company advised by the subsidiary, unless as allowed by regulation.

(6) Make any loan or extension of credit to the "bona fide" subsidiary unless the loan or extension of credit is within limits imposed by Section 23A of the Federal Reserve Act.

(7) Make any loan or extension of credit to an investment company for which the bank's subsidiary acts as an investment advisor unless the loan or extension of credit is within limits imposed by Section 23A of the Federal Reserve Act.

(8) Directly or indirectly condition any loan or extension of credit to any company on the requirement that the company contract with, or agree to contract with, the bank's subsidiary to underwrite or distribute the company's securities or directly or indirectly condition any loan or

extension of credit to any person on the requirement that the person purchase any security currently underwritten or distributed by the bank's subsidiary or affiliate.

Comments From the Board of Governors of the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

May 18, 1995

Mr. James L. Bothwell
Director, Financial Institutions
and Markets Issues
United States General Accounting Office
441 G Street, N.W.
Room 3858A
Washington, D.C. 20548

Dear Mr. Bothwell:

This is in response to your April 18, 1995 letter forwarding a draft report prepared by the GAO entitled "Banks' Securities Activities: Actions Needed to Improve Regulatory Oversight" for Board staff's review and comment. In general, the draft report provides an overview of the Federal Reserve's program to examine and monitor the securities activities of state member banks and section 20 companies supervised by the Board. In addition, the draft report cites a few deficiencies with respect to the Federal Reserve's assessment of compliance with firewall conditions during the course of section 20 company inspections. The draft report makes recommendations to address the noted deficiencies and to enhance interagency coordination of the supervision of bank-direct securities activities.

At the outset, Board staff is pleased to note that the draft report recognizes the significant resources the Federal Reserve has committed to developing comprehensive policies, examination and off-site surveillance procedures, and examiner training programs for supervising securities activities performed by banking organizations subject to Federal Reserve supervision. We are also pleased that the GAO staff recognizes the breadth of the Federal Reserve supervisory programs designed to insulate affiliate banks and the federal safety net from the activities performed by underwriting affiliates, and our extensive efforts to promote the safety and soundness of banking organizations engaged in securities activities, as well as to protect investors in connection with their dealings with the brokerage activities of banks. Finally, we are gratified that, with the exception of the comments related principally to our examination of firewall compliance, the draft GAO report does not raise any concerns about the other two important prongs of the Federal Reserve's

2

on-site section 20 company examination program--compliance with the Board's revenue test, and the financial and managerial aspects of a section 20 company's operations and their impact on the affiliated consolidated banking organization.

The Federal Reserve recognizes the importance of reviewing, on a continual basis, our securities activities supervision program; and, in this regard, we will address promptly the GAO's findings relating to firewall compliance. However, Board staff believe that it is important that the deficiencies pointed out in the draft report should be viewed with the proper perspective. The GAO staff responsible for the draft report extensively reviewed inspections and four infrastructure evaluations of 14 section 20 companies, and they found only three cases where Federal Reserve examiners supposedly did not review every firewall or document adequately their examination findings or those of a banking organization's internal auditors. These three instances involved only eight firewall conditions in total; however, the GAO fails to note that these examinations involved the separate review by our examiners of an aggregate of about 500 applicable firewalls. Moreover, the draft report does not suggest that any of the three companies' practices were deficient or that questionable practices went undetected for a period of time or otherwise raised safety and soundness concerns. When viewed from this perspective, we believe that, notwithstanding the few firewall assessment-related issues identified in the draft report, the Federal Reserve's section 20 oversight program is fundamentally sound and effective in measuring banking organizations' compliance with firewall conditions.

See comment 1.

GAO Recommendations

The draft GAO report contains two recommendations for the Federal Reserve that are addressed below. A separate report prepared by the staff of the Division of Banking Supervision and Regulation containing clarifying and technical comments to the draft GAO report is enclosed. Our staff's report and this letter also update events related to the securities activities of banking organizations supervised by the Federal Reserve that have transpired since the GAO's on-site reviews ended. Because several of the matters described in the GAO's draft report have been affected by recent interagency agreements and other events, we believe that it is important for your final report to contain the most up-to-date information about the supervision of banking organizations' securities activities by the Federal Reserve.

Recommendation Concerning Supervision of Bank-Direct Securities Activities

The draft report suggests that the Board, FDIC, OCC, SEC and NASD work together to develop and implement a consistent

3

approach for regulating brokerage activities conducted solely by bank employees--bank-direct securities activities. The Federal Reserve agrees with this recommendation and has been pursuing it in a number of ways for some time. As the draft report notes, the banking agencies have developed a productive relationship with the NASD and SEC as a means of coordinating our overlapping jurisdictions and avoiding unnecessary duplicative regulation. A second, no less important, goal of this relationship is ensuring that issues of common interest are addressed in a consistent manner by the securities and banking regulators. Our joint efforts with the securities regulators are resulting in a supervisory program for bank-direct sales activities that is analogous to, and consistent with, broker dealer regulation.

In this regard, although only the banking agencies have supervisory authority over banks' direct participation in securities brokerage activities, the banking agencies obtained the SEC's comments on the Interagency Statement on Retail Sales of Nondeposit Investment Products prior to its issuance in February 1994. Moreover, the sales practice requirements for banks contained in that statement are based on, and are consistent with, the SEC's and NASD's requirements applicable to all broker dealers. The Federal Reserve also obtained the NASD's comments on revised examination procedures for bank-direct sales of nondeposit investment products prior to their issuance in May 1994, and provided the final version to the NASD for use in developing its examination procedures for NASD member firms selling securities on bank premises. Coordination of examinations of bank affiliated broker dealers is being successfully implemented through an Agreement in Principle adopted by the banking agencies and the NASD in January 1995.

As the draft report also correctly notes, the banking agencies have asked the securities regulators to make their professional qualification examinations available to bank sales personnel and are developing a proposal that would include coordinated rulemaking by the banking agencies, as well as the development of a comprehensive central registration depository-type recordkeeping system for bank sales personnel. Most recently, the Federal Reserve commented on the NASD's proposed rule for its member firms operating on bank premises. Our comment letter focused on the need to obtain consistency between the NASD's requirements and the Interagency Statement. We are continuing our dialogue with the NASD and anticipate working closely to address possible differences in our guidelines and requirements.

Recommendation Concerning the Review and Testing by Federal Reserve Examiners or Internal Auditors of Firewall Compliance by Section 20 Companies

The draft report, which will complete the GAO's third comprehensive review of section 20 activities when it is finalized, recommends that the Federal Reserve ensure that either System examiners or internal auditors review and test all applicable firewalls at least once annually and appropriately document the work performed. In making this recommendation, the GAO found that, consistent with Board policies, section 20 companies are generally inspected annually by Federal Reserve examiners and that corrective action has been initiated where appropriate. It should be noted that in recent months additional enhancements have been made to our supervisory program to facilitate oversight of section 20 companies' regulatory compliance. These include the addition of another full-time, experienced staff member to our Division's section 20 oversight group, and the preparation of a quarterly profile of the operations of each section 20 company, including any violations of, or weaknesses in, controls relative to firewall conditions, and the status of any supervisory follow-up actions and corrective measures.

As previously stated, the draft report indicates that out of the numerous section 20 inspection report work paper reviews conducted by GAO staff, the GAO found three instances in which Federal Reserve examiners presumably either failed to review all the firewalls applicable to the respective section 20 companies, did not document adequately either their own or internal auditors' tests for compliance with each firewall, or relied improperly on an internal auditor's report. The instances cited by the GAO are, in our view, either minor or not completely accurate; and Board staff reviewed each situation in order to provide more details for the GAO staff's consideration.

In one situation where the draft report states that our examiners improperly relied on a year-old internal audit report, we found that, at the time of our examination of the section 20 firm, this audit was, in fact, the most recent one available. Due to a change in the Federal Reserve's examination schedule, the examination was closed prior to the initiation of the banking organization's new internal audit. Based on the firm's strong program of quarterly firewall testing, history of consistent compliance with applicable firewall conditions, and the high quality of its internal audit program, Federal Reserve examiners felt justified in their reliance on the then current audit report.

In the second situation noted in the draft report, the GAO reports that neither Federal Reserve examiners nor internal auditors conducted a review of firewalls relating to the sale of

5

securities underwritten by the section 20 company and to asset sales to its affiliates. Our review of this case disclosed that the internal audit department of this banking organization had not completed a full review of all firewalls during the year in question because of the substantial demands associated with a recent merger, and that, to address this omission, Federal Reserve examiners themselves did verify compliance with the firewall condition pertaining to the sale of underwritten securities to affiliates. Moreover, we found that, with respect to the firewall governing asset sales to affiliates, this section 20 company was, at the time of the inspection reviewed by the GAO staff, operating under one of the Board's 1987 Orders and, thus, was not subject to this firewall at the date of the inspection.

In a third case, the draft report cites a problem with a Reserve Bank's failure to review a firewall prohibiting reciprocal arrangements between the section 20 company and its affiliates, and its customers. In this situation, Federal Reserve examiners did review this section 20 company's policies and procedures pertinent to the anti-tying related firewalls and found them to be adequate. However, they did not test any transactions because the company essentially did not engage in the types or volumes of activities that would have triggered compliance issues associated with this firewall. When this section 20 company was inspected, about 98 percent of its business related to the sale and distribution of government securities, which generally is not subject to the firewalls; and, in those few instances where it was involved with an underwriting, the section 20 firm was either a minor syndicate participant or a selling group member. This means that there was an extremely minimal chance that this particular section 20 company could have on its own initiated, or been involved with, a reciprocal arrangement violative of this firewall. Using their discretion, Federal Reserve examiners determined that the testing of transactions for this company was not necessary.

In our opinion, the three instances described above either involve minor deficiencies or were misinterpreted by GAO staff and, in any case, certainly do not indicate fundamental weaknesses in our section 20 company oversight program. Nevertheless, in response to the GAO's recommendation in this area and in light of our strong commitment to the importance of firewall compliance, we intend to reiterate for System examiners the Board's longstanding policy to inspect and document fully section 20 companies' compliance with all applicable firewall conditions. In addition, we will instruct our examiners that when they rely on the reports of internal auditors, their work papers must explicitly cross reference the auditors' documentation of testing for compliance with each firewall.

6

Thank you for the opportunity to comment on the draft report. If you have any questions concerning this letter or the Division's staff report, please contact Mr. Herbert A. Biern, Deputy Associate Director, at (202) 452-2620.

Sincerely,

Stephen C. Schemering

Stephen C. Schemering
Deputy Director

Enclosure

The following is GAO's comment on the Federal Reserve's May 18, 1995, letter.

GAO Comment

1. The caption in the executive summary, the title of chapter 3, and our conclusion on the effectiveness of the Federal Reserve's program in the final report were modified. These changes were made in response to the Federal Reserve's noting the few problems we found after reviewing inspections of numerous individual firewall conditions.

Comments From the Federal Deposit Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Division of Supervision

May 18, 1995

James L. Bothwell, Director
Financial Institutions and Markets Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for the opportunity to review and comment on your report entitled Bank's Securities Activities: Actions To Improve Regulatory Oversight. Mr. Geer has asked that I reply to you directly.

Your report summarizes some weaknesses in our training of examiners and supervision of institutions. While we have established procedures in place or in process to address your concerns, which we share, each of your recommendations will be studied carefully in making any further changes to our examination program. In particular, we are working closely with other federal agencies to develop and implement an improved and coordinated approach to supervising securities activities. Secondly, we are undertaking to review and improve as appropriate our own program and training for securities activities.

Attached are some comments by us on specific parts of your report. We trust these comments will be helpful to you in gaining an understanding of our supervisory program.

Sincerely,

Stanley J. Poling
Director

Attachments

SPECIFIC COMMENTS RELATING TO THE GAO REPORT

See comment 1.

- On Page 2 you state that one purpose of your study is to evaluate FDIC's regulation of bank subsidiaries that FDIC allows to underwrite and deal in securities. Throughout the report you discuss activities that the FDIC "allows". The FDIC does not have authority to convey powers to banks. State and federal law allows banks to underwrite and deal in securities in certain circumstances. Our section 337.4 establishes the parameters under which the FDIC believes such activities can be conducted in a safe and sound manner.

- On Page 5 you state that the FDIC had no specific program to monitor the activities of the bona fide subsidiaries it authorized for state-chartered banks.

  It is important to realize that determining when a subsidiary engaging in securities activities must be a bona fide subsidiary as described in section 337.4 is not a simple matter. A subsidiary must be bona fide only when it is engaged in a securities activity that would not otherwise be authorized for the bank itself. Over the past several years, the range of permissible bank securities activities has been fluid. Therefore, the question of whether a subsidiary needs to be bona fide can and does change over time.

  Our regional examiner staffs are correct in obtaining a legal opinion before assuming any securities subsidiary must meet the definition of bona fide. The notices we receive at the FDIC are one-time notices. The information we have on file ranges from subsidiaries that may be engaging in activities that are not permissible for the bank itself, to broker/dealer activities, to activities that are no more extensive than holding the bank's own securities portfolio.

  Rather than requiring a burdensome reporting process, the FDIC deals with securities activities of subsidiaries on a case-by-case basis. We believe this method of supervision is effective, though it may not easily provide the types of aggregate numbers your study requested. Still, we see no reason to impose a further reporting burden on banks at this time solely to allow the FDIC to easily report aggregate totals.

Now on p. 5.
Now on p. 36.

- On page 6 you report that bank regulators had not reviewed the brokerage operation of 72% of the sampled banks. On page 48 that figure is further refined in that you report that the FDIC conducted examinations that included a review of bank-direct brokerage operations in only 2 of 19 instances sampled.

2

We have polled our regions relating to the 19 instances you sampled. Following are the results:

Atlanta Region: The only bank in the sample neither sells nondeposit products nor contemplates such sales.

Chicago Region: Five banks were included in the survey. In two instances an examination was conducted. In one other instance, the bank was involved only in limited discount brokerage activities, and no examination was conducted. One other bank did not begin its program until after our last examination during the period reviewed. One bank sold only U.S. Treasury securities through its correspondent bank as a customer accommodation.

Dallas Region: The one bank included in the sample provides indirect brokerage service to bank customers through helping to execute buy and sell orders with the bank's contracted brokerage firm. The service is maintained as a convenience for a limited number of customers.

Kansas City Region: Four banks were in the sample. One bank did not engage in the sale of nondeposit products and in two other cases the bank contracts with a third party broker/dealer. An examination was conducted in the fourth case in June, 1994.

Memphis Region: Five banks were included in the survey. Four of these banks have arrangements with third parties and have minimal transactions. The fifth bank only conducts an occasional transaction as a customer accommodation.

New York Region: The two banks included in the sample do not operate bank-direct brokerages.

San Francisco Region: The one bank included in the sample only sells U.S. Treasury securities through its correspondent bank to limited customers on an accommodation basis.

See comment 2.

This summary presents a different picture of our regulatory oversight than is indicated by the numbers presented in your report. Many of the banks sampled are not involved in the retail sale of nondeposit investment product except to accommodate customer requests. Others are conducting the activity through a third party vendor. Although our procedures were not flawless in the period reviewed, we believe the results as presented in your report may be misleading. Your report also minimizes the changes made by the FDIC in issuing the "Interagency Statement on Retail Sales of Nondeposit Investment Products", in February 1994; our April 1994 guidance to examiners on examination procedures; and our January 1995 cooperative agreement with the NASD.

Now on p. 6.
See comment 3.

- On page 7 you state that the banking regulators' examination agreement with the NASD does not address bank-direct brokerage operations. That is correct since banks that conduct bank-direct brokerage operations are not subject to NASD supervision. Therefore, we see nothing that the banking regulator/NASD examination agreement should have addressed.

Now on p. 6.

- Your report on page 7 discusses the parallel regulatory systems for bank and nonbank sales of securities. You state that the lack of consistent regulatory standards for bank-related and nonbank-related brokerages could result in confused investors, ambiguous sales practices, and inconsistent oversight of sales representatives.

  Our efforts have been directed to eliminating customer confusion and any differences among agencies. The disclosures given bank customers concerning the nature of the product being purchased are specifically required to increase customer knowledge. In addition, the FDIC has printed a brochure which is available to bank customers concerning the purchase of uninsured products. The FDIC has hired a market research firm to conduct a survey of bank sales practices. We will use the results of that survey to further enhance our supervision. Additionally, our onsite examination program is conducted on a regular basis and includes an analysis of sales practices. We feel our part of the parallel regulatory process is consistent with investor protection. We continue to work with SEC and NASD to harmonize rules among the parties they regulate and the banks we regulate.

Now on p. 8.

- On page 9 of your report you state that the FDIC had no formal examiner training program that focused on oversight of securities activities of state nonmember banks and their subsidiaries. That is so and we are considering the type and scope of training that is necessary. Since most of the banks we supervise, if they are to participate in the activity at all, contract with a third party broker/dealer regulated by the NASD and SEC, our examiners have supervisory responsibility for the examination of only a few banks in which the activity would require extensive specialized examiner training.

Now on p. 17.

- On page 20 you state, "When these services are provided on the bank's premises...bank regulators may examine the

See comment 4.

brokerage activities." Our examination authority does not extend to an unaffiliated company operating on the bank's premises. The bank's arrangement with the broker/dealer could provide for our access to the records indirectly through the arranging bank. The Federal banking agencies' "Interagency Statement on Retail Sales of Nondeposit Investment Products," February 15, 1994, requires that a bank's agreement with the third party broker authorize the appropriate banking agency to have access to all records of the third party as are necessary or appropriate to evaluate whether the third party broker is complying with the terms of its agreement with the bank.

Now on p. 39.
See comment 5.

- On page 57, you state that a cooperative effort could subject all bank securities sales personnel to NASD qualification and registration requirements. The federal financial institution regulators are working on such a proposal and have talked with the NASD and New York Stock Exchange concerning use of existing testing requirements.

See comment 6.

- On page 58, you state that "federal banking regulators seek to minimize disclosure of their enforcement actions against banks....". Section 8(u) of the Federal Deposit Act provides for the publication of enforcement actions, except where special circumstances are found.

Now on p. 64.
See comment 7.

- On page 91, you report that the FDIC regulation does not specify how the bank should calculate capital for regulatory purposes in dealing with subsidiaries engaged in activities not permissible for the bank. Section 337.4(b)(3) states that an insured nonmember bank's direct investment in a securities subsidiary... will not be counted toward the bank's capital. The subsidiary's capital requirements are set by the NASD and SEC net capital rules. Our full capital requirements are contained in Part 325.

See comment 8.

- Also on page 91 you report that subsidiaries that offer full-service brokerage must be bona fide subsidiaries. That is not the case. Only those subsidiaries that engage in securities activities that would not be permissible for the bank itself must meet the definition of a bona fide subsidiary.

- Your report criticizes our decentralized regulatory structure in that you believe it inhibits our ability to monitor the safety and soundness of banks with bona fide subsidiaries. We disagree with this conclusion. Our regions are responsible for the accurate reporting of the condition of banks. Centralized reporting would only report which banks at some point in time had a bona fide

5

subsidiary. Supervision of those institutions would still fall to regional personnel. Additionally, each of these subsidiaries would fall under the supervisory umbrella of the SEC and NASD. We feel it is appropriate for our regional personnel to cooperate with the regional personnel from those offices rather than attempting to manage these processes from Washington.

- Finally, we disagree with your conclusion that the FDIC's policies do not enable the agency to fulfill its responsibility to ensure that the risks securities activities pose to nonmember banks are minimized. We feel our record indicates that our policy has fitted well to the real risk our agency has faced from these activities. However, as the number of banks engaged in securities activities and the variety of such activities increases, we are considering various ways to improve our oversight of institution and systemic developments and issues.

The following are GAO's comments on FDIC's May 18, 1995, letter.

GAO Comments

1. The draft of this report referred to securities activities that FDIC "allows." Because FDIC pointed out that it did not have the authority to convey authority to banks, the text in this report was modified to delete the word "allows."

2. The analysis of table 2.2 and related text were modified, in part, in response to information provided by FDIC.

3. Table 1.1 was modified to reflect FDIC's comment that bank direct brokerages are not subject to regulation by SEC and NASD. The text was modified to include this information.

4. The text and table 1.1 were modified to indicate that bank regulators have no authority over third-party broker-dealers operating on bank premises.

5. As FDIC pointed, out the text was modified to indicate that bank and securities regulators are already cooperating on developing testing requirements for bank personnel.

6. FDIC pointed out that a statement in the draft was inconsistent with a provision in the Federal Deposit Act and the statement was deleted from the text.

7. FDIC pointed out that a statement in the draft about its regulatory requirements concerning bank capital was incorrect. The statement was revised to indicate that its regulations require that an insured nonmember bank's direct investment in a securities subsidiary not be counted toward the bank's capital.

8. FDIC pointed out that a statement in the draft about which subsidiaries must meet the definition of a bona fide subsidiary was incorrect and the statement was deleted from the text.

Comments From the Comptroller of the Currency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

June 8, 1995

Mr. James L. Bothwell
Director, Financial Institutions and Markets Issues
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have reviewed your draft audit report titled Banks' Securities Activities: Actions Needed To Improve Regulatory Oversight. The report was prepared in response to Congressional requests that GAO determine the extent to which banks provide securities brokerage services, bank regulators oversee these services when they are provided directly by banks, and banking and securities regulators coordinate their oversight activities. The audit found that many banks provide retail brokerage services, that bank regulators are working to improve their reviews of bank-direct sales activities and that the bank and securities regulators can cooperate to make oversight of bank-direct brokerage operations more consistent. To overcome differences in viewpoint and approach among bank and securities regulators, the draft recommends that the Federal Reserve, FDIC, OCC, SEC, and NASD work together to develop and implement an approach for regulating bank-direct securities activities. Further, the coordinated approach should provide consistent and effective standards for investor protection, while ensuring bank safety and soundness.

Your recommendation is consistent with our actions. We are continuing an ongoing dialogue with securities regulators on how to improve oversight of banks' securities brokerage activities, because we acknowledge the need for consistent regulations and improved cooperation. The issues under active discussion with securities regulators include referral fees, disclosure standards, and product names. The OCC plans in the near future to enter into a cooperation agreement with the SEC to conduct joint examinations of mutual funds advised by national banks or their subsidiaries and of national banks and national bank subsidiaries that provide advisory and other investment services to mutual funds. We have further agreed to consult and cooperate on NASD's rule proposal, examination procedures and examiner training.

The draft report recognizes our efforts, but, in many places, draws inaccurate conclusions or describes our regulations, policies, procedures and activities incorrectly. Our comments are intended to provide you with the current status of our oversight of bank retail sales of nondeposit investments, so that you may incorporate the additional information, clarification and corrections into your report as necessary and appropriate. You may also wish to consider inserting charts or tables into the final report, as an aid to readers, to compare the various regulations used by the regulatory agencies and to describe the content and frequency of examinations conducted by them.

Banks Engaged in Securities Activities

Risk

Now on pp. 14 and 15.
See comment 1.

The introductory section of the report, as currently drafted, incorrectly concludes that bank underwriting activities necessarily increase bank risk (pages 14 - 16). Diversification into securities activities, within limits and subject to appropriate supervision, can actually strengthen banks by lowering the variability of banks' returns and thereby reducing their overall risk. With regard to the particular issue of securities activities, it is notable that for decades, U.S. banks and their subsidiaries have been permitted to engage in a broad range of securities activities overseas in markets that are generally *less* regulated than U.S. markets, with no evidence that these activities undermine the safety and soundness of the banks involved. In addition, testimony presented at the House Banking Committee's recent hearings on financial services modernization included evidence from the pre-Glass-Steagall period in the U.S. (when banks could operate largely unregulated securities affiliates) that banks with securities affiliates had a much *lower* rate of failure -- even after adjusting for bank size, location and other variables -- than did other banks.

Structure

Now on p. 20.
See comment 2.

Page 26 of the draft report misrepresents our proposed rulemaking governing corporate applications. The proposal is not intended to provide automatic approval or to grant authority for subsidiaries of national banks to engage in securities activities from which the bank is prohibited. Instead, the proposal only sets up a process for OCC to consider applications from individual national banks to pursue new activities through establishment of operating subsidiaries. Applications would be considered and decided on a case-by-case basis.

Coordination with Other Regulators

Referral Fees

See comment 3.

The draft report incorrectly implies that banking agencies permit referral fees in a manner inconsistent with the NASD's proposed rule. The Interagency Statement provides that bank employees may only receive a one-time, nominal fee of a fixed-dollar amount for each customer referral for nondeposit investment products, and the payment of this referral fee may not depend upon whether the referral results in a transaction. The NASD proposed rule also permits the payment of referral fees provided the fees are not based on the effectiveness or success of the referral; the payments would flow through the bank to the employee rather than be paid directly to the employee (page 54).

Now on p. 39.

2

Disclosure Requirements

See comment 4.

It would be useful if the draft report clarified that the disclosure requirements in the Interagency Statement are significantly more comprehensive in scope than the NASD proposal. For example, the Interagency Statement requires repeated oral disclosures to customers during any sales presentation and extensive disclosures in advertising and promotional material. In contrast, the NASD's proposal only requires a one-time written disclosure statement (page 55).

Now on p. 40.

Sharing Information

See comment 5.
Now on p. 41.

The banking agencies have had direct access to information in NASD's Central Registration Depository for a number of years and make use of it as appropriate. It need not be highlighted in the draft report as a desirable new initiative (page 55).

Qualifications of Sales Representatives

See comment 6.

The draft report recommends that the banking and securities regulators cooperate so as to subject securities sales representatives in banks to NASD qualification and registration requirements. However, the draft report neglects to note that the regulators already have been engaged in precisely this effort for some time. The banking industry has been working to gain access to securities industry qualifications examinations for several years. Only last year, NASD committed to work with the bank regulators to find a way to make the examinations available to bank employees. Since then, the banking agencies have been working with the NASD, the SEC and the New York Stock Exchange to structure a bank employee testing and recordkeeping proposal that addresses the concerns of the securities regulators (page 56).

Now on p. 39.

OCC Examinations and Oversight

Following issuance of the Interagency Statement in February 1994, OCC directed examiners to include in all subsequent safety and soundness examinations, a review of nondeposit investment sales activities. The examinations are being conducted with statutory frequency. No more than 12 or 18 months may pass between examinations, depending on bank size and condition. By year-end 1995, all national banks that are engaged in bank-direct brokerage operations will have had at least one such examination (page 45). Moreover, banks are continuously subject to oversight through regulation regardless of the occurrence of an examination (page 47).

Now on p. 36.
Now on pp. 34 and 35.

Examiner Training

The draft report refers to training seminars held in Washington, D.C. In addition to those, each of our six district offices provided training to at least 35 examiners in the relevant examination procedures. These examiners, in turn, provided the training to examiners in other offices across the country (pages 48-51).

See comment 7.
Now on pp. 37 and 38.

3

Regulations

See comment 8.

Now on p. 17.

As noted in the draft report, all of the banking agencies have regulations requiring securities confirmations and customer recordkeeping that are substantially the same as the comparable SEC regulation. OCC's regulations are contained in 12 C.F.R. 12. The anti-fraud provisions of the federal securities laws apply to banks in the same manner as registered broker-dealers (page 21).

Enforcement Actions

The draft report incorrectly suggests that federal banking regulators try to minimize disclosure of their enforcement actions against banks. While we have not yet found it necessary to enter into an enforcement action as a result of our examination findings on sales of nondeposit investment products, we would publicize any disciplinary action as we are statutorily required to do under 12 U.S.C. 1818(u). Moreover, any related administrative hearing would be open to the public (page 58).

In conclusion, we believe that the OCC's oversight of national banks' direct securities activities through regulation and examination is no less vigorous than that provided by the securities regulators. Thank you for the opportunity to review and comment on the draft report.

Sincerely,

Judith A. Walter

Judith A. Walter
Senior Deputy Comptroller for Administration

4

The following are GAO's comments on OCC's June 8, 1995, letter.

GAO Comments

1. OCC said the introductory section incorrectly concludes that bank underwriting activities necessarily increase bank risk. It said that diversification into securities activities can actually reduce risk. In the Objective, Scope, and Methodology section we note that it was not in the scope of our review to determine comparative degrees of risk associated with different banking and nonbanking activities that banks might engage in. However, banks that engage in securities underwriting and dealing would be subject to risks of financial losses just as securities firms that underwrite and deal in securities are.

2. OCC said that the draft misrepresented its proposed rule governing corporate applications. The text was modified to incorporate OCC's interpretation of the proposal.

3. OCC said the draft incorrectly implied that the banking agencies permitted referral fees in a manner inconsistent with a NASD proposed rule. The text was modified to indicate that the Interagency Statement permits one-time fixed-dollar amount referral fees. OCC states that the NASD proposal also permits, or does not prohibit, such fees. However, fees paid by the bank to bank employees are beyond NASD's authority.

4. As OCC suggested, the text was modified to note that the Interagency Statement also requires oral disclosure at any sales presentation or offering of investment advice.

5. OCC said that banking agency access to CRD information should not be highlighted as a new initiative because they have had direct access to that information for years. A footnote was added to note limitation of the regulators access to CRD information.

6. In response to OCC's comments, information about the cooperative effort to make securities industry qualification examinations available to the banking industry is now characterized as an ongoing effort rather than a proposal.

7. The text was modified to include the additional training that OCC said was provided to examiners.

8. As OCC suggested, the text was modified to indicate that the antifraud provisions of federal securities law apply to banks in the same manner as registered broker-dealers.

9. The statement that banking regulators try to minimize their disclosure of enforcement actions against banks was deleted from the text.

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

May 19, 1995

Mr. James L. Bothwell
Director, Financial Institutions
and Market Issues
General Government Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

The Division appreciates the opportunity to comment on the General Accounting Office's ("GAO") draft report entitled Banks' Securities Activities: Actions Needed to Improve Regulatory Oversight ("Draft Report"). The Draft Report provides information that will contribute to the continuing debate on Glass-Steagall reform.

While the Draft Report makes a number of recommendations, our comments focus on the recommendation that the federal banking and securities regulators cooperate to develop and implement an approach for regulating "bank-direct" securities activities. According to the Draft Report, this approach should provide consistent investor protection standards while also protecting banks' safety and soundness.

The Draft Report defines "bank-direct" securities activities as those that are conducted on bank premises exclusively through bank employees and, thus, that currently are regulated only by the banking regulators. As the Draft Report explains, bank-direct securities activities comprise a relatively small portion of the total securities activities performed by banks.1/ The Draft Report notes that, to date, banks primarily have conducted securities activities either by entering into agreements with registered broker-dealers, or by forming their own broker-dealer affiliates.

Recent events suggest that the trend toward increased bank involvement in securities activities will continue. For example, the current proposal by the Office of the Comptroller of the Currency ("OCC"), which states that subsidiaries of national banks may engage in activities that may not be performed by the banks themselves, would accelerate the growth of banks' securities involvement.2/ In addition, pending legislative proposals to reform the Glass-Steagall Act, if passed, also likely would facilitate banks' securities activities. In sum, the financial services industry landscape appears to be evolving at a brisk pace.

1/ See infra note 5.

2/ See 59 Fed. Reg. 61034 (Sept. 23, 1994) (to be codified at 12 C.F.R. Part 5); see also NationsBank v. Variable Annuity Life Insurance Co., 63 U.S.L.W. 4076 (1995) (holding that the Comptroller of the Currency should be accorded substantial deference in deciding which activities are an "incidental power . . . necessary to carry on the business of banking.")

Mr. James L. Bothwell
May 19, 1995
Page 2

While the Commission, the federal banking regulators, and the National Association of Securities Dealers, Inc. ("NASD") have worked hard together in this changing environment, interagency cooperation alone is not enough. The fact remains that, depending upon the structure through which they are conducted, the securities activities of banks may be subject to differing regulatory requirements and varying degrees of oversight. As the Draft Report pointed out, such oversight may range from duplicative to almost non-existent. The key, therefore, is to ensure that the applicable regulatory scheme provides equal protection for all investors and reduces regulatory costs. This, in turn, would ensure that competition among firms is based on market performance, rather than on arbitrary differences in regulation.

The Commission has long maintained that only a system of functional regulation, in which each entity is regulated according to the particular activity that it undertakes and not according to its charter, can achieve these goals.3/ As evidenced by its testimony before Congress, the GAO also generally has supported the functional regulation of banking and securities activities.4/

Functional regulation would be a more efficient and responsible use of both taxpayer dollars and bank capital. The Commission and the NASD have developed systems and expertise over more than half a century regulating the securities industry. Attempts by the banking regulators to re-create this proficiency waste scarce government resources. Moreover, centralizing securities regulation in the expert regulators would help banks minimize their costs of regulatory compliance.

Instead of supporting a rational system in which the entity is supervised according to the function that it performs, however, the Draft Report appears to encourage a system of duplicative regulation. Moreover, by referring to the banking and securities regulatory structures as "parallel systems of regulation," the Draft Report appears to imply that these systems are the same. We strongly disagree with this suggestion. As the Draft Report points out, the federal banking regulators and the Commission have different statutory mandates. The primary goal of the federal banking regulators is to maintain the safety and soundness of the banking system; the Commission's primary goals are to protect investors and to maintain the integrity of the securities markets. As a result, the systems are not equivalent.

In addition to our overall comments, we have the following specific comments regarding methodology and investor confusion issues.

Methodology

We commend the GAO on its compilation of data on the extent of banks' securities activities. As the Draft Report noted, much of this information is not otherwise available because banks currently are not subject to any notice requirement with respect to their

---

3/ See Statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Before the House Committee on Banking and Financial Services (March 15, 1995).

4/ Statement of James L. Bothwell, Director, Financial Institutions and Markets Issues, General Government Division, U.S. General Accounting Office, Before the House Committee on Banking and Financial Services (March 15, 1995).

Mr. James L. Bothwell
May 19, 1995
Page 3

securities activities. This information, however, is valuable in quantifying the extent of banks' participation in securities activities.

See comment 1.

We have two comments regarding the methodology of the Draft Report. First, by comparing the number of banks providing bank-direct securities with the total number of banks (including those that do not provide any securities activities), the Draft Report seems to imply that an insignificant number of banks are engaged in bank-direct securities activities.5/ We believe, however, that a more relevant indicator of the significance of bank-direct securities activities is the number of banks providing bank-direct services compared to the total number of banks that provide securities services.

See comment 2.

Second, the Draft Report mainly discusses banks in two categories: those providing securities services exclusively through bank employees, and those providing securities services through broker-dealers. As table 2.1 of the Draft Report points out, however, 44 percent of the banks responding to the GAO survey -- the largest percentage of respondents -- provide securities brokerage services to their customers through the use of dual employees of the bank and the broker-dealer. It would be useful to determine how the current regulatory system affects the securities services provided by banks with employees in this category.

Investor Confusion

Although the Draft Report mentions the potential for customer confusion as a result of banks' securities activities, this issue should be explored further. Congress recently heard testimony from the Consumers Union that a number of bank practices lead investors to believe erroneously that the securities they purchase through a bank are insured by the Federal Deposit Insurance Corporation.6/ In February 1995, the NASD took a significant step toward addressing this potential for customer confusion by proposing amendments to its Rules of Fair Practice.7/

5/ The Draft Report indicates that banks offering bank-direct securities services comprise three percent of all banks, and twelve percent of the banks offering securities brokerage services. Moreover, in the sample discussed in the Draft Report, approximately 75 percent of the banks offering bank-direct securities services stated that they processed fewer than 25 transactions a month.

6/ Statement of Michelle Meier, Counsel for Government Affairs, Consumers Union, Before the House Committee on Banking and Financial Services (March 22, 1995). Among other things, the Consumers Union testified that banks use personal financial information regarding their current customers' deposit accounts to target consumers for the sale of their uninsured investment products, or give this information to third-party broker-dealers for use in targeting sales.

Now on p. 39.

7/ The Draft Report, at page 54, states that, "[d]espite . . . gainful coordination efforts, differences in approaches to and procedures for regulating bank brokerage operations persist." The Draft Report goes on to state that the NASD's proposed rules have generated controversy in the banking industry. We note that the NASD designed these proposed rules to supplement and clarify guidelines issued by the Commission staff in 1993. The NASD has clear authority and expertise to regulate its members' securities activities.

Mr. James L. Bothwell
May 19, 1995
Page 4

The Division appreciates the opportunity to comment on the Draft Report. I respectfully request that this letter be appended to the final report delivered to Congress.

Sincerely,

Brandon Becker
Director

BB\PJ\dn

The following are GAO's comments on SEC's May 19, 1995, letter.

GAO Comments

1. As SEC suggested, the text was modified to compare the number of bank-direct brokerages to the total number of banks that provide securities services.

2. Brokerage services that are provided through registered broker-dealers, including bank affiliates and independent third-party broker-dealers, were not included in the scope of this report, as SEC suggested, because they are subject to SEC and NASD regulation. See p. 22.

Comments From the National Association of Securities Dealers

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

NASD

John E. Pinto ▪ Executive Vice President ▪ Regulation ▪ 1735 K Street, NW ▪ Washington, D.C. 20006-1500 ▪ (202) 728-8233

May 17, 1995

Mr. James L. Bothwell
Director, Financial Institutions
and Market Issues
General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

The National Association of Securities Dealers, Inc. (NASD or Association) appreciates this opportunity to comment on the draft of the General Accounting Office (GAO) report entitled Bankers' Securities Activities: Actions to Improve Regulatory Oversight.

As a general statement, the main focus of the GAO report relates to securities brokerage services offered directly through the banks themselves, and the adequacy and comprehensiveness of the bank regulators' efforts to monitor these securities activities. These bank-direct securities activities occur at banks that exclusively use their own employees rather than an affiliated member or third party networkers, to provide securities brokerage services to retail customers. Thus, given the extent of NASD jurisdiction only to those SEC registered NASD member broker-dealers, there are relatively few areas covered by the draft report on which the NASD has any comment.

Before addressing the specific recommendations, let me begin by emphasizing that the NASD is a strong advocate of functional regulation as the long-term solution to establishing an effective regulatory structure that spans the securities activities of banks and broker-dealers. NASD President and Chief Executive Officer Joseph R. Hardiman testified before the House Subcommittee on Telecommunications and Finance on the proposed Securities Regulatory Equality Act on April 14, 1994, wherein he expressed the NASD's position over the years that securities activities regardless of the entity through which they are conducted must be regulated under a single set of consistently applied rules. Under this structure, the SEC would be the sole federal regulator responsible for regulating and enforcing securities rules and activities, with the bank regulators having the federal authority to regulate banking activities. In the meantime, the NASD is cooperating with SEC and the bank regulators, working together to achieve the most effective regulatory programs possible under the current regulatory structure.

National Association of Securities Dealers, Inc.

Mr. Bothwell
May 17, 1995
Page No. **2**

In this regard, one of the GAO's recommendations encourages the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), SEC and NASD to work together and implement an approach for regulating bank-direct securities activities that provide consistent and effective standards for investor protection. While NASD regulatory jurisdiction does not extend to bank-direct securities activities, we are totally supportive of working closely with the bank regulators and SEC to develop uniform, consistent and comprehensive examination, advertising and sales practice policies and procedures that subject banks and broker-dealers who sell securities on bank premises to similar standards. The GAO report correctly recognizes the NASD's Agreement with the four bank regulators (OCC, FDIC, Federal Reserve and Office of Thrift Supervision (OTS), signed in January 1995, that will be an important force in fulfilling the GAO's recommendations that bank and securities regulators work closely to coordinate examinations, share information, coordinate rules, and provide consistent examinations and interpretations. This coordinated effort will also play an important investor protection role by focusing regulatory efforts by both securities and bank regulators on reducing customer confusion when securities are purchased on the premises of a bank. Given the long history which the NASD and SEC have in the regulation of securities activities, including strong emphasis on investor protection issues, sales practices, suitability, overall fair dealing and supervision, the NASD welcomes playing a primary role in this undertaking. This would further opportunities designed to achieve cooperative approaches among regulators, uniform application of law and consistency of interpretations. This is particularly important because we must provide a level regulatory playing field for bank-direct and broker-dealer securities activities which fosters the highest degree of full disclosure and protection for the investing public.

As for specific comments on the draft report, they are as follows:

Now on p. 18.
See comment 1.

a) Page 20, Table 1. For the second "Method" which addresses retail brokerage services that occur "on bank premises and through a registered securities brokerage affiliate or third-party arrangement", the Regulatory responsibility column should read: "Bank and securities regulators for brokerage affiliates; securities regulators for third party arrangement broker--dealers. (new language underlined). This distinguishes the different roles bank regulators have for affiliates (where the relationship with the bank does provide bank regulators with a tie to the affiliated broker-dealers), as compared to the third party networker broker-dealer which is solely under the jurisdiction of the NASD and SEC, with no direct regulatory authority for the bank regulator. The NASD/bank regulator Agreement in Principle reflects this important distinction. To do otherwise would subject this group of broker-dealers to unnecessary and potentially burdensome overlap and duplication.

See comment 2.

b) Page 48. The bank regulators did not discuss, coordinate, or develop their joint policy statement with the NASD as stated in the draft. Any NASD involvement came well after the joint policy statement was issued. Therefore, the phrase ". . . which bank regulators developed with NASD assistance . . ." should be deleted.

Mr. Bothwell
May 17, 1995
Page No. **3**

Now on p. 40.
See comment 3.

c) Page 54. The NASD's proposed rules for bank/broker-dealers prohibits the ". . .use of confidential bank customer financial information . . ." (new language underlined)

Now on p. 40.
See comment 4.

d) Page 55. The GAO's reference to reporting by the financial press of the NASD's bank/broker dealer proposed rules requires a brief comment. The NASD is disturbed and frustrated by the inaccuracies and often inflammatory nature of the news coverage on the NASD proposal. While we expected some controversy, careless reporting has created confusion and concern well beyond the issues themselves. Simply stated, the NASD's proposed rules seek consistent treatment of affiliated and networking broker-dealers because the banking guidelines established by the Interagency Statement do not have the force and effect of law and cannot support disciplinary actions against broker-dealers. The proposed NASD rules will provide direction to NASD members as to what is expected of them when operating on the premises of a bank, and establish clear authority to bring enforcement actions for serious violations. Since the NASD rules will not govern bank-direct securities business, they do not duplicate the guidelines established by the Interagency Statement issued by the bank regulators. To the contrary, they complement these guidelines. To the degree possible, the NASD proposed rules are consistent with the SEC's Chubb no-action letter and the bank regulators' Interagency Statement. There are some differences such as the NASD's prohibition against broker-dealers paying referral fees to tellers and other non-registered persons under the proposed rules. This position, however, is consistent with long-standing NASD policy prohibiting payments by NASD members to non-registered persons. There is no overlap or duplication created by the proposed NASD rules; they will govern the activities of broker-dealers while the bank regulators' guidelines apply to the banks.

In recognition of the increased importance and rapid growth of our bank/broker-dealer members, the NASD Board of Governors approved the creation of a Bank/Broker-Dealer Committee as a standing committee of the Board. The new committee will be responsible for making recommendations to the NASD Board about rules and procedures governing the securities activities of NASD member firms that are affiliated with financial institutions or that provide brokerage services and products on the premises of a financial institution. The first task for this Committee, which is comprised of twelve members representing various segments of the NASD bank/broker-dealer membership, is to review the 284 comment letters received by the NASD in response to its request for comments on the proposed bank/broker-dealer rules.

We also plan to work closely with the four bank regulators -- the OCC, the FDIC, the OTS and the Federal Reserve -- as well as with various industry groups as we move toward developing final rule proposals.

Now on p. 39.
See comment 5.

e) Page 57. Top Paragraph. The NASD, SEC, NYSE and bank regulators are discussing various proposals to extend the securities industry qualifications testing and registration process to bank-only employees who are engaged in bank-direct securities activities that will be

Mr. Bothwell
May 17, 1995
Page No. **4**

backed by examination, enforcement and disciplinary functions by bank regulators that are identical to those in place for the securities industry. We anticipate some resolution of this issue within the next several months.

f) Page 60. Recommendations. While the NASD has no jurisdiction over bank-direct securities activities, the Association is willing to support this GAO Recommendation by sharing its many years of experience and expertise in securities examinations with the bank regulators and the SEC in designing examination formats, and assisting in bank examiner training if requested to do so.

The NASD appreciates the opportunity to comment on the draft report. The NASD is committed to protecting investors through the establishment of effective rules and regulations that address broker-dealer conduct when selling securities on bank premises, and in working closely with bank regulators and the SEC to coordinate consistent and uniform examination and enforcement policies and procedures wherever possible.

Very truly yours,

John E. Pinto
Executive Vice President
Regulation

The following are GAO's comments on NASD's May 17, 1995, letter.

GAO Comments

1. The clarification to table 1.1 that NASD suggested was made by providing separate categories for bank affiliates and third-party broker-dealers.

2. NASD said the bank regulators did not discuss their Joint Policy Statement with NASD as the draft stated. The phrase was deleted from the text.

3. The text was modified to special "financial" information as NASD recommended.

4. The text was modified to include NASD's views on regulation of banks' securities brokerage activities.

5. As NASD indicated, information about the cooperative effort to make securities industry qualification examinations available to the banking industry is now characterized as an ongoing effort rather than a proposal.

Technical Appendix: Survey of Banks

Ranking Minority Members of congressional committees asked us to determine whether bank examiners check for compliance with retail securities brokerage safeguards and whether sanctions are imposed on banks that breach those safeguards. To accomplish this, we needed to select for evaluation banks whose own employees were involved in the brokerage services offered by the bank. We also set out to describe the nature and extent of retail securities activities conducted by banks.

To help meet this request, we mailed questionnaires to a random sample of 2,233 banks. The results of that survey are representative of the entire banking industry.

Our questionnaire gathered data on the different types of retail securities brokerage services offered and through what arrangements with employees, subsidiaries, affiliates, or third parties the services were being offered. In addition, we included a number of questions on the related subject of bank mutual fund sales programs. The fieldwork for the survey was conducted from February through June of 1994.

Survey Sample Plan

We developed the survey frame (a listing, without duplicates or omissions, of each element in the population of U.S. banks) from a file containing the June 1993 Call Report data. This database listed 13,360 banks. After removing International Banking Associations and New York Investment Companies (which we felt were mostly commercial institutions unlikely to have retail brokerage programs), our frame contained 11,769 banks. Later, we excluded 559 mutual savings banks from the analysis, because they fell outside the scope of our work. Our total survey population, or universe, consisted of 11,210 banks.

From this frame, we randomly sampled 2,233 banks. We divided the institutions in the frame into 12 strata (see table VIII.1) and distributed our sample across those strata so that survey estimates from each stratum would be likely to have sampling errors for the most important questions of no more than ± 5 percent at the 95-percent level of confidence. Unless otherwise noted, the survey statistics in this report have sampling errors within that range.

Because we surveyed only one of a large number of possible samples of the bank population to develop the statistics used in this report, each of the estimates made from this sample has a sampling error, which is a measure of the precision with which the estimate approximates the population value. The sampling error is the maximum amount by which estimates derived from our sample could differ from estimates from any other sample of the same size and design and is stated at a certain confidence level, usually 95 percent. This means that if all possible samples were selected, the interval defined by their sampling errors would include the true population value 95 percent of the time. In addition to sampling error, all sample surveys may also be subject to error from a number of other sources, as described in the section on survey error and data quality below.

Questionnaire Design and Administration

We developed our questionnaires in consultation with experts in the finance industry and at regulatory agencies, and we conducted six pretests with banks that represented a range of sizes and regulators. We made revisions to the questionnaire on the basis of the comments we received. See appendix IX for a copy of the pages from the questionnaire used in our analysis.

We addressed each questionnaire to the office of the President or CEO at each institution, using the mailing address information listed in the Call Report file.

We mailed questionnaires to all 2,233 sampled banks in early February of 1994. To the institutions not responding to our survey by the end of March 1994, we sent a follow-up questionnaire on April 1, 1994. We ended the fieldwork for this survey on June 16, 1994, discarding any questionnaire returned after that date.

Survey Response

By the end of the survey fieldwork period, we had received 1,508 completed questionnaires, accounting for 68 percent of the banks in our sample. Table VIII.1 displays, by strata, the dispositions of the questionnaires we sent out. Because banks in different strata were sampled at different rates, and because institutions responded at different rates across the strata, the survey estimates made in this report were weighted, or statistically adjusted, so that the answers given by institutions in different strata were represented in proportion to their actual numbers in the entire population.

There was a slight tendency for the smaller institutions (in terms of asset size) to respond at higher rates than larger institutions. Also, those responding early in the survey period tended to be the banks not offering brokerage services (such questionnaires required little work on the part of our respondents, making it easier to fill out the questionnaire). We have no reason to believe that these patterns of response had any impact on the accuracy of the survey estimates. However, we conducted no follow-up contacts with any of the nonrespondents to determine if their answers were significantly different from the answers of those who did respond.

Table VIII.1: Survey Dispositions of Sampled Banks

	Questionnaires mailed out		
Strata (institution type and asset size)	**Original population[a]**	**Initial sample**	**Ineligible[b] from sample**
FRS national banks up to $150 million	2,514	350	2
$150-$250 million	348	174	4
$250 MM-$1 billion	388	194	5
$1 billion and up	202	150	4
FRS state banks up to $150 million	749	270	1
$150-$250 million	76	76	2
$250 million-$1 billion	84	84	0
$1 billion and up	63	63	1
FDIC state banks up to $150 million	5,900	375	4
$150-$250 million	428	214	2
$250 million-$1 billion	350	175	4
$1 billion and up	108	108	2
Totals	**11,210**	**2,233**	**31**

Adjusted sample[c]	Questionnaires received: Returned undeliverable by Post Office[d]	Returned unusable questionnaire[e]	Returned usable questionnaire	Response rate[f]
348	12	2	265	0.76%
170	6	0	122	0.72
189	10	0	98	0.52
146	4	2	75	0.51
269	8	1	207	0.77
74	4	0	47	0.64
84	3	0	55	0.65
62	5	0	33	0.53
371	9	2	284	0.77
212	7	0	143	0.67
171	13	1	120	0.70
106	10	1	59	0.56
2,202	**91**	**9**	**1,508.00**	**0.68**

[a]All banks identified in the June 1993 Call Report, except mutual savings banks, international bank associations, and New York investment companies.

[b]Sampled elements outside the survey population due to no existing address, merger, receivership, or other cessation of operations as a depository institution.

[c]Number in original sample minus number ineligible.

[d]Sampled elements in the survey population, but questionnaire returned undeliverable due to insufficient address, or unknown address and forwarding order expiration.

[e]Blank, incomplete, or refused questionnaire returned, or returned after cut-off date.

[f]Response rate calculated as the number of banks completing usable questionnaires divided by the number of eligible banks in the adjusted sample.

Survey Error and Data Quality

In addition to the presence of sampling errors, as discussed above, the practical difficulties of conducting any survey may introduce other types of errors, commonly referred to as nonsampling errors. For example, differences in how a particular question is interpreted, in the sources of information that are available to respondents, or in the types of people who do not respond can introduce unwanted variability into the survey results.

We included steps in both the data collection and data analysis stages for the purpose of minimizing such nonsampling errors. We selected our sample from the most complete and up-to-date listing of banks available, and we attempted to increase the response rate by conducting a follow-up mailing accompanied by cover letters stressing the importance of the survey. To minimize errors in measurement, we pretested the questionnaire thoroughly and obtained reviews from industry experts and agency officials.

To ensure data processing integrity, all data were double-keyed and verified during data entry. Computer analyses were performed to identify inconsistencies or other indication of errors, and all computer analyses were checked by a second independent analyst. Finally, we performed limited validation of a number of returned questionnaires through contacts with respondents or review of other agency records.

Survey of Banks and Thrifts on Mutual Fund and Securities Activities

United States General Accounting Office

Survey of Banks and Thrifts on Mutual Fund and Securities Activities

INSTRUCTIONS

This questionnaire asks whether any retail mutual fund or other securities sales or services are taking place at this bank or thrift, and requests basic information about any such activities. It can be completed by the president or CEO, or by another officer familiar with the financial products and services made available by this bank or thrift.

Please answer all questions in terms of retail mutual fund and securities sales activities carried out on the premises of this bank or thrift, or in any of its offices, branches, or subsidiaries.

If you have any questions, please call Ms. Dorothy LaValle at (212) 264-6468, or Mr. Jeffrey Shapiro at (212) 264-9314. Please return the completed questionnaire in the enclosed envelope within 5 working days of receipt, to avoid costly followup efforts. In the event the envelope is misplaced, the return address is:

U.S. General Accounting Office
Mr. Frank J. Philippi
441 G Street, NW, Room 3126
Washington, D.C. 20548

Thank you for your help.

BACKGROUND

1. Please provide the following information so that we can contact you if we need to clarify an answer.

Name of Primary Respondent: ____________________

Title: ____________________

Institution: ____________________

Address: ____________________

____

Phone: (   ) ____________________

PRODUCTS AND SERVICES OFFERED

2. Does this bank or thrift currently make available for sale any of the following products or services to its retail customers? *(Check "Yes" or "No" for each row.)*

	Yes	No
Mutual funds? (stock or bond funds, money market mutual funds, etc.)		
Any other retail securities brokerage services or products? (for example: stocks, bonds, financial planning or investment advice, etc.)		

IMPORTANT INSTRUCTIONS:

If you answered "NO" in both rows of Question 2, check below, and STOP:

☐ NO MUTUAL FUND OR SECURITIES ACTIVITIES

Thank you for your time and care in filling out this questionnaire; please return it in the envelope provided, or mail it to the address found on this page.

If you answered "YES" in any row in Question 2, CONTINUE:

This survey contains one section on mutual fund sales and a second section on other securities brokerage activities. Some banks or thrifts will complete only one of these sections; others will complete both.

Please turn the page and follow the directions to complete the section(s) applicable to your bank or thrift.

The following questions refer to securities brokerage services and products, other than mutual funds. If your bank or thrift makes any such services or products available to its retail customers, please CONTINUE with question 31. If your bank or thrift DOES NOT make such services or products available, please check the box below and skip to the last page:

☐ NO SECURITIES BROKERAGE ACTIVITIES ----------> *(Skip to page 15.)*

SECURITIES BROKERAGE SERVICES

31. Which of the following best describes this bank or thrift's retail securities brokerage operations: *(Check only one box.)*

    1. ☐ Investment advice and/or buy and sell recommendations in conjunction with executing customer buy and sell orders (full service brokerage).

    2. ☐ Acting solely as an agent in executing customer buy and sell orders (discount brokerage).

    3. ☐ Placing buy and sell orders as a service only when requested by a customer or to facilitate other transactions (accommodation brokerage).

    Please explain if necessary:

    ____

    ____

    ____

32. How are securities brokerage services made available for sale at this bank or thrift? *(Check one box in each row.)*

	Yes	No
Directly by employees of this institution		
By dual employees of this institution/affiliate/subsidiary and a registered broker-dealer		
Through affiliate or subsidiary broker dealer		
Through a networking or leasing arrangement with a registered broker-dealer (or third party)		
Other arrangement: *(please describe)*		

COMMENTS

33. If you have any comments on this questionnaire, or on the issues raised in it, please use the space provided below, and attach additional sheets if necessary.

Thank you for your time and care in filling out this questionnaire.
Please return it in the envelope provided, or mail it to the address on the front within 5 working days.

GGD/CR/3-94/233408

Major Contributors to This Report

General Government Division, Washington, D.C.

Michael A. Burnett, Project Director
David P. Tarosky, Project Manager
Charles Michael Johnson, Deputy Project Manager
Desiree W. Whipple, Reports Analyst
Carl Ramirez, Social Science Analyst

Chicago Regional Office

Roger E. Kolar, Senior Evaluator
Daniel K. Lee, Evaluator

New York Regional Office

Susan Chan, Evaluator
Phillip F. Merryman, Evaluator

San Francisco Regional Office

Susan J. Kramer, Senior Evaluator
Donald Y. Yamada, Senior Evaluator

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (301) 258-4097 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

United States
General Accounting Office
Washington, D.C. 20548-0001

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use $300

Address Correction Requested