The Convergence of Financial Products

and the

Implications for Regulatory Convergence

by

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Appendix—Types of Convergence Products
INTRODUCTION

Peter Wallison asked me to prepare this paper addressing the convergence of products in the financial marketplace as a basis for assessing the need for changes in the regulation of financial services in the United States.

This seemed a relatively easy assignment at first. The entire history of our financial services system in the past two decades has been characterized by convergence on a national scale. If there is any single word that describes the recent evolution of our financial service system, it is “convergence.”

But I found that my assignment was not so simple. Implicit in the assignment is the question of whether the convergence of financial products signifies a need for regulatory change and, if so, what kind of change. I found this to be a difficult question, for the following reasons:

First, the legal definitions applicable to various financial products often are nonexistent, overbroad, or not uniformly applied across industry lines.

Second, it is not always possible to separate a financial “product” from the services that go along with it, and the services often are the same across product lines.

Third, it is not always easy to distinguish a financial product from the type of institution that offers the product.

Fourth, some very large de-convergence transactions have occurred in the marketplace recently, suggesting that product convergence is a more complicated trend than we thought.
For these reasons, as my paper will show, the regulatory implications of product convergence are complex. In order to properly consider how product convergence should affect our regulatory structure—or vice versa—I believe we need to examine the elements of a financial product and financial product regulation in their most basic sense. Only then can we begin to contemplate meaningfully the implications of product convergence for regulatory restructuring.

My paper first reviews the convergence revolution that has occurred in the U.S. financial markets and the impact of the Gramm-Leach-Bliley Act on product convergence. It then attempts to identify the key elements of a financial “product” and the functional elements of regulation of the product. Finally, it discusses the regulatory implications of product convergence, including the concept of a single regulator and a single financial services charter.

My paper is not intended to provide a comprehensive analysis of the topic, but to suggest paths of inquiry that might be useful to explore as we contemplate changes in our financial regulatory structure.

**THE CONVERGENCE REVOLUTION**

The financial services industry in the United States has undergone a revolutionary convergence during the past two decades. Driven by economic and competitive forces, banks, securities firms and insurance companies have converged into a financial services industry capable of meeting every financial need of American consumers, business, and government with greater efficiency than ever before. The industry has converged on a national scale, creating a truly national marketplace for financial products in the United States, and making our financial institutions more competitive globally.
The most dramatic changes have occurred in banking. Less than two decades ago, banks were governed by legal distinctions that dictated what, where and how they could serve their customers. From a time when banks could not branch across state lines, and in some states could not even branch across city or county lines, banks and their affiliates now maintain banking offices nationwide. From a time when banks could not sell securities or mutual funds or underwrite securities, banks and their affiliates now rank among the top providers of these products and services. From a time when banks could not sell annuities and insurance to their customers, these products now are readily available at banks.

While banking organizations have galloped into the securities and insurance markets, securities firms and insurance companies have bounded into the banking business, offering deposit-like products and chartering limited-purpose banks to add a banking dimension to their services. In the process, the traditional distinctions between banking, securities and insurance have blurred, sometimes beyond recognition.

Banks, securities firms and insurance companies each serve financial needs that are different but at the same time complementary. Each is in the business of collecting money and redistributing it within the economy. They serve the same customers. A homeowner, for example, needs a checking account, credit cards, a mortgage, automobile and homeowners insurance, financial advice, and a place to invest retirement savings. A business concern needs a business checking account, business credit cards, commercial financing and credit facilities, plant and equipment insurance, liability insurance, employee health and disability insurance, payroll and other back office assistance, and, if it is sufficiently large, a means of issuing commercial paper and debt or equity securities. The ability of a single financial institution to offer all of these products
offers enormous operating efficiencies, customer convenience and opportunities to enhance shareholder value.

The convergence revolution has resulted in the emergence of numerous cross-industry products in response to demands by customers for greater diversity of product features, cost flexibility, and efficiency in the delivery of products. Convergence has been driven by the quest for synergies, economies of scale and competitive position in an intensely competitive marketplace.

The existing legal definitions applicable to various financial products in many cases have inhibited or thwarted the introduction of new products in the marketplace. On the other hand, because the legal definitions of financial products sometimes are vague and subject to interpretation, they have proven to be adaptable. We have seen wide variations in the design of financial products as banks, securities firms and insurance companies have introduced new hybrid products and sought to imbue their traditional products with broader features in order to retain existing customers and serve a more diverse financial clientele.

The core financial products are very flexible, and market players have shown ingenuity in creating innovative uses for them. We have seen deposit products linked to securities, securities linked to checking accounts, loans transformed into securities through securitizations, and insurance products that are treated as securities.

The variable annuity is a prime example of a cross-industry product. Traversing all three industry lines, it has been held to be insurance for purposes of state insurance laws, a security for purposes of the federal securities laws, and a deposit for purposes of the banking laws.
Among the other types of hybrid products that have been offered by banks are deposits with interest rates indexed to the stock market and so-called “sweep” accounts that sweep money out of a depositor’s checking account into a money market mutual fund on an overnight basis. In the early 1990’s, banks began offering an FDIC-insured annuity-like deposit account. Banks also offer debt cancellation contracts that are similar to insurance.

Securities firms offer mutual fund investment accounts with check writing capability and programs that invest in certificates of deposit at different banks. They also are big sellers of annuities. Insurance companies sell universal life insurance policies and guaranteed investment contracts with deposit-like features, in addition to fixed annuities which are the functional equivalent of certificates of deposits.

Attached to this paper is a description of some of the convergence products that developed in the financial marketplace as part of the convergence revolution, including deposit products with securities and insurance features, securities products with deposit and insurance features, and insurance products with deposit and securities features.

**PRODUCT CONVERGENCE AND THE GRAMM-LEACH-BLILEY ACT**

The process of convergence occurred in the United States over a twenty year period beset with controversial regulatory rulings, heated legal battles among industry sectors, and a long line of court decisions. Congress mainly stood by and watched until 1999 when it attempted to make sense of what had occurred in the marketplace and the courts by enacting the Gramm-Leach-Bliley Act (“GLBA”).

The Act created a framework for continued convergence within the financial services industry by allowing affiliations among banks, securities firms, and insurance companies through supercharged bank holding companies called
financial holding companies. But the Act did not reform the regulatory regime in a way that was conducive to further product convergence. Rather, the Act did just the opposite by declaring that financial holding companies would be regulated according to principles of “functional regulation.”

On the surface, functional regulation sounds like a logical and appealing concept to the extent that it suggests that like functions will be regulated alike. However, the version of functional regulation embraced by Congress was not truly function based. Rather, it was a strict product-based concept under which banking regulators would regulate entities offering banking products, securities regulators would regulate entities offering securities products, and insurance regulators would regulate entities offering insurance products. Rather than reform the regulatory system to reflect the convergence of financial products across traditional sector lines, the GLBA version of functional regulation perpetuated the regulatory framework based on outdated product definitions and left in place the cumbersome bureaucracy of multiple regulators supervising financial institutions at the state and federal levels.

Accordingly, the regulation of U.S. financial service firms under the GLBA framework remains burdensome and complex, notwithstanding efforts of regulators to streamline and simplify the regulatory process. Although GLBA eliminated some unnecessary and burdensome regulatory restrictions, it added new layers of regulation with which the industry is now contending. Armies of regulators at the federal and state levels continue to oversee the different financial sectors and, despite attempts at interagency cooperation and coordination, the industry remains beset with overlapping rules and supervisory requirements.

Recently, we have seen some very large de-convergence transactions in the marketplace, including the following:
• Citigroup’s divestiture of its Travelers’ property and casualty and life insurance underwriting business,
• Merrill Lynch’s disposal of its asset management unit,
• Citigroup’s divesting of its mutual fund business,
• Charles Schwab’s sale of US Trust,
• American Express’s spin-off of its financial advisory business; and
• Credit Suisse’s sale of its insurance business.

These transactions raise interesting questions about convergence. How is this counter-trend to be explained? Do these transactions suggest that the synergies and efficiencies thought to result from product convergence are not as substantial as hoped? Or is the GLBA brand of product-based functional regulation interfering unduly with the quest for synergies and efficiencies? A discussion of the reasons for these de-convergence transactions is beyond the scope of this paper, but these transactions need to be examined in connection with proposals to restructure the regulatory framework toward greater convergence.

**WHAT IS A FINANCIAL PRODUCT?**

When considering the regulatory implications of convergence among financial products, it is important to understand what a financial product is. Although most of us think we know what one is, I found that it is not so easy to define the essential elements of a financial product. As the list of convergence products in the appendix shows, financial products come in many varieties beyond the traditional notion of deposits, securities, and insurance. If we can identify the key functional components of the products, we may find a basis for regulating the products in a more uniform and effective way that does not impede their evolution in the marketplace.

Identifying the common functional elements of financial products is difficult because the legal framework defining the products is outmoded. No
legal definition of the term “financial product” exists in the law. The Gramm-Leach-Bliley Act, when speaking of activities of financial holding companies, refers to activities that are “financial in nature.” GLBA includes a list of activities that are deemed by statute to be “financial in nature,” including banking, securities, and insurance activities, but does not define the meaning of “financial product.”

Some of our most basic financial products have no clear legal definition that can be applied across industry lines. We may think we know what a “deposit” is, for example. But no universally applicable definition of “deposit” exists in the law. The term is defined in different ways for different regulatory purposes. An instrument may be a deposit for one purpose and something else for another. Usually, the distinction depends on the type of institution offering the product.

For example, in the Federal Deposit Insurance Act, the term “deposit” means money received or held by a bank which the bank is obligated to repay. The definition assumes the existence of a bank. Money received or held by a securities firm or insurance company would not be a deposit under this definition, because securities firms and insurance companies are not banks.

On the other hand, the definition of a “security” in the securities laws is very broad and can encompass deposits and insurance products in certain circumstances. For example, as noted in the appendix, courts have held that brokered deposits are “securities” when offered by a securities firm. Absent statutory exclusions for bank deposits and insurance policies, these products would fall within the meaning of a “security.”

The definition of “insurance” is not uniform in the law and, as noted in the appendix, courts have held that certain deposit products may be insurance, such as
a deposit with variable annuity features. On the other hand, courts have held that certain insurance products are securities.

Courts also have ruled that securities are banking products in certain cases, and that insurance products are securities. Moreover, in some instances a loan may be found to be a deposit, and vice versa.

In the most elemental sense, a financial product—whether it be a deposit, security, or insurance— involves an agreement under which a person (the buyer) gives money to another person (the seller) with the understanding that the buyer will get back some known or unknown amount of money in some form at an agreed upon date or circumstance in accordance with the agreement. A financial “product” typically involves an array of services, without which the product cannot exist. These services are very similar across different product lines and include sales activities, providing product information and advice, making recommendations, filling out forms, handling of customer funds, transferring funds, investing funds, safekeeping and custody of assets, monitoring, recordkeeping, issuing confirmations and monthly statements, and customer communications. That is why financial products typically are referred to as financial “products and services.” It is rare for a financial product to be offered without these services. Financial products generally cannot exist in the abstract without them. In some cases, the services are the product.

In each case, the financial institution is serving as a conduit for the transfer of money from the hands of individuals into the larger economy. Hence, we call our financial institutions “financial intermediaries.” Because the intermediation role is so important for the health and stability of our economy, financial intermediaries are highly regulated, not only in their use and handling of money they receive from customers, but in their conduct in the marketplace. The terms and conditions of the agreement for a financial product, the circumstances under
which the agreement arises, the services that are rendered in connection with the agreement, and what the seller can do with the buyer’s money in its possession all are matters of regulation.

Whether we need dozens of state and federal regulatory agencies to do the regulating, however, is questionable. When each regulator can impose its own conception of what a given financial product should look like and how it can be offered and to whom, the result is a regulatory quagmire that impedes the flow of financial products in the marketplace.

As a result of the GLBA brand of functional regulation, the characteristics of different types of financial products are determined largely by the regulations that govern the institution offering the product, and hence the regulator of the institution. A financial “product” in many cases is indistinguishable from the type of institution that offers it. For example, under our banking laws, only a “bank” may receive deposits. Under the insurance laws, only an insurance company may underwrite insurance. Moreover, securities underwriting is performed only by securities broker-dealers because banks and insurance companies generally are not permitted to engage in such activities.

Consider the following: Can a deposit exist separate and apart from a bank? Can a mutual fund security exist without the fund, or without the fund’s investment adviser? Can an insurance policy exist without an insurance company? Can securities exist without securities broker-dealers? The answer generally is “no.”

Financial products effectively are held captive by the regulatory framework applicable to the institution that offers the product. Although banks, securities firms, and insurance companies have been ingenious in inventing new
products that push the limits of the regulatory framework, the regulatory limits operate as a significant bar to new product development.

**IS PRODUCT CONVERGENCE BENEFICIAL OR DETRIMENTAL?**

In considering the implications of product convergence for regulatory reform, it is useful to consider whether product convergence is beneficial or detrimental to our financial system.

To the extent that product distinctions reflect artificial legal definitions based on the type of institution offering the product, they are inherently inefficient. A reduction in product distinctions could mean that fewer regulatory requirements and restrictions are needed, thereby reducing regulatory complexity and burden. Moreover, fewer product distinctions could smooth the functioning of the marketplace by necessitating fewer product choices by consumers.

On the other hand, the lack of clear distinctions could add confusion in the marketplace among competitors as well as consumers by making it difficult to compare products with similar features or to identify different types of products or product markets. How would a consumer know whether he was getting a deposit, security, or insurance, for example?

Product distinctions in the law are fundamental to the structure of our financial services industry. Consider the following: If banks were not distinct from mutual funds by virtue of an exemption from the definition of “investment company” in the Investment Company Act of 1940, they would be required to register as investment companies and would become subject to regulation as such. They no longer would be able to function as banks as we know them. Insurance companies likewise would be deemed to be investment companies absent an exemption under the Investment Company Act, and no longer could operate as insurance companies. Similarly, were it not for a regulatory interpretation of the
meaning of “deposit” to exclude shares of mutual funds, securities broker-dealers and investment companies might be deemed to be “banks” subject to banking regulation and could no longer engage in many of their securities activities. Were it not for certain exemptions for banks in the Securities Exchange Act of 1934, banks would be deemed to be broker-dealers subject to regulation as such, and could no longer engage in many traditional banking activities.

Without some legal and regulatory distinctions among financial institutions and their products, it is difficult to imagine how the financial services industry would be structured or could function. Regulatory distinctions help to ensure that institutions offering similar types of products will be subject to similar rules and standards of market conduct, thereby fostering a degree of market integrity that benefits legitimate competitors. Uniformity of regulation among competitors offering the same types of products helps to ensure a level playing field, and protects consumers who can rely on uniform product standards.

Without regulatory distinctions, the marketplace potentially would be chaotic and undisciplined. The integrity of the marketplace could be impaired, and consumers might shy away. Indeed, if there were no distinctions defining banking, securities, and insurance products, the industry most likely would invent them.

It can be argued that much of the product convergence that occurred prior to the Gramm-Leach-Bliley Act would not have occurred or been necessary had financial institutions had flexibility to offer each other’s core financial products. Indeed, now that banks, securities firms, and insurance companies can affiliate with each other, we may see less product convergence.

This is not to say that we need to have multiple regulatory agencies at the state and federal levels tripping over each other in regulating more or less the
same thing. As suggested below, it may be possible to have regulatory convergence while retaining meaningful distinctions between products.

**IMPLICATIONS FOR REGULATORY CONVERGENCE**

The convergence in product offerings by banks, securities firms, and insurance companies suggests a need for regulatory convergence to reflect the integration of banking, securities, and insurance products in the marketplace. What form regulatory convergence should take is the question that policymakers need to consider in the very near future if our financial system is to be efficient and competitive in the face of increasing global competition.

**The Elements of Regulation**

In considering how regulatory convergence might occur in response to product convergence, it is useful to identify the key components of financial services regulation. Then we can determine which ones are specifically related to the product rather than the institution offering the product. By assessing whether it is possible to regulate the product—or part of the product—separately from the institution, we may then be able to determine whether we need to limit the types of institutions that can offer the product.

**Product Regulation**

One component of financial services regulation focuses on the product itself—a deposit or loan, a security or investment product, an insurance policy. The regulatory focus is on the basic product features—interest rates, maturity, redemption features, payout events, payout periods, and contractual rights and obligations of the parties. With certain exceptions, our regulatory system tends not to regulate the price of various financial products but allows the marketplace to do that.
**Safety and Soundness Regulation**

A second functional component looks at the safety and soundness of the entity that issues or offers the product—a bank, securities firm or insurance company. The focus here is on the issuer’s financial condition, capital adequacy, and ability to satisfy its obligations under the product contract and applicable laws. The regulatory tools used are examinations and inspections, audits, and reporting requirements.

**Regulation of Competition**

A third component looks at competition in the product market, with regulation focused on the competitive structure of the market as a whole and the conduct of market competitors relative to each other. The regulatory goal is to prevent unfair competition, restraint of trade, and undue concentration of resources or monopoly. Anti-tying prohibitions fall in this category.

**Market Regulation**

A fourth component concentrates on the market mechanism—payments systems, securities exchanges, and reinsurance facilities, with regulatory concerns addressing market liquidity, efficiency and transparency.

**Consumer Protection Regulation**

A fifth component focuses on the process of making the product available to customers. The regulatory goal here is to protect users of the product. The regulatory focus is on the qualifications, conduct and supervision of those who deliver the product, adequacy of disclosures, accuracy of advertising, minimization of conflicts of interest, and other consumer protections, such as privacy of customer information.
**Public Policy Regulation**

Congress sometimes regulates financial institutions to achieve specific public policy objectives. For example, Congress has imposed on banks community development obligations under the Community Reinvestment Act. Banks also are subject to requirements designed to promote equal credit opportunity and to prevent redlining and discrimination in the granting of credit. Congress also has imposed on all types of financial institutions obligations to help prevent money laundering and terrorist financing.

**Enforcement Regulation**

Finally, when financial institutions fail to comply with applicable rules or engage in unsafe and unsound practices, regulators have an array of enforcement tools, including subpoena power, cease and desist orders, supervisory agreements, and authority to impose penalties.

Most of these functional components of regulation generally can be applied regardless of the financial product or institution involved. For example, a regulator that develops capital standards for banks generally should have the expertise or could be trained to develop capital standards for securities firms and insurance companies. Similarly, examiners who examine the financial condition of a bank generally should be able to do so for securities firms and insurance companies. Enforcement attorneys likewise have the basic litigation skills to take enforcement action with respect to banks, securities firms, or insurance companies.

The GLBA concept of functional regulation, however, lumps these components together along strict product lines. Rather than assigning regulatory responsibility according to specific regulatory functions, it gives the product
regulator for each institution responsibility for all of the regulatory functions with respect to that institution. Because each product regulator performs the regulatory functions differently, significant imbalances exist in how institutions are regulated, which affects how they can function in the marketplace.

While product-based functional regulation may make sense with respect to certain aspects of the financial service business, it has been made increasingly problematic by the convergence of financial products in the marketplace where banks, securities firms, and insurance companies now offer many of the same products. The product-based concept of functional regulation ignores market realities and is not workable in a modern financial system where financial service organizations offer all product lines.

In particular, the product-based concept of functional regulation creates an artificial construct for the regulation of highly integrated organizations that seek to deliver a variety of financial products and services on a seamless basis. In such an organization, the product delivery lines frequently are operationally intermingled and not readily conducive to product-based functional regulation. An attempt to functionally regulate the activities of such an organization along product lines results in operational inefficiency and awkward delivery of the product. While some banking organizations have structured their operations along distinct product lines in order to accommodate product-based functional regulation, many of these organizations still seek to integrate the delivery of their banking, securities and insurance products as a matter of customer service and convenience.

**The Single Regulator Concept**

It is questionable whether we need multiple regulators performing essentially the same regulatory functions at different financial institutions. It is
not inconceivable that a single regulator could perform these functionally similar aspects of regulation across different product lines more efficiently and effectively than the existing product-based functional regulators. Indeed, there appears to be growing interest among serious thinkers in considering whether our financial services industry might benefit from a single financial services regulator, perhaps along the lines of the Financial Services Authority in the United Kingdom.¹ The single regulator concept has much to commend it, especially when one considers the uniformities in basic regulatory functions and principles that regulators apply to different financial products and institutions.

Some financial institutions have expressed concern, however, that a single monolithic regulator might not offer the same flexibility as the current multi-regulator system under which the regulators have an interest in promoting their constituent financial institutions—so-called “competition in laxity.”

Suppose, for example, that Congress decided that the single regulator should be the Securities and Exchange Commission? The SEC historically has been hostile to banking organizations engaged in securities activities and has little experience with prudential regulatory principles employed by banking regulators. Not many banks would welcome the SEC as their primary regulator.

Or, suppose that Congress decided the single regulator should be the Federal Reserve Board? The Fed historically has been viewed as an overly cautious and intrusive regulator by bank holding companies, and would not necessarily be welcomed as a single regulator by banks, securities firms, or insurance companies.

Any single regulator would need to have a clear mission and regulatory mindset compatible with the long-term competitive viability of the financial services industry as a whole. In a global marketplace, where American financial institutions are vying with competitors from London, Hong Kong, and other strong and emerging markets, concerns about the competitiveness of U.S. financial markets should be a spur to regulatory flexibility and support for product innovation.

A Single Financial Services Charter

The concept of a single federal financial services charter for financial institutions also is being considered by serious thinkers as a means of addressing global competitive concerns. This proposal is somewhat more challenging to contemplate, in my view, due to the unique role of banks in our financial services industry and the economy as a whole. Banks are subject to certain regulatory policies that do not apply to securities firms or insurance companies. It is unclear how a single federal financial services charter would accommodate these policies. Some fundamental issues would need to be addressed, including the following:

The Federal Safety Net

Would we need to maintain banks as separate entities in order to avoid over-extending what Alan Greenspan called the “sovereign credit” of the federal government through the federal “safety net” for banks? The safety net generally is thought to consist of federal deposit insurance, cradle-to-grave prudential supervision, and access to Federal Reserve liquidity facilities for banks. The scope of the safety net is limited now by restrictions that prevent insured banks from engaging directly in underwriting and dealing in equity securities,

\footnote{Id.}
underwriting insurance, and other activities deemed too risky for insured institutions.

How would the federal safety net apply to an institution with a single charter enabling it to take insured deposits and engage in other activities not now permissible for banks to engage in? How practical would it be to provide FDIC insurance coverage for deposits taken by an institution with a single charter? Would we need to impose a comprehensive system of prudential regulation on the entire institution with a single charter?

The restrictions on transactions between banks and their affiliates in sections 23A and 23B of the Federal Reserve Act are an important part of our system of prudential regulation. How would these restrictions apply to an institution with a single charter that encompasses what previously were affiliates?

**Different Capital Standards for Banks**

How would the different capital standards applicable to banks and broker-dealers be reconciled? For example, under capital rules applicable to broker-dealers, a 100 percent haircut is applied to illiquid assets such as loans, which is why it is impractical for banks to register as broker-dealers.

**Community Reinvestment Act**

Unlike securities firms and insurance companies, banks are subject to community development obligations under the Community Reinvestment Act. How would the CRA apply to an institution with a single charter allowing it to engage in banking, securities, and insurance activities? Would securities and insurance activities become subject to CRA obligations?
Anti-Tying Rules

Special anti-tying prohibitions apply to banks. How would these prohibitions apply to an institution with a single charter that permits it to engage in banking, securities, and insurance activities?

Antitrust

Mergers and acquisitions among banking organizations are given special consideration under the banking laws. Would this same treatment be available to a financial institution with a single financial services charter?

Implications for State Regulation

State regulation is perhaps the most difficult issue that policymakers will confront in deciding whether to adopt a single regulator or a single charter for the financial services industry of the future. The states have long played a significant role in the regulation of banks, securities firms, and particularly insurance companies where they are the almost exclusive regulators.

While state regulation clearly inhibits the functioning of the national marketplace, state regulation historically has played an important role in fostering product innovation and consumer protection. Whether the states have outlived their usefulness in this regard is debatable.

More significantly, state regulation reflects principles of federalism unique to the U.S. governmental system and is supported by strong political interests at the state level and in Congress.

These issues are beyond the scope of this paper, but are indicative of the degree of difficulty facing policymakers who will be addressing the need for financial services reform in the months and years ahead.
CONCLUSION

The convergence of financial products signifies an integration of banking, securities, and insurance to a degree that is no longer compatible with the existing regulatory framework based on traditional product distinctions. On the other hand, recent de-convergence transactions, while difficult to interpret, suggest that the existing distinctions still have some relevance in the marketplace.

It seems theoretically possible to regulate financial institutions more efficiently and effectively on an integrated basis and still retain meaningful product distinctions by using a more function-based system of regulation than the product-based version of functional regulation embraced by the Gramm-Leach-Bliley Act. Such regulation could occur through a single regulator, possibly in conjunction with a single financial institution charter. Any serious consideration of such major restructuring, however, will necessitate that policymakers grapple with a host of difficult issues, including the role of the federal safety net applicable to banks and the system of state regulation.
# Appendix—Types of Convergence Products

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A variety of cross-industry products has emerged in the marketplace for financial services in the United States during the past twenty years, reflecting a growing convergence of the banking, securities and insurance sectors in response to customer demands and competitive dynamics. These products often raise difficult legal issues under U.S. banking, securities, and insurance laws, as described below, and sometimes are a subject of conflict among the various financial regulatory agencies.

**DEPOSITS AS SECURITIES**

A deposit possesses many characteristics of a security. Absent an express exemption from the securities laws, a deposit would be subject to regulation as a security. A certificate of deposit is specifically included in the definition of a “security” under the federal securities laws, for example, but generally is exempt when issued by a bank.3 Traditional bank deposits are exempt from the provisions of the Securities Act of 19334 and may or may not be exempt for purposes of the Securities Exchange Act of 1934 (“1934 Act”), depending on the context of the transaction in which they are offered.5

The question of whether an instrument is a deposit or a security has taken on new importance since the Gramm-Leach-Bliley Act was enacted. By eliminating the exemption for banks from broker-dealer registration, the Act makes it critically important for a bank to know whether it is offering a security or a deposit. If it is offering a security for sale, it must register as a broker-dealer, unless an exemption is available.

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3 15 U.S.C. § 77b (“The term ‘security’ means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement . . . certificate of deposit . . . .”)
4 12 U.S.C. § 77c (“The provisions of this subchapter shall not apply to . . . [a]ny security issued or guaranteed by . . . any bank . . . .”).
Most instruments in the financial marketplace are either deposits or securities. The distinction between a deposit and a security is not always clear, however, and it is possible for an instrument to be a deposit for one purpose and a security for another. As noted below, the Gramm-Leach-Bliley Act established a special procedure for determining when a hybrid product may be treated as a security. Whether an instrument is a “deposit” or a “security” frequently depends on whether the entity offering the instrument is a bank or a nonbank firm.

**CERTIFICATES OF DEPOSIT**

A certificate of deposit issued by an FDIC-insured bank and pledged by the borrower to guarantee a loan from the bank was found by the Supreme Court not to be a security for purposes of the 1934 Act in *Marine Bank v. Weaver*. The Court determined that it was unnecessary to protect purchasers of bank CDs under the antifraud provisions of the 1934 Act in this context since the CD was federally insured and the purchasers were “abundantly protected under the federal banking laws.”

The Fourth Circuit Court of Appeals in *Tafflin v. Levitt* ruled that a CD issued by a state-chartered savings and loan association was not a security for purposes of the 1934 Act in view of comprehensive state regulation and insurance of savings and loan associations. On the other hand, in *Holloway v. Peat, Marwick, Mitchell & Co.*, the Tenth Circuit Court of Appeals found that non-

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6 See, e.g., OCC Interpretive Letter No. 272 (Aug. 4, 1983) (national bank’s sale to retail customers of participations in bankers’ acceptances found to be a deposit for purposes of Regulations D and Q and a security for purposes of the Securities Act of 1933, but not for purposes of the Glass-Steagall Act).
7 455 U.S. 551 (1982).
8 Id. at 559. Although the case involved a $50,000 CD, lower courts have held that the rationale of the court’s decision applies equally to CDs in excess of the insurance limit of $100,000. See *Brockton Savings Bank v. Peat Marwick*, 577 F. Supp. 1281 (D. Mass. 1983).
9 865 F.2d 595 (4th Cir. 1989), aff’d on an unrelated issue, 110 S. Ct. 792 (1990).
10 900 F.2d 1485 (10th Cir. 1990), affirming its earlier decision at 879 F.2d 772 (10th Cir. 1989), in light of *Reves v. Ernst & Young*, 110 S. Ct. 930 (1990).
federally insured “thrift certificates” and “passbook savings accounts” issued by a trust company subsidiary of a bank holding company subject to regulation by Oklahoma banking authorities were securities for purposes of the applicable securities laws. State regulation was not viewed by the court as a relevant factor, contrary to the court’s decision in *Tafflin*.

Uninsured CDs issued by a North Dakota state chartered trust company and sold by mail similarly were found to be securities in *SEC v. First American Bank & Trust Co.*11 Uninsured savings passbooks issued by the Latin Investment Corporation, which was not chartered as a bank but held itself out as such, were treated as securities in *Gomez v. Leonzo*12.

CDs issued by a foreign bank were held not to be securities in *Wolf v. Banco National de Mexico, S.A.*,13 based on the court’s finding that the bank was subject to foreign regulation comparable to that of a United States bank, even though the CDs were uninsured.

So-called “international certificates of deposit” issued by a corporation that was not subject to federal or state banking regulation or federal deposit insurance protection were found to be securities in *Sanderson v. Roethenmund*.14

The securities laws were found to be applicable to protect investors from churning by a brokerage firm when CDs purchased by the investors were sold

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11 481 F.2d 673 (8th Cir. 1973).
before maturity in order to generate revenue from interest rate changes in Olson v. E.F. Hutton.15

Even though a CD may not be a security for purposes of federal securities law, it may be a security under state securities laws.16

SEC no-action letters have treated as securities publicly offered participations in a pool of jumbo CDs (i.e., CDs in excess of $100,000).17 The pool itself was deemed to be an investment company subject to the Investment Company Act of 1940.18 On the other hand, the SEC did not view CDs as securities when the issuing institution recognized the holders of the CD participations as beneficial owners of the CDs and the participations were FDIC insured.19

CDs marketed by a securities broker pursuant to a “CD Program” were found to be securities for purposes of the antifraud provisions of the securities laws in Gary Plastics Packaging Corp. v. Merrill Lynch.20 Merrill Lynch offered the CDs in a program under which it maintained a secondary market for the CDs and monitored the issuing banks’ solvency. The court found that Merrill Lynch was engaged in activity that was “significantly greater than that of an ordinary broker or sales agent” and that investors in the CDs were purchasing:

something more than an individual certificate of deposit.

They [were] buying an opportunity to participate in the

15 957 F.2d 622 (8th Cir. 1992).
18 Id.
[Merrill Lynch] Program and its secondary market. And, they [were] paying for the security of knowing that they might liquidate at a moment’s notice free from concern as to loss of income or capital, while awaiting for FDIC or FSLIC insurance proceeds.21

Unlike the situation in Marine Bank v. Weaver, “[t]hese investors were not ‘abundantly protected’ under the federal banking laws.”22

Bank CDs generally are not regarded as securities for purposes of the Glass-Steagall Act.23 Accordingly, banks may underwrite and deal in CDs and engage in repurchase transactions involving CDs.24 Regulation Y specifically authorizes such activity by bank holding companies.25

The OCC has authorized a national bank to sell to depositors participation interests in FDIC-insured certificates of deposit issued by other banks which the bank proposed to purchase using pooled deposits.26 As described by the OCC, the participation certificates would not be insured by the FDIC, although the underlying CDs were FDIC-insured. The OCC noted that no court had yet addressed whether participation certificates in deposits are covered by the antifraud provisions of the securities laws and advised the bank to seek the SEC’s views on this point. The OCC suggested, on the basis of Marine Bank v.

21 756 F.2d at 240.
22 Id. at 241.
25 12 C.F.R. § 225.28(b)(8)(i).
Weaver,27 that the participations should not be viewed as securities since the issuer was a federally insured bank.

DEPOSIT NOTES

In 1985, banks commenced issuing so-called “bank notes” or “deposit notes” to sophisticated investors.28 Such notes were general unsecured obligations of the bank that typically were not FDIC insured and were not subordinated to deposits. The proceeds of the notes were used by banks in the conduct of their banking business, including making loans and investments.

The OCC determined that such notes were not “securities” and that the issuance of such notes was a permissible activity for national banks.29 The OCC noted that 12 C.F.R. § 7.7530 authorized national banks to issue negotiable or non-negotiable notes of any maturity and cited Part 16 of its regulations regarding the issuance of securities by national banks which, until 1995, provided that the term security “shall not include any bank indebtedness incurred in the ordinary course of business.”30

The popularity of bank notes quickly faded after the FDIC issued a proposed rule to define such notes as deposits subject to FDIC premium assessments.31 Under the proposal, a “deposit” was defined to include:

Any liability of the insured bank on any promissory note, bond, acknowledgment of advance, or similar obligation that is issued or undertaken by

28 See Winkler, “Credit Gap Between Banks, Parent Firms Help Create Big Market in Deposit Notes,” Wall St. J., Mar. 1, 1988, at 42, cols. 4-6 (Reporting that “[t]he market in these so-called deposit notes, which didn’t exist before 1985, has mushroomed to almost $20 billion in less than two years and by year end could reach $30 billion, or 30% of all banking company bonds and notes expected to be issued this year….”).
30 12 C.F.R. § 16.2(d). This language was changed in 1994. See discussion below.
the insured bank on any promissory note, bond, acknowledgement of advance, or similar obligation that is issued or undertaken by the insured bank as a means of obtaining funds.

Certain exemptions were provided for, inter alia, repurchase agreements, bankers acceptances, and asset-backed obligations such as collateralized mortgage obligations (“CMOs”), and mortgage-backed bonds.

Chairman Dingell of the House Energy and Commerce Committee objected to the FDIC’s proposal on the basis that it would “deprive purchasers of bank debt of the protections afforded by the antifraud provisions of the federal securities laws” since, under the reasoning of *Marine Bank v. Weaver*, bank notes, as deposits, would not have the status of securities. Chairman Dingell also expressed concern that persons who created an aftermarket in bank notes could avoid broker-dealer registration.

The FDIC never adopted a final regulation concerning bank notes but issued several legal interpretations stating that deposit notes come within the meaning of “deposit.” Even though the deposit notes would be insured by the FDIC to the extent provided by law, however, the FDIC indicated that the way the notes in question were structured and sold made it difficult to identify which persons had an ownership interest in the notes.

In 1993, the OCC permitted a national bank to offer to accredited investors, through underwriters and directly, notes consisting of general unsecured bank obligations with maturities of between nine months and 15 years.

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32 455 U.S. 551 (1982).
33 Letter dated March 2, 1989, from John D. Dingell, Chairman, House Committee on Energy and Commerce, to William L. Seidman, Chairman, FDIC, and David S. Ruder, Chairman, SEC.
34 See, e.g., FDIC Legal Advisory Opinions 90-19 and 90-20 (April 25, 1990) by Roger A. Hood, Assistant General Counsel, FDIC.
in minimum denominations of $250,000.35 In 2001, the OCC permitted a broker-dealer subsidiary of a national bank to offer FDIC-insured deposit notes representing transferable individual time deposits of the bank held in book entry form in denominations of $5,000 or $10,000 for terms ranging to 20 years with fixed or floating rates of interest.36

Bank notes may be treated as securities for purposes of Part 16 of the OCC’s regulations governing securities offerings by national banks. In its revisions to Part 16 in 1994, the OCC determined to conform the definition of “security” in the regulation to the definition in the Securities Act of 1933.37 The OCC observed that the definition formerly was unclear as to what debt instruments were covered under the regulation and stated that there is no reason why senior debt should be treated differently from subordinated debt for purposes of the definition of “security.” The OCC stated that purchasers of both types of debt should receive the disclosures required under the regulation, especially in light of the depositor preference provisions of the Omnibus Reconciliation Act of 1993,38 which require the FDIC to pay the claims of uninsured depositors before claims of any other general creditors of a bank.

Part 16 generally requires national bank securities offerings to conform to the form of registration that nonbank issuers use when registering securities under the Securities Act of 1933. Unlike the SEC rules, however, Part 16 includes an abbreviated registration system for offers and sales of large denominations of nonconvertible debt to accredited investors.39 The OCC stated that an abbreviated

registration is appropriate for national bank debt because the market for such debt is now well-developed and has not presented particular disclosure concerns and generally is limited to sophisticated purchasers.\footnote{Id.}

The OCC has determined that some bank notes or deposit notes are not “securities” and are not subject to the registration requirements of Part 16.\footnote{See OCC Interpretive Letter No. 432 (Dec. 28, 1997); OCC Interpretive Letter No. 655 (March 28, 1995).} In the interpretive letter issued in 2001 referred to above, the OCC concluded that FDIC-insured notes sold by a broker-dealer were not securities for Part 16 purposes. The OCC reasoned as follows:

Application of both the \textit{Howey} and \textit{Reves} tests confirms that the Deposit Notes are not investment contracts or notes, and thus not securities for purposes of Part 16. Deposit Notes are not investment contracts, but deposit liabilities subject to the same regulatory scheme that applied to the CDs in \textit{Marine Bank}. The Bank will include its liabilities for Deposit Notes in its report of deposits to the local Federal Reserve Bank and maintain reserves pursuant to Regulation D of the Federal Reserve Board. Depositors are assured of the rate of their principal and interest, subject to applicable FDIC insurance limits. The Bank must meet the requirements of the Truth in Savings Act and Regulation DD in marketing the Deposit Notes. Since the Bank and its Deposit Note program are subject to an extensive regulatory scheme, it is unnecessary to impose additional federal securities law requirements or corresponding Part 16.
[The broker-dealer’s] participation in the sale of the Deposit Notes does not change this analysis. [The broker-dealer’s] activities do not resemble those of the broker-dealer in *Gary Plastics*, which actively designed and administered a deposit-gathering program. [The broker-dealer] is limiting its role to a sales agent for retail customers, accepting customer funds for deposit with the Bank. [The broker-dealer] is not creating certificates or monitoring the creditworthiness of bank issuers. [The broker-dealer] does not contribute expertise by maintaining a pool of CD issuers. The Bank is the only issuer of deposits in this program.

In *Gary Plastics*, the defendant’s creation and maintenance of a secondary market was crucial in its marketing efforts and permitted holders to profit from interest rate movements. [The broker-dealer], in contrast, is making no assurances to depositors concerning the existence of a secondary market. Although the Deposit Notes are transferable, the Bank will disclose that [the broker-dealer] has sole discretion to maintain a secondary market in the Deposit Notes. Depositors will not receive any liquidity assurances with respect to the Deposit Notes. Because there is no assurance that Deposit Notes will be more liquid than CDs or other deposits generally, the Bank does not offer purchasers an enhanced possibility of price appreciation due to interest rate movements.

The compensation structure in this case is unlike that in *Gary Plastics*. [The broker-dealer] will receive compensation from the Bank on a transaction basis for the services it provides. [The broker-dealer] will not charge depositors any fees for Deposit Note purchases. Purchasers will receive the same rate of interest regardless of whether they purchase Deposit Notes directly from the Bank or [the broker-dealer].
Given the limited role of [the broker-dealer] in the program, additional protections afforded by the federal securities laws are unnecessary to protect Deposit Note purchasers from fraud or other possible abuse. There is no need to treat Deposit Notes as investment contracts and thus, securities.42

**BANK INVESTMENT CONTRACTS**

A bank investment contract or “BIC” is a non-transferable liability issued by a bank generally to a pension fund sponsor of a defined contribution plan.43 A BIC is similar to a certificate of deposit in that the bank agrees to repay the depositor the amount deposited plus a specified rate of interest after an agreed period of time.

Unlike CDs, BICs offer a “window” during which pension plan investors may deposit monies at a fixed rate of interest for the life of the BIC, which may vary from several months to as long as ten years. Also unlike CDs, BICs allow withdrawals to be made prior to maturity without penalty in the event of retirement, disability, hardship, plant closings, or other circumstances.

BICs were developed by banks to compete with guaranteed investment contracts (“GICs”) issued by insurance companies in the 1970’s. The FDIC estimated that in 1988 about one-third of all funds in defined contribution plans were invested in BICs and GICs.44 Unlike GICs, BICs may be structured so that each participant is eligible for up to $100,000 in “pass-through” FDIC deposit insurance coverage.

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43 Under a defined contribution plan, employees select directly from several investment options, including BICs.
Whether or not a BIC qualifies as a deposit for FDIC deposit insurance or involves a “security” depends on whether the individual characteristics of the BIC satisfy the definition of “deposit” in the FDIC Act. In general, a BIC will be deemed a deposit if it is an obligation incurred by a bank in the ordinary course of business, treated as a deposit by the contracting parties, has a specified maturity date, interest is to be credited periodically and at maturity, and (with certain limitations) all or part of the BIC funds may be withdrawn prior to maturity.45

**THRIFT NOTES**

Thrift notes are small denomination, short-term obligations of bank holding companies and their nonbank subsidiaries that typically were issued in the 1970s and 1980s in order to raise funds and avoid Regulation Q interest rate ceilings. Such note offerings generally were registered with the SEC as securities under the Securities Act of 1933 or were exempt under section 3(a)(11) of the Act relating to intra-state offerings. The Federal Reserve Board prohibited such notes from being sold on the premises of affiliated banks and required that the notes indicate that they were not obligations of a bank and were not insured by the FDIC.46

Such notes were treated by the Board as securities for purposes of the Glass-Steagall Act. A bank holding company was found by the Board to be “engaged principally” in the issuance and public sale of securities for purposes of section 20 of the Glass-Steagall Act on the basis that “the continued issuance and

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45 See FDIC Interpretive Letter 90-47 (Sept. 21, 1990). FIRREA required the FDIC to submit to Congress a report concerning pass-through insurance coverage for BICs, including an assessment of the effects of insuring BICs on the safety of the federal deposit insurance funds and the operation of the capital markets. FIRREA § 229(b)(2). In its report, the FDIC did not recommend any changes in the pass-through deposit insurance provided to BICs. The FDIC Improvement Act of 1991, however, eliminated certain BICs with “benefit responsive withdrawals” from deposit insurance coverage. Pub. L. No. 102-242, § 311, codified at 12 U.S.C. § 1821(a)(8).

sale of such securities would be necessary to permit maintenance of the holding
company’s activities without substantial contraction and would be an integral part
of its operations.” In reaching this conclusion, the Board distinguished the sale
of thrift notes from the sale of commercial paper which it said was “a recognized
form of financing for bank holding companies” and not sold to the retail public.

The offering by a bank holding company of demand thrift notes involving
the acceptance of non-FDIC-insured funds in small amounts ($5,000) from
consumers with access on demand also was found by the Board to raise monetary
policy issues and required prior approval under the BHC Act.

In another case, the Board permitted a bank holding company to organize
a subsidiary to assist in the sale of the parent’s debt securities. Although the
subsidiary’s activities were limited to administrative and clerical services, the
Board stated that even if the subsidiary were engaged principally in securities
activities, section 20 of the Glass-Steagall Act would not be violated since the
subsidiary would be treated as a single entity with the parent holding company
which was not engaged principally in securities activities.

**Identified Banking Products**

The Gramm-Leach-Bliley Act created various exemptions from the
broker-dealer registration requirements applicable to banks under the 1934 Act,
including an exemption for banks that engage in the sale of identified banking
products. An “identified banking product” is defined to mean:

- a deposit account, savings account, certificate of deposit, or
- other deposit instrument issued by a bank;

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47 12 C.F.R. § 250.221, F.R.R.S. 4-867.
49 Board Letter dated December 27, 1977, F.R.R.S. 4-293.
a banker’s acceptance;

a letter of credit issued or loan made by a bank;

a debit account at a bank arising from a credit card or similar arrangement;

a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold to qualified investors or to other persons that have the opportunity to review and assess any material information, including information regarding the borrower’s creditworthiness and, based on such factors as financial sophistication, net worth, and knowledge and experience in financial matters, have the capability to evaluate the information available, as determined under generally applicable banking standards or guidelines; or

any swap agreement,50 including credit and equity swaps, except that an equity swap that is sold directly to any person other than a qualified investor shall not be treated as an identified banking product.51

HYBRID PRODUCTS

The Gramm-Leach-Bliley Act recognized that the development of new financial products could result in disagreements over whether such products are deposits and which are securities. In order to ensure that such products are not arbitrarily treated as securities by the SEC, the Act requires the SEC to conduct a rulemaking proceeding before determining that any “new hybrid product” is a

50 A “swap agreement” is defined to mean “any individually negotiated contract, agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets, but does not include any other identified banking product.” Pub. L. No. 106-102 § 206.

security. A “new hybrid product” is defined to mean a product that was not subjected to regulation by the SEC as a security prior to GLBA, is not an identified banking product as defined by GLBA, and is not an equity swap.

The SEC may not impose broker-dealer registration requirements on banks with respect to hybrid products unless it does so by rule or regulation after considering the views of the Federal Reserve Board with respect to “the nature of the new hybrid product; the history, purpose, extent, and appropriateness of the regulation of the new product under the Federal banking laws; and the impact of the proposed rule on the banking industry.” Before adopting such a rule, the SEC must determine that the new hybrid product is a security and that the rule is necessary and appropriate in the public interest and for the protection of investors.

The Federal Reserve Board may obtain expedited review of any such SEC rule in the U.S. Court of Appeals for the District of Columbia. The court must decide—without giving deference to the views of either the SEC or the Board—whether the product in question qualifies as a “new hybrid product,” whether the product is a security, and whether subjecting banks that offer the product to broker-dealer registration is appropriate in light of the history, purpose, and extent of regulation under the federal securities and banking laws. Private litigants may seek judicial review of an SEC rule on new hybrid products through the normal review process under the 1934 Act. In such a case, it is unclear what degree of deference a court would give to the views of the SEC or the Federal Reserve Board. The court presumably would give deference to the SEC with respect to its interpretation of the securities laws while deferring to the Board with respect to the Board’s interpretation of the banking laws.

DEPOSIT SWEEP ACCOUNTS

Banks and bank holding companies frequently offer “sweep” services in connection with their securities brokerage services. These services allow customers to transfer money from non-interest-bearing checking accounts into an interest-bearing capacity. In a sweep arrangement, customer deposits exceeding a predetermined amount are swept into money market mutual funds or other investments.55 The OCC has stated that the “use of a ‘sweep’ service [is] not . . . inconsistent with the Glass-Steagall Act where securities are purchased solely upon the order, and for the account, of customers, within the meaning of 12 U.S.C. § 224(Seventh).”56

In 1984, the Federal Reserve Board’s staff held a hearing concerning the legality under the Glass-Steagall Act of sweep arrangements offered by banks. The hearing was held in response to objections by the Securities Industry Institute that sweep services violated the Glass-Steagall Act. Based on the hearing, the Board’s staff issued a letter stating that, while certain sweep arrangements could violate the Glass-Steagall Act, the hearing showed that there were many varieties of sweep arrangements and the staff was not prepared to issue any generalized advice concerning such arrangements.57

The OCC authorized a national bank to make available to corporate depositors of the bank as well as unaffiliated banks a sweep service under which corporate deposits would be swept daily into accounts by an unaffiliated broker-

56 OCC Interpretive Letter No. 332, supra.
57 See Letter dated Nov. 6, 1984, from the Board’s general counsel to John M. Lifton, attorney for the Securities Industry Association.
dealer. The broker-dealer would use the funds to purchase shares of mutual funds selected by the corporate customers or to pay creditors of the corporate depositors. The bank offering this service would receive from the broker-dealer a percentage of the fees paid to the broker-dealer by its customers and a finder’s fee with respect to customers of other banks to which the bank offers the service.

The OCC permitted a national bank to purchase shares of bank-eligible mutual funds for resale to bank customers in order to facilitate such sweep arrangements offered to depositors. The OCC also permitted banks to use their own proprietary mutual funds in sweep arrangements, subject to sections 23B and 23B of the Federal Reserve Act. The OCC permitted such purchases to facilitate the sale of securities to nondeposit customers who are customers of the bank solely for securities transactions using the bank’s proprietary funds in a non-sales arrangement.

The FDIC has indicated that customer funds held by a bank as agent for a customer pending investment in a mutual fund pursuant to a sweep arrangement may be FDIC insured, but are not insured once invested in the mutual fund. The FDIC said that a sweep arrangement does not violate the prohibition on the payment of interest on demand deposits when demand deposits are swept into a money market fund since the funds are not received or held by the bank when interest is paid.

58 OCC Interpretive Letter Nos. 591 (June 18, 1992) and 593 (July 1, 1992).
63 FDIC Interpretive Letter No. 00-2 (April 4, 2000).
A bank is not required to register as a broker-dealer solely by virtue of offering sweep accounts provided the bank effects transactions “as part of a program for the investment or reinvestment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act of 1940 that holds itself out as a money market fund” 64 and complies with SEC regulations interpreting this provision.

**Mutual Fund Cash Management Accounts**

In the late 1970’s, Merrill Lynch introduced a highly competitive product called the “cash management account” which linked money market mutual funds and checking accounts. The product enabled customers to access their money market mutual funds by writing a check on a bank account, thereby increasing the popularity of mutual funds. The new product was designed to exploit an increase in short term interest rates above the deposit ceilings applicable to bank deposits, and was duplicated by other fund companies.

Banks were limited to paying no more than 5 percent interest on deposit accounts. Using the cash management account, customers could earn market rates above what their banks could pay them. The new product was so phenomenally successful that it caused an outflow of bank deposits—disintermediation—to a degree that Congress in 1980 was forced to authorize the repeal of interest rate ceilings on all but corporate checking accounts to stem the outflow.

Even though the cash management account functions like a checking account, Merrill Lynch was able to persuade regulators that it was not engaged in deposit taking because shares of a money market mutual fund constitute an equity

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64 15 U.S.C. 78c(a)(4)(B)(v), as added by the Gramm-Leach-Bliley Act, Title II.
interest rather than giving rise to a debtor-creditor relationship as in a deposit.65 Shares of a money market mutual fund similarly are not treated as deposits for other bank regulatory purposes because they are not issued by a depository institution.

HYBRID INSTRUMENTS

The Legal Certainty for Bank Products Act of 2000 (“Bank Products Act”)66 clarified the status of certain “identified banking products” and “hybrid instruments” under the Commodity Exchange Act (“CEA”).

The Bank Products Act provides that the CEA shall not apply to, and the CFTC shall not exercise regulatory authority with respect to, an identified banking product if:

- a banking agency certifies that the product has been “commonly offered, entered into, or provided” in the United States by any bank on or before December 5, 2000, under applicable banking law, or
- the product was not prohibited by the CEA and not regulated by the CFTC as a contract of sale of a commodity for future delivery (or an option on such a contract) or an option on a commodity, on or before December 5, 2000.67

The Bank Products Act provides that the CEA shall apply to, but the CFTC shall not exercise regulatory authority with respect to, an identified banking product if:

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65 See Letter dated Dec. 18, 1979, from the Assistant Attorney General, Criminal Division, U.S. Department of Justice, to Martin Lybecker, Associate Director, Division of Marketing Management, Securities and Exchange Commission, re Merrill Lynch cash management account.
banking product which had not been commonly offered, entered into, or provided in the United States by any bank on or before December 5, 2000, under applicable banking law if the product “has no payment indexed to the value, level, or rate of, and does not provide for the delivery of, any commodity, or the product or commodity is otherwise excluded from the CEA.68

An “identified banking product” is defined to mean the following:

a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank;

a banker’s acceptance;

a letter of credit issued or loan made by a bank;

a debit account at a bank arising from a credit card or similar arrangement;

a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold to eligible contract participants or to other persons that have the opportunity to review and assess any material information, including information regarding the borrower’s creditworthiness and, based on such factors as financial sophistication, net worth, and knowledge and experience in financial matters, have the capability to evaluate the information available, as determined under generally applicable banking standards or guidelines.69

The CEA similarly does not apply to, and the CFTC may not exercise regulatory authority with respect to, a hybrid instrument that is predominantly a banking product. A “hybrid instrument” is defined to mean an identified banking product having one or more payments indexed to the value, level or rate of, or providing for the delivery of, more or more commodities, except for the exempted products that were commonly offered by banks on or before December 5, 2000.

A hybrid instrument is considered to be “predominantly a banking product” if:

The issuer of the hybrid instrument receives payment in full of the purchase price of the hybrid instrument substantially contemporaneously with delivery of the hybrid instrument;

The purchaser or holder of the hybrid instrument is not required to make under the terms of the instrument, or any arrangement referred to in the instrument, any payment of the issuer in addition to the purchase price, whether as margin, settlement payment, or otherwise during the life of the hybrid instrument or at maturity;

The issuer of the hybrid instrument is not subject by the terms of the instrument to mark-to-market margining requirements;\(^70\) and

\(^70\) The mark-to-market margining requirement does not include the obligation of an issuer of a secured debt instrument to increase the amount of collateral held in pledge for the benefit of the purchaser of the secured debt instrument to secure the repayment obligations of the issuer under the instrument.
The hybrid instrument is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to the CEA.\footnote{7 U.S.C. § 27c.}

The CFTC may not regulate any other hybrid instrument unless it determines that such action is necessary and appropriate in the public interest and consults beforehand with the Federal Reserve Board concerning the nature of the hybrid instrument and the history, purpose, extent, and appropriateness of the proposed regulation under the CEA and the banking laws.\footnote{7 U.S.C. § 27d.} In the event that the Federal Reserve Board disagrees with the CFTC, the Board may obtain expedited judicial review of the dispute.

**Swap Agreements**

The Bank Products Act also clarified that no provision of the CEA shall apply to, and the CFTC shall not regulate, any covered swap agreement offered, entered into, or provided by a bank.\footnote{7 U.S.C. § 27e.} A “covered swap agreement” is defined to mean a swap agreement,\footnote{A swap agreement means “any individually negotiated contract, agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets, but does not include any other identified banking product.” Pub. L. No. 106-102 § 206.} including a credit or equity swap, based on a commodity other than an agricultural commodity if the swap agreement:

- Is entered into only between persons that are eligible contract participants\footnote{An “eligible contract participant” generally refers to an institutional investor. See 7 U.S.C. § 1a(12).} and is not entered into or executed on a trading facility; or
Is entered into or executed on an electronic trading facility, on a principal-to-principal basis between parties trading for their own accounts, and only between persons that are eligible contract participants, and is an agreement, contract or transaction in an excluded commodity.\(^{76}\)

**ANNUITIES**

In some cases, an instrument intended to be a deposit may be found to be a form of insurance. Insurance companies and state insurance commissioners have been particularly sensitive to the development of bank deposit products with annuity features and have brought legal challenges arguing that such products are “insurance” subject to licensing and other regulation under state insurance laws.

A fixed rate annuity is a financial investment that the Comptroller of the Currency has stated “functionally resembles” a certificate of deposit that pays interest and automatically withdraws principal at a rate calculated to reduce the balance to zero at the end of the annuity term.\(^{77}\)

In permitting national banks to broker annuities, the Comptroller noted that fixed annuities may be registered securities under the securities laws but stated that this fact was not dispositive of whether they are securities for purposes of the Glass-Steagall Act which, the OCC said, did not preclude national banks

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\(^{76}\) The term “excluded commodity” means - (i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure; (ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is - (I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or (II) based solely on one or more commodities that have no cash market; (iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or (iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is - (I) beyond the control of the parties to the relevant contract, agreement, or transaction; and (II) associated with a financial, commercial, or economic consequence. 7 U.S.C. § 1a(13).

\(^{77}\) OCC Interpretive Letter No. 499 (Feb. 12, 1990) (“An annuity with a life term resembles a life interest in a certificate of deposit.”).
from selling annuities in any case.\footnote{OCC Interpretive Letter No. 499, \textit{supra}. Indeed, some fixed rate annuities are exempt from the registration requirements of the Securities Act of 1933. \textit{See} 15 U.S.C. § 77c(a)(8), which has been interpreted to exempt only fixed, and not variable, rate annuities. \textit{See} \textit{SEC v. Variable Life Ins. Co.}, 359 U.S. 65 (1959). \textit{See also} 17 C.F.R. § 230.151(a) (SEC “safe harbor” provision distinguishing exempt from non-exempt annuities).} The Comptroller also determined that annuities are not an insurance product for purposes of the National Bank Act.\footnote{\textit{Id.}}

\section*{Annuity Deposits}

In view of the growing popularity of annuities as investment vehicles, banks have sought ways of structuring deposits with annuity-like features. For example, in 1987, banks persuaded Arkansas legislators to enact legislation authorizing state banks to offer “deferred income investment accounts” under which the depositor would either: (1) deposit a lump sum and receive an agreed monthly or annual payment for life or for a term certain beginning immediately or at a future date, or (2) make deposits periodically on an agreed basis and receive an agreed monthly or annual payment on a periodic basis beginning at some time in the future for a term certain.\footnote{Ark. Stat. § 23-32-1015.} These accounts were intended to be treated as annuities for federal income taxation purposes.

In response to a request for an FDIC interpretation as to the insurability of the account, the FDIC staff replied that, “[w]hile the deferred income account does have some features that are typical of certificates of deposits issued by banks, in many respects the accounts resemble annuities and are in fact required under the regulations to be eligible for treatment as annuities for federal tax law purposes.”\footnote{Letter dated March 18, 1988, from Pamela E. F. LeCren, Senior Attorney, FDIC, to Robert Alexander.} While noting that both annuities and deposits create a debtor/creditor relationship, the FDIC staff stated that “funds in the deferred income account are not deposited for safekeeping and are not subject to the order
and direction of the account holder. . . .” Accordingly, the staff stated that it had “serious doubts” that the funds in the account would qualify as insurable deposits held by a bank “in the usual course of the banking business.” The staff declined to give a definitive opinion, however, in view of the possible variations in structuring such an account and the absence of a particular deferred income account program to review.

**REirement CD**

In 1994, the FDIC and OCC permitted a national bank to market a similar FDIC-insured product called the “Retirement CD.” The Retirement CD functioned as follows. A customer opened an account with a minimum of $5,000 and subsequent deposits of not less than $1,000. The customer chose a date when the CD would mature and selected a payout option of up to two-thirds of the account balance to be paid in a lump sum at maturity. The amount that was not received in a lump sum was used as the basis for calculating equal monthly payments which would be made for the rest of the life of the customer or his survivor.

The FDIC concluded that the Retirement CD was an insured “deposit” covered by federal deposit insurance up to $100,000, although the FDIC said that insurance coverage would not extend to the bank’s commitment to make lifetime payments. The OCC and FDIC actions specifically did not address the tax status of the Retirement CD.

The Retirement CD caused an uproar in the insurance industry which viewed it as an impermissible form of insurance being sold by national banks.

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82 OCC Interpretive Letter No. 649 (May 12, 1994); Letter dated May 12, 1994, to American Deposit Corp. by Douglas H. Jones, Acting General Counsel, FDIC.
Congressman Dingell objected to the new product and urged the OCC and FDIC to withdraw their no-objection letters. Neither agency changed its position.

In 1995, the Internal Revenue Service, at the instigation of the insurance industry, commenced a rulemaking that would have effectively eliminated any tax-deferred treatment of interest accumulated on the Retirement CD. The bank offering the product unsuccessfully sought a preliminary injunction to set aside the IRS’ proposal.

The Illinois Insurance Commissioner took the position that the Retirement CD constituted “insurance” for purposes of state law and issued a cease and desist order against bank for offering the product without being licensed as an insurance broker. In the ensuing litigation, the district court sided with the insurance commissioner in ruling that the Retirement CD was “insurance” subject to state insurance regulation, effectively foreclosing national banks from offering the product. The guaranteed lifetime monthly payment, combined with the assumption of mortality risk, was the key feature that distinguished the product as insurance in the court’s mind. The U.S. Court of Appeals for the 7th Circuit affirmed.

In a Florida case challenging the Retirement CD, the court came up with another, more novel, reason to prevent national banks from offering the product.

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83 Letter dated May 25, 1994, from Congressman John D. Dingell to the Comptroller of the Currency and Acting Chairman of the FDIC.
88 American Deposit Corp. v. Schacht, 84 F.3d 834 (7th Cir. 1996), cert. denied, 117 S. Ct. 185 (1996).
Because the Retirement CD involved underwriting risk similar to that involved in underwriting securities, and because the Glass-Steagall Act prohibits national banks from underwriting securities, the court said that underwriting of the Retirement CD was not permissible as part of the business of banking due to the similarity of the risk involved.  

Congress put the nail in the coffin of the Retirement CD in 1996 by enacting legislation to deny federal deposit insurance eligibility for any liability of an insured depository institution that arises under an annuity contract the income of which is tax deferred—i.e., the Retirement CD.

In clarifying the scope of national bank insurance powers, the Gramm-Leach-Bliley Act specifically defined as “insurance” any “annuity contract the income on which is subject to tax treatment under section 72 of the Internal Revenue Code of 1986.”

**GLBA INSURANCE DEFINITION**

In defining the term “insurance” for purposes of clarifying the insurance powers of national banks, the Gramm-Leach-Bliley Act specifically excluded “deposit products.” As defined for this purpose, insurance does not include the following:

A deposit product;

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89 Blackfeet National Bank v. Nelson, 171 F.3d 1237, 1243-44 (11th Cir. 1999) (“Both the business of insurance and investment in securities involve the same dangers with respect to a bank’s involvement in them….both involve the fundamental feature of guarantying payment of proceeds….Both involve placing their customer’s assets at risk, at least to a certain extent. That being the case, it seems unreasonable to interpret the Bank Act impliedly to permit underwriting in one instance (Retirement CD) while expressly prohibiting it in another (securities).”). The court’s reasoning was strained—banks underwrite risk all the time in the form of credit risk on loans. The business of banking is the business of taking risks.


A loan, discount, letter of credit, or other extension of credit;

A trust or other fiduciary service; or

A financial guaranty (other than a product that includes an insurance component such as life insurance).92

The meaning of “deposit product” is left vague in this definition.

LOANS

The definition of “security” under the securities laws includes, “unless the context otherwise requires,” any “evidence of indebtedness.”93 Given the context in which they are made, loans made by banks and other financial institutions generally are not deemed to be securities.

Nevertheless, under certain circumstances, an interest in a loan may be deemed to be a “security” subject to regulation under the securities laws. For example, a certificate of participation in a pool of loans is a “security” for purposes of the securities laws.94 An interest in a loan participation also has been held by the courts to be a “security” in some cases.95

The National Bank Act authorizes national banks to conduct the business of banking by “discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt.”96 This authority has been held to include

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94 See § 5.07 infra.
95 See § 5.08[A] infra.
the power to acquire and hold a variety of debt and debt-like instruments, including certain instruments denominated as “securities.” 97

For example, the OCC has determined that preferred stock and trust preferred securities are debt obligations that may qualify either as investment securities permissible for national bank investment or as evidences of debt that may be discounted and negotiated by a national bank. 98 The OCC noted that an “investment security” by definition is a “marketable debt obligation that is not predominately speculative in nature.” 99 In determining whether a security has sufficient indicia of debt to qualify as a “debt obligation,” the OCC considers whether the returns on the investment are fixed or based on the success of the enterprise, the voting rights of the stockholder, the obligation to pay dividends, the right of stockholders in the event of the failure of the issuer, whether the security has a limited life, and whether the security is rated. 100 The OCC stated that these factors distinguish equity securities (e.g., common stock) from debt securities 101 and noted that banks that hold preferred stock as debt obligations are subject to lending limits. 102

A loan also may be deemed to be a “deposit” in certain instances. Indeed, a deposit represents a loan from the depositor to the bank and generally is deemed to give rise to a debtor-creditor relationship with the bank being the debtor.

97 See OCC Interpretive Letter No. 941 (June 11, 2002) (preferred stock); OCC Interpretive Letter No. 833 (July 8, 1998); OCC Interpretive Letter No. 834 (July 8, 1998); OCC Interpretive Letter No. 600 (July 31, 1992); OCC Interpretive Letter No. 908 (April 23, 2001) (trust preferred securities, which are debt-like instruments).
98 OCC Interpretive Letter No. 777 (April 8, 1997). See also OCC Interpretive Letter No. 911 (June 4, 2001).
99 12 C.F.R. § 1.2(e).
100 OCC Interpretive Letter No. 777 (April 8, 1997); OCC Interpretive Letter No. 941 (June 11, 2002).
101 The OCC noted that debt securities offer investors periodic interest payments, often in the form of fixed dividend payments, and a principal payment at maturity.
The term “deposit” is defined for reserve requirement purposes to include credit balances maintained with a bank and any liability of a depository institution on any promissory note, acknowledgment of advance, bankers’ acceptance, or similar obligation issued or undertaken by a depository institution as a means of obtaining funds, with certain exceptions. A sale of loans by a bank in an asset securitization also is treated as a deposit liability subject to maintenance of reserves if the bank retains some risk of loss from the transferred assets.

A deposit subject to check generally is distinguished from a “loan” in that the check is “a contract in writing by which the drawer contracts with the payee that the bank will pay to the payee therein the amount designated on presentation.”

**COLLECTIVE INVESTMENT FUNDS**

Until the late 1980s, it was uncommon for banks to invest fiduciary assets in mutual funds, particularly funds they managed, due to restrictions imposed under the Glass-Steagall Act. In lieu of mutual funds, banks operated commingled funds called “common trust funds” and “collective investment funds.”

Common trust funds and collective investment funds have been offered by banks to their trust customers since at least 1927. In 1936, Congress provided

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103 See 12 C.F.R. § 204.2(a)(1).
106 Investment Company Institute v. Camp, 401 U.S. 617, 624 (1971). Common trust funds were expressly authorized by the Federal Reserve Board in 1937 under Regulation F which then regulated national bank trust activities. See 1 Fed. Reg. 417, 420 (1936). The Board had responsibility for regulating national bank trust activities until 1962 when such responsibility was transferred to the OCC. See also Uniform Common Trust Fund Act, adopted by a majority of the states.
these funds with tax exempt treatment under the Internal Revenue Code\textsuperscript{107} and exempted such funds from regulation under the Investment Company Act of 1940.\textsuperscript{108} These funds are less common in recent years as most banks have converted such funds into mutual funds.

Collective investment funds are investment companies offered to trust customers. They would be subject to registration under the Investment Company Act of 1940 but for an exemption.\textsuperscript{109} Indeed, certain types of collective investment funds are registered under the Investment Company Act, such as funds for individual retirement accounts (IRAs), \textit{discussed infra}. Units of collective investment funds are securities, but similarly are exempt from registration under the Securities Act of 1933.\textsuperscript{110}

The SEC has narrowly construed the collective investment fund exemptions. Under the SEC’s interpretation, the exemptions apply only when the underlying trust relationship is created for “bona fide fiduciary purposes” rather than as a vehicle for general investment by the public.\textsuperscript{111} The SEC staff has stated that the exemption is available only when the fund is operated for the administrative convenience of the bank in a manner incidental to a bank’s traditional trust department activities and not primarily for investment in the

\begin{footnotesize}
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\item \textsuperscript{107} 26 U.S.C. § 584.
\item \textsuperscript{108} 15 U.S.C. § 80a-3(c)(3) and 3(c)(11). Common trust funds also are exempt from registration under the Securities Act of 1933. 15 U.S.C. § 77c(a)(2).
\item \textsuperscript{109} Investment Company Act § 3(c)(3) and 3(c)(11); 15 U.S.C. § 80a-3(c)(3) and 3(c)(11).
\item \textsuperscript{110} Securities Act of 1933 § 3(a)(2); 15 U.S.C. § 77c(a)(2).
\end{itemize}
\end{footnotesize}
fund. The SEC has taken enforcement action against a bank that ran afoul of these strictures.

In response to the OCC’s proposal to permit advertising of common trust funds in 1990, the Chairman of the SEC sent a letter to the OCC stating that, should the proposal be adopted, the SEC would issue an interpretive release describing the circumstances under which bank common trust funds would be subject to registration under the 1933 and 1940 Acts. In response, the OCC issued a banking circular cautioning banks that they must register common trust funds under the 1933 and 1940 Acts when the underlying trust accounts are established solely or primarily for the purpose of investment in the common trust fund or lack a “bona fide fiduciary purpose.”

Congress in 1999 essentially codified the SEC’s position in the Gramm-Leach-Bliley Act by limiting the exemption for common trust funds (i.e., section (a)(1) collective investment funds) to only those funds:

That are employed solely as an aid to the administration of trusts, estates or other fiduciary accounts;

That are not advertised or offered to the public (except in connection with ordinary advertising of the bank’s fiduciary services); and

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Whose fees and expenses are in accordance with applicable federal or state fiduciary law.\textsuperscript{116}

Accordingly, (a)(1) collective investment funds will be required to register like other investment companies under the 1940 Act if their availability is advertised to the general public. Registration under the 1940 Act should not cause collective investment funds to become prohibited under the Glass-Steagall Act. As noted below, the offering by banks of registered investment companies in the form of IRA funds has been found to be permissible under the Glass-Steagall Act.

In any event, as a result of the Gramm-Leach-Bliley Act, affiliates of banks now have broader latitude to organize and sponsor mutual funds and many banks have converted their collective investment funds into proprietary mutual funds.

**IRA Funds**

Funds for the investment of individual retirement accounts ("IRAs") are an example of bank-sponsored collective investment funds that are registered investment companies under the Investment Company Act of 1940.\textsuperscript{117} Because IRAs involve small amounts (the yearly investment limit is $2,000), they are well-suited for collective investment. Under the Internal Revenue Code, IRA assets may not be commingled with any other property except in a collective investment fund or trust fund.\textsuperscript{118}

\begin{footnotes}
\item[117] IRAs are tax-deferred retirement investment vehicles for individuals. See 26 U.S.C. § 408(a) and 408(o).
\item[118] 26 U.S.C. § 408(a)(5).
\end{footnotes}
In the early 1980s, banks began to compete for IRA monies by offering, in addition to IRA certificates of deposit, common trust funds devoted exclusively to the collective investment of IRA assets. The SEC determined that these funds were not exempt from the 1940 Act because, among other things, they were offered for investment purposes rather than solely for “bona fide fiduciary purposes.” Accordingly, IRA funds were required to register as investment companies. The SEC also determined that interests in an IRA fund were not exempt from registration as “securities” under the Securities Act of 1933.

In 1982, the OCC determined that the offering of IRA common trust funds by national banks was a permissible activity under the Glass-Steagall Act notwithstanding their regulation as investment companies under the 1940 Act. The OCC’s rulings were upheld by three U.S. courts of appeal.

Today, most banks have converted their IRA and other collective investment funds into mutual funds.

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120 The registration of IRA funds under the Investment Company Act created a potential problem in view of the Act’s requirement that the board of directors of an investment company not be composed of a majority of directors who are officers or directors of the fund’s manager or affiliates thereof. 15 U.S.C. § 80a-10(c). Under the OCC’s rules, a bank common trust fund was required to be managed exclusively by the trustee bank. The OCC did not strictly enforce this provision but allowed the IRA funds to be managed by a supervisory committee comprised of a majority of outside directors that retained the right to approve arrangements with the fund trustee and to terminate such arrangements. The OCC found that the bank retained exclusive management over the fund by virtue of its role as investment adviser, administrator, custodian, and transfer agent for the fund.

121 The OCC concluded that shares of IRA common trust funds were not “securities” for purposes of the Glass-Steagall Act, regardless of their status under the securities laws. Rather, the OCC found that such funds “merely represent the formal manifestation of a traditional banking service.” Moreover, the offering of IRA funds by national banks was found by the OCC not to involve any of the “subtle hazards” which condemned the bank managing agent fund in ICI v. Camp, in view of the applicability of standards of fiduciary conduct under state trust law. The fact that IRA funds were offered by banks in their capacity as trustee was sufficient, in the OCC’s view, to remove such funds from the prohibition of ICI v. Camp. See Decision of the Comptroller of the Currency on the Application by Citibank, N.A. (Oct. 31, 1982), reprinted in Fed. Banking L. Rep. (CCH) ¶ 99,939.

CONVERSIONS TO MUTUAL FUNDS

With the breakdown of Glass-Steagall Act barriers to bank involvement in the mutual fund business in the 1990s, banks began to convert their common trust funds and collective investment funds into mutual funds.

Mutual funds are perceived to be superior to collective investment funds as investment vehicles. In addition to professional management, mutual funds offer larger economies of scale and portfolio diversification by allowing personal trust and ERISA assets to be commingled in a single pool, along with non-fiduciary assets of retail investors.

Mutual funds also offer greater liquidity—they are valued daily and shares can be redeemed on any business day, compared to quarterly valuation and withdrawal typical among collective investment funds. Information on mutual fund performance is published daily in major newspapers and beneficiaries can monitor performance more easily than in the case of a collective investment fund.

In addition, a trustee can make distributions to beneficiaries in the form of mutual fund shares that a beneficiary can choose to hold for an indefinite period of time or transfer to another trustee. Units of participation in a collective investment fund cannot be distributed or transferred in the manner of mutual fund shares. Moreover, mutual funds are governed by an independent board of trustees and are regulated under the Investment Company Act of 1940.

From the bank’s point of view, a mutual fund offers significant possibilities for enhancing the profitability of fiduciary activities—a factor on which bank trust departments are rated by the federal banking regulators. Whereas a bank is limited in charging a management fee to a collective investment fund, the bank may receive compensation for serving as the
investment adviser of a mutual fund and also charge fees for performing shareholder and administrative services to the fund.

The conversion of a common trust fund to a mutual fund generally was a taxable event prior to 1996. In the case of an (a)(2) collective investment fund comprised of employee benefit plan assets, the tax impact of a conversion on the participants was nonexistent since the interests are held pursuant to tax-qualified plans in any case. Congress amended the Internal Revenue Code in 1996 to allow the transfer of collective investment fund assets to mutual funds on a tax-free basis.\textsuperscript{123}

**ASSET SECURITIZATION**

Asset securitization has become a major funding mechanism for modern lenders. Securitization enables banks and other lenders to package and sell pools of loans and other financial assets and thereby better manage their balance sheets, generate liquidity and fee income, and enhance their capacity to make more loans.

Mortgage loans were the first assets to be securitized because of the demand for home loans and because mortgage loans tend to have standard features that facilitate packaging them in pools. Approximately 90 percent of all mortgage loans in the United States now are securitized.

Lenders began securitizing automobile loans in the mid-1980’s, followed by credit card receivables. Any kind of assets with standardized features may be securitized. Commercial loans and other non-standard financing products

\textsuperscript{123} Small Business Job Protection Act of 1996, codified at 26 U.S.C. § 584(b). The legislation made collective investment fund conversions tax-free for federal taxation purposes only. State income tax consequences may remain, along with accounting and other tax issues related to the rebating of fees, the amortization of bond premiums, and capital gain distributions.
generally are not securitized because they tend to be tailored to specific borrowers and are non-homogenous.

The OCC in 1977 first interpreted the National Bank Act to permit national banks to sell participations in pools of their assets. The OCC in 1996 amended its rules to provide that a national bank may securitize and sell any assets that it holds, as part of its banking business, without limitation as to a specified percentage of the bank’s capital and surplus.

National banks are specifically authorized under 12 U.S.C. § 24(Ninth) to issue and sell securities representing undivided interests in pools of mortgage loans that are guaranteed by the Government National Mortgage Association (“GNMA”). The OCC by interpretation has allowed national banks to securitize any assets originated by them as well as assets originated by other lenders.

Questions arose in the 1980’s as to whether the Glass-Steagall Act permitted national banks to issue, underwrite and deal in asset-backed securities. The OCC concluded that the Act permitted such activities because the securities were not “securities” for purposes of the Act but rather were “legally transparent” and substantially the same as the underlying assets. The OCC’s interpretation was upheld by the Second Circuit which ruled that the sale of securitized assets by a bank constitutes the business of banking and that, “[i]f the activity constitutes

125 12 C.F.R. § 1.3(g).
127 OCC Interpretive Letter No. 361 (May 22, 1986); OCC Interpretive Letter No. 388 (June 16, 1987).
the ‘business of banking,’ then the Glass-Steagall Act prohibitions . . . do not apply.”128

The trust and special purpose vehicles used to securitize assets generally fall within the definition of “investment company” under the Investment Company Act of 1940 because they issue securities and are primarily engaged in investing in, owning, or holding securities.129 The Investment Company Act requires an investment company to register with the SEC prior to offering to sell, selling or purchasing securities, unless exempted from the applicable provisions of the Act.

In 1992, the SEC adopted Rule 3a-7 under the Act to promote the use of securitizations (or “structured financings”) by removing from the definition of investment company any securitization regardless of the type of assets securitized.130 Specifically, the rule exempts any issuer that is engaged in the business of acquiring and holding eligible assets, and activities related thereto, and which does not issue redeemable securities. The SEC stated that:

Structured financings are fundamentally different from investment companies in operation and purpose. Notwithstanding its size and rapid growth, the structured finance market has been virtually free of abuse. Requiring regulation based on theoretical concerns would only disrupt an increasingly important form of finance.131

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130 17 C.F.R. § 270.3a-7.
131 57 Fed. Reg. at 56,249.
In order to qualify for the exemption, the issuer must issue fixed-income securities or other securities that entitle their holders to receive payments that depend primarily on the cash flow from eligible assets, and the securities must be rated, at the time of initial sale, in one of the four highest categories assigned long-term debt by at least one nationally recognized statistical rating organization. The issuer must hold substantially all assets to maturity and the assets and cash flows must be maintained in the custody of an independent trustee.

The Gramm-Leach-Bliley Act created an exemption from the definition of “dealer” in the Securities Exchange Act of 1934 for banks engaged in the issuance or sale of securitized assets to qualified investors. A bank is not required to register as a dealer if:

The bank engages in the issuance or sale to qualified investors, through a grantor trust or other separate entity, of securities backed by or representing an interest in notes, drafts, acceptances, loans, leases, receivables, other obligations (other than securities of which the bank is not the issuer), or pools of any such obligations predominantly originated by—

the bank;

an affiliate of the bank other than a broker-dealer; or

a syndicate of banks of which the bank is a member, if the obligations or pool of obligations consists of mortgage obligations or consumer-related receivables.

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The SEC has stated that asset-backed securities must represent obligations predominantly (85 percent or more) originated by the bank or an affiliate of the bank other than a broker-dealer. If the underlying assets are mortgage obligations or consumer-related receivables, a syndicate of banks that includes the bank issuing and selling the securities must have originated 85 percent or more of the obligations and the bank issuing and selling the securities must have originated at least 10 percent of the value of the pool of obligations backing the securities.

The term “qualified investor” is defined in the Exchange Act to include other banks, broker-dealers, savings associations, and other parties that meet specified criteria.

The SEC has stated that the exemption is limited to the original placement of securities and does not permit a bank to repurchase and re-sell securities in the secondary market.

In 2004, the SEC adopted comprehensive registration, disclosure, and reporting requirements for asset-backed securities. The SEC noted that asset-backed securities and their issuers differ from corporate securities and operating companies. For example, there generally is no business or management to describe in public offering documents. Instead, the SEC noted that information about the transaction structure and the characteristics and quality of the asset pool and servicing often is what is most important to investors.

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136 SEC Staff Compliance Guide.
The new regulatory regime for asset-backed securities is designed to address the different nature of asset-backed securities consistent with developments in the market for these securities.

**HYBRID INSURANCE PRODUCTS**

A number of products have insurance-like features and may or may not come within the definition of “insurance” for regulatory purposes. Even if a product comes within the meaning of “insurance” and is subject to insurance regulation, it also may be subject to regulation as a banking or securities product if it has the characteristics of a deposit or a security. The Retirement CD, discussed above, is an example of one such product.

**INDEMNITY AGREEMENTS**

Insurance may involve an obligation to repair or replace property and does not necessarily require the payment of money by the insurer. In the case of *State ex rel. Duffy v. Western Auto Supply Co.*,\(^{138}\) for example, an Ohio court addressed whether Ohio insurance laws applied to an indemnity guarantee by an automobile tire merchant against blowouts and other defects that could render a tire unfit for use. Under the guarantee, the merchant promised to repair or replace the tire free of charge. Another tire guarantee at issue promised repair or replacement if the tire wore out within the guarantee period. The court found that both guarantees were unconditional promises constituting insurance.

Many states have adopted statutory exclusions that specifically exclude from the definition of insurance indemnity and other agreements relating to specific products.

\(^{138}\) 134 Ohio St. 163 (Ohio 1938).
PREPAID HEALTH CARE CONTRACTS

Prepaid health care contracts may or may not come within the meaning of “insurance” under state law. In *Prepaid Dental Services, Inc. v. Day*, a Utah court ruled that a prepaid dental services plan was not insurance but rather a type of “retainer” for future services, notwithstanding that the plan called for monthly payments to be made by the plan participant irrespective of whether any dental services were performed and the state insurance commissioner had found the plan to be a form of insurance.

DEBT CANCELLATION CONTRACTS

A debt cancellation contract obligates a lender that issues the contract to cancel the unpaid balance of the loan remaining at the death of the borrower. Courts have held that such a contract, although it may be regulated as insurance under state law, is not a part of the “business of insurance” when offered by a national bank because the contract does not require the issuer to take an investment risk or to make any payout. Rather, the debt is simply extinguished when the borrower dies. “Thus, the primary and traditional concern behind state insurance regulation—the prevention of insolvency—is not of concern to a borrower who opts for a debt cancellation contract.” Accordingly, while a state may treat a debt cancellation contract as insurance, the courts have ruled that any state regulation that operates to preclude a national bank from offering the product does not constitute regulation of the “business of insurance” and is not protected from preemption by federal law.

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139 615 P.2d 1271 (Utah 1980).