Financial Modernization in Missouri:

Analyzing Options for Missouri Banks Seeking New Opportunities in Financial Services

By Gregory D. Omer[1]

Synopsis: This article reviews and analyzes the options for Missouri banks to pursue new opportunities in insurance agency, securities brokerage, equity investment and offering other financial services, in the wake of recent state and federal financial modernization legislation.

The recent federal financial modernization law, known as Gramm-Leach-Bliley ("GLB"), was enacted at the end of 1999 and has become effective incrementally over the past two years.[2] Upon its passage, this law was heralded for ending Depression era barriers on the financial industries by allowing the corporate combination of banking, securities, and insurance services. Bankers, along with their insurance and securities counterparts, welcomed a new set of powers which allow them to become full service financial firms. However, the federal law required implementation by the states to allow state chartered banks to take full advantage of the new powers that became available for national banks through GLB.

In response to GLB, Missouri adopted financial modernization bills in 2000 and again in 2001, which implemented new insurance, securities, equity investment and other financial services powers for state chartered banks. The 2000 bill was Senate Bill 896 and the 2001 bills were House Bill 738 and Senate Bill 186. The financial modernization provisions of the 2001 bills were nearly identical.

While these bills opened up new ways for Missouri banks to provide financial services, each institution that is interested in entering into a new financial service area should closely examine both the new concepts in the law as well as the "pre-modernization" legal options to conduct those same activities.

I. Insurance Sales

A. Town of 5,000 Rule and Financial Subsidiaries

Before GLB both national banks and Missouri state chartered banks were limited in insurance sales by the "town of 5,000" rule. This rule, which is in the National Bank Act and in a Missouri regulation, allows these banks to sell full lines of insurance, as agent, only in places with a population of 5,000 or less.[3] Direct sales of full lines of insurance in larger towns is prohibited for these institutions. GLB addressed this limitation by authorizing national banks to create a new type of subsidiary, the "financial subsidiary," which can sell insurance in anywhere. The financial subsidiary concept was adopted into

Missouri law shortly thereafter in 2000 in Section 362.105.1(16), and the Missouri Division of Finance adopted a regulation at 4 C.S.R. § 140-2.138 to provide procedures and guidelines for establishment of the financial subsidiaries. The state requirements for financial subsidiaries are very similar to the federal requirements, which include bank capitalization requirements, bank CAMELS[4] and Community Reinvestment Act rating requirements, financial reporting requirements and investment limitations.[5]

So, although they are still subject to the "town of 5,000" rule, Missouri state chartered banks and national banks operating in Missouri now have the power to create their own financial subsidiaries to sell insurance anywhere. However, the creation of a financial subsidiary, which will be subject to the various regulatory requirements for capital, ratings, investment and reporting, may not be the most practical or efficient way for a Missouri bank to get into insurance sales.[6] This is because some types of insurance sales are not subject to the town of 5,000 rule, and some types of Missouri "banks" can sell insurance without regard to the town of 5,000 rule.

B. Small Town Sales

As state above, just as before GLB, any Missouri bank can still sell a full line of insurance in any place with a population of 5,000 or less.[7] Therefore, if a Missouri bank only intends to sell insurance from such places, the creation of a financial subsidiary is unnecessary. If a bank wishes to move the services into a subsidiary for liability or operational reasons, it can form a simple operating subsidiary without the need for application or approval by state or federal regulators.[8]

C. Limited Insurance Sales

If a Missouri state chartered bank is interested in selling only credit-related insurance or title insurance, it has the power to sell these types of insurance in connection with the bank’s traditional lending activities under § 362.106 RSMo Supp. 2001 as a power that is convenient to or incidental to banking. These sales are not subject to the town of 5,000 rule, and all Missouri state chartered banks have held this power since before GLB.[9] National banks operating in Missouri hold similar powers.[10]

D. Depository Trust Company Charter

Missouri state chartered depository trust companies are able to sell any type of insurance as agent from any location, regardless of population. The depository trust company is another type of Missouri "bank." Several longstanding Missouri "banks" are actually depository trust companies. These institutions have all of the powers of a state chartered bank and have additional agency powers spelled out in § 362.105.3(7) RSMo Supp. 2001. Some Missouri state chartered banks have converted to depository trust company charters, retaining a corporate name with the word "bank" in it, and gained the power to sell all types of insurance from any location.

Such a depository trust company could create a simple operating subsidiary to conduct the insurance sales to address liability or operational issues. Such an operating subsidiary would not be deemed to be a financial subsidiary under state or federal law, because the

parent institution would have the power to conduct the activities directly and the activities would be agency activities only.[11]

Insurance sales directly by a depository trust company or by a trust company operating subsidiary do not require application to or approval by the state. Also, while the federal regulators would require applications and approvals for financial subsidiaries, those agencies do not require application or approval for an operating subsidiary conducting only agency activities that the parent institution can perform directly.[12]

E. Contracting Arrangements

One of the most common arrangements to facilitate sales of a full line of insurance products in Missouri banks is the use of a lease arrangement in which a third party insurance agency contracts with the bank to sell insurance products from the bank lobby. The third party may be an affiliate or unaffiliated entity. Many times these arrangements involve a dual employee of the bank and third party and a percentage of commissions to be paid to the bank as lease payments.

These arrangements have the advantage of allowing an insurance agency specialist to handle the training, the product selection, the networking with the insurance underwriter companies and the licensing issues. Furthermore, banks subject to the town of 5,000 rule can use these arrangements to offer insurance products to customers in any location because the bank is not deemed to be the seller of the insurance under the banking law despite the commission and employee sharing.[13]

Contract terms should be reviewed closely when putting together these arrangements if they are with affiliates or companies controlled by bank insiders. The 2001 Missouri financial modernization legislation included statutory provisions requiring that the consideration paid by affiliates or insider controlled companies to banks under these arrangements must be at fair market value for the leased space.[14] This requirement is consistent with similar requirements in Section 23B of the Federal Reserve Act (12 U.S.C. §371c-1) and 4 C.S.R. § 140-2.110. Another applicable Missouri regulation deems 20 percent of commissions to be fair market value for space leased for insurance sales to an insider’s company or affiliate.[15]

F. Licensing and Operational Issues

In all cases of banks or depository trust companies offering insurance products to customers, the institutions should always be advised to review licensing requirements under Missouri insurance law. For example, even in the lease arrangements, Missouri insurance law requires a license for the bank or trust company itself if the lease payments are based on insurance commissions.[16] The institution should also review the special insurance sales consumer protection provisions of GLB effective October 1, 2001, the federal Interagency Statement on Retail Sales of Nondeposit Investment Products, Missouri statutes on insurance sales by depository institutions and the state statutes and regulations on the disposition of insurance commissions and credit insurance income.[17]

II. Securities Sales

A. Direct Discount Brokerage

Many institutions interested in getting into securities sales may wish to provide only discount brokerage services to their customers, and not be involved with investment advising. Discount brokerage is defined as purchasing and selling "investment securities, without recourse, solely upon order and for the account of customers."[18]

Missouri state chartered banks and depository trust companies may engage in discount brokerage directly or through an operating subsidiary, without application or approval.[19] However, neither type of state charter has the added power to engage in investment advising directly or through an operating subsidiary. This is true even though a depository trust company or a bank with trust powers may have trust officers on staff trained in conducting financial investments as fiduciary.[20]

National banks have direct and operating subsidiary discount brokerage power with investment advising; however the operating subsidiaries are subject to notice and (expedited) approval procedures if the services involve investment advising.[21]

B. Financial Subsidiaries

If the state chartered bank or trust company is interested in going beyond discount brokerage and offering investment advice to customers, the GLB financial subsidiary, authorized by Missouri’s 2000 financial modernization legislation, can also be used for securities sales, including investment advising. As in the case of using the financial subsidiary for insurance agency, establishing a financial subsidiary requires application and approval and includes the same regulatory hurdles.[22] If a financial subsidiary is used for investment advising, it will not be subject to FDIC notice requirements under 12 C.F.R. §362.18, because the FDIC does not consider investment advising to be an activity as a principal.

C. Securities subsidiaries

Another option available to Missouri state chartered banks and depository trust companies to conduct the same securities brokerage and investment advising activities that a financial subsidiary can conduct is the "securities subsidiary."[23] The securities subsidiary is a creature of Missouri law that has been authorized for both banks and depository trust companies since 1987. A securities subsidiary requires application to and approval by the Missouri Division of Finance, but the review considerations are similar to the national bank operating subsidiary used for brokerage and investment advising under 12 C.F.R. § 5.34. To establish a securities subsidiary, the parent institution must be adequately capitalized under state standards and the subsidiary must be "reasonably capitalized."[24] Because the FDIC does not consider investment advising to be an activity as principal, a securities subsidiary conducting brokerage and investment advising would not be considered a financial subsidiary under federal law and would not be subject to the

financial subsidiary regulatory requirements.[25] The Federal Reserve, however, has indicated informally that it may consider a securities subsidiary to be a financial subsidiary for Federal Reserve member banks, based on the definition in 12 C.F.R. § 208.77(d)(2).

D. Contract Arrangement

One of the most common arrangements that banks in Missouri use to provide their customers with securities brokerage services is through a lease arrangement in which a third party securities brokerage agency contracts with the bank to sell securities products from the bank lobby. The third party may be an affiliate or unaffiliated entity. Many times these arrangements involve a dual employee of the bank and third party and a percentage of commissions to be paid to the bank as lease payments.

These arrangements have the advantage of allowing a company specializing in securities brokerage to handle the training, the product selection, the networking with the securities exchanges and the securities registration issues. Furthermore, banks can use these arrangements to offer securities products and services to customers without limiting the services to discount brokerage, because the bank is not deemed to be the broker of the securities under the law on bank powers, despite the commission and employee sharing.[26]

E. Registration and Operational Issues

Banks using the contract arrangement should review the securities laws regarding when registration as a broker or dealer is required for the bank itself. GLB included language referred to as the "push out" provisions, which will, upon their effective date, currently set for May 12, 2002, govern when a bank would be required to register.[27] One of the exemptions from registration is for a contracting relationship.[28] The GLB push out provisions are to replace the current blanket exemption for banks from registration. The SEC rules promulgated to interpret the GLB push out provisions have been the subject of much criticism from bank regulators, who have publicly stated that the rules would inappropriately narrow the registration exemptions for banks created by GLB.[29] The SEC rules are still in proposed form only, and the SEC has reserved the right to make modifications.

At the state level, the Missouri Division of Securities has issued an interpretive letter dated September 11, 2000, regarding securities brokerage contracting arrangements involving banks. Banks considering such an arrangement should review this letter and the GLB push out provisions to determine whether they need to register as a broker or dealer at the state or federal level. The institution should also review the federal Interagency Statement on Retail Sales of Nondeposit Investment Products regarding such matters as required disclosures and separation of activities on bank premises.[30]

F. Insider and Affiliate Issues

The terms for the contracting arrangements should be reviewed closely when affiliates or companies controlled by bank insiders are involved. The fair market value requirements in Section 23B of the Federal Reserve Act (12 U.S.C. §371c-1) and 4 C.S.R. § 140-2.110 should be followed. The Missouri Division of Finance will generally require some

evidence of fair market value in the leasing arrangement, such as bids from non-related parties. [31]

III. Equity Investment

A. Merchant Banking under GLB

One of the most controversial issues debated when GLB was before Congress was whether banks would be able to conduct "merchant banking" as a new power. "Merchant banking" under GLB is essentially non-controlling-interest equity investment.[32] The compromise reached was that certain bank holding companies that qualify as "financial holding companies" under GLB can engage in merchant banking under certain limits and controls.[33] Although neither national banks nor Missouri state chartered banks can engage, either directly or indirectly, in these activities, the Federal Reserve and the Treasury Department can consider whether to allow financial subsidiaries of banks to engage in merchant banking after a period of five years from the passage of GLB (November of 2004).[34] This decision would affect state bank financial subsidiaries through § 362.105.1(16) RSMo Supp. 2001. In addition to the moratorium on merchant banking, financial subsidiaries are prohibited under state and federal law from engaging in insurance or annuity underwriting, developing or investing in real estate, and insurance portfolio investing.[35]

Like national and most state chartered banks, Missouri banks do not have broad powers to make non-controlling-interest equity investments. Missouri depository trust companies' broader power under state law to "buy, invest in and sell all kinds of stocks or other investment securities," is nonetheless limited by the Federal Deposit Insurance Act and the Federal Reserve Act to only investments which are legal for national banks.[36] So, national banks, Missouri chartered banks and Missouri depository trust companies all have essentially the same non-controlling-interest equity investment powers. Although federal law did not allow Missouri law to authorize new merchant banking powers for depository institutions, the 2000 and 2001 financial modernization legislation did retain certain existing equity investment powers and did create some new specialized equity investment powers.

B. Controlling-interest Equity Investment for Real Estate Development

Missouri state chartered banks and depository trust companies may still own real estate development corporations ("REDC's") under § 362.106(3) RSMo Supp. 2001. These subsidiaries can own, develop, lease and manage real property. Under federal law, the FDIC can object to such an investment only if it finds it poses a significant risk to the deposit insurance fund or the bank is not in compliance with applicable federal capital standards.[37] The Federal Reserve, however, in accordance with 12 U.S.C. § 335, will not approve Federal Reserve member state banks to invest in REDC's. REDC's are subject to certain regulatory limitations and state approval.[38] The power to invest in REDC's or real estate development is not available to national banks through financial subsidiaries or otherwise.

C. Special Non-controlling Equity Investments

Missouri's 2001 financial modernization legislation created a new power for banks and trust companies to make a non-controlling investment in any entity conducting activities that are financial in nature or incidental to financial activity or that is a financial subsidiary, if the majority of the entity's equity is held by Missouri banks, Missouri trust companies, Missouri-based national banks or foreign banks with a branch in Missouri.[39] "Financial in nature" and "incidental to financial activity" are GLB phrases describing the full scope of activities available for financial holding companies.[40] Most of these activities are also open to financial subsidiaries.[41]

This new investment power will allow Missouri banks to band together to create companies that can serve the needs of each bank in a group to offer financial modernization services to customers without each of those banks taking on the burden of establishing and operating the service provider itself. Depending on the activities conducted, federal law may require one of these new entities to be organized as a bank service company or a financial subsidiary and subject to the applicable regulatory requirements.

IV. Fiduciary Services - Trust Representative Offices

Missouri's 2000 modernization legislation superseded longstanding Missouri case law to authorize "trust representative offices" for Missouri banks and trust companies that are not defined as branches.[42] The required regulation for these offices became effective in 2001.[43] A trust representative office is defined in the regulation as a marketing office from which the institution can provide information to customers about matters related to their accounts; act as a liaison between the institution's trust office and the customer; or simply maintain custody of fiduciary assets.[44] An institution may not conduct "core" fiduciary activities at a trust representative office, such as accepting fiduciary appointments, executing documents that create a fiduciary relationship and making decisions regarding the investment or distribution of fiduciary assets.[45]

The creation of the trust representative office allows Missouri institutions to offer fiduciary services to customers without the regulatory burden of the state and federal branch application process. Although no application and approval process is required for the establishment of a trust representative office by a Missouri institution (only an after-the-fact notice is needed[46]), the institution may need to obtain lease or purchase approval for real estate involved.[47]

V. Super Wild Card

In the 2001 financial modernization legislation, Missouri adopted a "super wild card" statutory provision,[48] which allows Missouri state chartered banks and depository trust companies to exercise all the powers of national banks operating in the state of Missouri. This provision authorizes the new powers without requiring a regulation (only a prior notice to the Division of Finance from an institution seeking to exercise the powers is required), and the powers can be exercised even if they would otherwise be prohibited under Missouri law.[49] In response to the notice, the Division of Finance can prohibit the activity by finding it to be an unsafe or unsound practice.[50] The Division can also issue public approval and no-action letters on the powers requests.[51]

The prior notice to the Division is not required if another bank has already obtained an approval or no-action letter from the Division for the activity, provided that the new bank wishing to conduct the activity meets the conditions or requirements of the approval or no-action letter. Missouri institutions would be subject to the same limitations in exercising the powers as national banks and would be subject to Missouri licensing and registration law. The "super wild card" provision of Missouri law should allow Missouri chartered institutions to continue securing the latest financial modernization powers instituted at the federal level without going back to the legislature or even waiting for a regulation to be promulgated.

VI. Conclusion

With the advent of the 2000 and 2001 financial modernization initiatives, Missouri now appears well equipped to keep state bank and trust company charter powers not only competitive with the national charters but also ready to provide the latest innovations that will best serve the financial needs of our state's citizens. Counseling a bank or trust company on how to offer customers financial modernization services in the most practical and efficient way requires careful deliberation and consideration of both the modern and "pre-modern" options.

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[2] The Gramm-Leach-Bliley Financial Modernization Act of 1999; P.L. 106-102

[3] 12 U.S.C. §92; 4 C.S.R. § 140-2.051(1)

[4] CAMELS is the common name for the Uniform Financial Institutions Rating System, which is used by most bank regulators to assess Capital, Assets, Management, Earnings, Liquidity and Sensitivity to market risk. The system is explained at FDIC PR-126-79 (November 26, 1979) and Board of Governors, Federal Reserve System SR-96-38 (SUP) (December 27, 1996).

[5] 4 C.S.R. § 140-2.138; 12 C.F.R. §5.39; 12 C.F.R. §§362.17 and 362.18; 12 C.F.R. §§208.71 – 208.77

[6] *Id.*

[7] 12 U.S.C. §92; 4 C.S.R. § 140-2.051(1)

[8] §§ 362.105.1 and 362.106(1) RSMo Supp. 2001; 12 U.S.C. §§ 1831a(c) and 1831a(d); 12 U.S.C. §335; 12 C.F.R. § 5.34; 12 C.F.R. §§362.17 and 362.18; 12 C.F.R. §§208.71 – 208.77

[9] 12 U.S.C. §1831a; 12 U.S.C. §335

[10] 12 U.S.C. §24 (Seventh); OCC Interpretive Letter No. 283 (March 16, 1984); 12 C.F.R. Part 2; 15 U.S.C. §6713

[11] 12 C.F.R. §§362.17 and 362.18; 12 C.F.R. §§208.71 – 208.77

[12] 12 C.F.R. §§362.17 and 362.18; 12 C.F.R. §§208.71 – 208.77; FDIC Advisory Opinion 97-7 (October 20, 1998)

[13] See OCC Interpretive Letter No. 680 (July 26, 1995); the Missouri Division of Finance follows a similar interpretation in applying state law.

[14] § 427.220.2 RSMo Supp. 2001

[15] 4 C.S.R. § 140-2.051(2)

[16] § 375.012 RSMo Supp. 2001

[17] 12 C.F.R. §§208.81 - 208.86; 12 C.F.R. §§343.10 - 343.60; Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994); § 375.937 RSMo Supp. 2001; § 427.220 RSMo Supp. 2001; 4 C.S.R. § 140-2.050

[18] § 362.105.1(14) RSMo Supp. 2001; 4 C.S.R. § 140-2.130(7)

[19] *Id.*

[20] See 4 C.S.R. § 140-2.130

[21] OCC Interpretive Letter No. 380 (December 29, 1986); OCC Interpretive Letter No. 622 (April 9, 1993); 12 CFR 5.34

[22] 4 C.S.R. § 140-2.138

[23] 4 C.S.R. § 140-2.130

[24] *Id.*

[25] 12 C.F.R. §362.18

[26] See OCC Interpretive Letter No. 680 (July 26, 1995); the Missouri Division of Finance follows a similar interpretation in applying state law.

[27] 15 U.S.C. §78c(a)(4)(B); see SEC Order, Release No. 34-44570, July 18, 2001

[28] 15 U.S.C. §78c(a)(4)(B)(i)

[29] OCC 2001-30 (June 29, 2001); 66 Federal Register 27759, May 18, 2001

[30] Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994)

[31] The 20 percent rule in 4 C.S.R. § 140-2.051 for insurance commissions for space leased for insurance sales to an insider's company or affiliate does not apply to securities brokerage arrangements.

[32]12 U.S.C. §1843(k)(4)(H); 12 C.F.R. Part 225, Subpart J

[33] *Id.*

[34]P.L. 106-102, Section 122; see 12 U.S.C. §1843 note

[35] Section 362.105.1(16); 12 U.S.C. §24a(a)(2)(B)

[36] § 362.105.3(4) RSMo Supp. 2001; 12 U.S.C. §1831a(c)(1); 12 U.S.C. § 335

[37] 12 U.S.C. §1831a(d)(1); the FDIC has not considered REDC's to be financial subsidiaries under 12 C.F.R. §362.17

[38] § 362.106.3 RSMo Supp. 2001; 4 C.S.R. § 140-2.065

[39] § 362.105.1(6) RSMo Supp. 2001

[40] 12 U.S.C. §1843(k)

[41] 12 U.S.C. §24a(a)(2)

[42] § 362.105.4(1)(d) RSMo Supp. 2001; see *St. Louis Union Trust Company v. Pemberton*, 494 S.W. 2d 408 (Mo. App. W.D. Mo. 1973)

[43] 4 C.S.R. § 140-6.085

[44] 4 C.S.R. § 140-6.085(1)

[45] *Id.* The distinctions between core and noncore fiduciary activities in the Missouri regulation are based on OCC Interpretive Letters No. 866 (October 8, 1999) and No. 872 (October 28, 1999)

[46] 4 C.S.R. § 140-6.085(2)

[47] §§ 362.105.1(10) and 362.105.2 RSMo Supp. 2001

[48] "Wild card" is an industry and regulatory term describing a statute that grants a state chartered institution the same powers as other types of institutions, typically national banks operating in the same state, without enumerating specific powers. Missouri has had a regular "wild card" statute in place for several years at § 362.105.4 RSMo Supp. 2001, which required a regulation to be passed by the Division of Finance and which could not grant powers in conflict with any other Missouri statutes.

[49] § 362.106(4) RSMo Supp. 2001

[50] *Id.*

[51] § 362.106(5) RSMo Supp. 2001