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**Comment: Banks, Securities Firms a Tough Match**

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They say that breaking up is hard to do, but in the case of banks trying to affiliate with securities firms, the toughest part may be getting together. Look at the casualties:

\*Donaldson, Lufkin & Jenrette Inc. has difficulty finding a bank suitor.

\*Swiss Bank Corp. is encountering regulatory difficulties on acquiring the U.S. operations of S.G. Warburg & Co.

\*Bayerische Vereinsbank has reportedly been thwarted in its attempted acquisition of Oppenheimer & Co.

\*Swiss Bank has agreed to pay a $3.5 million fine arising from apparent violations of the 10% revenue limitation in another acquisition.

Revenue limitations impede mergers

According to press reports, the major obstacle in the proposed acquisition of Oppenheimer was that Bayerische Vereinsbank contemplated "debanking" after it acquired Oppenheimer - rather than operating Oppenheimer as a Section 20 subsidiary.

A Section 20 subsidiary is a securities affiliate of the bank that is permitted to engage in corporate debt and equity securities dealing provided that its underwriting activities are limited to 10% of the gross revenues of the securities company.

As a result, a Section 20 subsidiary is not a viable structure for acquiring a major securities firm. And this is one of the primary reasons no U.S. banking organization has acquired a major U.S. securities underwriter.

This point was abundantly clear in the case of Oppenheimer. Apparently, the Federal Reserve was unwilling to permit a significant level of banking activities to be retained subsequent to the Oppenheimer acquisition even for a limited period of time.

Instead, the Federal Reserve would have required the bank to eliminate all banking operations prior to the acquisition of Oppenheimer.

The Fed's stance was fairly predictable since the Glass-Steagall Act technically prohibits a bank from being affiliated with a company principally engaged in underwriting (like Oppenheimer), and it offers no temporary statutory exemption. Interestingly, there is an exemption for non-U.S. banks.

The temporary exemption for non-U.S. banks has been a critical factor in the recent spurt of acquisition activity by foreign banks. This issue arose with such institutions as Deutsche Bank, Dresdner, ABN Amro, and Swiss Bank in their acquisition of Morgan Grenfell and Sharps Pixley, Kleinwort Benson, Alfred Berg, and S.G. Warburg, respectively.

All of these transactions were primarily foreign in nature and therefore a temporary exemption was available. Note however, that if the target is primarily a U.S. investment bank, or the acquirer is a U.S. bank, the temporary exemption does not apply.

In the Swiss Bank acquisition of S.G. Warburg, the Federal Reserve has temporarily approved Swiss Bank to retain its interest in the U.S. operations of Warburg on the grounds that the acquisition was primarily a non-U.S. transaction.

However, the Federal Reserve has not yet given final approval to the acquisition. The application for retention of Warburg was submitted on July 11, 1995. Similar to Oppenheimer, Warburg's U.S. operations apparently involve a significant level of "ineligible" underwriting and dealing revenue.

Revenue limitations can spoil the honeymoon

The Federal Reserve appears to be rejecting Swiss Bank's requested temporary modification to the calculation of the 10% revenue limitation. In the past, the Fed practice has been to permit banking companies to calculate "ineligible" revenues on an annualized basis during the first year after the acquisition of a securities firm; then in all future years, to calculate ineligible revenues on the standard quarterly basis.

Swiss Bank's proposal includes a request to merge the operations of its preexisting securities subsidiary, Swiss Bank Capital Markets Inc., with the U.S. operations of Warburg.

The effect of this proposal is to exclude all ineligible underwriting activities for one year from the date of the temporary approval received on July 3, 1995, and to add all of Warburg's "eligible" revenues immediately into Swiss Bank Capital Markets.

This would allow Warburg's "eligible" revenues to offset the capital market unit's "ineligible" trading revenues until June 30, 1996, when Warburg's "ineligible" underwriting activities will first be calculated.

The Federal Reserve's apparent refusal to accept this proposal may be one reason why Swiss Bank has not received final approval, although other factors may exist.

A recent fine imposed on Swiss Bank illustrates that even after a bank affiliates with a securities firm, the Glass-Steagall Act can be onerous. Swiss Bank has agreed to pay a $3.5 million fine to the Federal Reserve arising apparently from the failure of its securities trading unit to comply with the 10% revenue limitation. Swiss Bank acquired the securities and derivatives trading house O'Connor two years ago.

Venture capital and other issues may make it difficult

Another hurdle for would-be acquirers is the "control" issue. A bank holding company cannot generally own more than 5% of the voting securities or 25% of the nonvoting equity of a U.S. industrial or commercial company and cannot "control" such a company.

The goal of most venture capitalists is to control portfolio companies to protect their investments and to resell them. When Donaldson Lufkin was looking for a buyer recently, potential bank acquirers were reportedly put off by its venture capital activities and investments, since a bank holding company cannot make such investments.

On the other hand, Donaldson was loath to sell its investments prematurely, just to meet banking regulations, because of the potential returns of holding these positions.

Dresdner Bank's potential acquisition of the asset management firm Kleinwort Benson is another example where venture capital was a roadblock.

Kleinwort Benson operates venture capital funds in a manner that the Federal Reserve views as giving the manager control of the fund and its investments. To acquire Kleinwort Benson, Dresdner Bank will need to divest or restructure this part of the business.

What acquirers must do

Given the Fed's stance and Congress' uncertain timetable in reforming the banking laws, what steps should would-be acquirers consider?

\*Calculate the ineligible/eligible revenue ratio of the target by each individual activity.

\*Consider the legal, economic, and marketing impacts of restructuring an activity to make it generate eligible revenue.

\*Consider whether there are bank operations that can be merged into the target securities firm which can boost eligible revenues.

Keep in mind that the Federal Reserve favors activities of a securities nature rather than activities like credit card servicing. Also remember that breaking up a bank can lead to problems with the Section 20 firewalls, which restrict certain interactions between a bank and a securities firm.

\*Review carefully and conservatively each activity of the target for permissibility under Federal Reserve rules. When evaluating an acquisition target, creative theories for justifying an activity are often counterproductive, since the bank and target need to know the worst-case scenario.

Focus on the nature of the product/service, its customer base, the role the target plays, etc. You will need to consider not only the revenues generated from the activity (which may be small) but how integral the activity is to the target's overall operations and profitability.

One thing is certain - the banking laws and the way the regulators interpret them have effectively created an environment as inhospitable to certain marriages as Shakespeare's Verona.

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