

Clients & Friends Memo

Federal Reserve Board opines on Anti-Tying Restrictions

February 27, 2004 On 2nd February 2004, the general counsel of the Federal Reserve Board (the “**Board**”) opined that a securities-based loan offered by a Utah industrial loan company (the “**Bank**”) was not in contravention of the anti-tying restrictions embodied in section 106 of the Bank Holding Company Act Amendments of 1970 (“**section 106**” and the “**Act**”, respectively). The decision follows a release by the Board at the end of 2003 of an official interpretation of the anti-tying restrictions in section 106 and provides further information as to the characteristics required in order for a product to be classified as “one product” for the purposes of section 106.

The Facts

The Bank and its affiliate (“**Finance Co.**”) offered securities-based loans, that is, loans collateralized by securities or other marketable investment assets (“**securities**”) on the condition that the securities collateralizing each loan be kept in collateral accounts with their broker-dealer affiliate.

Customers were not charged for establishing or maintaining these collateral accounts, they were not obliged to trade in the collateral accounts and they were not required to maintain securities in the collateral accounts beyond those necessary, in the opinion of the Bank or Finance Co., to support the credit extensions. The Bank and Finance Co. agreed to grant customers' request to withdraw assets from collateral accounts as long as collateral requirements would continue to be met after withdrawals. In the event that customers did trade securities held in the collateral accounts, customers were charged standard brokerage fees. Customers were not restricted in their ability to maintain brokerage accounts with other securities firms.

Section 106

Section 106 generally prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from (or provide another product to) the bank or an affiliate of the bank. Although tying arrangements by banks are subject to the general anti-trust laws, there are – subject to certain exceptions described below – only two essential elements that must be shown to establish that a tying arrangement by a bank violates section 106:

1. The arrangement must involve two or more separate products: the customer's desired product(s) and one or more separate tied products; and
2. The bank must force the customer to obtain (or provide) the tied product(s) from (or to) the bank or an affiliate of the bank in order to obtain the customer's desired product(s) from the bank.

There are a number of exceptions to the anti-tying prohibitions of section 106. A bank is allowed to restrict the availability or vary the price of any product if the customer:

- also obtains a "traditional bank product", as defined in the Act, from the bank or any affiliate of the bank;
- provides a product to the bank or any affiliate of the bank and such product is "related to and usually provided in connection with" the bank product;
- refrains from obtaining a tied product from a competitor of the bank or a competitor of an affiliate of the bank if that condition is reasonably imposed by the bank in a credit transaction to ensure the soundness of the credit (the "**exclusive dealing exception**");
- is not obliged, in any combined-balance discount packages, to purchase non-traditional products in order to obtain the discount; or
- is a "foreign person" as defined in the Act.

The Opinion

The opinion of the general counsel of the Board was principally decided on the basis that the first of the two essential elements necessary to establish a tied relationship that violates section 106 was missing: the arrangement did not involve two or more separate products. The general counsel of the Board concluded that the Bank and Finance Co. were not requiring the customer to obtain any product separate from the loan itself. The requirement that collateral be provided for a loan was found to be an "integral" part of the loan and the securities collateral did not represent a separate product distinguishable from the underlying credit product.

The general counsel also noted that the second element of an unlawful tied relationship, that of improper coercion by the bank, was not present. The fact that borrowers were permitted (but not required) to hold securities in a collateral account beyond those needed to satisfy the lender's collateral requirement and to trade securities in the collateral account was deemed to enhance customer choice, rather than be indicative of any duress. The general counsel further stated that

the Act is not intended to prevent banks from employing customary risk mitigation practices and that therefore the lenders, in the case at hand, could legitimately require borrowers to maintain their collateral accounts at the lenders' broker-dealer affiliate and to deposit additional collateral (or to pay down their loans) if the value of the securities in the collateral account should fall below the relevant lender's collateral requirement.

Conclusion

The general counsel's opinion is significant for a number of reasons. Firstly, the subject matter, credit (in this case a loan), is arguably the core area of tying abuse which section 106 seeks to address. Secondly, it concerned the aspect of tying which is the most difficult to prove – the conditioning of availability of a product, as opposed to price, on the requirement to obtain another product from a bank or affiliate. Thirdly, the case involved a connection between a traditional bank product (a loan) and a non-traditional bank product (a collateral account) – exactly the type of tying which section 106 seeks to prohibit.

The case provides some indication of how the recently released official interpretation of the 1970 anti-tying restrictions, provisions which are now over thirty years old, will be applied to the realities and complexities of modern banking. The task of the Federal Reserve Board going forward will be a difficult one as it seeks to distinguish, amongst other things, what products will fall within the “one product” analysis in an arena where the overriding distinction, that of what can be classified as a “traditional” and a “non-traditional” bank product, is becoming increasingly blurred.

If you have any questions regarding the contents of this memorandum, please contact Jim Croke of Cadwalader's London office at +44 (0) 20 7170 8758 or Peter Manbeck of Cadwalader's New York office at 212 504 6626.