MEMO# 1400

September 12, 1989

SECOND CIRCUIT REVERSES DISTRICT COURT DECISION ON BANK UNDERWRITING OF MORTGAGE-BACKED SECURITIES

September 12, 1989 TO: BOARD OF GOVERNORS NO. 56-89 RE: SECOND CIRCUIT DECISION ON BANK UNDERWRITING OF MORTGAGE-BACKED SECURITIES _____ The U.S. Court of Appeals for the Second Circuit has reversed a decision of the U.S. District Court that held that the sale of mortgage-backed securities by a national bank violated the Glass-Steagall Act. The case (SIA v. Clarke) involved the sale by Security Pacific National Bank of pass-through certificates held by a trust, which had purchased from the bank a pool of mortgage loans originated by the bank. The court of appeals held that the use of mortgage pass- through certificates to sell mortgage loans was a permitted "incidental power" of a national bank and, consequently, not barred by the Glass-Steagall Act. It rejected the district court's argument that the use of a separate entity to issue the certificates caused the transaction to be an underwriting of securities barred by the Act. In addition, the court rejected the argument that the bank's promotional interest in the sale of the certificates constituted a "subtle hazard" protected against by the Glass-Steagall Act, stating that the interest was no different than what the bank would have in selling the loans themselves. Finally, the court held that the Glass-Steagall Act was concerned with "ensuring the stability of banks and protecting bank depositors" rather than protecting investors, and that the only protection for investors who purchased assets backed by bad mortgage loans was under the securities laws. A copy of the court's decision is attached. We will keep you informed of developments. Craig S. Tyle Assistant General Counsel Attachment