SM-85-2

A Series of Occasional Papers in Draft Form Prepared by Members of the Research Department for Review and Comment

STAFF MEMORANDA

THE SECURITIES ACTIVITIES OF COMMERCIAL BANKS: A LEGAL AND ECONOMIC ANALYSIS

Thomas G. Fischer, William H. Gram,
George G. Kaufman, and Larry R. Mote

FEDERAL RESERVE BANK OF CHICAGO

Reprinted by permission of the Tennessee Law Review Association, Inc. from *51 Tennessee Law Review 467 (1984).*

THE SECURITIES ACTIVITIES OF COMMERCIAL BANKS: A LEGAL AND ECONOMIC ANALYSIS

THOMAS G. FISCHER*
WILLIAM H. GRAM**
GEORGE G. KAUFMAN***
LARRY R. MOTE****

---

* Staff Attorney, Federal Reserve Bank of Chicago
** Vice President, General Counsel, and Secretary, Federal Reserve Bank of Chicago
*** John F. Smith, Jr., Professor of Economics and Finance, Loyola University of Chicago; Consultant, Federal Reserve Bank of Chicago
**** Economic Adviser and Vice President, Federal Reserve Bank of Chicago

Note: The views expressed herein are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.

I. INTRODUCTION

In the United States, commercial banking has traditionally been at least formally separate from investment banking. However, the line between commercial and investment banking has never been firm and clear; it has been maintained more in form than in substance. Each type of institution conducts at least some activities in which the other specializes. This fact partially explains the current controversy over the extent to which commercial banks may legally engage in securities activities. Securities activities are usually associated with investment banking rather than with commercial banking. Commercial banks sell their own securities in the form of deposits and use the funds raised thereby to buy other securities from third parties with different characteristics in terms of size, term to maturity, and risk of default. Commercial banks are investors. Investment banks, in contrast, trade and underwrite (sell for the first time) third-party securities. Except for financing of securities temporarily held in inventory, investment banks are not investors. Thus, commercial banks assume investment risks, while investment banks assume underwriting and trading risks. Moreover, until recently, commercial banks dealt primarily in short-term funds, while investment banks dealt primarily in long-term funds.

The separation of commercial and investment banking is, like the greater part of our financial structure, in the British tradition. In some countries, such as France and Germany, the two functions are generally combined.[1] Although originally based on quite narrow economic considerations, the separation has been maintained for reasons that are largely social and political, including the limitation of excessive concentration of financial power and conflicts of interest. The long history of fear of financial concentration in the United States was reflected in the outright prohibition of commercial banking in some states in the early days of the country. That fear also provoked widespread opposition to a central bank and

1. Daskin and Marquardt, *The Separation of Banking from Commerce and the Securities Business in the United Kingdom, West Germany, and Japan*, Summer 1983 ISSUES IN BANK REG. 16.

refusal to renew the twenty-year charters of the first two central banks that were established (The First Bank of the United States, 1791-1811, and The Second Bank of the United States, 1816-1836); the prohibition against interstate branching; severe restrictions on intrastate branching in many states, particularly in the East and Midwest; and the separation not only of commercial from investment banking but also of these businesses from savings and loan associations, insurance companies, mutual funds, and nonfinancial firms (commerce).

However, these legal restraints have not been sufficient to withstand the forces of change in the marketplace that encouraged either bypassing the restrictions or violating them directly, and many of these barriers have fallen or been modified through time. For reasons discussed later, recent changes in market forces have accelerated the breakdown of financial segmentation and have contributed to the state of uncertainty in securities activities permitted to commercial banks. This article reviews the changing forces in the marketplace, analyzes the current legal status of commercial bank activity in important securities areas, and examines the economic implications of recent changes in these areas and of likely future developments.

II. RECENT CHANGES IN MARKET FORCES

Commercial banks have engaged in some securities activities throughout virtually their entire history.[2] The particular type of activity has changed through time depending upon federal and state legislatures, the courts, and the chartering agency of the particular bank; the extent to which banks are aggressive and innovative; available technology; and the prevailing economic environment. The range of securities activities in which commercial banks engage has expanded greatly in recent years and is likely to expand further in the future. A number of factors have contributed to this expansion. The demand for all financial services, including securities

2. For histories of the development of investment and commercial banking, see Corrected Opinion of Harold R. Medina in United States v. Morgan Stanley & Co., V. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY (1970); F. REDLICH, THE MOLDING OF AMERICAN BANKING: MEN AND IDEAS (1951); Carosso, *Washington and Wall Street: The New Deal and Investment Bankers*, Winter 1970 BUS. HIST. REV. 425; Kaufman, *The Separation of Commercial and Investment Banking*, THE U.S. FINANCIAL SYSTEM (2d ed. 1983); Perkins, *The Divorce of Commercial and Investment Banking: A History*, June 1971 BANKING L. REV. 483; Sametz, Kennan, Bloch, and Goldberg, *Securities Activities of Commercial Banks: An Evaluation of Current Developments and Regulatory Issues*, November 1979 J. OF COMP. CORP. L. AND SEC. REG. 155.

services, has increased. Greater economic wealth has increased the financial resources of households and business firms; longer life expectancies have increased both the magnitude and complexity of financial needs; higher rates of inflation have increased the importance of financial management; higher rates of interest have increased the cost of holding funds in noninterest bearing accounts; and more volatile interest rates have increased the complexity and the risks of financial management. Simultaneously, the cost of providing these services has decreased. Advances in computer technology have permitted funds and information to be collected, transmitted, stored, and manipulated cheaply and quickly. Small desk-top computers can manipulate and store more information at much lower costs than the most powerful computers of only ten years ago. Large main-frame computers can be shared at reasonable cost by every institution, including the smallest. Thus, funds can be transferred cheaply and almost immediately from any location in the country to another, from any institution to another, and from any account to another. The rapid growth of the money market funds in the early 1980's attested to the ability of a simple device, such as the 800 telephone number, to attract funds from practically anywhere in the country. Today, almost anyone with a large computer can provide many of the financial services previously provided only by commercial banks.[3]

For many years, statutes and regulations have restricted the kinds of activities in which different classes of institutions may engage and the prices and interest rates that they may pay or charge for their services. The restrictions were imposed in response to the problems of an earlier age, primarily the massive bank failures during the 1930's. The restrictions promoted bank safety by discouraging bank competition. However, many of the regulations restricted, or appeared to restrict, the ability of commercial banks to provide a number of financial services. As a result, other financial institutions stepped in to fill the perceived void by making use of information science and new computer technology. Investment banking and other firms were not only able to offer many new products, but were also able to offer products that closely resembled traditional banking products, including deposit-type securities (*e.g.*, shares in money market funds) and consumer credit cards. In time, the commercial banks sought to compete with investment banks and the other firms by lobbying to have the laws changed, by challenging the restrictive regulations of the regulatory

3. Kaufman, Mote, and Rosenblum, *The Future of Commercial Banks in the Financial Services Industry*, FINANCIAL SERVICES: THE CHANGING INSTITUTIONS AND GOVERNMENT POLICY 94-126 (1983) (hereinafter cited as Kaufman, Mote, Rosenblum).

agencies in the courts, and, perhaps most importantly, by becoming more aggressive and innovative.[4]

Commercial banks, particularly the large ones, are well positioned to expand their securities activities. They possess large customer bases, large trained staffs, and financially sophisticated computer systems. These firms can provide multiple services economically.[5] In addition, some banks engage in a full range of investment banking activities overseas, since United States statutes permit United States banks to follow local law. The effect of bank entry into securities activities would probably be twofold, involving enlargement of the market and, for at least some banks, success in competing with nonbank competitors.[6] Thus, commercial banks view additional securities activities as a source of potentially high revenues for little outlay and as a vehicle for attracting additional customers. Of course, nonbanks may expand into banking activities at the same time that banks expand into the new activities. If that happens, some banks may fail to profit from their expansion. Nevertheless, motives abound for banks to expand into a number of areas previously believed to be either illegal or unprofitable.

The statutory and regulatory restrictions concerning domestic securities activities by commercial banks appear not to be as carefully spelled out as many believed only a few years ago. As recently as the mid-1970's, many students of banking were reasonably certain of the legal status of most securities activities. However, the events of recent years have changed this perception. Activities perceived to be barely permissible ten years earlier—active securities brokerage and private placement—are commonplace today; some activities perceived to be nonpermissible—commingling trust investments and advising individual investors—are being introduced by more aggressive institutions. In addition, some of today's securities (*e.g.*, financial futures) either did not exist or were insufficiently important (*e.g.*, municipal revenue bonds) to be covered by statute or regulation.

---

4. Kaufman, *The Securities Activities of Commercial Banks*, R. ASPINWALL & R. EISENBEIS, HANDBOOK FOR BANKING STRATEGY (forthcoming 1984) (hereinafter cited as Kaufman).

5. For a discussion of economies of scope in banking, see Benston, Berger, Hanweck, & Humphrey, *Economies of Scale and Scope in Banking*, FEDERAL RESERVE BANK OF CHICAGO, PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 432-55 (1983).

6. Bierwag, Kaufman, and Leonard, *Interest Rate Effects of Commercial Bank Underwriting of Municipal Revenue Bonds*, in 8 J. BANKING & FINANCE 35 (1984).

As a result, the legality of many of the activities has been determined on a case-by-case basis, prompted either by a bank application to engage in the new activity or by a challenge to a bank's involvement in a particular activity. The determination of the legality of many of the services either was, or is now, being tested in the courts.

Moreover, hardly any particular banking statute or regulation concerning securities activities applies equally to all commercial banks. Most frequently, separate statutes and regulations apply to national banks and state-chartered banks, depending upon whether the state banks are insured by the Federal Deposit Insurance Corporation (FDIC) and whether they are members of the Federal Reserve System (FRS). Moreover, the statutes applicable to state-chartered banks vary greatly. Indeed, because the language of some provisions of the Glass-Steagall Act that restricts bank securities activities refers only to member banks, the FDIC has interpreted this language as applying only to members of the FRS. Nevertheless, the activities of banks that are not members of the FRS remain subject to the laws and regulations of the states in which they are chartered. Even when regulations apply equally to large groups of banks, it is unlikely that all banks will be affected equally; securities activities are engaged in primarily by larger banks. In addition, thrift institutions, which are rapidly becoming more similar to commercial banks, remain subject to different statutes and regulations.

III. LEGAL SEPARATION OF COMMERCIAL BANKING FROM INVESTMENT BANKING

A. Introduction to the Glass-Steagall Act

The Glass-Steagall Act[7] was designed in part to separate commercial from investment banking. Congress believed that the involvement of commercial banks with speculative securities had helped cause both the bank failures and the stock market decline that occurred during and helped contribute to the Depression.[8] As the Supreme Court explained:

> Congress acted to keep commercial banks out of the investment banking business largely because it believed that the pro-

7. The Glass-Steagall Act was part of the Banking Act of 1933, ch. 89, 48 Stat. 162 (Title 12, distributed throughout chapters 2, 3, and 6).

8. *See Hearings Pursuant to S. Res. No. 71 Before a Subcommittee on Banking and Currency*, 71st Cong., 3d Sess. (1931); S. REP. NO. 77, 73rd Cong., 1st Sess. (1933); SENATE COMM. ON BANKING AND CURRENCY, REPORT ON STOCK EXCHANGE PRACTICES, S. REP. 1455, 73rd Cong., 2d Sess. (1934).

> motional incentives of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was [sic] destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system.[9]

Congress attempted to accomplish its goal of separating commercial from investment banking by regulating both the activities of commercial banks and the affiliation of investment banks and commercial banks. Section 16 of the Glass-Steagall Act[10] regulates the activities of banks. It provides that

> [t]he business of dealing in securities and stock by [a national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order and for the account of customers, and in no case for its own account, and [a national bank] shall not underwrite any issue of securities or stock.

Section 16 permits a national bank to deal in, underwrite, and purchase for its own account federal government bonds, general obligation bonds of states and their municipalities, and obligations of specified government agencies. Section 5(c) of the Glass-Steagall Act[11] applies these same limitations to state banks that are members of the FRS.

Sections 20,[12] 21,[13] and 32[14] of the Glass-Steagall Act limit affiliations between commercial banks and investment banks. Section 20 proscribes affiliations between member banks of the Federal Reserve System and any corporation or organization "engaged principally in the issue, flotation, underwriting, public sale or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities. . . ."[15] Section 21, which applies to all depository institutions, not just to banks that are members of the FRS, prohibits "any person or organization engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits. . . ."[16] Section 32 provides that no individual and no officer, director, or employee of any organization "primarily engaged in the issue, flotation, underwriting, public sale, or distribution,

---

9. Investment Co. Inst. v. Camp, 401 U.S. 617, 634 (1971).
10. 12 U.S.C. § 24 (1982).
11. 12 U.S.C. § 335 (1982).
12. 12 U.S.C. § 377 (1982).
13. 12 U.S.C. § 378a (1982).
14. 12 U.S.C. § 78 (1982).
15. 12 U.S.C. § 377 (1982).
16. 12 U.S.C. § 378 (1982).

at wholesale or retail, or through syndicate participation, of stocks, bonds or other similar securities, shall serve at the same time as an officer, director or employee of any member bank."[17]

When, in response to an increasingly competitive financial marketplace, financial institutions began to offer new services to their customers, the administrative agencies and the courts were called upon to ascertain exactly what barriers the Glass-Steagall Act imposed between commercial and investment banking.[18] This section surveys administrative and judicial interpretations of the Act.

B. Operation of Fiduciary Investment Funds

1. *Investment Co. Institute v. Camp*

The Supreme Court analyzed the policies behind the Glass-Steagall Act in *Investment Co. Institute v. Camp* (*ICI I*).[19] In 1965 the First National City Bank of New York, the predecessor of Citibank, submitted for the Comptroller's approval a plan for the collective investment of managing agency accounts. At that time, it was well established that national banks might invest trust assets collectively, and in addition, that they might offer managing agency accounts. The Comptroller approved the plan, and it went into operation. The plan required the customer to tender between $10,000 and $500,000 to the bank and to submit an authorization making the bank the customer's managing agent. The bank then added the customer's investment to the fund and issued to the customer "units of participation" which represented the customer's proportionate interest in fund assets. The bank would freely redeem the units of participation at their net asset value and would allow the customer to transfer the units to anyone who had executed a managing agency agreement with the bank. The bank planned to register the fund under the Investment Company Act of 1940

17. 12 U.S.C. § 78 (1982).

18. The increasingly frequent interpretation of the Glass-Steagall Act by the agencies and courts has in turn stimulated an increased interest in the Act among commentators. *See, e.g.*, Bock, *Glass-Steagall Act and the Acquisition of Member Banks by Unregulated Bank Holding Companies*, 100 BANKING L. J. 484 (1983); Ianni, *"Security" under the Glass-Steagall Act and the Federal Securities Act of 1933 and 1934: The Direction of the Supreme Court's Analysis*, 100 BANKING L. J. 100 (1983); Orbe, *Glass-Steagall: Lest We Forget*, 11 FLA. ST. L. REV. 163 (1983); Comment, *A. G. Becker, Inc. v. Board of Governors of the Federal Reserve System, 693 F.2d 136*, 52 U. CIN. L. REV. 618 (1983); Comment, *Bankers' Adventures in Brokerland: Looking Through Glass-Steagall at Discount Brokerage Services*, 81 MICH. L. REV. 1498 (1983).

19. 401 U.S. 617 (1971).

and to register interests in the fund as securities under the Securities Act of 1933.

The Comptroller's ruling was challenged by the Investment Company Institute. In *ICI I*, the Court held that the marketing and sale of these units of participation by the bank violated Sections 16 and 21 of the Glass-Steagall Act.[20] The Court acknowledged that a bank could commingle trust funds and that a bank could act as a managing agent, but it concluded that a bank could not offer both services in combination:

> For at least a generation, therefore, there has been no reason to doubt that a national bank can, consistently with the banking laws, commingle trust funds on the one hand, and act as a managing agent on the other. No provision of the banking law suggests that it is improper for a national bank to pool trust assets, or to act as a managing agent for individual customers, or to purchase stock for the account of its customers. But the union of these powers gives birth to an investment fund whose activities are of a different character. The differences between the investment fund that the Comptroller has authorized and a conventional open-end mutual fund are subtle at best, and it is undisputed that this bank investment fund finds itself in direct competition with the mutual fund industry.[21]

To determine whether the bank's collective investment fund violated the Glass-Steagall Act, the Court discussed at great length the concerns that led Congress to enact the Glass-Steagall restrictions. The Court recognized the obvious danger that a bank might invest its own assets imprudently, but focused its attention on what it called "the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments."[22] First, the Court explained that if a bank's customers lost money through dealings with a bank's securities affiliate, public confidence in the bank might be impaired.[23] Second, a bank might be less careful, even to the point of making unsound loans, in lending to those companies in whose stock or securities the bank's affiliate had invested.[24] Third, a bank's depositors might suffer losses on investments that the depositors had purchased in reliance on the relationship between the bank and its securities affiliate, creating

---

20. *Id.* at 639.
21. *Id.* at 624-25.
22. *Id.* at 630.
23. *Id.* at 631.
24. *Id.*

a loss of customer good will to the bank.[25] Fourth, "the promotional needs of investment banking might lead commercial banks to lend their reputation for prudence and restraint to the enterprise of selling particular stocks and securities and . . . this could not be done without that reputation being undercut by the risks necessarily incident to the investment banking business."[26] Fifth, a bank might make loans to customers with the expectation that the loans would be used to purchase stocks and securities.[27] Sixth, a conflict of interest might occur between a bank's desire to promote stocks and securities and the bank's obligation to give disinterested investment advice to its customers.[28] Seventh, a bank's security affiliate might unload excessive holdings of a particular stock or security through the trust department of the bank.[29]

After discussing the concerns that prompted the passage of the Glass-Steagall Act, the Court turned to the question of whether the units of participation in the investment fund were "securities" within the meaning of Sections 16 and 21 of the Act. The Court showed in a lengthy analysis that the bank's sale of the units of participation created the same hazards that the Glass-Steagall Act was designed to prevent. The Court concluded that the units of participation therefore were "securities" within the meaning of Sections 16 and 21. Once the units of participation were classified as securities, it followed that the bank had violated Sections 16 and 21 of the Glass-Steagall Act, which prohibited underwriting and dealing in all but specifically exempted securities.

The Court's analysis of the Glass-Steagall Act in *ICI I* set the tone for future judicial and administrative interpretations by tying the issue of violations of the Act closely to the question of policy. Virtually all subsequent judicial and administrative opinions construing the Act contain a lengthy policy analysis.

2. Closed-end Investment Companies and Investment Adviser Activities

The Bank Holding Company Act of 1956, as amended in 1970,[30] regulates the nonbanking interests that a bank holding company may acquire. Section 4(c)(8) of the Act authorizes the FRB to allow holding companies to acquire or retain ownership in companies whose activities "are so closely related to banking or managing or controlling banks as to be a proper incident thereto."[31] In 1972

25. *Id.*
26. *Id.* at 632.
27. *Id.* at 631.
28. *Id.* at 633.
29. *Id.*
30. 12 U.S.C. §§ 841-49 (1982).
31. 12 U.S.C. § 843(c)(8) (1982).

the Federal Reserve Board amended Section 225.25(b) of Regulation Y,[32] which lists the activities that the Board has found to be closely related to banking, to include acting as investment adviser to closed-end and open-end investment companies[33] and sponsoring, organizing, or controlling a closed-end company.[34] The Board, however, did place some restrictions on these activities. The Board determined that:

> In view of the potential conflicts of interest that may exist, a bank holding company and its bank and nonbank subsidiaries should not (i) purchase for their own account securities of any investment company for which the bank holding company acts as investment adviser; (ii) purchase in their sole discretion, any such securities in a fiduciary capacity (including as managing agent); (iii) extend credit to any such investment company; or (iv) accept the securities of any such investment company as collateral for a loan which is for the purpose of purchasing securities of the investment company.[35]

In addition, the Board prohibited a bank holding company from engaging in the sale or distribution of securities of any investment company for which it acted as investment adviser.[36]

Nevertheless, in *Board of Governors v. Investment Co. Institute* (*ICI II*),[37] the Investment Company Institute brought suit against the Board. It challenged the Board's amendment as a violation of Sections 16 and 21 of the Glass-Steagall Act and as exceeding the Board's authority under Section 4(c)(8) of the Bank Holding Company Act. The Supreme Court upheld the Board's amendment of

---

32. 12 C.F.R. § 225.25(b) (1984).

33. The Board has discussed the difference between an open-end investment company (usually referred to as "a mutual fund") and a closed-end investment company:

> Briefly, a mutual fund is an investment company which, typically, is continuously engaged in the issuance of it [sic] shares and stands ready at any time to redeem the securities as to which it is the issuer; a closed-end investment company typically does not issue shares after its initial organization except at infrequent intervals and does not stand ready to redeem its shares.

Board Ruling 4-177, Federal Reserve Regulatory Service, Vol. 1, p. 4.58.

34. The Board found that the Glass-Steagall Act forbids a bank holding company from sponsoring, organizing, or controlling a mutual fund. *Id.*

35. *Id.*

36. *Id.* The Board also placed several other restrictions on these activities. First, officers and employees of a bank subsidiary were prohibited from rendering an opinion regarding the purchase of the investment company's securities. Second, a bank holding company was prohibited from furnishing the names of bank customers to the fund or its distributors. Third, a bank holding company was prohibited from serving as an investment adviser to a mutual fund with offices in a building likely to be identified in the public's mind with the bank holding company. *Id.*

37. 450 U.S. 46 (1981).

Regulation Y.[38] In a direct review proceeding of the Board's action, the court of appeals had held that the amendment did not violate Sections 16 and 21, but that Section 4(c)(8) did not authorize the amendment.[39] The court of appeals reasoned that because the legislative history of the Bank Holding Company Act indicated that Congress perceived the Glass-Steagall Act as an effort to effect as complete a separation as possible between investment and commercial banking, a similar intent should be read into the Bank Holding Company Act. This court then concluded that the activities permitted by the amendment were not consistent with this intent.[40]

The Supreme Court agreed that the investment adviser services approved in the amendment to Regulation Y did not violate Sections 16 and 21 of the Glass-Steagall Act.[41] However, the Court rejected the argument that activities in violation of Sections 16 and 21 could never be regarded as permissible for a bank affiliate under Section 4(c)(8) of the Bank Holding Company Act.[42] The Court found that the investment adviser services would not violate the Section 16 prohibition against banks underwriting securities or purchasing securities for their own account because the Board's interpretations expressly prohibited bank holding companies from engaging in the sale or distribution of securities of any investment company for which they acted as investment advisers and from purchasing securities of the investment company for which they acted as advisers.[43] The Court also found that the Section 21 prohibition applicable to any organization "engaged in the business of issuing, underwriting, selling, or distributing" securities was not applicable to investment adviser services because "[t]he management of a customer's investment portfolio, even when the manager has the power to sell securities owned by the customer—is not the kind of selling activity that Congress contemplated when it enacted Section 21."[44] Instead, that section was intended to require securities firms to sever their banking connections.

The Court then proceeded to explain that even if a bank violates the Glass-Steagall Act by offering investment adviser services, the Act would not necessarily prohibit a bank holding company from offering the same services.[45] It pointed out that Section 20 of the Glass-Steagall Act does not prohibit bank affiliation with a securities

---

38. *Id.* at 78.
39. *See* Investment Co. Inst. v. Board of Governors, 606 F.2d 1004 (D.C. Cir. 1979).
40. *Id.* at 1022-23.
41. 450 U.S. at 58-64.
42. *Id.* at 62-64.
43. *Id.* at 62.
44. *Id.* at 63.
45. *Id.* at 63-64.

firm unless that firm is "engaged principally" in activities such as underwriting.[46]

The Court explained that the Board's restrictions on investment adviser services would eliminate the hazards enumerated in *ICI I*.[47] Finally, the Court rejected the court of appeal's conclusion that an intent to effect as complete a separation as possible between investment and commercial banking should be read into the Bank Holding Company Act. After an extensive review of the legislative history, the Court stated that:

> Nothing in the legislative history of the Bank Holding Company Act persuades us that Congress in 1956 intended to effect a more complete separation between commercial and investment banking than the separation that the Glass-Steagall Act had achieved with respect to banks in §§ 16 and 21 and had sought unsuccessfully to achieve with respect to bank holding companies in § 19(e).[48]

Thus, the Court held that the Board had not exceeded its authority under Section 4(c)(8).

The Board's interpretation of the amendment to Regulation Y permitting bank holding companies to offer investment adviser services reflected careful attention to the analysis of the Glass-Steagall Act in *ICI I*. By prohibiting the holding company from engaging in the sale of the investment company's securities and imposing other restrictions that obviated the hazards discussed in *ICI I*, the Board undoubtedly made it easier for the Supreme Court to uphold the amendment.

3. Collective Investment of Individual Retirement Accounts

In October 1982 the Comptroller approved an application by Citibank to operate trust funds for the collective investment of assets from individual retirement accounts (IRA's).[49] The approval permitted Citibank to act as trustee of the individual IRA's and to invest the IRA assets in one or more trust funds maintained by Citibank. Citibank was to register the funds under the Investment Company Act and to register the offering of interests in the funds under the Securities Act.

The Comptroller admitted that some general similarities did exist between the collective investment of IRA trust assets and the investment fund found in *ICI I* to violate the Glass-Steagall

---

46. *Id.* at 64.

47. *Id.* at 66-67. The Court noted that the Board's restrictions would prevent a bank from extending credit to an investment company and help eliminate the promotional pressures inherent in investment banking. *Id.* at 67.

48. *Id.* at 71.

49. [1982-83 Transfer Binder] FED. BANKING L. REP. (CCH) ¶99,339.

Act. First, both plans involved funds and interests in funds that would be registered with the Securities and Exchange Commission (SEC). Second, "each plan involve[d] the collective investment of participants' assets in a fund maintained for the benefit of the participants as opposed to third-party beneficiaries."[50]

The Comptroller insisted, however, that the two plans should be analyzed differently under the Glass-Steagall Act. He pointed out that in *ICI I*, the Court distinguished the commingling of trust assets for investment efficiencies, which banks have traditionally done, from the commingling of agency accounts and explicitly found the former permissible under the Act. He concluded that because the IRA assets would be received by Citibank as trustee, the collective investment of IRA trust assets was permissible under the Court's analysis of the Act in *ICI I*.[51]

The Comptroller, however, decided to analyze the implications of the Glass-Steagall Act in light of the fact that the IRA trusts and interests in the trusts were to be registered with the SEC. The Comptroller maintained that:

> The Court's conclusion in *ICI v. Camp* was that the issuance and sale of securities by a bank violated the Glass-Steagall Act where the securities represented a nontraditional banking service and where, in the Court's view, certain potential abuses that Congress sought to avoid by the enactment of the Glass-Steagall Act were present.[52]

The Comptroller stressed that he believed the Glass-Steagall Act was not applicable when the securities represented the formal manifestation of a traditional banking service. The Comptroller, however, did analyze the IRA trusts in terms of the hazards identified in *ICI I*.[53] He concluded that the potential for the hazards discussed in *ICI I* to arise was nonexistent or negligible. Thus,

---

50. *Id.* at 86, 370.
51. *Id.* at 86, 372.
52. *Id.*
53. The Comptroller investigated five specific hazards. First, a poorly performing IRA trust fund could conceivably injure Citibank's reputation, but this injury was unlikely in light of the lack of adverse effects on banks' reputations from their involvement in the collective investment of pension fund assets. Second, the Internal Revenue Code bars Citibank from lending to the trust. Third, it was unlikely that Citibank would make loans to a customer to enable them to participate in an IRA trust because of the small annual contribution limitation for these investments. Fourth, in the case of a highly diversified fund, it was unlikely that Citibank would lend to an issuer whose securities were held by the fund just to support the fund. Moreover, the likelihood of this hazard was further reduced by the fact that Citibank's trust department was insulated from confidential information obtained in the commercial lending business. Fifth, in case of a highly diversified fund, it is unlikely that Citibank would render anything but disinterested advice. *Id.* at 86,373-74.

he found that interests in the funds were not securities for purposes of the Glass-Steagall Act.[54]

The Comptroller's ruling raises several interesting questions. First, it is not clear that when the Court found in *ICI I* that it was permissible under the Glass-Steagall Act for a bank to commingle trust funds, it was referring to occasions when a bank markets an investment vehicle to the public. The Court may only have been referring to occasions when a bank as trustee for preexisting trusts commingles the trusts for ease of management.[55] Second, contrary to the Comptroller's analysis, it is not at all clear that Citibank's fund would not give rise to a number of the hazards discussed in *ICI I*.[56] Therefore, it would be possible to find that the interests in Citibank's funds are securities and that Citibank is violating Sections 16 and 21 of the Glass-Steagall Act.

In January 1984 the Comptroller also approved proposals by Wells Fargo Bank and the Bank of California to set up collective investment trusts for IRA assets.[57] The Investment Company Institute has filed suits against the Comptroller in Washington, D.C., and in California, alleging that the collective investment trusts of Citicorp, Bank of America, and Wells Fargo Bank violate the Glass-Steagall Act.[58] The court in the California suit recently held

---

54. *Id.*

55. H. PITT, J. SCHROPP, J. WILLIAMS, THE EVOLVING FINANCIAL SERVICES INDUSTRY: STATUTORY AND REGULATORY FRAMEWORK AND CURRENT ISSUES IN THE BANKING/SECURITIES AREA 104 (1982) [hereinafter cited as "PITT & SCHROPP"].

56. First, although a bank's poor handling of the collective investment of pension fund assets could undoubtedly injure a bank's reputation, Citibank's fund will be offered as an investment vehicle to the public. An individual investor would be more likely to blame Citibank if he believed his investment was being mismanaged than would a beneficiary of a pension fund managed by Citibank because beneficiaries of pension funds might be unaware of what institution managed the fund and the performance of the fund. Second, there was no indication that the investment fund analyzed in *ICI I* was any less highly diversified than Citibank's fund. Yet the Court still discussed the hazard that the bank would lend to an issuer whose securities were held by the fund just to support the fund. Third, this hazard was not eliminated by the fact that Citibank attempted to insulate its trust department from its commercial loan department. The potential still existed for Citibank to breach the insulation and to make loans on this basis. Fourth, Citibank's desire to have its customers invest in these funds could still clash with its obligation to give disinterested investment advice to its customers.

57. *See Bank IRA Funds are Ruled Illegal by Federal Court*, Am. Banker, Aug. 31, 1984, at 1, col. 2 (hereinafter cited as *Bank IRA Funds*).

58. *See* I.C.I. v. Conover (D.D.C. No. 83-0549, complaint filed Feb. 24, 1983); *Bank IRA Funds, supra* note 57, at 1, col. 2. The Washington suit was dismissed without prejudice pending the appeal of A. G. Becker, Inc. v. Board of Governors, 693 F.2d 136 (D.C. Cir. 1982). *See Bank IRA Funds* at 1, col. 2. The court of appeals' holding in the *Becker* case was reversed by the Supreme Court in Securities Indus. Ass'n v. Board of Governors, 104 S.Ct. 2979 (1984), with the Court holding

that the collective investment trusts of Bank of America and Wells Fargo Bank did run afoul of the Glass-Steagall Act.[59] The court found that IRA assets commingled by the banks were received for investment purposes rather than true fiduciary purposes, and that the collective investment trusts gave rise to the potential dangers that result from commercial bank entry into the field of investment banking.[60]

C. Brokerage Activities

1. Automatic Investment Services

Agencies and courts have frequently been called upon to interpret the portion of Section 16 of the Glass-Steagall Act which provides that "[t]he business of dealing in securities and stock by [a bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account."[61] In *New York Stock Exchange, Inc. v. Smith,*[62] a district court was called upon to determine whether an Automatic Investment Service [AIS] violated Sections 16 and 21 of the Glass-Steagall Act. The Comptroller had ruled that the AIS did not violate these sections. The AIS permitted checking account customers to designate a sum of money between $20 and $500 to be deducted automatically from their account each month and invested in one of twenty-five selected securities. The twenty-five stocks available were those having the highest aggregate market value of outstanding stock on Standard & Poor's 425 Industrial Index. The bank made no recommendation as to the merits of any individual stock or the group of stocks as a whole. The customer selected the stocks to be purchased. Stocks purchased under the AIS were held in the name of the bank,

---

that commercial paper is a security for purposes of the Glass-Steagall Act. *See* text accompanying notes 108 to 130, *infra*, for a discussion of the *Becker* litigation. I.C.I. has refiled the Washington suit against the Comptroller. *See Bank IRA Funds* at 1, col. 2. Arguments were presented August 17, and the parties are awaiting a court decision. *Id.*

59. *See Bank IRA Funds, supra* note 57, at 1, col. 2.

60. *Id.*

61. 12 U.S.C. § 24(7) (1982). *See, e.g.*, Securities Indus. Ass'n v. Board of Governors, 716 F.2d 92, 96 (2d Cir. 1983); Securities Indus. Ass'n v. Conover, *Am. Banker*, Nov. 7, 1983, at 5, col. 1; New York Stock Exch., Inc. v. Smith, 404 F. Supp. at 1091 (D.D.C. 1975), *vacated on other grounds sub nom.* New York Stock Exch., Inc. v. Bloom, 562 F.2d 736 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 942 (1978); [1982-83 Transfer Binder] FED. BANKING L. REP. (CCH) ¶99,284, BankAmerica Corporation, 69 FED. RES. BULL. 105 (1983).

62. 404 F. Supp. 1091 (D.D.C. 1975), *vacated on other grounds sub nom.*, New York Stock Exch., Inc. v. Bloom, 562 F.2d 736 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 942 (1978).

but the customer had full beneficial ownership. The customer could vote the shares and would directly receive any dividends paid on them. A customer could withdraw from the plan at any time and receive his stock certificates or their cash value.

The district court began its analysis of the Glass-Steagall issue by pointing out that the bank met the criteria for the portion of Section 16 that permits banks to act as agents for their customers: participants in the AIS had to be checking account customers of the bank; the bank made no claims as to the quality of the stock; all sales or purchases were made at the customer's order; and the customer had full beneficial ownership of the stocks.[63] The court admitted that the Comptroller's early interpretation of Section 16 would have precluded a bank from offering an AIS. Soon after the passage of the Glass-Steagall Act, the Comptroller had ruled that a bank could purchase and sell stock for customers' accounts only if the service was an "accommodation," the customer relationship existed independently of the service, the bank did not engage in the brokerage business, and the bank made no profit on the transactions.[64] The court, however, explained that: "[t]he Comptroller now takes the position that the earliest construction of Section 16 announced by his predecessors embodied an overcautious approach to bank regulation reflecting the [atmosphere] of the years immediately after the 1929 market crash rather than the legislative history of the Act."[65]

The court stated that the legislative history of Section 16 indicated an intention by Congress to leave untouched the agency practice of banks as it had previously developed, and then concluded that the offering of an AIS was consistent with the traditional agency role of commercial banks, and thus, apparently within the scope of the Section 16 exemption.[66] The court explained that it would therefore find that an AIS violated Section 16 only if it gave rise to the hazards discussed in *ICI I*. Because the court found that the AIS did not give rise to these hazards,[67] it held that the AIS did not violate Section 16 of the Glass-Steagall Act.[68]

---

63. *Id.* at 1097.
64. *See* 1 Bulletin of the Comptroller of the Currency, No. 2, 1935, at 2-3.
65. 404 F. Supp. at 1097.
66. *Id.* at 1098.
67. *Id.* at 1099-1100.
68. *Id.* at 1101. The plaintiffs also argued that AIS constituted a security as defined by the Supreme Court in SEC v. W. J. Howey Co., 328 U.S. 293 (1946), and its progeny. The court summarily rejected that argument. 404 F. Supp. at 1101. It stressed that the Supreme Court's opinion in *ICI I* defined "security" in terms of the Glass-Steagall Act and did not make a single "reference to *Howey* or its progeny." It also pointed out that the Securities Act and the Glass-Steagall Act each have "a different legislative history and . . . underlying policies." *Id.*

In *New York Stock Exchange, Inc. v. Bloom*,[69] the court of appeals vacated the district court's decision and remanded the case to the district court with instructions to dismiss on the grounds that the agency action was not ripe for judicial review. The case, however, demonstrates that by the 1970's the agencies and courts had rejected the earlier, more cautious interpretations of what brokerage activities a bank could engage in under Section 16.

2. Brokerage Subsidiaries of National Banks and Bank Holding Companies

a. National Banks

In August 1982 the Comptroller approved an application from Security Pacific National Bank (Security Pacific) to offer discount brokerage services through a new subsidiary, Security Pacific Discount Brokerage Services, Inc. (Security Pacific Brokerage).[70] Security Pacific Brokerage was called a "discount brokerage" because it was to give no investment advice. Instead, it would engage in the purchase and sale of all types of securities, solely as agent on behalf of its customers. The commissions that it would charge would typically be significantly lower than those charged by full-service brokerage firms offering investment advice. Security Pacific Brokerage would also provide margin loans to customers and pay interest on credit balances. It planned to offer these services at Security Pacific's branch offices throughout California and eventually at non-branch locations inside and outside California. Security Pacific Brokerage was to be a registered broker-dealer under the Securities Exchange Act of 1934.

The Comptroller maintained that there was clear authorization for banks and their subsidiaries to engage in activities proposed by Security Pacific Brokerage, because "on its face, the Glass-Steagall Act permits those securities purchases and sales for customers in which the bank acts in the capacity of agent (i.e., brokerage transactions), while generally prohibiting purchases and sales by banks acting as principal."[71] The Comptroller then discussed his office's earlier, more narrow interpretations of Section 16 and noted that his office's later rejection of these interpretations was accepted by the district court in *New York Stock Exchange, Inc. v. Smith*.[72]

The Comptroller also explained that "various statements by the Supreme Court in cases addressing Glass-Steagall Act issues

69. 562 F.2d 736 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 942 (1978).
70. [1982-83 Transfer Binder] FED. BANKING L. REP. (CCH) ¶99,284.
71. *Id.*
72. 404 F. Supp. at 1091.

suggest that the express language of the Act is the primary factor in any analysis and that securities brokerage activities by banks are not proscribed by the Act."[73] The Comptroller first looked at the Court's analysis in *ICI I*. He maintained that in *ICI I* the Court found that the bank's investment fund violated the Glass-Steagall Act because the fund contravened the express language of Section 16 and the fund subjected the bank to the hazards that Congress had sought to prevent. The Comptroller also pointed out that the Court distinguished the investment fund from permissible activities, including purchases as agent for customers of securities. The Comptroller then looked at the Court's analysis in *ICI II*. The Comptroller maintained that the Court could find no prohibitions of the challenged activities in the Glass-Steagall Act and thus, rejected arguments based solely on broad policy statements. He noted that:

> [t]he Court went on to explain that the analysis of the risks presented in the earlier case [*ICI I*] was necessary only to respond to argument on behalf of the bank that despite the literal prohibition of the conduct then at issue it was not the intent of Congress to prohibit it.[74]

The Comptroller added that in *ICI II* the Court had reiterated its earlier views that purchases of securities as agent for customers were permissible under the Glass-Steagall Act.

The Comptroller then discussed the language in the legislative history of the Glass-Steagall Act that national banks were authorized by Section 16 to engage in securities brokerage transactions "to the same extent as heretofore."[75] The Comptroller explained that "this language appears only to have meant generally that the ability of national banks to engage in brokerage transactions was to be subject to no additional constraints after the enactment of the Glass-Steagall Act beyond those applicable before its enactment."[76] The Comptroller maintained that this analysis was adopted by the district court in *New York Stock Exchange, Inc. v. Smith*[77] because the court had concluded that even if an AIS created more extensive bank involvement in the brokerage business than existed prior to 1933, then the AIS was not prohibited by the statutory language or the legislative history if it "did not give rise to risks materially different from those normally associated with brokerage transactions."[78] The Comptroller applied the same analysis to the incidental services that Security Pacific Brokerage

73. [1982-83 Transfer Binder] FED. BANKING L. REP. (CCH) ¶99,284.
74. *Id.* at 86,256.
75. *Id.*
76. *Id.*
77. 404 F. Supp. at 1091.
78. [1982-83 Transfer Binder] FED. BANKING. L. REP. (CCH) ¶99,284.

planned to offer and found that they did not exceed the statutory authorization in Section 16 because Security Pacific Brokerage maintained its agency status in the transactions.[79] Finally, the Comptroller concluded that the phrase "engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities" in Sections 20 and 32 of the Glass-Steagall Act did not include securities brokerage activities of a company.[80]

After the Comptroller released his decision, the Securities Industry Association (SIA) filed suit, alleging that the Comptroller's decision should be set aside since it was in excess of statutory authority. The district court, however, upheld the Comptroller's determination on the Glass-Steagall issues.[81] The SIA had argued that Section 21 established an unyielding barrier between commercial and investment banking, except for the narrow exception in Section 16 for brokerage activities. It argued that this exception permitted brokerage activities only to accommodate existing bank customers. The court rejected this argument. It found that the phrase " 'for the account of customers' does not limit bank brokerage activity to existing customers, but serves to distinguish such activity from the buying and selling of securities by the bank for its own account."[82]

The court also found support for its holding in the language of Section 20 of the Glass-Steagall Act. The court interpreted the prohibition of Section 20 as being "clearly aimed at the investment banking business by which large blocks of securities newly-issued by corporations are bought by investment banks for resale to the public,"[83] a fundamentally different activity from brokerage activities in which the broker buys and sells only as agent and for the account of the customer. In addition, the court found that the requirement in Section 16 that bank purchases of securities be "without recourse" did not prohibit brokerage activity by bank subsidiaries.[84]

---

79. *Id.* at 86,258.

80. *Id.*

81. *See* Securities Indus. Ass'n v. Conover, *Am. Banker*, Nov. 7, 1983, at 5, col. 1.

82. *Id.*

83. *Id.*

84. *Am. Banker*, Nov. 7, 1983, at 10, col. 2. Although the court found that Security Pacific's creation of the Security Pacific Brokerage would not violate the Glass-Steagall Act, it held that the opening of offices of Security Pacific Brokerage outside of California would be a violation of Section 36 of the McFadden Act, 12 U.S.C. § 36 (1982), because "an office of a national bank for the conduct of discount brokerage activities is a 'branch' within the definition of Section 36(f) of the McFadden Act, subject to state law restrictions on the establishment of bank branch offices." *Id.* at 12, col. 5.

b. Bank Holding Companies

In January 1983 BankAmerica Corporation received the Federal Reserve Board's approval under Section 4(c)(8) of the Bank Holding Company Act and Section 225.4(b)(2) of Regulation Y to acquire 100 percent of the voting shares of the Charles Schwab Corporation, a wholly-owned subsidiary of which was Charles Schwab & Co., Inc. (Schwab).[85] Schwab was a retail discount securities brokerage firm with offices in twenty-six states and the District of Columbia. The Board described Schwab's activities fully:

> Schwab buys and sells securities solely as agent, on the order and for the account of customers. Schwab does not purchase or sell securities for its own account except to an insignificant extent, does not engage in dealing or underwriting, and gives no investment advice. Schwab characterizes itself as a "discount" broker because its commissions are significantly lower than those charged by full-line brokers. In addition to brokerage services, full-line brokers offer investment advice. A Schwab customer is not assigned a personal representative but deals with any available representative, who in many cases enters the customer's order in an automated execution system, which can execute the order in as short a time as thirty seconds.
>
> Schwab also extends credit for the purchase and carrying of securities and provides securities custodial services and various other services related to maintaining customer accounts, such as individual retirement accounts, a "sweep" arrangement with an unaffiliated money market mutual fund, payment of interest on net free balances awaiting investment, and third-party payment services.[86]

The SIA and other commentators argued that the acquisition of a securities brokerage firm by a bank holding company violated both the Glass-Steagall Act and the Bank Holding Company Act. The Board found that the acquisition of Schwab did not violate Section 20 of the Glass-Steagall Act because Schwab was not "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities."[87] The Board admitted that Bank of America, a member bank and the bank subsidiary of BankAmerica, would become affiliated with Schwab for purposes of Section 20.[88] However, the Board rejected the argument that Schwab was engaged principally in the "public sale" of securities because of its retail brokerage activities. Instead, it found that

85. BankAmerica Corporation, 69 FED. RES. BULL. 105 (1983).
86. *Id.* at 106.
87. *Id.* at 114.
88. *Id.*

brokerage activities did not constitute the "public sale" of securities for purposes of Section 20.[89]

In addition, the Board pointed out that Section 32 of the Glass-Steagall Act prohibits managerial interlocks between a member bank and a firm primarily engaged in the same securities activities described in Section 20, and that Regulation R, which implements the provisions of Section 32, provides that "[a] broker who is engaged solely in executing orders for the purchase and sale of securities on behalf of others in the open market is not engaged in the business referred to in Section 32."[90] The Board reasoned that because Sections 20 and 32 were part of the same statute and enacted for the same purpose, the meaning of "public sale" should be consistent within the two sections.[91] Finally, the Board determined that BankAmerica's acquisition of Schwab was not inconsistent with the purposes of the Glass-Steagall Act.[92]

In *Securities Industry Association v. Board of Governors*,[93] the court of appeals affirmed the Board's approval of BankAmerica's acquisition of Schwab. The analysis by the court of appeals closely resembled that of the Board. In addition, the court rejected the SIA's argument that, when interpreted together, Sections 16 and 20 prohibit a bank holding company from engaging in brokerage activities that are prohibited to banks. The court rejected this argument for three reasons: first, the Comptroller had rejected his office's earlier, more restrictive interpretations of Section 16 and had permitted a national bank to create a subsidiary that would offer brokerage services; second, Congress used very different language in Sections 16 and 20; and third, the congressional intent

89. *Id.* at 115.

90. 22 FED. RES. BULL. 51 (1936), codified at 12 C.F.R. § 218.1 (1984).

91. The SIA and other commentators had also argued that Bank of America's acquisition of Schwab would violate Section 16 of the Glass-Steagall Act, and thus, should not be permitted by BankAmerica, an affiliate of Bank of America. The Board pointed out that the fact that a bank was precluded from engaging in an activity did not mean that a bank holding company could not engage in that activity, citing *ICI II*. BankAmerica Corporation, 69 FED. RES. BULL. 105, 115 (1983). The court, however, then noted the brokerage exception in Section 16 and the Comptroller's approval for Security Pacific to establish a subsidiary to engage in brokerage services substantially the same as those provided by Schwab. *See* text accompanying notes 43 to 55 *supra*.

92. The Board found that the hazards addressed in *ICI I* were not present in connection with Schwab's activities. First, Schwab did not purchase or sell securities as a principal; second, Schwab did not have any interest in the success or failure of any particular issue of securities; third, the likelihood of harm to the reputation of Bank of America as a result of this proposal was minimal because Schwab did not actively promote any particular security and did not offer investment advice. BankAmerica Corporation, 69 FED. RES. BULL. 105, 116 (1983).

93. 716 F.2d 92 (2d Cir. 1983).

revealed that banks are to be treated differently from their affiliates under the Glass-Steagall Act because bank affiliates under Section 20 can engage in underwriting and dealing so long as they are not principally so engaged.[94]

In *Securities Industry Association v. Board of Governors*, the Supreme Court affirmed the decision of the court of appeals.[95] The court held that BankAmerica's acquisition of Schwab under Section 4(c)(8) of the Bank Holding Company Act did not violate the Glass-Steagall Act.[96] The Court based its affirmation on three major points that the Board had stressed in its initial approval. First, the term "public sale" in Section 20 of the Glass-Steagall Act refers to underwriting activity and not to the type of retail brokerage business in which Schwab engages. Second, because Sections 20 and 32 of the Glass-Steagall Act are part of the same statute and enacted for the same purpose, the meaning of "public sale" should be consistent within the two sections. Third, the "subtle hazards" of underwriting identified in *ICI I* are not created by the type of retail brokerage business in which Schwab engages.[97]

After the Court had affirmed the Board's approval of BankAmerica's acquisition of Schwab, the Board amended Section 225.25(b) of Regulation Y to include securities brokerage services in the list of activities found to be closely related to banking.[98] The amendment makes clear that the brokerage services are restricted to activities as agent and cannot include investment advice. The issue of whether national banks and bank holding companies can offer full-service brokerage activities still has not been resolved.[99]

The current controversy over the solicitation of public business for brokerage services by banks and bank holding companies arose because banks re-entered an activity long believed to be forbidden to them. The Comptroller had rejected an earlier Comptroller's restrictive interpretation of Section 16 of the Glass-Steagall Act, and the Board had never issued interpretations that would have

---

94. *Id.* at 99-100.
95. 104 S.Ct. 3003 (1984).
96. *Id.*
97. *Id.*
98. Section 225.25(b)(15) adds as a permissible activity:
providing securities brokerage services, related securities credit activities pursuant to the Board's Regulation T (12 C.F.R. Part 220), and incidental activities such as offering custodial services, individual retirement accounts, and cash management services, *provided* that the securities brokerage services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing or investment advice or research services.
99. *See* text accompanying notes 68-71 *supra*.

prohibited a bank holding company from soliciting public business for brokerage services, but banks and bank holding companies still refrained from doing so, even after changes in stock exchange rules in the mid-1970's made this solicitation possible.[100] When, because of increased competition in the financial marketplace, banks and bank holding companies sought approval to solicit public business for brokerage services, representatives of the securities industry attempted to block approval on the ground that this activity violated the Glass-Steagall Act.[101] At this point, the agencies and courts had to determine whether an activity that banks and holding companies had traditionally refrained from was actually prohibited to them.

c. Investment Advice

In March 1983 the Comptroller authorized American National Bank of Austin, Texas, to establish Mpact Brothers, a discount brokerage service.[102] In September 1983 the Comptroller authorized American National to establish Mpact Securities Corp.,[103] a subsidiary that would advise clients, including those trading securities through Mpact Brothers, on investments, distribute an investment advisory newsletter, and provide certain advisory services for corporate customers and correspondent bank trust departments. The Comptroller found that the investment advisory activity did not violate the Glass-Steagall Act when considered either alone or in conjunction with Mpact Brothers' brokerage activity. The Comptroller explained that:

> Providing investment advice has historically been recognized as a banking service. The types of advice proposed by the bank are consistent with traditional forms. Moreover, because the bank currently offers substantial amounts of investment advice and portfolio management services in its trust department, it has demonstrated the capacity to provide these types of advice.[104]

The Comptroller also noted that Section 16 of the Glass-Steagall Act prohibited banks from issuing, underwriting, selling, or

---

100. *See* Kaufman, *supra* note 4.

101. *See* Securities Indus. Ass'n v. Board of Governors, 716 F.2d 92 (2d Cir. 1983); Securities Indus. Ass'n v. Conover, *Am. Banker*, Nov. 7, 1983, at 5, col. 1; [1982-83 Transfer Binder] FED. BANKING L. REP. (CCH) ¶99,284; BankAmerica Corporation, 69 FED. RES. BULL. 105 (1983).

102. *See Breach Widened in Barrier to Bank-Brokerage*, Am. Banker, Sept. 9, 1983, at 3, col. 3.

103. *Id.*

104. *Id.*

distributing securities, and that this was not the type of language that would be used to describe an investment adviser.[105]

The SIA has announced plans to sue the Comptroller over this decision.[106] The SIA argues that even though American National's brokerage subsidiary and investment advisory subsidiary will be separate, American National will be offering both services to the same customer group, so the bank will be both advising customers and executing trades based on this advice. The Comptroller's authorization for American National to establish an investment advisory subsidiary, when coupled with the Comptroller's earlier authorization for American National to establish a discount brokerage subsidiary, appears to pave the way for a national bank to establish a full-service brokerage subsidiary. The courts will have to consider the additional hazards to the bank when investment advice is offered, such as the chance that the bank's reputation might be jeopardized because of advice given.[107]

---

105. *Id.*

106. *See Securities Group Maps Fight over Bank Gains*, Am. Banker, Oct. 14, 1983, at 3, col. 2.

107. The expansion of banks into brokerage activities has prompted the SEC to issue for public comment a proposed rule that specifies bank securities activities that must be performed through broker-dealers registered under the Securities Exchange Act of 1934. *See* 48 Fed. Reg. 51,930 (1983). Sections 3(a)(4) and (5) of the Act, 15 U.S.C. §§ 78c(a)(4) and (5), provide that the terms "broker" and "dealer" do not include a "bank." Proposed SEC Rule 3b-9 provides that, for purposes of the "broker" and "dealer" definitions, the term "bank" does not include a bank that engages in certain securities activities. These activities include a bank that does any of the following:

> [a] Publicly solicits brokerage business; [b] Receives transaction-related compensation for providing brokerage services for trust, managing agency, or other accounts to which the bank provides advice; [c] Deals in or underwrites securities other than exempted or municipal securities.

Id. at 51,932. The proposed rule requires that these activities be performed through a broker-dealer registered with the SEC and subject to the same rules and regulations as the others who engage in the activities. The bank itself would not need to register as a broker-dealer if the activities were conducted by a bank subsidiary or affiliate.

The SEC explained the rationale for the proposed rule:

> The Commission believes that in enacting the bank exclusion, the Congress did not contemplate that banks would publicly solicit brokerage business, receive transaction-related compensation for providing brokerage services for trust, managing agency or other accounts to which the bank provides advice, or deal in or underwrite (on either a best efforts or firm commitment basis) securities other than exempted securities or municipal securities. There is no persuasive evidence that Congress intended to permit banks to engage in those types of securities activities without being subject to the broker-dealer regulatory requirements imposed on others who engage in such activities.

Id. at 51,931. The SEC also noted that it was not expressing any views on the legality of particular bank securities activities under the Glass-Steagall Act.

D. Underwriting and Securities Placement

1. Commercial Paper

In the summer of 1978, Bankers Trust Company of New York (Bankers Trust), a state member bank of the Federal Reserve System, began offering for sale third-party commercial paper. Commercial paper is unsecured, short-term promissory notes issued by large business firms.[108] This activity was challenged as a violation of the Glass-Steagall Act by A. G. Becker, Inc., a securities broker, and the SIA, because Section 16 of the Glass-Steagall Act, with limited exceptions, prohibits a member bank from underwriting any security and Section 21 prohibits any organization engaged in the business of issuing, underwriting, selling, or distributing stocks, notes, or other securities from engaging at the same time in the business of receiving deposits. In June 1979 the Board concluded that, subject to certain limitations, state member banks could sell third-party commercial paper.[109] Thereafter, A. G. Becker, Inc., and the SIA filed suit to challenge the Board's determination. The district court in *A. G. Becker, Inc. v. Board of Governors*[110] found that commercial paper was in fact a "note or other security" for purposes of the Glass-Steagall Act, and thus held that the Board's determination was contrary to law.

The district court based its holding on three points. First, the Supreme Court in *ICI II* specified that courts must rely on the literal language of Sections 16 and 21 of the Glass-Steagall Act, and the literal language of Section 21 made it impossible to dispute that commercial paper was "a note or other security" as defined in that section.[111] Second, the district court found it relevant that commercial paper is a security for purposes of the Securities Act

---

108. As one commentator has explained:

> Commercial paper consists of unsecured, short-term promissory notes issued by sales and personal finance companies; by manufacturing transportation, trade, and utility companies; and by the affiliates and subsidiaries of commercial banks. The notes are payable to the bearer on a stated maturity date. Maturities range from one day to nine months, but most paper carries an original maturity between thirty and ninety days. When the paper becomes due, it is generally rolled over—that is, reissued—to the same or a different investor at the market rate at the time of maturity.

Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1972).

109. *See* LEGAL DIVISION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, COMMERCIAL PAPER ACTIVITIES OF COMMERCIAL BANKS: A LEGAL ANALYSIS (1979).

110. 519 F. Supp. 602 (D.D.C. 1981).

111. *Id.* at 613.

of 1933, which includes "any note" in the definition of security.[112] Third, the district court rejected the Board's "functional analysis" of commercial paper, in which the Board had found that the bank's sale of third-party commercial paper was functionally the equivalent of a commercial loan.[113]

The district court's holding was reversed on appeal to the District of Columbia Court of Appeals.[114] In describing Bankers Trust's sale of third-party commercial paper, the court of appeals noted that the third-party issuers had the highest rating from at least one of the rating services for commercial paper issuers.[115] It also noted that the customers for the third-party commercial paper were part of the bank's established base of institutional investors.[116]

The court of appeals rejected the district court's literal interpretation of Sections 16 and 21 of the Glass-Steagall Act. The court found that Sections 16 and 21 revealed a fundamental distinction between notes that arise from commercial banking transactions and securities such as investment notes. The court ruled that notes arising from commercial banking transactions are not recognized as securities. The court ruled that these notes and securities are permitted under the Glass-Steagall Act, while banks are prohibited from underwriting investment notes.[117] The court also found that the commercial paper market was not part of the problem which the Glass-Steagall Act addressed.[118]

The court of appeals also rejected the district court's assertion that the definition of "security" under the federal securities laws was relevant to the Glass-Steagall Act's definition of "security." Since the purpose of the federal securities laws was to protect investors, and the purpose of the Glass-Steagall Act was to protect the integrity of banks and the financial resources of depositors,[119] different meanings had to be assigned to the term "security" in the two laws.

The court of appeals then accepted the Board's "functional analysis" of commercial paper that the district court had rejected:

> Because neither the literal language of the statute nor other expressions of congressional intent available to us directly indicate whether commercial paper is a "security," it is necessary to conduct a "functional analysis" of Bankers Trust's commercial paper

112. *Id.* at 615.
113. *Id.*
114. A. G. Becker, Inc. v. Board of Governors, 693 F.2d 136 (D.C. Cir. 1982).
115. *Id.* at 138.
116. *Id.*
117. *Id.* at 144.
118. *Id.* at 145-46.
119. *Id.* at 146-47.

> to resolve this question. The problem becomes whether classifying commercial paper as a "security" would further the policies of the Act.[120]

The court agreed with the Board's conclusion that commercial paper has the economic characteristics of a loan. The court stressed that "[t]he commercial lender extends *short-term* credit to businesses to finance immediate needs for working capital"[121] and that "the commercial bank carefully evaluates the credit-worthiness of the borrower and the borrower's representations as to the use of funds."[122] The court also noted that the default rate on commercial paper was extremely low because only corporations with excellent bond ratings could market commercial paper; the third-party commercial paper that Bankers Trust sold was, like most commercial loans, of very short maturity; and Bankers Trust placed its third-party commercial paper with sophisticated institutional investors who could evaluate the risk.[123] The court therefore concluded that Bankers Trust's activities in commercial paper were far less risky than securities underwriting and even less risky than ordinary commercial lending. Finally, the court concluded that the sale by Bankers Trust of third-party commercial paper did not threaten the bank with those hazards that the Glass-Steagall Act was designed to prevent.[124]

The court of appeals, however, did limit its holding. It noted that if the third-party commercial paper were issued in smaller quantities, or to the general public, it might be a "security" under the Glass-Steagall Act.[125] During the course of this litigation, the

---

120. *Id.* at 147.
121. *Id.* at 148 (emphasis in original).
122. *Id.* at 149.
123. *Id.*
124. *Id.* at 150-51.
125. The court's holding was subject to a vigorous dissent. First, the dissent rejected the analogy between commercial lending and the sale of third party commercial paper. *Id.* at 152-53. Second, the dissent disputed the majority's conclusion that Bankers Trust's sale of third-party commercial paper did not threaten the bank with the hazards that the Glass-Steagall Act was designed to prevent. *Id.* at 153. Third, the dissent reasoned that a literal reading of Sections 16 and 21 of the Act demanded that the third-party commercial paper be classified as a note or security. *Id.* at 155. The dissent recommended that the case be remanded to the district court for consideration of whether Bankers Trust's sale of the third-party commercial paper constituted prohibited underwriting.

The dissent used as an example the Penn Central Transportation Company's default on $82.5 million in commercial paper when it entered bankruptcy in 1970. First, it pointed out that Bankers Trust did at times enter into commitments to purchase unsold commercial paper, and that the purchase of Penn Central's commercial paper would have harmed the bank. *Id.* at 153-54. Second, the collapse of Penn Central was an example of how a bank might be tempted to make loans

Board issued a Policy Statement on the Sale of Third-Party Commercial Paper by State Member Banks.[126] This policy statement incorporated the limitations of the holding and stipulated that banks could sell only prime-quality commercial paper that qualified for the exemption provided by Section 3(a)(3) of the Securities Act of 1933 (15 U.S.C. § 77c(a)(3)), banks could sell commercial paper only to financially sophisticated customers, and banks could only sell commercial paper in denominations of over $100,000.[127]

The court of appeal's analysis raises a number of questions regarding the application of the Glass-Steagall Act to Bankers Trust's sale of third-party commercial paper. The court's conclusion that the definition of "security" under the federal securities laws is irrelevant to the definition of securities under the Glass-Steagall Act is probably accurate. Courts applying the Glass-Steagall Act have consistently defined the term "security" in light of the purposes behind the Act.[128] The court's conclusion that Sections 16 and 21 reveal a fundamental distinction between notes that represent commercial banking transactions and securities, such as investment notes, however, is questionable. The language of the statute does not appear to reveal this distinction, and the Supreme Court stressed in both *ICI I* and *ICI II* that the language of the Act should be read literally. The functional analysis by which the court of appeals determined that Bankers Trust's sale of third-party commercial paper was essentially like commercial lending is also highly questionable. As the dissent pointed out, the court appeared to define "commercial lending" to include the sale of third-party commercial paper.[129] Finally, the court greatly downplayed the hazards to the bank, over the objections of the dissent.[130]

In *Securities Industry Association v. Board of Governors*, the Supreme Court did conclude that commercial paper is a "security" under the Glass-Steagall Act and reversed the judgment of the court of appeals.[131] The Court based its reversal primarily on six points. First, legislation passed in the early 1930's designed collectively to restore public confidence in financial markets, which includes the Glass-Steagall Act and the Securities Act of 1933, in-

to shore up an issuer whose commercial paper it handled. *Id.* at 154. Third, a bank's reputation might be severely harmed due to its association with commercial paper, because the institutional investors who purchased commercial paper were among the bank's most influential customers, and the Penn Central collapse revealed that these investors could be stuck with millions of dollars of worthless commercial paper that they had purchased from the bank. *Id.*

126. *See* Policy Statement on Sale of Third Party Commercial Paper by State Member Banks, 67 FED. RES. BULL. 494 (1981).

127. *Id.*

128. *See* note 42 *supra.*

129. 693 F.2d at 152-53 (Robb, J, dissenting).

130. *Id.* at 153.

131. 104 S.Ct. 2979 (1984).

dicates a congressional understanding that the term "security," unless modified, includes commercial paper. Second, the Glass-Steagall Act does not draw a distinction between notes it covers and notes it does not cover. Thus, the Court felt compelled to reject the Board's functional analysis. Third, the "subtle hazards" of underwriting identified in *ICI I* are present when a commercial bank has a pecuniary interest in promoting commercial paper. Fourth, the Board focused on the extremely low rate of default on prime-quality commercial paper, but the Court pointed out that Congress did not intend the prohibitions on underwriting to depend on the safety of particular securities. Fifth, the Court did not find it relevant that banks purchased commercial paper for their own account. Sixth, the Court stressed that the Glass-Steagall Act makes no exception according to the investment expertise of a customer.[132] The Court remanded the case to the court of appeals for consideration of whether Bankers Trust's sale of third-party commercial paper constituted underwriting the purposes of the Glass-Steagall Act.[133]

2. Private Placement

The private placement of securities by banks raises issues under the Glass-Steagall Act. Private placement of securities involves the sale of a new securities issue directly by the issuer to one or a small group of large investors.

> This process is often cheaper than the more usual public underwriting, since it bypasses some or all of the middleman, does not require SEC registration, and can be completed quickly. Registration is waived because large investors are presumed to be sufficiently knowledgeable and informed about the issue, from both their own investigations of as well as their negotiations with the issuer and to be aware of the risks involved. Security issuers often use the services of an intermediary to help originate the security, locate promising investors, and negotiate financing terms. Larger banks have increasingly offered this service at a fee.[134]

In 1977 the Federal Reserve Board issued a study which concluded that "while the answers are not completely free from doubt, the stronger case would support a conclusion that private placement activities are not prohibited either by Sections 21(a)(1) or 16 of the Glass-Steagall Act."[135] The study relied upon the definition of "underwriting" in the Securities Act and concluded that banks

132. *Id.* at 2984-92.
133. *Id.* at 2992.
134. *See* Kaufman, *supra* note 4.
135. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, COMMERCIAL BANK PRIVATE PLACEMENT ACTIVITIES 81 (1977).

involved in the private placement of securities were not engaged in underwriting in violation of the Glass-Steagall Act because the banks did not purchase securities for resale to third parties.[136] The Board also found that the involvement of commercial banks in private placement activities did not create the hazards that the Glass-Steagall Act was designed to prevent. The Board pointed out that in private placement activities a bank did not purchase any securities for its own account (thus, the bank would not be risking its own assets), and because potential investors were sophisticated individuals who used their own investment judgment, the bank did not face the promotional pressures that were present in a public offering.[137]

Soon after the Board released its study, the Comptroller issued his opinion on private placement activities.[138] The Comptroller found that the Glass-Steagall Act did not prohibit private placement activity as conducted by commercial banks.[139] He explained that his opinion was based on the language and history of the Act and on the lack of any dangers or serious conflicts associated with private placement activity.[140] The Comptroller found that in private placements, sophisticated investors do not enter into agreements until after consideration of relevant data, but in public securities markets, securities issues were often aggressively sold to unsophisticated investors. Thus, he concluded that conflicts of interest might arise in the public securities market that justified pervasive regulation, although similar justification did not exist for the regulation of private placement activity.[141]

The SIA recently announced plans to challenge private placement activity as a violation of the Glass-Steagall Act, alleging that Bankers Trust acted as underwriter for $70 million of Louisiana

136. *Id.* at 91.

137. *Id.*

138. *Propriety of National Bank Private Placement Activity in Light of the Glass-Steagall Act* [1978-79 Transfer Binder] FED. BANKING L. REP. (CCH) ¶85,107.

139. *Id.*

140. *Id.*

141. *Id.* at ¶ 77,104. In 1981 the Comptroller answered an inquiry regarding private placement activities. The bank proposed to provide advisory services in connection with a private placement of an industrial revenue bond and to issue a standby letter of credit to support the industrial revenue bond in question. The Comptroller found that this arrangement would not violate the Glass-Steagall Act. He explained that:

> The credit risk inherent in a standby L/C [letter of credit] is the kind of risk that commercial banks are equipped to evaluate and which can be monitored through the periodic examinations by their regulatory agencies. Also, the standby commitment would not require the Bank to assume directly any market risk for the underlying securities.

Guarantee of Bank Affiliate Liabilities Not Subject to Limitations of 12 U.S.C. § 2 [1981-82 Tranfer Binder] FED. BANKING L. REP. (CCH) ¶85,293 (Sept. 25, 1981).

Land and Exploration Co. debt securities and solicited orders for these notes from a large number of institutional investors.[142] Thus, this offer was not a private placement because the notes were offered to a large number of institutions and no investment intent letters were obtained.

E. Establishment of Banks by Securities Firms

Recently, the Comptroller has allowed several securities firms to create bank subsidiaries. The Comptroller's analysis of the Glass-Steagall issues involved has resulted in disputes with the Federal Reserve Board over the application of the Act.

In February 1983 the Comptroller issued a charter to establish the J. & W. Seligman Trust Company, N.A. (Seligman Bank).[143] The activities of the Bank were to be limited to fiduciary services of a trust company. The six organizers of the Bank were all associated with J. & W. Seligman & Co., Inc. (Seligman Co.), and the Bank was to be a wholly-owned subsidiary of Seligman Co., which served as investment advisor to six open-end mutual funds and one closed-end fund. These funds are referred to as the Seligman Group of Investment Companies. Seligman Co. had two wholly-owned subsidiaries, J. & W. Seligman & Co. Marketing, Inc. (Seligman Distributor) and Seligman Securities, Inc. (Seligman Securities). Seligman Distributor was the general distributor for the advised funds and acted as agent for the funds in selling their shares. Seligman Securities acted primarily as a broker and it handled the placement of orders for the Seligman Group of Investment Companies and Seligman Co.

Because Seligman Bank and Seligman Co. were to have common officers, directors, and employees, the Comptroller had to decide whether the arrangement would violate Section 32 of the Glass-Steagall Act. The relevant activities for a Section 32 analysis are "the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds or similar securities. . . ."[144] The Comptroller first pointed out the 1973 Federal Reserve Board ruling that: "Section 32 does not prohibit persons primarily engaged in the securities business from serving on the board of directors or on committees appointed by the board of directors of a limited-purpose trust company that does not offer significant commercial bank services."[145]

---

142. *See Securities Group Maps Fight Over Bank Gains*, Am. Banker, Oct. 14, 1983, at 3, col. 2.

143. *See OCC Approves National Bank Charter for Trust Company Owned by Mutual Fund Advisor and Broker* [1982-83 Tranfer Binder] FED. BANKING L. REP. (CCH) ¶99,463 (Feb. 11, 1982) (hereinafter cited as *Advisor and Broker*).

144. 12 U.S.C. § 78.

145. Board Ruling 3-932, Federal Reserve Regulatory Services, Vol. 1, p.

The Comptroller found that, even without this exception, the arrangement would not violate Section 32 because Seligman Co., Seligman Distributor, and Seligman Securities considered together as a single entity were not "primarily engaged" in Section 32 activities.[146] The Comptroller explained that beginning in 1963 the Federal Reserve Board had made use of the single entity doctrine, under which the separate corporate existence of a subsidiary is disregarded for the purpose of determining a Section 20 or Section 32 violation.[147] The Comptroller further described the effect of this doctrine when analyzing a possible Section 20 violation:

> The single entity theory is applicable here because Distributor performs only activities which could be performed by Seligman Co. itself (and would, if so performed, obviate any Section 20 problems because of the small amount of Section 20 activities vis-a-vis other activities), and because Distributor's activities are performed on behalf of Seligman Co. to facilitate its investment advisory business. Furthermore, Distributor's incorporation as a separate subsidiary serves to minimize state taxation, to facilitate state licensing, and to enhance marketing efforts. These are all legitimate business reasons for using the subsidiary approach and as such should not have any effect on the Glass-Steagall analysis. Accordingly, the proposed charter would not violate Section 20.[148]

To determine whether Seligman Co. and its two subsidiaries were "primarily engaged" in Section 32 activities, the Comptroller relied upon the definition of "primarily engaged" in *Board of Governors v. Agnew*,[149] in which the Supreme Court had explained that: "An activity or function may be 'primary' in that sense if it is substantial. If the underwriting business of a firm is substantial, the firm is engaged in the underwriting business in a primary way, though by any quantitative test underwriting may not be its chief or principal activity."[150] The Court then held that a firm which received between 26 percent and 39 percent of its gross income from underwriting activities was "primarily engaged" in underwriting within the meaning of Section 32.[151] The Comptroller also noted that the Federal Reserve Board, to consider a firm as "primarily engaged in Section 32 business, required that it derive

---

3.388. *See also* Board Ruling 3-934, Federal Reserve Regulatory Service, Vol. 1, p. 3.388 ("Securities Company Employee Serving on Trust Company Board of Directors.")

146. *See Advisor and Broker, supra* note 139, at ¶86,602.
147. 12 C.F.R. §§ 218.107(g) & (h)(1984).
148. *See Advisor and Broker, supra* note 143, at ¶99,463.
149. 329 U.S. 441 (1947).
150. *Id.* at 446.
151. *Id.* at 445-49.

either $10 million of revenues or close to 10 percent of its income from such business."[152] The Comptroller found that Seligman Co. and its two subsidiaries were not primarily engaged in Section 32 activities because the Section 32 activity of the total Seligman enterprise accounted for only 3 percent of its gross revenue during the first nine months of 1982.[153]

The Comptroller also had to consider whether the arrangement would violate Section 20 of the Glass-Steagall Act. The relevant activities for a Section 20 analysis are the same as those for a Section 32 analysis: "the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds or similar securities. . . ."[154] By again applying the single entity doctrine, the Comptroller found that Seligman Co., Seligman Distributor, and Seligman Securities considered together were not "primarily engaged" in Section 20 activities.

Finally, the Comptroller considered whether the Bank was "affiliated" with any of the Seligman Group of Investment Companies. 12 U.S.C. § 221(a) (1982) provides that the two organizations are affiliated for purposes of the Glass-Steagall Act if one organization controls the other "through stock ownership or in any other manner." The Comptroller decided that Seligman Co. did not control any of the Seligman Group of Investment Companies because

> the Investment Company Act of 1940 ("the Act") confers so much authority on the disinterested members of a fund's board that control of the fund by an investment advisor is precluded as a matter of law, especially where each fund's board is comprised of a majority of disinterested directors. In any event, the composition of the boards of funds advised by Seligman Co. mandates a conclusion that Seligman Co. does not control the funds it advises.[155]

Immediately thereafter, the Comptroller approved an application to issue a charter to establish the Dreyfus National Bank & Trust Company,[156] which was to be a wholly-owned subsidiary of The Dreyfus Corporation, the investment adviser to the Dreyfus Fund and a number of other mutual funds. This application presented some of the same Glass-Steagall issues as the Seligman application. In his approval, the Comptroller again applied the single entity doctrine and determined that an investment adviser did not control the mutual funds it advised.

---

152. *See, e.g.*, Board Letter 3-896, Federal Reserve Regulatory Service, Vol. 1, pp. 3.367-368; Board Letter 3-895, Federal Reserve Regulatory Service, Vol. 1, p. 3.389.

153. *See Advisor and Broker, supra* note 143, at ¶99,464.

154. 12 U.S.C. § 377.

155. *See Advisor and Broker, supra* note 143, at ¶99,463.

156. *Id.* at ¶99,464.

The Federal Reserve Board disagreed with the Comptroller's rationale in the Seligman and Dreyfus applications. The Board argued that a mutual fund issued its own securities continuously, and thus, was engaged principally in an activity covered by Section 20 of the Glass-Steagall Act.[157] The Board also argued that a company that managed a mutual fund was an affiliate of the fund for purposes of Section 20 because it controlled the funds by controlling the day-to-day operations of the fund. "Employees of the manager conduct the fund's operations. The manager sets up the fund, provides for the marketing of the mutual fund's securities, determines what securities are in the fund's investment portfolio, and provides administrative services to the fund, such as office space, clerical assistance, and similar services."[158] Finally, the Board explained that the single entity doctrine was inapplicable when a corporation claimed that the funds it managed were not affiliated with it.[159]

The concern of the Board over these issues eventually forced Seligman Bank to give up its national bank charter. Every national bank must be a member of the Federal Reserve System,[160] so Seligman Bank was required to apply for stock in the Federal Reserve Bank of New York. On March 28, 1983, the Federal Reserve Bank of New York advised Seligman Bank that it would issue stock to it, but that it would also conduct an examination to determine whether Seligman Bank would violate Section 20 of the Glass-Steagall Act when the Bank became a member of the Federal Reserve System.[161] If the Board had eventually found that Seligman Bank was in violation of the Act, it could have imposed a civil money penalty of $1,000 per day from the date the Reserve Bank stock was issued and Seligman Bank commenced business as a member bank under Section 20 of the Act. On April 6, 1983, the Reserve Bank issued Reserve Bank stock to the Seligman Bank.[162] On May 20, 1983, Seligman Bank gave up its national bank charter, terminated its membership in the Federal Reserve System, and reopened as a state-chartered trust company under the laws of New York.[163] Because of its conflicts with the Board over the Seligman and Dreyfus applications, on April 5, 1983, the Comptroller

157. Statement by Michael Bradfield, General Counsel, Board of Governors of the Federal Reserve System, before the Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations, U.S. House of Representatives, July 21, 1983, at 24.

158. *Id.* at 25.

159. *Id.*

160. *See* 12 C.F.R. § 209 (1984).

161. Statement by Michael Bradfield, *supra* note 157, at 27.

162. *Id.*

163. *Id.*

declared a moratorium that expired January 1, 1985, on similar applications except for those already before him.[164]

F. Securities Activities of Insured Nonmember Banks

In September 1982 the FDIC issued a policy statement regarding the applicability of the Glass-Steagall Act to securities activities of subsidiaries of insured nonmember banks.[165] The policy statement explained that the Glass-Steagall Act

> does not, by its terms, prohibit an insured nonmember bank from establishing an affiliate relationship with, or organizing or acquiring, a subsidiary corporation that engages in the business of issuing, underwriting, selling or distributing at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes or other securities. While the Glass-Steagall Act was intended to protect banks from certain of the risks in particular securities activities it does not reach the securities activities of a *bona fide* subsidiary of an insured nonmember bank.[166]

The FDIC noted that Section 21 of the Glass-Steagall Act is the only provision that is applicable by its terms to insured nonmember banks and relied on footnote 24 of *ICI II*, in which the Supreme Court explained that Section 21 does not include within its prohibition bank affiliates that do not receive deposits. In December 1984 the FDIC promulgated a regulation implementing this policy.

---

164. *See Non-Banks Face 1983 Moratorium by Comptroller*, Wall Street J., Apr. 6, 1983, at 4. In November 1983 the Comptroller acted on one of these applications by approving the issuance of a charter for the Templeton Management and Trust Co., N.A., of Fort Lauderdale, Florida [hereinafter referred to as "Templeton Bank"]. *See Comptroller Approves New Trust Charter*, Am. Banker, Nov. 25, 1983, at 3, col. 4. Templeton Bank was to limit its activities to providing fiduciary services through investment managing and counseling to institutional customers. Two of Templeton Bank's directors were also to serve as officers or directors of various Templeton mutual fund investment companies. As in the Seligman application, the Comptroller concluded that Section 32 of the Glass-Steagall Act did not prohibit management interlocks between companies that conduct Section 32 activities and limited-purpose trust companies that did not offer significant commercial banking services.

165. *Proposed Rule Would Govern Bank Subsidiary Securities Activities*, [1982-83 Tranfer Binder] FED. BANKING L. REP. (CCH) ¶99,556 (July 8, 1983).

166. 12 C.F.R. 9337.4 (1984).

167. *Id.* The basic features of the proposed regulation to implement this policy statement were: (1) Notice of intent to invest in a securities subsidiary; (2) no prior approval requirement; (3) no formalized restrictions on bank entry based on asset size or composite rating; (4) a prohibition on a nonmember bank establishing or acquiring a subsidiary that underwrites securities unless the underwriting activity is on a "best efforts" basis, is restricted to top rated debt securities, or is the underwriting of a money market fund type mutual fund; (5)

III. ECONOMIC IMPLICATIONS OF SECURITIES ACTIVITIES

The regulatory agency decisions and court rulings reviewed here have involved primarily legal issues, rather than economic ones. Unlike the antitrust laws governing mergers and acquisitions, which explicitly require the courts to make findings of competitive effects, most of the securities laws prohibit specified types of behavior that, at the time the laws were enacted, were deemed to have undesirable effects. No showing of adverse competitive effects or other undesirable economic consequences must be made in an individual case. In this sense violations of the securities laws are treated in a manner similar to those few types of behavior—for example, horizontal price-fixing agreements—that constitute per se violations of the antitrust laws.

However, the conditions under which many of the securities laws were adopted did not permit the leisurely accumulation of knowledge that underlay the development of the antitrust laws since the passage of the broadly worded Sherman Act in 1890. The effectiveness and economic value of many of the securities laws—including, in addition to the Glass-Steagall Act, the disclosure and other requirements of the Securities Exchange Act of 1934—have been subjected to increased questioning in recent years.[168] Given the purposes of these acts, economic analysis should play a key role in any revision of the legislation governing the securities activities of banks. Without any pretense at providing firm conclusions, this section sketches the general nature of the economic issues and offers some fragmentary evidence on the more important ones.

---

a twenty percent of equity capital ceiling on a bank's investment in one or more securities subsidiaries; (6) a limit on the amount of loans or extensions of credit that a bank may make to its securities subsidiary or affiliate; (7) a prohibition of loans for the purpose of acquiring securities underwritten or distributed by the bank's subsidiary or affiliate or the acceptance of securities such as collateral on a loan or extension of credit; (8) a prohibition of extensions of credit to companies whose securities are underwritten by the bank subsidiary or affiliate unless the securities are highly rated; (9) a prohibition of the purchase by the bank's trust department in its sole discretion of securities distributed, underwritten, or issued by the bank's subsidiary or affiliate; and (10) a prohibition of the transaction of business through the bank's trust department with the bank's securities subsidiary or affiliate unless those transactions are comparable to transactions with an unaffiliated securities company.

Additionally, the proposed regulation contains a definition of bona fide subsidiary which requires that the subsidiary be adequately capitalized; its operations be physically separate from that of the bank; separate records and corporate formalities be observed; separate employees be maintained; and the subsidiary function independently from, and not be identified with, the business of the bank. *Id.*

168. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117-42 (1964).

A. Bank Safety

As noted in the introduction, the primary purpose of the Glass-Steagall Act was to protect the banking system from the abuses believed to inhere in the combination of commercial and investment banking. The Pecora hearings in 1933 revealed a multitude of instances in which securities activities engaged in by banks or their affiliates appeared to compromise the safety of the banks.[169] The practice of lending to firms whose securities had been underwritten by the bank's affiliate and the purchasing of hard-to-sell securities by bank investment departments from affiliates clearly placed depositors' funds in jeopardy.[170] Losses to depositors as a consequence of these practices were largely eliminated by the introduction of federal deposit insurance. However, there is now a concern by the Federal Deposit Insurance Corporation for the safety of its insurance fund, particularly given the current flat rate method of pricing deposit insurance. Because the premium for this insurance is a uniform percentage of total domestic deposits, and does not vary with risk, the fund subsidizes risk-taking by banks.[171] However, it is not clear that a drastic remedy such as separation of commercial and investment banking is necessary to prevent a recurrence of the abuses of the 1920's.

Useful evidence on this point can be derived from a careful examination of the experience of bank trust departments. These departments, which manage in a fiduciary capacity approximately $500 billion of customers' funds[172] and invest these funds in a wide range of assets from government securities to corporate equities, contain the potential for all the abuses and dangers to bank solvency attributed to bank securities affiliates during the 1920's and 1930's.[173] A number of authors have made the point that the continued existence of the trust department as an integral part of the typical commercial bank (of the roughly 15,000 commercial banks in the United States, 4,000 have trust departments) is something

---

169. SENATE COMM. ON BANKING AND CURRENCY, REPORT ON STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73rd Cong., 2d Sess. (1934).

170. S. REP. NO. 584, 72d Cong., 1st Sess. 8 (1932).

171. For a discussion of the problems of pricing deposit insurance, *see* Bierwag & Kaufman, *A Proposal for Federal Deposit Insurance with Risk Sensitive Premiums*, Staff Memoranda 83-3 (1983) (Federal Reserve Bank of Chicago).

172. FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL, TRUST ASSETS OF BANKS AND TRUST COMPANIES - 1982 (1983).

173. *Financial Institutions Restructuring Act of 1981: Hearing on S. 241 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 1st Sess. 661-67 (1981) (written Statement of David Silver, President, Investment Company Institute).

of an anomaly in light of the ban on banks' underwriting and investment management activities.[174] Indeed, some of the same abuses have been observed in banks' trust activities that were evident earlier in their activities as dealers and underwriters.[175] There have been some calls for the separation of banks from their trust departments.[176] However, most students have concluded that existing safeguards are adequate to deter all but the most determined violators. These safeguards include specific regulations prohibiting certain abuses such as the holding of trust funds for long periods in noninterest-bearing demand deposits, the "Chinese Wall" between the trust and commercial lending departments, the general standards of fiduciary conduct embodied in the "prudent man" rule, and the greater sophistication of modern trust examinations.[177]

Since the funds invested are those of customers, the danger to the bank lies more in the effects on depositors' confidence than in the possibility of losses on trust department investments per se. Although it seems reasonable to expect poor investment performance to have an adverse effect on depositors' confidence in the bank's management, little is known of the importance of this effect. Indeed, because trust management fees typically are not tied to investment performance, losses on investments do not directly affect current bank earnings. Of course, poor investment performance eventually will lead to a loss of trust business, adversely affecting the long term earnings of the trust department and, therefore, of the bank.

A major conclusion of modern finance theory is that risk can be measured by the variability of return. It may appear that if the variance of earnings on securities activities is higher than that on existing banking activities, then combining the two sets of activities will raise the variance of the bank's earnings. However, if the earnings of the two sets of activities are negatively related (*i.e.*, declines in the earnings of the one tend to be offset by increases in the other), then combining them will tend to reduce the bank's earnings variability.

Consequently, in judging the effects of bank securities activities on bank safety, we must be concerned with the effect of engaging in these activities on the variability of the bank's total earnings.

---

174. Scott, *Fifty Years of Trusts*, 49 HARV. L. REV. 60, 62 (1936).

175. Herman, *Commercial Bank Trust Departments*, CONFLICTS OF INTEREST IN THE SECURITIES MARKETS (1975).

176. FINANCIAL INSTITUTIONS: REFORM AND THE PUBLIC INTEREST, STAFF REPORT OF THE SUBCOMMITTEE ON DOMESTIC FINANCE OF THE HOUSE COMMITTEE ON BANKING AND CURRENCY, 93d Cong., 1st Sess. 93-102 (1973).

177. *Id.*

To determine this, we need to know the variance of those earnings and their covariance with earnings from other banking activities. For activities permissible under the Bank Holding Company Act, diversification does not appear to have had any significant effects in reducing the risk of the overall organization.[178] Unfortunately, it is not possible to observe directly the effects of diversification by banks into areas, like most securities activities, that they have been prohibited from entering. However, one recent study looked at the correlation in operating income of banks and several nonpermissible nonbanking industries, including investment banking. The correlation between commercial banking and investment banking earnings was positive and relatively large, suggesting little benefit from combining the two activities.[179]

B. Conflicts of Interest

Closely related to the question of bank safety, but emphasized more in the context of their effects on users of bank services, are the conflicts of interest that are often alleged to inhere in the combination of banking and underwriting. As Senator Carter Glass said of the underwriting activities of banks in 1932, "there was a conflict between the business of marketing securities and the business of protecting depositors' money. . . ."[180] As the issue is usually stated, the combination of these activities puts the banks in the position of serving two groups of customers and of executing transactions that benefit one group at the expense of the other.[181] For example, the promotion of the sale of securities to customers underwritten by the bank for other customers may have the effect of lowering the costs of raising capital to the latter by increasing the investment risks borne by the former. Thus, the issue

---

178. Boyd, Hanweck, Pithyachariyakul, *Bank Holding Company Diversification*, FEDERAL RESERVE BANK OF CHICAGO, PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 105-21 (1980).

179. Stover, *A Re-examination of Bank Holding Company Acquisitions*, 13 J. BANK RESEARCH 101-08 (1982).

180. 75 CONG. REC. 9904 (1953). *See also* W. PEACH, THE SECURITIES AFFILIATES OF NATIONAL BANKS 113-43 (1941); F. PECORA, WALL STREET UNDER OATH: THE STORY OF OUR MONEY CHANGERS (1939).

181. A conflict of interest has been defined by one prominent student as follows:

> [T]he term *conflict of interest* is not obscure; it denotes a situation in which two or more interests are legitimately present and competing or conflicting. The individual (or firm) making a decision that will affect those interests may have a larger stake in one of them than in the other(s), but he is expected—in fact, obligated—to serve each as if it were his own, regardless of his own actual stake.

Schotland, *Introduction*, CONFLICTS OF INTEREST IN THE SECURITIES MARKETS 4 (1975).

is at its heart one of fairness, though efficiency and bank safety may be affected as well.

Some economists minimize the importance of conflicts of interest, not considering their elimination as a major goal of policy.[182] It is not that these economists deny the existence of conflicts, but rather that they see this conflicts as being ubiquitous and unavoidable. The seller of a good or service always has an interest in giving up as little, and charging as much, as is consistent with retaining the bulk of his customers in the long run. However, that is the rub. It is precisely the fact that customers would eventually learn that they were being ill-served and would take their business elsewhere that constrains the seller to maintain some minimum standard of quality or service and to limit his prices below what the traffic would bear in the very short run.

A bank in a competitive investment market would be constrained to meet these standards of services and price in marketing securities, even if the bank had other customers who would benefit from a deliberate misrepresentation of those securities. Conversely, if the market were sufficiently noncompetitive, or customers were sufficiently ignorant that they would not move their business elsewhere despite poor performance or excessive commissions, a profit-maximizing bank would take full advantage of the resulting inelasticity of demand by raising the price and reducing the quality, and, thereby, its cost of services.[183] Absent another group of customers whose securities the bank has some reason to promote and subsidize, the higher revenues or cost savings would simply end up in the banker's pocket. Thus, the existence or nonexistence of another group of customers with different interests from those of the group of investors should have no bearing on how the investors will be served.

This point was debated several years ago by Professor Sam Peltzman, an economist and long-time student of regulation, and Professor Roy Schotland, a lawyer and long-time student of conflicts of interest.[184] Peltzman's argument was simply that the outcome in terms of how well and at what price any group of customers is served depends primarily on the degree of competition in the market for the service in question and that the identification of conflicts of interest on the part of the seller adds nothing to the

182. As Sam Peltzman has argued, "there may be a problem, but I am not sure it has much to do with conflict of interest, however vaguely that is defined." Peltzman, *Comments on "Conflicts of Interest Within the Financial Firm: Regulatory Implications"*, ISSUES IN FINANCIAL REGULATION 155-57 (F. Edwards ed. 1979) (hereinafter cited as Peltzman).

183. For a brief description of the effects of competition and monopoly, see AREEDA, ANTITRUST ANALYSIS: PROBLEMS, TEXT, CASES 4-23 (2d ed. 1974).

184. *See* Peltzman, *supra* note 182, at 155-61.

analysis of the problem. As in the case of cross-subsidization,[185] predatory pricing,[186] reciprocal dealing,[187] and most examples of tie-in sales,[188] the great concern over conflicts of interest is viewed by many economists as resulting from analytical confusion. Schotland's response was commonsensical, and on the surface, convincing; whether they appear to be rational or not, abuses of conflicts of interest do occur and, most importantly, can be prevented by the elimination of the conflicts.[189]

Schotland's and Peltzman's arguments represent two competing hypotheses regarding the significance of conflicts of interest. An empirical test of the two hypotheses might consist of a comparison of the price and quality of investment services offered by firms similar in all respects, including the degree of monopoly power, except that the customers of some firms had identifiable conflicts of interest, while the customers of other firms did not. However, the systematic empirical testing required to yield a definitive answer has yet to be undertaken, and the existing evidence is almost wholly anecdotal.

Whatever the merits of the opposing views, the controversy over conflicts of interest is suggestive of broader issues involving the creation of incentives designed to encourage appropriate behavior. These issues were originally raised in the decades-long discussion of the separation of ownership and control in the modern corporation[190] and are now being examined by financial economists under the rubric of the "agency problem."[191] The basic problem is that of setting up a compensation plan and other arrangements so that the actions taken by the agent to maximize his own well-being also maximize that of the principal. The Reagan Administration's proposed Financial Institutions Deregulation Act raises many of these issues.[192] In an apparent effort to mitigate potential conflicts of interest and insulate the bank from possible hazards, the

---

185. Hale, *Dispersion: Monopoly and Geographic Integration*, 30 TEX. L. REV. 444, 446 (1952).

186. McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case*, 1 J. L. AND ECON. 137-69 (1958).

187. Liebeler, *The Emperor's New Clothes: Why is Reciprocity Anticompetitive?*, 44 ST. JOHN'S L. REV. 545 (1970).

188. Baldwin & McFarland, *Tying Arrangements in Law and Economics*, 8 ANTITRUST BULL. 743-80 (1963).

189. Schotland, *Conflicts of Interest Within the Financial Firm: Regulatory Implications—Discussion*, ISSUES IN FINANCIAL REGULATION 162-63, 168-69 (F. Edwards ed. 1979).

190. The seminal discussion of this problem was in A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

191. *See, e.g.*, Jensen & Mecklin, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINANCIAL ECON. 305 (1976).

192. S. 1609, 98th Cong., 2d Sess. (1984).

bill would expand the securities activities of banks, but would require them to be carried out through a separate "depository institution securities affiliate."

Ironically, there are considerable empirical evidence and strong theoretical reasons for believing that this arrangement either may make no difference or may even exacerbate these problems relative to what these problems would be if the bank engaged directly in securities activities. In the first place, the experience of some bank holding companies whose nonbank subsidiaries have failed offers little assurance that the bank can be effectively insulated from these failures, regardless of its legal liabilities. In several cases, the failure of a holding company or one of its nonbank subsidiaries has resulted in a serious run on the bank.[193] This has led to some students of bank holding company regulation abandoning the previously popular notion that the bank could be insulated from the failure of a nonbank subsidiary of the holding company.[194] More importantly, as Franklin Edwards argued at a 1979 conference on financial deregulation, unless the ownership and leverage of the bank and its securities affiliate are identical, managers may have incentives to promote the success of one over the other.[195] As he observes, "[t]he worst situation is undoubtedly where the officers and directors of the bank own all or most of the stock of the affiliate but little or none of the stock of the bank."[196] Moreover, even assuming that the ownership of the bank and the affiliate are identical, if the affiliate is more highly leveraged than the bank, stockholders will have an incentive to transfer bad assets to the affiliate in order to minimize their losses at the expense of debt holders in the event of bankruptcy. This assumes, of course, that the courts will not pierce the veil of the corporate organization to hold the bank responsible for the debts of its affiliate.

To the extent that these arguments are valid, the search for a way to allow banks to engage in expanded securities activities in a way that insulates banks from the risks associated with these activities may be illusory. It may be more straightforward and more effective to allow the bank to engage in the activities dir-

---

193. One of the most prominent examples was the failure of Beverly Hills Bancorp in 1974. There was a run on the company's bank, resulting in a decline in its deposits of 15 percent and its forced sale to Wells Fargo.

194. *See, e.g.,* Lawrence & Talley, *An Alternative Approach to Regulating Bank Holding Companies,* FEDERAL RESERVE BANK OF CHICAGO, PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 1-10 (1978).

195. Edwards, *Banks and Securities Activities: Legal and Economic Perspectives on the Glass-Steagall Act,* THE DEREGULATION OF THE BANKING AND SECURITIES INDUSTRIES 273-91 (L. Goldberg & L. White eds. 1979).

196. *Id.* at 286.

ectly subject to administrative safeguards like those designed to limit abuses by bank trust departments.

C. Competition and Concentration of Power

The existence and growth of large firms have long been the source of a widespread, but poorly articulated, concern over excessive concentration of power.[197] Concentration in particular product and geographic markets has been shown to have undesirable effects—restriction of output and higher prices—and its achievement by merger or acquisition is restricted by the antitrust laws.[198] Concentration in the individual markets would be likely to decline as a consequence of bank entry into a wider range of securities activities, particularly if that entry were accompanied by the entry of securities firms into traditional banking activities. However, concentration of resources in a broader sense, sometimes called "aggregate concentration" is a much more elusive concept. It refers either to the absolute sizes of firms or to the firm's size relative to the entire economy and, therefore, need not imply concentration in any particular product market. Despite being embodied in the Bank Holding Company Act's reference to "undue concentration of resources" as one of the possible adverse effects of bank acquisitions of nonbank firms,[199] the concept remains vague and ill-defined. In many instances, this concern is simply the feeling that "bigness is bad." It has been a factor in several cases decided by the Board of Governors of the Federal Reserve System, but has been the primary reason for denial of only two applications.[200] There have been several discussions of the general concept, but none that have been broadly accepted as a basis for government action to curb aggregate concentration.[201]

In most, but not all, discussions of concentration of power, the chief concern has been that firms of very large absolute size may

---

197. *See* THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA, INDEPENDENT BANKING: AN AMERICAN IDEAL (1973); S. RHODES, POWER, EMPIRE BUILDING, AND MERGERS (1983); Rhodes, *Aggregate Concentration: An Emerging Issue in Bank Merger Policy*, 24 ANTITRUST BULL. 1 (1979) (hereinafter cited as Rhodes).

198. For a good summary of the evidence, see F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 400-11 (1970) (hereinafter cited as SCHERER).

199. 12 U.S.C. § 1843(4)(c)(8) (1984).

200. *See* Application by Citicorp to Retain Advance Mortgage Company, 60 FED. RES. BULL. 50 (1974); Application by Chase Manhattan Corp. to Acquire Dial Financial Corp., 60 FED. RES. BULL. 142, 874. After Citicorp's application was denied a second time in 1978, Citicorp sought judicial review. The Board's decision was upheld in Citicorp v. Board of Governors, 589 F.2d 1182 (2d Cir. 1978).

201. *See, e.g.*, SCHERER, *supra* note 198, at 39-50.

have a disproportionate influence on the legislative process.[202] Several critics have argued that much recent growth by merger has been motivated more by a quest for power, political or other, than by considerations of profit or efficiency.[203]

Much of the recent literature on the subject of aggregate concentration grew out of the conglomerate merger movement of the 1960's. Faced with a new type of merger that did not present the market concentration problems of traditional horizontal mergers, but uneasy, nonetheless, over the possible effects of sheer size, students of industrial organization began to search for a coherent theory of the effects of size and diversification.[204] It is probably a fair but concise summary of this literature to say that it produced little in the way of rigorous theory or persuasive empirical evidence to substantiate any adverse effects of aggregate concentration.

Despite this absence of evidence, public concern over the potential consequences of aggregate concentration persists. The United States Senate held hearings on economic concentration in 1964 and 1965[205] and again in 1978.[206]. Testimony and evidence presented by a number of leading experts on industrial organization indicated that aggregate concentration in the manufacturing sector, as measured by the proportion of value added that was accounted for by the 100 largest firms, had increased from 23 percent in 1947 to 30 percent in 1954 and to 33 percent in 1972.[207]

Concern over aggregate concentration is particularly strong when banking institutions are involved, because banking is seen as having a pervasive influence on the entire economy due to its important position in the credit markets and its key role in the payments mechanism. This view is embodied in Section 4(c)(8)

---

202. Adams, *Corporate Power and Economic Apologetics: A Public Policy Perspective,* INDUSTRIAL CONCENTRATION: THE NEW LEARNING 360 (H. Goldschmid, H. Mann, J. Weston eds. 1974).

203. *See, e.g.,* S. REID, MERGERS, MANAGERS AND THE ECONOMY (1968).

204. An early attempt to devise this theory can be found in Edwards, *Conglomerate Bigness as a Source of Power,* NATIONAL BUREAU OF ECONOMIC RESEARCH CONFERENCE REPORT, BUSINESS CONCENTRATION AND PRICE POLICY 331-59 (1955).

205. *Hearings on Economic Concentration, Part I: Overall and Conglomerate Aspects, Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary,* 88th Cong., 2d Sess. (1964); *Hearings on Economic Concentration, Part II: Mergers and Other Factors Affecting Concentration,* 89th Cong., 1st Sess. (1965).

206. *Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, Hearings on Mergers and Industrial Concentration,* 95th Cong., 2d Sess., (1978).

207. *Hearings on Economic Concentration,* Part II *supra* note 205, at 673. *See also* R. CAVES, *The Structure of Industry,* THE AMERICAN ECONOMY IN TRANSITION 511-16 (180).

of the Bank Holding Company Act. The central importance of banks has led not only to concern regarding concentration in banking but also to a long-standing policy of separating banking from commerce. This separation goes back far beyond the founding of this country to the origins of modern commercial banking in England in the 17th century. There, it took the form of a provision in the act of Parliament chartering the Bank of England in 1694, which prohibited the bank from engaging in the "buying or selling of any goods, wares or merchandise whatsoever. . . ."[208] As Professor Bernard Shull recently observed in a historical review of the origins and implications of the separation, it was originally motivated by the fear of merchants that they would be at a disadvantage if forced to compete with a government-sponsored monopoly.[209] Industries fighting to prevent commercial banks from encroaching on their markets continue to fear competition. However, it is clear that public concern over aggregate concentration, one manifestation of which is opposition to any lowering of the barriers between commercial banking and investment banking, is motivated by much broader concerns. For example, a number of studies have attempted to ascertain the degree to which banks exercise control over nonfinancial firms through the stock held by their trust departments.[210] While these holdings are huge in the aggregate, there are relatively few cases in which the holdings of one or few banks are large enough to confer control.

Some industrialized countries in which commercial and investment banking have long been combined have been reexamining the long-term effects of that arrangement. In Germany, for example, it has been argued that banks exercise undue influence over the management of industrial enterprises through their equity holdings. In a report issued in 1976, the German Monopolies Commission recommended that a bank not be permitted to own more than 5 percent of a company's total equity.[211] However, a commission appointed by the Minister of Finance in 1974 to study this and other issues related to German "universal banking" found no convincing evidence of this influence.[212] More relevant to the entry of United States banks into securities and other activities is the fact that aggregate banking concentration in the United States is low relative

208. 5 & 6 W. & M. ch. 20, *cited by* Shull, *The Separation of Banking and Commerce: Origin, Development, and Implications for Antitrust*, 28 ANTITRUST BULL. 260 (1983).

209. *Id.* at 260-63.

210. *See, e.g.*, COMMERCIAL BANKS AND THEIR TRUST ACTIVITIES: EMERGING INFLUENCE ON THE AMERICAN ECONOMY, STUDY FOR THE HOUSE BANKING AND CURRENCY SUBCOMMITTEE ON DOMESTIC FINANCE (1978).

211. World Business Weekly, Apr. 30, 1979, at 29.

212. Kruemmel, *German Universal Banking Scrutinized; Some Remarks Concerning the Gessler Report*, 4 J. BANKING AND FINANCE 33-55 (1980).

to that in most other countries. For example, the five largest banks in the United States hold less than 20 percent of total deposits; the comparable figures for West Germany, Canada, and the United Kingdom are 61.8 percent, 77.7 percent, and 56.8 percent, respectively. There are more than 14,000 commercial banks in the United States, about 250 in West Germany, 11 in Canada, and only about 300 in the United Kingdom, including branches of foreign banks.[213] More surprisingly, aggregate banking concentration has not increased in the United States in recent years at as fast a rate as is commonly believed. The share of domestic deposits controlled by the 100 largest banking organizations declined from 49.4 percent in 1960 to 45.8 percent of 1971 before rising to 47.0 percent in 1973.[214] It then fell to 45.5 percent in 1980. At the same time, the share of domestic deposits held by the ten largest banking organizations fell from 20.2 percent to 17.9 percent between 1969 and 1980.[215]

In summary, the issue of concentration of power as it relates to bank expansion into securities activities remains a nebulous concept. It probably has more direct and serious implications for the political process than for the functioning of the economic system. Moreover, available data do not suggest that the problem it poses is currently a serious one or that it is growing rapidly. Nevertheless, the issue is not one that is likely to disappear soon from public debate over the appropriate legal limits to bank size and scope of activities.

D. Efficiency

In the absence of any legal impediments to entry into a line of business, there are no urgent reasons of public policy to study the consequences for efficiency of combining any particular set of activities. Competition can be relied on to reward those combinations that promote efficiency and to punish those that do not, thereby assuring an optimal degree of specialization or diversification. However, when other considerations such as fear of potential conflicts of interest or concentration of resources suggest limits on the size or scope of firms, a study of the consequences of these limits for efficiency should be an important ingredient in any policy decision.

---

213. These figures were taken from a variety of central bank publications. They depend, to some degree, on the precise definition of a "bank" that is used, since the institutional structures of the four countries differ considerably. However, the general picture is unchanged by the use of alternative definitions.

214. Rhoades, *Aggregate Concentration, supra* note 197, at 8.

215. Savage, *Developments in Banking Structure, 1970-81*, 68 FED. RES. BULL. 77, 82 (1982).

As observed earlier, many authors have argued that much merger activity is motivated by factors other than gains in efficiency and actually may be damaging to efficiency. However, several theories have been developed that suggest less sinister motives for conglomerate mergers and aggregate concentration, as well as the possibility that these mergers have salutary effects on performance.[216] One theory emphasizes the importance of "economies of scope" or joint production economies. Several authors have concluded that some conglomerate or product extension mergers could be expected to yield important synergies, the "two plus two equals five" effect.[217] Other studies have pointed out that conglomerate mergers are an efficient means of redeploying capital without incurring the transactions costs of using the capital market.[218] Still others have emphasized the variability of managerial ability and have pointed out that restrictions on mergers prevent the market from placing control of resources in the hands of those best able to manage them.[219]

However, just as little concrete evidence has been found of the detrimental effects of conglomerate mergers, similarly little evidence has been found of their vaunted synergies. A recent assessment of conglomerate mergers was that they had done little or nothing to benefit either stockholders or customers.[220] Many studies concluded that, although conglomerate mergers sometimes benefited stockholders of the acquired firms, their impact on the stockholders of the acquiring firm was often neutral or detrimental.[221] This result was also reported in some studies of acquisitions of additional banks by bank holding companies.[222] For acquisitions by bank holding companies of nonbank firms, the evidence, albeit meager, is even less favorable. Studies of bank holding company affiliated and independent mortgage banks,[223]

216. For a spirited argument to this effect that summarizes much of the recent literature, see Y. BROZEN, CONCENTRATION, MERGERS AND PUBLIC POLICY (1982).

217. *See, e.g.*, Weston, *The Nature and Significance of Conglomerate Firms*, 44 ST. JOHN'S L. REV. 66, 70 (1970).

218. O. WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR: AN INQUIRY INTO THE EFFECTS OF ORGANIZATION FORM ON BUSINESS BEHAVIOR (1970).

219. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110-20 (1965).

220. Mueller, *The Effects of Conglomerate Mergers: A Survey of the Empirical Evidence*, 1 J. BANKING & FIN. 315-47 (1977).

221. Hogarty, *Profits from Merger: The Evidence of Fifty Years*, 44 ST. JOHN'S L. REV. 378-89 (1970).

222. Piper and Weiss, *The Profitability of Multibank Holding Company Acquisitions*, 29 J. FIN. 163 (1974).

223. Talley, *Bank Holding Company Performance in Consumer Finance and Mortgage Banking*, 52 MAGAZINE BANK AD. 42-44 (1976); Rhoades, *The Effect of Bank-Holding Company Acquisitions of Mortgage Bankers on Mortgage Lending Activity*, 48 J. BUS. 344-48 (1975).

finance companies,[224] and equipment leasing firms[225] all failed to report any significant advantages to either shareholders or customers of affiliated firms. Nor do banks appear to have any perceptible competitive advantage in those securities activities such as underwriting general obligation municipal bonds in which they are allowed to engage.[226] Moreover, the estimated benefits to borrowers of allowing banks to engage in currently prohibited activities such as underwriting municipal revenue bonds do not appear to be very large.[227]

Although arguments for allowing expanded bank securities activities are founded on efficiency, there is little support for them in the available evidence from empirical studies. Rather, these arguments must rest on the general presumption that firms do not willingly enter into new activities if they expect to suffer an efficiency disadvantage and that free entry is generally conducive to more intense competition.

E. Changes in the Economic Environment

Little has been said so far about any changes in the economy that might alter the appropriate scope of bank securities activities. However, financial services have been among the most dynamic industries in recent decades. Probably foremost among the changes that have occurred has been the revolution in the technology of transmitting, processing, and storing information.[228] The rapid strides in applying computers to these tasks, which constitute some of the core activities of a financial institution, may have enormous implications for economies of scope (*i.e.*, the effects on efficiency of combining related financial activities). For example, many of the information items needed in supplying a customer with mortgage credit, consumer credit, and margin credit for purchasing securities are similar. By enabling those data to be collected once, stored in a single place, and readily accessed and updated, computers make

---

224. S. RHOADES & G. BOCZAR, THE PERFORMANCE OF BANK HOLDING COMPANY-AFFILIATED FINANCE COMPANIES, STAFF STUDY 90 (Board of Governors of the Federal Reserve System 1977).

225. Rhoades, *The Performance of Bank Holding Companies in Equipment Leasing*, 63 J. COM. BANK LENDING 53-61 (1980).

226. Bierwag, Kaufman, and Leonard, *supra* note 6.

227. Hopewell & Kaufman, *Commercial Bank Bidding on Revenue Bonds: New Evidence*, 32 J. FIN. 1647-56 (1977).

228. These developments and their effects on the provision of financial services are briefly discussed in Kaufman, Mote, & Rosenblum, *Implications of Deregulation for Product Lines and Geographical Markets of Financial Institutions*, Staff Memoranda 82-2, Federal Reserve Bank of Chicago 5-7 (1983).

it much more economical to offer a complete package of financing services. It has frequently been argued that the large investment required to make this technology economical would greatly increase the minimum size bank required for efficient operation. However, trends to date have been in the opposite direction, as time sharing services and less expensive computers with increasingly greater capabilities have brought the computer revolution to even small banks.[229] It is not clear at this time what the implications of further developments such as point-of-sale electronic funds transfer systems and in-home banking will be. However, it is clear that these are no longer Buck Rogers fantasies. Not only is the technology already here, but pilot point-of-sale systems enabling consumers to debit their accounts electronically to pay for purchases at retail stores are operating in several cities, and many banks are actively engaged in developing home banking, using existing television sets, the telephone system, and home computers.[230]

Perhaps more importantly, it is not clear how much value the typical consumer places on being able to acquire all or most needed financial services from a single source. In the past, "full-service banking" gave commercial banks some advantage in their competition with more specialized institutions. Whether the combination of banking and securities services offers a similar advantage is less clear.

CONCLUSION

The meaning and effectiveness of the Glass-Steagall Act's prohibitions of bank securities activities are considerably less clear today than they were believed to be even a decade ago. Not only is the act's coverage restricted by its exemption of thrift institutions and non-Federal Reserve member banks, but there is increasing litigation over the precise activities that the Act precludes (*e.g.*, assisting private placements and providing full service brokerage services). This state of affairs clearly suggests the desirability of legislation to clarify the meaning of the law under current conditions and to make uniform its applicability to Federal Reserve member and nonmember banks. It is hard to imagine what national policy is furthered by treating different classes of depository institutions differently in this respect.

---

229. *See, e.g.*, P. Metzker, *Future Payments System Technology: Can Small Financial Institutions Compete?* ECONOMIC REVIEW 58-67 (1982); Kaufman, Mote, Rosenblum, *supra* note 3.

230. Fisher, *Changing Roles of Financial Institutions: Banks*, FEDERAL RESERVE BANK OF ATLANTA, PROCEEDINGS OF A CONFERENCE ON THE FUTURE OF THE FINANCIAL SERVICES INDUSTRY 11-15 (1981).

However, the relatively noncontroversial goal of clarifying the current meaning of the Act is not readily separable from the highly controversial goal of substantially revising it. This is unfortunate because it precludes an orderly two-step approach. The first step would be to enact immediate clarifying legislation to give market participants greater certainty as to which securities activities are permissible to depository institutions. The second step, to be taken at some future date when the issues have been thoroughly researched, would be to adopt whatever revisions appear necessary or desirable. The pressures of financial industry lobbying simply do not permit this approach. On the basis of extremely scanty evidence regarding the effects on the public interest, a major segment of the banking industry is urging a wide-ranging liberalization of the Glass-Steagall Act. Largely for protectionist reasons, that approach is being actively opposed by the securities industry.

Both economic theory and the successes of deregulation elsewhere argue for the general desirability of freer entry into the provision of securities-related services. However, economists have known this for years. The general presumption that freer entry is desirable does not begin to deal with the questions raised by the subsidy to risk-taking provided by flat rate deposit insurance premiums and by the proclivity of the federal agencies to "bail out" failing banks; the difference in treatment of banks and other brokers under the Securities Exchange Act; or the perceived problems of aggregate concentration, conflicts of interest, and efficiency discussed in the preceding section. As that discussion made clear, the current state of knowledge of these issues, including how to deal with them in designing new legislation, leaves much to be desired.

A case can be made for postponing new legislation on bank securities activities until these broader issues can be dealt with in a more comprehensive approach to regulatory reform. However, there are also costs of postponing action. They take the form of continued uncertainty on the part of market participants, expensive litigation, and potential losses in competition and efficiency. However, it is possible to exaggerate these costs. For one thing, the Glass-Steagall restrictions are not barriers to all entry into securities activities, but only to entry by commercial banks. Moreover, the costs of a broad-scale liberalization of restrictions on bank securities activities unaccompanied by fundamental reform of deposit insurance or safeguards against concentration could produce potentially irreversible adverse effects. These arguments against ill-considered legislative action apply equally to actions of regulators to relax restrictions unilaterally through strange interpretations of existing law such as those that led to *ICI I* and *ICI II*.

The issues were summarized well by the former general counsel of the SEC, Harvey L. Pitt, who argued in testimony concerning the proposed Financial Institutions Deregulation Act of 1983 before the House Committee on Government Operations that

> [e]ither the current laws applicable to the financial services industry make sense, and should be enforced as written, or our present system of financial services regulation should be amended to accommodate changing notions of appropriate policy and changing technological advances.
>
> But, if our laws are to be changed, they should be changed only by the Congress, with a clear view of the structure intended to be created, in a manner that avoids competitive inequalities, and in a manner that takes into consideration the lessons of history.[231]

This is not a call for inaction or for a leisurely approach to revision of the law. Failure to act on a comprehensive financial reform package within a reasonable period of time could result in Congress being faced with a *fait accompli* in which the financial system of the future is shaped by a continuing series of *ad hoc* rulings and private sector efforts at circumventing the ill-defined strictures of existing law. Although history suggests that decisive action by Congress is unlikely in the absence of an ongoing crisis, the perceived consequences of inaction may yet spur Congress to act.

231. *Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations*, 98th Cong., 1st Sess. 172 (1983) (written statement of Harvey L. Pitt).