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Bank-Sponsored Investment Services: Statutory Proscriptions, Jurisdictional Conflicts, and a Legislative Proposal

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BANK-SPONSORED INVESTMENT SERVICES: STATUTORY PROSCRIPTIONS, JURISDICTIONAL CONFLICTS, AND A LEGISLATIVE PROPOSAL

> I think the time has come to ask whether the fears — and resulting barriers — of 40 years ago are the same concerns that should rule us now, or whether, in view of the extensive securities industry supervisory structure and greatly strengthened bank regulatory structure which now exists, a greater role for banks in the matter of broadening participation in our equities markets should now be permitted.[1]
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> — Jeffrey M. Bucher, Member, Board of Governors of the Federal Reserve System, November 21, 1974

> I know of no responsible person in the securities industry who thinks that we can survive for long as an independent industry either as investment bankers or as brokers if the commercial banks are permitted to continue to compete against us . . . .[2]
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> — John C. Whitehead, Chairman, Securities Industry Association, May 29, 1974

The quotations set forth above illustrate polar positions in a long-running struggle between two of the nation's principal suppliers of capital over the extent to which commercial banks may provide their customers with investment services long considered the exclusive province of broker-dealers and investment bankers. As the banks continue to prosecute their offensive on a number of fronts, each vigorously contested by the securities industry, it appears increasingly unlikely that the conflict can be resolved without the necessity of congressional action. Legislative intervention is required, not only to arbitrate between two powerful sectors of the American financial community, but also to end serious jurisdictional squabbling between the federal bank regulatory agencies[3] and the Securities and Exchange Commission. Each claims, predictably, that it is, or should be, the proper regulatory authority in matters relating to banks' securities activities. As an indication of its determination to resist what it considers jurisdictional interloping by the bank regulators, the SEC last year called for comments[4] on the entire spectrum of issues involving banks and the securities business, even those over which it had previously disclaimed any authority.[5] As a result of its study, the SEC will probably take

1. 279 BNA SEC. REG. L. REP. A-15, A-16 (1974).

2. 259 BNA SEC. REG. L. REP. F-1, F-2 (1974).

3. Responsibility for bank supervision is divided among three federal regulatory authorities: The Comptroller of the Currency for national banks, 12 U.S.C. §§1 *et seq.* (1970); the Board of Governors of the Federal Reserve System for member banks and bank holding companies and their affiliates, 12 U.S.C. §§241 *et seq.*, §§1841 *et seq.* (1970); and the Board of Directors of the Federal Deposit Insurance Corporation for insured nonmember state banks, 12 U.S.C. §§264 *et seq.* (1970).

4. SEC Securities Act Release No. 5491 (April 30, 1974), 39 Fed. Reg. 18,163 (1974).

5. The SEC has repeatedly disclaimed jurisdiction over questions arising under the Banking Act of 1933 (Glass-Steagall Act, 98 Stat. 162 (codified in scattered sections of 12 U.S.C.)). SEC Securities Act Release No. 5491 (April 10, 1974), 39 Fed. Reg. 18,163. Letter from William L. Cary, Chairman, SEC, to the Secretary of the Treasury, Feb. 7, 1963, *reprinted in*

further steps to bring these banking activities within its regulatory ambit, either through promulgation of administrative regulations, proposals for legislation, or both.[6] The conflict has spread to the judicial branch as well. Presently pending in federal district court are two suits brought by securities industry interest groups to force banks to abandon two of their most important investment services, the operation of automatic monthly investment plans[7] and the advising of investment companies.[8] Moreover, it is likely that any administrative action by the SEC aimed at bringing banking activities within its purview will engender still more litigation as banks seek to avoid what they consider redundant or unnecessarily burdensome regulation.

An understanding of the issues involved in the controversies between the banks and the securities industry and between the bank regulators and the SEC requires an analysis not only of the historical forces that led to the legislatively mandated divorce of commercial and investment banking four decades ago, but also of the technological and economic forces that are today driving them back together. Accordingly, this note first examines the origins of the investment services issues facing policymakers today, focusing particularly on the Banking Act of 1933[9] (the Glass-Steagall Act), by which the commercial-investment banking separation was effected. Following this historical introduction, a description of the various investment services presently being offered by banks is presented, along with an appraisal of their legality under the Glass-Steagall Act and their desirability in light of the abuses the Act was designed to remedy. Finally, the issue of "equal regulation" of bank-sponsored investment services is treated, and a model for possible legislative resolution of this jurisdictional dispute is suggested.

BANKING PRACTICES PRIOR TO THE GLASS-STEAGALL ACT

Traditionally, the primary investment function of American commercial banking has been to supply relatively short-term capital in the form of well-

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Hearings on Common Trust Funds — Overlapping Responsibility and Conflict in Regulation Before a Subcomm. of the House Comm. on Gov't Operations, 88th Cong., 1st Sess. 136 (1963) [hereinafter cited as *Common Trust Funds Hearings*]; Letter from William L. Cary, Chairman, SEC, to Reese H. Harris, March 7, 1963, *reprinted in Common Trust Funds Hearings* at 161.

6. Several Commisioners have indicated obliquely that the SEC is likely to move toward greater regulation of these banking activities. *See, e.g.*, Evans, *Regulation of Bank Securities Activities*, 91 BANKING L.J. 611, 619 (1974); Address by Ray Garrett, Jr., Chairman, SEC, *The SEC's Concern with Bank Trust Activities*, before the National Trust Conference, San Francisco, Cal., Feb. 4, 1974, *reported in* CCH FED. SEC. L. REP. ¶79,641, at 83,710 (1974).

7. New York Stock Exch. v. Smith, CCH FED. SEC. L. REV. ¶94,798 (D.D.C., complaint filed Sept. 24, 1974).

8. Investment Co. Institute (ICI) v. Board of Governors, CCH FED. SEC. L. REP. ¶94,540 (D.D.C., complaint filed May 8, 1974). Discussion of these new investment services begins in text accompanying note 85 *infra*.

9. Act of June 16, 1933, ch. 89, 48 Stat. 162. Relevant sections of the Glass-Steagall Act are: §16, *as amended*, 12 U.S.C. §24, ¶7 (1970); §20, *as amended*, 12 U.S.C. §377 (1970); §21, 12 U.S.C. §378 (1970); §5, 12 U.S.C. §335 (1970); §32, *as amended*, 12 U.S.C. §78 (1970). See text accompanying notes 51-56 *infra*.

secured loans to businessmen, farmers, and consumers. In addition, banks have long been able to invest in low-risk debt securities, particularly government issues.[10] Such conservative and highly liquid investments were, of course, logically mandated for institutions capitalized largely by debt in the form of highly volatile demand deposits. The National Bank Act of 1864,[11] which established the present system of nationally chartered banks, did not expressly prohibit national banks from dealing in corporate stocks, but such a proscription was inferred by the courts from the failure of Congress to grant the power.[12] In addition to their lending functions, commercial banks in this country have long served as corporate trustees, a role permitted national banks by the Federal Reserve Act of 1913.[13] Even to a greater degree than the commercial side, the trust department of a bank was severely circumscribed in the kinds of uses to which it could put funds held in its fiduciary capacity. "Legal lists" of approved investments were common devices[14] for insuring the fulfillment of the trustee's primary duty – the conservation of principal.[15] Even those states that did not require investments to be made in accordance with a "legal list" held fiduciaries to a strict "prudent man" rule, which was frequently interpreted to forbid investment in common stock of corporate issuers.[16] Of course, no trustee could invest in new and untested commercial ventures.[17]

Although most possessed a deserved reputation for financial conservatism, a few influential bankers in the second decade of the twentieth century began to engage in activities that later were found to have contributed to the severity and persistence of the Great Depression. These activities involved the creation of securities affiliates by several large banks.[18] These affiliates, whose only purpose was to circumvent prohibitions against banks dealing in stocks, were masterful, if dubiously legal, instruments for doing indirectly what could not be done directly. The most notorious example of the national bank securities affiliates was National City Company, formed in 1911, which became the largest such affiliate in the nation. The company was wholly owned by the shareholders of National City Bank, then, as now, the country's second largest commercial bank.[19] The bank's shareholders exercised control of the company

10. *See, e.g.,* Junction City v. Central Nat'l Bank, 96 Kan. 407, 153 P. 28 (1915) (upholding power of national bank to purchase municipal bonds).

11. Act of June 3, 1864, ch. 106, 13 Stat. 99, 12 U.S.C. §§1 *et seq.* (1970).

12. First Nat'l Bank v. National Exch. Bank, 92 U.S. 122 (1875).

13. Federal Reserve Act §11(k), Act of Dec. 23, 1913, ch. 6, 38 Stat. 251, 262, 12 U.S.C. §248(k) (repealed 1962) conferred authority on the Federal Reserve Board to grant permits allowing national banks to act as trustee, executor, administrator, or registrar of stocks and bonds when not in contravention of state or local law. Identical power now resides in the Comptroller, 12 U.S.C. §92a (1970). See text accompanying note 64 *infra.*

14. G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES §613 (2d ed. 1960).

15. *See* A. SCOTT, THE LAW OF TRUSTS §227, at 1806 (3d ed. 1967).

16. G. BOGERT, *supra* note 14, §679.

17. A. SCOTT, *supra* note 15, ¶227.6, at 1816.

18. For a comprehensive discussion of the history, structures, and functions of these affiliates, see W. Peach, *The Security Affiliate sof National Banks,* in 48 JOHN HOPKINS UNIVERSITY STUDIES IN HISTORICAL AND POLITICAL SCIENCE pt. 3 (1941).

19. National City Bank is now First National City Bank as the result of its merger with

through a voting trust, which held legal title.[20] Shares in the company and shares in the bank could not be traded separately and, in fact, their certificates were printed on reverse sides of the same sheet of paper.[21] Most importantly, this state-chartered alter ego was not a bank and thus was not subject to either state or federal supervision. Powerful political considerations prevented any legal challenge to the growing affiliate system even though the Comptroller of the Currency noted as early as 1920:

> Some "securities companies" operating in close connection with and often officered by the same men who manage the national banks with which they are allied, have become instruments of speculation and headquarters for promotion of all kinds of financial schemes.[22]

Not surprisingly, the abuses outlined by the Comptroller became more the rule than the exception as formerly staid bankers clamored for their shares of huge profits to be had during the speculative years 1928-1929.[23] Some of the most egregious examples of abuses involving banks' securities affiliates were:

> (1) The making of unsound loans by the bank to its affiliate for promotion and underwriting ventures or to individuals for the purpose of financing securities purchased from the affiliate. The identity of ownership and control between the bank and its affiliate effectively removed the protection afforded by arm's-length negotiations, during which ordinary loan applications are scrutinized as to the credit-worthiness of the borrower and the solidarity of his collateral.[24]
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> (2) The use of the securities affiliate as a burial ground for bad loans made by the bank. National City Bank, for example, rid itself of $25 million in worthless loans to Cuban sugar companies by having the National City Company purchase all of the shares of a newly-formed dummy corporation that, in turn, bought the bad loans from the bank.[25] This disappearing act was financed by selling $50 million in stock, divided evenly between the bank and the company, to unsuspecting bank shareholders. Since the burying of bad loans had a beneficial effect on the financial position of the bank, and the affiliate was not subject to regulatory supervision, bank examinations were ineffectual in discovering the abuse.

First National Bank of New York. The Bank of America is the nation's largest commercial bank. FORTUNE, July 1974, at 114.

20. Testimony of Charles E. Mitchell, *Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency*, 72d Cong., 2d Sess. 1780 (1933) [hereinafter cited as *Stock Exchange Practices*].

21. F. PECORA, WALL STREET UNDER OATH 79 (1939).

22. COMPTROLLER OF THE CURRENCY, ANNUAL REPORT 55 (1920).

23. The number of securities affiliates of national banks eventually grew to nearly 200. J. GOODBAR, MANAGING THE PEOPLE'S MONEY 127 (1935). "Starting with the issue of bonds as their major activity, the affiliates had gradually passed . . . to the financing and issuing of preferred stock, and then to the issuing and financing of common stock. From such activities they had then passed to stock market operations . . . ." H. WILLIS & J. CHAPMAN, THE BANKING SITUATION 67 (1934). "[B]y 1930 [securities affiliates] were sponsoring 54.4 per cent of all new securities issues." S. KENNEDY, THE BANKING CRISIS OF 1933, at 212 (1973).

24. *See* J. GOODBAR, *supra* note 23, at 128.

25. Testimony of Charles E. Mitchell, *Stock Exchange Practices*, *supra* note 20, at 1827-39.

(3) The payment of exorbitant management fees that, in the case of National City Company, totaled twenty per cent of net operating profit.[26]

(4) The use of the affiliated company to support the price of the bank's own stock. This tactic was a major contributor to the failure in 1930 of the Bank of United States.[27]

(5) The utilization of the affiliate to control investment trusts, one of the preeminent engines of speculation in the late twenties. Essentially a closed-end mutual fund,[28] the investment trust was an ideal vehicle for "leveraging" the investor's dollar.[29] To support the dizzying ascent in the price[30] of these trusts, banks were under almost irresistible pressure to provide call loan funds[31] to finance the security affiliate's margin accounts in the trusts' shares. Of course, the same laws of leverage that had propelled investment trust shares to such heights so quickly were also responsible for their equally precipitous fall.[32] The crash humbled not only investors and the trusts they owned, but also the investment affiliates and associated banks, which had lately been so eager to insure financing of the most speculative issues. The skewed parabola described by call money rates in

26. In 1928 Charles E. Mitchell, President of National City Bank, received as his share of this "management fund" $750,000 from National City Company alone. This figure was 30 times his annual salary as president of the bank. *Id.* at 1773.

27. The Bank of United States (BUS), a state-chartered institution, had created three securities affiliates, which had in turn purchased a large number of BUS shares. In 1928 an exchange merger was effected between BUS and another New York bank. The recipients of the exchanged BUS shares, however, began to "dump" them on the market, threatening to depress the price of the stock. To avoid a price decline, the affiliates purchased more BUS shares in the open market. Unable to resell these shares at satisfactory prices, the affiliates were left holding a huge portfolio of BUS shares, which they could not sell without completely destroying the market and realizing a sizable loss. The bank was in a similar predicament, having $12 million outstanding in loans to affiliates, secured by its own frozen stock. These and other questionable practices led to the collapse of BUS in 1930, at that time the largest such failure in American history. See J. GOODBAR, *supra* note 23, at 130-35; S. KENNEDY, *supra* note 23, at 1-3.

28. A closed-end fund is negatively defined as a management company other than one "which is offering for sale or has outstanding any *redeemable* security of which it is the issuer." Investment Company Act of 1940, §5(a), 15 U.S.C. §80a-5(a) (1970) (emphasis added). Shares of closed-end funds are traded in the secondary markets and may sell at a premium or discount from the prorated net asset value of the fund's portfolio. Open-end funds ("mutual funds") typically issue and redeem shares constantly at a price that represents the shares' prorata portion of net asset value.

29. Leverage exists whenever the owner of variable-return capital can utilize capital contributed for a fixed return. A common example is the margin account, in which the investor borrows part of the price of stock from his broker at a fixed rate. The speculative dangers of excessive margin lending led to inclusion in the Securities Exchange Act of 1934 of a provision allowing the Board of Governors of the Federal Reserve System to set margin limitations. 15 U.S.C. §78(g) (1970).

30. Investment trusts in 1928-1929 sold at a considerable premium over net asset value, presumably because of investor faith in the expertise of trust management. To fuel this faith, the trusts actively recruited luminaries from the fields of economics and finance for their boards of directors. J. GALBRAITH, THE GREAT CRASH 56 (1955).

31. By 1929 many nonbanking corporations were providing call loans to brokers. These loans often yielded a considerably higher return than did more traditional uses of corporate funds. S. KENNEDY, *supra* note 23, at 14.

32. The same principle of leverage also works to the disadvantage of the variable-return security holder in a declining profits or price situation. The greater the leverage the sharper the decline.

the period 1928-1930 illustrates the dramatic rise and even more dramatic fall in securities speculation.[33] In late March of 1928, the call money rate on new loans to members of the New York Stock Exchange was five per cent per annum.[34] One year later, the rate had soared to twenty per cent.[35] Twelve months after the crash, call loans were commanding a mere two per cent.[36] Total loans to members of the Exchange rose from $3.9 billion in October 1927 to a record $8.5 billion two years later.[37] Inevitably, but for reasons still not fully understood, the great price pyramids built of borrowed money tumbled in late October 1929. Worse, the New York bankers were unable to reverse the decline as they had done during a similar break the previous spring.[38] As speculators faced the prospect of being "sold out" by their creditor brokers, they were forced to sell their solid holdings in order to meet margin calls on their leveraged investment trusts and other speculative issues, which were fast approaching worthlessness. Thus, the collapse of the rotten issues carried with it many substantial, nonspeculative stocks.[39]

THE GLASS-STEAGALL ACT

In 1932 the Senate authorized an investigation into practices that were believed to have caused the crash and subsequent depression.[40] The committee appointed to examine these practices soon came to be known as the Pecora Committee after its chief counsel, Ferdinand Pecora, a thorough and relentless reformer. That same year Senator Glass of Virginia introduced a bill embracing a congeries of banking reforms.[41] Unfortunately, his proposals made little headway against the opposition of the banking interests,[42] the Hoover Ad-

33. Call money rates, margin percentages, and other measures of lending activity in the securities markets are valuable indicators of the degree of speculation obtaining at a particular time.

34. NEW YORK STOCK EXCHANGE, YEAR BOOK 1930-1931, at 96 (1931).

35. *Id.* at 97.

36. *Id.* at 98.

37. *Id.* at 111, 115.

38. National City Bank and other large New York City banks, whose officers dominated the Federal Reserve Bank of New York, had prevented a threatened crash early in 1929 by providing the market with a stimulating infusion of new call money. J. GALBRAITH, *supra* note 30, at 41-43. In October, however, the banks were unable to stem the deflationary tide. Worse still, there is evidence that rescuing the market was in conflict with some bankers' personal pecuniary interests. The president of Chase National Bank, for example, actually profited from the crash by maintaining a short position in the shares of his own bank. F. PECORA, *supra* note 21, at 153-54.

39. J. GALBRAITH, *supra* note 30, at 128-29.

40. S. Res. 84, 72d Cong., 2d Sess. (1932).

41. S. 3215, 72d Cong., 1st Sess. (1932). The Glass Bill was the product of hearings held in 1930-1931 on the need for reform in American banking regulation. The major provisions of the bill as revised were: (1) restrictions on bank loans upon securities, (2) strengthening of Federal Reserve control over bank lending activities, (3) guaranty of bank deposits, (4) severance of commercial banks from their securities affiliates, (5) restrictions on time deposits, (6) restrictions on bank holding companies, and (7) liberalization of branch banking for national banks. S. 4115, 73d Cong., 1st Sess. (1933). See H. WILLIS & J. CHAPMAN, *supra* note 23, at 62-83.

42. H. WILLIS & J. CHAPMAN, *supra* note 23, at 87.

ministration,[43] and, later, President-elect Roosevelt.[44] In early 1933, however, a combination of factors joined to propel the Glass bill rapidly toward passage. In February the sudden collapse of a large number of banks ended any hope that the depression was abating.[45] Although psychologically devastating, the banking crisis had the salutary effect of persuading Roosevelt to drop his opposition to the banking reform represented by the Glass bill.[46] The most important impetus to the bill, however, was provided by the public's reaction to the Pecora hearings, which had become a collective *mea culpa* of once powerful and respected New York bankers.[47] Public outrage reached its peak in February and March of 1933 as Charles Mitchell, president of National City Bank, spread before the committee tales of National City Company's sordid financial machinations.[48] These revelations, superimposed upon news of nationwide bank failures, insured that mere regulation of banks' investment activities would no longer suffice. A complete divorce of commercial from investment banking activities was demanded by the public.[49]

The Banking Act of 1933, popularly known as the Glass-Steagall Act,[50] provided for separation in several ways. Section 16 of the Act forbade national banks to purchase, sell, or underwrite corporate securities except "upon the order, and for the account of, customers . . . ."[51] The exception was made to allow banks to continue offering "managing agency" services to their depositors.[52] Section 5(c) of the Act made the provisions of section 16 applicable

43. *Id.* at 86.

44. *Id.* at 100. President Roosevelt's principal objection to the bill concerned the deposit guaranty provision. S. KENNEDY, *supra* note 23, at 214-15.

45. Between February 14 and March 3 banking holidays or other restrictions on deposit withdrawal went into effect in 18 states. On March 4 the New York and Illinois banks, the securities exchanges, and the Federal Reserve banks closed. On March 5, the day after his inauguration, President Roosevelt declared a four-day national banking holiday. J. BOGEN & M. NADLER, THE BANKING CRISIS 201 (1933).

46. S. KENNEDY, *supra* note 23, at 220. Despite his earlier hostility to the Glass Bill, President Roosevelt announced upon signing the Banking Act that it was the best banking legislation since the passage of the Federal Reserve Act twenty years earlier. H. WILLIS & J. CHAPMAN, *supra* note 23, at 102. See Note, *The Banking Act of 1933 in Operation*, 33 COLUM. L. REV. 697, 698 (1935).

47. S. KENNEDY, *supra* note 23, at 103.

48. See text accompanying notes 24-39 *supra*.

49. The committee that drafted the Glass Bill had originally proposed to subject bank securities affiliates to federal supervision and to regulate their relations with the parent banks. Mail from irate citizens, however, demanded "absolute elimination of the affiliate system — root and branch — from the national banking and Federal Reserve system." H. WILLIS & J. CHAPMAN, *supra* note 23, at 68-69.

50. Carter Glass of Virginia and Henry B. Steagall of Alabama were the Act's sponsors in the Senate and House respectively.

51. 12 U.S.C. §24, *para. seventh* (1970).

52. A managing agency account is a type of fiduciary service in which the bank provides investment management to a customer. The managing agency relationship may be nondiscretionary (the bank provides only advice to the customer) or discretionary (the bank possesses a power of attorney authorizing it to execute transactions in the customer's behalf). E. MCINNIS, TRUST FUNCTIONS AND SERVICES 210-15, 243-46 (1971). Section 16 of the Glass-Steagall Act was amended in 1935 to make clear that Congress did not intend to prohibit managing agency relationships. Act of Aug. 23, 1935, §308, ch. 614, 49 Stat. 709, 12 U.S.C. §24,

to state bank members of the Federal Reserve System.[53] Section 21 prohibited any person or firm engaged in the business of issuing, underwriting, selling, or distributing securities from engaging simultaneously in the business of receiving deposits.[54] Section 20 made it unlawful for any member bank to be affiliated with any organization engaged principally in the issue, flotation, underwriting, public sale, or distribution of securities.[55] Interlocking directorates between securities companies and banks were proscribed by section 32, which prohibited a person primarily engaged in the business of dealing in securities from serving at the same time as an officer, director, or employee of any member bank.[56] Radical as the Act's surgery was, it met little opposition since most of the commercial banks affected were already in the process of divesting themselves of their investment banking affiliates.[57] Concerned as they were with rebuilding their tarnished image as the conservative bulwark of the American financial community, bankers, for the most part, had little desire to remain in the securities business.

THE RENEWAL OF INTEREST IN INVESTMENT SERVICES

For thirty years following passage of the Glass-Steagall Act, a chastened banking industry was more than content with its truncated functions of short-term lending, receiving deposits, and administering trusts. One of the few innovations of the period was the development of the common trust fund, a device for taking advantage of economies of scale in the management of trust investments. Forbidden at common law in the absence of express authority in the trust instrument,[58] the commingling of trust corpora makes available to small accounts many of the benefits previously offered only to large trusts, such as high-quality portfolio management, diversification, lower brokerage commissions, and participation in private placements.[59] Although common trust funds were established as early as 1927, they were not used extensively until 1936 when Congress amended the Internal Revenue Code to provide for pass-through treatment of common trust funds held by a bank in its capacity as

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para. seventh (1970). The committees, in reporting the 1935 amendments, emphasized that "since buying and selling for the account of a customer does not involve investment by the bank of its own funds . . . no objection can be seen thereto." H.R. REP. No. 1948, 73d Cong., 2d Sess. 2 (1934); S. REP. No. 1260, 73d Cong., 2d Sess. 2 (1934).

53. 12 U.S.C. §335 (1970).

54. 12 U.S.C. §378 (1970).

55. 12 U.S.C. §377 (1970).

56. 12 U.S.C. §78 (1970).

57. *See* Note, *supra* note 46, at 703.

58. *See* SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, COMMINGLED OR COMMON TRUST FUNDS ADMINISTERED BY BANKS AND TRUST COMPANIES, H.R. DOC. No. 476, 76th Cong., 2d Sess. 5 (1939); G. BOGERT, *supra* note 14, §677.

59. Pitts, *Un-Common Trust Funds,* 112 TRUSTS & ESTATES 634, 635 (1973). Effective May 1, 1975, stock exchanges were prohibited from adopting or retaining rules requiring their members to charge fixed commission rates. SEC RULE 19b-3, CCH FED. SEC. L. REP. ¶80,067 (1975). Although the introduction of rate competition may lower the cost of transactions for the small investor, he will still be at a disadvantage relative to the institutions whose volume of trading gives them a superior negotiating position.

trustee, executor, administrator, or guardian.[60] To be eligible for pass-through treatment, however, all funds must meet standards set for national banks.[61] In 1937 the Board of Governors of the Federal Reserve System (Board) amended its trust department regulations ("Regulation F") to include rules for common trust funds, one of which was that the funds must be composed exclusively of individual trust accounts held for a "true fiduciary purpose."[62]

After three decades of relative quiescence, a new period of aggressive bank expansionism was inaugurated in 1961 by the appointment of James J. Saxon as Comptroller of the Currency.[63] In 1962 Congress shifted authority over national bank trust activities from the Board to the Comptroller,[64] who used his new powers to launch banking into the previously exclusive preserve of the securities industry. This move was accomplished by deleting the "true fiduciary purpose" limitation in Regulation F, which had become Regulation 9 in the Comptroller's nomenclature.[65] In addition, the Comptroller expressly provided for the operation of a commingled managing agency account,[66] whereby customers of a national bank could have their agency accounts collectively invested in a common fund managed by the trust department.[67] In effect, a bank could sponsor an investment vehicle that was difficult to distinguish in operation from an ordinary no-load mutual fund.[68] The banking interests and the Comptroller, however, insisted that this commingled investment fund (CIF) was merely the combination of two recognized services of a commercial bank: the common trust fund and the managing agency account.[69]

Opposition to the CIF came from two sources: the securities industry, threatened by competition for the then-booming mutual fund business, and the SEC, which insisted that the operation of the CIF would violate the registration requirements of the Securities Act of 1933[70] and the Investment Company Act of 1940.[71] The SEC's position was that participations in the CIF were securities[72] and that the CIF itself did not fit within the Investment

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60. Revenue Act of 1936, §169, 49 Stat. 1708 (now INT. REV. CODE OF 1954, §584). Section 584(b) provides: "A common trust fund shall not be subject to taxation under this chapter and for purposes of this chapter shall not be considered a corporation." Section 584(c) requires participants in a common trust fund to include in computing taxable income their proportionate share of the gains, losses, and income of the fund.

61. INT. REV. CODE OF 1954, §584(a)(2).

62. 2 Fed. Reg. 2976 (1937); see note 13 *supra*.

63. For an account of Saxon's controversial tenure and a history of the office of Comptroller, see R. ROBERTSON, THE COMPTROLLER AND BANK SUPERVISION (1968).

64. Act of Sept. 28, 1962, 76 Stat. 668, 12 U.S.C. §92a (1970).

65. 12 C.F.R. §9 (1974).

66. See note 52 *supra* for an explanation of managing agency accounts.

67. 38 Fed. Reg. 3309, 3311 (1963).

68. A no-load fund is one that charges no sales commission on transactions.

69. Statement of James J. Saxon, Comptroller of the Currency, *Common Trust Funds Hearings, supra* note 5, at 34.

70. Subject to several exceptions, §5 of the Securities Act of 1933 requires issuers of securities to register them with the SEC. 15 U.S.C. §77e (1970).

71. Section 7 of the Investment Company Act requires all investment companies, unless exempted, to register with the SEC. 15 U.S.C. §80a-7 (1970).

72. For a discussion of what constitutes a security, see text accompanying note 137 *infra*.

Company Act provision exempting "any common trust fund or similar fund . . . maintained by a bank . . . in its capacity as *trustee, executor, administrator* or *guardian.*"[73] Furthermore the SEC maintained that, under its "ectoplasmic" or "two-entity" theory, the fund itself, not the bank, was the issuer of the securities.[74] The importance of the ectoplasmic theory lay in determining whether the CIF was entitled to cloak itself in the bank's exemption from registration under the Securities Act[75] and its exclusion from the definition of investment company under the Investment Company Act.[76]

The securities industry's attack focused on the vulnerability of the CIF under the Glass-Steagall Act. The issue was joined when, in 1966, First National City Bank of New York (Citibank), acquiescing in the SEC's view regarding the applicability of the securities law, registered its CIF under the Securities and Investment Company Acts.[77] The Investment Company Institute (ICI) immediately brought suit, requesting that Regulation 9 be declared invalid insofar as it authorized national banks to operate CIFs.[78] After five years of litigation, the Supreme Court, in *Investment Company Institute v. Camp,*[79] ruled that Citibank's CIF involved that institution in the underwriting, issuing, selling, and distributing of securities in violation of section 16 of the Glass-Steagall Act while being simultaneously engaged in the business

73. 15 U.S.C. §80a-3(c)(3) (1970) (emphasis added).

74. Under the "ectoplasmic theory," a bank, insurance company, or other exempt entity that offers a pooled investment fund may be deemed to have created a legally separate entity subject to the provisions of the securities laws. The theory is based on the functional distinctions between the securities activities of the fund and the banking, insurance, or other activities of the exempt entity. The theory emphasizes that purchasers of the fund's securities are purchasing interests only in the fund itself and not in the sponsoring entity. *See* Prudential Ins. Co., 41 S.E.C. 335 (1963), *aff'd,* 326 F.2d 383 (3d Cir.), *cert. denied,* 377 U.S. 953 (1964).

75. Section 3(a)(2) of the Securities Act of 1933 exempts from registration "any security issued or guaranteed by a bank." In 1970 Congress amended this section to specifically exempt "any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment or reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator or guardian." Participations in collective funds, however, are not "securities issued or guaranteed by a bank." 15 U.S.C. §77(c)(a)(2) (1970).

76. Section 3(c)(3) exempts banks and common trust funds maintained by a bank "in its capacity as trustee, executor, administrator, or guardian" from the definition of "investment company." 15 U.S.C. §80a-3(c)(3) (1970).

77. The SEC, exercising its authority under §6 of the Investment Company Act, waived the prohibition in the Act against an investment company having "a majority of its board of directors consisting of . . . directors, officers or employees of any one bank." 15 U.S.C. §80a-10(c) (1970). The purpose of this section, like that of §32 of the Glass-Steagall Act, is to prevent abuse arising from interlocking directorates between banks and companies engaged in securities dealing. Comment, *Banks, Trusts and Investment Companies: The Commingled Investment Fund,* 115 U. PA. L. REV. 1276, 1294-95 (1967) [hereinafter cited as *Investment Fund*].

78. The National Association of Securities Dealers (NASD) also brought suit to challenge the SEC's authority to grant exemptions from §10 of the Investment Company Act. This suit was consolidated with the ICI action at the appellate level. NASD v. SEC, 420 F.2d 83, 84 (D.C. Cir. 1969), *vacated,* 401 U.S. 617 (1971).

79. 401 U.S. 617 (1971).

of accepting deposits, a violation of section 21 of the Act.[80] The Court did not, however, accept the ectoplasmic argument advanced by ICI. Rather, the Court, in approving the Board's previous opinion[81] that a CIF does not violate the affiliation and interlocking directorate proscriptions of the Act, stated:

> The Bank has effective control over the activities of the investment fund. Moreover, there is no danger that to characterize the bank and its fund as a single entity will disserve the purpose of Congress. The limitations which the banking laws place on the activities of national banks are at least as great as the limitations placed on the activities of their affiliates.[82]

In support of its decision that the Glass-Steagall Act prohibited a bank-sponsored mutual fund, the Court relied on the legislative history of the Act and reviewed the actual and potential abuses the Act was designed to remedy. The Court concluded that, although:

> From the perspective of competition, convenience and expertise, there are arguments to be made in support of allowing commercial banks to enter the investment banking business. . . . Congress determined that the hazards . . . made it necessary to prohibit this activity to commercial banks. Those same hazards are clearly present when a bank undertakes to operate a mutual fund.[83]

In addition to reciting the litany of abuses that brought about passage of the Glass-Steagall Act, the Court admonished that promotional pressures engendered by the existence of a "salesman's stake in the performance of the fund" might prove to be inconsistent with the "conservative traditions of commercial banking."[84]

BANK-SPONSORED INVESTMENT SERVICES TODAY

Although the *Camp* decision was a sharp blow to banking interests hoping to secure their beachhead in the securities business, it has not forced banks into abandoning attempts to provide investment services to their customers. Indeed, today there are a greater number of such services in operation than ever before, despite a serious downturn in the economy and resultant disillusionment with equity investments. It is probable that an improvement in economic conditions will provide the impetus for an even greater proliferation of bank-sponsored investment devices. Two other factors are also likely to encourage the growth of such services: increased computerization in the banking industry and the demand by small investors for competent professional advice in a market increasingly dominated by institutional traders.

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80. See text accompanying notes 51, 54 *supra*.
81. 30 Fed. Reg. 12,836 (1965), 12 C.F.R. §218.111 (1974).
82. ICI v. Camp, 401 U.S. 617, 625 n.12 (1971).
83. *Id.* at 636.
84. *Id.* at 637.

The imaginative utilization of the computer has revolutionized banking services in the past two decades, greatly reducing the paperwork and analytical time required in the management of trust department investments.[85] However, the high fixed costs of electronic data processing force banks to seek ways to utilize their computing facilities to the limits of capacity. One way to maximize computer utilization is to extend more administrative, bookkeeping, custodial, and management services to the banks' smaller customers. These customers have been increasingly discouraged from entering the market in recent years by brokerage firms preoccupied with trust accounts, pension funds, and other institutional investors.[86] This disparity in access to the market between large and small investors is further intensified by the imposition of an odd-lot differential on small transactions.[87] Often, large institutions can minimize commission fees by dealing with "third market" broker-dealers or eliminate them altogether by trading in the "fourth market."[88] Yet another advantage of the large investor is its ability to obtain the benefits of professional investment research services provided by the major brokerage firms. A common practice of large "research houses" is to make their data available to institutions several days before furnishing them to their account executives for dissemination to individual customers.[89]

The new services presently being offered by banks can be grouped under two headings: those that offer investment advice or portfolio management and those that are primarily custodial and bookkeeping services. All but one of the new services are based on the pooling of customers' funds and all but one are nondiscretionary, that is, the customer, not the bank, has the responsibility for making investment decisions.

Advising Investment Companies

Both banks and nonbank affiliates of bank holding companies have recently begun serving as advisers to independent investment companies, primarily companies specializing in income securities. The nonbank affiliates of bank holding companies are required to register under the provisions of the Investment Advisers Act of 1940,[90] but banks themselves are specifically exempt

85. *See* Chase, *The Emerging Financial Conglomerate: Liberalization of the Bank Holding Company Act,* 60 GEO. L.J. 1225, 1234 (1972); New York Clearing House Association, *Response to SEC Securities Act Release 5491,* at 6, 67 (1974) [hereinafter cited as *Clearing House Response*].

86. *See* BUS. WEEK, June 2, 1973, at 58; BUS. WEEK, April 17, 1971, at 86.

87. An odd-lot differential is the variable surcharge placed on orders of fewer than 100 shares (a round lot) of listed stocks.

88. The "first market" refers to the organized exchanges. The "second market" is the "over the counter" market in unlisted issues. Brokers in the "third market" specialize in arranging transactions of listed stocks directly between large buyers and sellers. The "fourth market" consists of the large institutional investors that maintain a computerized trading interchange, thus avoiding brokerage commissions.

89. *See* Lybecker, *Regulation of Bank Trust Department Investment Activities: Seven Gaps: Eight Remedies,* 2 SEC. REG. L.J. 122, 154 n.87 (1974).

90. 15 U.S.C. §80b-3 (1970). The Investment Company Act defines "investment adviser" as, *inter alia,* "any person . . . who pursuant to a contract with [an investment] company reg-

from registration.[91] Two factors appear to have provided the primary impetus for the entry of banking organizations into the investment advising business. The first was the *Camp*[92] decision, which debarred national and Federal Reserve banks from marketing their own mutual funds. The second was the Board of Governors' 1972 amendment to section 225.4 of Regulation Y,[93] the Board's administrative rules for bank holding companies. That amendment, which authorized holding company subsidiaries to serve as advisers to investment companies registered under the Investment Company Act of 1940, quickly became the focal point of the advisory services controversy.

Under the provisions of the Bank Holding Company Act of 1956, the Board is charged with supervisory authority over all bank holding companies.[94] The 1970 amendments to the Act vested in the Board broad discretion in determining the types of businesses that lawfully could be controlled by bank holding companies.[95] In addition to banks, holding companies may own or control any company that "the Board after due notice and opportunity for hearing has determined . . . to be so closely related to banking or managing or controlling banks as to be a proper incident thereto."[96] In determining whether a proposed activity is a "proper incident" to banking, the Board is required to weigh the likely public benefits of the activity – such as greater convenience, increased competition, or greater efficiency – against possible adverse effects – such as undue concentration, impairment of competition, conflicts of interest, or unsound banking practices.[97] Before it ruled that serving as an investment adviser to an investment company was a proper incident to banking, the Board considered possible Glass-Steagall impediments, which it addressed in an interpretive release[98] accompanying its ruling.

In its release the Board acknowledged the applicability of the Glass-Steagall proscriptions to all bank holding companies and their banking and nonbanking subsidiaries, whether or not the holding company controlled any member banks of the Federal Reserve System.[99] According to the Board, however, the advising of mutual funds was not the sort of investment activity that the Act sought to prohibit. Rather, it viewed such services as merely a variation of the long-accepted banking practice of rendering investment advice to, and executing discretionary orders for, bank customers.[100] The Board and the banking

ularly furnishes advice to such company wth respect to the desirability of investing in, purchasing or selling securities or other property or is empowered to determine what securities of other property shall be purchased or sold by such company." *Id.* §80a-2(a)(20).

91. *Id.* §806-2(11) (banks excluded from definition of "Investment Adviser").

92. ICI v. Camp, 401 U.S. 617 (1971).

93. 12 C.F.R. §225.4(a)(5)(ii) (1974).

94. 12 U.S.C. §§1841 *et seq.* (1970).

95. Bank Holding Company Act Amendments of 1970, §103, 12 U.S.C. §1843 (1970).

96. *Id.* §1843(c)(8).

97. *Id.*

98. 12 C.F.R. §225.125 (1974).

99. *Id.*

100. See note 52 *supra.* Although the Board forbade bank holding company affiliates from sponsoring, organizing, or controlling mutual funds, it applied no such restriction to their relationships with closed-end investment companies. Since, unlike mutual funds, such companies are ordinarily not engaged in issuing and redeeming their securities, the Board

industry insisted that the provisions of the Glass-Steagall Act were aimed at preventing banks from participating in the issuance and distribution of securities and that there was no evidence that bank holding companies or their subsidiaries had engaged in such sales activity.[101] The Investment Company Institute, however, took the position that banks, bank holding companies, and their associated investment companies should be viewed as a "single entity" for Glass-Steagall purposes, citing the usual intimate relationship that exists between a fund and its adviser.[102] Failing in its attempt to have the Board reconsider its ruling, ICI filed suit in May 1974, requesting that the court declare unlawful the advisement of mutual funds by bank holding company affiliates.[103] That suit is still pending at the time of this writing.

The applicability *vel non* of the Glass-Steagall proscriptions to bank-related investment advisers of open-end funds would appear to turn on whether a particular adviser is so intimately connected with its associated investment company as to be functionally one entity. The Glass-Steagall Act, as interpreted in *Camp*, forbids such a relationship since the adviser-banking organization would be, in effect, the issuer of the fund's securities.[104] Arguably, control of an investment company by a bank or bank holding company could constitute that company an alter ego of the controlling entity for Glass-Steagall purposes. The Bank Holding Company Act includes within the meaning of "subsidiary" any company *controlled* by the holding company.[105] The Act embodies an exceedingly broad definition of control, encompassing not only ownership and voting power, but also the exercise of a "controlling influence over the management or policies of the bank or company."[106] The determination of whether such influence exists in a particular instance is made by the Board after notice and opportunity for hearing.[107] Although the Board has included general management agreements in its list of rebuttable presumptions of control, it has specifically excluded investment advisory contracts.[108] Further-

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was of the opinion that banks could sponsor them without contravening the provisions of the Glass-Steagall Act. 12 C.F.R. §225.125(f) (1974). The distinction between open- and closed-end funds is discussed in note 28 *supra*.

101. Letter from the Board of Governors of the Federal Reserve System to counsel for ICI, March 8, 1974, *reprinted in* CCH FED. BANKING L. REP. ¶96,202, 81,261 (1974); Citizens and Southern Investment Counseling, Inc., *Comments on Banks Acting as Investment Advisers to Investment Companies* 11 (filed with the SEC in response to Securities Act Release No. 5491) (Aug. 9, 1974).

102. ICI petition to Board of Governors of the Federal Reserve System, Dec. 12, 1973.

103. Letter from the Board of Governors of the Federal Reserve System to counsel for ICI, March 8, 1974, *reprinted in* CCH FED. BANKING L. REP. ¶96,202, at 81,261 (1974).

104. ICI v. Camp, 401 U.S. 617, 639 (1971). If the adviser in such circumstances is a bank, §§16 and 21 of the Glass-Steagall Act would be violated. If the adviser is a nonbank subsidiary of a bank holding company, only §21 would be violated. For an argument that the advising of a mutual fund by a nonbank subsidiary does not contravene §21, see Letter from the Board of Governors of the Federal Reserve System to counsel for ICI, March 8, 1974, *reprinted in* CCH FED. BANKING L. REP. ¶96,202, at 81,260-61 (1974).

105. 12 U.S.C. §1841(d) (1970).

106. *Id.* §§1841(a)(2)(C), (d).

107. *Id.*

108. 12 C.F.R. §225.2(b)(3) (1974).

more, the Board, in a review of exhibits submitted by ICI in its petition for reconsideration of the Regulation Y amendment, found no evidence that advisers were involved in the distribution of any fund securities.[109] These factual findings, combined with the traditional judicial deference[110] to rules promulgated by administrative agencies under a specific statutory grant of rulemaking power,[111] place ICI at a serious disadvantage in its struggle to have bank advisement of investment companies declared illegal.

Assuming no single entity is shown, does an investment company-adviser relationship fall within the managing agency exception to section 16 of the Glass-Steagall Act? The facile response of the banking interests that a mutual fund is merely a "customer" like all other managing agency clients[112] is somewhat disingenuous in that it fails to point out that ordinary clients, unlike mutual funds, are not in the business of buying, selling, and underwriting securities. Given the sordid history of bank relationships with investment trusts and the potential for abuse, it would seem that the adviser-mutual fund relationship merits close scrutiny to determine to what extent it conflicts with or subserves public policy. Few of the abuses that motivated the drafters of the Glass-Steagall Act, however, are likely to arise from the adviser-investment company relationship among entities subject to Regulation Y. The danger of unsound loans from the bank to the company is obviated by the Board's prohibition of any extension of credit to the company.[113] Nor may a holding company or one of its subsidiaries as principal, trustee, or agent, purchase shares of the advised company. This provision discourages any temptation to push shares onto trust department accounts.[114] A holding company and its subsidiaries may not accept the investment company's shares as collateral for loans to purchase such shares.[115] Other provisions established by the Board prohibit: the name of the investment company from being the same as, or similar to, that of the holding company or its subsidiaries;[116] the solicitation on behalf of, or the giving of opinions respecting, the investment company by holding company personnel;[117] and the furnishing of names of bank customers to the investment company.[118] For nonbank subsidiaries of a bank holding company, the restrictions imposed by the Board are augmented by the requirements of the Investment Advisers Act.[119] Where the adviser is a bank, it is subject to general fiduciary obligations imposed upon banks in their role as managing agent.[120]

109. Letter from the Board of Governors of the Federal Reserve System to counsel for ICI, March 8, 1974, *reprinted in* CCH FED. BANKING L. REP. ¶96,202, at 81,261 (1974).

110. *See* 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE §5 (1958).

111. Rulemaking authority is conferred on the Board by 12 U.S.C. §1844(b) (1970).

112. *See, e.g.,* Association of Registered Bank Holding Companies, *Reply to Comments of Justice Department and ICI on Proposed Amendment to Regulation Y* at 3 (1971).

113. 12 C.F.R. §225.125(g)(3) (1974).

114. *Id.* §§225.125(g)(1), (2).

115. *Id.* §§225.125(g)(1), (4).

116. *Id.* §225.125(f).

117. *Id.* §225.125(h).

118. *Id.* §225.125.

119. 15 U.S.C. §§80b-3 through 80b-8 (1970).

120. "Unless otherwise agreed, an agent employed to make or to manage investments has a duty to the principal: (a) to use care to invest promptly; (b) to invest only in such

Furthermore, the activities of banks and nonbank affiliates *qua* investment advisers are subject to the scrutiny of federal bank examiners: the Comptroller, the Board of Governors, and the Board of Directors of the Federal Deposit Insurance Corporation.[121] All state chartered banks are, of course, also subject to examination by state banking authorities. The Comptroller's Regulation 9 is expressly made applicable to managing agency, as well as trust, accounts.[122] Regulation 9 forbids, *inter alia,* unreasonable "float" (the profit made by a bank from the interest-free use of deposited funds) by requiring that funds not be held uninvested or undistributed any longer than is reasonably necessary.[123] The Regulation also prohibits certain types of self-dealing by a fiduciary, thus minimizing the likelihood of the bank as adviser purchasing its own issues or supporting the price of its stock.[124] Regulation 9 prohibits another common investment trust abuse by limiting compensation of fiduciaries to "reasonable" sums.[125] In addition, banks, bank holding companies, and their affiliates are subject to liability under the antifraud provisions of the securities laws.[126]

Although technically, Regulation Y governs only the nonbank subsidiaries of bank holding companies, the Board has indicated that it intends to impose the same standards on all state member banks of the Federal Reserve System. A serious disparity in regulation could develop, however, if the Comptroller declines to follow the Board's standards in his capacity as overseer of national banks. For example, Regulation 9 permits the sale of assets from one fiduciary account to another.[127] Regulation Y, on the other hand, forbids the sale of the investment company's shares to the bank.[128] Not only does the inapplicability of the Board's rules to national banks create unnecessary complexity in regulation, it also provides loopholes for national banks tempted to circumvent the strictures of Regulation Y. Additional confusion is injected into the regulatory scheme by the existence of another set of banks not subject to the limitations

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securities as would be obtained by a prudent investor for his own account, having in view both safety and income, in the light of the principal's means and purposes; and (c) to change investments on the conditions of the principal, if his duties include management." RESTATEMENT (SECOND) OF AGENCY §425 (1957). Statutes or administrative rules may alter the duties of the managing agent. *See, e.g.,* text accompanying notes 122-126 *infra.*

121. See note 3 *supra.*

122. 12 C.F.R. §9.1(b) (1974).

123. *Id.* §9.10(a).

124. *Id.* §9.12(c). A potentially dangerous exception to this prohibition exists in the clause that allows the parties to agree in the instrument that the agent bank may buy or sell its own stock.

125. *Id.* §9.15(a). As in §9.12(c), this section excepts agreements contained in the instrument.

126. *See* Securities Act of 1933, §17(a), 15 U.S.C. §77q(a) (1970); Securities Exchange Act of 1934, §10, 15 U.S.C. §78j (1970); SEC Rule 10b-5, 17 C.F.R. §240.10b-5 (1974). "A national bank acting as investment agent . . . is not immune or exempt from the antifraud provisions of the federal securities laws . . . ." Bakery Drivers Pension Fund Trust, Local 734 v. Continental Illinois Nat'l Bank & Trust Co., CCH FED. SEC. L. REP. ¶94,565, at 95,955 (N.D. Ill. 1974). *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

127. 12 C.F.R. §9.12(d) (1974). The transaction must be "fair to both accounts." *Id.*

128. 12 C.F.R. §225.125(g)(2) (1974).

of Regulation Y: the numerous independent state banks answerable only to the FDIC and state banking authorities. Given the potential for abuse that inheres in an investment company-adviser relationship, the present hodgepodge of regulations is unnecessarily dangerous to both depositors and investors.

The Automatic Investment Service

The automatic investment service (AIS) is a nondiscretionary device that allows a bank depositor to make systematic investments in corporations selected from a list of 25 to 35 of the largest companies in the United States. An allotted amount, ranging from 20 dollars to 500 dollars, is withdrawn each month from the customer's account and combined with funds of others purchasing the same stock. Promptly after a cutoff date (which may be no longer than 30 days from the date of withdrawal from the depositor's account), the pooled monies are used to purchase the designated shares. For this service the customer pays the bank a fee of up to two dollars, plus a pro rata share of the brokerage commission.[129] Advantages of the AIS are convenience, regularity of investment, and lower cost through avoidance of the odd-lot differential. Certificates are normally held in the bank's name or that of its nominee. Although the first AIS was organized in 1973, following an opinion from the Comptroller that its operation would not violate the Glass-Steagall Act,[130] continued uncertainty as to its legality and unfavorable economic conditions have limited the total number of such plans in operation to approximately 22 as of mid-1974.[131]

Once again, the Investment Company Institute, now joined by the New York Stock Exchange, has emerged to do battle with a competitor. In September 1974 suit was filed in federal district court alleging that the Comptroller had exceeded his authority in approving a service allegedly violative of sections 16 and 21 of the Glass-Steagall Act.[132] The plaintiffs maintain, *inter alia,* that the banks are creating security interests by pooling the funds of individual customers and by holding shares in the name of the bank or its nominee.[133] The banking industry and Comptroller, however, take the position that AIS is merely a variety of managing agency service, made possible by the advent of electronic data processing.[134] They emphasize that the stock is selected by the customer, not the bank, and that there is no separate fund or entity issuing shares.[135]

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129. SEC Securities Act Release No. 5491 (April 30, 1974), 39 Fed. Reg. 18,163 (1974).

130. Letter from James E. Smith, Comptroller of the Currency, to G. Duane Vieth, June 10, 1974, *reprinted in* CCH FED. BANKING L. REP. ¶96,272, at 81,354 (1974) [hereinafter cited as Smith Letter].

131. AM. BANKER, July 26, 1974, at 1.

132. New York Stock Exch., Inc. v. Smith, CCH FED. SEC. L. REP. ¶94,798 (D.D.C., complaint filed Sept. 24, 1974).

133. *Id.* at 96,656.

134. Smith Letter, *supra* note 130, at 81,306; Security Pacific National Bank, *Response to SEC Inquiry Into Bank-Sponsored Investment Services* 23-45 (Aug. 12, 1974).

135. Smith Letter, *supra* note 130, at 81,359.

Since the Glass-Steagall Act does not define the term "security," the courts have looked to the definition set forth in the Securities Act of 1933. That act defines "security" as one of an enumerated list of interests, of no concern in the present discussion, and as an "investment contract."[136] The commonly used definition of "investment contract" was set forth by the Supreme Court in *SEC v. W.J. Howey Co.*:

> A contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.[137]

Clearly, an AIS is a common enterprise in the limited sense that any profits or losses would accrue to all investors in a particular stock. There is, however, no expectation of profits from the managerial efforts of the bank, since the customer, not the AIS, determines the amount and nature of the investment to be made. In contradistinction to the CIF struck down in *Camp,* the AIS does not involve a situation where "an investor relinquishes control over his funds and submits their control to another . . . ."[138] Rather, the bank is bound to execute the customer's order, the timing of the purchase being the only discretion allowed it. Moreover, the staff of the SEC has considered the question and has issued a "no action" letter stating that, if certain requirements are met, AIS would be considered a "user's account" and not an issuer of a security within the meaning of the Securities and Investment Company Acts.[139] The New York Stock Exchange itself has, for many years, sponsored its own monthly investment plan. That plan, and similar plans sponsored by investment brokerage houses, have never been considered to be issuers of securities.

The securities industry cites a host of abuses that it believes might occur if banks are allowed to offer AIS. One of the more serious of these is that the interests of the bank's trust department, which administers AIS, are, or might be, antithetical to the interests of the commercial side. For example, the commercial loan department might be pressured into distorting "a bank's credit decisions regarding loans to AIS participants to facilitate purchases of stock through AIS and possibly loans to companies whose stocks could be bought through AIS."[140] There would seem to be little support for these charges, however, since the bank's stake in its customers' AIS investments is limited to a modest service fee—hardly the incentive to accept poor credit risks. Furthermore, such loans are detectable by bank examiners, whose functions include analyzing patterns of loans to detect conflicts of interest.[141]

A more substantial charge directed at AIS is that the sponsoring bank will abuse its discretion in timing purchases in order to maximze the interest-free

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136. 15 U.S.C. §77b(1) (1970).

137. 328 U.S. 293, 301 (1946).

138. ICI v. Camp, 274 F. Supp. 624, 642 (D.D.C. 1967).

139. *See* Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶79,411, at 83,184 (1973).

140. New York Stock Exch., Inc. v. Smith, CCH FED. SEC. L. REP. ¶94,798, at 96,656 (D.D.C., complaint filed Sept. 24, 1974).

141. Smith Letter, *supra* note 130, at 81,361.

use of the customer's funds.[142] However, abuse of "float" is unlikely because, under the terms of the Comptroller's opinion[143] and the SEC's "no action" letter,[144] the bank must purchase stock within thirty days after withdrawal of the funds from the customers' checking accounts. Moreover, uninvested trust department cash has traditionally been the object of particular attention by bank examiners.[145] According to one commentator, "trust department internal auditors, to spike potential trust examiner criticism, are said to be criticized by their own bank supervisors for being . . . more hardnosed than trust examiners in reviewing uninvested trust department cash."[146]

The Mini-Account

"Mini-account" is a rubric for two types of managing agency services made possible through the computerization of investment management functions. Under one such plan, entitled Special Investment Advisory Service (SIAS) by its originator, Citibank, the bank possesses discretion in managing a client's investment portfolio. In the second type of mini-account the bank merely mails a list of recommendations to the client, who is free to follow or disregard them.[147] The distinguishing feature of both types is that they offer professional, semi-individualized investment management for accounts as small as $10,000-$25,000. In contrast, many banks require a minimum of $200,000 for traditional managing agency accounts. As the result of a consent decree accepted by Citibank in settlement of a 1970 suit brought by the SEC, the SIAS variety of automatic investment service is no longer offered.[148] The SEC had insisted that the SIAS was, in effect, an unregistered investment company issuing unregistered securities.[149] It based its allegations on the fact that Citibank had discretionary power over the customer's funds and that its investment decisions, while ostensibly individualized, showed a marked degree of parallelism.[150] To

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142. New York Stock Exch., Inc. v. Smith, CCH FED. SEC. L. REP. ¶94,798, at 96,656 (D.D.C., complaint filed Sept. 24, 1974).

143. Smith Letter, *supra* note 130, at 81,362.

144. Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶79,411, at 83,184 (1973).

145. Smith Letter, *supra* note 130, at 81,362.

146. Lybecker, *supra* note 89, at 142.

147. For an annual fee of $100, the Harris Bank of Chicago supplies its mini-account subscribers with the following information on each of 12 selected common stocks: (a) a monthly commentary, (b) a one-, six-, and twelve-month price performance history, (c) the most recent closing price, (d) the high and low prices for the year, (e) the annual dividend rate, (f) the current dividend yield, (g) an estimate of the company's earning per share for the current year, and (h) the current price-to-earnings ratio. Letter from James E. Mandler, Sr., Vice President, Harris Bank & Trust Co., to George Fitzsimmons, Secretary, SEC, Aug. 9, 1974, in response to SEC Securities Act Release No. 5491.

148. SEC v. First Nat'l City Bank [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶92,592 (S.D.N.Y. 1970). In harmony with its theory that the investment service was a separate juridical entity, the SEC joined as defendants not only the bank and its broker but also the SIAS itself. *Id.*; see note 74 *supra*.

149. SEC Litigation Release No. 4534 (Feb. 6, 1970).

150. *Id.*

the SEC these factors strongly suggested the existence of a security within the meaning of the Securities Act. What emerged from the 1970 stipulation was the advice-by-mail type of mini-account presently offered by a number of banks. The legality of this plan under the Glass-Steagall Act would not appear to be in serious doubt. The SEC's Advisory Committee on Investment Management Services recently stated that, since under such a plan "the investor in each instance is free to accept or reject a specific recommendation, it would be difficult to find a security under present interpretations of the Securities Act."[151]

Although there appears to be no Glass-Steagall impediment to the operation of nondiscretionary mini-accounts, it has been suggested that a bank as creditor might be tempted to recommend to its advisees the shares of a faltering debtor corporation in order to forestall possible default. It seems unlikely, however, that any benefit accruing to the bank through support of the debtor's stock in the open market or even through the purchase of its shares during a new issue would be commensurate with the risk involved in such a scheme. The appearance of an unsound corporation on the records of both the commercial lending and the investment management divisions of the bank could hardly escape the notice of examiners. Clearly, too, the use of the mails to make misleading investment recommendations would subject the bank to civil suits and criminal penalties under the antifraud provisions of the Securities Exchange Act of 1934.[152]

The Dividend Reinvestment Plan

A dividend reinvestment plan (DRP) typically involves the bank as agent for the shareholder of a participating company, which pays the shareholder's dividends directly to the bank. The bank then "bunches" the individual dividends and purchases more of the participating corporation's shares, retaining in its custody the whole and fractional shares purchased. Many of the plans also allow the shareholders to contribute additional sums for purchase of the company's stock. The Glass-Steagall and conflict-of-interest considerations previously discussed in regard to AIS are equally applicable to dividend reinvestment plans.[153] The SEC staff has adopted a "no action" position on

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151. SEC, SMALL ACCOUNT INVESTMENT MANAGEMENT SERVICES 24-25 (1973). Although the report did not specifically deal with bank-sponsored mini-accounts, the Committee made one statement that, if accepted by the courts, would cast doubt on the continuing validity of the discretionary managing agency account. The Committee suggested that each such discretionary account might be considered an investment contract, albeit not one involving a public offering. This analysis, however, hardly comports with the *Howey* requirement of "common enterprise." See text accompanying note 137 *supra*. A similar argument was rejected by the circuit court in Milnarik v. M-S Commodities, 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972). There the court held that an individual, discretionary commodities trading account was not a security but an agency. An opposite conclusion, however, was reached by the Fifth Circuit in SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).

152. 15 U.S.C. §§78j, 78ff (1970); SEC Rule 10b-5, 17 C.F.R. §240.10b-5 (1974). *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

153. See text accompanying notes 132-146 *supra*.

DRPs that conform to certain standards designed "to insure that the operation of the plan does not result in the creation of a separate security . . . ."[154]

THE "CHINESE WALL" ISSUE

All bank-sponsored investment services that place the bank in the role of adviser or discretionary account manager involve the danger of what is probably the greatest potential abuse in today's complex and interdependent commercial environment. That is the possibility of the wrongful use by a trust department of material inside information obtained from the bank's commercial side. In recent years the traditional fiduciary duty to utilize all available sources of information in investment management[155] has collided with a growing body of case law holding insiders and their "tippees" liable for taking advantage of their favored circumstances.[156] Although the possibility of misuse of inside information is often cited in arguments against allowing banks to enter new areas of the investment business, there is no indication that investment services are more subject to abuse than are banks' traditional trust and pension fund management activities. In fact, it has been not commercial banking, but rather the securities industry, that has been most involved in litigation over insider abuses. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,*[157] the court found Merrill Lynch in violation of section 10(b)[158] and rule 10b-5[159] of the Securities Exchange Act for disclosing to its brokerage customers material inside information to which it had become privy in its role as lead underwriter for Douglas Aircraft Company. The court held that a person in possession of material inside information must either disclose it to

154. *See* Lucky Stores, Inc., CCH FED. SEC. L. REP. ¶79,903 (1974). The following restrictions were imposed by the Division of Investment Management as conditions to a "no-action" position regarding Investment Company Act registration: (1) dividends must be invested promptly, (2) charges must be limited to reasonable transaction fees, (3) economies of scale must be passed on pro rata to participants, (4) proxy materials must be passed on to participants, (5) participants must be able to receive certificates for their whole shares if they so desire, and (6) provision must be made for passing on rights or warrants to the participants. In addition, if the plan allows cash contributions, it must: (1) urge participants to transmit cash as close as possible to the dividend payment date, (2) provide for investment of late contributions as soon as funds sufficient to purchase a round lot are accumulated, and (3) allow for return of cash if the participant so requests up until a reasonable time before the cash is invested. *Id.* at 84,315.

155. Traditionally, bank trust department personnel were expected to meet regularly with lending officers in order to keep abreast of relevant inside information upon which to base investment decisions. Failure to utilize the resources of the commercial side in managing trust investments might even have subjected the bank to liability for breach of trust. Herman & Safanda, *The Commercial Bank Trust Department and the "Wall,"* 14 B.C. IND. & COM. L. REV. 21, 22-26 (1973).

156. *See, e.g.,* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), *cert. denied,* 394 U.S. 976 (1968); Cady, Roberts & Co., 40 S.E.C. 907 (1961).

157. 495 F.2d 228 (2d Cir. 1974).

158. 15 U.S.C. §78j (1970).

159. 17 C.F.R. §240.10b-5 (1974).

the public or refrain from using the information.[160] This "disclose or abstain" rule is equally applicable to banks, which often receive privileged information in their role as creditor.

One reaction of large banks to cases such as *Shapiro* has been the abandonment of the traditional habit of sharing inside information with the trust department. Indeed, many large banks have constructed "Chinese walls" between their commercial and trust departments in order to prevent the passage of material inside information. The existence of a "wall," of course, presents a number of new problems, such as determining what information is both "material" and "inside" and explaining to trust customers why their portfolios were being loaded with XYZ stock when the XYZ Company was simultaneously defaulting on a loan from the bank's commercial side. Serious impairment of efficiency can result where the trust officer is precluded by a too-strict policy from tapping valuable nonprivileged information in the files of the lending officers. On the other hand, liability under the securities laws awaits the bank that is remiss in building and maintaining its "wall."[161]

Even more disturbing to banks and investment houses than insuring impermeability of the "wall" is the spectre raised by the case of *Slade v. Shearson, Hammill & Co.*[162] In that case a federal district court rejected the "wall" as a defense to a 10b-5 suit by brokerage customers of Shearson, Hammill who claimed they had been advised to purchase certain shares of a corporation even though the underwriting side of the brokerage firm had come into possession of materially adverse information concerning that corporation. The court in *Slade* admonished members of the investment banking-brokerage industry (and by implication the commercial banking industry) that, if they continued to place themselves in what the court viewed as a conflict-of-interest situation by performing both advisory and underwriting functions, they would have to accept the consequences.[163] The circuit court of appeals recently declined to decide the *Slade* issue until the factual and legal questions involved have been further defined by the district court.[164]

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160. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974). The rule that insiders either must publicly disclose material inside information or refrain from taking advantage of it was first enunciated in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), *cert. denied,* 394 U.S. 976 (1968).

161. The Comptroller in an effort to discourage the illegal use of material inside information, amended Regulation 9 to allow departments of a national bank to utilize the facilities and personnel of other departments only to the extent not prohibited by law. 12 C.F.R. §9.7(d) (1974). In addition, Regulation 9 requires that legal counsel be readily available to advise the bank and its trust department. 12 C.F.R. §9.7(c) (1974).

162. CCH FED. SEC. L. REP. ¶94,329 (S.D.N.Y. 1974) (mem. opinion denying motion by defendant for summary judgment).

163. *Id.* at 95,132.

164. Slade v. Shearson, Hammill & Co., 283 BNA SEC. REG. L. REP. A-1 (1974). The court refused to decide the certified question whether "a brokerage firm that received adverse inside information about a company as a result of a confidential investment banking relationship violates Rule 10b-5 when its brokerage division continues to solicit customers for the company's securities." *Id.* The court considered the issues so complex that "an abstract answer is the least desirable of judicial solutions." *Id.*

The obvious import of *Slade,* should it be upheld by the appellate court, is that, at least in the second circuit, banks may find themselves in the impossible position of being liable for advising customers on the basis of material inside information and equally liable if they make recommendations at variance with such information. Many of the large commercial banks most active in the sponsorship of advisory services are also those most involved in extensive lending relationships with widely traded corporations. These institutions may find it impossible to conduct advisory activities without exposing themselves to broad 10b-5 liability to disappointed customers.[165] Large banks may thus be forced to divest themselves of such services, including the management of trusts and pension accounts. The probable effect of such divestitures would be an immediate increase in the cost of advisory services and possibly the liquidation of smaller, less profitable accounts.[166]

A MODEL FOR "EQUAL REGULATION" OF BANK-SPONSORED INVESTMENT SERVICES

In addition to objections based on alleged violations of the Glass-Steagall Act, the securities industry also opposes bank-sponsored investment vehicles on the grounds that, since banks are exempt from many of the provisions of the federal securities laws, their investment customers lack the protection afforded by those laws and the banks themselves enjoy an unfair competitive advantage.[167] In response to the outcry from the securities industry for "equal regulation" of the competing banks, the SEC appears to be moving toward a position as protector of the economic interests of the industry, in addition to its traditional role as champion of the investing public.[168] The tendency for regulatory agencies to bring their regulated industries under their protective aegis is, of course, a common one and may be unavoidable in a pluralistic society where policy is formulated through the clash of special interests. The Comptroller, for example, is commonly considered the "friend" of the national banks in their confrontations with other special interest groups.[169] There is no evidence that this role vis à vis outsiders impairs his ability to perform traditional supervisory functions over banks. What this sort of relationship does mean, however, is that the Comptroller and the SEC are likely to view issues of mutual concern through the parochial eyes of their respective client industries. This identification of the regulator with the regulated is exacerbated by inter-agency power struggles in which each regulatory body seeks to defend

165. Small banks, of course, are less likely to be in the position of "insider" with respect to companies in which their trust departments invest or that they recommend for investment.

166. Herman & Safanda, *supra* note 155, at 43.

167. Merrill Lynch, in its response to SEC Securities Act Release No. 5491 (requesting comments on bank-sponsored investment services) listed 14 areas in which it alleged unequal regulation exists between banks and the securities industry. Letter from Thomas B. Shearman, Vice President, Merrill Lynch, to George Fitzsimmons, Secretary of the SEC at 8-11, Aug. 21, 1974. *See also* Letter from Norman S. Poser, Senior Vice President, American Stock Exchange, to George Fitzsimmons, Secretary of the SEC at 5 (Nov. 1, 1974).

168. Explanations for this drift are couched in the language of "equal regulation." Evans, *supra* note 6, at 612.

169. 73 YALE L.J. 1249, 1264 n.123 (1964).

(and often to expand) its traditional scope of authority.[170] Thus, the Comptroller, quite predictably, takes an "entity" approach to regulatory boundary marking, which requires that, because the investment services are offered by national banks and national banks are regulated by the Comptroller, the investment services should also be regulated by the Comptroller.[171] The "special needs" of banks, such as the maintenance of solidarity and prudential practices, and the special expertise of the bank regulators in meeting those needs are also used to justify the "entity" approach. The SEC, on the other hand, accustomed to four decades of dealing with the securities issues of companies in a multitude of disparate industries, naturally takes a functional approach to the regulation of bank-sponsored investment services. The Chairman of the SEC recently stated that, in his opinion, the demarcation between the banking and securities industries, upon which Congress presumably based its decisions to exempt banks from some parts of the securities laws, has become blurred in recent years.[172] The exemptions, he stated, are inappropriate where a bank performs functions indistinguishable from those performed by brokers or mutual funds.[173] The "ectoplasmic" concept has for many years been the SEC's principal theoretical vehicle for circumventing the entity exemptions in the securities laws.[174] In litigation the "ectoplasmic" theory has enjoyed some success, although the courts have refrained from expressly articulating this conceptually awkward doctrine, possibly for fear of creating precedent for its application in unsuitable circumstances.[175] Equally important, the mere threat of suit by the SEC to require registration of bank-sponsored investment services has usually been enough to force banks to conform to the SEC's "no action" conditions.[176] This threat of suit is an effective regulatory tool largely because

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170. A modern classic in the literature of regulatory politics is Huntington, *The Marasmus of the ICC: The Commission, The Railroads, and the Public Interest,* 61 YALE L.J. 467 (1952). Professor Huntington describes the evolution of the ICC from its creation in the face of railroad opposition, through its gradual detente with the industry, to its eventual acceptance of the role of industry ombudsman.

171. Memorandum from James J. Saxon, Comptroller of the Currency, to a subcomm. of the House Committee on Government Operations, *reprinted in Common Trust Fund Hearings, supra* note 5, at 34. The entity approach, common among regulatory agencies, is enthusiastically supported by the regulated industry. *See* Huntington, *supra* note 170, at 477.

172. Garrett, *supra* note 6, at 83,713.

173. *Id.*

174. See text accompanying note 74 *supra.*

175. The Supreme Court lent some support to the SEC approach in SEC v. Variable Annuity Life Ins. Co. (VALIC), 359 U.S. 65 (1959). Piercing the exemptions granted to life insurance and annuity contracts under the Securities Act and the Investment Company Act, the Court enjoined VALIC from offering variable annuity contracts without registering under the two acts. Variable annuities, the Court found, are functionally dissimilar to ordinary insurance and annuity plans in that the risk is borne by the annuitant, whose return is dependent largely on the exigencies of the stock market. The SEC's position regarding bank-sponsored investment services is similar in its insistence that if a bank offers investment services functionally distinguishable from traditional banking services it may lose its exemptions under the securities laws. *See* note 74 *supra.*

176. Banks have been careful to conform their AIS and DRP plans to the dictates of the SEC staff's "no action" letters. See notes 139, 154 *supra* and accompanying text. Today's

an adverse court decision would mean not merely the registration of the service as sought by the Commission, but its complete prohibition. This is so because the necessary prerequisite to a requirement for registration is the issuance of a "security," an activity forbidden to banks and their affiliates under the Glass-Steagall Act. The existence of the Glass-Steagall prohibitions thus affords the SEC significant de facto regulatory power over the investment activities of banks.

The position of the banking industry and their regulators is that the bank exemptions were placed in the securities laws, not because the banks performed or did not perform certain functions, but because they, unlike most other types of businesses, were subject to extensive governmental oversight, including regular visitorial examinations.[177] The banking interests maintain that requiring banks to conform to laws and rules designed to protect investors in ordinary, relatively unregulated corporations would be duplicative and burdensome. Such requirements, they claim, would actually place banks at a disadvantage relative to competitors not subject to expensive and time-consuming on-site examination.[178] Another reason often cited for exempting banks from the securities laws is that the disclosure orientation of those laws is ill-suited to an industry where public confidence is the *sine qua non* of continued solvency.[179] Bank regulation, in contrast to that of the securities industry, is largely characterized by confidentiality in examinations, reports, and corrective action.[180] Usually, serious financial problems of a bank will not become public knowledge until after the FDIC and other regulatory agencies have arranged for the bank's merger with a stronger institution.[181] Despite the advent of deposit insurance, presently limited to 40,000 dollars per customer,[182] there still exists the real danger of runs by depositors who become aware of the bank's financial difficulties. The liquidity of demand deposits makes them exteremely volatile. It is only prudent for a large depositor to withdraw its demand deposit balance at the first indication of trouble even where there may be little real danger of bank failure. Adding to this danger is the increased reliance by banks on purchased funds, which has made many of them overly

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mini-accounts are likewise the product of conditions set by the SEC. See SEC Litigation Release No. 4534 (Feb. 6, 1970); *Clearing House Response, supra* note 85, at 17.

177. *See* Citizens and Southern Investment Counseling, Inc., *Comments on Banks Acting as Investment Advisers to Investment Companies* (filed with the SEC in response to Securities Act Release No. 5491) (Aug. 9, 1974).

178. See Security Pacific National Bank, *Response to SEC Inquiry Into Bank-Sponsored Investment Services* 13-14 (Aug. 12, 1974).

179. The importance of confidentiality in matters relating to the financial condition of banks was recognized by Congress when it provided an exception to the Freedom of Information Act for "examination, operating or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. §522(b)(8) (1970).

180. *See* Murane, *SEC, FTC, and the Federal Bank Regulators: Emerging Problems of Administrative Jurisdictional Overlap,* 61 GEO. L.J. 37 (1972).

181. *See, e.g.,* the recent case of Security National Bank, which was quickly and quietly merged with Chemical Bank of New York. Wall Street J., Jan. 20, 1975, at 3.

182. Act of Oct. 28, 1974, Pub. L. 93-495, 88 Stat. 1500 (1974).

dependent on the continued confidence of money market suppliers.[183] In blaming several recent bank failures on the sudden drying up of these funds, a Director of the FDIC has stated: "[I]t would appear that the greatest danger to a financial institution today lies not in a loss of confidence by the public at large, but rather illiquidity resulting from the mistrust of money market funds."[184] Despite the proven sensitivity of depositors and money market suppliers, it is still problematical, however, whether their confidence would be affected by activities as remote and unrelated to bank solvency as the investment services currently being offered.

Both the bank regulators and the SEC have legitimate interests in the supervision of bank-sponsored investment services. The challenge is to formulate a means for synthesizing these interests in a workable regulatory model. Both the jurisdictional and the Glass-Steagall issues engendered by banking's recent incursions into the securities business are likely to be considered and possibly resolved by the 94th Congress.[185] Senator Harrison Williams, Chairman of the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee, announced in May 1974 that his subcommittee would probably undertake a "thorough reexamination of the appropriateness and effectiveness of the Glass-Steagall prohibitions" in light of today's regulatory environment.[186] Clearly, some adjustment in the Glass-Steagall Act is called for. The Antitrust Division of the Department of Justice, commenting on the desirability of bank-sponsored investment vehicles, noted that "the encouragement of new and diverse forms of investment services for investors will further efficiency and innovation and thereby result in lower costs and greater choice in services."[187]

Clearly, too, adequate provision must be made for the protection of investors utilizing these services and for the competitive interests of both the banks and the securities industry. In seeking solutions to the myriad problems presented by bank-sponsored investment services, several factors should be borne in mind:

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183. Money market funds are brokered by various financial institutions, including large New York banks and relatively small independent brokers. Access to sources of funds is dependent on the continued confidence of the lenders. For further discussion of money market activities, see M. MAYER, THE BANKERS 201-31 (1974); Murane, *supra* note 180, at 52-58.

184. Address by George A. LeMaistre, Director, FDIC, before the Earnings Assets Conference of the Pennsylvania Bankers Association, *reprinted in* 277 BNA SEC. REG. L. REP. A-21 (1974).

185. Two previous attempts by the Senate to allow banks to sponsor CIFs were rebuffed in the House. *See* HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H.R. REP. No. 1382, 91st Cong., 2d Sess. 9, 10 (1970); S. 2704, 89th Cong., 2d Sess. (1966).

186. Address by Sen. Harrison A. Williams before the Governing Council of the American Bankers Association, White Sulphur Springs, W. Va., April 25, 1974.

187. United States Department of Justice, *Comments in Response to SEC Inquiry Concerning Bank-Sponsored Investment Services* at 3 (Aug. 23, 1974).

(1) The need for adequate investor protection.
(2) The need for protection of legitimate banking requirements of confidentiality in examination and enforcement.
(3) The desirability of equalization, to the extent allowed by differing regulatory requirements, of competitive position between banks and members of the securities industry. This does not mean, in the words of a member of the SEC, that regulatory requirements should be "cast in the same Procrustean mold merely to serve symmetry."[188]
(4) The desirability of uniform application of regulation among state and nationally chartered banks.
(5) The desirability of minimizing duplicative regulation.

In a recent article concerning bank-sponsored investment services, Commissioner Evans of the SEC outlined a number of regulatory alternatives located along a continuum from "doing nothing" to completely precluding the offering of such services.[189] He suggested that the optimal solution to the jurisdictional problem might be to leave rulemaking and enforcement functions in the hands of the respective federal bank regulatory agencies but to give the SEC the authority to review and, if necessary, alter the agencies' decisions regarding investment services.[190] A similar model for achieving the five desiderata listed above is suggested by the municipal securities trading provisions of the recently enacted Securities Acts Amendments of 1975.[191] Section 13 of the Act provides for self-regulation of municipal securities dealers through a rulemaking board composed of representatives from the various categories of institutions involved in municipal securities trading.[192] The board is charged with the responsibility for adopting rules relating to, *inter alia,* the qualifications of municipal securities dealers, the prevention of fraudulent and manipulative acts, the facilitation of municipal securities transactions, and, in general, the protection of the investing public.[193] To avoid duplication and unnecessary expense, the rulemaking board does not have examination and enforcement powers of its own, but relies on the established regulatory authorities to perform those functions in accordance with the board's rules.[194] Coordination of enforcement activities is insured by requiring the regulatory authorities to consult with the

188. Letter from John R. Evans, Commissioner, SEC, to Sen. Harrison A. Williams, Jr., May 8, 1974, *quoted in* United States Department of Justice, *Comments in Response to SEC Inquiry Concerning Bank Sponsored Investment Services* 7 (Aug. 23, 1974).

189. Evans, *supra* note 6.

190. *Id.* at 618-19.

191. Securities Acts Amendments of 1975, §13, Pub. L. No. 94-29, 89 Stat. 131, *amending* Securities Exchange Act of 1934 by adding new §15B after §15A, 15 U.S.C. §78o-3 (1970).

192. "[M]embership of the Board shall at all times be equally divided among public representatives, broker-dealer representatives, and bank representatives, and . . . the public representatives shall be subject to approval by the [Securities and Exchange] Commission to assure that . . . at least one is representative of investors in municipal securities and at least one is representative of issuers of municipal securities." Securities Acts Amendments of 1975, §13, Pub. L. No. 94-29, 89 Stat. 133.

193. Securities Acts Amendments of 1975, §13, Pub. L. No. 94-29, 89 Stat. 132-34.

194. Responsibility for examining banks that deal in municipal securities is vested in the federal bank regulatory agencies. Enforcement authority lies with both the bank regulators and the SEC. Securities Acts Amendments of 1975, §13, Pub. L. No. 94-29, 89 Stat. 133-36.

SEC prior to the entry of an order of investigation or the commencement of any enforcement proceeding. Similarly, the SEC must consult with the appropriate regulatory agency before it may take such action.[195] It is clear from the legislative history of the Securities Acts Amendments that the establishment of this regulatory scheme is a conscious attempt to accommodate the conflicting interests of the SEC and the bank regulators. In its report the Senate Committee on Banking, Housing and Urban Affairs stated:

> Bank dealers have a natural and competitive disinclination to be subjected to an additional federal regulator, and bank regulatory agencies have consistently opposed the regulation of banks through quasi-governmental, self-regulatory associations. These agencies also urge that any regulation of banks' municipal securities activities not be inconsistent with other bank regulation and that examination of banks by persons other than the banking agencies be kept to a minimum. These positions, of course, are in dramatic and historical contrast to those of municipal securities firms and the [Securities and Exchange] Commission who desire to retain the present self-regulatory structure of the securities industry and to include the dealer banks within it. The Committee has evaluated these diverse positions and has endeavored on the one hand to minimize any additional and unnecessary regulatory burdens while on the other to reposit in the municipal securities industry itself maximum policymaking authority.[196]

A similar self-regulatory apparatus would appear to be well suited as a means for resolving the often conflicting demands of depositor security and investor protection in the context of bank-sponsored investment services. Establishing a rulemaking board composed of representatives from federal and state bank regulatory agencies, the banking industry, and the SEC and vested with authority over all banks and bank holding companies sponsoring investment services would insure that rules and examination procedures for enforcing the rules would be uniformily applied. The board would be free to tailor rules to fit the particular needs of banks while, at the same time, providing increased protection to the investor. If the examination and enforcement functions were performed by the agencies currently responsible for such functions and paid for by the regulated banks, the plan would entail no expensive and cumbersome addition to the federal bureaucracy.

Conclusion

The economic and regulatory milieu in which the banking industry operates today is qualitatively different from that of 1933. Extensive government oversight has virtually eliminated the opportunity for the sort of speculative abuse in securities dealing common before the passage of the Glass-Steagall Act. Of course, conflicts of interest, some potentially dangerous, still exist in the industry, as they do in other sectors of the nation's complex and interdependent financial community. Two alternative methods of dealing with these

195. Securities Acts Amendments of 1975, §13, Pub. L. No. 94-29, 89 Stat. 136.
196. S. Rep. No. 94-75, 94th Cong., 1st Sess. 46 (1975).

conflicts are prohibition and regulation. Because of a surge of public outrage, the first method was embodied in the Glass-Steagall Act. In contrast, the securities laws were based on the assumption that, given power to demand full disclosure and punish fraudulent behavior, a federal regulatory agency could prevent potential conflicts from becoming actual abuses. The granting of broad rulemaking and enforcement powers to the SEC has allowed that agency to adapt pragmatically to new needs and new dangers as its experience dictated. The regulation of bank-sponsored investment services likewise needs to be made responsive to experience in a changing environment. The public interest demands, not the a priori prohibition of any relationship susceptible of conflict, but rather the establishment of a mechanism for minimizing abuses while maximizing the benefits to be gained from the availability of new and competitive investment vehicles.

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