

University of Michigan Journal of Law Reform

Volume 10

1976

Bank Securities Activities and the Need to Separate Trust Departments from Large Commercial Banks

Thomas J. Schoenbaum
University of North Carolina

Follow this and additional works at: <https://repository.law.umich.edu/mjlr>



Part of the [Banking and Finance Law Commons](#), [Legislation Commons](#), and the [Securities Law Commons](#)

Recommended Citation

Thomas J. Schoenbaum, *Bank Securities Activities and the Need to Separate Trust Departments from Large Commercial Banks*, 10 U. MICH. J. L. REFORM 1 (1976).

Available at: <https://repository.law.umich.edu/mjlr/vol10/iss1/2>

This Article is brought to you for free and open access by the University of Michigan Journal of Law Reform at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in University of Michigan Journal of Law Reform by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mLaw.repository@umich.edu.

BANK SECURITIES ACTIVITIES AND THE NEED TO SEPARATE TRUST DEPARTMENTS FROM LARGE COMMERCIAL BANKS

Thomas J. Schoenbaum*

Commercial banks are undergoing a period of fundamental change. During the past fifteen years, larger banks have joined the general trend toward diversification and growth by expanding into many nonbanking areas as well as by extending their operations into regional, national, and foreign markets. They have developed holding company structures that have aggressively sought bank mergers and acquisitions. In addition to their traditional role as depository institutions and suppliers and allocators of short term credit to commerce and industry, banks also have become heavily engaged in mortgage banking, consumer credit, management of real estate investment trusts, and many other businesses.¹

The movement toward diversification and growth has, however, been called into question. The 1973-1974 recession came at a time when many commercial banks had overextended their financial resources. In many cases this was due to interest-free loans to unprofitable nonbank subsidiaries. Several large banks failed, and many more were placed on "problem" lists by regulatory authorities.² Disclosure of this has helped to undermine the public's confidence in the nation's banking industry.

Events such as these, as well as the recent "credit crunch," have generated attempts to reform financial institutions. Congress is considering legislation to consolidate the tripartite system of federal bank regulation by the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corpor-

*Professor of Law, University of North Carolina. B.A., 1961, St. Joseph's College; J.D., 1965, University of Michigan.

I am grateful to my research assistant, H. M. "Buzz" Burwell, J.D., University of North Carolina, 1976, for his help and counsel.

¹Under the Bank Holding Company Amendments of 1970, one-bank holding companies, which previously had been virtually exempt from restrictions with respect to the acquisition of companies engaged in nonbanking activities, were subjected to the same restrictions as multibank holding companies. 12 U.S.C. §§ 1841-1850, 1971-1978 (1970); 12 C.F.R. § 225 (1976). Bank mergers are regulated under the Bank Merger Act of 1960 as amended in 1966. 12 U.S.C. § 1828 (1970). Bank regulatory agencies have been quite permissive, however, in the regulation of bank mergers and holding company activity. See Reid, *Legislation, Regulation, Antitrust, and Bank Mergers*, 92 BANKING L.J. 6, 28-29 (1975).

²See, e.g., *Citibank, Chase Manhattan on U.S. 'Problem List'*, Wash. Post, Jan. 11, 1976, at 1, col. 1; *Holder-Firm Concept Turns Sour for Banks as Profits Fall Short*, Wall St. J., Apr. 20, 1976, at 1, col. 6.

ation into a Federal Banking Commission³ because of an alleged "race of laxity" between the different regulatory agencies, exacerbated by attempts of banks to choose their regulators.⁴ In an effort to remove restrictions on competition among financial institutions and to increase the supply of credit, legislation has been proposed to permit thrift institutions, savings and loan associations, savings banks, and credit unions to offer checking account services and to allow the payment of interest on checking account deposits. Thrift institutions would be granted the power to make consumer loans, invest in debt securities, and handle trust accounts; commercial banks would be given increased incentives for home mortgage lending.⁵ In addition, Congress and the SEC are considering whether to compel increased disclosure by banks and bank holding companies.⁶

The recent financial and regulatory stresses have caused many commercial banks to rethink their involvement in nonbanking areas of business. Increasingly, they are divesting themselves of their nonbanking subsidiaries in order to concentrate on more

³S. 2298, 94th Cong., 1st Sess. (1975). This bill was introduced by Senator Proxmire and was referred to the Senate Committee on Banking, Housing and Urban Affairs. 121 CONG. REC. 15374 (1975). Similar legislation is being considered in the House of Representatives. See HOUSE COMM. ON BANKING, CURRENCY AND HOUSING, 94TH CONG., 1ST SESS., FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY (FINE) DISCUSSION PRINCIPLES, (Comm. Print 1975) [hereinafter cited as FINE REPORT]. These proposals have a long history, beginning with the U.S. PRESIDENT'S COMM. ON FINANCIAL STRUCTURE REGULATION, REPORT at iii (1972), which is commonly known as the Hunt Comm. Report, after its chairman, Reed O. Hunt. See SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, FINANCIAL INSTITUTIONS ACT OF 1975, S. Rpt. No. 94-487, 94th Cong., 1st Sess. (1975).

At this writing, the prospect for passage of a far-reaching reform bill appears to have dimmed, especially in the House. See *Bank Lobby Cashes in on Grass-Roots Power to Sway Legislators*, Wall St. J., Mar. 30, 1976, at 1, col. 6; *House Democrats in Retreat on Overhaul of Bank Laws, Split Proposal into 3 Bills*, Wall St. J., Mar. 31, 1976, at 3, col. 2; *Watered-Down Measure to Revise the Fed Further Weakened*, Wall St. J., Apr. 28, 1976, at 6, col. 2.

⁴For a case study of such attempts, see *Changing Charters, Did the Bank Switch Rather Than Fight the Fed Examiners?*, Wall St. J., Apr. 26, 1976, at 1, col. 6.

⁵S. 1267, 94th Cong., 1st Sess. (1975). The bill is subtitled: An Act to Expand Competition, Provide Improved Consumer Services, Strengthen the Ability of Financial Institutions to Adjust to Changing Economic Conditions, and Improve the Flow of Funds for Mortgage Credit. Analogous legislation is being considered by the House Banking Committee. See FINE REPORT, *supra* note 3. This legislation also grew out of the Hunt Comm. Report, *supra* note 3.

⁶These disclosure proposals have been made in the wake of the fact that several large banks are on the "watch list" of the Comptroller of the Currency. Unlike the SEC, bank regulatory agencies consider disclosure of financial instability of banks as needlessly exacerbating concern over the nation's banking system. *Fed Aide Sees Problem—Bank Disclosures Spurring Needless Concern Over System*, Wall St. J., Jan. 27, 1976, at 6, col. 2. Like other corporations, banks are subject to the registration and continuous disclosure requirements of the Securities Exchange Act of 1934, 15 U.S.C. § 781 (1970), but § 12(i), 15 U.S.C. § 781(i) vests enforcement jurisdiction in the bank regulatory agencies and imposes substantially fewer requirements on banks than the SEC imposes on other corporations. See Mann, *Securities Disclosure Requirements—Vive La Difference*, 92 BANKING L.J. 109 (1975). See also *Rising Disclosures About Problem Banks May Erode Confidence*, Wall St. J., Jan. 23, 1976, at 26, col. 1.

traditional concerns.⁷ At the same time, however, banks are considering the possibilities of expanded services to their traditional customers, which would involve not only taking deposits and making short and medium term loans, but also "merchant banking"—offering a full range of money management and financial services to business and individual customers.⁸ Thus, it appears that banks will become increasingly involved in securities activities such as arranging private placements of securities, providing agency and investment services to give customers more convenient access to the securities markets, and offering financial advisory services.⁹

As this trend continues, new questions of public policy must be examined. What will be the impact of these activities on the investment banking community and financial markets? How valid are the restrictions of the Banking Act of 1933 (the Glass-Steagall Act),¹⁰ which have limited the entry of banks into the securities business? Are new regulatory structures needed? This article (1) analyzes the traditional Glass-Steagall Act restrictions on banks and the leading case of *Investment Company Institute v. Camp*,¹¹ where the Supreme Court held that the offering by commercial banks of commingled agency accounts violated the Glass-Steagall Act prohibition against underwriting securities, (2) considers the developments since that decision, and (3) offers suggestions on an approach to devising solutions to the policy questions involved.

I. GLASS-STEAGALL ACT RESTRICTIONS ON BANKS AND *INVESTMENT COMPANY INSTITUTE V. CAMP*

A. *The Basic Statutory Restrictions*

The Glass-Steagall Act is the principal law determining the extent to which banks may engage in securities activities. Passed in response to the 1929 stock market collapse, the Act is directed toward specific abuses perceived at that time in the operation by commercial banks of affiliates which engaged in underwriting securities. The commercial banks often abused their loan powers by financing for their customers the purchase of securities underwritten by affiliates, by making loans to affiliates to finance their underwriting activities, and by making loans to corporations who

⁷See *Commercial Banks Seek More Business From Individual Depositors, Borrowers*, Wall St. J., Dec. 26, 1975, at 16, col. 1; *Holding Firm Concept Turns Sour for Banks as Profits Fall Short*, Wall St. J., Apr. 20, 1976, at 1, col. 6.

⁸*Merchant Banking, Is the U.S. Ready For It?* BUS. WEEK, Apr. 19, 1976, at 54.

⁹*Id.*

¹⁰Banking Act of 1933, ch. 89, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.).

¹¹401 U.S. 617 (1971).

agreed to use bank affiliates as underwriters.¹² These abuses compromised bank loan policies, caused banks to take undue risks, increased speculation in securities, and contributed significantly to the widespread failures of commercial banks.¹³

Congress considered and rejected regulation of bank securities' affiliates and, in enacting the Glass-Steagall Act, chose the extreme solution of completely divorcing investment banking from commercial banking.¹⁴ Under sections 16¹⁵ and 20¹⁶ of the Act, neither national banks¹⁷ nor their affiliates may engage in the business of issuing, underwriting, selling, or distributing securities. Section 21¹⁸ prohibits corporations in the business of issuing, selling, or underwriting securities from engaging in commercial banking. Finally, to prevent interlocks of directors or employees, section 32¹⁹ provides that no officer, director, or employee of a business primarily engaged in the underwriting or distribution of securities may be an officer or director of a member bank of the Federal Reserve System.

This separation of functions did not, however, totally exclude commercial banks from securities activities. A 1935 amendment to section 16 expressly permits banks to deal in securities to the extent of purchasing and selling them upon the order of and for the account of their customers.²⁰ In addition, the limitations of section 16 are expressly inapplicable to commercial banks' underwriting of obligations of the United States and of general revenue bonds of state and local governments.²¹ Moreover, banks are permitted to purchase investment securities for their own account, subject to the regulations of the Comptroller of the Currency.²² Thus, in addition to having important functions as underwriters of federal, state, and municipal bonds, banks may buy and sell securities on behalf of customers and for their own account.

Banks buy and sell securities on behalf of customers through the operations of their trust departments. The Federal Reserve Act granted trust department powers to National Banks in 1913,²³ and

¹²*Operation of the National and Federal Reserve Banking Systems: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency pursuant to S. Res. 71, 71st Cong., 3d Sess., Pt. I at 1058, 1063-64 (1931).*

¹³75 CONG. REC. 9911-12 (1932) (remarks of Sen. Bulkley).

¹⁴See 75 CONG. REC. 9888 (1932) (remarks of Sen. Glass).

¹⁵12 U.S.C. § 24 (1970).

¹⁶12 U.S.C. § 377 (1970).

¹⁷Under 12 U.S.C. § 335 (1970), state banks that are members of the Federal Reserve System are subject to the same prohibitions as national banks with respect to dealings in securities.

¹⁸12 U.S.C. § 378 (1970).

¹⁹12 U.S.C. § 78 (1970).

²⁰Banking Act of 1935, ch. 614, § 308(a), 49 Stat. 709 (codified at 12 U.S.C. § 24 (1970)).

²¹12 U.S.C. § 24 (1970).

²²*Id.* The applicable regulations may be found in 12 C.F.R. §§ 1.1-1.410 (1976).

²³Federal Reserve Act, ch. 6, § 11, 38 Stat. 262 (1913).

the Glass-Steagall Act left these powers intact. Pursuant to this authority, banks give investment advice to individual investors by managing agency accounts. In addition, for many years, banks have managed common trust funds for assets entrusted to them in their fiduciary capacities as trustees, executors, administrators, and guardians.²⁴ These activities have enjoyed a remarkable growth stemming to a considerable extent from the act of Congress which in 1962 transferred regulatory jurisdiction of the fiduciary activities of national banks from the Federal Reserve Board to the Comptroller of the Currency.²⁵ At the end of 1974, the assets of commercial bank trust departments totaled \$328 billion, and their stock holdings, measured in terms of market value, reached 27 percent of total stock outstanding.²⁶ Much of this growth is attributable to banks' management of pension, profit-sharing, and other tax benefited plans in common trust funds.²⁷

B. *Investment Company Institute v. Camp*

In 1971, in *Investment Company Institute v. Camp*,²⁸ the Supreme Court of the United States faced what it called the "novel and substantial" questions raised under the Glass-Steagall Act concerning the extent to which commercial banks may engage in securities-related activities. The case involved a challenge brought by the Investment Company Institute, a trade association of open end investment companies,²⁹ to Regulation 9,³⁰ issued by the Comptroller of the Currency. Regulation 9 authorized for the first time the commingling of managing agency accounts as within national banks' fiduciary powers under section 92a of the Federal

²⁴The fiduciary powers of national banks are governed by regulations promulgated by the Comptroller of the Currency. 12 C.F.R. §§ 9.1-9.104 (1976).

²⁵Pub. L. No. 87-722, 76 Stat. 668 (12 U.S.C. § 92a (1970)). For an account of the development of bank common trust funds, see Saxon and Miller, *Common Trust Funds*, 53 GEO. L.J. 994 (1965).

²⁶*Hearings on the Expansion of Commercial Banks' Securities Business Operations and the Elimination of Barriers Between the Banking and Securities Industries Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 137 (1975) [hereinafter cited as *Securities Subcomm. Hearings*] (statement of Roderick M. Hills, Chairman, Securities Exchange Commission). This figure was estimated to be \$400 billion as of November 1, 1975. U.S. DEP'T OF THE TREASURY, PUBLIC POLICY ASPECTS OF BANK SECURITIES ACTIVITIES, AN ISSUES PAPER 7 (1975) [hereinafter cited as DEP'T OF THE TREASURY ISSUES PAPER, *reprinted in Securities Subcomm. Hearings* 22-59].

²⁷E. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS 17-18 (1975).

²⁸401 U.S. 617 (1971).

²⁹This type of investment company (commonly called a mutual fund) generally issues only redeemable stock which it stands ready at all times to redeem at an amount equal to the net asset value of its investment portfolio. See R. JENNINGS AND H. MARSH, JR., *SECURITIES REGULATION* 1441-42 (3d ed. 1972).

³⁰12 C.F.R. § 9.18 (1976).

Reserve Act of 1913.³¹ First National City Bank (Citibank) had attempted to take advantage of this authorization by establishing a plan to accept deposits of a minimum of \$10,000 and to invest the funds together with those of other participants. Commingling was an essential part of Citibank's plan, because only through the economies of scale gained by collective management was it economically feasible to make such an offer. Citibank's intention was to use this plan to make available to the "small" investor the same investment management services that it traditionally offered to its wealthy customers. Although the depositor was a principal and the bank a managing agent, the account was the functional equivalent of a mutual fund, since each customer obtained an undivided interest in the fund (expressed as a "unit of participation") which was redeemable at net asset value. Accordingly, the account was registered as an Investment Company under the Investment Company Act,³² and the units of participation were registered as securities under the Securities Act of 1933.³³

The Supreme Court framed the issues involved in *Camp* in terms of whether the operation of this type of investment fund involves a bank in "underwriting" the sale of "securities" under the Glass-Steagall Act.³⁴ Although the terms "security" and "underwriter" had been interpreted in many different contexts under the securities law, the court of appeals, in considering this same question, had stated that the judicial gloss on these definitions in the securities acts could not be imported wholesale into the Glass-Steagall Act because the laws serve different purposes.³⁵ The Supreme Court implicitly agreed with this position, in holding that the participations in the commingled investment account were securities involving the bank in illegal underwriting relying, not

³¹Ch. 6, § 11, 38 Stat. 262 (12 U.S.C. § 92a (1970)).

³²15 U.S.C. §§ 80a-1 to -52. (1970). Pursuant to its authority under 15 U.S.C. § 80a-6(c) (1970), the SEC granted the account an exemption from 15 U.S.C. § 80a-10 (1970) which permitted three members of the account's five member investment committee to be persons affiliated with Citibank. The National Association of Securities Dealers (NASD) brought suit to challenge this exemption and this case was consolidated with *Camp*. The court of appeals upheld the validity of the exemption, *National Ass'n of Sec. Dealers v. SEC*, 420 F.2d 83 (D.C. Cir. 1969) [hereinafter cited as *NASD v. SEC*]. In reviewing the consolidated cases, the Supreme Court did not reach the Investment Company Act exemption issue, but vacated the *NASD v. SEC* opinion on the same grounds as the *Camp* case.

³³15 U.S.C. § 77a-77bbbb (1970 & Supp. V 1975). Citibank was concededly a statutory underwriter under the Securities Act of 1933 for the units of participation issued. The defendants relied upon and the court of appeals accepted the "two entity" theory that the account is an entity separate from the bank. *NASD v. SEC*, 420 F.2d 83 (D.C. Cir. 1960). Therefore it did not enjoy the bank's exemption but was a nonexempt investment company and a nonexempt issuer of a security subject to regulation. Although the bank was an underwriter of a security under the definition of those terms in the Securities Act, it was not an underwriter within the meaning of the Glass-Steagall Act.

³⁴401 U.S. at 634-35.

³⁵420 F.2d 83, 89. The court of appeals' decision in *Camp* is reported under the name of its companion case. See note 32 *supra*.

upon the well-known line of decisions under the securities acts,³⁶ but upon the purposes and policies of the Glass-Steagall Act.³⁷

Considering the policies of the Glass-Steagall Act, the Court found three hazards in the sale of units of participation in a commingled investment account that are not present when a bank, following traditional practices, undertakes to purchase stock for the account of its individual customers or to commingle assets that it has received as a fiduciary in a trust account. First, losses on a commingled investment account could endanger public confidence in the bank itself. Second, promotional incentives to market the units of participation aggressively make it impossible for the bank to give disinterested investment advice in its role as a fiduciary. Third, the managing of the account could tempt the bank to make unsound loans to customers for the purpose of participating in the account or to companies in whose stocks the account was invested.³⁸ The Court interpreted the Glass-Steagall Act as permitting banks to operate a collective investment fund for the investment of funds held for a "true fiduciary purpose," but as prohibiting them from commingling assets which it has received for investment.³⁹

Further analysis, however, reveals that none of the problems the Court cites are unique to commingled investment accounts as opposed to traditional agency or common trust funds. No special danger exists that losses on a commingled investment account would deplete bank depositors' money, because the securities purchased are only for the account of participants in the fund. Neither is there any unique problem that portfolio losses would cause diminished public confidence in banks. Through their trust departments, banks already hold significant stock positions in portfolio companies. The Patman Report of 1968 found that the forty-nine largest trust banks held more than 5 percent of the stock of 145 of the 500 largest industrial corporations, and that these holdings were often accompanied by director interlocks.⁴⁰ In some industries, such as the airlines industry, banks, through their trust departments, have been particularly dominant.⁴¹

The argument that special promotional incentives exist to market the fund that would interfere with the ability of banks to offer

³⁶The two leading Supreme Court cases on the definition of a security under the securities acts are still *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), and *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). For the most recent Supreme Court pronouncement, see *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).

³⁷401 U.S. at 623-34.

³⁸*Id.* at 636-38.

³⁹*Id.* at 638.

⁴⁰STAFF OF SUBCOMM. ON DOMESTIC FINANCE, HOUSE COMM. ON BANKING AND CURRENCY, 90TH CONG., 2D SESS., I COMMERCIAL BANKS AND THEIR TRUST ACTIVITIES: EMERGING INFLUENCE ON THE AMERICAN ECONOMY Ch. 3 (Comm. Print. 1968).

⁴¹*Id.* at 484-85.

disinterested financial advice is also not convincing. Banks have promoted their trust services aggressively, regarding them not only as directly profitable but also as sources of other loan and deposit business.⁴² The possibility of distortion of loan policy is inherent in trust department activities and is a source of continuing concern.⁴³

The Court's holding that a commingled investment fund involves a bank in underwriting a "security" under the Glass-Steagall Act thus cannot be supported by the distinction between the sale of fiduciary services and the sale of investments. But the Court advanced another reason for its holding. Conceding that the three powers that would be used in marketing the account—pooling trust assets, acting as managing agent for individual customers, and purchasing stock for the account of its customers—were within a banks' powers under the banking laws, the Court nevertheless found that "the union of these powers gives birth to an investment fund whose activities are of a different character."⁴⁴ Thus, the Court reasoned, that because the investment fund created was indisputably in direct competition with the mutual fund industry, and because the selling of mutual fund shares is undeniably the issuance of a security, the bank investment fund must also be a security.⁴⁵

The difficulty with this analysis is that the Court abandons the idea, which it had implicitly accepted, that there may be a distinction between the ways the terms "security" and "underwriting" are used in the Glass-Steagall Act and in the securities laws. By adopting the test of "direct competition" with mutual funds, the Court is judging the bank investment fund by the securities acts and investment company act standards. It had, of course, been conceded by the banks that their fund was a "security" under the Securities Act of 1933 and an "investment company" under the Investment Company Act of 1940.⁴⁶ However, the Court ignores the possibility that an interest may be a security under the 1933 and 1934 securities acts and the account may be an investment company, without involving the bank in the underwriting of a security under the Glass-Steagall Act.⁴⁷ Because of the breadth of the judicial holdings relating to the definition of a security under the

⁴²E. HERMAN, *supra* note 27, at 16.

⁴³*Id.* at 16-17.

⁴⁴401 U.S. at 624-25.

⁴⁵*Id.* at 625.

⁴⁶*See* note 33 *supra*.

⁴⁷Unlike the two securities acts, the Glass-Steagall Act does not define the term "security."

securities acts, the Glass-Steagall Act would become unworkable if these doctrines were imported into it wholesale.⁴⁸

The use of the "direct competition" test nevertheless permeates the entire Supreme Court opinion in the *Camp* case.⁴⁹ The result is a compartmentalized view of the activities of commercial banks and other investment vehicles that does not comport with reality and that incorrectly interprets the Glass-Steagall Act as embodying a policy of prohibiting direct competition between banks and the investment company and securities industries. In addition, the test used for the definition of "security" and "underwriting" under the Glass-Steagall Act gives no firm guidance as to how lower courts and agencies such as the SEC should treat banks' securities-related activities in the future. The irony of the Court's opinion is that it substantially increases the difficulty of sorting out forays by banks into the investment and securities business. This has become clear in the aftermath of the *Camp* decision.

II. THE AFTERMATH OF *INVESTMENT COMPANY INSTITUTE V. CAMP*

A. *Newer Forms of Bank Securities-Related Activities*

Despite the Supreme Court's unwarranted view in *Camp* that the policy of the Glass-Steagall Act is to prohibit banks from direct competition with the investment company and securities industries, commercial banks have increased their securities-related activities in the years since the decision. These activities can be divided into three general categories. First, banks offer their customers many agency securities services in which they act as intermediaries between the customer and the broker-dealer commun-

⁴⁸The definition of a "security" under the securities laws has been construed to cover any instrument whose economic impact is the use of money of passive investors on the promise of profits. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 844 (1975). Thus, in *Tcherepnin v. Knight*, 389 U.S. 332 (1967), withdrawable capital shares in a state-chartered savings and loan association were held to be securities. Moreover, the definition has been construed to cover certain trust department activities of banks. *Local 734 Trust v. Continental Ill. Nat'l Bank & Trust Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94, 565 (N.D. Ill. 1974). See also *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970). It has also been held applicable to revocable inter vivos trusts sold by a trust company where the trustee had unlimited investment discretion and the investor was assured a return. *SEC v. Heritage Trust Co.*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,282 (W.D. Ariz. 1976).

⁴⁹401 U.S. AT 625, 635, 638.

ity.⁵⁰ These services go beyond the traditional custodial account in which the customer deposits his portfolio for safekeeping and the bank distributes the dividends or buys and sells securities at the customer's direction. Many banks offer an individual portfolio management plan under which the customer instructs the bank to make purchases or sales of securities with the aid of recommendations by the bank or a correspondent broker-dealer.⁵¹ Also available are dividend reinvestment plans under which the customer may request a corporation to pay all his dividends to a bank which aggregates them and purchases additional shares of the corporation's common stock.⁵² The newest type of agency securities service is the automatic investment service (AIS) under which the bank deducts an amount from a bank customer's checking account monthly and invests it in common stock of issuers selected by the customer from a list of the twenty-five largest corporations based upon the market value of outstanding stock. The bank pools the monthly deductions from each participant for the purpose of executing the transactions, but each month the customer receives a statement indicating the number of full and fractional shares purchased on his behalf.⁵³

Second, banks are heavily engaged in securities activities through their offering of two different types of money-management collective investment funds. A common trust fund can be maintained for the investment of moneys managed by the bank in its capacity as trustee, executor, administrator, or guardian. Banks can also set up collective investment funds consisting solely of assets of retirement, pension, profit-sharing, stock bonus, or other tax benefited plans.⁵⁴ In addition, since 1972 banks have been

⁵⁰Because the Glass-Steagall Act prohibits banks from acting as underwriters or dealers but permits agency securities activities, 12 U.S.C. § 24 (1970), it is arguable that banks could operate a retail brokerage business for customers. Banks have not chosen to test this proposition, however, presumably for economic reasons.

⁵¹Commercial banks have typically offered these services to wealthy investors who can afford the minimum account, typically \$200,000 or more. In recent years the minimum account size has been lowered to as little as \$10,000. No pooling of the accounts takes place, and transactions are not executed by the bank without prior approval of the customer. *Securities Subcomm. Hearings, supra* note 26, at 97 (written comments of the SEC). Banks generally do not accept discretionary investment accounts because of the securities law implications. See text accompanying note 88 *infra*. The *Camp* case, of course, prevents the commingling of these accounts. See note 39 and accompanying text *supra*.

⁵²These plans have enjoyed remarkable growth in the last five years. *Securities Subcomm. Hearing, supra* note 26, at 94.

⁵³In 1974, about twenty-five commercial banks offered an AIS plan. *Id.* at 96-97.

⁵⁴12 C.F.R. § 9.18 (1975). These collective funds are permitted even after *Camp* because of their fiduciary purpose. As of November, 1975, the nation's commercial banks were handling approximately \$400 billion in trust assets. Of this, \$150 billion represented pension funds and other assets of institutional customers; the remainder was being managed for private individuals. DEP'T OF THE TREASURY ISSUES PAPER, *supra* note 26, at 7, reprinted in *Securities Subcomm. Hearings, supra* note 26, at 31.

authorized to serve as investment advisors to both open end and closed end investment companies; they may even sponsor, organize, and control closed end investment companies.⁵⁵

Third, banks offer corporate customers financial consulting services. This involves complete analysis of long term financing objectives and alternatives. Where appropriate, they grant long or medium term loans, arrange a private placement of the corporation's securities, and assist in dealing with an investment banker to carry out a public offering.⁵⁶ In this area, banks are in direct competition with investment bankers despite the fact that the Glass-Steagall Act prohibits them from underwriting and dealing in securities except for United States Government bonds and general obligation bonds of state and local governments.⁵⁷

B. *The Counter-Attack of the Investment Company Industry*

The Investment Company Institute, the trade association of open end investment companies that was the plaintiff in *Camp*, has brought two separate actions in the United States District Court for the District of Columbia to obtain declaratory and injunctive relief against two of the above-mentioned bank securities activities. In the first case, the Institute challenged, as an infringement of sections 16 and 21 of the Glass-Steagall Act, that part of the Federal Reserve Board's Regulation Y which permits banks to act as investment advisors of mutual funds.⁵⁸ However, the action was dismissed on procedural grounds without resolution.⁵⁹ The second

⁵⁵12 C.F.R. §§ 225.4(a), 225.125 (1976). In the opinion of the Federal Reserve Board, as expressed in the regulations, a bank which sponsors, organizes, or controls a mutual fund would violate the Glass-Steagall Act. Nonetheless, this is not true with respect to closed end investment companies, because, unlike mutual funds, they do not continuously issue and redeem their securities and are thus not primarily in the business of selling securities. 12 C.F.R. § 225.125(f) (1976). For a discussion of these problems see Comment, *Bank Sponsored Investment Services: Statutory Proscriptions, Jurisdictional Conflicts, and a Legislative Proposal*, 27 U. FLA. L. REV. 726, 789-92 (1975).

⁵⁶DEP'T OF THE TREASURY ISSUES PAPER, *supra* note 26, at 9, reprinted in *Securities Subcomm. Hearings*, *supra* note 26, at 33. See also BUS. WEEK, *supra* note 8, at 54-55.

⁵⁷See notes 15-22 and accompanying text *supra*. There is a separate debate over the question of whether banks' underwriting powers should be broadened to include municipal revenue bonds, which can be repaid only from specific revenues. Attempts by banks to enter this field have been struck down by the courts. See *Baker, Watts & Co. v. Saxon*, 261 F. Supp. 247 (D.D.C. 1966), *aff'd sub. nom.*, *Port of N.Y. Auth. v. Baker, Watts & Co.*, 392 F.2d 497 (D.C. Cir. 1968). For an argument that legislation should be enacted granting this power to banks, see Mehle, *Bank Underwriting of Municipal Revenue Bonds: Preserving Free and Fair Competition*, 26 SYRACUSE L. REV. 1117 (1975).

⁵⁸See note 55 *supra*.

⁵⁹*ICI v. Board of Governors*, No. 74-697 (D.D.C. filed May 8, 1974), *dismissed for lack of jurisdiction* (July 30, 1975), *appeal docketed*, No. 75-1822 (D.C. Cir. Aug. 1, 1975). For the text of the complaint, see [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94, 540 (D.D.C. May 8, 1974).

case, *New York Stock Exchange & Investment Co. Institute v. Smith*,⁶⁰ involved a challenge to the ruling of the Comptroller of the Currency that AIS services offered by national banks do not violate the Glass-Steagall Act.⁶¹ The district court granted summary judgment for the defendant, holding that selling units of participation in the AIS plan does not constitute selling a security by an affiliate under the Glass-Steagall Act, and that the underlying securities transactions by banks are within the agency exception of section 16.⁶² The court distinguished *Camp* on the grounds that the AIS offering does not create in the banks a salesman's interest in the performance of the securities or threaten the bank's prestige because they do not "manage" the customer's investments. The banks' lending policies would not be affected because the corporations whose securities were involved are all "blue chip" companies and are solvent by definition. The court also found that under an AIS, banks compete with investment brokers "only in terms of convenience, cost and dependability" and that this presents no danger to bank solvency.⁶³

This analysis shows the difficulty of applying the *Camp* approach to the ever-changing kaleidoscope of new activities by banks in this field. The courts are faced with judging each form of securities-related activity on a case-by-case basis against the policies of the Glass-Steagall Act. Furthermore, the result in *Smith* is difficult to reconcile with the *Camp* decision. AIS plans are in direct competition with similar plans provided by the investment company industry,⁶⁴ and banks pool participants' funds for the purpose of executing securities transactions just as in other investment funds. Yet the court ignored the Supreme Court's "direct competition" test and disregarded the commingling of funds in a nonfiduciary account. It is also difficult to accept the court's view that a bank is totally indifferent to the performance of the twenty-five securities it selects for the plan. The court's narrow view of the policy of the Glass-Steagall Act is quite subjective, and this *ad hoc* approach to the resolution of the problem of what bank securities activities are permissible is undesirable because it can only lead to confusion and conflicting interpretations.

⁶⁰404 F. Supp. 1091 (D.D.C. 1975). The complaint is reprinted in [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,798 (D.D.C. 1975).

⁶¹This ruling was contained in a letter, dated June 10, 1974, from the Comptroller of the Currency to the attorney for the Investment Company Institute. For the relevant text, see *Glass-Steagall Act—A History of Its Legislative Origin and Regulatory Construction*, 92 BANKING L.J. 38 (1975).

⁶²404 F. Supp. at 1097.

⁶³*Id.* at 1099-1100.

⁶⁴*Securities Subcomm. Hearings, supra* note 26, at 100 (written comments of the SEC).

C. *The Regulatory Response*

1. *The Bank Supervisory Agencies*—Bank supervisory agencies regulate and monitor bank fiduciary activities, including the traditional and newer forms of securities-related activities, through the bank examination process. Because the national banks are most active in this area, the primary regulatory responsibility falls on the Comptroller of the Currency.⁶⁵ Applicable rules require an annual trust department examination separate from the general bank examination.⁶⁶ Investments must be examined to determine whether they are in accordance with law and sound fiduciary principles.⁶⁷ The assets of each fiduciary account are required to be segregated from the assets of the bank and either kept separate from those of other accounts or otherwise adequately identified.⁶⁸

Bank supervisory agencies argue that the bank examination process can be adapted to provide adequate regulation of bank securities activities,⁶⁹ but there are several difficulties with this proposition. First, there are substantial doubts whether trust department supervision has been adequate even with respect to traditional trust department investment activities, especially in the areas of conflicts of interest, disclosure, and cash management.⁷⁰ Second, the Comptroller of the Currency, during the last decade, has been in the forefront of advocating increased bank power to engage in securities activities. In view of the "sense of constituency"⁷¹ of this and other bank regulatory agencies, it is doubtful whether effective regulation by them is possible. Third, even if the trust department supervision process is adequate for its purpose, which is to assure that breaches of fiduciary duty will not endanger the bank's solvency, this process does not seem well-suited to the purpose of protecting investors. Furthermore, disclosure, the tra-

⁶⁵All national banks are examined by the Comptroller of the Currency, while state chartered banks which are members of the Federal Reserve System are examined by the Federal Reserve Board. Federally insured state chartered banks are examined by the Federal Deposit Insurance Corporation, and noninsured banks are left to state regulatory authorities.

⁶⁶*Securities Subcomm. Hearings, supra* note 26, at 176 (letter of Comptroller of the Currency to Subcomm. Chairman, Feb. 3, 1976).

⁶⁷12 C.F.R. § 9.11(a) (1976).

⁶⁸12 C.F.R. § 9.13 (1976).

⁶⁹*Securities Subcomm. Hearings, supra* note 26, at 168-70 (statement of the Comptroller of the Currency). However, the Comptroller's Office leaves audit procedures of the newer forms of bank securities activities, such as AIS, to the discretion of the individual examiner. There is also no special scrutiny of bank investment advisor activities. *Id.* at 176. For a defense of the adequacy of agency supervision over bank securities activities, see Comment, *The Legality of Bank-Sponsored Investment Services*, 84 YALE L.J. 1477, 1498-1504 (1975).

⁷⁰See Lybecker, *Regulation of Bank Trust Department Investment Activities*, 82 YALE L.J. 977 (1973).

⁷¹The phrase is Professor Gerard T. Dumme's. Editor's Headnotes, 93 BANKING L.J. 387 (1976).

ditional tool for protecting investors and safeguarding the allocative efficiency of the securities markets, is distrusted by the banking agencies.⁷² Fourth, insofar as banks are effectively competing with investment companies and securities dealers through the evolving forms of bank securities activities, it seems unfair to subject the banks to substantially different regulatory requirements, because this skews the competition between them.

2. *The Securities and Exchange Commission*—The SEC, which exercises regulatory jurisdiction over the securities and investment company industries, has been unsure and inconsistent in its approach to the regulation of bank securities activities. Banks are clearly subject to the antifraud provisions of the securities acts,⁷³ even with regard to transactions on behalf of their traditional trust and custodial accounts.⁷⁴ The problem presented to the SEC in the face of increasing bank securities activities is that the securities laws contain broad exemptions for banks from the registration requirements which are applicable to most other participants in the securities markets. The Securities Act of 1933 exempts securities issued or guaranteed by banks as well as participations in common trust funds and most tax benefited single or collective trust funds.⁷⁵ The Securities Exchange Act exempts banks from the definitions of “broker” and “dealer”⁷⁶ providing that the continuous reporting and proxy solicitation requirements applicable to banks are to be administered by the appropriate federal bank regulatory agen-

⁷²See note 6 *supra*.

⁷³The principal antifraud provisions are, of course, section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970) and Rule 10b-5 thereunder, 17 C.F.R. § 240, 10b-5 (1976). Also relevant is 15 U.S.C. § 77q (1970), which is the general antifraud provision under the 1933 Securities Act.

⁷⁴See cases cited in note 48 *supra*. In a significant recent decision, a federal district court held a nonvoluntary, noncontributory employee pension plan to be a “security” subject to the federal securities laws, including the antifraud provisions. *Daniel v. International Bhd. of Teamsters*, 410 F. Supp. 541 (N.D. Ill. 1976).

⁷⁵15 U.S.C. § 77c(a)(2) (1970). This exemption applies to the registration requirements of the 1933 Securities Act but does not extend to the antifraud sections. Moreover, the exemption is not available if the plan provides that contributions are to be held in a single trust fund maintained by a bank for a single employer and an amount in excess of the employer’s contribution is allocated to securities issued by the employer. The exemption is also not available to plans which cover self-employed individuals (H.R. 10 plans) within the meaning of section 401(c)(1) of the Internal Revenue Code, although the SEC can exempt them by rule. *Id.* In addition, the SEC has interpreted the exemption to be unavailable where a trustee bank acts as a mere custodian for a collective trust fund and does not have investment discretion. *In re Sterling Bank & Trust Co.*, [1976] FED. SEC. L. REP. (CCH) ¶ 80,433.

⁷⁶15 U.S.C. § 78c(a)(4), (5) (1970). An important aspect of this exemption with respect to newer forms of bank securities activities is that banks are not subject to any specific “suitability” requirement which bars brokers from recommending securities unsuitable for their customers. See *Securities Subcomm. Hearings*, *supra* note 26, at 163 (response of SEC). The Chairman of the SEC has recently stated that the SEC is considering whether to interpret existing law to require that banks assure the suitability as investments of the securities they purchase for customers. *SEC Mulls Regulating Investment Plans of Banks Competing with Broker Firms*, Wall St. J., Aug. 9, 1976, at 2, col. 4.

cies⁷⁷ and including common trust fund interests and most tax benefited plans in the definition of "exempted security."⁷⁸ In addition, the Investment Company Act of 1940 excludes banks, trust companies, and common trust funds from the definition of "investment company,"⁷⁹ and banks are not "investment advisors" as that term is defined under the Investment Advisors Act of 1940.⁸⁰

The debate over the wisdom of these broad exclusions for banks in the federal securities laws should focus on three separate issues: (1) whether the bank supervisory agencies are capable of adequately regulating disclosure on the issuance of new bank securities as well as the continuous reporting disclosure requirements,⁸¹ (2) whether additional disclosure should be required of bank trust department activities, particularly with respect to pension and other collective investment funds,⁸² and (3) whether the other exemptions, such as the exclusion from the definitions of broker-dealer, investment company, and investment advisor, are now outmoded because of the newer forms of bank securities-related activities.

The first question has not yet been directly faced by the SEC, and is a source of continuing controversy.⁸³ The second question is the subject of an ongoing SEC study,⁸⁴ but any increased disclosure requirements are certain to be opposed by bank regulators. The solution adopted by the SEC in response to the third question is the "two entity" theory which holds that when a bank creates an investment plan or fund going beyond any of the express exemptions of the acts, it has created a separate nonexempt entity that is engaged in the issuance of securities. This entity is subject to regulation because the account or fund is the issuer, rather than the

⁷⁷15 U.S.C. § 781(i) (1970).

⁷⁸15 U.S.C. § 78c(a)(12) (1970). This has the effect of an exemption from all of the requirements of the Act except the antifraud provisions. Single and collective trust funds maintained by a bank for self-employed individuals (H.R. 10 plans) are not included in the definition of exempted security, but are specifically exempt from the registration provisions of the Act. 15 U.S.C. § 781(g)(2)(H) (1970).

⁷⁹15 U.S.C. § 80a-3(c)(3), (11) (1970).

⁸⁰15 U.S.C. § 80b-2(a)(11) (1970). However, banks that are advisors for registered investment companies are not exempt from the provisions of the Investment Company Act that pertain to investment advisors. 15 U.S.C. § 80a-2(a)(20) (1970).

⁸¹Under their general power of supervision over banks, the bank supervisory agencies adopted disclosure requirements for offering circulars of new issues of bank securities, analogous to 1933 Securities Act regulation. See 12 C.F.R. § 16.1-.6 (1976). New issues by bank holding companies are subject to SEC jurisdiction.

⁸²For a review of current proposals in this area, see Lybecker, *supra* note 70, at 998-1001.

⁸³See, e.g., Mann, *supra* note 6; Butera, *Bank Exemption from the 1933 Securities Act*, 93 BANKING L.J. 432 (1976).

⁸⁴See *SEC Studies Easing of Mutual Fund Reins*, Wall St. J., Apr. 5, 1976, at 2, col. 3.

bank, which is exempt.⁸⁵ This was the theory applied by the SEC to the commingled fund in *Camp*.⁸⁶ The decision of the Supreme Court, however, left open for definitive resolution the question of the viability of the "two entity" approach, and did not provide the SEC with any guidance on how the securities acts are to be applied to the other newer forms of bank securities activities.⁸⁷

As a result, the SEC has taken a tentative approach to regulation in this area. In 1970, before *Camp*, the SEC asserted its regulatory authority over a proposal by First National City Bank (Citibank) to create a special investment advisory service for individual investors who would invest at least \$25,000. Under the plan, the investor gave Citibank discretion through power of attorney to place orders for his account with Merrill Lynch, which kept custody of the securities invested for the participating accounts. Despite the fact that the investment advisory service was represented as an individual portfolio management service, the SEC brought an action for injunctive relief. The theory, an application of the "two entity" approach, was that the substantial parallelism in investing showed that in reality the special investment advisory service was itself an investment company, and that the units of participation were securities subject to registration under the federal securities laws. Citibank entered into a consent decree and abandoned the service without admitting or denying the validity of the SEC's position.⁸⁸

Despite this initial assertion of authority, in the years since *Camp* the SEC has largely avoided direct regulation, not only of individual portfolio management services, but also of AIS plans and dividend reinvestment plans. In 1973, the SEC issued a "no action" letter regarding an AIS plan where the participants had ownership rights over the securities.⁸⁹ In another release, the SEC set out participant ownership criteria for exemption of dividend reinvestment plans from registration.⁹⁰ However, the SEC has

⁸⁵See note 33 *supra*. This theory was first developed by the SEC in connection with investment fund activities of insurance companies. See Prudential Ins. Co., 41 S.E.C. 335 (1963), *aff'd*, 326 F.2d 383 (3d Cir. 1963), *cert. denied*, 377 U.S. 953 (1964).

⁸⁶See note 33 *supra*.

⁸⁷See Address by SEC Chairman Ray Garrett, Jr. before the National Trust Conference, Feb. 4, 1974, *rptd. at* [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,641.

⁸⁸SEC v. First Nat'l City Bank, [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,592 (S.D. N.Y. Feb. 6, 1970). Subsequent to this, the SEC staff agreed to permit Citibank to offer its small account portfolio management service without registration as long as the bank exercises no investment discretion. *Securities Subcomm. Hearings, supra* note 26, at 198 (staff study outline). In 1974, the SEC announced that it would publish guidelines on the problems raised by these services. Sec. Act Rel. No. 5491, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,767 (Apr. 30, 1974). Nonetheless, no further position has been taken by the SEC.

⁸⁹Investment Data Corp., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,411.

⁹⁰See Lucky Stores, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,903.

announced its refusal to issue additional "no action" letters⁹¹ and, not surprisingly, has taken the position that the general antifraud provisions of the securities acts are applicable to these interests.⁹²

The SEC has also demonstrated caution in its approach to regulation of newer forms of collective trusts maintained by banks in connection with retirement and profit-sharing plans. House Resolution 10 (Keogh) plans, established by Congress to allow self-employed individuals to establish tax-qualified retirement plans,⁹³ are exempt from the registration requirements of the Securities Exchange Act of 1934⁹⁴ and the Investment Company Act of 1940,⁹⁵ but are subject to registration under the Securities Act of 1933, unless the SEC determines that exemption of such interests would be appropriate.⁹⁶ The SEC has not yet formulated a general policy for these plans and has issued "no action" letters on an *ad hoc* basis. Most banks establishing such plans, however, are relying on the intrastate offering exemption of section 3(a)(11) of the 1933 Act⁹⁷ to avoid registration.⁹⁸

The SEC has also failed to provide effective protection for individual retirement accounts (IRA's), which can be offered by banks under section 2002(b) of the Employee Retirement Income Security Act of 1974.⁹⁹ IRA's and collective investment funds for IRA's are not exempt under either section 3(c)(11) of the Investment Company Act of 1940¹⁰⁰ or section 3(a)(2) of the Securities Act of 1933¹⁰¹ because they are not trusts as described under section 401 of the Internal Revenue Code. Despite this, the SEC has issued "no action" letters to banks stating that registration will not be required under either act if the IRA participants direct investment of their assets into individual bank savings accounts or if the plans are funded by mutual fund shares or exempted securities.¹⁰² The SEC has thus chosen to ignore the "two entity" approach in this area.

⁹¹Securities Subcomm. Hearings, *supra* note 26, at 152 (response of SEC).

⁹²Investment Data Corp., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,411.

⁹³Pub. L. No. 87-792, 76 Stat. 809 (Oct. 10, 1962), amending section 401(c) of the Internal Revenue Code.

⁹⁴See note 78 *supra*.

⁹⁵See note 79 *supra*.

⁹⁶See note 75 *supra*.

⁹⁷15 U.S.C. § 77c(a)(11) (1970).

⁹⁸Securities Subcomm. Hearings, *supra* note 26, at 161 (response of the SEC).

⁹⁹29 U.S.C.A. §§ 1001-1381 (1975). Section 2002(b) added section 408 to the Internal Revenue Code, creating a new form of tax sheltered retirement medium for individuals not covered by qualified or governmental pension plans or tax sheltered annuities. 26 U.S.C. § 408 (Supp. V 1975).

¹⁰⁰15 U.S.C. § 80a-3(c)(11) (1970).

¹⁰¹15 U.S.C. § 77c(a)(2) (1970).

¹⁰²Investment Co. Institute, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,018 (1974); Continental Ill. Nat'l Bank & Trust Co., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,411.

In addition, the SEC has hesitated to assert any authority over other securities-related powers which banks have assumed in the last several years. Banks offer investment advisory services not only to corporate pension and profit-sharing plans qualified under section 401 of the Internal Revenue Code, but also to investment companies and real estate investment trusts. The exclusion of banks and bank holding companies from the definition of "investment adviser" under the Investment Advisers Act of 1940¹⁰³ exempts them from regulation under that act, and the SEC has not attempted to use the "two entity" theory to extend regulation to these new forms of advisory activities.¹⁰⁴ Bank underwriting activities are subject only to the antifraud provisions of the securities laws despite the recent expansion of this type of activity.¹⁰⁵ The SEC has only been given authority to study¹⁰⁶ the exemption of banks from the definition of broker and dealer,¹⁰⁷ although, under the Securities Act Amendments of 1975, the municipal securities activities of banks are now subject to regulation, and dealer banks or their separately identifiable departments are required to register as "municipal securities dealers."¹⁰⁸

D. *A Summary View of the Impact of the Camp Decision*

The events of the past five years show that *Camp* has had an unexpected impact. The Supreme Court's attempt to breathe new life into the Glass-Steagall Act and to restrict bank securities activities has been a well-intentioned failure unnecessarily complicating the search for solutions to the problems they present. The unsupportable distinction, between banks' collective management of funds held for a fiduciary purpose and those funds received for an investment purpose, has become embedded in the Glass-Steagall Act. An inefficient case-by-case adjudication process is being used to test newer forms of bank securities activities against the Glass-Steagall Act limitations. Having been given no guidance as to the extent of its regulatory jurisdiction and the validity of the

¹⁰³15 U.S.C. § 80b-2(a)(11) (1970).

¹⁰⁴In theory the use of the "two entity" approach is possible because nonbank subsidiaries of banks and bank holding companies are not exempt. In its recent legislative proposals on the Investment Advisers Act, the SEC merely asked for authority to study the possibility of eliminating the bank exclusion. See Investment Advisers Act Release No. 491, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,341.

¹⁰⁵See text accompanying notes 56-57 *supra*.

¹⁰⁶Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 7(c), 89 Stat. 111 (to be codified in 15 U.S.C. § 78k-1(e)).

¹⁰⁷See note 76 and accompanying text *supra*.

¹⁰⁸Securities Acts Amendments of 1975, Pub. L. No. 94-29, §3, 89 Stat. 97 (to be codified in 15 U.S.C. § 78c(30)).

“two entity” theory, the SEC has understandably vacillated in asserting regulatory authority in this area. A definitive solution to these problems, which can come only from Congress, has been delayed by the *Camp* decision because of unnecessary confusion as to the real issues involved: the continuing validity of the policies of separation enacted in 1933 through the Glass-Steagall Act, and the extent to which the SEC, as opposed to the bank supervisory agencies, should be given regulatory jurisdiction in this area.

III. REEXAMINATION OF THE GLASS-STEAGALL ACT RESTRICTIONS AND THE ROLE OF THE SEC IN CONTEXT: THE REFORM OF FINANCIAL INSTITUTIONS

A. *The Narrow Scope of the Response in Congress*

The increasing number and variety of bank securities activities have caused Congress to begin a review of the Glass-Steagall Act restrictions on banks and the need for additional regulation. The congressional study is being conducted by the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs (the Williams Subcommittee).¹⁰⁹ No definitive solution has yet been advanced, but the subcommittee has published a “study outline”¹¹⁰ setting out the scope of its review and has held hearings on the issues involved. The inquiry is focusing upon the exploration of public policy questions underlying the entry of commercial banks into the securities field without a broad reexamination of the basic limitations and underlying policy of the Glass-Steagall Act.¹¹¹ Most of the policy issues have been developed through the competing arguments of the two principal antagonists involved—the commercial banking and the securities-investment company industries.

The methodology of the study is to weigh each newer form of bank securities activity against several competing policy considerations. On the one hand, the banking industry argues that permitting broad bank securities activities will benefit the consumer, the capital markets, and the economy. The consumer would benefit from increased competition with the investment company industry,

¹⁰⁹The chairman of this subcommittee is Harrison A. Williams, Jr. In addition, separate studies of this same problem are being conducted by the SEC and the Department of the Treasury. See Sec. Act. Rel. No. 5491, *supra* note 88; DEPT OF THE TREASURY ISSUES PAPER, *supra* note 26.

¹¹⁰SUBCOMM. ON SECURITIES, SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 94TH CONG., 1ST SESS. THE SECURITIES ACTIVITIES OF COMMERCIAL BANKS, STUDY OUTLINE (Comm. Print 1975).

¹¹¹*Id.* at iv (introduction by Senator Williams).

and banks would be able to provide small investors with the financial money management services that are now available only to large entities through economies of scale from pooling.¹¹² Allowing bank competition in the underwriting of government revenue bonds would drive down prices for this service.¹¹³ The expansion of banks' securities services would also increase total investment in the securities markets, would provide financial benefits for the brokerage community executing the transactions on behalf of banks, and would increase liquidity.¹¹⁴ Conflicts of interest and unequal regulation could be ameliorated through increased regulatory powers granted particularly to the bank supervisory agencies. Bank supervision and disclosure would be adequate to prevent both financial difficulties and concentration of economic power. Because banking is already highly competitive, the regional banks would enjoy the greater portion of any growth of power involved.¹¹⁵

On the other hand, the investment company and securities industries emphasize competing policy considerations. They argue that banks enjoy freedom from regulation¹¹⁶ because the bank supervisory agencies are largely captives of the banking industry,¹¹⁷ and that the competition from bank securities activities is unfair because banks use their economic power and relationships with customers to gain securities business.¹¹⁸ They foresee failures of investment banking and securities firms, concentration of economic power, and a further institutionalization of the securities markets, all exacerbating the trend toward creation of a "two tier" market in which stocks of larger companies trade at higher multiples of earnings than do stocks of smaller companies.¹¹⁹ They contend that regulation will not prevent conflicts of interest, and that banks will be tempted to skew their loan policies in favor of portfolio companies.¹²⁰ They also fear that regulation will not prevent banks from making profits on the "float"—uninvested customer cash

¹¹²See *Securities Subcomm. Hearings*, *supra* note 26, at 283-85 (statement of Ray F. Myers on behalf of the American Bankers Association).

¹¹³*Id.* at 285-86.

¹¹⁴*Id.* at 342-44 (testimony of Charles W. Buek, Chairman of the Board, United States Trust Company).

¹¹⁵*Id.* at 338-39 (Buek's testimony), 288-90 (Myers' statement).

¹¹⁶*Id.* at 308-12, 316.

¹¹⁷*Id.* at 307.

¹¹⁸*Id.* at 313-16 (statement of Robert L. Augenblick on behalf of the Investment Company Institute).

¹¹⁹*Id.* at 318.

¹²⁰*Id.* at 263-68 (written statement of the Securities Industry Association).

that is deposited in noninterest bearing accounts with the commercial side of the bank.¹²¹

By posing the issues in this narrow framework, the Williams Subcommittee and the supervisory agencies have obviously become embroiled in an unanswerable dilemma. Their deliberations are circumscribed by the competing, self-interested arguments of two hostile interest groups. This type of study with the issues framed as narrowly as they are can only produce a small-minded legislative compromise permitting a modicum of bank securities activity coupled with increased regulation by the SEC and the bank supervisory agencies.

Instead of refusing to reconsider the line of separation drawn by the Glass-Steagall Act between banks and investment banking and defining the issues narrowly in terms of whether the newer forms of bank securities activities should be permitted, the primary focus should be on a reexamination of the policy basis of the Glass-Steagall Act separation and the validity of the Supreme Court's analysis in *Camp*. Another important emphasis should be in considering how to deal with bank securities activities in the context of the need for reform of financial institutions.

B. The Basis of a Solution: the Separation of Trust Departments from Commercial Banks

The Glass-Steagall Act was enacted in 1933 in response to specific abuses that contributed to the collapse of the banking system subsequent to the 1929 stock market crash.¹²² At that time banks were heavily engaged through affiliates in underwriting and dealing in securities. Senator Carter Glass and his subcommittee documented the dangers of bank involvement in the trading and ownership of securities. Banks unwisely loaned money to their securities affiliates, made loans to investors so they could purchase stock from affiliates, and offered loans to portfolio companies as well as to corporations that agreed to use bank affiliates as underwriters. Larger banks pressured regional correspondent banks to promote their securities business, and affiliates were used to manipulate the bank's own stock and to hide bad bank investments by shifting them to affiliates.¹²³ Underlying the legislative solution of

¹²¹*Id.* at 320 (statement of Robert L. Augenblick).

¹²²See notes 12-13 and accompanying text *supra*.

¹²³Hearings Pursuant to S. Res. 71, *supra* note 12, at 1064.

restrictions on bank securities activities was the conviction of Senator Glass that intensive participation by banks in the securities markets, especially through the use of their depositary assets, exaggerates financial and business fluctuations, ultimately undermining the stability of the economic organization of the country.¹²⁴

However, the problems of 1933 have given way to newer concerns not present at that time. The most important of these is the economic power of bank trust departments. The Glass-Steagall Act did not disturb the established trust department activities of banks as a point of contact with the securities markets because trust department structure and policy was characterized by the personal trust function involving a large number of relatively small personal trust accounts, each of which had to be given individual attention. Conservative investment policies emphasized avoidance of risk and preservation of the principal.¹²⁵

Although this still accurately describes many bank trust departments, large commercial banks have in recent years established trust departments managing billions of dollars in collective employee benefit and advisory trust accounts. There are tax and other incentives to invest these funds in the stock market, and preoccupation with performance has caused increasing use of high-risk, high-gain securities investment opportunities.¹²⁶ At the end of 1974, bank trust department holdings of securities amounted to \$328 billion, and recent estimates state that this has grown to over \$400 billion.¹²⁷ Most of this economic power is concentrated in a few commercial banks. At the end of 1972, of the 3,804 bank trust departments, only 71 had trust assets of \$1 billion or more, and 1.9 percent of bank trustees managed \$292 billion in trust assets. By contrast, 3,051 banks had trust assets of under \$25 million.¹²⁸

Numerous abuses have been shown to surround the operation of large bank trust departments. Foremost among these are problems of conflicts of interest, such as communications of inside information between a bank's commercial department and its trust de-

¹²⁴*Id.* at 1001.

¹²⁵See E. HERMAN, *supra* note 27, at 21-23.

¹²⁶See *id.* at 23-24. State trust law concepts of the "prudent man" and even the federal fiduciary standard established by section 1104(a)(1)(A) of the Employee Retirement Income Security Act of 1974, 29 U.S.C.A. § 1104(a)(1)(A) (1975) have been inadequate for imposing substantive investment restrictions in the area of employee benefit plans. See Herbert, *Investment Regulation and Conflicts of Interest in Employer-Managed Pension Plans*, 17 B.C. INDUS. & COM. L. REV. 127, 144-46, 156-58 (1976). Higher than expected returns from a tax qualified pension plan directly benefit the employer, either through reduction of his costs or direct recovery of the "surplus" upon termination of the plan. *Id.* at 152-53.

¹²⁷See note 26 *supra*.

¹²⁸E. HERMAN, *supra* note 27, at 21.

partment.¹²⁹ There are indications that the conventional solution of establishing a "Chinese wall" between the two departments has not been effective.¹³⁰ Furthermore, larger trust departments regularly deposit so-called "uninvestible funds" from their trust departments in noninterest bearing accounts with the banks' commercial departments, turning net operating losses on trust department activities into substantial profits.¹³¹ Large banks' trust activities also present problems of potential bank influence on or control of portfolio companies, misuse of trust department resources to service the demands of commercial customers, possible consideration of commercial customers' reactions to trust department decisions to buy or sell securities, and bank control of proxy voting.¹³²

These problems appear to be insoluble without major structural changes. In 1973, a staff report by the House Committee on Banking and Currency proposed a complete separation from commercial banks of all trust departments with trust assets in excess of \$200 million.¹³³ This solution has been echoed by at least one former member of the Federal Reserve Board.¹³⁴ The proposal has appeal not only because it would ameliorate the problems of large commercial banks and their trust departments; it would also provide

¹²⁹See generally Herman & Safanda, *The Commercial Bank Trust Department and the "Wall,"* 14 B.C. INDUS. & COM. L. REV. 21 (1972); Lybecker, *Regulation of Bank Trust Department Investment Activities: Seven Gaps; Eight Remedies* (pt. 1), 2 SEC. REG. L.J. 122 (1974); E. HERMAN, *supra* note 27.

¹³⁰The "Chinese wall" is the solution proposed by the Hunt Commission, *supra* note 3. It relies on a body of rules and procedures adopted by the bank to regulate the flow of information between its trust and commercial departments. For criticism of the "wall" solution, see Herman & Safanda, *supra* note 129; Lybecker, *supra* note 70, at 983-84; Verkuil, *Perspectives on Reform of Financial Institutions*, 83 YALE L.J. 1349, 1372 (1974). However, the wall seems to pose an unresolvable dilemma in the case where a bank comes into possession of inside information about a corporation as a result of its commercial banking activities and the trust department is trading or recommending the corporation's securities. If the "wall" prevents the transmission of information, the bank may be held liable for the trust department's ignoring the information in the possession of the commercial side of the business. See *Slade v. Shearson, Hammill & Co.*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329 (S.D. N.Y., Jan. 2, 1974), *remanded without resolution for further factual findings*, 517 F.2d 398 (2d Cir. 1974).

¹³¹In 1974, the ten largest trust departments in New York City had an aggregate operating loss of \$40.5 million, but this became a net profit of \$141.7 million after they received credit for trust department funds which had been deposited with their credit departments. *Securities Subcomm. Hearings*, *supra* note 26, at 147 (statement of Roderick M. Hills, Chairman of the SEC). See also Lybecker, *supra* note 129, at 138-43.

¹³²E. HERMAN, *supra* note 27, at 30-72. Preliminary indications are that problems of disclosure, substantive controls on investment, and prevention of conflicts of interest are not adequately addressed in the new Employer Retirement Income Security Act of 1974. See Herbert, *supra* note 126, at 166-67.

¹³³STAFF OF THE HOUSE SUBCOMM. ON DOMESTIC FINANCE, COMM. ON BANKING AND CURRENCY, 93D CONG., 1ST SESS., FINANCIAL INSTITUTIONS: REFORM AND THE PUBLIC INTEREST 98-101 (Comm. Print 1973). To be most effective, a total separation of trust and commercial activities into unaffiliated entities should be required.

¹³⁴*Securities Subcomm. Hearings*, *supra* note 26, at 9-10 (testimony of Jeffrey M. Bucher).

the cornerstone for a solution to the overall problem of banks' securities activities in the context of reform of financial institutions.

If this separation were a part of the line of demarcation drawn by the Glass-Steagall Act, the resulting trust companies could be allowed, under appropriate regulatory constraints, to extend their securities-related activities and to enter freely into competition with the investment company and securities industries by offering commingled investment accounts, investment advice, and even underwriting services. Consumers and small investors would benefit from increased competition and would gain the benefit of money management services that have long been available to wealthy investors. The dangers of market domination would be removed, and equality of opportunity in the marketplace would be achieved through severance of the connection of trust departments with commercial banking. It has been predicted that many large trust departments would fail without the benefit of their tie to commercial banks,¹³⁵ but this does not take into account the increased economic opportunities they would have by permitting them to engage broadly in securities activities. Furthermore, if the present structure of trust fees is so low that bank trust departments are unprofitable, it must mean that trust department customers are not paying the true marginal costs of service but are receiving subsidies from commercial banking customers. Continuation of this inequity cannot be a good argument against separation.¹³⁶

C. *The Dispute Over Regulatory Jurisdiction*

Separating trust departments from commercial banks would also be the basis for resolving the problem of regulatory jurisdiction between the SEC and the bank supervisory agencies. The present situation, without separation, presents an insoluble regulatory puzzle. While the SEC, in carrying out its mission of protecting investors, seeks increased disclosure from banks of their trust

¹³⁵Lybecker, *supra* note 70, at 1001.

¹³⁶Verkuil, *supra* note 130, at 1371-72. Moreover, allowing trust companies to compete freely with investment companies and securities firms should be accompanied by measures to allow mutual fund complexes, insurance companies, and brokerage and investment advisory firms to compete for the employee pension fund business. Tax law restrictions preventing these entities from serving as trustees or custodians for qualified retirement funds should be eliminated. Under § 401 of the Internal Revenue Code, brokerage and investment companies, investment advisors, and insurance companies are not permitted to be trustees or custodians of qualified retirement funds. However, the Employment Income Securities Act of 1974 amended § 401(f) of the I.R.C. to permit persons other than banks, upon designation by the Secretary of the Treasury, to be appointed trustee for § 403(b) custodial accounts and for § 408(a) Individual Retirement Accounts. 26 U.S.C. § 401(f)(2) (Supp. V 1975).

department activities, the bank supervisory agencies, whose task is primarily to safeguard the financial solvency of banks, view disclosure as causing needless concern over the financial stability of major banks.¹³⁷ The banking agencies thus are resisting the SEC's assertion of jurisdiction over banks' trust department activities. This regulatory conflict would be reduced by separation, giving the SEC the authority to subject the new trust companies to the same disclosure and substantive regulatory requirements as other vehicles for pooled investment without conflicting or overlapping with the jurisdiction of bank supervisory agencies.

Disclosure to investor-participants in the various types of trust department collective investment funds is beginning to be recognized as a major problem. Concern is especially acute with regard to employer-funded pension plans. In the recent case of *Daniel v. International Brotherhood of Teamsters*,¹³⁸ the court denied a motion to dismiss an action brought by an employee under section 10(b) and Rule 10b-5 of the 1934 Securities Exchange Act and section 17(a) of the 1933 Securities Act against the trustees of a union-managed pension fund. The court not only found an interest in a pension fund to be a "security," but also held that the transfer of the interest was a "sale"¹³⁹ under the securities laws despite the fact that the pension fund was both "involuntary" and "non-contributory" in the sense that it was funded solely by employer contributions and that participants came under the plan automatically by reason of their employment without any choice on their part. In coming to this conclusion, the court rejected the long established SEC position that there is no sale in the absence of individual choice or contribution,¹⁴⁰ finding that this position "comports neither to logic nor economic reality."¹⁴¹ More significantly, the court also considered whether, as a matter of policy, there was a need for disclosure in view of the significant body of special legislation enacted by Congress to govern pension fund management. It found a need for disclosure under the securities laws because of the more limited purpose of the pension legislation. "It is significant to note that this entire body of pension legislation is concerned with administration of such funds, so as to protect the interests of its participants, rather than regulation of circumstances of entry into the plan."¹⁴²

¹³⁷See note 6 *supra*.

¹³⁸[1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,453 (N.D. Ill., Mar. 1, 1976).

¹³⁹The term "sale" is defined as a "disposition of a security . . . for value." 15 U.S.C. § 77b(3) (1970).

¹⁴⁰See Opinion of the Assistant General Counsel of the SEC, [1941] FED. SEC. L. REP. (CCH) ¶ 2105.50

¹⁴¹*Daniel, supra* note 138, at 99,297.

¹⁴²*Id.* at 99,294.

Although this case involved a union-managed pension fund, its significance extends to trust department collective investment vehicles as well. *Daniel* not only confirms the possibility of 10b-5 liability, but also indicates the need for giving adequate information to potential participants at the time of entry into the fund. At this point the bank examination process is no substitute for disclosure. Disclosing adequate information should be accomplished, not by relying on the general antifraud provisions of the securities laws, but by subjecting trust department collective investment vehicles and securities activities to the same SEC regulations that apply to similar activities of the investment company and securities industry.

D. The Relation to Reform of Financial Institutions

Separation of trust departments from large commercial banks as a solution to problems of bank securities activities is also consistent with recent proposals for reform of financial institutions. The same considerations supporting the reform movement directed toward removing barriers to competition between banks and thrift institutions in the area of commercial banking in order to assure a more stable supply of credit¹⁴³ indicate that the consuming public would also benefit from more competition in the area of collective trust funds and pooled investment opportunities. Just as separation of large trust departments from commercial banks is necessary to assure competitive equality in the marketplace between thrift institutions and commercial banks,¹⁴⁴ separation is also necessary for effective competition in the collective investment fund and pension fund area. Moreover, the removal of bank supervisory agencies from regulatory responsibility for banks' collective investment funds should simplify the problems involved in consolidating and streamlining the present tripartite bank regulatory system into one federal bank supervisory agency.¹⁴⁵

IV. CONCLUSION

The recent increase in the types and amount of bank securities activities has caused the Senate Securities Subcommittee, the SEC, and the Department of the Treasury to undertake a review of the public policy implications involved. Two major questions are

¹⁴³See note 5 and accompanying text *supra*.

¹⁴⁴See Verkuil, *supra* note 130, at 1366-67.

¹⁴⁵See note 3 and accompanying text *supra*.

involved: (1) whether any or all of the activities in question should be prohibited through amendment of the Banking Act of 1933 (the Glass-Steagall Act), and (2) what form of regulation by the SEC and the bank supervisory agencies is appropriate for those activities that are not wholly prohibited.

All three studies have taken a relatively narrow approach to the problem, accepting the basic prohibitions of the Glass-Steagall Act and the analysis of the Supreme Court in *Investment Company Institute v. Camp* as largely beyond the scope of their inquiry. They have also defined the issues involved merely in terms of the competing arguments of the primary industry interest groups involved—the commercial banks and investment companies.

A more appropriate line of inquiry would be to wholly reevaluate the *Camp* decision as well as the line of separation drawn between banks and investment banking by the Glass-Steagall Act in light of the problems presented by all bank securities activities and in the context of reform of financial institutions. Such a reconsideration compels the conclusion that the Supreme Court in *Camp* was incorrect, at least in terms of policy, in its conclusion that bank trust department securities activities do not present the same dangers as bank commingled investment funds. On the contrary, conflicts of interest and other problems are inherent in large banks' trust department activities, and the Glass-Steagall Act restrictions should be replaced by a separation of large bank trust departments from their commercial departments.

This separation of functions would have several salutary effects. It would remove the present competitive advantages and potential for market domination by large banks as well as the conflicts of interest that are inherent problems in the union of a bank's commercial and trust department activities. Greater competition would be injected into the marketplace if trust departments were allowed the freedom to compete and were subjected to the same regulation in their securities activities as investment companies and securities firms. Regulatory conflicts between the SEC and the bank supervisory agencies would also be more easily resolved. These considerations suggest that Congress has been far too timid in coming to grips with these problems and that a much broader approach is necessary in order to deal adequately with bank securities activities.