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S. P. DeVolder

*University of Iowa*

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## **Expansionary Possibilities for Affiliated Commercial Banks: A Current Dilemma**

S.P. DEVOLDER\*

In *Investment Company Institute v. Camp*,<sup>1</sup> the United States Supreme Court stated that Congress enacted the Glass-Steagall Banking Act of 1933<sup>2</sup> for two primary purposes: (1) to protect against the financial risk inherent when banks engage in speculative securities investments; and (2) to guard against "subtle hazards" that appear when banks act not in their capacity of managing agent for their clientele's accounts but as buyer and seller of investment securities.<sup>3</sup> Congress, therefore, intended to achieve the plenary separation of the business of commercial banking from the business of investment banking.<sup>4</sup>

While Congress, with assistance from the courts,<sup>5</sup> was severing the

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\* B.A., B.S. 1981, Iowa State University; J.D., 1984, The University of Iowa. The author wishes to express his thanks to W. H. Knight, University of Iowa Professor of Law, for his extensive critique of the article's first draft. The author also thanks Gary S. Gill, J.D. 1985, for his helpful comments.

1. 401 U.S. 617 (1971).

2. 12 U.S.C. §§78, 324, 377, 378 (1982).

3. 401 U.S. at 630.

4. See 12 U.S.C. §§78, 324, 377, 378.

5. See, e.g., *New York Stock Exchange v. Bloom*, 562 F.2d 736, 737 (D.C. Cir. 1977) ("[s]ections 16 and 21 of Glass-Steagall impose strict limitations on the authority of banks

ties of investment and commercial banking, an almost simultaneous severance was occurring in another banking field as well: the differentiation of commercial banking from other related financial institutions.<sup>6</sup> In *United States v. Philadelphia National Bank*,<sup>7</sup> the Supreme Court held that section 7 of the Clayton Act<sup>8</sup> applied to bank mergers and acquisitions.<sup>9</sup> Moreover, in delineating the critical "line-of-commerce" market<sup>10</sup> as required under section 7, the Court drew a compact boundary line encompassing "commercial banking."<sup>11</sup> The ramifications of the draftsmanship were profound for two reasons.

First, the Bank Holding Company Act of 1956 (BHCA)<sup>12</sup> defines a "bank" as any institution that accepts demand deposits and makes commercial loans.<sup>13</sup> These operations represent the two necessary conditions of commercial banking.<sup>14</sup> The analysis by the *Philadelphia National* Court seemed to imply, therefore, that banks governed under the BHCA would be regulated by section 7 of the Clayton Act for antitrust purposes.

Second, given the restrictive definition by the *Philadelphia National* Court of the line-of-commerce market in bank merger cases, challenges to bank holding company mergers and acquisitions stood a good chance to succeed under antitrust analysis. Success was promised because competition from noncommercial bank depository institutions, such as thrifts, would not be considered in the determination of actual competition in the commercial banking market.<sup>15</sup>

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to purchase, sell, issue, underwrite, distribute, or otherwise deal in stocks and securities"); *Independent Bankers Ass'n v. Board of Governors*, 516 F.2d 1206, 1211 n.8 (D.C. Cir. 1975).

6. What might be labelled as "related" to a commercial bank presents a difficult determination of pedigree. This difficulty arises because the regulatory authorities have an amorphous definition of a "bank." See *infra* note 49 and accompanying text. For the purposes of this essay, "related financial institutions" are those *predominately* depository-type financial concerns. Operationally, savings and loans, for instance, are included within the ambit of this definition. Excluded thereby would be financial concerns such as Merrill Lynch, which although offering services of a suspiciously depository nature (e.g., CMA's), nevertheless are predominately nondepository.

7. 374 U.S. 321 (1963).

8. 15 U.S.C. §18. Section 7 of the Clayton Act, as amended, provides in pertinent part: No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or tend to create a monopoly.

9. 374 U.S. at 343-49.

10. See *supra* note 8.

11. 374 U.S. at 356.

12. As codified in 12 U.S.C. §§1841-1849.

13. 12 U.S.C. §1841(a)(6)(c).

14. *Id.*

15. See, e.g., *United States v. Connecticut Nat'l Bank*, 418 U.S. 656, 660-66 (1974).

In effect, the *apparent* result of this two-prong separation attack was that banks were barred from participating vigorously in the securities field by the proscriptions of the Glass-Steagall Act as interpreted by the judiciary in decisions such as *Camp*. Moreover, commercial banks found themselves barred from merging and undertaking new acquisitions in seemingly competitive markets because of the restrictive antitrust analysis by the judiciary, as exemplified in *Philadelphia National*.

Appearances, however, can be deceiving. The question remains whether *Philadelphia National* is the exception to the rule. Although the BHCA included "affiliated" commercial banks to the *Philadelphia National* antitrust analysis because of the definition of a "bank," the Act concomitantly has unleashed such banks from the purported restrictions of the Glass-Steagall Act. This has resulted in a change in the earlier trend in securities law of absolute separation between investment and commercial banking. On the other hand, the antitrust trend created by *Philadelphia National*, of restricting competition between commercial banks and other functionally related financial institutions, has remained on its original path.<sup>16</sup>

With these two present trends in mind, this article proposes to detail the historical development of the Glass-Steagall and Bank Holding Company Acts, and to address the question whether changed conditions and new institutional outlooks demand that like changes occur in current agency and judicial analyses. Moreover, this article will demonstrate that the current judicial trend of fusing commercial and investment banking threatens to cause another financial upheaval, and that the current trend in the bank holding company merger and acquisition field, unlike the trend in the investment area, is one of separation.

This article will focus on the problems raised from the perspective of the *national* commercial bank, particularly from the perspective of the bank holding company and its affiliated national commercial banks.<sup>17</sup> Consequently, the arguments of overseeing investment banks and other noncommercial bank financial institutions, calling for even greater encroachment into the prerogatives of the commercial banker, are beyond the scope of this article. State banking restrictions that

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16. See, e.g., *United States v. Citizens Nat'l Bank*, 422 U.S. 86, 120 (1975); *United States v. Connecticut Nat'l Bank*, 418 U.S. 656, 667 (1974); *United States v. Phillipsburg Nat'l Bank*, 399 U.S. 350, 359 (1970); *United States v. Third Nat'l Bank in Nashville*, 390 U.S. 171, 182-83 (1968).

17. The principal reason for this is that a large majority of the demand deposits held by commercial banks are held by commercial banks affiliated to a holding company.

are of only marginal relevance to national banking also will not be discussed.<sup>18</sup> With these limitations in mind, the discussion will begin with an overview of the historical development of the Glass-Steagall and Bank Holding Company Acts.

#### THE SECURITIES FIELD: AN INSECURE OPPORTUNITY

The Glass-Steagall Act was enacted to eliminate the possibility of history repeating itself. In this sense, the Act exemplifies other major legislation dealing with the business of banking in this country. In other words, the Act was a reaction to a crisis and was not a prophylactic piece of legislation promulgated to protect against an unwanted progeny. The crisis, in this case, was the Great Depression of the 1930s.

This section will examine the Glass-Steagall Act. A brief description of the crisis that gave rise to the need for the Act initially will be given. Arguments then will be suggested that historical conditions have changed to such an extent that the Act has outlived any usefulness. Next, with this consideration in mind, the Bank Holding Company Act will be examined, with emphasis placed on controversial language that permits bank holding company expansion into non-banking areas. The author next will analyze specifically how this permissive statutory recipe has served to succor bank holding companies during their periods of incursion into the securities and investments camp. The article will continue with an argument on the very probable prospects that these incursions represent merely the prelude to an imminent full-scale invasion. Finally, this section of the article will suggest the problems this invasion might create for the expanding bank holding companies themselves.

##### *A. The Glass-Steagall Act of 1933*

Sections 16, 20, 21, and 32, as amended, of the National Banking Act of 1933,<sup>19</sup> commonly referred to as the Glass-Steagall Act, are relatively straightforward. Section 16<sup>20</sup> grants to national banking associations all such incidental powers, subject to law, necessary to

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18. For instance, the Douglas and McFadden Amendments, which incorporate state branching restrictions to nationally chartered banks, makes such state law relevant to federal banking issues. See 12 U.S.C. §§36, 1842(d). Thus, state branching restrictions properly will be emphasized in the article, unlike, for instance, state chartering requirements.

19. 12 U.S.C. §§24(7), 377, 378, and 78.

20. 12 U.S.C. §24(7).

carry on the business of banking.<sup>21</sup> This broad grant of power, however, is tempered by the significant limitation that national banking associations are relegated to an agency role when dealing in securities.<sup>22</sup> Banks that handle securities, therefore, are restricted to purchasing and selling securities solely upon the order and account of their third-party customer. In addition, the transaction must be without recourse.<sup>23</sup> Banks can purchase and sell securities for their own accounts only in limited circumstances.<sup>24</sup> Banks explicitly are prohibited from actually underwriting an issue. Moreover, section 20 proscribes affiliation mechanisms to defeat the mandates of section 16.<sup>25</sup> Section 32 prevents the interlocking directorate alternative.<sup>26</sup> Finally, section 21<sup>27</sup> prohibits securities dealers from engaging in the business of commercial banking or accepting demand deposits. The legislative history and purposes of the Act must be examined to understand the rationale underlying the restrictions promulgated in these sections.

### 1. Legislative History and Purpose

Prior to 1900, national banks were regulated by the National Bank Act of 1864.<sup>28</sup> The Act empowered national banks to engage solely in the banking business, which included the power to discount notes and otherwise negotiate "evidences of debt."<sup>29</sup> Although not considered as broad a grant of authority to engage in the investment securities practice as was undertaken by many state chartered banks at the time,<sup>30</sup> nationally chartered banks nevertheless became involved in the purchase and sale of stocks and bonds both for their own account and for the accounts of their customers.<sup>31</sup> Prohibited from actually underwriting or trading in corporate stocks,<sup>32</sup> national banks, sometimes

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21. *Id.* Along with "incidental powers," arguably a separate grant of power, the provision includes five specified banking powers as well: discounting, deposit receiving, circulating exchange, personal and commercial lending, and circulating notes. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. 12 U.S.C. §377.

26. 12 U.S.C. §78.

27. 12 U.S.C. §378.

28. Ch. 106, 13 Stat. 99 (1864) (codified as amended in scattered sections of 12 U.S.C.).

29. National Bank Act of 1864, ch. 106, §8, 13 Stat. 99, 101 (1864) (codified at 12 U.S.C. §24(7)).

30. New Jersey, for example, permitted banks to engage in a full-range of securities activities, subject to prohibitions against "speculating." See *Clucas v. Bank of Montclair*, 110 N.J.L. 394, 166 A. 311, 313 (1933).

31. See Note, *National Banks and the Brokerage Business: The Comptroller's New Reading of the Glass-Steagall Act*, 69 VA. L. REV. 1303, 1306-13 (1983).

32. See, e.g., *California Bank v. Kennedy*, 167 U.S. 362, 367 (1897).

directly but usually through the operation of their affiliates, were left fairly free from federal regulation to conduct a full range of stock and bond trading activities.

After the bottom fell out of the securities market in 1929, the previous freedom banks enjoyed in cultivating the securities market came to an end. When the Bank of the United States failed in 1930, Congress was quick to point the finger of blame at the speculative activities of the numerous securities affiliates in the banking industry.<sup>33</sup> Many members of Congress believed that commercial banks had fueled the rampant speculation that led to the dramatic decline of the stock market. Fuel to increase the speculative fever was supplied by banks both in the direct form of trading in speculative issues for their own accounts and in the indirect form of unwisely providing generous margin loans for their customers' stock schemes.<sup>34</sup> With thousands of banks closing<sup>35</sup> and the term "public confidence" battered about as a cruel joke, the historical climate was ripe<sup>36</sup> for strong corrective medicine. The prescription by President Franklin Delano Roosevelt and Congress was the National Bank Act of 1933,<sup>37</sup> relevant sections of which became known popularly as the Glass-Steagall Act.

The broad purpose of the Glass-Steagall Act was to protect customer deposits from a repetition of the widespread bank closings of the Great Depression.<sup>38</sup> The Act was to achieve this substantive end principally by the creation of federal deposit insurance,<sup>39</sup> which was to increase depositor confidence in the overall banking system. Congress sought to provide still further protection for depositors by annulling the ill-fated commercial and investment banking elopement. Clearly, section 16 of the Act prohibits a commercial bank from underwriting or dealing in a security issue. What other activities might be perceived as arguably related to investment banking operations was not immediately clear, however.<sup>40</sup> Thus, the courts were left to determine the intent of Congress in drafting and adopting Glass-Steagall. In *Investment*

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33. *Hearings Pursuant to S. Res. 71 before a Subcommittee of the Senate Committee on Banking and Currency*, 71st Cong., 3d Sess. 116-17, 1068.

34. See S. REP. NO. 77, 73d Cong., 1st Sess. 6, 8, 10.

35. By 1933, nearly 9,000 banks had failed. Clark & Sanders, *Judicial Interpretation of Glass-Steagall: The Need for Legislative Actions*, 97 BANKING L.J. 721, 723 (1980).

36. See Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483 (1971); 2 F. Redlich, *THE MOLDING OF AMERICAN BANKING* 1-85 (1968).

37. See *supra* note 19.

38. 77 CONG. REC. 3837 (1933).

39. 48 Stat. 168-80 (1933).

40. See Note, *A Banker's Adventures in Brokerland: Looking Through Glass-Steagall at Discount Brokerage Services*, 81 MICH. L. REV. 1498, 1511-27 (1983).

*Company Institute v. Camp*<sup>41</sup> the Supreme Court approached this issue by inquiring into the particular risks and abuses Congress desired to eliminate when separating commercial from investment banking.<sup>42</sup>

The Court held in *Camp* that the Comptroller of the Currency (the Comptroller) lacked the authority to authorize commercial banks to operate collective investment funds in direct competition with the mutual fund industry. An opposite result, reasoned the Court, would permit commercial banks to deal and underwrite securities issues in direct violation of sections 16 and 21 of the National Bank Act of 1933.<sup>43</sup> The Court read the underlying purpose of the statute as precluding commercial banks from involvement in the investment banking business. Any potential anticompetitive effects that might result from such an interpretation of the Act were more than "outweighed by the 'hazards' and 'financial dangers' that arise when commercial banks engage in the activities proscribed by the Act."<sup>44</sup>

The Court noted that Congress also had more than just the intent to ensure that commercial bankers acted solely as the fiduciary or managing agents of their customers' accounts. The Court in *Camp* listed the following:

[Congress also] had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments. This course places new promotional and other pressures on the bank which in turn create new temptations.<sup>45</sup>

The results would be as follows: (1) unsound loans would be made to invigorate a troubled security affiliate leading to the risk of bank instability; (2) banking reputation would be undermined by the results of such unsound practices; (3) the public would lose confidence in the overall banking system; (4) risky margin loans would be made to customers; (5) promotional campaigns would be launched to advertise the specific investments of the bank at the expense of its role as the disinterested investment advisor; and (6) self-dealing would be encouraged.<sup>46</sup>

Pressure to make unsound loans to affiliates would arise because

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41. 401 U.S. 617 (1971).

42. *Id.* at 630-38.

43. *Id.* at 639.

44. *Id.* at 630.

45. *Id.* at 630-31.

46. *Id.* at 631-38.



of the close association by the public between the bank and the troubled affiliate.<sup>47</sup> Moreover, any investment and depository losses that the public might suffer because of investment losses by a bank would undermine confidence in the national banking system, leading to a potential repeat of the disastrous Depression era bank runs, which, the Court feared, might recur during a period of a prolonged bear market.<sup>48</sup> Finally, any bank that operated a securities department would have particular investments to sell. Such a bank, in acting as a security vendor rather than merely offering disinterested advice, obviously would be subjected to pressures forcing it to finance potential customers investments in its own offerings. These pressures could serve to corrupt the pure investment advice supposedly offered by the bank acting solely as a fiduciary or agent.<sup>49</sup>

## 2. *Changing Historical Conditions*

Some commentators argue that the considerations that motivated Congress in 1933 to separate investment and commercial banking are no longer relevant today.<sup>50</sup> If so, those blatant and subtle hazards that the *Camp* Court elucidated in 1971 are out of place in the evolving financial markets of the 1980s. The champions of this view, in order to bolster their assertions, point to the comparatively liberal recent policies of the Comptroller and the Federal Reserve Board (the Board).<sup>51</sup> Indeed, they claim that the Court of the 1980s has adopted this view, citing as support the 1984 case of *Securities Industry Association v. Board of Governors (SIA II)*.<sup>52</sup>

These prognostications by the proponents for the integration of investment and commercial banking appear to be amassing current evidentiary support. In this regard, the predictions of the prognosticators cannot be ignored by those who wish to stay at the vanguard of the banking field. True, bank holding companies have made great inroads into the securities field, predominantly through section 4(c)(8) of the Bank Holding Company Act of 1956<sup>53</sup> and

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47. *Id.* at 631; *see also* 1931 Hearings at 1064.

48. 401 U.S. at 631.

49. *Id.* at 636-38; *see also* 75 CONG. REC. 9912 (1932) (comments of Sen. Buckley on the loss of public confidence in banks caused by questionable investment counselling).

50. *See supra* note 35.

51. *See infra* notes 102-06 and accompanying text.

52. 104 S. Ct. 3003 (1984) (held Board had authority to permit a bank holding company to acquire a nonbanking corporation engaged solely in the retail securities brokerage business, despite the fact that the acquisition would not facilitate any banking operations of the holding company).

53. 12 U.S.C. §1843(c)(8).

“Regulation Y,”<sup>54</sup> a regulation promulgated by the Board under authority granted under the Act. For example, pursuant to this regulation, a bank holding company may manage a closed-end investment company. Moreover, the company can provide both general economic forecasts and specific portfolio advice to any interested person.<sup>55</sup> Thus, before a more in-depth analysis of the current expansionary phenomenon by commercial banks into the investment banking field can be undertaken cogently, a preliminary analysis of section 4(c)(8) of the 1956 statute, and of the regulation that it spawned, must be made.

### B. The Bank Holding Company Act of 1956

The Bank Holding Company Act of 1956 (BHCA), similar to its 1933 predecessor, appears straightforward and simple.<sup>56</sup> A bank holding company is a company that controls a bank.<sup>57</sup> “Company” includes almost any organizational structure that reasonably can come to mind, with the exception of individuals and individuals acting in concert.<sup>58</sup> A “bank” is a domestic institution that receives demand deposits and makes commercial loans.<sup>59</sup> Finally, “control” over a bank is found to exist if: (1) a bank holding company has direct or indirect control over one-quarter or more of the bank voting shares or the voting rights over them; (2) the holding company controls the election of a majority of the bank directorate; or (3) the Board determines that the company directly or indirectly exercises a controlling influence over the actual management or policies of the bank.<sup>60</sup>

The substantive provision of the statute, by which we will attempt to answer our inquiry on affiliated commercial bank expansion into the securities field, is section 4(c)(8). Section 4(c)(8) permits bank

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54. 12 C.F.R. §225.

55. See *infra* notes 102-06 and accompanying text.

56. The 1956 Act, unfortunately, is analogous to its predecessor in another respect as well. The countenance of facial simplicity disguises the souls of these creatures, souls that are complex and cold. A bank holding company, for instance, is any company that controls a bank. See *supra* note 50 and accompanying text. Something obviously is amiss when a definer uses the very term of the object being defined (bank) in the body of the definition in order to describe the necessary conditions of that object. This is a circular analysis.

57. 12 U.S.C. §1841(a)(1). Also, for a superb study of the intricacies of bank holding company law, see P. HELLER, HANDBOOK OF FEDERAL BANK HOLDING COMPANY LAW (1976).

58. 12 U.S.C. §1841(b).

59. 12 U.S.C. §1841(c). Demand deposits are literally payable upon the legal demand of the customer. Commercial lending, on the other hand, has been given a functional definition by the Board, dependent upon the factors of regularity in this category of lending and of substantiality in total volume. See 12 C.F.R. §§225.2(a)(1)(ii)(A), (B) (1984); Heller, *supra* note 57, at 11.

60. 12 U.S.C. §§1841(a)(2)(A), (B), (C).

holding companies and their nonbanking subsidiaries to engage in activities "closely related to banking."<sup>61</sup> Section 5 also is important by granting the Board statutory authority "to issue such regulations and orders as may be necessary to enable it to administer and carry out" the purposes of the statute.<sup>62</sup> Pursuant to this grant of authority, the Board has promulgated the (in)famous "Regulation Y."<sup>63</sup>

Under this regulation, the Board has named specific areas of prohibited nonbanking acquisitions and activities,<sup>64</sup> exempted certain activities and acquisitions from general prohibitions,<sup>65</sup> established procedures for applications, notice, and hearings that bank holding companies must follow either to engage in nonbanking businesses *de novo* or to acquire nonexempt nonbanking affiliates already engaged in such practices,<sup>66</sup> enacted a list of nonbanking activities that are "so closely related to banking" that a bank holding company can engage in them without being subject to the procedural requirements,<sup>67</sup> and stated the factors it considers when acting on bank holding company applications to provide nonbanking services and other activities.<sup>68</sup> The central factor that the Board considers in the application determination process is a cost/benefit analysis. Under this analysis, the Board is required to determine whether the benefits expected to flow to the public from the bank holding company engaging in a non-

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61. Section 4(c)(8), as codified in 12 U.S.C. §1843(c)(8) (1982). This section reads as follows: [Exempted from the prohibitions in this section outlawing ownership or control by a bank holding company of any shares of a nonbank company, or of engaging in activities other than banking] shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto . . . .

*Id.*

62. 12 U.S.C. §1844(b).

63. 12 C.F.R. §225.

64. *Id.* §225.21.

65. *Id.* §225.22.

66. *Id.* §225.23.

67. *Id.* §225.25.

68. *Id.* §225.24. This subpart reads:

In evaluating an application or notice under §225.23 of this subpart, the Board shall consider whether the performance by the applicant of the activity can reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, the [sic] gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices). This consideration includes an evaluation of the financial and managerial resources of the applicant, including its subsidiaries, and any company to be acquired, and the effect of the proposed transaction on those resources. Unless the record demonstrates otherwise, the commencement or expansion of a nonbanking activity *de novo* is presumed to result in benefits to the public through increased competition.

*Id.*

banking business will outweigh the possible adverse effects that such an engagement could cause. In making this determination, the Board must consider the relative financial resources and managerial acumen of each of the involved companies, and the possible effects the proposed action will have on the wealth of each.

Although this is an amorphous explanation of the analysis that the Board adheres to in weighing the public benefits of an applicant's plan, this represents real-life uncertainty. The Board has *never* articulated a laundry list of the factors considered in making the cost/benefit determination; indeed, the Board expressly has left this determination to be made on a case-by-case basis.<sup>69</sup> The courts, meanwhile, are highly deferential to the "public benefits" determination. No court has made an independent determination that a particular proposed bank holding company activity was or was not likely to produce public benefits sufficient to outweigh potential social costs.<sup>70</sup>

This article now will turn to a more detailed analysis of both section 4(c)(8) and Regulation Y. Such an examination indicates that the interaction between the statutory provision and the regulation has drilled a gap into the wall separating commercial and investment banking. Under the escort of their parent holding companies, affiliated commercial banks have slithered through this gap, and become actively involved in investment undertakings.

*1. Section 4(c)(8) and Regulation Y: "Closely related . . . as to be a proper incident thereto"*

Section 16 of the National Bank Act grants banks "incidental powers . . . necessary to carry on the business of banking."<sup>71</sup> In *Arnold Tours, Inc. v. Camp*,<sup>72</sup> the First Circuit Court of Appeals ruled that bank activities were properly permissible under the incidental powers provision if the activities under question were "convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act."

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69. Annot., 31 A.L.R. FED. 541.

70. *Id.*

71. See *supra* note 20 and accompanying text.

72. 472 F.2d 427, 432 (1st Cir. 1972) (bank lacking the power to continue to travel agency business despite authorization from the Comptroller); followed by *National Retailers Corp. v. Valley Nat'l Bank*, 411 F. Supp. 308 (D.C. Ariz. 1976) (held that Retail Information System service by bank to customers under auspices of Comptroller's regulation violated §16); *M & M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977) (held leasing of personal property, including motor vehicles, by a bank as lessor under authority of a regulation promulgated by the Comptroller was both "convenient and useful" and pursuant to an express banking power).

Analytically, the *Arnold Tours* interpretation of the incidental powers clause is powerful; the analysis clearly grounds the incidental powers of banking into the penumbra of those express powers that Congress specifically provided in the Act such as discounting, receiving deposits, circulating exchange and notes, and lending.<sup>73</sup> The arguably related language of section 4(c)(8) of the BHCA,<sup>74</sup> however, has been interpreted by the United States Supreme Court *not* to require that the proposed activity of a bank holding company affiliate be grounded upon an express banking prerogative or facilitate any of the actual banking operations of the holding company.<sup>75</sup>

This interpretation by the court is based on Regulation Y. This concise answer is, of course, cryptic and, as such, insufficient. However, clarity and, perhaps, satisfaction can be achieved by contrasting two cases that the Supreme Court decided a decade apart. In the more recent decision, the Court attempted a reconciliation of the legislative goals that led to the creation of the Glass-Steagall and Bank Holding Company Acts. First, the Court artfully narrowed the prior interpretation of the regulatory breadth of Glass-Steagall. The Court then found that Regulation Y, as amended, facially avoided the proscriptions of "narrowed" Glass-Steagall. Finally, the Court concluded that the Board had almost *carte blanche* authority to interpret section 4(c)(8), the BHCA "closely related" powers provision.<sup>76</sup> Such a chain of illogic, even if leading to a clearer end, cries out for closer analysis.

In *Investment Company Institute v. Camp*,<sup>77</sup> the Court held that the Comptroller lacked the power to authorize a bank to operate a collective investment fund in competition with the mutual fund industry. More importantly, the Court elucidated those blatant dangers and "subtle hazards" from which Congress, by enacting Glass-Steagall, sought to immunize the commercial banking system.<sup>78</sup>

Ten years after *Camp*, the Court considered whether the *Board* had

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73. See *supra* note 21 and accompanying text.

74. See *supra* note 61.

75. Securities Industry Ass'n v. Board of Governors, 104 S. Ct. 3003, 3008 (1984).

76. The Comptroller cannot even seem to sneak a data processing rule past the judiciary. See *National Retailers Corp. v. Valley Nat'l Bank*, 604 F.2d 32, 34 (9th Cir. 1979). On the other hand, the Board can amass a *unanimous* Court to affirm a Board ruling that full discount securities brokerage affiliation is a permissible nonbanking activity. See *Securities Industry Ass'n v. Board of Governors*, 104 S. Ct. 3003, 3012 (1984). Data processing is not only a "related" function of operating a bank, but, given the volume of business even a small bank handles, it is a *necessary* banking operation as well. By contrast, operating a discount brokerage house has little or nothing to do with circulating currency, making loans, and receiving deposits.

77. 401 U.S. 617 (1971).

78. For a listing of the "subtle hazards," see *supra* notes 44-49 and accompanying text.

authority to permit a bank holding company, through a banking affiliate, to act as an investment advisor to another affiliate that was engaged solely in the business of closed-end investments and securities dealing. In *Board of Governors v. Investment Company Institute (ICI)*,<sup>79</sup> the Court held that the Board had such authority. In rationalizing the decision, the Court drew a curious distinction between the situations presented in *ICI* and *Camp*.

First, the Court noted that a bank holding company could be authorized to engage in some types of activities that would be illegal if undertaken by an unaffiliated bank.<sup>80</sup> Thus, even if a bank, standing independent, could not perform closed-end investment advisory services without violating the mandates of section 16 of Glass-Steagall,<sup>81</sup> or section 21 of the same Act,<sup>82</sup> or both, Glass-Steagall prohibitions would not follow necessarily if identical conduct were undertaken by an affiliate of a bank holding company pursuant to Board interpretation of section 4(c)(8) of the BHCA.<sup>83</sup>

Second, the Court admitted that Congress intended the BHCA “to maintain and even strengthen Glass-Steagall’s restrictions on the relationship between commercial and investment banking.”<sup>84</sup> Given this admission, the question arises how the first and second premises, which seemingly are contradictory, can be reconciled. This crossroad marks the point where the Court engages in analytical sleight of hand. The Court found that section 19(e) of the original Glass-Steagall Act of 1933<sup>85</sup> contained a loophole through which bank holding companies could control or own affiliate corporations engaged principally in the actual issuance or underwriting of securities issues. The only limitation on the bank holding companies was that they could not vote the shares of their *bank* subsidiaries.<sup>86</sup> In other words, they could vote the shares of their investment affiliates and all of their other nonbanking affiliates. The BHCA plugged this loophole and, accord-

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79. 450 U.S. 46 (1981).

80. *Id.* at 60 (“[m]oreover, bank affiliates may be authorized to engage in certain activities that are prohibited to banks themselves”).

81. In this particular case, however, the Court expressly found that section 16 was not violated, given Board proscriptions against actual underwriting and dealing in securities. *Id.* at 62.

82. Unlike section 16, the Court was unsure whether the Board regulation permitting a bank holding company to engage in the business of closed-end investment advising services would pass muster under Section 21 if that regulation had been promulgated by the Comptroller. *Id.* at 62-64.

83. *Id.* at 64.

84. *Id.* at 69 (emphasis added).

85. 48 Stat. 188 (1933).

86. *Id.*

ing to the Court, strengthened the Glass-Steagall separation of the businesses of investment and commercial banking.<sup>87</sup>

This form of carpentry, concluded the Court, marked the extent of the relationship of the BHCA to its predecessor statute:

[n]othing in the legislative history of the Bank Holding Company Act persuades us that Congress in 1956 intended to effect a more complete separation between commercial and investment banking than the separation that the Glass-Steagall Act had achieved with respect to banks in [sections] 16 and 21 and had sought unsuccessfully to achieve with respect to bank holding companies in [section] 19(e).<sup>88</sup>

In effect, a loophole in Glass-Steagall was closed, which was at best disputably important,<sup>89</sup> while section 4(c)(8) of the BHCA emerged unscathed from the investment limitations incorporated in sections 16 and 21 of Glass-Steagall.<sup>90</sup>

After this preliminary conclusion, the Court found that Congress did not intend the BHCA to "limit the Board's discretion to approve securities-related activity as closely related to banking beyond the prohibitions already contained in the Glass-Steagall Act."<sup>91</sup> Given the breadth of section 4(c)(8) of the BHCA, the limited prohibitions still relevant from Glass-Steagall would seem to be against affiliated activity that amounted to the *direct* "issuing, underwriting, selling, or distributing of securities."

When the above cases are interpreted in this light, the attempt by the Court to distinguish the "subtle hazards" involved in *Camp*,<sup>92</sup> yet simply ignored in *ICI*, is understandable. Those subtle hazards do not exist in the latter case, according to the Court, since the involved affiliated commercial bank could not extend credit to the affiliated investment company, or underwrite or sell affiliate stock, or become constantly involved in the search for new capital with which to cover the costs of redeeming other securities that the investment affiliate might purchase. Finally, the *Camp*-type promotional pressures were found not to exist in *ICI* since the affiliated bank would receive only a nominal advisory fee for any services provided to a sister affiliate, and therefore would have "little incentive"<sup>93</sup> to promote investments with vigor.

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87. 450 U.S. at 69-70.

88. *Id.* at 71.

89. *Id.* at 71 n.49.

90. See *supra* notes 17-19 and accompanying text.

91. 450 U.S. at 77.

92. See *supra* notes 44-49 and accompanying text.

93. 450 U.S. at 67.

The analytical artistry of the Court displays the brush strokes of a master. Yet the viewer is left to ponder an incongruous piece of surrealism that defies pure analytical reason. Why will the affiliation that exists between the companies, logically rooted in the mind of the public, not lead to the build-up of promotional pressures on the affiliated bank? The affiliates, after all, do share the same parent.

In cases such as *ICI*, the principle that an affiliated bank serves as a mere advisor to sister investment affiliates, holding a detached view toward their potential success or failure, appears intuitively absurd. Is not this case a literal restatement of the very type of facts that concerned the Court in *Camp*?<sup>94</sup> The author does not intend to imply the *Camp* subtle hazards criteria have been *totally* read out of section 4(c)(8) cases. Instead, the author expressly states that the applicability of the subtle hazards standards in such cases seems restricted to the "narrowed" cases of *direct* engagement by the investment affiliate of the bank holding company in the issuing, underwriting, selling, and redeeming of securities.

That the author's interpretation is consistent with current law is illustrated by consideration of recent amendments to Regulation Y. Further consistency can be garnered upon reading the most recent Supreme Court case pertaining to the issue. Both of these current developments will be discussed in the next subsection of this article. The author will demonstrate that these developments translate into a direct bank holding company expansion into the investment field.

## 2. Expansion into the Securities Field

We have seen that the Board possesses broad discretion to determine what activities are "closely related" to banking. This author has speculated that such authority, given the *ICI* analysis, could extend up to the *literal* prohibitions of Glass-Steagall. The outer limits may have been reached in the recent case of *Securities Industry Association v. Board of Governors (SIA II)*.<sup>95</sup> In *SIA II*, the Supreme Court held that Bank America Corporation, holding company of Bank of America, the largest commercial bank in the United States, could acquire one of the largest retail securities brokerage corporations as an affiliate in accordance with section 4(c)(8) of the BHCA and the regulations prescribed by the Board.

The rationale of the Court displays the full implications of the "closely related" test. Section 4(c)(8) requires the Board to make two

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94. 401 U.S. at 631.

95. 104 S. Ct. 3003 (1984).



determinations when listing activities as permissible under Regulation Y.<sup>96</sup> First, is the activity “closely related” to banking?<sup>97</sup> If so, then can the particular activity be expected to produce possible public benefits that outweigh potential harmful effects? On judicial review of the determinations by the Board, great deference is given by the courts to the banking expertise of the Board.<sup>98</sup> Deference is due because section 4(c)(8) fails to specify any factor that the Board must consider in making the “closely related” determination. Thus, the Court ruled that “Congress vested the Board with considerable discretion to consider and weigh a variety of factors in determining whether an activity is ‘closely related’ to banking.”<sup>99</sup>

From this broad congressional grant of discretion, the Board has adopted, and the courts have acquiesced in, a “functional and operational” testing criterion for determining whether an activity is “closely related to banking.” In *SIA II*, the Court deferred to the Board determination that discount brokerage activities were “closely related” to banking. The Board reasoned that because such brokerage services were similar in nature to the practice of banks acting solely as agents for their customers’ orders, a practice specifically permitted by section 16 of Glass-Steagall,<sup>100</sup> then no section 4(c)(8) violation occurred. The acquisition by Bank America Corporation therefore was legal.

The assumption by the Board and the Court that discount brokerage houses act as pure agents or fiduciaries for their customers’ investment decisions is controversial at best.<sup>101</sup> Moreover, detailed analysis of the relevant subpart of Regulation Y reveals that the Court may

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96. *Id.*

97. The “closely related” standard is in fact a misnomer. In determining whether an activity is closely related, the Board must ask whether banks generally have undertaken such an activity, if the activity is of such a nature that banks are operationally or functionally equipped to provide it, and whether banks generally provide services so integrally related to the proposed activity as to require their provision in a specialized form. See *National Courier Ass’n v. Board of Governors*, 516 F.2d 1229, 1275 (D.C. Cir. 1975). Were this the final test, it would be quite analogous to the restrictions placed on the Comptroller when he or she determines what is a permitted incidental banking power— i.e., a direct relationship would be required, in the case of “closely related,” between a recognized banking service and the contested activity. This, however, is not the final test. The Board has stated that it will not be limited exclusively to the *National Courier* guidelines; rather, the Board will consider “any . . . factor that an applicant may advance to demonstrate a reasonable or close connection or relationship to the activity of banking.” 49 Fed. Reg. 806 (1984) (emphasis added). The Supreme Court has acceded to the assertion of the Board. *Securities Indus. Ass’n v. Board of Governors*, 104 S. Ct. 3003, 3006 n.5 (1984).

98. *Securities Indus. Ass’n.*, 104 S. Ct. at 3008.

99. *Id.*

100. *Id.*

101. To those of us who are cynics at mind, the conclusive statement by the Court on this point may well make us smile.

be on the wrong side of the controversy, since the Board is prepared to go beyond the parameters of *SIA II*.

Section 225.25(b)(4) details permissible nonbanking investment or financial advisory activity.<sup>102</sup> Subpart (ii) permits those kinds of advisory services that occurred in *SIA II*, while the very next subpart, (iii), permits portfolio advice "to any other person." In a footnote to this subpart, bank holding companies and their subsidiaries are abjured to "observe the standards of care and conduct applicable to fiduciaries."<sup>103</sup> Moreover, subpart (iv) permits affiliated commercial banks to sell general economic information and advice, as well as to undertake and distribute general economic statistical forecasting and industry studies.<sup>104</sup> Finally, section 225.25(b)(15) permits bank holding company acquisitions of affiliated securities brokerage concerns that are restricted to the buying and selling of securities solely as agent for their customers' accounts. In this last case, any provision of investment advice and research services by the affiliated commercial bank to sister investment affiliates is proscribed.

Clearly, the Board has distinguished securities brokerage activity from investment and financial advisory activity. Seemingly, a bank holding company could acquire a closed-end investment company as in *SIA II*, sponsor, organize, and manage the affiliate in an investment advisory capacity through the expertise of an affiliated commercial bank,<sup>105</sup> and also provide portfolio investment advice "to any other person."<sup>106</sup> The affiliated bank advises customers as "other persons" on potential portfolio investments, while advising investment affiliates as well. Such an inherent conflict-of-interest situation is presented by Board regulations, and would be consistent with *SIA II* analysis.

The author's concern may be of only academic interest because no Board or court decision has addressed this fact pattern to date. The above example from Regulation Y nevertheless underscores the point. With the exception of "narrowed" Glass-Steagall, the Board, with the blessing of the judiciary, is in the process of permitting bank holding companies to make substantial inroads into the securities field.

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102. 12 C.F.R. §225.25(b)(4).

103. How a warning hidden in a footnote of an agency regulation is supposed to elevate the nature of the fiduciary relationship to a standard commensurate with the *statutory* duty required of actual underwriters and dealers by the Securities Act of 1933 is not explained.

104. "Management consulting," detailed information and analyses of a *particular* firm, is prohibited.

105. 12 C.F.R. §225.25(b)(4)(ii).

106. 12 C.F.R. §225.25(b)(4)(iii).

The remaining applicability to the Board of the *Camp* subtle hazards concerns is an open question.<sup>107</sup> This author now will attempt to predict the potential problems and possibilities that could arise from a continued lenient policy by the Board and the courts in permitting affiliated commercial banks to operate in the investment industry.

### C. Problems and Possibilities

The *Camp* Court stated that the purpose of Congress in enacting Glass-Steagall was to protect depository safety.<sup>108</sup> Security would be assured, and public concerns assuaged, through the divorce of investment banking from commercial banking. The settlement would relieve the pressures causing unsound investment and marginal lending practices, questionable promotional schemes, and other malevolent manifestations projected by conflict of interest. The credit granting and promotional pressures broadly can be classified as problems of full disclosure.

#### I. Disclosure

As they continue their involvement in the investment field, banks are subject to rigorous regulatory structures. These structures, however, are designed to ensure depository protection and banking system stability. Solvency is the regulatory goal, and, although a modicum of public disclosure is required by banking regulations, the amount of disclosure is of a lesser sum than the amount of disclosure brokers must give under the Securities and Exchange Acts.<sup>109</sup>

The Acts, enforced by the Securities Exchange Commission (SEC), seek to protect investors by controlling unethical business practices<sup>110</sup> via strict agency enforcement of the statutes and frequent public disclosure.<sup>111</sup> Banks are excluded from the disclosure provisions of the Securities Exchange Act of 1934 because that Act specifically

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107. Was the BHCA really enacted to "maintain" Glass-Steagall? See *supra* note 84 and accompanying text.

108. See *supra* notes 38-39 and accompanying text.

109. 15 U.S.C. §§77q, 78; see also Evans, *Regulation of Bank Securities Activities*, 91 *BANKING L.J.* 611, 612 (1976) (concentration of financial resources in banks, added to regulatory differences, will undermine effect of Glass-Steagall and harm securities industry); Note, *supra* note 40, 81 *MICH. L. REV.* 1498, 1529-30; Mowder, *Regulations Covering Bank's Securities Brokerage*, 123 *TR. & EST.* 47, 49-50 (1984).

110. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976).

111. Note, *The Legality of Bank-Sponsored Investment Services*, 84 *YALE L.J.* 1477, 1499 (1975) (bank "enforcement proceedings are not as well publicized as those of the SEC, which announces disciplinary actions relating even to minor infractions").

exempts banks from the definitions of "broker" and "dealer."<sup>112</sup> Banks, however, are not free from public disclosure requirements. Operationally, SEC and local exchange rules on disclosure, confirmation, and investment recommendations indirectly could be placed on commercial banks because of the relationships between banks and broker-dealers, who are subject to regulatory restraints.<sup>113</sup>

In the context of a bank holding company, however, these secondary regulatory relationships prove even more tenuous. The bank affiliate, for instance, could communicate with the brokerage affiliate through the chain of one or more other affiliates, perhaps through an investment advisory affiliate in a manner similar to our hypothetical case above, or through a parent holding company. Disclosure to bank customers, as well as to the general public, therefore, can be obscured in the labyrinth of affiliation. How may promotional and investment pressures generated by this intercorporate maze be curtailed, especially given the "any . . . factor"<sup>114</sup> criterion of the Board on permissible nonbanking activities and permissive current outlook on proper banking investment activity? This certainly would have been a matter of concern to the Glass-Steagall Congress that sought to maintain bank stability, as well as to the BHCA Congress that desired to "maintain and strengthen" the Glass-Steagall separation of commercial and investment banking.<sup>115</sup>

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112. 15 U.S.C. §§78b-78ii. A caveat with respect to holding companies should be added. Although an affiliated bank is excluded definitionally, such is not the case for the other affiliated corporate entities of the holding company, if they are engaged in brokerage activities.

113. Mowder, *supra* note 109, at 49.

114. *See supra* note 97.

115. *See supra* note 84 and accompanying text. The first draft of this article was criticized for overemphasizing the disclosure problem. One professor with banking expertise suggested that I argue current bank holding company disclosure requirements be supplanted by Securities and Exchange Commission (SEC) jurisdiction. The good professor's suggestion mirrors then SEC Commissioner John Evans' prediction of what would in fact occur. Evans, *supra* note 109, at 619.

Upon reflection, I have decided to remain firm in my original position. The disclosure problem is reflective of interpretations of the purposes of Glass-Steagall. For instance, in the Yale Law Journal note, the student author offered the thesis that existing disclosure requirements for bank-sponsored investment services were adequate. Note, *supra* note 111, at 1503-04. His thesis, however, is based on the ridiculous assumption that investment activities by banks are facially within section 16 and do not violate other provisions of the Act. *Id.* at 1487-90. Commissioner Evans disagrees, finding banks and securities firms to be *direct* competitors in the investment markets despite Glass-Steagall restrictions. Evans, *supra* note 109, at 613-14. Ironically, Commissioner Evans makes a statement of which our Yale student should take note: "I have difficulty understanding how any disinterested person could oppose redressing this [disclosure] imbalance. . . ." *Id.* at 615.

Why I part company with the professor and commissioner is based on *my* reading of Glass-Steagall. Investment affiliates of bank holding companies are undertaking the types of investments that Glass-Steagall was to eliminate. This is the point I am making with respect to "narrowed" Glass-Steagall. A new statute saddling SEC-type disclosure restrictions on affiliated commercial

## 2. Conflict-of-Interest

The pressures inherent in those situations in which banks act as investment advisor both to sellers, investment companies, and buyers, bank customers, led the *Camp* Court to fear that a conflict of interest would develop between banks and their customers. Saddled by the connection, banks would support investment concerns, promotionally and financially, during times of sustained market decline. This type of support to investment concerns is anathema to the advertised role of banks as pure fiduciary and agent. The weak attempt by the *ICI* Court to distinguish the relationship presented in *Camp* from that of a bank affiliate and *sister* brokerage affiliates is particularly unpersuasive.

In a footnote in *ICI*, the Court admitted that “this association [in the public’s mind between a bank affiliate and an investment company affiliate] cannot be completely obliterated;”<sup>116</sup> nevertheless, the Court proclaimed that protection to the public would come from the requirement of the 1934 Securities Exchange Act that performances of large securities portfolios of common trust funds be published.<sup>117</sup> The *ICI* Court, however, did not indicate how this publication will prevent conflict of interest, and loss of public confidence should investments turn sour.<sup>118</sup>

Recent Court decisions place considerable emphasis on the affiliation distinction between subsidiaries of a parent holding corporation. Intuitively, the distinction between a *parent* bank corporation with a subsidiary investment company and an *affiliated* bank corporation with a one-step removed relationship with a sister affiliated investment firm, through a parent bank holding company, does not obliterate, or even assuage, the underlying pressures caused by a close connection between the investment and banking concerns. Simply, treating the holding company affiliation case differently than the direct subsidiary relationship case represents a differing treatment devoid of analytical substance. “Strengthened” Glass-Steagall, however,

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banks could only be interpreted as legislative acquiescence in these types of investing. In sum, disclosure differences are a symptom of the sickness, not the directing agent. Those doctors of law who suggest we treat the symptom have thereby condemned their patient.

116. 450 U.S. at 67 n.39.

117. *Id.*; see also 15 U.S.C. §78m(f).

118. The Court did note that the interpretive ruling by the Board prohibited banks from giving the names of depositors to their investment company affiliates. This, reasoned the Court, would prohibit a bank from “[straying] from its obligation to render impartial advice to its customers . . . .” 450 U.S. at 67 n.39. This reasoning is particularly unsatisfying, since, although the bank could not distribute investment company literature, or otherwise orally express an opinion on the advisability of company investments, nothing prohibited bank employees from identifying the investment affiliate to customers.

applies to the direct case through sections 16 and 21, while “narrowed” Glass-Steagall applies to the holding company situation by way of section 4(c)(8) of the BHCA. The distinction, one of mere multicorporate organizational form rather than actual operating substance, posits the question of what consequences might be inflicted onto the banking system from the very real risks that we have just uncovered.

### 3. Does History Repeat Itself?

The author is certainly not volunteering to join the multitude of prognosticators of doom and gloom.<sup>119</sup> The economy will not be put to such a rout in the foreseeable future that the financial movers of the United States will take screaming leaps from atop the skyscrapers abutting Wall Street—however efficacious such conduct could prove to be. Still, that the dangers awaiting the unwary—and they are unwary, if the opinion by the Board of Governors in *Citicorp*<sup>120</sup> is indicative—are quite real and imminent.

These realistic dangers can be illustrated by the curious case of some short-term, high denomination commercial paper. In *A.G. Becker Inc. v. Board of Governors*,<sup>121</sup> a circuit court majority agreed with the Board that, not only was commercial paper of this kind not a “security” within the meaning of Glass-Steagall,<sup>122</sup> but that investment in the same by banks “is less risky even than banks’ ordinary commercial lending.”<sup>123</sup> In sum, the relative riskless nature of large denomination, short-term commercial paper precluded categorization as a speculative investment covered by Glass-Steagall.

119. For a collection of recent essays dealing with these dismal concerns, see Watchtel, *CRISIS IN THE ECONOMIC AND FINANCIAL STRUCTURE* (1982). The title headings to four chapters display the general optimism of the works included within: Monetary Crisis, Bankruptcy Issues, International Crisis, and Speculative Bubbles. *Id.*

120. In that case, not only did the Board note the “any factor” test on permissible banking activities, but it applied the three-pronged *National Courier* test in a *disjunctive* fashion. That is, if the challenged activity could pass muster under any one prong, the activity was “closely related” and hence permissible. *Citicorp*, New York, New York, 68 Fed. Res. Bull. 505, 506 (1982).

121. 693 F.2d 136 (D.C. Cir. 1982), *rev’d*, *Securities Indus. Ass’n v. Board of Governors*, 104 S. Ct. 2979 (1984). Granted, the Supreme Court reversed on the ground that commercial paper was a “security” and hence under the auspices of Glass-Steagall. Moreover, the same “subtle hazards” at work in *Camp* were determined to be at work in this case as well. *Id.* at 2984-86. However, sections 16 and 21 of Glass-Steagall were implicated because a *state* commercial bank sought to enter the third-party commercial paper market. On the other hand, a bank holding company, through an affiliated securities dealer, could certainly deal in third-party commercial paper under the BHCA §4(c)(8) “closely related” test. *SIA II*, the companion case of *SIA I*, is clear support of the author’s proposition. Why the *Camp* concerns are implicated in the former case, but not the latter, should again make us smile.

122. *A.G. Becker, Inc.*, 693 F.2d at 150-51.

123. *Id.* at 149.

The notion that such paper is relatively risk free, however, and therefore outside the Glass-Steagall concerns as articulated in *Camp*, was dispelled in a dissenting opinion by Senior Circuit Judge Robb.<sup>124</sup> Initially, Judge Robb quickly disposed of the notion of the majority that a bank acting in the role of commercial lender was analogous to the same bank acting in the role of seller in the sale of third-party commercial securities.<sup>125</sup>

Next, Judge Robb conjured the spectre of the defunct Penn Central Company, which defaulted on \$82.5 million in "prime" commercial paper.<sup>126</sup> Not only did the corporate collapse of Penn Central cause those same dramatic consequences as was foreshadowed by the *Camp* Court,<sup>127</sup> the Penn Central case also serves to illustrate the very real "ripple effects" that can occur when bank investments fail. In this case, the investment firm of Goldman, Satche & Co. sold \$5 million of Penn Central commercial paper to the American Express Company. This sale predated the corporate drowning of Penn Central by just seven weeks. Clearly, Penn Central was floundering in the water, ready to turn belly-up, at the time American Express, one of the most sophisticated investment conglomerates in the country, deposited an additional \$5 million into Davey Jones' Locker.

The hazards present when financial incentive exists to give unreliable investment advice, therefore, are manifest,<sup>128</sup> even in cases of alleged risk-free investment activity. Continued expansion up to the limits of narrowed Glass-Steagall is inevitable. Even this limit, perhaps, will be breached in the not too distant future.

In any event, the author does not wish to relegate the role of the commercial banker to that of warden over his depositor's funds. Financial areas exist in which commercial banks should be allowed to expand and compete with increased vigor. These areas include depository gathering, even beyond the traditional demand deposit category, and commercial-personal lending fields. Within these areas thrifts and "nonbank banks" seriously threaten the commercial banker's ability to operate efficiently. This article, therefore, will

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124. *Id.* at 152 (Robb, J., dissenting).

125. *Id.* (A bank as lender "place[s] its funds at risk"; whereas a bank as seller of commercial paper "has no direct financial interest in the issuer's ability to meet its. . . obligations.")

126. *Id.* at 153.

127. In this case, loss of confidence occurs when the actual result stands in stark contrast to the predicted result of the promotional literature, creation of pressure causes distortion of credit decisions leading to unsound loans, and loss of key customer goodwill jeopardizes the financial soundness of the bank. *Id.* at 153-54.

128. *Id.* at 154.

examine this side of the affiliated commercial bank expansion dilemma, and will discern how such a threat might be repulsed.

#### THE THREAT FROM THE THRIFTS

Two points must be made prior to discussion of the author's antitrust polemic. First, those savings and loan institutions that are guilty of poor investment are beyond the scope of this article, which examines competition between banks and other financial institutions. Second, despite public conceptions to the contrary, savings and loan associations are not banks. Before discussion can commence on commercial banking competition, therefore, this author must define the institutions that are considered "banks."

#### A. Banks and Nonbanks

##### 1. What is a "Bank"?

In *United States v. Philadelphia National Bank*,<sup>129</sup> the Supreme Court decided for the first time a case dealing with the antitrust aspects of commercial banking.<sup>130</sup> Faced with the novelty of the issue, the Court logically began with a historical description of commercial banking. The majority, however, erred at the outset, saying that "[c]ommercial banking in this country is primarily unit banking."<sup>131</sup> Commercial banking in this country actually is under the umbrella of a highly centralized regulatory system. The Court next defined the object "commercial bank" as an institution that is alone permitted by law to accept demand deposits;<sup>132</sup> that is a dealer and source of money and credit to individuals, entities, and the nation;<sup>133</sup> that is an intermediary of most financial transactions;<sup>134</sup> that is a repository of funds;<sup>135</sup> and that is the chief supplier of short term credit.<sup>136</sup> Among these aspects, the Court identified as the most important functions of commercial banking the creation of money and credit, the management of the checking account system, and the furnishing of short-term business loans.<sup>137</sup>

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129. 374 U.S. 321 (1963).

130. *Id.* at 324.

131. *Id.* at 325.

132. *Id.* at 326.

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.* at 326-27.



Additionally, another perspective emerged in *Philadelphia National*. In a dissenting opinion, Justice Harlan agreed with the list of necessary conditions that made up a "commercial bank." He placed more importance, however, on the role of commercial banks in the national economy via their ability to control the money supply.<sup>138</sup>

With respect to judicial definitions for antitrust purposes, the *Philadelphia National* definition of "commercial banking," with the two possible prongs of emphasis, has remained the standard.<sup>139</sup> With the continual blurring of the lines separating banking, insurance, securities, and real estate activities, however, the judicial definition of the banking business<sup>140</sup> has amassed no greater number of adherents than many other definitions. To understand the recent plethora of academic attempts<sup>141</sup> in the area, Professor Symons' recent work is illustrative.<sup>142</sup>

Symons identifies a narrow and a broad view of the banking business. The narrow view is predicated on the principle of *expressio unis est exclusio alterius*; that is, the "business of banking" is not an independent source of authority and the only powers a bank legally can exercise are those powers specifically enumerated in the National Bank Act.<sup>143</sup> Such powers<sup>144</sup> closely parallel those conditions listed by the Court in *Philadelphia National*.

Symons' analysis of the judiciary ends here, but the author wishes

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138. *Id.* at 374-75 (Harlan, J., dissenting).

139. *See, e.g.,* County Nat'l Bancorp. and TGB Co. v. Board of Governors, 654 F.2d 1253 (8th Cir. 1981), *decided en banc*; Mercantile Texas Corp. v. Board of Governors, 638 F.2d 1255 (5th Cir. 1981). *But see also* United States v. Connecticut Nat'l Bank, 418 U.S. 656 (1974), where, though the conditions listed in *Philadelphia National* were followed, the Court, to distinguish the growing similarity between commercial and savings banking, emphasized the larger volume of commercial service financing undertaken by commercial banks. This financing was of the short-term business loan nature emphasized by the majority in *Philadelphia National*. Though only a little more than a decade passed between these two decisions, the Court recognized the role of savings banks in financing commercial ventures, sometimes of a relatively short-term nature, and the diversity of commercial bank financing, which evolved from straight business lending to sophisticated financing of investment plans and big-time commercial paper. At the very least, this is a diversion of emphasis from *Philadelphia National* in what is a "commercial bank," if not an outright different definition. Did the Court make this distinction with the wish of updating the working definition to modern reality? Or was the distinction a device to avoid the method that the district court adopted in the case, to combine commercial and savings banks in the same product market for antitrust analysis? These questions certainly will be addressed in the pages that follow.

140. The phrase "the business of banking" has been in every National Bank Act since the original 1864 Act. For the modern statute, see 12 U.S.C. §24(7) (1982).

141. *See, e.g.,* Huck, *The Business of Banking*, 21 BUS. LAW. 537 (1966); Symons, *The "Business of Banking" in Historical Perspective*, 51 GEO. WASH. L. REV. 676 (1983); Wallison, *Banking Regulatory System Badly in Need of Reform*, LEGAL TIMES, June 27, 1983, at 27, col. 1.

142. Symons, *supra* note 141, at 678.

143. *Id.* at 679.

144. *See* 12 U.S.C. §24(7) (1982).

to build upon it. Like Symons, the author interprets the judicial definition of “the business of banking” and its subcomponent, “commercial banking,” as definitionally restrictive. By contrast, the judicial definition of permissible “closely related” activities to commercial banking is almost licentious.<sup>145</sup> We have seen this with respect to the discussion of bank holding company investment undertakings. From a logical standpoint, the definitional distinction of the Court certainly is not illegitimate, and arguably may serve to ameliorate widely different extremes. This definitional distinction, however, does stand as our first reason why line-of-commerce markets are construed narrowly, while activities related to such markets are treated broadly. This distinction may appear out of context at this point in our discussion, but for pedagogical purposes the distinction is easiest to draw at this time.

Professor Symons argues that the broad view of the “business of banking” interprets the phrase as an independent source of banking authority; thus, the enumerated powers in the National Bank Act merely serve as guideposts, not as an exhaustive list, of the types of banking conduct permissible.<sup>146</sup> Finally, Professor Symons champions his own position, an intermediate view. Namely, the phrase “the business of banking” is a pseudo-grant of independent authority, grounded in the types of activities expressly enumerated, while limited by law and the policy considerations of depository safety and economic neutrality with respect to credit decisions.<sup>147</sup> In contrast to the dogmatic efforts of the Judiciary, the more expansive academic attempts are grounded functionally; that is, they focus on what banks can and ought to do within the confines of congressional guideposts and public policy manifestations.

As promised, this article will not develop a definitive definition of “banking.” A definitional “notion” with which to operate, however, will be determined. “Banking,” therefore, includes the historical practices banks have displayed for over the last century plus various activities grounded within these historical practices yet altered or created anew to meet modern demands. To refine our efforts further, we must ask when an institution that is arguably a bank under the above analysis is not in fact a bank.

## 2. *Doublespeak: “Nonbank Banks” (Or, A is Not-A)*

Centuries ago, the great Greek philosopher Aristotle pondered over

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145. See *supra* notes 80-94 and accompanying text.

146. Symons, *supra* note 141, at 679-80.

147. *Id.* at 680-84.

the problem of the foundation of knowledge. To Aristotle, if the foundation called "justified true belief" could be established, the methodology of syllogistic logic would lead mankind down the path of correct thought. The foundation upon which Aristotle constructed his epistemological edifice was that of identity. That is, an object is what it is. Existence is to exist; thought is to think; *A is A*.

With the usual ups and downs—and some fascinating downright doubts<sup>148</sup>—mankind has found the concept of identity indispensable to the attainment of true knowledge. Those involved in the business of banking, and the regulators of the same, however, are not by nature an inquisitive species.<sup>149</sup> The BHCA defines a bank as an institution that accepts deposits that the depositor has a legal right to withdraw on demand, and, at the same time, engages in the business of making commercial loans. If the bank, however, fulfilled one of these definitional requirements but not the other, then it would be a nonbank bank.<sup>150</sup> In this capacity, it could perform almost the same functions as a commercial bank—such as lend funds, maintain trust departments, exchange currency, and operate a checking department—yet escape the restrictions of the BHCA by deleting one or the other of the essential definitional elements.<sup>151</sup>

In sum, our operational definition of banking, and of an affiliated commercial bank in particular, cannot remain grounded solely in a narrow historical interpretation that is tempered by modern academic criticism. The definition must be refined further by ludicrous terminology. Still, the definition is operational, and, as such, is in-

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148. For an illustration of such doubts, called skepticism, see, e.g., DESCARTES, *MEDITATION ON FIRST PHILOSOPHY* (1641); LOCKE, *AN ESSAY CONCERNING HUMAN UNDERSTANDING* (1894); BERKELEY, *THREE DIALOGUES BETWEEN HYLAS AND PHILONOUS* (1713); RUSSELL, *THE PROBLEMS OF PHILOSOPHY* (1912); NOZICK, *PHILOSOPHICAL EXPLANATIONS* (1981).

Nozick's modern example, of how we might not know that an object is even an object, rivals Descartes' renown "evil demon" example, and thus will be used here. Surely, you say to yourself, you know that you are reading this note. But do you? Logically, you could be floating prostrate in a tank of water on the planet Alpha Centuri. There, super-psychologists are stimulating your mind to give you this and every other sensation that you have ever experienced (and will ever experience—evil demons indeed!). Should this prove to be the case, then the author hopes the Alpha Centurians will soon grant you more provocative stimulation, rather than continue torturing you in this manner.

149. They are acquisitive animals, a point to be made later.

150. For an in-depth analysis of the "nonbank bank" phenomenon, see Lobell, *Nonbank Banks: Controversy Over a New Form of Consumer Bank*, 39 BUS. LAW. 1193 (1984).

151. See, e.g., *First Bancorporation v. Board of Governors*, 728 F.2d 434, 436 (10th Cir. 1984) (held Utah industrial loan company was not a commercial bank since "Utah law specifically proscribes [such companies] from accepting demand deposits"); *Wilshire Oil Co. v. Board of Governors*, 668 F.2d 732, 739 (3d Cir. 1981) (held affiliated institution of holding company was a "bank" because the reservation of right to 14 days advanced notice of withdrawal from deposits was a sham to avoid the BHCA). See also *infra* note 178.

dispensable to the final duty of this article, which is to turn away from the investment field and consider the expansion of commercial banking into various commercial financing and depository collecting fields. At this point, of primary concern is one of the most common forms of enterprise expansion, expansion by combination through merger or acquisition. Of course, the antitrust laws are implicated because of the *Philadelphia National* decision. This “practical response” that regulates expansionary activities within the commercial banking context now will be considered.

*B. The Practical Response: Antitrust Regulation*

Current antitrust law mirrors banking law because it also remains the captive of flux and uncertainty.<sup>152</sup> Bank holding company law has been chained to its fellow antitrust prisoner by statute.<sup>153</sup> The BHCA requires that the Board, on considering an acquisition of a bank by a bank holding company, examine the anticompetitive aspects of the transaction. If the anticompetitive costs are not outweighed clearly by the benefits that will accrue to the public interest should the combination occur, then the Board must deny application for the merger or acquisition.<sup>154</sup> When quantifying the public interest criterion, the Board weighs the following factors: the needs and conveniences of the community, the financial and managerial resources of the organizations involved, the future prospects of the concerns, and the capital structures of the involved banks.<sup>155</sup>

That the *anticompetitive* standard the Board considers is the same

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152. See, e.g., Grady, *Introduction to the Symposium on Current Developments in Antitrust Law*, 9 J. CORP. LAW 573 (1984).

153. 12 U.S.C. §§1842(c)(1), (2) (factors that the Board must consider in determining whether to approve an application for a bank holding company, or a company that would become one if approval is granted, to acquire assets or shares of a bank).

The Board shall not approve—(1) any acquisition or merger or consolidation under this section which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize the business of banking in any part of the United States, or (2) any other proposed acquisition or merger or consolidation under this section whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint or [sic] trade, unless it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

*Id.*

154. *Id.*

155. *Id.* For a general overview of the statute, see Hakala and Austin, *Denials of BHC Formations and Acquisitions: Has There Been a Shift In Policy?*, 99 BANKING L.J. 947, 948-49 (1982).

as the standard under the general antitrust laws<sup>156</sup> is a rule demonstrated by case law. For instance, in *County National Bancorporation v. Board of Governors*,<sup>157</sup> the Eighth Circuit Court of Appeals rejected the contention of the Board that the "convenience and needs of the community" language of section 3(c)(2)<sup>158</sup> of the BHCA was a congressional grant of authority to the Board to apply its own anticompetitive standard, even if that standard should prove more strict than the one used in cases brought under the Sherman and Clayton Acts. Indeed, the court held that, given the expressly articulated command of Congress that both administrative agencies and courts apply the antitrust statutes in a uniform fashion, section 3(c)(2) of the BHCA therefore must have set an anticompetitive standard identical to that set by the Sherman and Clayton Acts.<sup>159</sup>

Because the anticompetitive standards are the same in all of the antitrust statutes, the analysis used in Clayton Act antitrust cases to determine the competitive effects of an acquisition or a merger will be developed in this article concomitantly with the way the courts have applied this anticompetitive analysis to the banking industry specifically through section 3(c)(2) of the BHCA. Of prime importance will be the question whether, as applied to banking, the judicial analysis has been too hard-line, given the restrictive definition of the terms "banking" and "commercial bank."<sup>160</sup> In addressing the combination question, antitrust law looks to the line-of-commerce, or product market, the geographic market, and to various types of competition that may occur within these markets.

### 1. The "line-of-commerce"

Mergers are regulated by section 7 of the Clayton Act. In *Brown Shoe Co. v. United States*,<sup>161</sup> the Supreme Court commented upon the 1950 Celler-Kefauver Amendments to section 7. These amendments enacted three changes in the section. First, the present "substantially

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156. The relevant provision of the Sherman Act provides that "[e]very contract, combination . . . , or conspiracy, in restraint of trade or commerce among the several States, . . . is declared to be illegal." Moreover, the Act provides that "[e]very person who shall monopolize, or attempt to monopolize, or combine or conspire . . . to monopolize any part of the trade or commerce among the several States, . . . shall be deemed guilty of a felony . . ." 15 U.S.C. §§1 and 2 (1982). This article, however, is concerned predominately with section 7 of the Clayton Act. For the relevant provision of that Act, see *supra* note 8.

157. 654 F.2d 1253 (8th Cir. 1981).

158. See *supra* note 153.

159. 654 F.2d 1253, 1259-60.

160. See *supra* notes 129-47 and accompanying text.

161. 370 U.S. 294 (1962).

to lessen competition” language was added. Second, acquisitions of assets was added to the already-covered acquisitions of stock. Third, vertical mergers were placed under the ambit of the Act.<sup>162</sup> The *Brown Shoe* Court continued the preliminary analysis of section 7 by noting that two issues were raised by the Clayton Act, the relevant “line-of-commerce” and the proper “section of the country.”<sup>163</sup> With respect to the first issue, the Court declared that Congress amended the original definition in the Clayton Act of the “line-of-commerce” in order to “halt the rising tide of economic concentration in particular lines of commerce”<sup>164</sup> in the incipient states of the problem.<sup>165</sup> Following this broad overview of the Act and amendments, the Court turned to an analysis of the factors that had to be considered in order to define the proper product market. First, the Court constructed the broadest parameter of this market: “The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand<sup>166</sup> between the product itself and substitutes for it.”<sup>167</sup> The Court, however, limited this broad construction by noting that “within this broad market, well-defined submarkets may exist that, in themselves, constitute product markets for antitrust purposes.”<sup>168</sup> The boundaries of such submarkets, the Court concluded, are determinable by “examining such practical indicia as industry or public recognition of the submarket as a separate economic entity, the product’s peculiar characteristics and uses, unique productive facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors.”<sup>169</sup>

Generally, the broader the market as defined by the above indicia, the relatively more competitive such a market will prove to be. For instance, assume two Iowa City bookstores wish to merge their opera-

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162. Previously, only horizontal mergers were covered under the Clayton Act. See SULLIVAN & HOVENKAMP, *ANTITRUST LAW POLICY AND PROCEDURE* (1984) at 587.

163. 370 U.S. at 298. For an analysis of the “section of the country,” see *infra* notes 190-202 and accompanying text.

164. 370 U.S. at 315.

165. *Id.* at 313-14.

166. Cross-elasticity of demand is an economic term, quantifying a rate of substitution between a price change in one product and demand changes in others. For instance, assume the price of a one dollar pound of chocolate increased by 50 cents. We could expect consumers of that chocolate pound to purchase a less expensive chocolate product from a different company, or to substitute entirely and buy, for example, vanilla wafers. When this occurs, the chocolate demand curve is said to be *elastic*. If no one switched from, or substituted, another product, then the cross-elasticity of demand would be zero, or totally *inelastic*. If, on the other hand, all chocolate pound consumers substituted or switched, the cross-elasticity for the chocolate pound would be one, or perfectly elastic.

167. 370 U.S. at 325.

168. *Id.*

169. *Id.*

tions under the name "Merged Books, Inc." (MBI). Within the city limits of Iowa City are approximately twenty bookstores,<sup>170</sup> and, with the exception of the two major textbook retailers, no single book vendor is of a significantly larger size than any competitors. Therefore, if this product market is defined broadly as "books," then the MBI merger would have little to no anticompetitive effect on the Iowa City book retail market.

On the other hand, consider the effect if the formerly independent stores that made up the MBI merger each sold rare books, and Iowa City has only two such stores.<sup>171</sup> If these retailers merged, and the relevant product market was defined as "rare books," then this merger would result in the creation of market monopoly. In antitrust jargon, the Iowa City rare book market would be quantified by a "concentration ratio"<sup>172</sup> of 100%.

Consequently, defendants in challenged merger or acquisition cases argue for the broadest product market definition conceivable, while

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170. See Iowa City Telephone Directory.

171. *Id.*

172. "Market concentration" is a quantitative term that measures how much of a defined product and geographic market specified firms "control" before and after a merger. For purposes of illustration, the 1982 Justice Department merger Guidelines, 47 Fed. Reg. 28,493 (1982), will be used. In determining whether a proposed merger will result in undue market concentration, and thus tend to cause illegal anticompetitive effects, the Justice Department uses the "Herfindahl-Hirschmann Index" (HHI) of market concentration. Assume a market consists of four firms, two of which each control 30 percent of the market, while the remaining two have 20 percent shares of the market. The HHI simply adds the sum of the squares, or, in our example,  $30^2 + 30^2 + 20^2 + 20^2 = 2600$ . An HHI below 1000 is characterized as unconcentrated, between 1000 and 1800 as moderately concentrated, and above 1800 as highly concentrated. Since the sum of the squares is the equation, the greater the number of firms controlling relatively limited market shares, the lower the HHI, and *vice versa*. For instance, in the 20-firm Iowa City bookstores example, assuming each firm controlled an identical five percent of the market, the HHI for this market would be 500, an unconcentrated market. On the other hand, our rare book market example would give a premerger HHI, if both firms controlled 50 percent of the market, of 5,000, a very concentrated market.

The above step represents part one of the HHI analysis, the premerger stage. The next step is, naturally enough, the postmerger stage. Since the premerger equation was the sum of the squares, the two merging firms in the premerger stage algebraically can be represented as  $a^2 + b^2$ . Since, in the postmerger stage, the firms would combine their operations, then this is represented algebraically as the sum of their market shares squared, or  $(a+b)^2$ . This equation, when multiplied out, equals  $a^2 + 2ab + b^2$ . Clearly, the change in the HHI from premerger sum to postmerger sum is represented algebraically as  $2ab$ . Going back to our first example, assume one of the 30 percent control firms merges with one of the 20 percent controllers. Then,  $2(30)(20) = 1200$ , which, since it represents the change in the HHI from the pre to the postmerger periods, must be added to the premerger HHI of 2600. The Justice Department Guidelines state that mergers with postmerger HHIs below 1000 usually will not be challenged, mergers that increase the premerger HHI by 100 points or more in the 1000 to 1800 HHI range probably will be challenged, and mergers that increase the premerger HHI by even 50 points in the over 1800 range likely will be challenged.

**BUT PLEASE NOTE:** The author is *not* implying that these HHI ranges of the Justice Department are also relevant in the commercial banking antitrust context. Given the nature of the industry involved, the author believes that lower HHI numbers, perhaps significantly so, could quantify anticompetitive markets.

the plaintiffs across the aisle argue with equal vigor for the least inclusive product market imaginable. As discussed above, the Supreme Court, in *Philadelphia National*, has defined the relevant line-of-commerce or product market for commercial bank acquisition and merger cases as “commercial banking.”<sup>173</sup> Because the judicial definition of this term is narrow,<sup>174</sup> the product market must be defined as relatively underinclusive. This means actual concentration ratios in these cases are higher than they otherwise would be if the judicial definition of “commercial banking” were to follow the broader academic definitions. The result is that relatively few mergers and acquisitions among affiliated and nonaffiliated commercial banks will pass unscathed through the combined scrutinies of the Board, the Justice Department, and the courts.

If the judicial definition is correct, then it serves to further the clearly articulated command of Congress for antitrust law to stem the rising tide of economic concentration, preferably during the early stages of the problem. If, however, the judicial definition, still in vogue after emerging over twenty-two years ago, is too restrictive, the ability of affiliated commercial banks as well as nonaffiliated commercial banks to compete successfully in financial markets against thrifts, credit unions, nonbank banks, insurance companies, and other forms of financial conglomerates, could be seriously impaired.

A cornerstone in the *Philadelphia National* definition of a commercial bank was that commercial banks were “unique among financial institutions in that they alone are permitted by law to accept demand deposits.”<sup>175</sup> This “distinctive power” was critical, allowing commercial banks to be a major source of credit and to be the intermediaries in almost all financial transactions.<sup>176</sup>

If this is the judicial cornerstone, then the analytical structure in the last seventeen years has crumbled. From 1945 to 1978, demand deposits dropped from seventy-one percent to twenty-four percent of the total deposits held in depository institutions.<sup>177</sup> With the ability of thrifts to offer NOW accounts,<sup>178</sup> the downward spiral of com-

173. *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 356 (1963).

174. *See supra* notes 132-45 and accompanying text.

175. 374 U.S. at 326.

176. *Id.*

177. Federal Deposit Insurance Corporation, Assets, Liabilities, and Capital Accounts, Commercial and Mutual Savings Banks, December 31, 1945, 1960, and 1970.

178. Although a negotiable order of withdrawal (NOW) account is not technically a demand deposit, it is practically. A NOW account permits the depositor to write checks, and the reservation clause allowing the savings and loan up to 30 days before it must honor the draft is understood to be a sham. The judiciary should expand the rule of *Whilshire Oil Co. v. Board of Governors*, 668 F.2d 732 (3d. Cir. 1981) and call such restricted accounts demand deposits,



mercial bank depository holdings can only continue.<sup>179</sup>

Moreover, the other mainstay of the restrictive judicial definition, commercial lending, also is dated. In *United States v. Connecticut National Bank*, the Comptroller argued that the judicial definition was too restrictive,<sup>180</sup> an argument that led him to approve a consolidation between two Connecticut banks. In upholding the consolidation agreement against a Clayton Act challenge brought by the Justice Department, the district court accepted the Comptroller's position that thrifts and banks compete in a wide array of standard banking services, including checking services and lending activities. In support, the court said that Connecticut thrifts and other financial institutions exceeded commercial banks in total number and volume of deposits.<sup>181</sup>

The Supreme Court, however, reversed the lower court.<sup>182</sup> The Supreme Court admitted that banks and financial institutions, such as thrifts, compete directly in the demand deposits market and in the commercial financing field. The Court reasoned, however, that since commercial lending by thrifts is generally of a short-term nature, and is of distinctly lower volume than the amount of commercial lending undertaken by commercial banks, then the line-of-commerce analysis of *Philadelphia National* still applied.<sup>183</sup>

In concluding, the Court interestingly seemed concerned with the degree of actual market "overlap" between commercial banks and thrifts.<sup>184</sup> This perspective is novel to antitrust law. Nonbanking antitrust cases, in defining product markets, universally have looked to the actual and potential competition that exists between or among arguably disparate products. This competition is measured through the use of devices such as the cross-elasticity of demand; actual market overlap never has been utilized as a *product* defining criterion.<sup>185</sup>

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even when the restriction is due to *state* law. The courts, however, have refused to expand *Wilshire Oil*. Rather, the case has been limited to time restrictions promulgated by the savings and loan itself. See *supra* note 151.

179. 60 Fed. Res. Bull. 375 (1974).

180. 362 F. Supp. 240, 242 (D. Conn. 1973), *vacated and remanded*, 418 U.S. 656 (1974).

181. 362 F. Supp. at 246-49.

182. *United States v. Connecticut Nat'l Bank*, 418 U.S. 656 (1974).

183. *Id.* at 664-66. Considering "short term" business lending was a key aspect of commercial banking to the *Philadelphia National* Court, the distinction drawn by the Court in *Connecticut National* between commercial banks and thrifts is particularly unpersuasive. See *supra* note 137 and accompanying text. That Connecticut thrifts account for only one-fifth of the Connecticut commercial lending market is immaterial. The point is that they are *in* the market, i.e., that they are *competing*.

184. 418 U.S. 656, 663 (1974).

185. Requiring actual market overlap could well gut antitrust enforcement, creating the most restrictive product market definition possible *beforehand*. That is, rather than considering a merger between a bank and a thrift that offer the same services in the same geographic area as a merger between competitors (a horizontal merger), exact market overlap would require

The “arty” antitrust analysis by the Supreme Court has forced many commercial bankers, both those working for affiliated concerns as well as those employed by nonaffiliated institutions,<sup>186</sup> to abandon their merger plans. This has relegated them to the position of competitive disadvantage in the commercial lending and depository gathering markets,<sup>187</sup> particularly in the commercial lending market, in which size is a prerequisite to supply major business financing.<sup>188</sup> Given the noticeable shift of demand deposits formerly held by commercial banks to those same and functionally identical deposits now held by other financial institutions, the conclusion appears as self-evident that commercial banks will be permitted to merge, and bank holding companies will be allowed to acquire other commercial banks. Only an updated reading of the critical product market, without a great change in antitrust analysis, would be required.

In the lending and deposit taking markets, Congress has determined that commercial banks alone are qualified to provide these services; they must provide them by definition or not be considered a “commercial bank.”<sup>189</sup> Under the author’s broadened product market analysis, the current operational definition of commercial banking would not be forced to undergo a major transplant or even serious surgery. The lenient or expansive view of the definition of “bank” in section 16 of Glass-Steagall already has academic and institutional support from the Comptroller. Moreover, this definition has the backing of financial reality. Furthermore, since “the business of banking” encompasses the narrower term “commercial banking,” the former is a definitional ceiling while the latter is a definitional floor, a broader reading of section 16 logically would entail a broader reading of section 2(a)(1) of the BHCA. Even should the author’s suggestion prove meritorious, the antitrust analysis remains incomplete. The second issue

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such a merger to be analyzed under the more lenient standard of conglomerate merger law (a merger between noncompetitors). For a clear statement that overlap is not required in the process of defining the proper product market, see *e.g.*, 1982 Justice Department Merger Guidelines, 47 Fed. Reg. 28,493 (1982); *Brown Shoe Co. v. United States*, 370 U.S. 294, 325-26 (1962).

186. The reason for the identical antitrust treatment is that the BHCA antitrust standard and the general antitrust law standard are identical.

187. For a detailed analysis of the historical and the practical implications of current commercial bank merger law, see Friedlander and Slayton, *Determination of the Relevant Product Market in Bank Mergers: A Time for Reassessment?*, 36 BUS. LAW. 1537 (1981); Austin, *The Evolution of Commercial Bank Merger Antitrust Law*, 36 BUS. LAW. 297 (1981); Note, *Commercial Bank Mergers: The Case For Procedural and Substantive Deregulation*, 95 HARV. L. REV. 1914 (1982).

188. *But cf.* Rhoades, *Are the Big Banks Big Enough?*, 26 ANTITRUST BULL. 315 (1981), for the proposition that banks are big enough to supply the credit needs of their largest customers.

189. *See supra* note 59 and accompanying text.

raised by *Brown Shoe*, the "section of the country," or geographic market, awaits discussion.

## 2. The Geographic Market

In *United States v. Marine Bancorporation, Inc.*,<sup>190</sup> the Justice Department challenged the proposed merger of two commercial banks located in the State of Washington. The Department contended that, among other relevant "section[s] of the country," the entire state demarcated the geographic area in which these banks competed.<sup>191</sup> In rejecting the contention of the Justice Department, the Supreme Court identified the process of delimitating the relevant section of the country for antitrust purposes. First, the Court stated that "section of the country" and "relevant geographic market" has been treated as identical.<sup>192</sup> These synonymous concepts can be defined as "the area in which the goods or services at issue are marketed to a significant degree by the acquired firm."<sup>193</sup> Should the acquired firm market goods or services in more than one region, the Court will recognize such distinct geographic markets.<sup>194</sup> A key limiting consideration, that the Court was quick to add, however, was that the acquired firm must be an actual, direct competitor in the purported geographic market, even in a potential competition case.<sup>195</sup>

Today large commercial banks market their services on literally a world-wide scale. The well-publicized fear of imminent loan default by such countries as Mexico, Argentina, and Poland would make this statement axiomatic. Yet, the relevant geographic area of commercial banking services continues to be controlled by *Philadelphia National*, a twenty-two year old case.<sup>196</sup>

In *Philadelphia National*, the Court recognized the proposition that the place where a commercial bank locates offices "does not delineate with perfect accuracy an 'appropriate section of the country' in which

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190. 418 U.S. 602 (1974).

191. *Id.* at 620.

192. *Id.*

193. *Id.* at 621.

194. *Id.*

195. *Id.* at 622. For an analysis of the "potential competition doctrine," see *infra* notes 208-16 and accompanying text. Note that the Court is incorrect in stating that antitrust law, for purposes of geographic market definition, requires the acquired firm to be an actual competitor in the market, even in a potential competition case. The Court actually has applied this restrictive requirement only to the banking industry.

196. See, e.g., *Wyoming Bancorporation v. Board of Governors*, 729 F.2d 687, 689 (10th Cir. 1984) (citing with approval the *Philadelphia National* method of determining the geographic market).

to appraise the effect of [a] merger on competition.”<sup>197</sup> The Court admitted that large borrowers and depositors, as well as those of an intermediate size, “may find it practical to do a large part of their banking business outside their home community.”<sup>198</sup> Only the very small borrowers and depositors were constrained to banks located within their neighborhood.<sup>199</sup> Despite this rational analysis, the Court limited the relevant geographic market in *Philadelphia National*, a market that included giant Philadelphia banks operating on national and super-national scales, to the four contiguous counties of the Philadelphia metropolitan area.<sup>200</sup>

Clearly, defining the proper geographic market narrowly has the same effect as defining the relevant product market too restrictively. Concentration ratios quantifying the actual degree of competitiveness in the market will be skewed toward showing the market as less competitive, perhaps artificially so. In this event, mergers and acquisitions that might otherwise serve to *foster* competition by enabling smaller concerns to combine and battle the Goliaths is doomed by jaundiced judicial analysis.<sup>201</sup>

With the arguments already exposed in this article for departing from the *Philadelphia National* analysis, a further one is presented in the geographic market context. This is because of the convenience of modern technologies. By placing a card into an automatic teller machine, a depositor can accomplish all of his banking needs from any location in the state. From a purely technological standpoint, automatic teller banking could be done on a national scale.<sup>202</sup> The major affiliated commercial banks, therefore, directly compete in both national and international financial markets. The *Philadelphia National* geographic market analysis is not only dated, but is absurd. In order to discover a rational and workable antitrust analysis for regulating affiliated commercial bank acquisitions, a look at the types of competition that occur in financial industries must be made.

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197. 374 U.S. 321, 360 (1963).

198. *Id.* at 360.

199. With the EFTs, query if even this is still true. See *infra* note 202 and accompanying text.

200. *Id.* at 361-62. The Court is unclear whether the relevant geographic market would have even been that large, had not the State of Pennsylvania permitted branch banking into contiguous counties.

201. The analysis is “jaundiced” in the sense of having a misapprehension of actual reality, not in the sense of ill-begotten motive.

202. From a legal standpoint, the Douglas and McFadden Amendments would prohibit such an undertaking. See 12 U.S.C. §§32 and 1842(d). For a discussion of some of the legal problems that would be raised by such a sharing of the electronic funds transfer system, see Goldberg, *Shared Electronic Funds Transfer Systems: Some Legal Implications*, 98 *BANKING L.J.* 715 (1981).

### 3. *The Types of Competition*

In bank merger and acquisition disputes, antitrust law delimits the types of possible competition into two broad categories, actual competition and perceived potential competition.<sup>203</sup> The latter category is further divided into the product extension and market extension branches.<sup>204</sup> Under the author's broadened view of the proper affiliated commercial bank antitrust analysis, each category is applicable.

#### a. *Actual competition*

As we have seen, current antitrust analysis with respect to the banking industry requires that an acquired bank be an actual, direct competitor within the market under consideration.<sup>205</sup> Otherwise, the relevant geographic market is construed too broadly.

With respect to the area of competition, the author adheres to current antitrust methodology. Actual competition within a given geographic region will be taken into account for purposes of quantifying market concentration.<sup>206</sup> Likewise, no methodological change would occur in defining the proper product market. The author's analysis would merely take into account those financial institutions that compete head-to-head with commercial banks in amassing and distributing liquidity to finance industrial and other forms of commercial ventures. Thus, the methodological approach of current antitrust analysis, with respect to actual competition, would remain the same. Analytically, the courts and the Justice Department should be well-equipped to update their analysis without difficulty.

Every successful antitrust action in the banking field has been based solely on the theory of actual competition.<sup>207</sup> Under the author's theory, however, two additional antitrust doctrines also would be used. The first of these is perceived potential competition, the product extension branch.

#### b. *Perceived potential competition: product extension branch*

In *Federal Trade Commission v. Proctor and Gamble Company*,<sup>208</sup>

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203. *United States v. Marine Bancorporation*, 418 U.S. 602, 626-27 (1974).

204. *Id.* at 624 (market extension); *Federal Trade Comm'n v. Proctor and Gamble*, 386 U.S. 568, 573-74 (1967) (product extension).

205. *See supra* note 195.

206. The author's suggestions would require *broader* definitions of the proper geographic market(s). Yet the method of analysis for "section of the country" would not change; rather, the method would be applied to 1985, not to 1963.

207. *United States v. Marine Bancorporation*, 418 U.S. 602, 627 (1964) ("[all] the Court's prior bank merger cases have involved combinations between actual competitors").

208. 386 U.S. 568 (1967).

the Supreme Court reversed a ruling by the lower court that an acquisition by Proctor and Gamble of the Chlorox Chemical Company, the leading manufacturer of household liquid bleach, did not violate the antitrust laws because Proctor and Gamble did not market an independent brand of bleach. In justifying reversal, the Court reasoned that because Proctor and Gamble was the dominant firm in the national soap, detergent, and cleanser markets, the firm would need to take but a short step to enter the bleach market *de novo* or through a toehold acquisition.<sup>209</sup> Such a move was a logical parallel of other “product extension” undertakings previously accomplished by the conglomerate. As a result, other firms in the bleach industry most likely had considered the probable moves of the giant firm when setting their marketing and pricing strategies. In effect, Proctor and Gamble, through the marketing of related household products, was positioned physically in the same geographic market with the bleach firms. Consequently, it was a potential competitor, perceived by the bleach firms as capable of entering the bleach market at will. This led the Court to conclude that the proposed merger substantially could lessen competition in the household liquid bleach market.<sup>210</sup>

The *Proctor and Gamble* doctrine would have applicability under the author’s broadened antitrust banking analysis. Many financial institutions compete directly in those areas that this article has defined as encompassing “the business of banking” and “commercial banking.” For example, an acquisition by a bank holding company of a mortgage company, consumer finance bank, industrial bank, or some other nonbank bank,<sup>211</sup> could raise antitrust considerations, should evidence show a possibility that the affiliate bank was perceived as a likely competitor in a given geographic market wherein both the affiliated commercial bank and the to-be-acquired nonbank bank competed. To require actual and direct competition, as the courts currently do, is a *de facto* exemption from an important segment of the antitrust laws,<sup>212</sup> and further serves to adulterate actual concentration ratios by narrowing the operative markets solely to overlapping competition. These same criticisms apply to the final form of competition that this article will consider, that of perceived potential competition, market extension branch.

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209. *Id.* at 573-74. A “toehold” acquisition is an acquisition of a firm with an insignificant market share in its industry.

210. *Id.* at 578.

211. This reference is to acquisitions that are permissible without prior Board approval. See 12 C.F.R. §225.22(c)(8).

212. Congress intends antitrust laws to have uniform application, and the courts have expressly recognized this. See *supra* note 159 and accompanying text.

c. *Perceived potential competition: market extension branch*

Like the perceived product entrant, the mere presence of the perceived market entrant in the periphery affects the marketing and pricing decisions of other firms in a defined market. In the latter case, however, the perceived market competitor already produces the good or provides the service that encompasses the product market. Rather, such a potential competitor does not operate directly within the geographic market under consideration—although those firms operating within that geographic market fear that the outside firm can enter at will. This theory of competition was given antitrust effect by the Supreme Court in the case of *United States v. Falstaff Brewing Corporation*.<sup>213</sup> In *Falstaff*, the Court held, in determining whether the Falstaff Brewing Company could enter the New England brewery market through acquisition of the largest beer retailer in the region, that the primary factor to consider was whether the mere presence of Falstaff on the fringes of the market was “likely to exercise substantial influence on [the] market behavior” of the brewing firms already in the market.<sup>214</sup>

In the affiliated commercial banking context, the utility of this competitive theory is open to question, given the restrictions of the Douglas Amendment.<sup>215</sup> This amendment, however, is not as restrictive with respect to geographic market determination for antitrust purposes as the language might seem. The amendment, for instance, does not prohibit bank holding companies from acquiring “closely related” nonbanking financial institutions across state lines. Acquisitions by bank holding companies of such nonbank banks are increasingly common. Under the broadened analysis proposed by the author, antitrust issues would be implicated despite the facial restrictions of the Douglas Amendment.

Moreover, most of the largest nationally-chartered commercial banks are affiliated with a holding company. With an anticipated relaxation by the Comptroller of some interstate banking restrictions, combined with modern technological feasibilities, banks in polar sections of the nation will be forced to respond to increased potential, and actual, competition. The antitrust tools of *Philadelphia National* and *Marine Bancorporation* are incapable of working with these new materials. Using the antitrust tools that the author suggests,

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213. 410 U.S. 526 (1973).

214. *Id.* at 532.

215. 12 U.S.C. §1842(d) (prohibiting national bank acquisitions of out-of-state banks, unless the state wherein the national bank is located permits local banks to acquire out-of-state banks).

however, should serve to build a workable structure of competitive analysis for the banking industry. At the very least, the author's alternative is more in tune with congressional demand that antitrust analysis be applied uniformly. This alternative additionally is consistent with the quantitative data showing a marked degree of competitive overlap between banks and other financial institutions.

#### CONCLUSION

The dual trends affecting affiliated commercial banks are equally disturbing. On the one hand, increased involvement in the investments industry portends financial dislocation. On the other hand, continued quarantine from related financial markets promises economic misallocation. Reassessment of the relationship between the Glass-Steagall and Bank Holding Company Acts, plus an updated analysis of the antitrust statutes, are the defenses required to defeat these potential disasters.



