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The Legal Status of a National Bank's Automatic Stock Investment Service Under Sections 16 & 21 of the Glass-Steagall Act of 1933

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The Legal Status of a National Bank's Automatic Stock Investment Service Under Sections 16 & 21 of the Glass- Steagall Act of 1933

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For many years, commercial banks bought and sold common stock while acting in an agency capacity for their customers. Frequently, these transactions were made while the bank was acting as trustee or as custodian for its beneficiaries or principals. Generally, the banks did not advertise this service extensively, but limited

promotional activities to prior bank customers. In 1973, a dramatic change began as several commercial banks, notably Security Pacific National Bank of Los Angeles and Chase Manhattan of New York, began to promote this service vigorously in advertising addressed to the general public through the various media. Threatened by the increased competition for the investor's dollar, the mutual fund industry, the broker-dealer community, and the stock exchanges immediately challenged the legality of this service by petitioning to the office of the Comptroller of the Currency. The Comptroller ruled in June 1974 that the banks' investment service was not proscribed by sections 16 and 21 of the Glass-Steagall Act of 1933.

This Note will examine one of the first legal hurdles that an agency stock service must surmount—whether such a service is permitted under the relevant banking laws—sections 16 and 21 of the Glass-Steagall Act. Pursuant to this examination, this Note will focus on the following areas:

- (1) The legal restrictions currently imposed on national banks' buying and selling common stock;
- (2) The history of national banks' acting as agents for customers in stock transactions;
- (3) The policies restricting an agency service as stated by the Supreme Court in *Investment Company Institute v. Camp*;
- (4) The Comptroller's opinion approving the service; and
- (5) An analysis of the arguments on legality of such a service under sections 16 and 21 of the Act.

I. INTRODUCTION

A. *Description of AIS*

During the spring of 1973, following approval by the Comptroller of the Currency, Chase Manhattan Bank of New York and Security Pacific National Bank of Los Angeles began offering a new common stock agency purchase plan through an extensive advertising program.¹ Under the plan designated "Automatic Investment

1. The banks promoting their agency stock purchase programs have utilized radio, television, newspapers, magazines, as well as printed brochures to sell their new service. The Chase Manhattan plan has been the subject of a three-quarter page ad in *The New York Times* that included these statements:

It's Chase Manhattan's Automatic Stock Investment Plan. This has got to be the easiest way ever for a small investor to be a small investor. It's so darn automatic! Chase is Bullish on small investors. And if you use this coupon today, you can find out why small investors are so bullish on Chase Manhattan's Automatic Stock Investment Plan. Now.

Service" (AIS),² a checking account customer of a national bank selects one or more stocks from a list of the twenty-five corporations having the largest capitalization on the Standard & Poor's 425 Industrial Index³ and authorizes the bank to make regular monthly deductions from his checking account for the purchase of the stock

A programmer can invest \$20 a month in stock through Chase Manhattan.

The Chase Manhattan promotional brochure includes these statements:

INTRODUCING CHASE MANHATTAN'S AUTOMATIC STOCK INVESTMENT PLAN.

Now buying stocks can be easy and troublefree . . .

We think that this is a fantastic new way for the small or new investor to establish a regular stock investment program . . .

Maybe you never thought that you could be a Wall Street investor. But you can. On the installment plan. Just fill out the attached form, indicating which of the 25 corporations you wish to invest in and the amounts you wish to invest. And you're on your way to Wall Street.

Memorandum for Investment Company Institute in Support of Request to the Comptroller of the Currency for a Ruling that Operation of an Automatic Investment Service by a National Bank is Unlawful at 4-5 (August 15, 1973)(hereinafter cited as Memo for ICI).

Although each participant in the plan must be a checking account customer of the bank, the advertising for the plan has been aimed at the general public, rather than being limited to those already customers of the bank. As one ad for First & Merchants National Bank stated:

Anyone who is at least 18 years of age and has an F&M checking account may participate in the plan. If you don't have an F&M checking account, don't let that stop you. Our checking accounts are free. You can open one at any of our convenient offices.

Other illustrations of the type of advertising that has been utilized in promoting these services include the following:

Buy stocks on blue collar wages? Ray Snyder does.

Charlene Sciarretta is a capitalist.

Now Ed Ghee checks the stock market before he gets into the main news.

The captions appear with the named purchaser smiling broadly, presumably because of his satisfaction with the plan, and in some instances holding big cigars. Memorandum for New York Stock Exchange in Support for a Ruling that Operation of Automatic Investment Service by a National Bank is Unlawful at 3 (March 22, 1974)(hereinafter cited as Memo for New York Stock Exchange).

2. Automatic Investment Service (AIS) is the name of the plan utilized by Security Pacific and developed by Investment Data Corporation over the course of the past several years. Chase Manhattan's plan is called the "Automatic Stock Investment Plan." The details of these 2 plans and others offered by different banks may vary to some extent but the basic elements of the plans are the same. In the accompanying description of the plan and throughout this Note, the Chase plan is utilized as the model and referred to as "AIS," the "plan," or "service." Any reference to the plans offered by other banks will be expressly noted.

3. The 25 stocks that may be acquired by participants under the plan are the stocks of the 25 largest corporations included in Standard & Poor's 425 Industrial Index, based upon the year-end market value of the outstanding shares of common stock of these corporations. The bank will add to the list the stock of any corporation which in the future becomes a part of this group of the 25 largest corporations as shown on information furnished annually to the bank by Standard & Poor's Corporation. The bank will discontinue the plan as to any stock or stocks that in later years do not appear on the list of the 25 largest for 2 consecutive annual reviews.

or stocks designated. The minimum monthly investment is twenty dollars per stock and the maximum monthly investment is 500 dollars per stock. Periodically, but not less frequently than once a month, the bank accumulates the deductions for purchases of each particular stock and thereafter purchases whatever amount of stock the aggregated funds will buy. Acting pursuant to an agency agreement with its customers, the bank makes the acquisitions on a securities exchange through a broker-dealer, in the over-the-counter market,⁴ by negotiated transactions,⁵ or by offsetting sales of other participants under the plan.⁶

The shares purchased under the plan are held for all participants registered in the name of the bank or its nominee⁷ unless a

4. The bank could make purchases in the over-the-counter market from dealers who "make a market" in the New York Stock Exchange listed stocks included in the plan. The market for listed stocks off the Exchange has been termed the "third market." *See generally* SECURITIES EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, pt. 2, 88th Cong., 1st Sess. 716-17, 870-81 (1963). The price of the stocks in the third market closely parallels the price on the Exchange but could vary slightly depending on market conditions. The brokerage commissions in the third markets are negotiated freely between the parties. Only transactions involving more than \$300,000 are presently negotiable on the New York Stock Exchange. For these reasons it is important for the bank as agent for their customers in executing their orders to seek the best purchase price for the stock and the lowest brokerage commissions by comparing the prices in other markets with the third market.

5. In executing purchases by negotiated transactions, banks would purchase stock directly from other financial institutions including insurance companies and pension funds. The price of the stock would parallel the Exchange market price closely and any commissions would be freely negotiable.

6. The bank can purchase additional shares for participants in the plan from other participants who have decided to sell their stock in the plan. Under the agency contract between the bank and the participant, an offsetting transaction of this type shall be deemed to have been made on the date and at the price of the first nonoffsetting purchase of the particular stock made after the notice of termination is received. For example, a customer terminates his participation in the plan and directs the bank to sell his 100 shares of Gulf Oil stock. The next day the bank purchases 200 shares of Gulf stock for the participants in the plan—100 shares come from the offsetting transaction and 100 shares are purchased on the New York Stock Exchange. The price paid for the Gulf stock on the Exchange is deemed to be the price of the offsetting transaction.

Most banks will probably use a nominee for the purpose of registering securities under AIS. A nominee is an individual, partnership, or corporation which holds title to stock on behalf of others who are beneficial owners. Typically, a bank uses the partnership form of organization for its nominee, selecting several officers in the bank to act as partners. The bank then agrees to employ the partnership under the condition that the nominee will cause stocks to be transferred out of the nominee name only as directed by the bank. The nominee becomes the holder of record of the security but the legal and beneficial owner is the individual participant in the plan.

7. Although the participant's stock is held by the bank in the bank's name or the name of its nominee, the legal and beneficial ownership of the stock is vested in the individual participant alone. The sole purpose of a nominee is to facilitate the transfer of securities. If

participant requests certificates to be delivered to him. Each participant owns a definite number of shares or fractional shares in his chosen stocks, not an undivided interest in a pool of stocks, and, similar to an individual shareholder in a company, possesses the rights of stock ownership. The bank furnishes ballots upon which each participant can exercise the right to vote his shares⁸ and in addition, will provide each involved company with the address of each participant owning an interest in the company and will request the company to forward all notices, advertising materials, annual reports and other shareholder information directly to the participants.⁹ Any stock dividends or split shares distributed by a corporation on shares held by the bank will be credited to the involved participants' accounts. Further, if the company makes a rights offering, the bank will sell the rights and use the net proceeds to purchase additional shares of that company's common stock at no service charge to the participant.

A purchaser may terminate his participation in the plan or in the purchase of any particular stock or stocks at any time, and upon termination the bank will either deliver share certificates for all full shares purchased or sell full shares if so requested. The bank will also sell any fractional shares owned by a participant and pay the proceeds to him. A statement indicating the amount deducted from a participant's checking account, the bank service charge, the number of shares purchased, the price per share,¹⁰ the acquisition date

the stock is held in the nominee's name, the customer can conveniently direct the bank to sell his stock without having to go to the lockbox to pick up the certificate or having to fill out a stock transfer power of attorney. Since the stock is registered in the nominee's name, the bank's officers who constitute the partners in the nominee can transfer the stock without the customer's signature.

The use of a nominee for bank security holdings requires enabling legislation under state law or authority under the instrument establishing the fiduciary appointment for which the nominee registration is employed. Further specific authorization is granted by the AIS participant to the bank to utilize a nominee. The nominee statutes generally provide that the bank shall be absolutely liable for any loss caused by the acts of its nominee. See Fischer, *The Mysterious Bank Nominee*, 89 BANKING L. J. 911, 913-14 (1972).

8. It is clear from the Chase Manhattan's brochure that the bank will vote the shares for the participants in accordance with the ballots that are returned to the bank in time for the vote of shareholders. It is not clear from the brochure whether Chase will vote the shares for which ballots are not returned.

9. Chase Manhattan expressly disclaims any responsibility for sending any corporate information to the participants and undertakes solely to request the companies to forward such information to the participants.

10. The price of shares acquired for the participant will be the price actually paid for the stock including the brokerage costs. For example, if a round lot of 100 shares of Ford Motor Co. is purchased at \$50 per share, then the price of the shares will be \$5000 plus the

of such shares,¹¹ and the total shares accumulated under the plan will be included with the participant's monthly checking account statement.

Each purchaser under the plan pays his proportionate share of the brokerage charges and, in addition, a bank service charge of five percent of the amount invested, up to a limit of two dollars for each stock purchased.¹² Significantly, the proportionate brokerage costs plus the bank service charges are said to be less than the comparable brokerage charges for the purchaser's stock if purchased individually through a broker.¹³

brokerage costs. Under certain conditions, such a round lot plus an odd lot (less than 100 shares) or a large round lot order (5000 shares), it is possible that the bank will not be able to purchase all of the block at one price. In that event, the price per share shown on the monthly statement may be shown as an *average* price for all shares purchased in Ford stock during the acquisition interval from the cutoff date through the next 30 days until the purchases are complete.

This average price will be the price provided by the bank which the participant is to utilize as his tax basis. This may create a problem if the Internal Revenue Service is not willing to accept an average price as the cost basis. It is apparent that the Service may be considering such a position since the tax ruling request by Security Pacific with respect to basis was withdrawn, perhaps an indication of an unfavorable ruling. Revenue Ruling to Security Pacific, April 12, 1973, by Chief of Individual Income Tax Branch, Internal Revenue Service, Washington, D. C.

11. If purchases for a particular stock are made on different days, the Internal Revenue Service has ruled that the holding period will be a split holding period with an allocable percentage of the stock of each participant being considered to have been purchased on each date stock was purchased. Rev. Rul. 70-627, C.B. 1970-2, 159. Letter to Security Pacific National Bank, April 12, 1973, from Chief of Individual Income Tax Branch, Internal Revenue Service, Washington, D.C.

12. The maximum amount of the monthly service charge varies with the different plans but is generally \$2 or \$3 per stock.

13. In a letter dated May 7, 1973, to the Division of Investment Management Regulation of the Securities and Exchange Commission, counsel for Security Pacific provided some computations to support the assertion that brokerage fees plus the bank service charges under the plan would be lower than commissions charged on open market purchases because of the plan's aggregation of purchases. The operative principle involved is that the brokerage rate is lower with the increasing amount of purchases.

The letter assumed that the commissions charged by New York Stock Exchange member firms on single share purchases vary from 8.4% to a minimum of \$6.40. Those figures seem to be accurate. Taking the 8.4% figure as the lower figure, the cost figures were calculated under two hypothetical situations. In the first situation the purchase of one share of Gulf Oil Corp. at \$25.50 (the price on the date of the letter) would result in a commission of \$2.14 to a non-AIS investor. If 102 participants under the plan invested \$25.00, 100 shares of Gulf Oil could be purchased for a total commission of \$44.95. The commission shared by each participant would be \$.44 plus 5% of the amount invested (\$1.25) to provide a total cost to the AIS participant of \$1.69. The savings to AIS investors would amount to \$.45 per share (\$2.14 - 1.69).

The second hypothetical involved the purchase of one share of Ford Motor Co. at \$63.50 (the current price), which would result in a commission of \$5.33 to the non-AIS investor. If 254 participants invested \$25.00 to buy Ford stock, 100 shares would be purchased for a total

B. Comptroller Approval and Reconsideration

Security Pacific National Bank of Los Angeles made the first application for administrative approval of AIS in a letter filed with the Comptroller of the Currency on February 12, 1973.¹⁴ The Comptroller responded promptly with a one-page opinion letter dated February 27, 1973, ruling that AIS was consistent with sections 16 and 21 of the Glass-Steagall Act, and, therefore, Security Pacific could proceed to implement the plan.¹⁵ Reacting to this brief opinion, counsel for both the Investment Company Institute (ICI) and the New York Stock Exchange filed letters and memoranda of law with the Comptroller requesting reconsideration of his AIS approval and arguing for a ruling that sections 16 and 21 of the Act prohibit AIS.¹⁶ On June 10, 1974, the Comptroller again upheld AIS in a lengthy letter to counsel for ICI.¹⁷

C. The Glass-Steagall Act Problem

Since the inauguration of AIS early in 1973, the plan has generated much interest among the banking community. In December 1973, it was reported that sixty-five banks were offering or planning

commission of \$65.00. Commission costs to each participant would be \$.26. Assuming that it would take 3 investments of \$25.00 each to accumulate one share of Ford, total service charges would be $\$1.25 \times 3$, or \$3.75. This amount plus the \$.26 commission times 3 purchases to accumulate one share, or \$.78 altogether, amounts to a total cost of \$4.53. The savings under the plan would be \$.80 per share ($\$5.33 - 4.53$). (The result obtained in the letter was \$1.32 savings, but apparently an error was made in failing to multiply the \$.26 commission charge by the three purchases needed to accumulate one share, as was done with the bank service charges.) In both situations the costs under the plan were less than open market purchases by non-AIS investors. The letter also noted that it was highly unlikely that a brokerage house would accept an order for one share of any stock since the paperwork costs of opening an account and processing the order make acceptance of the order economically unfeasible.

Both of these hypotheticals were structured to avoid any odd lot purchases that would increase brokerage costs. Letter from Counsel for Security Pacific to the Division of Investment Management Regulation of SEC, May 7, 1973.

14. Letter on behalf of Security Pacific National Bank to Comptroller of the Currency, Feb. 12, 1973.

15. William B. Camp, then Comptroller of the Currency, concluded in his letter that AIS:

- (1) involves only purchases for the account of customers and not for the bank's own account; (2) that the bank in creating and managing the service is not engaged in the business of issuing, underwriting, selling or distributing securities; and (3) that the operation of the service by the bank is consistent with the provisions of sections 16 and 21 of the Glass-Steagall Act.

Letter of Comptroller to Security Pacific National Bank, Feb. 27, 1973.

16. Memo for New York Stock Exchange, *supra* note 1, at 8. See *Hearings Before House Committee on Banking and Currency, The Credit Crunch and Reform of Financial Institutions*, 93 Cong., 1st Sess., Part 2, at 889 (1973).

17. CCH FED. BANKING L. REP. ¶ 96,272, at 81,353 (1974).

to offer AIS, and that one bank and at least four computer companies intended to perform the necessary bookkeeping functions.¹⁸ By February 1974, approximately twelve banks were offering the service and deducting from checking accounts a total of 600,000 dollars worth of investments each month. Another forty banks indicated an intention to offer their own plans as soon as the investment climate improved.¹⁹

In spite of the considerable interest in the plan expressed by many banks, uncertainty over the legality of the plans under the Glass-Steagall Act caused cautious banks to wait reluctantly until the resolution of the legal issues before offering AIS.²⁰

18. SECURITIES WEEK, Dec. 10, 1973, at 7-8.

19. The Wall Street Journal, Feb. 17, 1974, at 28, col. 1.

20. The scope of this Note is limited to the banking law problems arising under sections 16 & 21 of the Glass-Steagall Act, 12 U.S.C. § 24 (1970), and will not consider the numerous securities law questions that are raised by AIS.

In August 1973, in a hearing before the House Banking Committee, the Chairman of the Securities and Exchange Commission, Ray Garrett, clearly stated the SEC's interest in regulating innovative banking programs, including AIS, that extend beyond the traditional custodian and accommodation functions performed by banks.

The Commission's threshold concern with respect to the innovative services offered by banks, therefore, is not to prevent banks, or other qualified business entity, from providing and marketing brokerage and investment management services to a broad segment of the public, but rather to ensure that the protections offered by the statutes which we administer be applied equally to *all* segments of the securities industry. To the extent that banks enter the securities industry, therefore, we believe the commission should be vested with clear jurisdiction to regulate their activities in the same manner as other securities business entities.

In addition, Garrett identified 10 specific concerns with AIS: (1) the participants in AIS do not have the benefit of SEC regulations applicable to nonbank securities entities including regulated brokers, investment companies and investment advisers; (2) substantial cash contributions by a large number of participants in AIS could result in an increase of concentrated purchases and the likelihood that such purchases may disrupt ordinary trading in a security or otherwise lead or dominate the market; (3) if the plans allowed the banks to vote fractional shares or vote proxies that are not returned by the participants, the resultant concentration of voting power in the banks could create significant regulatory problems; (4) the bank could charge unreasonable fees for their service due to lack of SEC supervision; (5) possible conflicts of interest problems could arise; (6) unlike registered brokers and dealers, banks are not subject to suitability rules designed to place the responsibility on the brokers for determining whether an investment is appropriate to a potential investor before making a recommendation; (7) inappropriate advertising material by the banks is not regulated by the securities laws unless the ad is fraudulent within the meaning of the securities laws; (8) since banks are unregulated entities when engaging in the business of buying and selling securities as an agent for a customer, the customer has no assurance that the bank is getting the best price possible under the prevailing market conditions; (9) the bank has no regulatory entity to ensure that participants receive adequate confirmations; (10) customers who leave their securities with the bank are not accorded insurance protection under FDIC, and the only remedy available is to sue the bank unless the bank has voluntarily acquired insurance protection. In contrast, the Securities Investor Protection Act of 1970 accords coverage of up

The controversy surrounding the legality of AIS marks the second time in the last three years that the scope of sections 16 and 21 has been questioned. The Supreme Court in April 1971, held, in the leading case of *Investment Company Institute v. Camp*,²¹ that a national bank offering a commingled managing agency account²² for its customers violated the restrictions imposed on a national bank's entry into the securities business by sections 16 and 21. Since AIS raises similar problems under the Glass-Steagall Act, this Note will examine one of the legal questions surrounding AIS—the proper scope of a national bank's role as an agent in the purchase and sale of equity securities for the accounts of its customers.²³ Section 16 of

to \$50,000 for securities held in custody by brokers. For the text of Garrett's remarks, see SEC. REG. L. REP., No. 219, at K-1 to K-3 (Sept. 19, 1973).

The staff of the SEC has issued a no-action letter on the question whether AIS constitutes an investment company within the meaning of the Investment Company Act of 1940 (hereinafter cited as '40 Act). On May 12, 1973, the Division of Investment Management Regulation stated that the staff would not recommend that the SEC take action against Investment Data Corporation (IDC) or Security Pacific if they did not register the proposed AIS under the '40 Act provided they proceeded in reliance upon Counsel's opinion that AIS would not constitute an issuer under § 2(a)(22) and participation in the plan would not constitute a security within the meaning of § 2(a)(36) of the '40 Act; and provided further that the brochure explaining the plan point out that the investments may or may not be suitable for the participant, and therefore, the participant should consider whether to make an independent investigation into the merits of the security he wishes to purchase under the plan. Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411, at 83,181 (1973). Later, the staff acknowledged the understanding of counsel of Security Pacific that AIS does not give rise to a fiduciary relationship as exists between a broker and his customer so as to impose suitability requirements on the bank. Security Pacific National Bank, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,412, at 83,185 (1973).

It must be noted that the SEC has not taken a position on the applicability of the Securities Act of 1933 or the Securities and Exchange Act of 1934 to AIS. Address by Ray Garrett, The Bond Club of Chicago, Oct. 19, 1973. The Staff has indicated that the SEC is presently conducting a review of cash payment plans such as AIS and that the results of the review may affect the above no-action letter. See *Investment Data Corp. supra*, at 83,182.

21. 401 U.S. 617 (1971).

22. This very interesting amalgamation that was held to be unlawful was really the union of three traditional banking powers into a single entity: (1) the power to pool trust assets into a common trust fund; (2) the power to act as managing agent for an individual wherein the bank had investment discretion over the funds even though legal title was vested in the investor and not in the bank; and (3) the § 16 power to purchase stock for the account of customers. For a discussion of the case as applicable to AIS see text accompanying notes 102-07, *infra*.

23. 12 U.S.C. § 335 provides that state member banks of the Federal Reserve System are subject to the same limitations with respect to the purchase and sale of stock as are applicable in the case of national banks under § 16 of the Glass-Steagall Act, 12 U.S.C. § 24 (1970). Therefore the scope of permissible activities with respect to agency stock purchase services is the same for both national banks and state member banks.

the Glass-Steagall Act provides: "The business of dealing in securities and stock by [a national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers" ²⁴ The proponents of the plan contend that the bank's role in AIS is limited to acting as an agent for its customers in that the bank merely executes the order as directed by the customer who is vested with legal and beneficial ownership of the stock after the transaction. Furthermore, the proponents argue that section 21 of the Act, which makes it unlawful for any corporation engaged in the business of "issuing, underwriting, selling or distributing" stocks to engage at the same time in the business of deposit banking, does not limit the bank's power to act as an agent for its customers because of an express proviso to section 21 declaring that such limitations shall not prohibit national banks from dealing in, purchasing, and selling stock to the extent permitted by section 16 of the Act. ²⁵ Led by the ICI, the representative association of the American mutual fund industry, and the New York Stock Exchange, which represents the interests of a powerful segment of the broker-dealer community, the broker-dealer community and the mutual fund industry vigorously oppose AIS and share a common goal of preventing new competition from banks in seeking the individual investor's business. They contend that Congress intended the express language of section 16 per-

24. The precise language of the applicable portion of § 16 is as follows:

The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.

Glass-Steagall Act of 1933 § 16, 12 U.S.C. § 24 (1970).

25. Section 21 of the Glass-Steagall Act provides in pertinent part:

[I]t shall be unlawful—

(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon the request of the depositor: *Provided*, [t]hat the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in underwriting, purchasing, and selling investment securities, or issuing securities to the extent permitted to national banking associations by the provisions of section 24 of this title

Glass-Steagall Act of 1933 § 21, 12 U.S.C. § 378 (1970). The above proviso was added to § 21 in 1935 to make clear that § 16 was not intended to prohibit national banks from buying and selling *stocks* in addition to the debt securities expressly authorized under § 16 in 1933. Act of Aug. 23, 1935, § 307(a), 49 Stat. 709; *Hearings on H.R. 5357 Before House Comm. on*

mitting banks to engage in agency stock transactions to allow only unadvertised and nonprofit stock services offered merely as an accommodation to a bank's existing customers, and not entry into the brokerage business. Furthermore, they argue that AIS violates the Act's underlying purpose of effectuating a separation of the commercial banking business from the securities business. Finally, the opponents of AIS assert that public policy demands that section 16 be read as disallowing AIS because of the conflicts of interests created, the lack of adequate investor protection for participants, and the potential adverse impact on the securities markets caused by increased investment in the authorized "blue chip" stocks, which thereby hinders to some extent the efforts of other corporations to raise capital.

II. SECTIONS 16 & 21 OF THE GLASS-STEAGALL ACT OF 1933—THE SCOPE OF PERMISSIBLE SECURITIES TRANSACTIONS

To understand the limitations imposed on national banks in engaging in securities transactions, it is useful to compare the restricted securities activities of the banks with the varied types of transactions in which a full service securities business²⁶ may actively participate. As an underwriter for a corporation issuing new securities, the investment banker generally will purchase the entire issue of securities from the corporation and then resell the securities to the public.²⁷ The underwriter assumes the risk of a decline in the market price of the securities until completion of the distribution to the investors. As a dealer²⁸ in securities, a firm may both invest or speculate in the stock market for its own account and serve as a "market-maker"²⁹ for selected stocks by holding an inventory and standing ready to trade the stocks with other investors. As an issuer³⁰ of securities, the full service securities firm may issue its own

Banking and Currency, 74th Cong., 1st Sess., at 663 (1935). Section 16 was amended at the same time and for the same purpose. Act of Aug. 23, 1935, § 308, 49 Stat. 709.

26. A full service securities firm refers to a company engaged in investment banking, brokerage and other common securities activities. A security, unless expressly stated otherwise, means any common or preferred stock, bond or debenture.

27. This is known as a "firm commitment underwriting." In a "best efforts underwriting," the risk of loss on any unsold securities rests on the issuer, since the underwriter agrees only to use his best efforts to sell the stock. See generally REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SEC, H.R. Doc. No. 95, pt. 1, 88th Cong., 1st Sess., at 493-95 (1963) [hereinafter cited as SPECIAL STUDY].

28. The term "dealer" in this Note is used to mean any person or company including a bank that engages as a *principal* in the buying and selling of securities for its own benefit and account.

29. See SPECIAL STUDY, pt. 1, *supra* note 27 at 13.

30. Issuer simply refers to the company that seeks to raise capital by issuing common or preferred stock, bonds, debentures or other securities.

securities to the public and may offer the securities of an affiliate, such as a mutual fund³¹ for which the investment banker serves as investment adviser.³² In its capacity as a broker,³³ the securities firm acts as an agent for its customer and performs a variety of functions, including buying and selling stock for the customer's account on a commission basis, giving research advice, making recommendations, acting as custodian to ensure safekeeping and to facilitate trading of the investor's securities, and lending funds to its investors for trading.³⁴

Compared to the extensive variety of services performed by brokerage firms, the scope of securities transactions by banks is quite limited. Section 16 of the Glass-Steagall Act, as amended, provides the relevant statutory provisions imposing restrictions on a national bank's investment activities. This section divides permissible securities transactions into three categories.³⁵ First, national banks are authorized to buy and sell all types of securities, including bonds, debentures, and common stock, provided the bank acts as agent for the account of a customer.³⁶ Secondly, national banks are permitted to purchase for their own account certain debt instruments, including bonds, notes, and debentures, subject to limitations and restrictions imposed by the Comptroller of the Currency.³⁷ Equity securities including common and preferred stock do not constitute "investment securities"³⁸ as defined by the statute and hence

31. Mutual fund is the popular term for the legal entity known as an "open-end investment management company." It is an investment company within the meaning of the Investment Company Act of 1940 § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (1970) because it is engaged primarily in the business of investing, reinvesting, or trading in securities. It is an "open-end" company because it stands ready to redeem any security which it issues. 15 U.S.C. § 80a-5(a)(1).

32. Investment adviser is defined as any person who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. Investment Advisers Act of 1940 § 2(a)(11), 15 U.S.C. § 80b-2(a)(11) (1970).

33. As used in this Note, a broker is an agent who acts for another in the purchase or sale of securities.

34. See SPECIAL STUDY, pt. 1, *supra* note 27, at 389.

35. For a good discussion of a bank's investment activities see CCH FED. BANKING L. REP. ¶ 96,272, at 81,356.

36. The relevant language of § 16 is as follows: "The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account" Glass-Steagall Act of 1933 § 16, 12 U.S.C. § 24 (1970).

37. The relevant language of § 16 is as follows: "Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe." *Id.*

38. The statute defines the terms as follows: "As used in this section the term 'invest-

the Comptroller cannot authorize their purchase for the bank's own account. Thirdly, national banks possess unrestricted authority to purchase and sell for their own account and to serve as underwriter for obligations of the United States and general obligations of states and municipalities.³⁹

Section 16 also prohibits national banks from engaging in two very important investment transactions: the purchase of corporate stock for the bank's own account,⁴⁰ and the underwriting of any issue of stocks or bonds with the exception of certain government securities.⁴¹ These rather specific authorizations and prohibitions combine to promote the underlying purpose of the banking laws—to protect the funds of depositors. The agency transactions present no risk to depositors' funds because the bank uses the investors' funds at the investors' direction, making any profit or loss attributable to the investor and not the bank. In the two other categories of permissible transactions—the Comptroller's approved list of debt instruments and government securities—the bank may make an inventory profit or loss, but the risks are minimized by the nonspeculative low-risk nature of these securities. The prohibited transactions—non-governmental securities underwriting and corporate stock purchases for the banks' own accounts—also reduce the risk of loss by preventing banks from engaging in excessively speculative transactions.

To accomplish the purpose of protecting depositors' funds while allowing banks to engage in certain nonspeculative, low-risk securities transactions, Congress formulated in section 16 certain carefully defined authorizations and prohibitions. In enacting section 21, Congress created the ambiguity in the statutory pattern that gives rise to the AIS problem by adopting a different approach to accomplish the same result. In section 21, Congress broadly declared that

ment securities' shall mean marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency." *Id.*

39. The statute provides as follows: "The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof. . . ." *Id.*

40. Section 16 provides: "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation." *Id.*

41. The relevant language is as follows: "[T]he association shall not underwrite any issue of securities or stock . . ." *Id.* The exception for government securities is found in the language quoted in note 39 *supra*.

the *business* of deposit banking was to be separated from the *business* of issuing, underwriting and dealing in securities,⁴² attempting to compel a firm to choose to engage in one business or the other but not both. The broad prohibition of section 21 appears inconsistent with the carefully defined authorizations of section 16 and efforts to harmonize the two provisions present inevitable difficulties in applying the statute to AIS.

III. HISTORICAL DEVELOPMENT OF SECTIONS 16 & 21

When the present national banking system was established in 1864, the National Bank Act placed restrictions on the scope of activities of national banks operating under its provisions.⁴³ Intending to confine the activities of national banks principally to deposit banking and the making of short-term loans and viewing these limitations as necessary to protect depositors and shareholders of the banks, Congress granted no explicit power to national banks to engage in the business of buying and selling investment securities. Beginning in 1908, however, national banks, through the formation of "security affiliates"⁴⁴ incorporated under state law, devised methods to circumvent the national banking law restrictions and effectively participate in the ownership and underwriting of equity securities. In addition to underwriting and dealing in securities, banks, acting under the incidental powers clause,⁴⁵ also engaged in agency stock transactions for their customers. By 1933, most of the abuses arising from the close relationship between banks and the securities business that Congress identified as responsible in part for the stock market crash in 1929 were associated directly with the banks' underwriting and dealing functions and not its agency functions. As a result, the congressional hearings accompanying the Glass-Steagall Act⁴⁶ provide virtually no discussion of the scope of the banks'

42. See note 25 *supra*.

43. The National Bank Act authorized a national bank:

To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter.

National Bank Act, 12 U.S.C. § 24 (1970), formerly ch. 106, § 8, 13 Stat. 101 (1864).

44. See notes 81-101, *infra*, and accompanying text.

45. Under the incidental powers clause, Congress expressly authorized national banks to exercise "all such incidental powers as shall be necessary to carry on the business of the bank" National Bank Act, 12 U.S.C. § 24 (1970).

46. See Memorandum of Law for Security Pacific in Support of the Opinion of the

agency services. In examining the historical background of sections 16 and 21, this Note will first investigate the historical, legislative, and administrative development of the agency services, then focus on the underwriting and dealing functions, and finally summarize those policies of the Act that arguably limit the seemingly unrestricted agency powers authorized by section 16.

A. *National Banks as Agents in Securities Transactions*

Although the origin of the commercial banks' acting as brokers for the purchase and sale of stock remains somewhat unclear, some evidence exists that banks performed agency stock purchase functions for customers prior to the Civil War.⁴⁷ In any event, the National Banking Act of 1864 provided no express authority for a bank's agency powers.⁴⁸ Nevertheless, the argument was proposed that such a power was appropriately incidental to the express powers granted to the bank by federal legislation. The case law in the late nineteenth century evidenced a split on the question. Some courts upheld the power of a national bank to buy and sell securities as agent for its customers under the incidental powers clause,⁴⁹ while

Comptroller of the Currency that the Operations of a Stock Purchase Service by a Bank is Consistent with the Provisions of the Glass-Steagall Act at 21-22 (Oct. 12, 1973) [hereinafter cited as Memo for Security Pacific].

47. "Most of the firms and individuals engaged in buying and selling securities were either private hankers, partnerships that did not issue their own paper money as incorporated banks did, stock brokers, auctioneers, or other bankers, very often commercial ones." V. CAROSSO, INVESTMENT BANKING IN AMERICA 13 (1970) (emphasis added).

48. See note 43 *supra*.

49. In analyzing the pre-Glass-Steagall Act cases, it is important to distinguish national banks, which operate under federal legislation, and state banks, which derive their powers from state statutes. This Note concerns itself with the powers of national banks to operate agency stock purchase services. One of the early national bank cases that approved the role of national banks acting as agents for purchase of stock for their customers was *Central Nat'l Bank v. White*, 139 N.Y. 631, 34 N.E. 1065 (1893). The plaintiff/national bank sought to recover money fraudulently paid by a cashier of the bank with cashier's checks in settlement of the cashier's personal stock speculations. The defendant/stockbrokers won the case on grounds that the defendants testified that they always supposed their dealings were with the bank on behalf of its customers. In the course of the opinion, the Court of Appeals of New York noted the existence of bank agency stock transactions:

While it is true that the bank could not lawfully speculate for itself, and risk capital and deposits in that sort of stock gambling which ruins so many both in character and fortune, yet it is equally true that its customers could do so if they pleased, and it was possible to believe that they bought upon margins through the *agency of the bank* . . .

Id. at 633-34, 34 N.E. at 1066 (emphasis added). The practice was apparently accepted by 1931 in Minnesota, when the District Court noted that a customer had arranged for purchase of some bonds by the bank acting as agent. *Mark v. Westin*, 48 F.2d 609 (D. Minn. 1931). Finally, the Supreme Court noted the practice without objection in a 1932 case in which

others denied it on an *ultra vires* theory.⁵⁰ The former view prevailed, however, after a unique legal entity designated as a "trust company" began a rapid period of growth during the last quarter of the nineteenth century. State law authorized the trust company to hold title and manage property for the benefit of others in the same manner as an individual trustee.⁵¹ The agency stock purchase activities performed by banks differed from the trust services in that the title to the property under the trust became vested in the trust company whereas in an agency arrangement title remained in the investor and did not pass to the bank.⁵² Nevertheless, because of the similarity between the type of services performed under both the agency and trust arrangements and the possibility of combining the agency and trust functions without harm to the beneficiaries of the services, most courts adopted the incidental powers view and

plaintiff paid a national bank approximately \$4000 to buy bonds as agent for him and the bank declared bankruptcy. *Blakey v. Brinson*, 286 U.S. 254 (1932). Importantly, each court's approval of the bank's agency stock transactions constituted dicta, and the specific question whether a national bank had the authority to perform such a service was not decided.

Although extensive research of the history of national banks acting as brokers for their customers appears to reveal few cases and secondary sources that document the scope of the practice, national banks clearly engaged in the practice. Perhaps because of a question of the bank's authority in such transactions, it seems that the practice was not widely promoted to the general public but rather was limited to the bank's customers who needed such services. In our dual system of banking in which state banks with certain powers compete with national banks having different powers, it is interesting to note that the state banks were apparently authorized to engage in agency transactions and did so, perhaps to gain a competitive advantage over the national banks. If we can assume that national banks would probably respond to this competitive pressure by offering similar services, it may be reasonable to infer from the widespread acceptance of the practice among state banks that the practice among national banks was more prevalent than the small amount of evidence may indicate. For a sample of the state bank cases expressly or impliedly approving the agency power see *Clucas v. Bank of Montclair*, 10 N.J.L. 394, 166 A. 311 (Ct. Err. & App. 1931); *Block v. Pennsylvania Exch. Bank*, 253 N.Y. 227, 170 N.E. 900 (1930) (Cardozo, C.J.) ("The practice of bank agency stock transactions is so general that it may be the subject of judicial notice." *Id.* at 232, 170 N.E. at 901-02); *Dyer v. Broadway Cent. Bank*, 252 N.Y. 430, 169 N.E. 635 (1930); *Le Marchant v. Moore*, 150 N.Y. 209, 44 N.E. 770 (1896); see 9 C.J.S. *Banks and Banking* § 161 (1938).

50. In *Cassatt v. First Nat'l Bank*, 111 N.J.L. 536, 168 A. 585 (Ct. Err. & App. 1933), plaintiff stockbrokers sought to recover purchase price and commissions for 300 shares of stock purchased for defendant national bank. The court upheld the *ultra vires* defense that the purchase of stock by the bank as agent was beyond the scope of its authority. In *Byron v. First Nat'l Bank*, 75 Ore. 296, 146 P. 516 (1915), the court stated, "It may be conceded, and it is the law, that a national bank cannot act as a broker . . ." *Id.* at 299, 146 P. at 517. See 9 C.J.S. *Banks and Banking*, § 655 (1938).

51. See generally C. HERRICK, *TRUST DEPARTMENTS IN BANKS AND TRUST COMPANIES 2 et seq.* (1925) [hereinafter cited as HERRICK]; H. MOULTON, *FINANCIAL ORGANIZATION AND THE ECONOMIC SYSTEM 194 et seq.* (1938) [hereinafter cited as MOULTON]; J. SMITH, *THE DEVELOPMENT OF TRUST COMPANIES IN THE UNITED STATES* (1928) [hereinafter cited as SMITH].

52. 1 A. SCOTT, *THE LAW OF TRUSTS* § 8.1 (3d ed. 1967) [hereinafter cited as SCOTT].

approved the banks' agency functions.⁵³ Moreover, intending to provide national banks with the same trust powers available to trust companies in the several states, Congress passed the Federal Reserve Act of 1913, which granted national banks the right to obtain authority to exercise fiduciary powers upon application to the Federal Reserve Board.⁵⁴ Subsequent to the passage of the Federal Reserve Act, banks began offering a new service known as a "custodian account" in which the bank acted as a depository for the customer's portfolio and as broker for the client in purchases and sales of securities in addition to performing the necessary bookkeeping services.⁵⁵ Finally, consistent with the majority case law⁵⁶ and the general practice of banks and trust companies,⁵⁷ Congress, in section 16 of the Glass-Steagall Act, gave banks the express power, completely separate from their fiduciary powers under the Federal Reserve Act, to act as agent for customers in the purchase and sale of securities.⁵⁸

No bank agency transaction service exactly paralleling AIS existed in the pre-Glass-Steagall Act years, the closest approximation having been the custodian account utilized by national banks to handle financial matters, manage property, and keep safely securities for persons who needed such services. Persons utilizing custodian accounts included those in ill health, civilian and military travelers, active and retired businessmen desiring to avoid the worries of management, and others basically unfamiliar with business affairs.⁵⁹ Unlike AIS, which serves primarily the small investor desiring to invest on a regular basis, custodian accounts generally benefitted wealthy persons who did not want the inconvenience of managing their own property.⁶⁰ Moreover, unlike the trust arrangement in which the bank held legal title to the transferred trust property, AIS plans leave title in the customer.⁶¹

53. See Peach, *The Security Affiliates of National Banks*, 58 *JOHNS HOPKINS UNIVERSITY STUDIES IN HISTORICAL AND POLITICAL SCIENCE*, No. 3, at 39 (1941).

54. Federal Reserve Act of 1913, ch. 6, § 11(k), 38 Stat. 262, as amended, 12 U.S.C. § 92a (1970).

55. See notes 59-66 *infra* and accompanying text.

56. Compare cases cited note 49 *supra* with cases cited note 50 *supra*.

57. See note 49 *supra*.

58. Compare 12 U.S.C. § 24 (1970) with 12 U.S.C. § 92a (1970).

59. HERRICK, *supra* note 51, at 236.

60. This conclusion, although accurate as a general statement, may be misleading. The not-so-wealthy customers utilized custodian accounts especially during World War I when large numbers of men and women who were assigned to military or naval service arranged for banks to handle their funds as custodians. *Id.*

61. The nature of the bank's duties under the agreement and the legal nature of the arrangement depend upon the intention of the parties. Under one type of agency arrange-

In establishing a custodian account, the customer and the bank executed a contract that defined the duties undertaken by the bank in handling the customer's property.⁶² Under the agreement, the bank would typically undertake, when so directed or authorized, to execute the purchase and sale of securities in addition to the following services: (1) to receive, issue receipts for, and safely keep securities; (2) to collect dividend and interest income from stocks and bonds; (3) to execute the necessary ownership certificates required for income tax purposes; (4) to notify the customer regarding all collections; (5) to collect matured or called principal and report all such collections to the customer; (6) to exchange temporary securities for definitive securities; and (7) to notify the customer of calls, subscription rights, defaults in principal or interest, and the formation of protective committees.⁶³

ment, when title to the property is not vested in the bank and the bank is entrusted with the possession of a customer's property with no other duties, the bank may be a mere bailee. When a customer hires a safe-deposit box, the bank probably does not possess even a bailee status because the customer retains control of the property and the bank does not have possession of the contents. When securities are deposited with a bank for safekeeping, however, the bank becomes a bailee with a duty to use proper care to keep the securities safely and deliver them to the customer on his order. SCOTT, *supra* note 52, at § 5.1. If the bank undertakes other duties beyond possession, control, and safekeeping, then it may become another type of agent known as a custodian. The duties of a custodian are ministerial rather than discretionary. On any discretionary matters, the bank acts only on order of the customer. Some of the principal duties of a custodian are discussed in the text accompanying notes 64-66, *infra*.

If the bank undertakes additional duties beyond those of a custodian, such as the duty to make recommendations with respect to the retention or change of investments, the bank may become another type of agent termed a managing agent. The traditional managing agent did not undertake to make changes or investments on its own authority, but only on the order of a customer. SCOTT, *supra* note 52, at § 8.1.

A bank may also undertake duties of an attorney-in-fact, which may include the entire management of investments for a customer, making and changing investments on its own responsibility without specific directions. SCOTT, *supra* note 52, at § 8.1.

These various agencies differ from trusts in several ways. In an agency the title to the property remains in the customer, but in a trust legal title vests in the bank. The agency may be terminated by either party at any time and it automatically terminates on the death of the customer, but the trust terminates as directed in the trust instrument. In an agency control remains with the customer, but in a trust the settlor retains only such control as he has reserved by the terms of the trust. The liability of a bank as agent depends on whether it has used due care in the performance of its duties, whereas a trustee's liability depends on whether it has committed a breach of trust. SCOTT, *supra* note 52, at § 8.1.

Most banks operate their agency services through their trust departments, and it is not always clear whether the authority to execute stock transactions is derived from the agency power of section 16 given to all national and Federal Reserve member banks or from the fiduciary powers authorized originally by the Federal Reserve Act of 1913 and now codified in 12 U.S.C. § 92a (1970).

62. SCOTT, *supra* note 52, at § 8.1.

63. *Id.*; HERRICK, *supra* note 51, at 236-41; MOULTON, *supra* note 51, at 206-11; SMITH, *supra* note 51, at 130-32.

Although the nature and extent of services performed under the custodial agreement varied with individual contracts, certain characteristics were common. First, the customer and the bank executed an agency agreement prior to any purchase or sale transactions. Secondly, the customer transferred property for safekeeping to the bank. Thirdly, the bank offered the service as a convenience to bank customers who for various reasons could not undertake the proper custody and management of funds.⁶⁴ Fourthly, the bank often executed purchases and sales at cost and without profit.⁶⁵ Lastly, the bank generally did not advertise itself as performing the brokerage function.⁶⁶ Although similar to the custodial service on the first two characteristics, AIS differs significantly on the last three. AIS is designed to return a profit to the banks and is not offered as a convenience to existing bank customers in need of the service. Moreover, the banks widely advertise and aggressively promote the service to the public through the various media, including radio, television, magazines and newspapers.

In approving section 16 of the Glass-Steagall Act, Congress gave little, if any, consideration to the propriety of banks' brokerage functions,⁶⁷ primarily because the banks offered agency services on a limited basis to a limited group of customers, and thus presented minimal risks to the bank and its depositors and, more importantly, minimal competition to the brokerage industry. Although the language of section 16 places no limitations on the agency power of banks, the Senate Report states that Congress intended to allow banks to continue engaging in agency transactions "as heretofore."⁶⁸ It follows, therefore, that AIS extends considerably beyond the rather limited pre-1933 implementation of the agency powers and arguably violates the legislative intent of Congress in 1933.

In addition, the administrative history of the Comptroller of the Currency's interpretations of section 16 agency power in the years immediately following the enactment of the Glass-Steagall Act

64. See text accompanying note 59 *supra*.

65. "Either a bank or a trust company will take a customer's order for purchase or sale of stocks or bonds and execute those orders, and as a rule not make a brokerage charge for itself. In so far as they do this they are acting as an agent gratuitously." (emphasis added). SMITH, *supra* note 51, at 133-34. See notes 69-75, *infra* for the 1936 construction of § 16 by the Comptroller, which agreed with this view.

66. "The trust company performs a brokerage service, which is an agency, for its clients in connection with its various other services, but ordinarily does not advertise itself as a broker in the general sense . . ." SMITH, *supra* note 51, at 133 (emphasis added). See notes 69-75, *infra*, for original construction of § 16 by the Comptroller, which agreed with this view.

67. See note 46 *supra*.

68. See *id.*

lends support to a restricted agency power. The Comptroller's rulings appeared to place five limitations on the power. First, the bank could act only as an "accommodation agent"⁶⁹ for its customers. Although not explicitly defining the term, the Comptroller suggested in his 1933 Annual Report⁷⁰ and in hearings before Congress⁷¹ that its meaning related to banks performing agency services as a convenience to customers, especially in communities removed from the financial centers where persons rarely engaged in the brokerage business. Secondly, the bank could make no profit on the agency service and must have limited customer charges to the fair costs of the transaction.⁷² Thirdly, the principals in the stock agency trans-

69. In 1936, the Comptroller of the Currency issued a summary of previously issued interpretive regulations that narrowly restricted the authority of the bank under § 16. The term "acomodation agent" was used in the ruling but was not defined:

35. General scope of law pertaining to dealings in securities and stock by bank.

—In general this clause confines the activity of a national bank in purchasing and selling securities for the accounts of customers to that of an *acomodation agent*, the purpose being to prevent such banks from engaging in the business of dealing in securities for profit, without limiting the service which may be rendered to customers in purchasing and selling securities upon their orders and for their accounts . . . (emphasis added).

1 BULLETIN OF THE COMPTROLLER OF THE CURRENCY, No. 2, Oct. 26, 1936, at 2-3 [hereinafter 1936 BULLETIN], as quoted in Memo for Security Pacific, *supra* note 46, at 27.

70. In discussing proposed legislation to expressly authorize the banks to buy and sell stocks or equity securities as well as debt instruments, the Comptroller pointed out the importance of national banks' providing a stock agency service in rural areas.

It would appear from the language that a national bank is prohibited from performing the service of purchasing and selling corporate stocks for the account of one of its customers. Since this does not entail the investment by the bank of its own funds and the bank merely acts in an *acomodation capacity*, it is believed that it was not the intention of Congress to penalize *the public located in communities removed from the money centers* in disposing of or purchasing securities in the form of corporate stocks for investment purposes.

1933 ANNUAL REPORT OF COMPTROLLER OF CURRENCY 11 (1934) (emphasis added).

71. In testimony before the House Committee on Banking and Currency, the Comptroller in 1935 made reference to the importance of agency stock services in communities away from financial services.

Section 307(a), which is also new, in part, makes it clear that section 16 of the Banking Act of 1933 was not intended to prohibit national banks or member banks from buying or selling stocks solely for the account of their customers and as an *acomodation thereto* and not for their own account. *This is extremely important, particularly in communities remote from financial centers*, and since there is involved no investment by the bank of its own funds, no objection can be seen thereto.

Hearings on H.R. 5357 Before the House Comm. on Banking and Currency, 74th Cong., 1st Sess., at 663 (1935) (emphasis added).

72. The Comptroller's interpretation is quoted as follows: "40. Retention of commissions or rebates by bank. —*This clause does not authorize a bank to charge any commission or fee in excess of the fair cost of handling the transaction*; the charge made by the bank must bear a reasonable relation to the actual cost of the service rendered to the customer. A purpose of this clause is to prevent national banks from engaging in the brokerage business for profit, and therefore within the meaning of the foregoing, the bank is not authorized to retain any

action were limited to actual customers of the bank who had an independent customer relationship with the bank apart from the agency transaction.⁷³ Fourthly, the customer was required to pay the bank prior to the agency transaction or at least have sufficient collateral or credits with the bank to cover the costs.⁷⁴ Finally, the authority granted to banks under section 16 to execute agency stock transactions was not intended to allow banks to become licensed brokers in securities for profit.⁷⁵ The Comptroller abolished, however, the profit limitation in 1957⁷⁶ and by his express approval of AIS in 1973 and 1974,⁷⁷ clearly indicated that he no longer regarded these prior interpretations as valid limitations on the section 16 power. Nevertheless, for purposes of analyzing the legislative and administrative history in determining the scope of the power as viewed by Congress in 1933, the prior interpretations of the Com-

commission, rebate, or discount, obtained from others in purchasing for a customer, but the benefit of such reduction in price must be passed on to the purchaser, unless it does not exceed the cost of handling the transaction" 1936 BULLETIN at 2-3, as quoted in Memo for Security Pacific, *supra* note 46, at 28 (emphasis added).

73. The Comptroller's interpretation provided: "36. Purchase and sale transactions limited to actual customers of bank. —The clause is to be construed as limiting the purchase and sale transactions mentioned to *actual customers of the bank*, which customer relationship exists independently and apart from the particular transaction in which the bank buys and sells upon the order and for the account of such 'customer,' in distinction to the relationship arising solely by virtue of the particular transaction." 1936 BULLETIN 2-3, as quoted in Memo for Security Pacific, *supra* note 46, at 27 (emphasis added).

74. The Comptroller's interpretation provided: "38. Customer's credits or collateral with bank sufficient to cover transaction. —This clause does not authorize the bank to purchase stocks or securities for a customer unless *a payment therefor has been received by the bank, or the customer has credits or collateral with the bank sufficient to cover*, and the bank is authorized to charge the cost of the transaction against such credits or collateral; the bank must not use its own funds in such transactions . . ." 1936 BULLETIN at 2-3 as quoted in Memo for Security Pacific, *supra* note 46, at 28 (emphasis added).

75. The Comptroller provided as follows: "41. Bank as licensed dealer; employment of solicitor or middleman. —The spirit and purpose of this clause is opposed to a national bank becoming a *licensed dealer in securities*, which would imply a definite effort by the bank to engage in the securities business *for profit*, rather than for accommodation. . . ." 1936 Bulletin at 2-3, as quoted in Memo for Security Pacific, *supra* note 46, at 28 (emphasis added).

76. In 1957 the Digest of the Comptroller's Opinions, which had theretofore included language similar to that used in 41 (*see* note 75, *supra*), was amended to indicate that banks did not need to provide their stock purchase services on a nonprofit basis. The Comptroller provided:

In view of the express authorization in Section 16 of the Glass-Steagall Act to purchase and sell securities and stock for the account of customers, a national bank may receive compensation upon the performance of such a service. However, since the bank is acting as an accommodation, it may not retain commissions, discounts, or rebates obtained from brokers or dealers unless authorized so to do by the customers for whom it acts as agent. COMPTROLLER OF THE CURRENCY DIGEST OF OPINIONS, ¶ 220A (1957), as quoted in Memo for Security Pacific, *supra* note 46, at 31.

77. *See* notes 15 & 17 *supra*.

troller, as the regulatory agency charged with responsibility over national banks, deserve considerable weight.

Despite the section 16 history in support of a restrictive view of banks' agency powers, several reasons militate against invalidating AIS on purely historical grounds. Most importantly, AIS appears to fall within the unrestricted statutory grant to act as agents, and any limitations from the historical background and administrative interpretations constitute only persuasive authority that is not binding until a court or Congress so declares. Secondly, what Congress would do or would have done if confronted with the AIS problem remains an uncertainty. Therefore, policies underlying the Glass-Steagall Act as applied to banks acting as underwriters and dealers in securities will now be examined to determine whether they support a restrictive view of the agency power.

B. *National Banks as Underwriters and Dealers in Securities*

In contrast to the minimal congressional concern evidenced in the Glass-Steagall Act for banks acting as agents in securities transactions, Congress exhibited a serious interest in the abuses it viewed as resulting from national banks acting as underwriters of new securities and as dealers who could own, invest, and speculate for the bank's own account. A study of the abuses that Congress found to result from the close association of the banking and securities industries and an attempt to measure AIS against these findings to determine whether the same hazards potentially exist may prove revealing in evaluating AIS under the Glass-Steagall Act.

Initially, it should be noted that banks acting as underwriters and dealers both violated the federal banking laws⁷⁸ and offended the basic American theory⁷⁹ that since banks operated on depositor's funds subject to withdrawal on short notice, banks should not use those funds in long-term investments not subject to quick liquidation. With safety and liquidity of the depositor's funds constituting the fundamental tenets of sound banking, the supplying of long term credit to companies by banks who performed the investment banker functions of underwriting and owning stocks and bonds of

78. The National Banking Act of 1864 did not grant national banks an express authority to engage in the underwriting and the ownership of corporate stocks and bonds. See note 43 *supra*. Under the prevailing court view at the time, national banks could exercise only those powers expressly granted or necessarily incidental to the banking business, and those incidental powers were not regarded as including the business of buying and selling securities although many carried on such a business under those powers. Peach, *supra* note 53, at 39.

79. Peach, *supra* note 53, at 9.

corporations was viewed as inconsistent with their normal role as sources of short-term credit. In addition, the federal banking laws prohibited banks from participating in underwriter or dealer functions.⁸⁰

Beginning in 1908,⁸¹ however, national banks circumvented these restrictions by forming state incorporated subsidiaries known as security affiliates to take advantage of the more liberal state laws allowing state banks and trust companies to underwrite and own stocks and bonds.⁸² Although banks formed security affiliates in several different ways, the common characteristic of these operations was a transfer of a portion of the depositors' funds to the affiliate and ownership by an identical group of shareholders of the same equity interest in both the bank and the affiliate.⁸³ Prior to Glass-Steagall, national banks would purchase companies' new issues through security affiliates and resell them to the banks' customers with the risk of any market decline resting directly on the shareholder group and the depositors of the bank. In addition, security affiliates could own stocks and bonds in their own name, invest, speculate, and ride the market, suffering gains and losses with other investors. Moreover, since security affiliates and banks often had similar names and operated out of the same building, the public closely associated the retail sale of new public securities issues with the banks.⁸⁴

National banks entered the underwriting and dealing business in the period of 1910-1930 for several reasons. First, banks discovered that with a healthy market the underwriting business produced substantial profits.⁸⁵ Additionally, an overall decline in the demand for commercial loans characterized this period during which businesses discovered the method of raising capital through issuing securities rather than borrowing from the bank.⁸⁶ Also, the highly successful experience of national banks in selling and distributing Liberty Bonds led banks to reason that the integration of underwrit-

80. *Id.*

81. The first security affiliate on record was organized in 1908 by First National Bank of New York City. *Hearings Before a Subcommittee of the Committee on Banking and Currency*, S. Res. 71, 71st Cong., 3d Sess., pt. 4, at 1052 (1931) (hereinafter cited as GLASS-STEAGALL HEARINGS).

82. 75 CONG. REC. 9909 (1932) (Remarks of Senator Bulkey) (hereinafter cited as Bulkey remarks).

83. For a summary of the organization and formation of security affiliates see GLASS-STEAGALL HEARINGS, *supra* note 81, at 1055-56. See also Peach, *supra* note 53, at 66-70.

84. GLASS-STEAGALL HEARINGS, *supra* note 81, at 1063.

85. Peach, *supra* note 53, at 21.

86. *Id.* at 24-28.

ing with traditional commercial banking functions would create a "department store" of "one-stop banking services" that would prove beneficial to banks, their customers, and the public.⁸⁷ Moreover, the competitive pressures of state banks and trust companies to some extent forced national banks into the underwriting and dealing business.⁸⁸ Finally, the national banks recognized a strong market for new issues in the correspondent banking relationship with the rural banks, who desired to own stocks and bonds and participate in the resulting profits.⁸⁹

Although the increasing entry of national banks into the underwriting business signaled a divergence of traditional banking theory from banking practice, banking regulators never took action to forestall this development while the economy remained healthy.⁹⁰ With the McFadden Act of 1927, Congress undertook to authorize the national banks' actual engaging in the underwriting of stocks and bonds.⁹¹ After the market crash of 1929 and the collapse of the Bank of the United States in 1930⁹² because of abuses by the banks' security affiliates in performing investment banking functions, Congress began to question seriously the close association between commercial banking and the securities business. In the Glass-Steagall Act hearings, Congress identified five primary abuses resulting from this relationship.

Initially, Congress expressed concern over the undue risks to depositors' funds that resulted from the underwriting and dealing business of security affiliates. Although a high profit potential existed, the possible loss of years of profits through two or three unprofitable commitments presented risks to depositors' funds that were inconsistent with traditional banking theory. An extreme example involved several security affiliates who, prior to the 1929 market crash, paid approximately 108 dollars per share for stock in Bethlehem Steel Corporation. At the end of 1930, however, the affiliates held a substantial portion of an unsold offering as the price of

87. *Id.* at 32-33; MOULTON, *supra* note 51, at 336-50.

88. Bulkey remarks, *supra* note 82, at 9911.

89. *Id.* at 9910.

90. With 2 exceptions, the banking regulators and the Congress were complacent as the national banks invaded the underwriting business. Attorney General Wickersham wrote a brief in 1911 disapproving the legality of security affiliates but he was overruled by Secretary of the Treasury MacVeagh. Bulkey remarks, *supra* note 82, at 9909. The Comptroller in his Annual Report to Congress in 1920 noted the growing "menace" of the security affiliates but his warning went unheeded. 1920 ANNUAL REPORT OF THE COMPTROLLER OF THE CURRENCY vol. 1, 55-56.

91. Ch. 191, 44 Stat. 1224. See Peach, *supra* note 53, at 41.

92. CAROSSO, *supra* note 47, at 279.

Bethlehem stock dropped sixty percent.⁹³ In addition to the underwriting risks, the high fixed costs involved in maintaining a sales force resulted in a further likelihood of losses in a depressed market.⁹⁴

Secondly, Congress discovered that the close association in the public's mind of the securities business of the affiliates with the commercial bank caused a loss of the public confidence in the banks⁹⁵ essential to sound banking, raising fears that customers might withdraw their funds and threaten the bank with insolvency. Because the affiliates often used a name and office location similar to that of the bank in order to capitalize on the bank's good will, the reputation of the bank became linked to the particular stocks promoted by the bank's affiliate and thus to the general market trends.⁹⁶

A third problem that concerned Congress involved the loss of the bank's independent judgment in evaluating loan requests.⁹⁷ Because of the bank's interest in ensuring the success of the affiliate, an increased likelihood existed of its making unsound loans to investors, the companies whose stock the affiliate had promoted, and the affiliate itself. Thus, the banks faced a conflict of interest dilemma. If a loan was made to assist the affiliate, the investor, or the company in the sale of securities, the bank sacrificed independent credit judgment to the possible detriment of its depositors and shareholders. If, however, the bank upheld its independent judgment and refused the loan, then the underwriting business of the affiliate suffered.

Additionally, Congress indicated apprehension over the possible loss of the bank's ability to provide customers with disinterested investment advice because of the pressures to promote and sell securities.⁹⁸ Regarding the bank as the financial confidant of its depositors, Congress felt it crucial that banks retain the freedom to advise disinterestedly both the individual saver and the large company concerning their respective financial problems.

Finally, Congress indicated a feeling that banks could no longer function as an impartial source of credit for businesses in need of

93. GLASS-STEAGALL HEARINGS, *supra* note 81, at 1057-58.

94. Bulkey remarks, *supra* note 82, at 9911.

95. GLASS-STEAGALL HEARINGS, *supra* note 81, at 1063-64.

96. See Osterweis, *Security Affiliates and Security Operations of Commercial Banks*, 1 HARV. BUS. REV. 124, 127 (1932).

97. GLASS-STEAGALL HEARINGS, *supra* note 81, at 1063-64.

98. Bulkey remarks, *supra* note 82, at 9912.

new capital, in light of the potentially large underwriting profit available from the distribution of new issues.⁹⁹

To resolve these problems, Congress decreed a return to the traditional American banking theory that called for a separation of the commercial banking function from the underwriting and dealing functions of the securities business. In section 16 of the Glass-Steagall Act, Congress, while allowing banks to engage in certain low risk securities transactions, prohibited banks from underwriting corporate stock issues and made it unlawful for banks to buy and sell corporate stocks for their own account.¹⁰⁰ Moreover, in sections 20 and 21, Congress attempted to separate the business of deposit banking from that of underwriting and dealing in securities.¹⁰¹

The remedies enacted to deal with the abuses were directed exclusively to the banks' underwriting and dealing functions and not to the expressly authorized section 16 agency power. Since AIS involves banks performing an execution function regarded by some as an aspect of the securities business, however, it may be appropriate to evaluate AIS in light of the kinds of abuses that Congress saw as resulting when banks engaged in the underwriting and dealing business. Before engaging in that evaluation, an evaluation must be made of the Supreme Court's recent analysis of these same abuses.

IV. INVESTMENT COMPANY INSTITUTE v. CAMP—THE SUPREME COURT'S APPROACH ARISING UNDER SECTIONS 16 & 21 OF THE GLASS-STEAGALL ACT

The *Investment Company Institute v. Camp*¹⁰² litigation, concluded in 1971, provides the Supreme Court's latest analysis of the scope of sections 16 and 21 of the Glass-Steagall Act. The case involved the legality under the Act of the First National City Bank of New York's commingled managing agency account, sometimes referred to as a collective investment fund. The bank based the establishment of this account on a combination of three basic powers possessed by banks: (1) the section 16 agency power of banks to purchase and sell securities for the account of customers; (2) the power of a national bank to pool the assets of trust funds into a common trust fund; and (3) the power of a bank to act as managing agent for its customer and exercise investment discretion in manag-

99. *Id.*

100. *See note 24, supra.*

101. *See note 25, supra.*

102. 401 U.S. 617 (1971), *rev'g* 420 F.2d 82 (D.C. Cir. 1969), *rev'g* 274 F. Supp. 624 (D.D.C. 1967).

ing, investing and reinvesting the customer's assets. Although the legality of each of these powers is well recognized, their union created a legal entity that seemed the functional equivalent of a mutual fund since the investor owned an undivided interest in a pool of stocks that were invested and reinvested by the managers of the account who exercised unfettered investment discretion.

Under the plan a bank customer transferred from 10,000 dollars to 500,000 dollars to the bank with an authorization to allow the bank to act as managing agent with investment discretion. Pursuant to a management agreement, the bank itself functioned as an investment adviser and managed the actual investment of funds. The customer's interest in the pool of assets was evidenced by a "unit of participation," which constituted a "security" under the Securities Act of 1933¹⁰³ and was registered accordingly with the SEC. The units were freely redeemable by the bank and transferable to anyone who had executed a managing agency agreement with the bank. The fund itself was registered as an investment company under the Investment Company Act of 1940.¹⁰⁴

Facing the primary issue of whether this plan constituted "issuing, underwriting, selling, or distributing" a security by a bank in violation of sections 16 and 21 of the Glass-Steagall Act, the Court held the plan unlawful on two grounds. Initially approaching the question as a matter of statutory interpretation, the Court concluded that the plan violated the Act on its face because the units of participation constituted "securities" for purposes of the Glass-Steagall Act,¹⁰⁵ and the fund participated in "buying securities for its own account" and in "issuing" and "selling" stock in violation of the Act. Furthermore, recognizing that substantial weight should be accorded the views of the Comptroller, the Court discussed, secondly, the policies underlying the Act and concluded that four principal hazards recognized by Congress in 1933 in prohibiting banks from engaging in the underwriting and dealing business arose out of the bank's close association with the investment fund: (1) public confidence in the bank might be adversely affected if the fund performed poorly; (2) the bank might tend to make unsound loans; (3) promotion of the fund by the bank might impair the bank's ability to function as an impartial source of credit to businessmen; and (4)

103. 15 U.S.C. §§ 77a *et seq.*

104. 15 U.S.C. §§ 80a-1 *et seq.*

105. Without deciding the question, the Court implied that the definition of security under the Glass-Steagall Act of 1933 was perhaps coextensive with the broad scope of the definition of security under the Securities Act of 1933. 401 U.S. at 635.

finally, the promotional interest of the bank might also impair the bank's ability to act as a disinterested investment adviser to its customers.

Although the two-step approach utilized by the Court—statutory, interpretation followed by policy analysis—appears proper, the Court failed to provide a thorough policy analysis, merely listing in a conclusive fashion the hazards recognized by Congress when studying banks' underwriting functions and offering no evidence from the record to support its conclusions. Moreover, the Court failed to point out that perhaps the major hazard recognized by Congress in 1933—the risk to depositors' funds because of the nature of the underwriting business—did not exist with the fund because the money invested belonged to the participants and not to the bank.¹⁰⁶ In addition, the Court distinguished the bank's "sale of fiduciary services" from its "sale of investments" and concluded that while the former involved none of the specified hazards, the latter encompassed most of them.¹⁰⁷ The Court, in failing to define a true fiduciary purpose, left open the question of which category would properly encompass a service such as AIS.

V. AN ANALYSIS OF THE LEGALITY OF AIS UNDER SECTIONS 16 & 21 OF THE GLASS-STEAGALL ACT

The legality of AIS seems to turn on two basic questions. The first problem is whether the section 16 agency power expressly accorded to banks is a restricted power, and if so, what are the restrictions imposed on the power. The second major problem that must be considered is the extent to which section 21, which dictates the separation of the business of deposit banking from the securities business, imposes limitations on the bank's agency power under section 16 when the bank is not acting as agent.

A. *The Section 16 Agency Power—Restricted or Unrestricted?*

In interpreting the scope of the section 16 agency power, the banks¹⁰⁸ have taken the position that absolutely no limits on the power exist, construing the language of Congress as unrestricted¹⁰⁹ and the cases prior to the Act as expressly recognizing the banks'

106. See the concurring opinion of Chief Judge Bazelon in this case in the Court of Appeals, 420 F.2d 83, 89 (D.C. Cir. 1969).

107. 401 U.S. at 637-38.

108. The proponent banks of AIS include Security Pacific and Chase Manhattan.

109. See note 24 *supra*.

power to engage in agency stock purchase transactions.¹¹⁰ The opponents of AIS, including the ICI and the New York Stock Exchange, argue that although the statute appears unrestricted on its face, the legislative history evidences a congressional intent to sanction only those agency transactions falling within the narrow limits of the pre-Glass-Steagall Act agency transactions. Relying further on the contemporaneous administrative history¹¹¹ and without considering the custodian account as a forerunner of AIS,¹¹² the opponents contend that several restrictions¹¹³ limit the section 16 power. First, the banks can offer such agency services only as an "accommodation" or a convenience to persons who can demonstrate a need for the service. Secondly, the banks can offer the service only to existing bank customers who can demonstrate a previously existing independent banking relationship. Thirdly, the bank cannot advertise the service to the general public. Finally, the bank cannot realize a profit from the agency transactions, but may charge the customer only the reasonable costs. The opponents conclude that since AIS violates these restrictions on all four counts, it exceeds the lawful scope of section 16.

Although sufficient bases seem to exist to support reading these restrictions into the statute, several reasons dictate against the use of such reasoning as the proper grounds for a decision. Neither the statute itself nor the legislative history imposes any direct limitations or restrictions on the power. In addition, how Congress would have acted or would act if the AIS situation arose remains impossible to determine. Furthermore, AIS creates several benefits that cannot be ignored. It presents a convenient method by which a small investor can purchase "blue chip" stocks at a reduced brokerage cost as an alternative to placing funds in a savings account, and possibly provide himself with a better hedge against inflation.¹¹⁴ More importantly, perhaps, without AIS, brokerage firms would most likely always refuse to handle orders of twenty to 500 dollars per month.¹¹⁵ The Comptroller pointed out in his recent opinion authorizing AIS that the service undoubtedly will appeal to many people who previously have never invested in stocks and will provide

110. Compare cases cited in note 49, *supra*, with cases cited in note 50, *supra*. See Memo for Security Pacific at 6-12, *supra* note 46.

111. See notes 69-77, *supra* and accompanying text.

112. See notes 59-68, *supra* and accompanying text.

113. See notes 69-77, *supra* and accompanying text.

114. See note 13, *supra*.

115. Letter from Counsel for Security Pacific to Division of Investment Management Regulation of SEC, *supra* note 13.

needed new sources of capital.¹¹⁶ In addition to stimulating the capital markets in this country, AIS has already proved a procompetitive force in the securities industry. Furthermore, the new bank service provides an encouraging innovation by brokerage firms in giving new services to the often neglected small investor. Merrill Lynch, Pierce, Fenner & Smith, Inc., announced in April, 1974, a new Sharebuilder Plan that allows small investors a reduction in their commissions and a means of investing by the dollar rather than by the share.¹¹⁷ The Comptroller stressed the importance of this procompetitive influence in his approval letter as follows:

The expansion of AIS will be a procompetitive force in a business which has been criticized for unduly rigid pricing patterns and restrictions to entry. We believe such competition will be constructive and not destructive of nonbank competitors. There is no obstacle to brokers offering AIS and in fact the first plans were offered by brokers. It is very possible that in years to come the brokers will find that the entry of banks into AIS broadened interest in the securities market to the great advantage of all competitive suppliers in it. This has been the result in some other fields which banks have entered in recent years such as equipment leasing.¹¹⁸

1. Glass-Steagall Act Policies

In view of the Court's two-step approach in the *Camp*¹¹⁹ case, the benefits of AIS, and the lack of risk that AIS presents to the depositor's funds, it seems necessary to measure AIS against the basic Glass-Steagall Act policies to determine whether AIS contravenes the spirit of the Act. In analyzing these policies, the banks contend that the Act's policy restrictions arose to prevent the bank's investing depositors' funds for the benefit of the banks who derived profits from underwriting, investing, and trading in various securities, and did not apply to the agency power since AIS, with the bank acting merely as an agent to execute the transaction,¹²⁰ presented no risks to depositors' funds. The New York Stock Exchange disagrees, reasoning that since the Supreme Court applied the restrictive policies underlying the Act in *ICI v. Camp*¹²¹ to assess the validity of a commingled managing agency account involving no risk to depositors' funds, the same approach should be utilized to invalidate AIS.

116. CCH FED. BANKING L. REP. ¶ 96,272, at 81,363.

117. Wall Street J., March 29, 1974, at 13 (advertisement); Merrill Lynch brochure, Sharebuilder Plan, 1974.

118. CCH FED. BANKING L. REP. ¶ 96,272 at 81,363.

119. See notes 102-07, *supra* and accompanying text.

120. Memo for Security Pacific at 19-20, *supra* note 46.

121. See note 102, *supra*.

Turning to a discussion of the policies Congress sought to promote as construed by the Court in the *Camp* case, the first problem is whether AIS involves a risk of loss of public confidence in the bank.¹²² The essential feature of this policy relates to the association in the public mind of the reputation of the bank with the fluctuations of a *particular* security. When a bank's affiliate in the 1920's underwrote and sold a corporation's new issue, the investors naturally linked the reputation of the bank directly to the fortunes of the company because of the bank's extensive promotion of the company during distribution. If the company's stock price decreased, a strong possibility existed that an upset public might withdraw its funds on a large scale and threaten the bank with insolvency. As to the collective investment fund involved in the *Camp* case, although the court found a substantial risk of erosion of public confidence the bank was not actually selling a particular security, rather it sold expertise and discretion in choosing a diversified group of investments; consequently, the threat of a decline in the bank's reputation seems less substantial. Similarly, since AIS involves merely an execution service, the threat appears minimal. Moreover, since AIS involves no sale of a bank's investment expertise, AIS presents less danger than exists with a collective investment fund.¹²³

Secondly, Congress expressed concern over the close association of banks with the securities industry, reasoning that the promotion of particular securities and the lucrative profit margins present in the underwriting business hindered the bank's important role as a disinterested investment adviser to customers.¹²⁴ The Comptroller concluded in his approval letter that AIS presents no threat to the bank's role of investment adviser because the banks offering AIS "expressly disclaim any responsibility for the purchaser's investment decisions."¹²⁵ Additionally, the promotional literature and the agreement itself clearly state that the bank does not render investment advice to an AIS participant. Moreover, banks neither make recommendations of individual securities¹²⁶ nor pay commissions to

122. See note 95, *supra*.

123. In summary, the only person the AIS investor can blame for a poor investment decision is himself—the burden is on the investor, not the bank.

124. See note 98, *supra*.

125. CCH FED. BANKING L. REP. ¶ 96,272, at 81,361.

126. It can be argued, of course, that the choice of the twenty-five largest corporations by market value of outstanding stock listed on Standard & Poor's 425 Industrial Index is a recommendation of stocks. But such general investment guidance is not the hazard Congress attempted to guard against under the Glass-Steagall Act. Furthermore, the Comptroller concluded that such general guidance does not constitute "investment advice" as the term is generally used. CCH FED. BANKING L. REP. ¶ 96,272, at 81,361.

officials who sell particular securities. In this respect, AIS differs significantly from the security affiliates of the 1920's and the commingled managing agency account of the 1960's in which the bank personnel sold investment advice to customers. With the security affiliates, the bank personnel encouraged investors to buy a particular stock underwritten by the bank because the bank officials regarded it as having a bright future. In *ICI v. Camp*, bank personnel told investors to buy a share in the bank's fund because of the bank's expertise in portfolio management. In both cases, banks recommended a particular security, but with AIS the banks expressly disclaim and refuse to make any investment recommendation. The customer, with the aid of any independent investment advice he obtains makes the investment decision.

Congress identified as a third hazard the potential for the making of unsound loans by the bank to investors, the companies whose stock was being underwritten, and the affiliate itself.¹²⁷ The Comptroller concluded that AIS posed no increased opportunity for unsound loans because the periodic bank examination process would detect such a lending pattern and prevent its recurrence. The unsound loan argument, the Comptroller reasoned, proves too much in that its adoption would preclude commercial lending to any corporation recommended for investment purposes by the trust department. Although such a divorce has been recommended, the Comptroller stated that the "weight of regulatory opinion is that the probability of abuse can be obviated by the examination process and enforcement of existing trust law."¹²⁸ Finally, in contrast to bank-security affiliate relationships no substantial reasons exist for a bank to favor unduly an AIS company since, under AIS, the bank undertakes no responsibility for the performance of AIS stocks. Any credit or blame is reposed in the individual investor or his independent adviser.

In summary, AIS presents no risk whatsoever to the depositors' funds and only minimal potential for abuse in the areas of public confidence, unsound loans and disinterested investment advice. It appears, therefore, that in the absence of concrete evidence of substantial abuse, AIS does not violate the policies underlying the Glass-Steagall Act as construed by the Court in *Camp*.

2. Other Public Policies

If AIS succeeds in overcoming the two initial hurdles discussed

127. See note 97, *supra*.

128. CCH FED. BANKING L. REP. ¶ 96,272, at 81,361.

above, it faces a third in the New York Stock Exchange's contention, set forth in its memorandum to the Comptroller in support of a rehearing of his favorable AIS ruling, that public policy considerations alone dictate a narrow construction of the section 16 agency power to preclude operation of AIS by the banks. Basing its contention on three specific points,¹²⁹ the Exchange argues first that the operation of AIS raises significant conflict of interest problems.¹³⁰ The bank's interest under AIS lies in utilizing the funds deposited during the acquisition interval between the time of deposit and purchase of securities for as long as possible in order to earn a profit for the bank—a practice known as “float.” The AIS investors' interest, on the other hand, may well lie in effecting the stock purchase as rapidly as possible, especially if the price of the company's stock is rising. Other potential conflicts of interest include the bank's timing of buy and sell orders when it sells for its trust account the same stock as it buys for AIS purchasers and the possible crossing of orders between AIS and the trust department.

The Comptroller properly rebutted these contentions by noting that disclosure to the investor of the limited thirty day acquisition interval and the safeguard of the regular trust examiner's inspection would be sufficient to correct any abuse of the “float.”¹³¹ The potential timing problems of buy and sell orders is not unique to AIS and presents no unusual problems if no party acts on the basis of non-public information.¹³² The Comptroller noted the similarity of an AIS bank to a broker who also acts as an investment adviser for a mutual fund and possibly advises the fund to sell stock while also executing orders for customers to buy stock. As long as no party acts on material, nonpublic information, no problems arise. Finally, with respect to direct crossing transactions between the bank and AIS, the Comptroller noted that no AIS banks permit this type of activity.¹³³

129. As an additional point, the Exchange argues that AIS programs might adversely affect the securities market and the economy. Memo for New York Stock Exchange, at 47-51. The Exchange asserts that AIS channels funds to top quality “blue-chip” stocks aggravating the so-called “two tiered market” problem, hindering other corporations in their efforts to raise equity capital, and reducing liquidity in the markets by increasing the percentage of large securities transactions and decreasing the number of individual orders that are critical to depth and liquidity. Address by Ray Garrett, The Bond Club, in Chicago, Oct. 19, 1973, as quoted in Memo for New York Stock Exchange at 48. Furthermore, to the extent that AIS impairs the capital-raising function of the markets, the general economy also suffers.

130. Memo for New York Stock Exchange *supra* note 1, at 35-42.

131. CCH FED. BANKING L. REP. ¶ 96,272 at 81,362.

132. For the application of Federal Securities Laws to this problem see text accompanying notes 142-47 *infra*.

133. FED. BANKING L. REP., *supra* note 131.

Secondly, the Exchange proposes that the lack of coverage under the Securities Investor Protection Act of 1970 (SIPC) will disadvantage AIS participants.¹³⁴ The Exchange points out that customers of registered broker-dealers receive insurance coverage up to 50,000 dollars under the Securities Investor Protection Act of 1970 whereas AIS investors do not receive this protection. Asserting that the greater actuarial risk of loss through agent insolvency exists with nonbank rather than bank agents, the Comptroller rejected the Exchange's contention, stating that the AIS customer will have his uninvested cash held by a bank during the acquisition interval covered by FDIC insurance up to 20,000 dollars. More importantly, the AIS participant will have his invested money represented by identifiable shares, which as trust assets will not constitute a part of the estate of an insolvent bank. In addition, banks cannot pledge customers' securities as do broker-dealers. Therefore, the Comptroller concluded, the investor has better protection under AIS with the bank as agent than under a comparable program under which a broker-dealer acts as the agent.¹³⁵

Thirdly, the Exchange contends that the lack of federal securities law protections under AIS mitigates against the legality of such a program.¹³⁶ The specific protections alluded to include the lack of a "know your customer" or "suitability" rule and the lack of adequate disclosure protection under the 1933 and 1934 Acts due to the exemptions accorded to banks by both acts. The Comptroller rejected the former as inapplicable to AIS since the bank refuses to recommend investments to participants. On the disclosure question, the Comptroller noted that since the registration, reporting, proxy, and prospectus requirements of both securities acts apply to the issues of the stock offered under AIS, the participant receives full disclosure protection. More importantly for enforcement purposes, the antifraud provisions of these laws apply to the banks as well as nonbank broker-dealers.

The Comptroller further declared that "the AIS customer is in the same position with regard to these statutes as he would be if he were dealing with a broker," a possibly misleading statement because of one significant difference—the broker is regulated by the SEC while the AIS bank is regulated by the Comptroller. Although the Comptroller's approval letter quite properly does not address

134. Memo for New York Stock Exchange *supra* note 1, at 42-46.

135. *Id.*

136. Memo for New York Stock Exchange *supra* note 1, at 42-46.

the difficult problem of having separate agencies regulating competing investment services, he does itemize the safeguards provided to AIS participants under the banking laws—regular bank examinations and reports to the Comptroller,¹³⁷ FDIC insurance protection,¹³⁸ customer protections in event of bank insolvency,¹³⁹ the cease and desist power, and the removal and suspension power accorded to bank regulatory agencies for use in the event of unsafe and unsound banking practices.¹⁴⁰

Upon analysis, the Comptroller's decision that resolution of the regulatory problems at this point is unnecessary seems well founded. Although the substantial public policy considerations raised by the AIS opponents require close scrutiny, particularly if supported by concrete evidence, these policies, in view of the unrestricted, unambiguous statutory language of section 16 authorizing an AIS service, appear more relevant to future regulation than to the statutory validity of AIS. The following rationale of the Comptroller best summarizes the proper treatment of the policy questions:

Since our opinion is that Section 16 on its face clearly and unambiguously permits AIS service, such considerations are matters more relevant to future supervisory vigilance than to the statutory interpretation which is the subject of this letter.¹⁴¹

A potential problem with the Comptroller's position is the Supreme Court's purported examination of the public policy underlying the Glass-Steagall Act in *ICI v. Camp* and the use of such policy analysis as a ground for its decision. The critical point, however, seems to be the recognition of which public policy arguments materially relate to the issue of the legality of AIS. The appropriate

137. Every national bank is subject to examination twice in each calendar year unless one examination in a 2-year period is waived by the Comptroller. 12 U.S.C. § 481 (1970). In addition the trust department is subject to a separate examination once a year. Every national bank must make at least 4 reports of condition to the Comptroller each year disclosing its assets and liabilities and such other reports as required by the Comptroller. 12 U.S.C. §§ 161, 64 (1970).

138. Investors' funds deducted from checking accounts and awaiting investment under AIS during the acquisition interval are deposited in special accounts which are eligible for FDIC protection. 12 U.S.C. §§ 1813(l)(3), (m) (1970).

139. Stocks held for AIS customers are segregated from other property, do not constitute assets of the banks, and will not be subject to any prior claims in case of bankruptcy. Banks also are required to take specific security precautions with respect to cash and securities, including security devices and procedures, and to report to the Comptroller with respect thereto. 12 U.S.C. §§ 1881-84; 12 C.F.R. pt. 21 (1974).

140. 12 U.S.C. § 1818 (1970); 12 C.F.R. pt. 19 (1974).

141. CCH FED. BANKING L. REP. ¶ 96,272, at 81,360 (1974).

policy problems to examine on the legality issue are those that Congress investigated in enacting the Glass-Steagall Act in 1933—namely, public confidence, maintenance of the banks as disinterested investment advisers, and the avoidance of unsound loans. The policy problems raised by the Exchange—conflicts of interests in banks, inadequate insurance protection, and a lack of federal securities law protections—were not considered by the Court in *ICI v. Camp*, and likewise, should not be considered on the AIS question since they relate more properly to the problem of the regulation of AIS. Since any resolution of the regulation question should come only after a final determination of whether AIS violates section 16, the policy considerations introduced by the Exchange should not constitute the basis for a decision on the scope of section 16.

B. The Section 21 Securities Business Restrictions—The Separate Security Argument

Assuming that the section 16 agency power validates AIS, one must confront the second major problem—whether the section 21 restrictions imposed on banks participating in the business of issuing, underwriting and distributing securities apply to AIS. The proponents of AIS argue that the proviso to section 21¹⁴² eliminates any possible section 21 restrictions relative to banks engaging in the securities business.¹⁴³ The Exchange, however, proposes the ingenious argument that even if AIS is valid within the scope of section 16, section 21 applies because AIS involves the issuance of “separate securities.”¹⁴⁴ The Exchange regards the AIS investor’s interest in the funds awaiting investment during the acquisition interval as a “security” within the Securities Act of 1933¹⁴⁵ since each purchaser possesses neither funds nor the right to withdraw them, but rather an undetermined interest in the pooled funds and an interest in an unspecified number of shares of a particular stock to be purchased. In addition, the Exchange asserts that the fractional shares composing an inevitable part of AIS also constitute securities. With these interests construed as securities, the bank would become an “issuer” or “underwriter” for purposes of the Securities Act, and thus AIS could violate section 21 because the bank engages in the busi-

142. See note 25, *supra*.

143. Memo for Security Pacific *supra* note 46, at 38-42.

144. Memo for New York Stock Exchange *supra* note 1, at 24-33.

145. As stated, the Court in *ICI v. Camp* implied that the definition of security for purposes of the Glass-Steagall Act corresponds with the definition under the Securities Act of 1933.

ness of "issuing, underwriting, selling, and distributing"¹⁴⁶ securities.

The separate security argument presents possibly the most serious threat to the legality of AIS because it relates closely to the rationale adopted by the Supreme Court in *Camp* in invalidating the commingled managing agency account. The Comptroller, however, rejected the separate security argument and distinguished the *Camp* case on several grounds. In *Camp*, the investor purchased "units of participation" representing a proportionate interest in a collective pool of assets. These units of participation were registered as securities pursuant to the Securities Act of 1933, and the Fund itself was registered as an investment company under the Investment Company Act of 1940. The Court found that the "units of participation" constituted "securities" and that the marketing of such securities by a bank violated section 21. In the AIS situation, the Comptroller concluded, there existed no separate fund of assets requiring registration under the Investment Company Act of 1940 and no separate securities requiring registration under the 1933 Act. Furthermore, AIS involves no management committee or investment advisory group because no management of assets occurs. The Comptroller asserted that the Exchange's argument represented a "strained construction" of the applicable statutes and that the uninvested cash and fractional shares constitute "mere book entries incidental to the main agency transaction." The Comptroller noted that the SEC may have "tacitly confirmed" the Comptroller's conclusion since the Commission has issued no action letters with respect to AIS.¹⁴⁷

The Comptroller's analysis appears proper. Although the Supreme Court indicated in *ICI v. Camp* that the scope of the definition of "securities" for purposes of the securities laws corresponds to the scope of the term for the banking laws, it seems more accurate to distinguish the different purposes underlying the two statutes and accord a narrower scope to the term securities for purposes of section 21 of the Glass-Steagall Act. The purpose for the broad scope of the term in the securities laws is to extend the protection and benefits of the act to as many investors who need such protection as possible. A basically different purpose underlies the Glass-Steagall Act in general and section 21 in particular. To construe the term "security" under section 21 to include the uninvested cash and

146. See note 25, *supra*.

147. CCH FED. BANKING L. REP. ¶ 96,272, at 81,359-60 (1974).

fractional shares involved in AIS conflicts with the clear authorization of agency services under section 16. Section 16 specifically permits banks to engage in certain securities transactions and prohibits others. Section 21 merely reinforces section 16 in broader, more general terms, and thus the general language of section 21 should be read consistently with the specific language of section 16. The Glass-Steagall Act was designed to restrict certain bank security transactions in order to protect depositors' funds, but an agency stock transaction did not come within the restricted group. A contrary reading that logically follows adoption of the separate security argument must be viewed as improper. Uninvested cash and fractional shares are merely incidental by-products of a transaction which in substance constitutes an agency service.

V. CONCLUSION

In analyzing the legality of AIS under the Glass-Steagall Act, this Note has considered the general background of the Act, including the legislative and administrative history surrounding sections 16 and 21. Turning to the *ICI v. Camp* case, the Supreme Court's two-step approach to problems arising under sections 16 and 21 was studied. Finally, analysis was made of the principal arguments for and against AIS with a particular focus on the response of the Comptroller.

The legality of AIS remains unclear. Although several possible bases exist for invalidating the service, the public may derive numerous benefits from allowing banks to offer AIS; furthermore, no risks to depositor's funds exist and only minimal threats to the bank's reputation and its ability to provide independent credit judgment and serve as a disinterested investment adviser. Finally, although AIS may extend beyond the types of agency purchase services offered by banks in the pre-Glass-Steagall years, it still seems encompassed by express authorization of section 16 since it does not violate the policies underlying the Act.

If the courts uphold AIS, the question becomes who should regulate AIS and how should it be regulated. AIS would be subject to minimal regulation by the banking authorities and some question presently exists as to whether the SEC has the authority to regulate AIS because banks possess express exemptions from the regulations of the Securities Act of 1933 and the Securities and Exchange Act of 1934. It is essential to recognize, however, in determining the validity of AIS under the Glass-Steagall Act that the policies and

arguments surrounding the regulation issues, although certainly important, should not hinder a proper analysis of the legality issue.

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