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Thinking the Unthinkable: What Should Commercial Banks or Their Holding Companies Be Allowed to Own?

CYNTHIA C. LICHTENSTEIN*

INTRODUCTION

Long before Congress enshrined the shibboleth of the separation of banking and commerce in the Bank Holding Company Act of 1956,1 states in chartering state banks and Congress in chartering national banks limited banks to the "business of banking"2 by deliberately failing to provide intermediaries with the power to take shares in other corporations.3 The expressed reason for the restriction was the need to ensure that commercial banks, which were chartered to funnel deposits from the public into short-term working capital loans to businesses, did not make themselves illiquid with equity investments or risk those deposits in businesses that the bank was ill equipped to manage. The restriction's effect, however, was to ensure that the banks did not sneak into other forms of business through investment

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1. 12 U.S.C. §§ 1841-1850 (1988 & Supp. 1989-1990) (§ 1845 repealed 1966). The original Act applied only to bank holding companies owning or controlling two or more commercial banks. It was less a response by Congress to the use of a holding company to combine banking and nonbanking business than it was an effort to preserve the local character of banking by ensuring that the holding company device was not used to permit national expansion across local and state lines. Only after the money center banks, led by what was then First National City Bank, proceeded to use the holding company form (with a one-bank holding company not at that time subject to the Act) for expansion into other forms of business did Congress in the Bank Holding Company Act Amendments of 1970 focus full force on the policy of separation of banking and commerce policy. See generally Lichtenstein, Foreign Participation in United States Banking: Regulatory Myths and Realities, 15 B.C. INDUS. & COM. L. REV. 879, 917 (1974). For the early history of the BHCA, see Hackley, Our Baffling Banking System, 52 VA. L. REV. 565, 569-80 (1966).


3. However, entities chartered as "banks" were given the power to take shares in such quasi-public enterprises as canal building and operation that the states wanted to support with deposits.
in the equity of commercial companies. Banking regulators came to see the value of this effect as concern over the potential for banks and bank holding companies to self-deal became apparent.

As this Article will explain, the dual concerns of protecting the safety and soundness of banks and of preventing overreaching continue to drive banking regulation today. However, the means chosen by Congress to implement those purposes confuses them, making domestic compliance inefficient and costly. Moreover, the Federal Reserve Board (the Fed) has compounded the problem internationally because it has exported the domestic notions about the means of separating banking and commerce into the newly revised Regulation K, the mechanism by which the Fed regulates bank holding companies operating abroad. The consequence is unnecessary interference with United States banks' ability to compete internationally.

This Article begins by examining how the idea of equity limits developed domestically. It then discusses in detail how this notion was exported into Regulation K and how it affects both the securities and investment operations of United States banking organizations operating overseas. The Article concludes with recommendations for congressional action to eliminate the confusion these notions cause both at home and abroad.

I. DOMESTIC LIMITS ON EQUITY INVESTMENTS

A. The Evolution of Limitations

Even before passage of the Bank Holding Company Act (BHCA), banks, by definition, were to be judges of credit worthiness, not venture capitalists or entrepreneurs making judgments as to what would sell. The states had too much experience with companies with banking powers that failed in their other ventures and went under, taking their deposits and their outstanding notes with them. Banking was thus separated from commerce, for safety and soundness reasons, by a prohibition on equity investment.

During the period of enactment of banking statutes by the major commercial states and at the time of enactment of the National Bank Act by
Congress, there was no concern with the nature of the shareholders in such banks or with the possibility of combining banking and commerce in a holding company. While a shareholder might be engaged in commerce, the bank was not so engaged; the shareholder's activities were not considered a threat to the bank's safety and soundness.\(^9\)

The recognition that bank affiliations could threaten the bank burst upon the scene with the Great Depression and the hearings Congress held prior to passage of the Banking Act of 1933.\(^{10}\) The result was the separation of commercial banking and investment banking in the Glass-Steagall Act,\(^{11}\) not because investment banking was a business so foreign to commercial banking that it could not be considered within the capacities of commercial bankers, but because of what the Supreme Court has termed, in an infamous phrase, the "subtle hazards" of the combination.\(^{12}\)

In 1933, Congress took a preliminary look at member banks'\(^{13}\) other affiliations and set up a system requiring those owning or acquiring control

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9. The National Bank Act contained a double liability provision for shareholders, making them equally ratable and liable "for all contracts, debts, and engagements of such association [the national bank] to the extent of the amount ... invested in such shares." Id. at 103. Thus, in theory, depositors were protected from bank failure by having the double liability of the national bank's shareholders to fall back upon. By the 1920s, however, Congress had shifted its focus from imposing liability on shareholders to regulating director and officer control of bank funds in developing an investment portfolio. See H. Willis & J. Chapman, The Banking Situation: American Post-War Problems and Developments 532 (1934). The double liability provisions were all but removed with the institution in 1933 of the federal scheme of deposit insurance.


13. "Member banks" are banks that are members of the Federal Reserve System and subject to an additional layer of federal supervision. National banks are required to be members; state incorporated banks may choose to become members and, if they do, subject themselves to certain prudential limitations imposed upon national banks. See E. Symons & J. White, supra note 7, at 26. For example, Congress in the Glass-Steagall Act chose to forbid all entities taking deposits subject to check to be at the same time "engaged in the business of issuing, underwriting, selling or distributing . . . securities," 12 U.S.C. § 378(a)(1), but only forbade affiliations between member banks and companies engaged principally in such business. 12 U.S.C. § 377. Thus, there is no federal ban on such state nonmember bank affiliations unless the FDIC declares the connection with a securities business to be an "unsafe and unsound" practice, and the FDIC has generally deferred to the states' notions of what are appropriate affiliations for state banks. However, Congress applied to nonmember insured banks the "firewall" provisions regulating bank lending to affiliates that had previously only applied to member banks and their affiliates. Act of July 1, 1966, Pub. L. No. 89-485, § 12(c), 80 Stat. 236, 242. See infra text accompanying note 17.
over a member bank to apply to the Federal Reserve (the Fed) for permits to vote their stock. The Fed could also examine and require reports from the holding company affiliates. The voting and reporting requirements did not prevent, nor apparently were they intended to prevent, the combination of banking and commerce through a holding company; they simply gave the Fed a method of supervising bank affiliations. However, unlike the states' banking statutes and the National Bank Act, which did not address solvency of bank owners, Congress in 1933 was concerned with the financial stability of the holding company structure: It required a ratio of assets in the holding company to support the subsidiary bank's balance sheet.

Equally as important as the financial stability of the holding company was a new concern: that bank deposits might be used to make unfair and undeserved loans to affiliates. The affiliate provisions of the Banking Act of 1933 had a third prong that put limits on the total quantum of loans a bank subsidiary could make to other affiliates and required those loans to be heavily secured. The provision arose out of fear that a bank's owners could overreach; that is, a bank subsidiary could be used to give a competitive advantage to the bank owners' other businesses. This prong, section 23A of the Federal Reserve Act, was, and still is, the first "firewall" to insulate a bank from its affiliates so that the bank's credit decisions will be neutral.

Thus, by the time Congress began to consider the Bank Holding Company Act, there existed two ways of dealing with the tendency of bank owners to self-deal. One was the method used in the Glass-Steagall Act, which was to prohibit absolutely joint ownership of securities firms and commercial banks. The second was the method used in section 23A of the Federal

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14. Banking Act of 1933, ch. 89, § 19, 48 Stat. 162, 186 (1933); see also Lichtenstein, supra note 1, at 891-94.

15. See Banking Act of 1933 § 19, 48 Stat. at 187 (adding paragraph (b) to R.S. 5144, 12 U.S.C. § 61 (1988)). Five years after enactment of the Banking Act of 1933, the holding company affiliate was required to possess readily marketable assets other than bank stock in an amount not less than 12 per centum of the aggregate par value of all bank stocks controlled by such holding company affiliate, which amount shall be increased by not less than 2 per centum per annum of such aggregate par value until such assets shall amount to 25 per centum of the aggregate par value of such bank stocks; and (2) shall reinvest in readily marketable assets other than bank stock all net earnings over and above 6 per centum per annum on the book value of its own shares outstanding until such assets shall amount to such 25 per centum of the aggregate par value of all bank stocks controlled by it.

Id.


Reserve Act, which was to place special restrictions on lending and other relationships between a bank and its sisters or parent.18

B. The Bank Holding Company Act and Its Confused Policy Purposes

By 1956, Congress determined that, at least with respect to companies owning two or more banks, a holding company system, the method of totally prohibiting joint ownership of nonfinancial firms and commercial banks would be the preferable way of attacking the self-dealing problem. Although Congress in successive amendments to the Bank Holding Company Act has tinkered with the concept of what is included in “banking” and other financial business and what is impermissible nonfinancial business, the BHCA since 1956 has forbidden any company that owns banks or, as of 1970, a bank19 to own or control five percent or more of the voting stock of companies engaged in impermissible activities.20 This prohibition includes indirect ownership of voting stock through nonbank subsidiaries of the holding company and, although the interpretive issue is presently in litigation,21 possibly ownership through bank subsidiaries of the holding company.

Since the measurement of the holding company system’s investment is the percentage of the investee’s voting stock that the holding company owns, this prohibition is not driven by concern for the financial health of the holding company and its banks. If prudential concerns were at issue, the limit would be a ratio of the holding company’s capital to the amount invested22 or even a total amount beyond which the regulator would have to review the proposal.23

Since a prohibition on holding voting stock of nonfinancial companies is not an efficacious method of preserving the health of banks as equity

18. Id.


23. It is true that a limit based on a percentage of the equity owned is a rough surrogate for distinguishing between a portfolio investment and an entrepreneurial joint venture in a business that the banking organization knows little about in terms of management. Presumably, however, if banks and their owners know only credit and not investment, neither should be allowed to invest in equity at all. Nevertheless, bank holding companies are not prohibited from investing in equity, only from taking more than five percent of the voting stock of a nonfinancial company.
owners, one can only conclude that the BHCA prohibition is related to the issue of overreaching. But this line of thought raises the question: If an elaborate system of firewalls is sufficient to avoid the "subtle hazards" of combining commercial and investment banking, why would not firewalls between a system's banks and its other interests take care of similar overreaching hazards in the combination of banking and commerce?

Such firewalls already exist in sections 23A and B of the Federal Reserve Act. Moreover, it is easy enough to institute a prohibition on depository institutions' lending to bank holding company affiliates or to insist that the parent nonbanking holding company do all the funding of the commercial arms. It is also easy to draft a prohibition that would limit participation in the payments system to the highly supervised banks in the system. With such prohibitions, a company owning a bank would not invest in a commercial enterprise unless the managers believed that the enterprise could attract financing from nonaffiliated lenders.

In effect, the Treasury Department reached this conclusion concerning the present separation of banking and commerce in the United States regulatory structure. The Treasury proposed legislation that would permit commercial enterprises to invest—indirectly—in banks. However, the Treasury in drafting its legislation became entangled in elaborate conceptions concerning the prudential function of the BHCA bank/commerce separation and has provided for financial services holding companies, which, like their predecessors, the bank holding companies, are limited to holding no more than five percent of the voting stock of nonfinancial companies. Given that the bill would permit nonfinancial company investment in the financial services holding companies, why should one complain about the retention of the old BHCA test? The remainder of this Article tries to make this case.


27. Section 1001 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. § 1811 (1988 & Supp. 1989), directed the Treasury Department to conduct a study of the United States Federal Deposit Insurance System and to include the Treasury's suggestions for modernizing the U.S. regulatory structure for financial institutions. See DEPARTMENT OF THE TREASURY, supra note 4. H.R. 6, supra note 24, is the House Banking Committee's much redrafted version of the bill that the Treasury introduced into the House to implement its study recommendations.

28. Supra note 24.
II. INTERNATIONAL BANKING AND EQUITY LIMITATIONS ON SECURITIES ACTIVITIES

In April, 1991, the Fed, the regulatory authority primarily concerned with regulation of United States banking organizations' foreign activities, released its complete revision of the International Banking Regulation, Regulation K.29 In the process of revising Regulation K, the Fed staff tried to reconcile the notions it had developed in carrying out its responsibilities under the BHCA to separate banking and commerce by counting equity to make sure no one was sneaking into "impermissible" activities with the congressional authority granted United States banks in the Edge Act30 to invest indirectly in equity abroad—and, indeed, to hold equity abroad in the course of international securities activities. The revisions demonstrate intellectual confusion in both the changes to investment powers for United States banks under Regulation K and the additional regulation imposed upon United States banks' participation in the international securities markets.

A. The Evolution of Edge Corporations and Regulation K

In 1919, when Congress, through the Edge Act, provided for federal incorporation of organizations (Edge Corporations) to engage in "international or foreign banking or other international or foreign financial operations,"31 Congress intended not only to encourage United States exports, but also to use American capital to help rebuild war-devastated Europe. Congress specifically expected Edge Corporations to act as merchant banks, taking equity and long-term debt interests in European enterprises. Thus, even though Edge Corporations were granted broad banking powers, including such banking and financial operations as the Fed might determine to be usual abroad where the Edge Corporation was conducting its business, Congress also specifically gave Edge Corporations the authority, subject to the Fed's consent, to "purchase and hold" stock or "other certificates of ownership" in foreign or domestic corporations so long as those corporations were not engaged in general commercial business in the United States but were only transacting business in the United States connected to their international or foreign business.32 At the time, Congress had no intention, so far as can be learned from the legislative history of the Edge Act, of exporting abroad the United States' conception of the necessity of separation

29. Regulation K, supra note 5.
31. Id. § 611.
32. Ch. 18, § 615c, 41 Stat. 380 (1919). Similar authority was not granted to national banks or state member banks at that time or now.

However, Congress in 1919 was not unconcerned with the prudential aspects of these new international banking entities it was authorizing. For example, the Edge Act (in a now-repealed provision) limited the total liabilities of an Edge Corporation. In addition, any Edge Corporation that intended to invest more than ten percent of its capital and surplus in any one corporation (more than fifteen percent in a corporation engaged in the business of banking) needed—and still needs—the Fed's approval. Furthermore, to ensure that domestic banks did not become too heavily invested in these broadly defined new international merchant banking organizations, Congress authorized national banks to invest in these new entities, as well as in state-chartered corporations with similar powers (so-called Agreement Corporations), but only up to an amount in the aggregate not exceeding ten percent of paid-in capital and surplus of the investing national or state member bank. In short, Congress provided as the prudential measure a cap on total investment by United States banks in the new activities and investments abroad and indicated that the Fed was to look specifically at any Edge investment representing more than ten percent of the Edge Corporation's capital and surplus.

When Congress in the 1950s enacted, and in 1970 revised, the BHCA to regulate the growing combination of domestic banking and nonfinancial activities through the bank holding company device, it did not touch the Edge Act's structure. Nor does the legislative history of either the BHCA or its 1970 amendments indicate any interest on Congress's part in exporting the domestically mandated separation of banking and commerce. To the contrary, the legislative history of the International Banking Act of 1978, which provided the federal structure for foreign bank entry into the United States, is replete with congressional efforts to ensure that domestic regulation of foreign banks would not impose the United States notion extraterritorially on foreign banks in their foreign business. The BHCA does have specific exemptions for foreign bank holding company activities or holdings, all subject to the Fed's discretion, as well as a special provision for United

35. State banks that are members of the Federal Reserve System are also covered by this congressional authorization. Together, these two categories today cover all but a minuscule number of U.S. banks engaged in business abroad.
States bank holding company ownership (otherwise than through an Edge Corporation) of foreign companies whose business in the United States is only "incidental." However, as far as the structure of overseas activities conducted by a United States bank through its Edge Corporation is concerned, one can assume that Congress meant that structure to be exempt from bank holding company regulation under the BHCA exemption for "shares . . . of the kinds and amounts eligible for investment by" national banks.

When Congress decided to regulate foreign bank entry into the United States banking markets in the International Banking Act of 1978, it also overhauled certain aspects of the Edge Act (not relevant here) and rewrote its instructions to the Fed as to how it should regulate Edge Corporations. Since Congress was thinking about the powers of foreign banks in the United States, it added to its statement of purposes of the Edge Act the command that Edge Corporations should have "powers sufficiently broad to enable them to compete effectively with similar foreign-owned institutions in the United States and abroad." In connection with this broadening of the instructions to the Fed, Congress instructed the Fed to undertake every five years a review of its regulations under the Edge Act "to ensure that such purposes are being served."

At the time of the 1978 Act, the Fed had already permitted some United States banks to have securities activities abroad through their Edge Corporation subsidiaries, and Edge Corporation subsidiaries had been acquiring, since the original enactment of the Edge Act, equity interests in foreign companies. This activity suggests that the Fed had concluded that Congress did not intend to export fundamental notions of domestic banking regulation. The Fed's present staff, however, in preparing the 1991 revisions to
Regulation K in the portions of the Regulation affecting the securities activities of United States banks abroad and the powers of United States banking organizations to acquire equity interests abroad, has confused congressional policy directions emanating from the BHCA (the separation of banking and commerce) and the Fed’s legitimate area of concern with United States banking organizations’ Edge subsidiary activities and investments—the safety and soundness issues.


When the Fed announced the 1991 revisions, it claimed that they would expand the existing authority to engage in underwriting and dealing in equity securities outside the United States. The statement is true as to underwriting authority, but the revisions to Regulation K so restrict the dealing powers of United States bank-owned broker-dealers abroad, for reasons unrelated to prudential considerations, that the capacity of the entities to compete abroad in either underwriting or dealing may well be doubted.

When the Fed completely rewrote Regulation K after Congress passed the 1978 International Banking Act, it added to the list of permissible foreign activities of Edge Corporations the securities activities it had previously approved by order for individual banks: underwriting, distributing, and dealing in debt and equity securities outside the United States. Presumably for prudential reasons, each equity underwriting commitment by a subsidiary of an investor (a defined term) for shares of an issuer was limited to two million dollars and could represent no more than twenty percent of the capital and surplus or voting shares of the issuer.

These limits were placed only on equity underwriting commitments, not on dealing in equity securities. The 1979 Regulation restricted dealing in

44. In fairness to present staff, it must be pointed out that Regulation K has, at least since the Fed’s general consent to equity investments was codified in 1969, limited Edge investment in voting stock of companies to not more than 25%, presumably to ensure that banks did not get into activities through foreign subsidiaries abroad that they would not be permitted to do at home—but the original theory of the restriction seems to have been prudential. Foreign Acquisitions of U.S. Banks and the Non-Banking Activities of Foreign Bank Holding Companies: Hearings Before a Subcomm. of the Comm. on Government Operations, House of Representatives, 96th Cong., 2d Sess. 372 (1980) (statement of Henry C. Wallich, Member, Board of Governors of the Federal Reserve System). Present staff are explicit in their belief that the BHCA § 4, 12 U.S.C. § 1843, prohibition should be read through into Edge “holdings,” but seem unaware of the import of the BHCA § 4(c)(5) exemption.


equity securities only by an ultimate limit coming out of a separate provision of Regulation K. This provision related to the total amount of shares (and subordinated debt where shares were also owned) an investor could own in nonfinancial companies.\textsuperscript{47} The limit, which is called the “aggregate portfolio investment limit,” is measured by 100 percent of the investor’s capital and surplus, and the provision requires counting for the purpose of the limit “securities held in trading or dealing accounts.” Diligent search of the Fed materials available to the public has revealed no stated reason for the inclusion of securities held in trading and dealing accounts in this limit, but one assumes that, since the limit is dependent on a measure of the \textit{financial strength} of the holder (the measure that Congress used in 1919—a percentage of capital and surplus of the investor), the aim was prudential.

This aggregate portfolio investment limit is retained by the final 1991 Regulation K revisions, but it is changed by (1) measuring it against Tier 1 Capital\textsuperscript{48} of the investor, rather than against capital and surplus; (2) adding to the limit underwriting commitments made under Edge Act authority; and (3) adding to the limit any “portfolio investments” in nonfinancial companies made by the “affiliates” of the investor. For bank holding companies, the limit is now stated as twenty-five percent of Tier 1 Capital.\textsuperscript{49}

Since the 1991 revisions have changed the definition of “investment” to include the ownership or control of “equity” and “equity” is defined to include warrants and convertibles and “loans that provide rights to participate in the profits of an organization,” the calculation of the effect of the revised aggregate limit on any particular bank’s participation in the international capital markets outside the United States is unpredictable. Adding in “affiliates” here could mean that if the banking organization, through the holding company, engages in or if the holding company’s subsidiaries engage in certain types of domestic (or foreign) \textit{financing} involving the acquisition of warrants or loans that fall into the new definition of “equity,” such financing activities will affect the quantum of inventory of shares that the organization’s foreign broker-dealer may hold. This is a possibility because the \textit{aggregate} limit is on all \textit{holdings} of “equity” of nonfinancial companies.\textsuperscript{50}

\textsuperscript{47} Id. § 211.5(b)(1)(i)(C).

\textsuperscript{48} The term is defined in Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure, 12 C.F.R. § 208 app. A (1991).

\textsuperscript{49} 56 Fed. Reg. 19,565 (1991) (to be codified at 12 C.F.R. § 211.5(b)(iii)(A)(2)).

\textsuperscript{50} If the banking organization has a domestic securities affiliate, all “investments” in “equity” owned by it would, under the literal language of the revisions, have to be counted, except that revised Regulation K specifically exempts “shares” held by such an affiliate from the computation. 56 Fed. Reg. 19,565 (1991) (to be codified at 12 C.F.R. § 211.5(d)(14)(iv)).
Since the pre-1991 aggregate limit applied only to investments (as then defined) made directly or indirectly by the entity whose capital was the test and did not include organization-wide interests held by “affiliates,” one suspects that the above interpretation, including in the test “investments” by “affiliates,” is a drafting error not intended by the Fed. To test organization-wide holdings of equity by the capital of an Edge Corporation subsidiary or of a foreign bank subsidiary of a member bank is an anomaly. Equally, the drafting is peculiar in that only “shares” held in trading or dealing accounts authorized under the Edge Act are part of the calculation, and nothing in revised Regulation K indicates whether the term “shares” includes rights to acquire shares that are covered by the term “equity.”

The Fed, in its preamble to the revisions, has suggested that the purpose of the aggregate limitation is safety and soundness and that the limitation has been adopted as revised “to make certain that the overall capitalization of an investor is not impaired by market and other risks attendant to equity holdings in nonaffiliated companies.”

The staff report to the Fed on the comments received on the revisions as proposed admitted that the limit was a very rough surrogate for any measure of market or position risk. One cannot really quarrel with the Fed for trying to adopt some prudential limitations on participation by United States banks as broker-dealers in the international capital markets. However, why underwriting or position risk should be specially appreciated for positions in nonfinancial companies as opposed to positions in shares of financial companies is not immediately apparent. Market risk is market risk, regardless of the nature of the issuer.

The distinction makes one think that, despite its protestations, the Fed has taken its cue from the domestic policy against combining banking and commerce and mixed prudential issues with the question of the nature of the activities carried on by the “investee.” The preamble to the revisions also indicates that the Fed staff was aware of the adverse comments on the provision as revised. The commentators stressed the inhibiting effect the revisions might have on United States organizations’ capacity to engage competitively in underwriting and dealing in the international markets, and the preamble states that the Board will monitor future developments “to determine the continued appropriateness of the aggregate limitation.”

Even if one cannot quarrel with the Fed over prudential limitations, using the aggregate portfolio investment limit as a check on the risks of shares held in trading and dealing accounts operated under Edge Act authority

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51. Id. at 19,549, 19,555.
52. Presumably, the offshore broker-dealers are all subject to host country regulation in their host countries. Certainly all broker-dealers in the United Kingdom, for example, are subject to the Securities Industry Association’s capital requirements, which have very sophisticated measures of position risk in equity-dealing accounts.
would appear more reasonable in the case where there were no other prudential limitations on that authority. However, the current set of revisions directly addresses both the old limits on equities underwriting and the question of setting direct prudential limits on the amounts of equities held in trading or dealing accounts. The previous limit on underwriting commitments of two million dollars per subsidiary has been changed to permit, with the approval of the Board, underwriting commitments "by an investor and its affiliates" (not including in "affiliates" a domestic securities affiliate subsidiary) of up to the lesser of sixty million dollars or twenty-five percent of the investor's Tier 1 Capital.\(^4\)

There is also provision made for obtaining special permission for additional underwriting authority over the sixty million dollar limit on certain conditions relating to the capital of the bank and its holding company where the securities activities are conducted by a subsidiary of a United States bank.

The Board thus seems very much aware of the safety net issues where the securities business is conducted inside the bank chain. However, just what including the underwriting commitments in the aggregate portfolio investment measure adds to this panoply of prudential limits is unclear. Moreover, it is an anomaly to include underwriting commitments in an "investment" limitation for another reason.

The provisions in Regulation K on investments by Edge Corporations implement the section of the Edge Act giving Edge Corporations the power to "purchase and hold stock." On October 19, 1979, Frederick R. Dahl, then Associate Director of the Division of Banking Supervision and Regulation, circulated to the officers in charge of international applications at each Federal Reserve Bank a set of "Questions and Answers" on the then new Regulation K issued in 1979. Page three contains the following question: "May foreign subsidiaries underwrite and distribute abroad the shares of United States companies or of foreign companies that transact business in the United States that is not incidental to international or foreign business?" The answer was "Yes. The statutory limitations on investments in companies doing business in the United States refer to the holding of shares and not to the underwriting of shares."\(^5\)

Had this interpretation by the Fed staff in 1979 also been explicitly drafted to say that dealing in shares (that is, having an inventory of shares of an issuer for sale as a dealer) under the 1979 securities authority is not the "holding" of shares for the purposes of the Edge Act limitations on

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4. The former permissible deduction of binding commitments from subunderwriters or other purchasers is still included.

5. Letter with attached Questions and Answers on Revised Regulation K from Frederick R. Dahl, Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, to the Officer in Charge of International Applications at Each Federal Reserve Bank (Oct. 19, 1979) (copy on file with the Indiana Law Journal).
investments, the present staff might have been saved a great deal of
difficulty. It is in the 1991 Regulation K revisions to regulate foreign
securities dealing by United States banking organizations that the greatest
intellectual confusion concerning the policy of limiting "investment" in
nonfinancial companies, and the need for prudential supervision, seems to
have arisen.

While an inventory of the equity securities of an issuer certainly entails
risk, it is the typical risk of any dealer that the goods will not be sold at
a profit, that the market for the goods will fall or disappear. The dealer
has an investment in his inventory; he has not made an "investment" in
the particular issuer in any sense known to Congress when it gave Edge
Corporations the authority to "purchase and hold stock" in companies not
in commercial business in the United States.

Nevertheless, the Regulation K revisions as proposed would have limited
authorized dealing to equity securities of foreign issuers and not permitted
the securities affiliates to deal in securities of United States issuers. The
commentators, of course, pointed out that to so revise Regulation K would
put United States banks' foreign securities affiliates out of business. The
natural customers for underwriting are United States corporations raising
capital abroad; a broker-dealer that does not end up with an inventory of
the issue to provide continuing liquidity for the offering will not be asked
to bid for the underwriting.

The final revision permits dealing in the shares of United States organi-
zations as well as shares of non-United States organizations, but limits the
dealing in United States issuer shares to dealing with "foreign persons"
only. "Foreign person" is defined in the revision as being an office or
establishment located, or individual residing, outside the United States, thus
keeping the overseas arms of United States broker-dealers available as
counterparties for United States banks' securities arms. The limitation is
apparently intended to ensure that the dealing stays offshore and that the
authorized broker-dealers are not used to evade the strict conditions limiting
the domestic securities business done by United States bank holding com-
panies in their domestic securities subsidiaries.

The second limitation put on dealing in shares of United States issuers,
however, is not supported by such a reasonable rationale. The revisions
impose upon a dealer's inventory of shares of a United States issuer a
limitation, lifted from the BHCA's prohibition in section 4 of the Act, on
the acquisition of five percent or more of the voting shares of any company

56. As the great securities law professor (and former SEC Commissioner) Louis Loss has
said, for the dealer, securities are no different than cans of beans.
which is not a bank or otherwise falling into the exemptions from the general prohibition set out in section 4.

There is no possible prudential justification for this restriction.\textsuperscript{57} It surely is no riskier to hold in inventory more than five percent of the voting shares of a United States issuer than it is to hold five percent of the voting shares of a non-United States issuer. Nor is marketability of publicly issued shares determined by their being voting or nonvoting.

Moreover, the terms of the BHCA do not require the Fed to impose this limitation on shares of United States issuers held in dealing accounts. First, the BHCA, while it has a special exemption from section 4 for shares of foreign companies doing the greater part of their business outside the United States, does not base any exemption simply on the place of incorporation of the issuer. Thus, the distinction made in this dealing limitation between United States organizations and non-United States organizations makes no sense in terms of the BHCA.

Second, the Board has interpreted the BHCA's restrictions on "owning or controlling" shares to mean that the restrictions do not apply to shares taken by foreign bank holding companies (whose securities activities abroad are not prohibited by Glass-Steagall) in an underwriting,\textsuperscript{58} paralleling in effect the 1979 Fed staff interpretations of the Edge Act and underwriting.\textsuperscript{59} In a classical underwriting, the shares are purchased by the underwriter and then resold pursuant to subunderwriting commitments, as recognized by Regulation K in its deduction for commitments from subunderwriters or other purchasers. If acquiring shares for distribution as an underwriter is not "owning or controlling" shares for BHCA purposes, why should a temporary passage of such shares through inventory be subject to the BHCA's attempt to separate the ownership of commercial enterprises from the ownership of the allocators of credit?

\textsuperscript{57} Indeed, the Fed staff does not attempt a prudential rationale for this limitation. The preamble to the Federal Register publication of the 1991 revisions states:

This determination [that it is permissible to deal in shares of U.S. issuers because shares held in inventory are not "held" within the meaning of the Edge provisions] with respect to the shares of U.S. issuers must, however, take account of the provisions of the Bank Holding Company Act ("BHC Act"), under which a U.S. banking organization may not generally acquire more than 5 percent of the voting shares and 24.9 percent of the total equity of a U.S. company. Therefore, a bank holding company may not exceed these limits on an aggregate basis, even where such shares are held in a foreign securities subsidiary and regardless of whether the ownership of the subsidiary is through a bank holding company or an Edge corporation that is a subsidiary of a bank. Banking organizations engaged in securities activities domestically through the section 20 structure are subject to these same limitations.


\textsuperscript{59} See supra note 55 and accompanying text.
The policy concern behind section 4 of the BHCA is that if a bank and the enterprises to which it lends are commonly owned the credit decision may be distorted by the desire to favor the enterprise in which the bank owner has an interest. Inventory holdings, however, are not investments which raise this concern. The last thing that a dealer in securities is interested in is the long-term profit to be made from owning a controlling interest in an enterprise that prospers. The dealer makes its money from selling inventory at more than it cost to purchase.60

Finally, the revisions have made explicit two other limitations on dealing in equity securities,61 neither of which seems to relate to the Fed's proper oversight of the safety and soundness of Edge Corporation operations. First is the limitation (buried in the interstices of the text of the regulation) that the total of voting shares of an organization engaged in nonfinancial activities held by an investor or its affiliates, including shares held in Edge Act authorized trading or dealing accounts, must be limited to twenty percent of the voting shares of the organization so engaged.62 Thus the capacity of a banking organization's foreign securities business to deal and market-make in the voting shares of an organization in which other divisions of the banking enterprise have also invested is limited by the quantity of such investment.

This limitation makes little sense. The preamble explains that voting shares in dealing accounts were included in the limitation on holdings of voting shares of nonfinancial companies in the organization's investment accounts because "[w]ithout such limitation, there is a potential for evasion of the prohibition on exercising control over nonfinancial companies, through holding substantial blocks of equity in both an investment and dealing account."63 If indeed the Fed fears that investment limitations will be evaded by hiding shares in dealing accounts, surely the remedy here is to alert examiners to this possibility or to ensure that voting shares in dealing

60. To the extent that access to credit might make a company's shares more desirable to a buyer, a dealer overloaded with one company's shares might try to publicize the company's newly found financing, but this scenario is truly peculiar. One would imagine that the putative buyer might be as pleased to make the same purchase of the enhanced stock from another dealer. In any event, if the fear (however unfounded) is preferential access to credit, isn't the cure the extension of a firewall between the bank and any company in which an affiliated broker-dealer has obtained over a certain size share? Why should the dealing business of the broker-dealer in the highly competitive international capital markets be hobbled with a constraint unrelated either to the nature of the business or to its soundness? (The Bank of England does prohibit the clearing banks it regulates from taking in their securities business more than 10% of an issue, but the focus of the rule is the prudential issue of a large exposure and no distinction is made as to the nature of the issuer.)

61. These limitations are distinct from the inclusion of shares held in trading and dealing accounts in the "aggregate portfolio investment limit" discussed above. See supra notes 47-55 and accompanying text.

62. 56 Fed. Reg. 19,566 (1991) (to be codified at 12 C.F.R. § 211.2(o)).

63. Id. at 19,553 (to be codified at 12 C.F.R. § 211).
accounts are not voted. To restrict the dealer's business judgment as to the desirable size of inventory for fear that such accounts will be used for "impermissible" investments is simply to burden United States bank participants in the international secondary markets. That this restriction is not related at all to safeness or soundness or concern for the safety net is also demonstrated by the fact it does not apply to inventory holdings of the voting stock of financial companies. Again, market risk is market risk; certain shares are more prone to volatility than others, but the proper dividing line is surely not the one the Fed is using here. The same comments would apply to an additional limit imposed in the revisions—again presumably because the Fed has convinced itself that shares in inventory are nevertheless to be counted for determining "control"—on the total quantum of equity of nonfinancial companies that may be held by an investor and its affiliates (other than a section 20 subsidiary) in any nonfinancial organization, a total which is now forty percent of the total equity. Once again, the broker-dealer will need elaborate counting systems which scan the entire banking organization to ensure that all shares or other equity interests held anywhere for any purpose (other than trading or dealing in a United States broker-dealer subsidiary) are counted before the offshore broker-dealer can determine how much room there is for the inventory of the issuer's shares. The result of any prohibition stated in terms of a percentage of an issuer's voting shares or equity is to require elaborate tracking systems to count perfectly legitimate business. If the total is needed for a prudential limit, the cost of counting the total may be justified. If the reason for the limit is to control overreaching, a firewall would serve better. It does not require a tracking mechanism to ensure that there are no violations; it requires only a compliance manual to instruct lending officers as to what transactions would constitute a breach. Lists of who may not be lent to are cheap to generate and examiners can take care of the "evaders." The costs of thoughtless application of one act's system of policy implementation to another act's authorized dealing are thus clear.

### III. REVISED REGULATION K LIMITATIONS ON EDGE CORPORATION INVESTMENTS: ILLUSTRATION TWO OF CONFUSION

The 1991 revisions of Regulation K's investment authority provide another illustration of the confusion between BHCA policy implementation and

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64. While the original 1979 limitation on underwriting, 12 C.F.R. § 211.5(d)(13), limited the uncovered commitment to less than 20% of the issuer's voting shares, that limitation made no distinction between financial and nonfinancial companies.
The thesis of this Part is that the 1991 Regulation K scheme covering Edge Corporation investments, while less

65. This Article does not address the difficult question of whether commercial firms should be permitted to own banks and bank holding companies. The most comprehensive, sensible, and cogent discussion of this question is Corrigan, supra note 2, at 1-13.

This Article assumes at all times that the top parent company is a company regulated by banking supervisors under a scheme of consolidated supervision, filing consolidated financial statements in accordance with banking supervisors' rules, and adhering to the capital adequacy requirements demanded of a company, one of whose subsidiaries is a depository bank having access to the federal safety net. Consolidated supervision means that the home country regulator supervises the entire banking organization's business, including the business of its foreign subsidiaries. For an excellent definition of the term "federal safety net," see id. at 2.

It should also be noted that it is immaterial to the argument whether the foreign investment is made by the holding company or its Edge subsidiary, or by the depository bank through an Edge whose stock is owned by the bank under the Edge Act authorization, 12 U.S.C. § 601 (1988), to national banks to so invest. Some bank holding companies, notably Security Pacific Corporation, conduct their Edge-type business and investments through an Edge Corporation owned by the holding company; most others, such as Chase Manhattan Corporation and Citicorp, own their Edges through the money center national bank which created and invested in the Edge structure before entering into a one-bank holding company structure in the 1960s. It is mainly because the present structure of firewalls contained in sections 23A and B of the Federal Reserve Act, 12 U.S.C. § 371c (1988), now distinguishes between affiliates owned by the holding company other than in the subsidiary bank or bank line and affiliates held through subsidiary banks that how the foreign investments are held is important. This Article assumes that any sensible legislative or regulatory correction of the present scheme of limits on foreign investment would amend sections 23A and B to provide for limits on Edge affiliate dealings to prevent conflicts of interest and self-dealing, if necessary and/or advisable, regardless of the place of the nonfinancial affiliate in the corporate structure.

When the foreign investment is in the stock of foreign banks and other financial institutions, imposing the strictures of sections 23A and B on the investment clearly would only impede normal correspondent relationships between the U.S. bank subsidiary and the foreign financial institutions in the bank holding company system; it is in this area that the distinction between financial and nonfinancial affiliates makes sense. The corporate structure through which the investment is made should not determine the issue.

66. Although the Fed at first separated United States bank holding company foreign investment (covering the topic in its implementation of the BHCA in Regulation Y) from its implementation of the Edge Act in Regulation K (and national bank direct foreign investment in the defunct Regulation M), the Fed in the 1979 revision of Regulation K after enactment of the International Banking Act of 1978 folded the provisions of Y regulating bank holding company foreign activities and investments into Regulation K. Although the drafting exigencies of the combination made Regulation K a horror to parse, the idea made sense. Essentially, bank holding companies get the authority to take the voting "shares which are of the kinds and amounts eligible for investment by national banking associations" so long as the investees are "not engaged in the general business of buying or selling goods, wares, merchandise or commodities in the United States," 12 U.S.C. § 615(c), and are not transacting business in the United States other than business that is incidental to its foreign or international business, 12 U.S.C. § 1843(c)(5) (1988). National banks are authorized to invest in the stock of Edges, presumably meaning Edges whose own investments are made under the provisions of the Edge Act authorizing ownership of stock by Edge Corporations in other corporations. Thus when the Board exercises its authority under the Edge Act to consent to Edge investments, it is also setting the limits of bank holding company investment under section 4(c)(5) of the BHCA. Therefore, for the sake of simplicity, whenever this Article hereafter refers to "Edge investment," a similar investment by a bank holding company directly or indirectly without the
flawed than the scheme for limiting the inventory holdings of United States banking organizations' foreign broker-dealers, because an investor can always make a special application to the Fed, also suffers from the intellectual confusion that is engendered when the domestic policy of separating banking and commerce is exported from the BHCA into implementation of a different statutory mandate with a different history and a totally different policy approach.\footnote{67}

Section 4 of the BHCA,\footnote{68} the section of the Act forbidding any bank holding company to acquire or "retain direct or indirect ownership or control of any voting shares of any company which is not a bank [as defined] or bank holding company,"\footnote{69} exempts "shares which are of the kinds and amounts eligible for investment by"\footnote{70} national banks. National banks are specifically authorized to invest up to an aggregate of ten percent of capital and surplus in the stock of Edge and Agreement Corporations\footnote{71} to "purchas[e] and hold[ ] stock in any corporation,"\footnote{72} so long as that corporation is not "engaged in the general business"\footnote{73} of buying and selling in the United States and is only transacting within the United States business that is in the Board's judgment "incidental to its international or foreign business."\footnote{74} Nothing in this statutory authority suggests that Congress wanted to confine the businesses that Edge Corporations might invest in or interposition of an Edge is also referred to. The Fed itself does not make this simple section 4(c)(5) national bank-Edge Corporation investment authority connection. Instead, judging from the citation of authority in 12 C.F.R. § 211.1(c), the "scope" section of Regulation K, the Fed thinks it is regulating in Regulation K the authorization given in section 4(c)(13) of the BHCA. This section allows bank holding companies to invest in shares of (or activities conducted by) any company "which does no business in the United States except as an incident to its international or foreign business," if the Fed determines that the exemption "would not be substantially at variance with the purposes of this chapter and would be in the public interest." 12 U.S.C. § 1843(c)(13). Perhaps it is because the Fed staff thought, in amalgamating portions of Regulations Y and K, that they were implementing section 4(c)(13) as well as section 4(c)(9) for foreign bank holding companies that they got so tangled up with BHCA banking/commerce policy.

\footnote{67} The policy of the Edge Act is "to provide for the establishment of international banking and financial corporations operating under Federal supervision with powers sufficiently broad to enable them to compete effectively with similar foreign-owned institutions in the United States and abroad." 12 U.S.C. § 611a. Certainly there is not a word in 12 U.S.C. § 611a to suggest that BHCA banking/commerce separation policy was to be exported to Edge activities abroad.

\footnote{68} 12 U.S.C. § 1843.
\footnote{69} Id. § 1843(a).
\footnote{70} Id. § 1843(c)(5).
\footnote{71} 12 U.S.C. § 601.
\footnote{72} Id. § 615(c).
\footnote{73} Id. For a theory of what Congress meant when it used the term "general business" with regard to a national bank, see Lowry Nat'l Bank, 29 Op. Att'y Gen. 81 (1911). General business presumably means other than incidental to foreign headquarters business, and does not mean, for example, the quantum of mercantile business that might suffice to trigger United States or state jurisdiction over the company.
\footnote{74} 12 U.S.C. § 615(c).
take what might be considered "control" of the banking and financial businesses. Congress's concern, at least so far as the Fed's own research into the legislative history of the Edge Act goes, was with the power of banking and financial corporations to monopolize trade.

A. Control or Passive Investment: The Voting Stock Measurement

In the past, the Fed staff has recognized that the Edge Act itself places "no limits . . . on the kinds of activities that a corporation whose shares are held by an Edge Corporation may engage in abroad." However, according to the 1980 Staff Memorandum, "The Board . . . in administering the statute has tended to stress the purpose of Edge Corporations of serving as a means of engaging in 'banking' and 'financial' operations abroad." The 1980 Staff Memorandum goes on to describe the structure of the 1979 Regulation K, which for the first time articulated that "activities of investors abroad, whether conducted directly or indirectly, shall be confined to those of a banking or financial nature and those that are necessary to carry on such activities." At no place in either the 1980 Staff Memorandum or the preamble to the 1979 revisions of Regulation K was there any extensive explanation as to why the Board had chosen to so restrict the offshore activities (direct or through foreign subsidiaries of an Edge Corporation) of United States banking organizations. Indeed, in the case of

75. See 56 Fed. Reg. 19,551 (1991). "The legislative history of the Edge Act demonstrates that the Congress was concerned that the ownership of U.S. equity securities by Edge corporations could permit Edge corporations to monopolize the businesses that they were intended to finance . . . ." Id. This quotation from the preamble to the 1991 Regulation K revisions uses a curious phraseology. The statute as quoted does not show any particular concern by Congress with United States equity securities; it does indeed indicate Congress's concern that Edges not invest in stock in corporations doing business in the United States, whatever the jurisdiction of incorporation, and the language of the Edge statute goes right back to the old Charter of the Bank of England and fear of banks monopolizing trade. This particular fear would not seem apposite, say, to Edge control of a hotel in Mexico or a toy manufacturer in Switzerland.


77. Id.

78. 44 Fed. Reg. 36,010 (1979) (codified at 12 C.F.R. § 211.5(a) (1991)).

79. The closest the 1980 Staff Memorandum comes to an explanation is the following statement:

The Board's regulations with respect to portfolio investments are designed to afford Edge Corporations a degree of flexibility in their foreign operations particularly in instances where small equity acquisitions may be a part of a financing transaction. At the same time, the limits imposed ensure that Edge Corporations do not serve solely as holding companies for investments in commercial enterprises.

1980 Staff Memorandum, supra note 76, at 562.
Edge Corporations, one must accept the word of the 1979 preamble that the limitation had been the policy of the Fed in the past. As noted by the preamble, "Until now, the activities that could be engaged in abroad could only be determined by reference to individual Board consents to particular investments." Until 1969, the Regulation K Edge Corporation investment provision, then 12 C.F.R. § 211.8, only provided that Edge Corporations needed prior specific consent of the Board "with respect to the acquisition of any shares" other than purchases of stock to prevent loss on debts previously contracted.

That the Board in the past was, presumably for reasons relating to the issue of the propriety of a banking or financing corporation owning a commercial company, examining any proposed Edge Corporation investment that would permit the Edge Corporation to control the acquisition is indicated by the addition, in 1969, of a "general consent" authority to the then-Regulation K investment provision. By that provision, Edge Corporations were allowed to make investments, directly or indirectly, without receiving the specific consent of the Board, in "shares of foreign corporations not doing business in the United States" so long as the Edge Corporation did not invest more than $500,000 in the shares or "hold more than 25 percent of the voting shares, of any such corporation." The amount limitation simply guaranteed that the Board would get a prior look at any significant Edge Corporation expenditure for shares. It is the limitation on the holding of the voting shares of the investee that is of interest.

International investment literature distinguishes between "direct investment," where the multinational is itself entering a country by the means of acquisition or establishment of a subsidiary, and "portfolio investment," where the investor is purchasing interests in foreign entities in order to diversify its portfolio. With portfolio investment, the aim truly is "passive" investment to earn dividend and interest or capital gain income and not to expand abroad the business of the investor.

Regulation K's original limitation on portfolio investment in voting shares is similar to the way in which the BHCA defines "subsidiary." Under the BHCA definition, a subsidiary is "any company 25 per centum or more of whose voting shares . . . is directly or indirectly owned or controlled by such bank holding company" or "any company the election of a majority of whose directors is controlled in any manner by such bank holding company."
The BHCA definition of subsidiary is presumably related to the concept of expansion of a bank holding company. One would therefore imagine that it was that definition of subsidiary that influenced the Board to deny general consent to an Edge Corporation investment, regardless of expenditure, in more than twenty-five percent of the voting stock of an investee. In short, in 1969, the Board said that when an Edge Corporation expanded its own business through a direct investment, the Board wanted to have a prior look at the proposed investment before approving it. On the other hand, the 1969 change in Regulation K meant that defined portfolio investments of $500,000 or less, regardless of the business of the investee, were preauthorized.

Again, one must take the word of the 1980 Staff Memorandum that the Board was in the habit of denying direct investments in nonfinancial-type businesses by Edge Corporations, but the 1969 change to Regulation K as well as the 1980 Staff Memorandum statement\(^87\) that Edge Corporations are not to serve as holding companies for ownership of commercial enterprises suggest that to have been the policy. Given that in 1919 Congress seemed to be encouraging the movement of venture capital to war-torn Europe through the Edge mechanism and that the legislative history of the Edge Act is barren of any suggestion that Congress wanted Edges to be able to engage in nonfinancial-type business abroad, the Board’s policy choice is not astounding. However, it is certain that in 1969, there was no elaborate scheme of counting “equity” to determine “control” or even any reference whatsoever in the provisions for Edge investments to the five percent of voting stock standard of the BHCA for the prohibition on the ownership of nonfinancial companies.

The 1979 revision of Regulation K carried out the Board’s intention not to permit Edge Corporations to take entrepreneurial control of nonfinancial companies by making explicit the definition of “subsidiary” for Edge Act investment authority purposes. The revision stated that a “subsidiary” is “an organization more than 50 percent of the voting shares of which is held directly or indirectly by the investor, or which is otherwise controlled or capable of being controlled by the investor or an affiliate of the investor.”\(^88\) The Board also made clear that only banking or financial-type subsidiaries could be acquired and, in an effort to improve transparency,

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87. See 1980 Staff Memorandum, supra note 76, at 555-68.
listed in § 211.5(d) just what banking or financial activities would qualify for a general consent investment in a subsidiary. If an investor wished to “invest” in a subsidiary engaged in a banking or financial activity not on the list, it had to apply for specific consent. However, if an investor wished to take shares in a company engaged in business not on the permitted list, that is, take shares in a nonfinancial or “commercial” company, it was permitted to do so only up to an aggregate of less than twenty percent of the voting stock. The aggregate included in the computation voting stock held directly or indirectly by an “affiliate,” essentially another entity in the banking organization.

Thus Regulation K in its 1979 form set up a scheme for distinguishing between direct investment and portfolio (noncontrolling, “passive”) investments by Edge Corporations. If the Edge or one of its subsidiaries was making the investment to run the business as part of the banking enterprise, the purchased company or joint venture was not to be a commercial company, even though the list of permitted activities was considerably broader than would be permitted to a banking organization in the United States (including, for instance, underwriting and dealing in debt and equity). Indeed, if the investee engaged in activities that the investor considered to be “usual in connection with the transaction of the business of banking or other financial operations abroad,” but these financial activities were not on the permitted list, the 1979 Regulation K provided for application to the Board. However, where the investment was clearly only a portfolio one, with less than twenty percent of the voting shares being taken, the investment could be in a company engaged in any kind of business, so long as that business was not conducted in the United States.

While one can question the Board’s policy decision to narrow the literal terms of the Edge Act so as to prevent Edge Corporations from making foreign direct investments in nonfinancial companies, one cannot fault the system for distinguishing between portfolio and direct investments. Using twenty percent of voting stock as a test for the dividing line between the two types of holdings was perfectly reasonable if what was at issue was a question of corporate control. While the definition of “investment” then included the taking of subordinated debt when shares in the investee were

89. 44 Fed. Reg. 36,007, 36,011 (as codified at 12 C.F.R. § 211.5(d)).
90. The 1979 Regulation K defined the term “investment” as “the ownership or control of shares ... including the holding of an organization's subordinated debt when shares of stock of the organization are also held directly or indirectly by an investor.” Id. at 36,008.
91. See 1980 Staff Memorandum, supra note 76.
92. The 1979 scheme also provided for direct investments in financial-type companies with other investors, so-called “joint ventures,” with voting stock up to 50% being permitted and the investees being permitted to have no more than 10% of consolidated assets or revenues attributable to nonfinancial activities. 44 Fed. Reg. at 36,010 (as codified at 12 C.F.R. § 211.5(b)(1)(i)(B)).
93. Id. at 36,011.
also held, this definition was not the test for the distinction between portfolio and direct investment. Only voting stock mattered for that computation or, if, in fact, the investor and/or its affiliates actually controlled or could control the company acquired.94

B. The Test for Prudence: Amount Invested, Not Amount of Voting Stock

Having distinguished between types of investment, the Board in the 1979 Regulation K nevertheless did not relinquish supervision of the prudence of both types of investments. The test, however, for prudence was correlated to the amount of the investment. In 1969 the Board had provided for preauthorized ("general consent") investments by Edges so long as not more than $500,000 was invested and not more than twenty percent of the voting stock was acquired. In the 1979 Regulation K the Board continued to preauthorize certain Edge investments but redrafted the application procedures "to reduce the number of routine investment applications that must be acted on by the Board... Specific consent will be necessary only for investments which because of their size or some other aspect of the proposal, deserve Board consideration."95

The Board determined that investments in new kinds of financial operations not on the permissible list would require a specific application to the Board, but that was the only distinction depending upon the type of activities of the investee. Otherwise, the issue always was size of investment. The 1979 Regulation K raised the general consent amount limit to the lesser of two million dollars or five percent of the investor's capital and surplus,96 regardless of whether the investment was in a company engaged in financial or nonfinancial activities.

Under the 1979 Regulation K, when the investor wanted to put more than two million dollars into a company engaged in permissible activities but the amount to be invested did not exceed ten percent of the investor's capital and surplus, the investor simply had to give the Board sixty days written notice so that the Board might during the notification period disapprove the investment, suspend the time period, or require that an application be filed by the investor for the Board's specific consent. This ensured that any investment in a subsidiary or joint venture exceeding ten percent of the

94. It is notable that at no time since the 1979 Regulation K has the Board or staff ever spoken as to the meaning of the term "controlled or capable of being controlled" as used in the definition of "subsidiary."
95. 44 Fed. Reg. 36,005, 36,007 (1979) (as codified at 12 C.F.R. § 211).
96. In the case of an Edge Corporation not engaged in banking, the top limit if less than $2 million was 25% of the Edge's capital and surplus. Id. at 36,010 (as codified at 12 C.F.R. § 211.5).
investor's capital or surplus (the statutory limit in the Edge Act) would require specific consent on the part of the Board. Any portfolio investment over the lesser of two million dollars or the permitted percentage of capital had to be pursued under the specific consent procedure.

Apart from these prudential amount limitations to ensure that the Board specifically reviewed investments over a certain size, the Board included one other limitation in the 1979 revision to ensure that the total quantum of investment in nonfinancial activities did not threaten the capitalization of the Edge. The Board provided that the total amount of portfolio investments that could be made in all nonfinancial organizations would be limited by an amount equal to 100% of the investor’s capital and surplus. Evidently the Board felt the need for a total ceiling on the permissible amount of portfolio investments in shares for safety and soundness reasons. This assumption is made because this limitation was not calibrated to voting stock, but necessarily included in the calculation, because of the definition of “investment,” all voting or nonvoting shares held and subordinated debt in any organization in which shares were held.

The 1979 revisions also provided that securities held in trading or dealing accounts had to be included in making the calculation of whether further portfolio investments could be made. One assumes that the inclusion of the trading and dealing shares was for the purpose of imposing a rough ceiling on the risk of holding shares in dealing accounts, although as noted previously in connection with the discussion of the limitations on securities dealings imposed by the 1991 revisions, when one is discussing a trading or dealing account, differentiating between shares of a nonfinancial company and a financial company makes no intellectual sense. However, in 1979, it seems most unlikely that the few United States banking organizations engaged in broker-dealer operations abroad made a market in bank shares at all. What is important to recognize is that this aggregate portfolio investment limitation appears to have had nothing whatsoever to do with any attempt to keep Edges out of commercial business since that was already taken care of by the limitation on investment in nonfinancial companies to less than twenty percent of the voting stock.

97. Id. at 36,010-11 (as codified at 12 C.F.R. § 211.5).
98. Id. at 36,010 (as codified at 12 C.F.R. § 211.5). See text at note 47.
99. Id. (as codified at § 211.5(b)(1)(i)(C)).
100. In several places, the 1991 revisions insist that this aggregate portfolio investment limitation include in the calculation as well shares in “underwriting accounts,” but it is impossible to discover any place in either the 1979 Regulation K or the 1985 revision any limitations on underwriting commitments other than those stated in the respective activity list, that is the limitation to $2 million and less than 20% of the capital and surplus or voting stock of the issuer. At no time prior to 1991 did Regulation K limit underwriting in equity securities by the amount of capital of the underwriter. Of course, it may be assumed that the underwriting subsidiaries are covered by some form of net capital requirements mandated by their host countries.
This basic, sensible scheme for oversight of Edge Corporation investments was very little changed by the 1985 congressionally mandated revisions. The dollar general consent limitation was raised from two million dollars to fifteen million dollars (although the alternative test of percentage of the investor's capital and surplus remained the same as in the 1979 version). The period for the Board to act when given prior notice was reduced to forty-five days, and a provision was added that "the Board may waive the forty-five day period if it finds immediate action is required by the circumstances." This presumably permitted an investor to receive accelerated action from the Board where an acquisition was moving along at a snappy pace.

The Board seems to have been talked into making two other apparently small changes which may have begun the Fed staff's intellectual confusion in reading the domestic policy of separating banking and commerce into the Regulation K scheme for foreign investments of Edges. However, in no other way did the 1985 revisions move over into the Regulation K investment provisions any of the scheme contained for the separation of banking and commerce in the BHCA and Regulation Y. For that, it was necessary to await the 1991 revisions.

102. 44 Fed. Reg. 36,007, 36,010 (1979) (as codified at 12 C.F.R. § 211.5(c)(1)(i)(A)).
103. 50 Fed. Reg. 39,974, 39,984 (1985) (as codified at 12 C.F.R. § 211.5(c)(1)(i)(A)).
104. Id.
105. Under the 1979 revision, any investment that fell into the "subsidiary" category could only be in a company all of whose activities conformed to the permissible list unless the investor went specifically to the Board for an exemption. Apparently recognizing that for Edges or subsidiaries of Edges making acquisitions of foreign banking or financial companies it might be impossible to find such acquisitions that were totally "clean" (in the sense that all of their activities fell within the Board's conception of what was usual in banking abroad), the Board added a de minimis provision to 12.C.F.R. § 211.5(b)(1)(i)(A). It provided that "in the case of an acquisition of a going concern, existing activities that are not otherwise permissible for a subsidiary may account for not more than five percent of either the consolidated assets or revenues of the acquired organization." 50 Fed. Reg. 39,974, 39,983 (1985) (as codified at 12 C.F.R. § 211.5(c)(1)(i)(A)).

In a more interesting and more problematic change, the Board revised what it called the "divestiture" provision in the 1979 and 1985 Regulation K. This was a provision which in effect repeated the statutory limitations on Edge investments concerning activities in the United States and provided that an investor should dispose of an investment promptly, "(unless the Board authorizes retention)," if the investee organization either engaged in impermissible business in the United States or engaged in impermissible activities for the particular kind of investment. However, it seems that the commentators on the proposed 1985 revisions sold the staff the notion that since bank holding companies could acquire up to five percent of any company, 12 U.S.C. § 1843(c)(6), whether United States or foreign, that was engaging in any form of business, the Board should add to the divestiture provision the exception that "an investor may hold up to 5% of the shares of a foreign company that engages directly or indirectly in business in the United States that is not permitted to an Edge Corporation." 50 Fed. Reg. 39,974, 39,984 (1984) (as codified at 12 C.F.R. § 211.5(b)(3)(i)(B)). In the case of an Edge Corporation, the Board had no statutory authority to permit the Edge to make such an investment since the Edge Act itself contains no such exception.
IV. IMPORTING DOMESTIC CONCERNS INTO THE EDGE ACT

In the early 1980s, the Fed became concerned with the apparent attempt of banking organizations to avoid the restrictions under section 3 of the Bank Holding Company Act on the acquisition of bank shares. The Act phrased the restriction in terms of voting shares. However, the banking organizations were purchasing nonvoting preferred stock and other forms of interests in out-of-state banks which the banking organizations hoped to acquire when and if the laws preventing nationwide banking by bank holding companies were repealed. The Fed responded by issuing a policy statement in which it discussed the kind of arrangements under which so-called "toehold acquisitions" in out-of-state banks were being made. The Fed stated that "[a]fter a careful review of a number of these agreements, the Board believes that investments in nonvoting stock, absent other arrangements [that presumably might give "control"], can be consistent with the act."

At no place in the policy statement does the Fed set down any quantitative limit on the amount of nonvoting shares that may be acquired; instead, other indicia of "control" found in certain agreements between the acquiring and acquired bank are discussed. Nor did the Fed in the policy statement provide a set percentage as to when the acquisition of nonvoting equity in other banks might give "control" so as to violate section 3 of the BHCA. However, the Board did discuss one case of potential for control where the investor holds a very large percentage of the acquiree's total equity. Thus the Board indicated in its opinion that control of a company (meaning another bank in the context of the policy statement) could be acquired by taking nonvoting stock, depending upon the percentage of total equity held.

However, the Fed staff seized upon the policy statement and made a leap from the policy statement's discussion of the acquisition of equity in the context of section 3 of the BHCA to the question of the acquisition of nonvoting interests in nonbanking companies under section 4 of the BHCA. In an opinion entitled Acquisition of Nonbank Interests—Nonvoting Equity Investments, the staff listed a number of indicia of carrying on forbidden activities not permissible to bank holding companies through the medium of an investee. Among those criteria are total investment representing more than twenty-five percent of the total shareholders' equity of the nonbanking

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109. Id. at 414.
company. The staff opinion at that time did not state the percentage of nonvoting equity as a hard and fast rule. The real issue, according to this opinion, is whether the bank holding company is "more than a passive investor, assuming the role of an entrepreneur in the organization, promotion or operation of the non-banking company." We see here the same distinction that the Fed was trying to make in Regulation K throughout its history.

However, in revising Regulation K in 1991, the staff has somehow decided that the Board's policy statement "imposes a limit for noncontrolling investments of 25 percent of a company's total equity."' Moreover, although the policy statement referred only to nonvoting equity investments in banks, which by definition do not create any additional prudential issues since banks acquired by a bank holding company are subject in their own right to all of the banking prudential restraints, the staff went on in the proposed 1991 revision's preamble to claim that "[t]he 25 percent ceiling was implemented both to limit an investor's ability to control a company through nonvoting shares and to impose prudential constraints upon the acquisition of nonvoting instruments."' The staff opinion, as it has been implemented by the staff, appears to attempt to control the equity sweeteners banks were taking when financing leveraged buyouts, an attempt presumably fueled by the Fed's legitimate prudential concerns.' But the staff's 1991 revision of Regulation K takes these constraints, developed in the domestic context to control the process of acquiring equity sweeteners, and applies them to the holding of nonvoting equity in foreign nonbanking companies in a fashion that has almost completely destroyed the careful scheme created by the Board in 1979 to regulate Edge Corporation investments.

As is true of the 1991 revision's regulation of the foreign securities activities of United States banking organizations, the staff apparently has confused the concerns about "control" of nonfinancial entities with the concerns about prudential limits, completely forgetting that the prudential limits on Edge Corporation investments are set by the general consent dollar limitation.' The limitation on the quantum of the percentage of voting stock the Edge Corporation may hold in nonfinancial companies is related only to the issue of control and the Fed's 1979, and probably earlier, conviction that Edge

112. Id.
114. See supra text accompanying notes 85 and 103. Beyond these limits, the investment, whether in a financial or nonfinancial corporation, must be submitted to the Fed for review.
Corporations should not act as entrepreneurs in nonfinancial businesses. By importing into the Edge scheme the domestic concerns about the total amount of "equity" acquired by United States banking organizations, the staff has produced a 1991 investment authority section which makes little sense and will require, as does the offshore securities business authority, a banking organization to make an organization-wide check of "equity" holdings it might have acquired in any capacity.\textsuperscript{115}

Not only must a banking organization make a counting to determine whether it can cover a particular Edge Corporation investment under the general consent provisions or it will have to give notice to or make a specific application to the Board, it must also make a counting to stay within the aggregate portfolio investment limitation. This limit includes in the count shares held in trading and dealing accounts, as well as (in the 1991 revision) shares for which underwriting commitments have been made. The result is that not only is a United States banking organization's securities business abroad constrained by other activities of the organization, such as its portfolio investments by its Edge Corporation, but the Edge Corporation also will have its investments constrained both by the financing wing of the organization, which may be in certain circumstances taking subordinated debt or other types of equity acquired in today's so-called mezzanine financing, and by the quantum of its securities business abroad. As with the constraints on the securities business, this type of constraint on investment makes no intellectual sense. In the case, however, of Regulation K investment authority, the constraints are less serious. It simply means that the banking organization will have to make specific application to the Board for review of investments which would, in the normal course, without the revisions' requirements of adding into the count the total equity holdings, be available to the organization under the general consent limitation. It is also possible that since the revisions, instead of including in the limit loans to the investee, as was proposed,\textsuperscript{116} will permit holdings up to forty percent of the total equity, without including loans, the revisions in practice will not be a significant constraint on United States banking organizations, apart from the unnecessary cost of elaborate tracking systems.

V. RECOMMENDATIONS FOR LEGISLATIVE ACTION

The intellectual confusion between prudential constraints and "control" issues evident in the 1991 revisions to Regulation K is the product of Congress's failure to properly separate those issues in the Bank Holding Company Act.

\textsuperscript{115} 56 Fed. Reg. 19,569 (1991) (to be codified at 12 C.F.R. § 211.5).
\textsuperscript{116} 55 Fed. Reg. 32,424, 32,436 (1990) (as codified at 12 C.F.R. § 211.5(b)).
Since the Fed in revising Regulation K took its cue from the policies expressed by Congress in the BHCA, Congress can alleviate the confusion both at home and abroad by scrapping equity limitations as a means of addressing both safety and soundness matters and self-dealing. In place of equity limitations as a single means of addressing both concerns, Congress can implement separate strategies already in place either in this country or in Europe for each concern.

In considering the restructuring legislation now before it, Congress should first recognize that its attempt to separate banking and commerce by a flat five percent of voting stock is flawed because it uses that flat figure as a bright line between bank holding company investments in nonfinancial companies that are permissible and impermissible. The more appropriate concern is not the level of investment, but as the Fed has recognized in previous instances, the nature of the investment: whether it is intended to be entrepreneurial or passive.¹¹⁷

Congress should also recognize that the Fed has compounded the problem of intellectual confusion about its policies by exporting the domestic idea of separating banking and commerce and the equity limitation mechanism for implementing that idea into the regulation by which the Fed oversees the international securities and investment activities of Edge Corporations. This exportation of domestic concerns is clearly uncalled for because Edge Corporations were established to serve different purposes than domestic bank holding companies or their affiliates. There are better means of addressing the twin concerns of prudence and overreaching and Congress should consider them in any comprehensive restructuring.

Under a proper conception of safety and soundness, it is submitted that the European Community's standard in the Second Banking Directive¹¹⁸ is a viable test for dealing with the question of how much equity in nonfinancial companies is too much. That test only treats an interest in a nonfinancial company as being significant to a bank's health when the interest exceeds ten percent of the stock of the nonbanking company (a "qualified participation") and when that qualified participation would amount to more than ten percent of the bank's capital. Thus, the European Community utilizes Congress's ultimate protection for member banks investing in Edge Corporations, a limitation to ten percent of the capital of the investing member bank.¹¹⁹ Shareholdings of less than ten percent of the investee are not considered, apparently regardless of the amount such a shareholding would represent of the capital of the investing bank. In other words, in the European Community, shareholdings representing any proportion of the stock of a nonbanking

¹¹⁸. See supra note 22 and accompanying text.
company is permissible so long as they do not exceed in value ten percent of
the bank's capital. However, there is an aggregate limitation upon the quantum
of qualified participations in nonbanking companies of sixty percent of the
capital of the bank.120

In the European Community scheme of limiting shareholdings by banking
organizations in nonfinancial companies, the concern is purely with prudential
standards. The European Community does not address at all the issue of
economic neutrality since, under the Directive, so long as the shareholding
remains below the aggregate of the limits measured by the bank's capital, the
bank can have any amount of control over the investee. However, if United
States policy should continue to be concerned with bank overreaching, that
is, with bank preference for companies in which the bank has an entrepre-
neurial interest, the way to deal with this is shown by the present provisions
of sections 23A and B of the Federal Reserve Act.121 Section 23A at present
exempts subsidiaries of banks from its firewall provisions, without distinguis-
ning whether the subsidiary of the bank is a financial or nonfinancial subsidiary.
If section 23A were to be amended to distinguish among the types of bank
subsidiaries, it would be possible to limit, or even forbid, bank financing of
nonbank subsidiaries with deposits. It would be possible to provide that only
the holding company could lend to nonbanking subsidiaries, whether those
subsidiaries were held in the bank line or directly under the holding company.
There would be no limit on the amount of voting stock or on the amount of
total equity that the holding company and/or its subsidiary banks could hold,
provided that the prudential limits drafted along lines suggested by the
European Community's Second Banking Directive were in force.

Under a scheme such as this, even the distinction between an entrepreneurial
interest and a "passive investment" would be obviated, except for determining
when firewalls should have to be applied. If firewalls were to be used and a
bright line would be desirable, then at that point one could utilize the old
Regulation K standard instituted in 1969—that is, twenty-five percent of the
voting stock or actual control would trigger the firewalls. The BHCA would
no longer need to contain the section 4 standard of five percent of the voting
stock as the dividing line, and there would be no need for a staff-imposed
arbitrary figure of twenty-five percent of the equity. If the BHCA were
amended to itself provide a rational scheme for how bank investments in
nonbanking companies should be limited, there would be no need for the
elaborate counting schemes that have been imposed upon Edge Corporation
investments by the 1991 revisions to Regulation K. If the legislative changes
proposed in this Article were enacted, United States banking organizations

121. Supra note 17.
would become truly competitive with their foreign counterparts, without any diminution in the regulatory structure for safety and soundness and protection of the federal safety net.