Avoiding the Glass-Steagall and Bank Holding Company Acts: An Option for Bank Product Expansion

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Avoiding the Glass-Steagall and Bank Holding Company Acts: An Option for Bank Product Expansion

In the past few years, consumers of financial services have experienced a dramatic upheaval in the financial services industry. Change has been particularly dramatic in the banking sector. The development of new financial products, increased consumer awareness of investment options, deregulation, and competition from investment and nonbank entities have resulted in increased homogenization of financial institutions. More importantly, the competition from nonbank institutions has been particularly instrumental in the resulting push by commercial banks to offer a more diverse array of products.

The pressure resulting from the encroachments into the banking market has had numerous effects. New competitive accounts and high interest rates

1. Unless otherwise noted, "bank products" refers to both products and services.
3. Sears and Merrill Lynch provide the best examples of nonbank institutions that have encroached on traditional bank markets. In July 1982, Sears opened its first financial supermarket which included Allstate Insurance, Coldwell Banker, and Dean Witter Reynolds. Rowe and Vise, Sears Opens Financial Supermarket, Wash. Post, July 16, 1982 at D, col. 1; see also Sears Weighs Acquiring Banks or S & L's, Unveils Several New Financial Services, Wall St. J. May 17, 1983 at 4, col. 1. With these subsidiaries, Sears can now buy and sell houses, trade securities, offer money market funds and Individual Retirement Accounts, and write insurance. Rowe and Vise, supra. Sears, in addition to providing one-stop shopping, is very close to providing one-stop banking. Merrill Lynch's services also resemble those of a full service bank. Smith, Merrill Lynch's Latest Bombshell for Bankers, Fortune, April 19, 1982, at 67. In the past four years the "Merrill Lynch bull [has] gored a gaping hole in the wall that separates brokers from bankers" id. first by offering its Cash Management Account and then by opening a new subsidiary, Capital Resources, to enter the lending business. Id.
4. A "commercial bank," as distinguished from other bank and non-bank financial institutions, is an institution authorized to receive both demand and time deposits, to make loans of various types, to engage in trust services and other fiduciary functions, to issue letters of credit, to accept and pay drafts, to rent safety deposit boxes, and to engage in many similar activities.
are now almost universally available, and increased deregulation is imminent. The pressure has initiated a search by commercial banks for loopholes in the existing banking regulations that would allow these banks to expand their product offerings and geographic coverage. This Note considers one such loophole, and argues that product expansion is available for state-chartered banks that are not members of the Federal Reserve System, regardless of whether such banks are subsidiaries of bank holding companies, if the expansion is implemented through an affiliate. The existence of this loophole is supported by statutory construction, legislative history, and the policy underlying existing banking legislation. This loophole is significant because it allows state nonmember banks to engage in activities that will increase their competitiveness with nonbanks and investment banks that have entered the depository business.

The Note begins by explaining the structure of banking regulation, and then discusses why neither the Glass-Steagall Act nor the Bank Holding Company Act applies to a state nonmember bank that expands its product offerings through an affiliate. To understand why the Glass-Steagall and Bank Holding Company Acts do not restrict product expansion through an affiliate of a state-chartered nonmember banks, one must have some understanding of how the banking industry is regulated. The first two sections of this Note discuss, respectively, the structure of the regulatory system and the major regulatory acts. The remaining sections discuss why neither the Glass-Steagall nor Bank Holding Company Act restricts the aforementioned product expansion.

I. STRUCTURE OF THE REGULATORY SYSTEM

Commercial banking institutions may be chartered by either the state or federal government. Under this dual system, a bank may be subject to any one of four possible combinations of regulation. A national bank obtains

9. See infra note 39.
10. Id.
12. Scott, supra note 11, at 3.
its charter from the Comptroller of the Currency and is required to become both a member of the Federal Reserve System and insured by the Federal Deposit Insurance Corporation.\textsuperscript{13} A state member bank obtains a charter from the state regulatory authorities, joins the Federal Reserve System and therefore is required to obtain federal deposit insurance.\textsuperscript{14} A state nonmember bank obtains a state charter, foregoes membership in the Federal Reserve System and may obtain federal deposit insurance.\textsuperscript{15} Finally, a state nonmember bank may choose to operate without deposit insurance.\textsuperscript{16}

The framers of modern banking legislation did not envision the creation of this dual federal-state banking system.\textsuperscript{17} Except for the First and Second Banks of the United States, banks originally were chartered exclusively by the states.\textsuperscript{18} The federal government began chartering banks in 1863 under the National Bank Act.\textsuperscript{19} Although the primary reason for the Act was to finance the Civil War, a secondary reason was to bring uniformity to the system of chartering banks.\textsuperscript{20} The authors of the Act believed that uniformity would be achieved because nationally chartered banks would drive state banks out of existence.\textsuperscript{21} Empirically, the Act has not been detrimental to state banks. State-chartered banks continued to exist and competition for banks developed between the two chartering systems. Because of the dual chartering system, general federal banking legislation will affect banks differently depending upon which regulatory agency is given authority to enforce that legislation.

The choice of chartering authority is only one regulatory complexity facing commercial banks; in addition, both state and national banks are subject to regulation by three federal agencies.\textsuperscript{22} First, the Comptroller of the Currency charters national banks\textsuperscript{23} and determines the scope of permitted activities for

\begin{itemize}
\item \textsuperscript{13} Id.
\item \textsuperscript{14} Id. All banks that are members of the Federal Reserve System are automatically covered by federal deposit insurance from the Federal Deposit Insurance Corporation. See Hackley, supra note 11, at 567.
\item \textsuperscript{15} Scott, supra note 11, at 3.
\item \textsuperscript{16} Id. Empirically, very few banks choose to operate without deposit insurance. In 1980, there were 53,649 commercial banks, only 478 of those operated without federal deposit insurance. There were 24,217 national banks, 5,768 state member banks, and 23,186 state nonmember banks that carried federal deposit insurance. Bureau of the Census, U.S. Dept. of Commerce, \textit{Statistical Abstract of the United States: 1981}, at 510 (102d ed. 1981).
\item \textsuperscript{17} Hackley, supra note 11, at 569-70.
\item \textsuperscript{18} Id.
\item \textsuperscript{19} Id. at 572, 574.
\item These early regulations are the product of two pieces of legislation, one in 1863, Act of Feb. 25, 1863, ch. 58, 12 Stat. 665, and one in 1864, Act of June 3, 1864, ch. 106, 13 Stat. 99. Both are often referred to as the National Bank Act. \textit{But see} Levin, \textit{In Search of the National Bank Act}, 97 \textit{Banking L.J.} 741 (1980) (expressing the view that the National Bank Act is too elusive to be defined).
\item \textsuperscript{20} Hackley, supra note 11, at 570-71.
\item \textsuperscript{21} Id. at 571.
\item \textsuperscript{22} J. White, \textit{Banking Law} 45-82 (1976); see E. Reed, B. Cotter, E. Gill & R. Smith, \textit{Commercial Banking} 25-30 (1976).
\item \textsuperscript{23} Id. at 45.
\end{itemize}
banks that are members of the Federal Reserve System. Second, the Federal Reserve Board regulates members of the Federal Reserve System, determines the scope of permitted activities of bank holding companies and their non-bank subsidiaries, and regulates the foreign activities of all member banks. Finally, the Federal Deposit Insurance Corporation promulgates rules that apply to all insured banks, and governs routine examinations of insured state nonmember banks and special examinations of national and state member banks.

Because a state bank has both the option of not joining the Federal Reserve System and the option of not obtaining federal deposit insurance from the Federal Deposit Insurance Corporation, it can choose the regulatory system to which it will subject itself. Due to limitations on the authority of any particular regulatory body, a bank can choose the regulatory system which allows it more product expansion. The regulatory systems and the authority of the regulatory bodies that run them are products of the three major pieces of legislation: The McFadden Act of 1927, the Glass-Steagall Act of 1933, the Bank Holding Company Act of 1956 and its 1970 Amendments.

II. THE MAJOR REGULATORY ACTS

The McFadden Act was passed in 1927 to resolve a national liquidity crisis and to restore competitive equality between state and national banks in regard to branching. Section 7 of the Act disallowed banks from intracity branching if state law did not permit state banks to engage in such branching. Under
the McFadden Act, the federal government has authority over the definition of a branch, and defers to the states on questions of where, when, and how to branch.\textsuperscript{38}

The next structural addition to the banking laws was the Glass-Steagall Act passed in 1933.\textsuperscript{39} The Glass-Steagall Act imposes liability on commercial banks that prevent such banks from offering certain products and engaging in activities such as underwriting mutual funds and corporate securities products and activities that have, until very recently, been part of the investment banking sector. Four sections of the Act, 16,\textsuperscript{40} 20,\textsuperscript{41} 21,\textsuperscript{42} and 32\textsuperscript{43} separate commercial banking activity from investment banking activity by defining certain activities to be the business of banking and restricting the type of institution which may engage in that business. It is noteworthy, however, that sections 16, 20, and 32 are applicable only to banks that are members of the Federal Reserve System,\textsuperscript{44} while section 21 is applicable to both member and nonmember banks.\textsuperscript{45}

\textsuperscript{38} First Nat'l Bank in Plant City v. Dickinson, 396 U.S. 122, 131, 133-34 (1966); see also North Davis Bank v. First Nat'l Bank, 457 F.2d 820, (10th Cir. 1972) (a drive-in banking facility across the street from the main office of a bank was not a branch); Independent Banker's Ass'n of Am. v. Smith, 534 F.2d 921 (D.C. Cir.) (customer based communication terminals are bank branches), cert. denied, 429 U.S. 862 (1976).

\textsuperscript{39} The Glass-Steagall Act is the name given to sections 16, 20, 21, and 32 of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified in scattered sections of chapters 3 and 6 of 12 U.S.C. (1982)).

\textsuperscript{40} Section 16 of the Act authorizes commercial banks to deal in securities "solely upon the order and for the account of, customers, and in no case for its own account." 12 U.S.C. § 24 (Seventh) (1982) (as codified). "For the account of customers" refers to the activities undertaken by a commercial bank in its fiduciary capacity as "an accommodation agent for the convenience of its customers." The bank is acting as an agent not as a principal in these activities. Commercial banks act for the accounts of customers when for example they engage in trust department activities. \textit{See Glass-Steagall Act - A History of its Legislative Origins and Regulatory Construction}, 92 BANKING L.J. 38, 42-45 (1975) [hereinafter cited as \textit{Regulatory Construction}.]

\textsuperscript{41} The section also authorizes dealing in United States Treasury Securities and other federal securities and obligations of states and municipalities, but there is no authorization for dealing in nongovernmental securities.

\textsuperscript{42} Section 20 prohibits commercial banks from engaging in the investment activities of underwriting and dealing through affiliation with "organization[s] engaged principally in the issue, flotation, underwriting, public sale or distribution . . . of . . . securities." 12 U.S.C. § 377 (1982) (as codified).

\textsuperscript{43} Section 21 is the converse of section 16. It prohibits organizations engaged in underwriting and dealing in securities from receiving deposits. 12 U.S.C. § 378 (1982) (as codified).

\textsuperscript{44} Section 32 completes this separation of commercial from investment banking by disallowing officers, directors, and certain other employees of investment organizations, from also serving as officers, directors, or employees of member banks. 12 U.S.C. § 78 (1982) (as codified).

\textsuperscript{45} Section 16 states: "a national banking organization . . . shall have power . . . ." 12 U.S.C. § 24 (1982) (as codified) (emphasis added).


\textsuperscript{45} Section 21:

(a) After the expiration of one year after June 16, 1933, it shall be unlawful—

(l) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing underwriting, selling, or distribution, at wholesale or retail, or through syndicate participation, stocks, bonds, deben-
In 1956, Congress passed the Bank Holding Company Act\(^4\) to subject multi-bank holding companies\(^7\) to the type of restrictions that Glass-Steagall imposed on commercial banks.\(^4\) In 1970, the Bank Holding Company Act was amended to subject one-bank holding companies to its restrictive provisions.\(^9\) In addition to preventing the union of commercial banking and investment banking through group banking, the Act and its amendments sought to prevent the union of banking and commerce through the bank holding company structure.\(^9\) Because most banks are subsidiaries of holding companies, a state nonmember bank may be subject to regulation of its products by virtue of its status as a subsidiary bank.

The Bank Holding Company Act authorizes the Federal Reserve Board to determine permissible activities for bank holding companies. Permissible activity is determined by evaluating two criteria.\(^\text{i}\) To be permitted\(^\text{ii}\) the activity must be "so closely related to banking, or managing, or controlling..."; 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 request of the depositor...


47. Multi-bank holding companies hold at least two bank subsidiaries. One-bank holding companies hold only one bank. Both types of holding companies may hold nonbank subsidiaries in addition to bank subsidiaries.


Though the stock market crash focused attention on bank holding companies, there was very little in the 1933 banking legislation that restricted them. One reason for the lack of restrictions in that Act may have been that the survival record for bank holding companies exceeded that of banks. As a matter of record, however, between 1933 and 1956 at least one bill aimed at restricting bank holding companies was introduced at every session of Congress. M.A. Jessee & S.A. Seelig, BANK HOLDING COMPANIES AND THE PUBLIC INTEREST 8 (1977).


For a discussion of how the one bank holding company was used to circumvent the restrictions of the 1956 Act see sources cited infra note 51.

50. S. REP. No. 1095, supra note 55, at 2483. See also Chase & Mingo, The Regulation of Banking Holding Companies, 30 J. FINANCE 281 (1975) (stating that the Act had "two major objectives: to control [holding company] expansion in order to avoid the creation of monopoly power, and to circumscribe activities of [bank holding companies] so as to maintain the nation's traditional separation of banking from other lines of business").

51. 12 U.S.C. § 1843(c)(8) (1982); Chase, The Emerging Financial Conglomerate: Liberalization of the Bank Holding Company Act, 60 Geo. L.J. 1225, 1237, 1342-44 (1972). But cf. Comment, Implementation of the Bank Holding Company Act Amendments of 1970: The Scope of Banking Activities, 71 MICH. L. REV. 1170, 1188 (1973) (taking the view that there is but one test, and that the public benefits test is one factor in determining whether an activity is "so closely related to banking... as to be proper incident thereto.") [hereinafter cited as The Scope of Banking Activities].

52. The Board of Governors of the Federal Reserve System, hereinafter referred to as the Board, determines permissible activities by approving or rejecting applications from bank holding companies to engage in those activities. 12 U.S.C. § 1842(a) (1982) (as codified).
banks as to be proper incident thereto.” In addition, the activity must be one that “can reasonably be expected to produce benefits to the public such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices.” Thus the Bank Holding Company Act regulates group banking limiting bank holding company activities to those activities that can be properly defined as or are related to banking.

III. A Gap in the Regulatory Structure

Although the Glass-Steagall Act, the Bank Holding Company Act, and the McFadden Act attempt to completely isolate commercial banking from investment banking and commerce by regulating product offerings and geographic expansion, state nonmember banks may be able to circumvent this regulatory scheme. Only section 21 of the Glass-Steagall Act applies to nonmember banks. Section 21, however, does not refer to bank affiliates, and the Supreme Court has found that bank affiliates could not be read into the section. In Board of Governors of the Federal Reserve System v. Investment Company Institute, the Court noted that “the language of section 21 cannot be read to include within its prohibition, separate organizations related by ownership with a bank.” It is possible, therefore, that activities of an affiliate of a state nonmember bank are beyond the reach of the Glass-Steagall Act.

A state nonmember bank which is a subsidiary of a bank holding company also may avoid regulation by setting up an affiliate. If the affiliate is neither a nonbank subsidiary of the holding company nor the holding company itself, the Bank Holding Company Act, which would otherwise prohibit investment activity, may not be applicable.

54. Id.
55. Group banking refers to the holding company structure in which the holding company “acquire[s] a controlling interest in a bank or banks, and . . . thereafter supervise[s] the activities of the subsidiaries.” J. Wuumr, supra note 22, at 265.
56. See supra notes 39-45 and accompanying text.
57. An affiliate is a company effectively controlled by another company. BLACK'S LAW DICTIONARY 54 (rev. 5th ed. 1979).
59. Id.
60. Id. at 58 n.24.
61. “Although affiliate as originally defined in § 2(b) of the Glass-Steagall Act did not include holding companies, see 48 Stat. 162, Congress in 1966 amended the statute to bring holding companies within the definition of ‘affiliate’ and thereby within the reach of § 20” of the Glass-Steagall Act. Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. at 60 n.26. The amended section, § 221(a), however, is applicable only to member banks. 12 U.S.C. § 221(a) (1982).
62. This Note argues that theoretically it is possible to structure an arrangement so that an affiliate of a state nonmember bank could avoid being considered indirectly controlled by the
Expansion by this route may be challenged by the states, federal regulatory authorities, and by competing institutions. To engage in otherwise prohibited activity, a state nonmember bank will have to show that its actions are supported by the language and legislative history of the Glass-Steagall and Bank Holding Company Acts, the courts' interpretation of the acts, and policy considerations.

IV. THE GLASS-STEAGALL ACT

A. Language and History

A state nonmember bank wishing to expand its product offerings to include activities such as underwriting mutual funds, revenue bonds, or corporate securities through an affiliate, first must determine that it is not subject to regulation under sections 16, 20 or 32 of the Glass-Steagall Act. The language of these sections is explicit and does not mention nonmember banks. Yet the legislative history and judicial interpretations of these sections prevent such cursory treatment of the question of permissible state nonmember bank activity. Banking regulatory authorities challenging a nonmember bank's expansion through an affiliate could claim that while nonmember banks are not included in the specific language of sections 16, 20, and 32, the legislative history and court opinions concerning those sections suggest that such a hypertechnical distinction would undermine the drafters' intent to separate commercial from investment banking.

A fundamental rule of statutory construction, however, is "that the language of the statute controls when sufficiently clear in its context," and there is no language in sections 16, 20, and 32 to bring nonmember banks within the prohibitions of those sections. Furthermore, Congress has amended the bank-holding company. In such a situation the affiliate would not be a nonbank subsidiary of the holding company (nor obviously would it be the holding company). See infra notes 152-162 and accompanying text.

63. Golombe & Holland, supra note 7.
64. Until 1956 there was a question of standing in banking litigation. Because the pre-1956 legislation was not intended to provide protection from competition for any one financial sector, it was questionable whether a party could sue as a result of a competitor's violations. In 1956, the Bank Holding Company Act specifically granted standing to "[a]ny party aggrieved by an order of the Board," May 9, 1956, ch. 240, § 9, 70 Stat. 138 (codified as amended at 12 U.S.C. § 1848 (1982). See also Investment Co. Inst. v. Camp, 401 U.S. 617, 620-621 (1971); Data Processing Serv. v. Camp, 397 U.S. 150, 157 (1970); Karmel, Glass-Steagall: Some Critical Reflections, 97 Banking L.J. 631, 637 (1980).
65. See supra note 44. Only Section 21 of the Act includes nonmember banks within its prohibitions. See supra note 45.
67. See supra notes 44-50. One author notes that the exclusion of nonmember banks from sections 16, 20, and 32 was probably not planned by the framers of the legislation: The Banking Act of 1933 . . . required that virtually all banks to be covered by the new federal deposit insurance law become members of the Federal Reserve System. The membership provision was not to take effect immediately, however,
ing laws many times since 1933 and has promulgated additional banking legislation to close the loopholes of the early laws. The most notable pieces of legislation that were passed to this end were the 1956 Bank Holding Company Act, designed to prevent product expansion through the holding company structure, and the 1970 Bank Holding Company Act Amendments, designed to prevent one-bank holding companies from such expansion. Yet significantly, Congress has never closed the loophole that was formed by limiting the applicability of sections 16, 20, and 32 of Glass-Steagall to national and state member banks.

Further support for state nonmember bank product expansion can be found in the legislative history of the Glass-Steagall Act. The Act signified Congressional response to the stock market collapse of 1929 and the financial crisis that followed. The stated purpose of the Act was “to provide for the safer, more effective use of the assets of the Federal Reserve Banks and of national banking associations, to regulate interbank control, to prevent undue diversion of funds into speculative purposes, and for other purposes . . . .” The diversion of funds was of paramount concern to the framers. Senator Glass perceived “the excessive security loans and overinvestment in securities of all kinds” as the main reason for the banking insolvencies of the period.


69. See supra note 46 & 48.

70. See supra note 48 and accompanying text.

71. See supra note 50 and accompanying text.

72. See supra note 48 and accompanying text.

73. S. REP. No. 584, 72d Cong., 1st Sess. 1 (1932).

74. Id. at 9.

75. Id. at 8.

76. Id. In theory, a banking crisis is the result of “an abrupt and sharp increase in the public's demand for currency relative to demand deposits [i.e. a decrease in the deposit-currency ratio] which, if unsatisfied, results in bank suspensions. The actual panic occurs when businesses and households revise their liquidity expectations and thus 'run on' the banks.” Wicker, Causes of the Banking Panic of 1930, 40 J. Econ. Hist. 571, 573 (1980). The crucial inquiry, then, is what causes the increased demand for currency? The congressional explanation for the banking crisis does not address this issue. The Congressmen who were instrumental in drafting the Banking Act of 1933 concentrated their criticisms on the quantity of security loans and investments that were made in the years before the crash. Several economists have explained the problem differently, concentrating instead on the quality of loans and investments, and the passive role taken by the Federal Reserve Board in the 1920's. M. Friedman & A.J. Schwartz, A Monetary History of the United States 234, 352-56 (1963).

Friedman and Schwartz view the deposit-currency ratio as exogenous, and their resulting explanation for the run on at least 120 banks of Arkansas, Kentucky, North Carolina, and Tennessee in November of 1930 is an unidentified “contagion of fear [that] spread among depositors, starting from the agricultural areas, which had experienced the heaviest impact of bank failures in the twenties.” M. Friedman & A.J. Schwartz, supra, at 308. Friedman and Schwartz also view the collapse of the Bank of the United States in December 1930 as an extremely signifi-
Specifically, Senator Glass viewed speculation as the cause of inflation of bank credit, especially with respect to brokers loans, and the government’s use of bank loans to carry unfunded public debt. 77

Senator Glass and his congressional colleagues were not alone in their perceptions of why the banking system had collapsed. In hearings before a subcommittee of the Committee on Banking and Currency in 1931, witnesses testified to the problems in the banking system:

When the commercial bank makes a loan to finance a single turnover of goods whether in production or trade it facilitates the current process of industry and commerce. When it uses its powers of credit expansion to finance the sale of securities, however, either through making a loan or investment, it anticipates the accumulation of capital through creating purchasing power which is denoted to capital purchase. This tends to make the ability of the capital markets to absorb securities much more flexible than would otherwise be the case, and thus tends to increase the amplitude in fluctuation in the supply of capital available at different times. 8

77. S. REP. No. 584, 72d Cong., 1st Sess. 3-4, 7.
The Glass-Steagall Act was designed to prevent these abuses by separating commercial from investment banking. The framers wanted to prevent the scramble for speculative profit derived from volatile markets and financed by depositors' savings.97 One way in which banks had purchased securities with depositors' funds was by establishing wholly controlled investment affiliates.80 These affiliates often had the same name as their parent bank. Therefore, when the stock market collapsed, the banks' prestige was damaged and public confidence in the banking system waned.81

Emerging from that crisis and the concern about affiliates was section 20 of the Glass-Steagall Act.82 Section 20 prohibits member banks from having investment affiliates.83 Because state nonmember banks are not subject to regulation under section 20, however, the section's prohibitions against investment affiliates, and its restrictions on all affiliates generally, do not prohibit state nonmember banks from establishing such entities. The right of a state nonmember bank to operate affiliates is left to state law84 and as a result will not necessarily be restricted to the same degree that section 20 restricts affiliates of member banks85

Although the Glass-Steagall Act sought to protect the public by separating commercial from investment banking, the Act did not totally prohibit commercial banks from engaging in investment activities. The drafters

79. See id.
80. Id. at 629; see also, Perkins, supra note 11, at 490-95. The securities affiliates system of the 1920's was described by Senator Bulkeley in his 1932 remarks before the Senate:

Securities affiliates of banks are corporations operating in the long-term capital market in competition with the investment houses, typically unincorporated, that have traditionally done most of the business in that market.

Securities affiliates are controlled usually by having their stock placed in the hands of trustees, who hold it for the pro rata beneficial interest of the bank concerned, each certificate of stock in the bank evidencing by indorsement the ownership also of the same number of shares of stock in the affiliate. All such affiliates are, of course, State-chartered corporations. The majority of them, or about two-thirds, belong to national banks, and about one-third to State banks, the reason for this difference being apparently that State charters are often more liberal than national charters, and grant powers which make an affiliate superfluous. It is also possible for State banks to own their affiliates outright in many States, and this makes resort to the device of trusted stock less common with them than with national banks. Many of the important securities affiliates, especially those controlled through trusted stock, were provided with their original capital by declaration of a stock dividend.

75 CONG. REC. 9909 (1932).
83. 12 U.S.C. § 377 (1982) (as codified); see supra note 44.
84. The Federal Deposit Insurance corporation has proposed a rule that would cover state nonmember banks operating affiliates. See infra notes 129-33 and accompanying text.
85. If state-chartered nonmember banks were prevented from establishing an affiliate by state law, the state banks might be able to engage in a successful lobbying effort to have that law changed. Because banks may convert their charters, they often switch to take advantage of greater laxity in either the state or federal system; the threat of conversion has caused federal laws to become more lax and may spark the same response from states. See Hackley, supra note 11, at 568.
intentionally\textsuperscript{86} allowed banks to purchase investment securities for customer accounts, purchase limited securities for their own accounts, and underwrite government securities.\textsuperscript{87} Furthermore, the Banking Act of 1935\textsuperscript{88} amended section 16 of the Glass-Steagall Act\textsuperscript{9} to make it clear that banks covered by the section, member banks, could purchase stocks for customer accounts,\textsuperscript{90} in addition to their investment securities. The purpose of the amendment was to give the appropriate regulatory agency authority to protect bank customers from risk, not to prevent banks from reaching new markets or from developing new methods of investing their money. That the Glass-Steagall Act allows banks to retain some investment activities, therefore, suggests that new low risk activities may be permissible.\textsuperscript{91}

Section 16 of the Act\textsuperscript{92} separates commercial from investment banking by delimiting permissible activities of commercial banks. These permissible activities are divided into three categories according to the character of the security involved.\textsuperscript{93} The first category covers those activities in which a commercial bank may engage in an agency capacity, the buying and selling of stocks and securities for the accounts of its customers.\textsuperscript{94} The second category covers the buying of investment securities for the bank's own account.\textsuperscript{95} The final category covers unrestricted activities, those undertaken with government securities for the bank's own account.\textsuperscript{96} Those activities in which bank involvement is most limited are those that have the greatest potential to affect depositors' funds; those activities in which bank involvement is least limited involve, or are perceived to involve, the low risk securities of government obligations. This dichotomy reflects the desire to retain some interaction between the banking and security sectors, and apparently is predicated on a risk analysis of the security involved in each type of activity.

Neither early Comptroller's Opinions\textsuperscript{97} nor the Federal Reserve Board's 1935

\textsuperscript{86} 12 U.S.C. § 24 (Seventh) (1982); \textit{Regulatory Construction, supra} note 40, at 40.
\textsuperscript{87} National banks are to be permitted to sell investment securities for their customers to the same extent as heretofore, but hereafter they are to be authorized to purchase and sell such securities for their own account only under such limitations and restrictions as the Comptroller of the currency may prescribe, subject to certain definite limits as to amounts. \textit{Regulatory Construction, supra} note 40, at 40 (quoting S. Rep. No. 585, 72d Cong., 1st Sess. 15 (1932); S. Rep. No. 77, 73d Cong., 1st Sess. 16 (1933); H. Rep. No. 150, 73d Cong., 1st Sess. 3 (1933)).
\textsuperscript{91} See Note, \textit{A Conduct Oriented Approach to the Glass-Steagall Act}, 91 \textit{Yale L.J.} 102 (1981).
\textsuperscript{92} 12 U.S.C. § 24 (Seventh) (1982) (as codified); see \textit{supra} note 39.
\textsuperscript{93} See Karmel, \textit{supra} note 64, at 634.
\textsuperscript{94} \textit{Regulatory Construction, supra} note 40, at 41.
\textsuperscript{95} Id.
\textsuperscript{96} Id.
\textsuperscript{97} Id. at 45.
comment on section 16 of the Glass-Steagall Act supports the idea of a complete severance of commercial from investment banking. In those opinions, the emphasis was on the difference between securities purchases from the bank’s own account as opposed to purchases for the accounts of customers. The opinions do not address the issue of removing investment activities from commercial banking altogether. Rather, the legislative history suggests that the Act was not intended to completely divorce commercial from investment banking, that it was designed to protect depositors. As a result, the Glass-Steagall Act permits banks to engage in low risk activities that do not endanger bank deposits. Judicial interpretations of the Glass-Steagall Act also suggest that a state nonmember bank can expand its products through an affiliate.

B. Judicial Interpretation

Judicial opinions have not expanded the coverage of sections 16, 20, and 32 of the Glass-Steagall Act to nonmember banks. Nor have courts expanded the scope of section 21, which applies to nonmember banks, to cover affiliates of state nonmember banks.

In Investment Company Institute v. Camp, the issue before the Court was "whether the Comptroller of the Currency [could], consistently with the banking laws, authorize a national bank to offer its customers the opportunity to invest in an [open-end investment fund]." The Court described what the challenged ruling would have allowed as follows:

[U]nder the plan, the bank customer tenders between $10,000 and $500,000 to the bank, together with an authorization making the bank the customer's managing agent. The customer's investment is added to the fund, and a written evidence of participation is issued which expresses, in "units of participation," the customer's proportionate interest in the fund assets. Units of participation are freely redeemable and transferable to anyone who has executed a managing agency agreement with the bank. The fund is registered as an investment company under the Investment Company Act of 1940. The bank is the underwriter of the Fund’s units of participation within the meaning of that Act.

The Court concluded that this plan violated the Glass-Steagall Act because the units of participation were found to be securities for the purpose of sec-

98. Id.
99. See supra note 44.
100. 401 U.S. 617 (1971).
101. Id. at 621. In an open-end investment fund, a bank issues shares in a fund composed of securities which the banks buys. The bank then redeems shares in the fund on demand. BLACKS LAW DICTIONARY 741 (rev. 5th ed. 1979).
102. 401 U.S. at 622.
tions 16 and 20 of the Act. The opinion reflects that the Court had difficulty, however, with the plan's combination of two otherwise proper commercial banking activities: pooling trust assets, and acting as a managing agent for individual customers. The Court intimated that such a combination presented all the hazards that the Glass-Steagall Act was designed to prevent, and therefore held that the Comptroller's regulation was invalid.

Although the Camp holding is limited to national banks, it is nevertheless significant, due to its interpretation of the Glass-Steagall Act. In discussing the regulation of bank affiliates, the Court concluded that affiliates do present hazards that the Glass-Steagall Act was designed to prevent. The Court could have classified the fund as an impermissible affiliate and expanded section 21 of the Glass-Steagall Act, yet it instead chose to broaden the definition of the term security in sections 16 and 20. This is particularly noteworthy because it is consistent with the notion that the Glass-Steagall Act was designed primarily to protect depositors from risk. The Court's analysis focused on the nature of the security rather than on the method of providing access to that security.

In Board of Governors of the Federal Reserve System v. Investment Company Institute a 1981 decision, the Court again interpreted sections of the Glass-Steagall Act. The issue before the Court was whether the Board of Governors had the authority to promulgate an amendment to Regulation Y. The regulation was designed to permit bank holding companies and their non-bank subsidiaries to act as investment advisors to closed-end investment companies. In contrast to an open-end investment fund, "a closed-end investment company typically does not issue shares after its initial organization except at infrequent intervals and does not stand ready to redeem its shares."

The ICI Court took a much more restrictive view of the Act than it had in the Camp case. Although the Court agreed with the idea expressed in Camp that depositors should be protected by not allowing the same institutions to undertake commercial banking and investment activities, it did not perceive that idea as establishing parameters on commercial bank activities. It noted, in dicta, that although an activity was prohibited to a commercial bank itself,
this did not mean that the activity was prohibited to an affiliate of the bank under Section 16 of the Glass-Steagall Act.\textsuperscript{115} The Court also noted that the activity was arguably permissible even under section 20 of the Act,\textsuperscript{116} intimating that member banks may engage in the activity through an affiliate depending on the nature of that affiliate’s business as a whole.\textsuperscript{117} Section 20 states that:

\begin{quote}
no member bank shall be affiliated in any manner described in subsection 221(a) of Title 12 with any corporation, association, business trust or any similar organization \textit{engaged principally} in the issue, flotation, underwriting, public sale or distribution at wholesale or retail or through any syndicate participation, of stocks, bonds, debentures, notes or other securities . . . .\textsuperscript{118}
\end{quote}

The Court focused on the language of Section 20, finding it significant that the section uses the words “\textit{engaged principally}” rather than merely “\textit{engaged}”. The Court pointed out that engaged principally and engaged, which is used in section 21 of the Glass-Steagall Act, have significantly different meanings.\textsuperscript{119}

The choice of these particular words indicate a distinction in the scope of coverage of the sections prohibiting bank affiliation with firms that undertake underwriting activities.\textsuperscript{120} “\textit{Engaged}” prohibits affiliation with companies that undertake any securities activities whereas the “\textit{engaged principally}” prohibition does not come into effect unless securities activities make up the bulk of the affiliates’ business. In articulating this distinction, the Court appears to recognize implicitly that even a member bank, to which section 20 applies, may have affiliates which engage in some securities activities.

\textit{Camp}\textsuperscript{121} and \textit{ICP}\textsuperscript{122} therefore, indicate that the Supreme Court does not view the Glass-Steagall Act as completely separating commercial from investment banking. In both cases, the Court refused to extend regulation of member banks under sections 16, 20, and 32.\textsuperscript{123} A state-chartered nonmember bank could use either opinion as authority for the proposition that these sections

\begin{footnotesize}
\begin{enumerate}
\item[115.] \textit{Id.} at 60.
\item[116.] \textit{Id.} at 60 n.26.
\item[117.] \textit{Id.}
\item[118.] 12 U.S.C. § 377 (1982) (as codified) (emphasis added); see supra note 39.
\item[119.] \textit{ICP}, 450 U.S. at 60 n.26. Board of Governors of the Fed. Reserve v. \textit{Agnew}, 329 U.S. 441 (1947). In \textit{Agnew} the Court considered sections 30 and 32 of the Glass-Steagall Act and held that “a decision of the board to remove from office national bank directors . . . is subject to judicial review even in the absence of a charge of fraud and removal may be enjoined if the Board has acted beyond the limits of its statutory authority.” \textit{Id.} at 444. In the \textit{Agnew} case, the Court read “\textit{engaged}” to mean engaged to any extent whatever. \textit{Id.} Such a broad reading could not be given to “\textit{engaged principally}” of section 20 and to “\textit{engaged primarily}” of section 32. \textit{Id.} The \textit{Agnew} Court noted that “within the same Act we find Congress dealing with several types of underwriting firms—those ‘\textit{engaged}’ in underwriting, those ‘\textit{primarily}’ engaged in underwriting, those ‘\textit{primarily}’ in underwriting.” \textit{Id.}
\item[120.] \textit{Agnew}, 329 U.S. at 448. See also case cited supra note 58 and accompanying text.
\item[121.] \textit{Camp}, 401 U.S. 617 (1970).
\item[122.] \textit{ICP}, 450 U.S. 46 (1981).
\item[123.] See supra notes 100-122 and accompanying text.
\end{enumerate}
\end{footnotesize}
do not completely prohibit undertaking of investment activities by commercial banks.

C. Section 21 of the Glass-Steagall Act

Expansion of state chartered nonmember banks through an affiliate will not violate section 21 of the Glass-Steagall Act. Although section 21 is applicable to both member and nonmember banks, in the 1981 ICI case the Supreme Court limited the scope of the section's restrictions. The Court upheld the Board of Governors' authority to amend its list of permissible activities for bank holding companies and their nonbank subsidiaries to include investment advisory services to a closed-end investment company. In determining that the Board had not exceeded its authority by promulgating the amendment, the Court emphasized that "bank affiliates may be authorized to engage in certain activities that are prohibited to banks themselves." The Court stated that Section 21 "could not be read to include within its prohibitions separate organizations related by ownership with a bank which does receive deposits." Section 21, therefore, is not violated until the affiliate is engaged in both securities operations and the acceptance of deposits. Thus, a state nonmember bank could open an investment affiliate without violating section 21 as long as the affiliate refrained from accepting deposits.

D. Recent Action of the Federal Deposit Insurance Corporation

The question of whether the restrictions of the Glass-Steagall Act are applicable to the activities of affiliates or subsidiaries of state nonmember banks has also been the subject of a recent policy statement and accompanying rule of the Federal Deposit Insurance Corporation. In September 1982, the FDIC published a policy statement which concluded that because sections 16, 20 and 32 of the Act apply specifically to member banks and because the wording of section 21 does not refer to affiliates or subsidiaries, state nonmember banks are not restricted by these provisions in setting up affiliates and subsidiaries. Subsequent to the publication of this policy statement, the FDIC proposed a rule to regulate the securities transactions of state nonmember banks.

124. See supra note 45.
126. Id. at 78.
127. Id. at 60.
128. Id. at 58 n.24.
129. Hereinafter referred to as the FDIC.
The proposed rule defines affiliate and subsidiary, and restricts investment in securities activities and affiliation with securities companies.\(^{132}\) The rule, however, limits securities activities of commercial banks not authorized by section 16 of the Glass-Steagall Act to those undertaken on a best efforts basis or those limited to debt securities or investments in mutual funds composed of government securities.\(^{133}\) Therefore, the rule, like judicial opinions, legislative history, and the express language of the statute, does not prohibit a state nonmember bank from expanding through an affiliate.

V. **Regulation by the Bank Holding Company Act**

To this point, this Note has argued that a state nonmember bank may expand its product offerings to the investment realm through an affiliate because sections 16, 20, and 32 of the Glass-Steagall Act do not apply to nonmember banks and because section 21 of the Act should not be expanded to cover bank affiliates. For a state nonmember bank that is a subsidiary of a holding company to expand its product offerings, however, it must also avoid the restrictions of the Bank Holding Company Act.\(^ {134}\) The Bank Holding Company Act grants the Board of Governors discretion to determine whether a holding company is exerting such control over the management and policies of another company that the latter should be considered a subsidiary for the purpose of that Act.\(^{133}\) If the Board determines that a company is a holding company subsidiary, it then must determine whether the activities of the subsidiary are permissible.\(^{136}\) Two tests are employed to make this determination. First, the activity must be "so closely related to banking . . . as to be proper incident thereto."\(^{137}\) Second, the activity must "reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects."\(^{138}\) Accordingly, the subsidiary state nonmember bank, to avoid the Board's discretionary authority on permissibility, must set up its affiliate so that the affiliate does not become a subsidiary.

Analysis of the Bank Holding Company Act suggests that it applies only to holding companies and their nonbank subsidiaries but not to bank subsidiaries of holding companies. To demonstrate that subsidiary nonmember banks are not within the scope of the Bank Holding Company Act, the following sections argue that the statute uses the words "bank subsidiary" in a limited way, and thus that bank subsidiaries are not within the Board's authority.

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133. Id. at 22,163. In addition, the rule sets limits on the relationship between a bank and its affiliates that are designed keep a securities affiliate and its parent bank separate. Id. at 22,162-63.
138. Id.
under the Act. The legislative history will demonstrate that arguments to the contrary are not persuasive.

A. History and Interpretation of the Bank Holding Company Act

Holding companies, until 1956, used the group banking structure to avoid the restrictions of the Glass-Steagall Act.139 The Bank Holding Company Act140 and its 1970 amendments141 were implemented to enforce the Glass-Steagall Act’s policy of separating commercial from investment banking; “to maintain the separation of banking and commerce; to preserve competition in markets; to prevent undue concentration of economic power; and, to protect the right of states to determine the type of banking structure within their borders.”142 A primary concern that arose from the combination of banking and commerce was the increased “risk of cartelizing the financial resources of the economy”143 which can in turn increase economic concentration.

The language of the statute indicates that an affiliate of a subsidiary state nonmember bank is not itself a subsidiary of the holding company under section 2(d)(3)144 of the Bank Holding Company Act. Section 2(d)(3), added in 1970 to expand the Board’s jurisdiction,145 defines a subsidiary:

Subsidiary with respect to a specified bank holding company, means (1) any company 25 per centum or more of whose voting shares (excluding shares owned by the United States or by any company wholly owned by the United States) is directly or indirectly owned or controlled by such bank holding company, or is held by it with power to vote; (2) any company the election of a majority of whose directors is controlled in any manner by such bank holding company; or (3) any company with respect to the management of policies of which such bank holding company has the power, directly or indirectly, to exercise a controlling influence, as determined by the Board, after notice and opportunity for hearing.146

An affiliate of a state-chartered nonmember bank could avoid the percentage ownership test or the director control test147 but might have difficulty show-

139. See supra notes 39-45 and accompanying text.
140. See supra notes 46-55 and accompanying text.
141. See supra notes 49-50 and accompanying text.
143. Chase, supra note 51, at 1227.
147. A subsidiary state nonmember bank and its parent holding company trying to expand product offerings through an affiliate of the state bank would have to structure the arrangement very carefully. If the holding company owns 100% of the stock of the state bank which in turns
ing that it is not indirectly controlled by the holding company. To survive scrutiny under this section, the subsidiary state nonmember bank must show that the management and policy decisions of the affiliate are made by that affiliate and not by the holding company.

The concern in 1956, when the Bank Holding Company Act was passed, and in 1970, when it was amended, was to separate banking from commercial activity. Federal Reserve Chairman Martin, testifying before the Senate Committee on Banking and Currency in 1969 on the one bank holding company exception of the 1956 Act stated:

If a holding company combines a bank with a typical business firm, there is a strong possibility that the bank's credit will be more readily available to customers of the affiliated business than to customers . . . not so affiliated. Since credit has become increasingly essential to merchandising, the business firm that can offer an assured line of credit to finance its sales has a very real competitive advantage over one that cannot. In addition to favoring the business firm's customers, the bank might deny credit to competing firms or grant credit to other borrowers only on condition that they agreed to do business with the affiliated firm . . . if we allow the line between banking and commerce to be eased, we run the risk of cartelizing our economy.

The legislative history indicates that the Act was designed to regulate interactions among members of the holding company to prevent nonbank subsidiaries from obtaining an unfair credit advantage. Section 3 of the Act restricts acquisitions of voting shares of banks by the holding company to a nominal amount. This restriction prevents the bank holding company from capturing the bank and using the assets to support other subsidiaries. Section 4 prohibits acquisitions of nonbanks without prior approval of the board. Because the Act's prohibitions are against acquisition of shares of banks and nonbanks by the holding company, the Act does not regulate establishment or acquisition of an affiliate by a subsidiary bank.

owns 100% of the stock of the affiliate, then the Board will consider the holding company the indirect owner of and in indirect control of the affiliate under subsections (1) or (2).

148. 12 C.F.R. § 225.102 is a precursor to (d)(3). Section 225.102 is merely an interpretive ruling, and as such does not have the force of law. National Ass'n of Ins. Agents, Inc. v. Board of Governors of the Fed. Reserve Sys., 489 F.2d 1268 (D.C. Cir. 1974).

149. Because of the broad language of section (d)(3), the presumptions it establishes as to when a company will be considered controlled by a holding company are difficult to overcome. As a practical matter then, it may be very difficult to structure this arrangement so that the bank benefits from its affiliate.

150. See supra text accompanying note 142.

151. S. REP. No. 1084 91st Cong. 2d Sess. 6, reprinted in 1970 U.S. CODE CONG. & ADMIN. NEWS at 5524. The 1956 Bank Holding Company Act did not include one bank holding companies which did not become very popular until the late 1960's. M.A. Jesse & S.A. Seelig, supra note 48, at 17.


155. Section 4 contains an exception to the requirement of prior Board approval for nonbank acquisitions. A holding company may acquire up to five percent of the outstanding voting shares of any company without prior Board approval. 12 U.S.C. § 1843(c)(6) (1982) (as codified); see supra note 134.
The Act uses the phrase "bank subsidiary" and the word "subsidiary" and they are not interchangeable. The Act regulates bank subsidiaries per se. In *Cameron Financial Corp. v. Board of Governors of the Federal Reserve System*, the Fourth Circuit found that the word "subsidiary" in section 4(a)(2), the grandfather proviso, does not refer to banking subsidiaries. The Act uses the words "banking subsidiary" only twice. Both of these sections dispense with the need for the holding company to obtain Board approval before undertaking certain activities. These exempted activities are recognized by the Glass-Steagall Act as permitted activities for operating subsidiaries of national banks. Therefore, the use of the words "banking subsidiary" does not expand the scope of the Bank Holding Company Act to cover affiliates of a banking subsidiary.

B. Judicial Interpretation of the Bank Holding Company Act.

Judicial opinion supports the contention that the Board's authority is limited to holding company activities and to activities of nonbank subsidiaries of the holding company. In *ICI*, the Supreme Court addressed the contention that the Board's regulation "authorize[d] banks as well as bank holding companies and nonbank subsidiaries to act as investment advisors. The operative definition of bank holding companies in the Board's . . . ruling include[d] their bank and nonbank subsidiaries." It was also contended that banks used this ruling as authority for their establishment of investment advisory services. The Court summarily dismissed this argument in a footnote pointing out that "not only does the interpretative ruling confer no authorization to undertake any activities . . . the Board does not have the power to confer such authorization on banks." The Court then quoted from the Board's appendix to its petition for certiorari:

The Board regulation was adopted pursuant to section 4(c)(8) of the Bank Holding Company Act and authorizes investment advisory activity to be conducted by a nonbanking subsidiary of the holding company.

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156. 497 F.2d 841 (4th Cir. 1974).
158. See *Cameron*, 497 F.2d at 849. ("[T]he grandfather proviso of section 4(a)(2) stipulates that a bank holding company may engage in those activities in which directly or through subsidiary . . . it was lawfully engaged on June 30, 1968 . . . "). *But see Patagonia Corp. v. Board of Governors of the Fed. Reserve Sys.*, 517 F.2d 803 (9th Cir. 1975).
160. *See supra* note 159.
161. 12 C.F.R. § 7.7376 (1982). It is important to remember that sections 16, 20 and 32 of the Glass-Steagall Act do not apply to nonmember banks.
164. *Id.* at 59 n.25. The Board's ruling is located at 12 C.F.R. §225.4(a)(5)(ii) (1982).
165. *ICI*, 450 U.S. at 59 n.25.
166. *Id.*
authorizing of national banks or state member banks to furnish investment advisory services does not derive from the Board's regulation and its scope is to be determined by a particular bank's primary supervisory agency.\textsuperscript{167}

It thus appears that the Board would not have the authority to restrict the activities of bank subsidiaries of holding companies. As the Board itself notes, bank subsidiaries are subject to the authority of a different regulatory agency.\textsuperscript{168}

The Board exercises its control through approving or disapproving applications from holding companies and their subsidiaries. Because bank subsidiaries are beyond the scope of the Board's authority, they need not apply for approval to establish affiliates. Therefore, a state nonmember bank expanding through an affiliate would not be inhibited by the Bank Holding Company Act.

\textbf{VI. \textit{Risk and Policy Analysis.}}

A state nonmember bank, whether or not a holding company subsidiary, wishing to expand its product offerings through an affiliate also must demonstrate that the establishment of the affiliate would not pose the risks that the Glass-Steagall Act and the Bank Holding Company Act were designed to prevent.\textsuperscript{169} Two recent judicial opinions used a similar risk analysis and policy analysis in determining permissible bank activity. In \textit{New York Stock Exchange v. Smith}\textsuperscript{170} and \textit{A.G. Becker v. Board of Governors},\textsuperscript{171} federal courts restricted the authority of the Comptroller and the Board, respectively, by allowing commercial banks to undertake services that very closely resembled services offered by investment banks.\textsuperscript{172} These two decisions may be construed as limiting the authority of the federal regulatory agency to prohibit banks from offering certain types of products to those products that pose the risks which the Glass-Steagall Act and the Bank Holding Company Act were designed to prevent.\textsuperscript{173}

In \textit{Smith}, the D.C. District Court validated a ruling by the Comptroller, holding that automatic investment services\textsuperscript{174} do not violate the Glass-Steagall Act.

\begin{itemize}
  \item \textsuperscript{167} \textit{Id.}
  \item \textsuperscript{168} \textit{Id.}
  \item \textsuperscript{169} See source cited supra note 142 and accompanying text.
  \item \textsuperscript{172} In \textit{Smith}, the controversy centered on a automatic investment service, 404 F. Supp. at 1091, and in \textit{Becker}, on a commercial bank’s sale of commercial paper. 693 F.2d at 136.
  \item \textsuperscript{173} See supra notes 73, 150-51 and accompanying text.
  \item \textsuperscript{174} [An Automatic Investment Service] allows a bank’s checking account customers to invest in common stock through automatic deductions from their accounts. Although only persons maintaining a checking account with the bank may use this service, the account may be opened simultaneously with participation in AIS. Banks generally have limited investors’ selections to common stock of the 25 corporations having the largest capitalization on Standard & Poor’s 425 Industrial Index, though no law or regulation requires this selection method.

\textbf{Note,} \textit{The Legality of Bank Sponsored Investment Services}, 84 \textit{Yale L.J.} 1477, 1478 (1975), (footnotes omitted).
\end{itemize}
The court's decision embodies a risk analysis and explains why the services in question "substantially avoid the hazards Congress feared when it enacted the Glass-Steagall Act." The court noted that because of the manner in which the automatic investment service was operated, the bank did not have a salesman's interest in the performance of the securities; the service did not threaten the prestige of the bank; the bank would not be making bad loans to corporations on the investment list because by definition these corporations were solvent; no purchases were made on credit; and finally, the service was computerized so manpower did not have to be diverted to oversee it. The court looked to the statute and its underlying policy concerns, approving the service only after finding none of the above concerns implicated by that service.

Similarly, in Becker, the D.C. Court of Appeals held that "commercial paper is not a security for the purposes of the Glass-Steagall Act's prohibitions against the banks dealings in securities." Unable to find that the issue had been addressed in the statute or legislative history, the court looked at the relative risks involved in commercial paper to decide whether commercial paper was a security. The court concluded that commercial paper resembled a loan. "[P]urchase of commercial paper, like lending by a commercial bank, represents a very reliable means by which the lender may earn a return on excess cash over a short period of time." Commercial paper's low default rate and short maturity means that its sale by a commercial bank is potentially less risky than a commercial loan. It thus "does not threaten the bank with those dangers that the Glass-Steagall Act was designed to prevent."

The dangers that the affiliate must avoid are promotional conflicts of interest and damaging public confidence in the bank. To avoid those dangers,
the affiliate and its relationship with the bank must be carefully constructed. There are four criteria derived from the Glass-Steagall Act and the Bank Holding Company Act that the affiliate may have to satisfy to survive scrutiny by the courts. First, to prevent the public from attributing any failure of the affiliate to the bank and hence eroding public confidence in the bank, the affiliate and the bank should not have the same name. Second, to avoid promotional conflicts of interest the affiliate should neither promote securities for the bank's large corporate customers, nor trade with the banks trust department. Third, the establishment of the affiliate also must not monopolize the financial resources of the community. Finally, the affiliate should avoid high risk endeavors because the spectacular failure of such endeavors in the late 1920's and early 1930's was primarily responsible for the banking restrictions as they are today.

CONCLUSION

The structure of banking regulation allows banks to choose their regulatory authority. Careful planning by a commercial bank in choosing its chartering authority and primary regulators may leave the bank free to engage in activities that will allow it to offer products competitive with those offered by investment banks and nonfinancial institutions.

Because the Glass-Steagall Act does not prohibit state nonmember bank product expansion through an affiliate, and because a subsidiary state nonmember bank so expanding would not be regulated by the Board, such banks may expand their product offerings. A state nonmember bank offering new products would certainly be challenged by the regulatory authorities, and thus would need a deep pocket in addition to solid legal arguments. It is likely that the investment involved with expansion and a subsequent challenge would be worthwhile. Deregulation, while imminent, will not be immediate. As a result, a state bank that successfully expands to offer nonrisky products through an affiliate would have the advantage of being able to reach markets unavailable to other types of commercial banks and the advantage of being established in those markets once deregulation occurs.

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