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Recommended Citation

John S. Zieser, *Security Under the Glass-Steagall Act: Analyzing the Supreme Court's Framework for Determining Permissible Bank Activity*, 70 Cornell L. Rev. 1194 (1985)
Available at: <http://scholarship.law.cornell.edu/clr/vol70/iss6/7>

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SECURITY UNDER THE GLASS-STEAGALL ACT: ANALYZING THE SUPREME COURT'S FRAMEWORK FOR DETERMINING PERMISSIBLE BANK ACTIVITY

INTRODUCTION

The distinction between commercial banking and investment banking has become increasingly blurred. As part of this trend, commercial banks have begun to deal in commercial paper which, traditionally, has been traded exclusively by investment banks.¹ The term commercial paper refers to prime quality, short-term,² unsecured promissory notes which large, financially strong corporations issue to fund seasonal needs.³ The Supreme Court recently

¹ Almost all nonbank financial institutions have widened their product lines to include areas traditionally reserved for banks. For example, securities firms have entered the retail banking business by offering money market investments. These firms typically do not lend directly to corporations, but they do compete with commercial banks for short-term loans by acting as agents in the commercial paper market. Commercial banks have responded to increased competition from the securities industry by adding such products as discount brokering, asset management accounts, home banking, and data processing. See generally D. CRANE, *THE EFFECTS OF BANKING DEREGULATION* (1983) (explaining overlap of securities firms with commercial banks). See also Simpson & Parkinson, *Some Implications of Financial Innovations in the United States*, 70 FED. RESERVE BULL. 621 (1984) (study focusing on deregulation and market innovation in depository institutions).

² Most commercial paper matures in 60 days or less. See Hurley, *The Commercial Paper Market*, 63 FED. RESERVE BULL. 525 (1977).

³ *Id.* Only about 1,200 firms borrow money in the commercial paper market. Hurley, *The Commercial Paper Market Since the Mid-Seventies*, 68 FED. RESERVE BULL. 327 (1982). Such firms offer commercial paper to investors either directly or through dealers. Hurley, *supra* note 2, at 525.

In the early 1960s only a limited number of companies used the commercial paper market. However, during the tight money periods in 1966, 1969-70, and 1973-74, more nonfinancial firms began obtaining funds in the commercial paper market. Banks unintentionally encouraged this movement into commercial paper by setting the prime rate higher than the commercial paper rate. *Id.* at 531-35. Because of increased use, the commercial paper market is now an important source of capital and, consequently, significantly affects the level of commercial lending by commercial banks. See D. CRANE, *supra* note 1, at 55 (market share of domestically chartered banks fell from 88.2% of commercial loan market in 1973 to 77.3% in 1981, while during this same period, market share of commercial paper issued by nonfinancial corporations rose from 5.0% to 12.9%).

Commercial paper not only competes on the asset side of a bank's balance sheet with short-term commercial loans, but also competes on the liability side by offering an alternative short-term investment to the bank's certificates of deposits. COMMERCIAL BANKING 1975 AND 1980, at 70 (G. Fisher ed. 1970). Money market funds are the primary purchasers of commercial paper. Bank trust departments, life insurance companies, pension funds, nonprofit organizations, and nonfinancial corporations also

held⁴ that commercial paper is a security for the purposes of the Glass-Steagall Act⁵ (the Act) which prohibits banks from dealing in securities.⁶ Therefore, commercial banks are now prohibited from selling, underwriting, or distributing third party commercial paper.

This Note attacks the Court's conclusion that commercial paper constitutes a security under the Act. First, this Note introduces two approaches which the Court used in earlier cases to determine whether a particular financial instrument constitutes a security: the literal analysis focuses on the facial meaning of the statute;⁷ the non-literal or transactional analysis focuses on the role of the commercial bank in dealing with financial instruments.⁸ Then the two-part analysis the court used to conclude that commercial paper is a security will be outlined⁹ and criticized.¹⁰

This Note rejects the Court's literal analysis of the Glass-Steagall Act because it disregards the underlying objective of the Act, to separate commercial banking from investment banking.¹¹ Although the Court's transactional analysis may be useful in distinguishing commercial banks from investment banks, it fails to consider the functional attributes of a financial instrument.¹² The Court should therefore modify the transactional analysis properly to consider the instrument's functional attributes.

BACKGROUND

One of the major objectives of the Glass-Steagall Act is to prohibit commercial banks from entering the investment banking business.¹³ The Act reflects Congress's determination that the possible hazards outweigh the "policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks" into investment banking.¹⁴ The separation of investment

purchase commercial paper. Finally, banks hold a small amount of paper for their own accounts. Hurley, *supra*, at 333-34.

⁴ Securities Indus. Ass'n v. Board of Governors, 104 S. Ct. 2979 (1984) [hereinafter cited as SIA II].

⁵ Banking (Glass-Steagall) Act of 1933, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

⁶ 12 U.S.C. § 378 (1982). See generally *Glass-Steagall Act—A History of Its Legislative Origins and Regulatory Construction*, 92 BANKING L.J. 38 (1975) (tracing development of regulations restricting securities transactions).

⁷ See *infra* notes 32-34 and accompanying text.

⁸ See *infra* notes 35-57 and accompanying text.

⁹ See *infra* notes 58-90 and accompanying text.

¹⁰ See *infra* notes 91-112 and accompanying text.

¹¹ See *infra* notes 91-93 and accompanying text.

¹² See *infra* notes 94-112 and accompanying text.

¹³ See *Investment Co. Inst. v. Camp*, 401 U.S. 617, 629 (1971). A bank may participate in investment banking directly or indirectly through a security affiliate. *Id.* at 630.

¹⁴ *Id.*

banking activities from commercial banking activities fosters public confidence in the banking system because it protects banks against the risks inherent in the securities business. For example, speculation in the securities business during the 1920s by banks and their affiliates resulted in tremendous losses when the securities markets soured. These losses undermined depositor confidence and caused a rash of bank runs, which led in turn to many bank insolvencies and an unstable money supply.¹⁵ Thus, by keeping commercial banks out of investment banking and imprudently investing in risky securities, Congress sought to avoid this same erosion of depositor confidence.¹⁶

A second hazard in permitting commercial banks to engage in investment banking is that the promotional pressure arising from a bank's participation in investment banking might impair that bank's ability to function as a disinterested lender. Congress feared that if a bank were involved in a certain company's security issue, the pressure to make its investment successful might induce the bank to make unsound loans to that company.¹⁷ Moreover, commercial banks might be tempted to make a loan on the belief that the borrower would use it to purchase securities with which the bank was involved.¹⁸

Furthermore, participating in the securities business creates conflicts of interest which may impair a commercial bank's ability to render disinterested financial advice. For example, a conflict of interest may arise when a commercial bank publicly offers the securities of its corporate customers. Banks routinely advise corporate customers on financial matters such as how to structure an issue. Congress feared that a bank could not impartially advise these customers if it stood to gain from distributing a particular security.¹⁹ Further conflicts may arise where a commercial bank promotes a certain security to ensure that the issuing corporation will have sufficient funds to repay its outstanding loan with the bank. Because a successful issue may eliminate a problem loan, the bank may attempt to unload the issue on its customers regardless of the customers' needs.²⁰

¹⁵ See *SIA II*, 104 S. Ct. at 2984.

¹⁶ See *Camp*, 401 U.S. at 630.

¹⁷ See *id.* at 631.

¹⁸ See *id.* at 632.

¹⁹ See *SIA II*, 104 S. Ct. at 2984.

²⁰ See *id.* at 2985. As a result, bank depositors might suffer losses on these investments. See *Camp*, 401 U.S. at 631. Therefore, "the banker who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who . . . distribute[s] circulars" to depositors concerning investments on which the banker receives an organization, underwriting, distri-

Sections 16²¹ and 21²² of the Act are the principal provisions separating commercial and investment banking activity. However, each section approaches the problem from a different perspective.²³ Section 16 approaches the problem by restricting the activities of commercial banks. It requires banks to “purchas[e] and sell . . . securities and stock without recourse, solely upon the order, and for the account of, customers.”²⁴ Section 16 also prohibits commercial banks from purchasing securities, other than “investment securities” for their own account, and from “underwrit[ing] any issue of securities or stock.”²⁵ Section 21, however, separates commercial and investment banking activity by restricting the activity of investment banks. It prohibits persons conducting specified investment banking activities from receiving deposits.²⁶

A. The *Camp* Court’s Two-Part Analysis

In *Investment Company Institute v. Camp*²⁷ the Court used a two-part analysis to determine whether a particular financial instrument constituted a security under the Glass-Steagall Act. In *Camp*, First National City Bank of New York (First National) offered units of par-

bution, or trading commission. *Id.* at 633 (quoting statement of Sen. Bulkeley, 75 CONG. REC. 9912 (1932)).

21 12 U.S.C. § 24 (1982). This section states that

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

Id.

22 12 U.S.C. § 378 (1982). This section provides that

It shall be unlawful . . . [f]or any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits . . . : *Provided*, That the provisions of this paragraph shall not prohibit national banks or State banks . . . from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by [Section 16 of the Glass-Steagall Act].

Id. § 378(a)(1).

23 See Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46, 63 (1981) [hereinafter cited as IC1] (“Sections 16 and 21 of the [Act] approach the legislative goal of separating the securities business from the banking business from different directions.”).

24 12 U.S.C. § 24 (1982).

25 *Id.*

26 12 U.S.C. § 378(a)(1) (1982).

27 401 U.S. 617 (1971).

ticipation in a collective investment plan.²⁸ The units were "freely redeemable, and transferable to anyone" and included a managing agency agreement with First National.²⁹ The bank, in its capacity as managing agent for the fund, invested the fund's assets. The Court found that although a bank may properly pool assets, act as a managing agent, and purchase stock for customers, the combination of these powers creates the functional equivalent of a mutual fund.³⁰ The Court addressed the issue of whether the Comptroller of the Currency may authorize a bank to offer its customers such a fund created and maintained by the bank, and concluded that a bank offering units in such a fund was "underwriting, issuing, selling, and distributing . . . securities in violation of sections 16 and 21 of the [Act]."³¹

The Court's analysis in *Camp* consisted of two parts. First, the Court undertook a literal analysis to determine whether the Act on its face prohibited a bank from operating the investment fund in question. The Court noted that nothing in the language of section 16 or section 21 suggests a narrow reading of the term security.³² Therefore, "the sale of an interest in the business of buying, holding, and selling stocks for investment [should not] be distinguished from the sale of an interest in a commercial or industrial enterprise."³³ Finally, the Court indicated that a broad definition of security corresponded with Congress's intent "to divorce commercial banking" from investment banking activities.³⁴ Therefore, the Court held that the statutory language of section 16 and 21 applied to a bank's sale of redeemable and transferable units of participation in a common investment fund operated by the bank.

Although the Court found that the term security encompassed the investment trust managed by First National, it undertook a second analysis in which it examined the hazards that sections 16 and 21 sought to prevent.³⁵ In light of these hazards, the Court considered the nature of the First National's mutual investment fund as

²⁸ *Id.* at 619. The Comptroller of the Currency approved First National's collective investment plan pursuant to regulations promulgated in 1963. *Id.* at 622 & n.7.

²⁹ *Id.* at 622.

³⁰ *Id.* at 625. "A mutual fund is an open-end investment company." *Id.* at 625 n.11. The Investment Company Act of 1940 defines an investment company as "any issuer which is or holds itself out as being engaged primarily . . . in the business of investing . . . in securities." 15 U.S.C. § 80a-3(a)(1) (1982). An open-end investment company is one "which is offering for sale or has outstanding any redeemable security of which it is the issuer." *Id.* § 80a-5(a)(1).

³¹ 401 U.S. at 639 (emphasis added).

³² *Id.* at 635.

³³ *Id.*

³⁴ *Id.*

³⁵ *See id.* at 636-39. The Court undertook this second analysis because the Comptroller of the Currency approved First National's plan and "courts should give great

well as the bank's function in managing the fund. The Court concluded that the potential hazards and abuses flowing from the entry of banks into the mutual investment business are the "same basic hazards and abuses" which Congress designed the Glass-Steagall Act to eliminate.³⁶

The Court noted that banks entering the mutual investment business might impair the public's confidence in the banking system.³⁷ A bank operating a mutual investment fund places its reputation and facilities behind the fund. As a result, public confidence in the bank would be damaged if the fund proved unsuccessful or was imprudently managed. Moreover, if the fund developed financial problems, the bank might attempt to rescue the fund through improvident actions.

The promotional pressures in operating an investment fund produce the conflicts of interest that Congress feared would impair a bank's ability to render disinterested advice to its customers. Such an investment fund directly competes with aggressively promoted funds offered by other investment companies. Therefore, a bank may feel pressure to promote its investment fund to its customers.

The Court also asserted that the bank's interest in the fund might lead it to make unsound loans. The bank might exploit its confidential relationship with other commercial or industrial creditors.³⁸ It might also make its credit facilities available to the fund at the expense of its depositors' best interests.³⁹ Finally, talent and resources might be directed away from the bank's other operations to promote the fund.⁴⁰

B. Applications of the Transactional Approach to Commercial Bank Activity After *Camp*

Since *Camp*, the Court has applied its transactional approach in *Board of Governors of Federal Reserve System v. Investment Company Institute* [hereinafter *ICI*],⁴¹ *Securities Industry Association v. Board of Governors of Federal Reserve System* [hereinafter *SIA I*],⁴² and *Securities Industry Association v. Board of Governors of Federal Reserve System* [hereinafter *SIA II*].⁴³ Although only *SIA II* presented the issue of

weight to any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute." *Id.* at 626-27.

³⁶ *Id.* at 639.

³⁷ *Id.* at 637.

³⁸ *See id.* at 636-37.

³⁹ *See id.* at 638.

⁴⁰ *See id.*

⁴¹ 450 U.S. 46 (1980). *See infra* notes 44-50 and accompanying text.

⁴² 104 S. Ct. 3003 (1984). *See infra* notes 51-57 and accompanying text.

⁴³ 104 S. Ct. 2979 (1984). *See infra* notes 59-90 and accompanying text.

whether a particular financial instrument was a security under the act, both the *ICI* and the *SIA I* courts used the *Camp* transactional analysis to determine whether a bank's activity violated the Glass-Steagall Act.

In *ICI* the Court applied the transactional analysis to determine whether a bank holding company may provide investment advice to a closed-end investment company without violating sections 16 and 21 of the Act.⁴⁴ After its initial issuance, a closed-end investment company does not issue additional shares and does not stand ready to redeem its shares. In contrast, an open-end investment company or mutual fund will issue new shares and stands ready at any time to redeem outstanding shares.⁴⁵ The Court held that the hazards contemplated by the Act are not present when a bank provides investment advice to a closed-end investment company, provided it does not issue, sell, or underwrite shares in that company.⁴⁶

The *ICI* Court distinguished *Camp*, observing that "[t]he mutual fund under review in [*Camp*] was the functional equivalent of an open-end investment company."⁴⁷ The Court reasoned that because of the functional attributes of the closed-end investment company and the strict Federal Reserve Board regulations of such companies, they did not present the hazards of impairing the bank's disinterested lending and advice. Because a closed-end investment company does not redeem its issued shares, the company will not request additional capital from the bank to cover redemption of its shares. Moreover, the advisory fee earned by the bank in advising a closed-end company, based on portfolio value, provides little incentive for a bank to risk its assets by extending imprudent loans to companies whose stock is held by the investment company.⁴⁸ Furthermore, the Federal Reserve Board strictly regulates closed-end

⁴⁴ 450 U.S. at 58-68. The Court described the typical relation between an investment adviser and an investment company:

Investment companies, by pooling the resources of small investors under the guidance of one manager, provide those investors with diversification and expert management. Investment advisers generally organize and manage investment companies pursuant to a contractual arrangement with the company. In return for a management fee, the adviser selects the company's investment portfolio and supervises most aspects of its business.

Id. at 50-51 (footnotes omitted).

⁴⁵ See 12 C.F.R. § 225.125(c) (1985) (defining mutual fund to include these characteristics).

⁴⁶ See *ICI*, 450 U.S. at 66-68.

⁴⁷ *Id.* at 65 (footnote omitted); see *id.* at 65 n.36 (describing *Camp's* mutual fund).

⁴⁸ *Id.* at 67. The advisory fee in connection with an open-end fund is typically one-half of one percent of the value of the fund's assets. *Id.* The advisory fee associated with an open-end company or mutual fund increases both with the increase in portfolio value and through sale of the company's shares. In a closed-end investment company, however, the advisory fee earned by the advisor increases only if the value of the investment

investment companies.⁴⁹ These regulations prohibit a bank from either owning any interest in the investment company or extending credit to the investment company.⁵⁰

The Court also applied a transactional approach in *SIA I*.⁵¹ In that case the Court addressed the question of whether the Federal Reserve Board is authorized to permit a bank holding company, the BankAmerica Corporation (BankAmerica), to acquire a retail brokerage firm, Charles Schwab and Company (Schwab). The Court found that the Federal Reserve Board has such authority⁵² and that its approval was proper in this case because the *Camp* concerns were not present. The Court stated that a loss of depositor confidence through unsuccessful or imprudent management of the investment activity was not a concern because Schwab, trading as an agent rather than as a principal, was "not subject to the vagaries of the securities markets."⁵³ The Court added that promotional pressure was not present because BankAmerica had no salesman's stake in the securities that Schwab traded.⁵⁴ Schwab's profits depended solely upon share volume and not on "the purchase or sale of particular securities."⁵⁵ Consequently, BankAmerica had no incentive to extend credit to particular securities issuers or to favor particular securities when managing depositors' assets. Thus, the Court concluded that the brokerage activities would not hinder BankAmerica's role as an impartial lender.⁵⁶ Finally, the Court found that BankAmerica's ability to render disinterested financial advice to depositors was not a concern because Schwab, a discount broker, did not promote particular securities but merely executed purchase and

portfolio increases. *See id.* at 67 n.40 (citing *SEC Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. 96-99, 204-05 (1963)).

⁴⁹ *See* 405 U.S. at 52 & nn.12-13, 67.

⁵⁰ *See* 12 C.F.R. § 225.125(g) (1985). The *ICI* Court further observed that a bank may not promote an investment fund by rendering partial advice because the regulations prohibit a bank from giving the names of its depositors to the investment company. 450 U.S. at 67 n.39. In addition,

the bank could not act as investment adviser to any investment company having a similar name; prospectuses and sales literature of the investment company could not be distributed by the bank; officers and employees of the bank could not express an opinion with respect to the advisability of the purchase of securities of the investment company, and the investment company could not locate its officers in the same building as the bank.

Id.

⁵¹ 104 S. Ct. 3003 (1984).

⁵² The authority is pursuant to § 4(c)(8) of the Bank Holding Company Act. 12 U.S.C. § 1843(c)(8) (1982).

⁵³ 104 S. Ct. at 3011.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *See id.*

sell orders placed by its customers.⁵⁷

II

ANALYSIS OF COMMERCIAL PAPER UNDER THE LITERAL AND TRANSACTIONAL APPROACHES

In 1978 the Bankers Trust Company (Bankers Trust) began placing the commercial paper of several of its corporate customers.⁵⁸ It sold only issues receiving the highest rating from at least one of the commercial paper rating services. Bankers Trust sold commercial paper to institutional investors who regularly purchased other short-term instruments from the bank. Although it did not commit itself to purchase unsold paper, the bank did purchase some of its issues in the secondary market. The Securities Industry Association (SIA) and A. G. Becker (Becker), a commercial paper dealer, petitioned the Federal Reserve Board to rule that Bankers Trust's activities were prohibited by sections 16 and 21 of the Glass-Steagall Act.⁵⁹

The Board ruled that the commercial paper placed by Bankers Trust was not a security under the Act.⁶⁰ After concluding that the literal language of the Act failed to indicate whether commercial paper was a security under the Act, the Board applied a functional analysis. According to the Board, if the instrument "evidences a transaction that is more functionally similar to a traditional commercial banking operation than to an investment transaction, . . . the instrument should not be a security."⁶¹ Because Bankers Trust's commercial paper was short-term, designed to provide corporations with cash, and the purchasers were the bank's institutional customers, the Board determined that this commercial paper was more similar to commercial lending than to an investment transaction. Accordingly, the Board ruled that such activity was not prohibited by the Act.⁶²

The United States District Court for the District of Columbia reversed the Board's ruling. The court concluded that commercial paper represents a "note or other security" under section 21 of

⁵⁷ *Id.* at 3010 n.18.

⁵⁸ *See* 104 S. Ct. at 2981.

⁵⁹ *See* A.G. Becker, Inc. v. Board of Governors, 693 F.2d 136, 138 (D.C. Cir. 1982), *rev'd sub nom.*, *SIA II*, 104 S. Ct. 2979 (1984).

⁶⁰ *See* 104 S. Ct. at 2982.

⁶¹ *See id.* (quoting FEDERAL RESERVE SYSTEM, STATEMENT REGARDING PETITIONS TO INITIATE ENFORCEMENT ACTION 135a (1980) (on file at *Cornell Law Review*)).

⁶² The Board also set forth guidelines governing a bank's sale of third party commercial paper. These guidelines concerned the type and amount of paper sold, the kinds of records that must be maintained, and the allowable purchasers. *See* Policy Statement Concerning the Sale of Third Party Commercial Paper by State Member Banks, 46 Fed. Reg. 29,333 (1981).

the Act.⁶³ The district court reasoned that the proper focus under the functional analysis is on the role of the commercial bank in the transaction and not the role of the commercial paper in the financial affairs of the issuer. According to the court, the Board misapplied the functional approach by “ignor[ing] the specific conduct of the bank [in performing] transactions unquestionably at the heart of the securities industry.”⁶⁴

The United States Court of Appeals for the District of Columbia reversed the district court’s judgment. The court of appeals held that commercial banks may sell third party commercial paper.⁶⁵ The court first stated that the statutory language of the Act “strongly suggests that sale of commercial paper should be treated as a ‘loan’ rather than a sale of securities for the purposes of the Act.”⁶⁶ However, the court found that neither the Act’s language nor its legislative history expressly determine whether commercial paper is a security under the Act.⁶⁷ Turning to a nonliteral approach, the court endorsed the Board’s version of the functional analysis. According to the court, the Board “correctly focused on whether the commercial paper marketed by Bankers Trust functioned economically as a loan or as a security [because] the hazards the Act was designed to prevent”⁶⁸ are likely only when commercial paper functions as a security. The court concluded that Bankers Trust’s commercial paper more closely resembled a loan because of its extremely low default rate, its very short maturity, and its sophisticated purchasers.⁶⁹

In rejecting the district court’s nonliteral approach, the court of appeals noted that marketing the paper did “not have the same economic impact on the bank as would marketing of securities.”⁷⁰ Bankers Trust merely acted as an agent in the transaction and sold only prime quality, short-term commercial paper; therefore, no danger existed in placing funds in speculative securities and thereby impairing depositor confidence. Furthermore, commercial paper is purchased only by large sophisticated investors. Consequently, Bankers Trust was not in a position to give unreliable financial advice to these purchasers to promote an issue. Finally, the court found that Bankers Trust could not use its credit facilities to facilitate its commercial paper sales because no investor would borrow

⁶³ *A.G. Becker, Inc. v. Board of Governors*, 519 F. Supp. 602, 612 (D.D.C. 1981).

⁶⁴ *Id.* at 615.

⁶⁵ 693 F.2d at 151.

⁶⁶ *Id.* at 144.

⁶⁷ *Id.* at 147.

⁶⁸ *Id.* at 148.

⁶⁹ *Id.* at 149.

⁷⁰ *Id.* at 150.

from a commercial bank to buy commercial paper since the interest rate on commercial loans usually exceeds the rate of return on commercial paper.⁷¹ Also, because the paper was low-risk and "issued only by very solvent corporations,"⁷² there was little risk that Bankers Trust would advance unsound loans to the issuers. Accordingly, the court concluded that "[t]he bank's role as seller d[id] not threaten the bank with those dangers which the . . . Act was designed to prevent."⁷³

The Supreme Court in *SIA II*⁷⁴ reversed the court of appeals. The Court concluded that commercial paper falls within the plain language and legislative purposes of sections 16 and 21 of the Glass-Steagall Act. The Court held that commercial paper constitutes a security under the Act and, therefore, commercial banks are prohibited from placing commercial paper.⁷⁵ The *SIA II* Court's reasoning followed a two-part analysis similar to that articulated in *Camp*.

The *SIA II* Court first undertook a literal analysis of sections 16 and 21 of the Glass-Steagall Act. Because the Act does not define notes or other securities, the Court " 'start[ed] with the assumption that the legislative purpose is expressed by the ordinary meaning of the words used.' "⁷⁶ Relying on the sweeping language in *Camp* that " 'nothing in the phrasing of either § 16 or § 21 . . . suggests a narrow reading of the word 'securities,' " ⁷⁷ the Court reasoned that it should broadly construe the phrase "notes . . . or other securities" to "separat[e] as completely as possible commercial from investment banking."⁷⁸

The Court refined the literal approach employed by *Camp* by looking to the securities laws and other contemporaneous statutes to help define the term security under the Glass-Steagall Act.⁷⁹ The Court examined several laws which were "collectively designed to

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ 104 S. Ct. 2979 (1984).

⁷⁵ Because the court of appeals had concluded only that Bankers Trust's commercial paper was not a security under the Act, the Supreme Court did not address the issue of whether the activity of Bankers Trust constituted underwriting under § 16 or "the business of issuing, underwriting, selling, or distributing" under § 21. *Id.* at 2992 n.12.

⁷⁶ *Id.* at 2986 (quoting *Russello v. United States*, 464 U.S. 16, 21 (1983)).

⁷⁷ *Id.* at 2987 (quoting *Camp*, 401 U.S. at 635).

⁷⁸ *Id.* at 2992 (quoting *ICI*, 450 U.S. at 70). The Court flatly rejected the Board's version of the functional approach. *Id.* at 2988-89 ("[W]e find it difficult to imagine that Congress intended the Board to engage in the subtle and ad hoc 'functional analysis' described by the Board.").

⁷⁹ In construing the meaning of security under § 16 and § 21, the *Camp* Court made no reference to the securities laws or other statutes' definitions. *See supra* notes 27-40 and accompanying text.

restore public confidence in financial markets” and found “considerable evidence” that the terms security and note include commercial paper.⁸⁰ Each of these statutes contains an explicit exemption for commercial paper. The Court reasoned that the absence of such an exemption in the Glass-Steagall Act indicates that Congress intended the term security to include commercial paper.⁸¹

The Court next applied a transactional analysis to Bankers Trust’s commercial paper activities to determine whether such commercial paper is a security under the Act.⁸² The Court distinguished the transactional approach, which focuses on the role of the bank, from the Board’s functional analysis, which centers on the nature of the financial instrument.⁸³ The Court found the Board’s approach deficient because it “misapprehends Congress’ concerns with commercial bank involvement in marketing securities.”⁸⁴ The functional approach may prevent future bank losses by prohibiting a bank from underwriting speculative, long-term investments. However, according to the Court, that approach fails to address “the role of [the] bank as a promoter of securities [which is] fundamentally incompatible with its role as a disinterested lender and advisor.”⁸⁵ Furthermore, the Court rejected the notion that the functional attributes of commercial paper could affect the role of the bank in selling that paper. The Act’s prohibition, the Court emphasized, depends neither on the extreme safety of commercial paper nor on the sophistication of its purchasers.⁸⁶

The Court concluded that Bankers Trust’s transactional role produced essentially the same hazards as those articulated in *Camp*.⁸⁷ First, a bank dealing in the commercial paper market risks losing the confidence of its depositors because the bank may use its depositor list to locate commercial paper customers. If the issuer thereafter defaults, depositors induced by the bank to purchase the paper may lose confidence in the bank.

Second, the *SIA II* Court noted that a pecuniary interest in a particular investment offering may “impair [the bank’s] ability to function as an impartial source of credit.”⁸⁸ A bank may feel pres-

⁸⁰ *SIA II*, 104 S. Ct. at 2987 (citing the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.); the Securities Act of 1933, 15 U.S.C. § 77a (1982); the Securities Exchange Act of 1934, 15 U.S.C. § 78a (1982); and the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79a (1982)).

⁸¹ *Id.*

⁸² *Id.* at 2989-92.

⁸³ *Id.* at 2989.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.* at 2990-91.

⁸⁷ *See id.* at 2989-92.

⁸⁸ *Id.* at 2989 (quoting *Camp*, 401 U.S. at 631).

sure to enhance the marketability of an issue by extending back-up credit to the issuer. Furthermore, because a commercial bank will be competing with other dealers to sell commercial paper, a bank may feel forced to purchase its unsold commercial paper "in order to demonstrate the reliability of its distribution system, even if the paper does not meet the bank's normal credit standards."⁸⁹

Third, if a commercial bank markets commercial paper, the conflict of interest may impair the bank's ability to render disinterested financial advice to its depositors.⁹⁰ This potential for abuse becomes acute when a bank distributes the commercial paper of a financially troubled commercial loan customer who will use the proceeds to retire an outstanding debt owed to the bank. In such a situation, the bank would have a strong interest in the success of the commercial paper offering because a successful distribution would eliminate a problem loan.

III

ANALYSIS

The *SIA II* Court's two-part analysis is seriously flawed. First, the Court's literal analysis of the Glass-Steagall Act is unworkable. There is no ordinary meaning of the critical terms in sections 16 and 21 to support the Court's conclusion that commercial paper is a security. Moreover, the Court's reliance on the securities laws to define security under the Act is misplaced. Second, the *SIA II* Court's transactional approach fails to recognize that the functional attributes of a financial instrument determine the bank's transactional role. Therefore, the *SIA II* Court's conclusion that commercial paper is a security under the Act is erroneous.

A. The *SIA II* Court's Misapplication of the Literal Analysis

The literal analysis focuses on whether the statutory language clearly prohibits the activity in question. This analysis is workable only when the activity clearly violates the applicable statute, as the mutual fund in *Camp* violated the Glass-Steagall Act. However, when financial instruments such as commercial paper are at issue, no literal meaning of the critical terms in the Act indicates that commercial paper is a security. Consequently, the formalistic and oversimplified literal approach becomes problematic.

The decision in *SIA II* misuses the literal approach. The *SIA II* Court substantially relied on the Securities Act of 1933 and other

⁸⁹ *Id.*

⁹⁰ *Id.* at 2990.

legislation to infer Congress's meaning of the term security.⁹¹ This analogy is inappropriate, however, because the Glass-Steagall Act and the securities laws were intended to serve different purposes. The Glass-Steagall Act was designed to prohibit commercial banks from engaging in investment banking activities. In contrast, the securities laws were intended to regulate the capital markets.⁹² Thus, congressional objectives did not require that the term security have an identical meaning under the two laws. Securities under the securities laws includes instruments that are not securities under the Glass-Steagall Act. For example, a bankers' acceptance is a security under the securities laws, but not under the Glass-Steagall Act.⁹³

Thus, the *SIA II* Court's literal analysis is an improper method of determining whether commercial paper is a security under the Act. The Court's literal approach merely applies formalistic rules, in lieu of careful consideration of the underlying purpose of the Act, to separate investment banking from commercial banking. By disre-

⁹¹ See *supra* notes 80-81 and accompanying text.

⁹² See *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975) ("primary purpose" of securities legislation of 1933 and 1934 was to eliminate abuses from "the capital market of the enterprise system" and "to prevent fraud and to protect the interests of investors").

⁹³ The Board determined that such instruments were not securities under the Glass-Steagall Act. See *SIA II*, 104 S. Ct. at 2999-3000 (O'Connor, J., dissenting); see also Letter from Secretary of the Board of Federal Reserve Agency, Federal Reserve Bank of New York (June 8, 1934) (on file at *Cornell Law Review*).

Furthermore, a facial construction which characterizes commercial paper as a security under the Act creates contradictions in long-established federal banking policy. Commercial banks routinely purchase commercial paper for their own accounts. See A. GREEF, *THE COMMERCIAL PAPER HOUSE IN THE UNITED STATES* 96 (1938) ("by 1900 [commercial banks] were purchasing 95 per cent or more of the total volume of paper sold by dealers each year"); see also N. BAXTER, *THE COMMERCIAL PAPER MARKET* 76-81 (1966) (statistical data regarding commercial banks' investment in commercial paper). Section 16, however, prohibits banks from purchasing securities and stocks, other than "investment securities," for their own accounts. 12 U.S.C. § 24 (Supp. 1984).

Section 16 defines "investment securities" as "marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency." *Id.* The Comptroller has stated that "[t]he term 'investment security' means a marketable obligation in the form of a bond, note, or debenture which is commonly regarded as an investment security. It does not include investments which are predominantly speculative in nature." 12 C.F.R. § 1.3(b) (1984).

In banking practice commercial paper has never been regarded as an investment security. On the contrary, it has been a long-standing banking policy to regard commercial paper as a loan, not as an investment security. See *SIA II*, 104 S. Ct. at 2996 (O'Connor, J., dissenting) (noting Comptroller's chief counsel's position that commercial paper is not investment security).

The *SIA II* Court did not decide whether commercial paper is an investment security under the Act. *SIA II*, 104 S. Ct. at 2991 n.11 (Court suggested that phrase "discounting and negotiating promissory notes" gives commercial bank authority to acquire commercial paper for its own account because such activity is not the "business of dealing" in securities).

garding the purpose of the Act and relying instead on oversimplified statutory analogues, the *SIA II* Court incorrectly concluded that commercial paper is a security for the purposes of the Glass-Steagall Act.

B. The *SIA II* Court's Misapplication of the Transactional Analysis

The *SIA II* Court also applied a transactional analysis to establish that commercial banks should not be allowed to deal in third party commercial paper.⁹⁴ Instead of applying the Board's functional version of the transactional analysis, the Court completely disregarded the functional characteristics of commercial paper and focused only on the bank's role in dealing with commercial paper. Thus, the *SIA II* Court failed to consider how commercial paper's functional attributes affect the bank's role in the commercial paper transaction. Consequently, the Court erroneously held that commercial paper is a security under the Act.

Permitting banks to deal in commercial paper will not unduly risk a reduction in depositor confidence. Although commercial bank participation in the commercial paper market may create a risk to depositor confidence, this risk is no greater than that resulting from traditional commercial banking activities.⁹⁵ For example, whenever a commercial bank extends a loan, there is a possibility of default.⁹⁶ Similarly, whenever a bank purchases commercial paper or extends credit to the issuer, a possibility exists that the paper will not be paid at maturity.⁹⁷

Furthermore, commercial paper's functional attributes tend to

⁹⁴ See *supra* note 35.

⁹⁵ The variability of a bank's portfolio represents the bank's total risk. The bank's risk in carrying commercial paper must therefore be measured in relation to the bank's other business activities. A bank will seek to reduce its total risk by investing in instruments with negatively correlated risks. See Wagner & Lau, *The Effect of Diversification on Risk*, 27 FIN. ANALYST'S J. 48 (Nov.-Dec. 1971). However, not all of the bank's risk may be eliminated by diversification. The risk that can be eliminated by diversification is called unsystematic risk. The risk that diversification will not eliminate is known as market risk. Market risk exists because there are economy-wide perils that threaten all businesses. See R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 125 (1984). As a result, a business conducting a large number of higher risk activities may have less risk in total than a business conducting a small number of improperly diversified low risk activities. See Wagner & Lau, *supra*, at 51-52 (presenting empirical data supporting proposition). Allowing commercial banks to sell commercial paper will increase the total risk of banks only if the market risk rises.

⁹⁶ Total composite net loan losses for 1983 of holding companies equalled 1/2 of 1% of average loans outstanding. See Morgan Stanley Investment Research, *Bank Performance Review 1983 Edition* 164-65.

⁹⁷ Commercial paper defaults during the past 10 years average approximately 1/10 of 1% of average annual commercial paper outstanding. See M. STIGUM, *THE MONEY MARKET* 628, 635 (1983); see also A. GREEF, *supra* note 93, at 313-14 (from 1922 to 1935

reduce the probability of a default. Independent credit rating services evaluate each corporation's commercial paper.⁹⁸ Accordingly, only financially strong, highly-rated firms issue commercial paper.⁹⁹ The short-term maturity of commercial paper further minimizes the risk of default. Most obligations have an initial maturity of less than sixty days.¹⁰⁰ The credit condition of a financially sound issuer is unlikely to deteriorate significantly during such a short period. Moreover, the banking system provides several mechanisms to protect against issuer default. For example, the banking system provides lines of credit to commercial paper issuers to back their paper. These funds allow companies that are experiencing difficulties to redeem their paper without disrupting the financial markets.¹⁰¹

Allowing banks to deal in commercial paper will not impair a bank's ability to act as disinterested lender. A commercial bank's pecuniary interest in a paper offering would not be sufficient to create promotional pressures that would impair the bank's ability to function as an impartial credit source. Because the fees associated with placing commercial paper are significantly less than those associated with longer-term instruments,¹⁰² commercial paper place-

less than one percent of firms using the market were unable to redeem their paper); M. STIGUM, *supra*, at 635.

⁹⁸ The five rating services currently evaluating commercial paper are Moody's Investors Serv.; Standard & Poor's Corp.; Fitch Investors Serv.; Duff & Phelps, Inc.; and McCarthy, Crisanti, Maffei, Inc. Moody's and Standard and Poor's rate more than 900 and 1,000 issuers, respectively. These two services use simple numerical schemes to distinguish three or four categories of issuers. See Hurley, *supra* note 3, at 331.

⁹⁹ See Hurley, *supra* note 2, at 529; Lowenstein, *The Commercial Paper Market and the Federal Securities Laws*, 4 CORP. L. REV. 128, 129 (1981) (defining commercial paper as promissory notes issued by financially sound firms).

Nonfinancial corporations account for more than 60% of the commercial paper issued through dealers. Such corporations use paper to meet seasonal needs, as a substitute for bank credit or to await the improvement of longer-term market conditions. Most of these firms have a net worth over \$100 million. The few that are worth as low as \$50 million are not heavily leveraged and have very good financial records or a well-established parent company. Financial corporations using the dealer market usually have a net worth on the order of \$40-50 million. Accordingly, financial companies in the dealer market often have lower commercial paper ratings and pay higher interest rates than other borrowers. See Hurley, *supra* note 2, at 527-28.

¹⁰⁰ Hurley, *supra* note 2, at 530. The average maturity on dealer-placed paper ranges from 30 to 45 days. *Id.* Lower quality commercial paper tends to have a short maturity, as issuers attempt to design the maturity to appeal to the investor's caution. Short maturities allow investors to withdraw quickly if the issuer shows signs of financial difficulty. Consequently, commercial paper represents a volatile source of funds for weak borrowers.

¹⁰¹ In addition, lenders support commercial paper through "irrevocable commitments to lend" under which a bank lends the issuer funds to cover its outstanding notes. Banks also extend loans at below market rates to companies facing temporary impediments in raising funds in the paper markets. See Hurley, *supra* note 3, at 332-33.

¹⁰² The traditional dealer placement fee is one-eighth of one percent per annum. This translates to \$1,250 for \$1 million of commercial paper placed. Lowenstein, *supra* note 99, at 132. In comparison, underwriting notes, debentures, or bonds produces an

ment is not as profitable as other services provided by the bank. Dealing in such paper merely encourages issuers to use the dealer's more profitable services.¹⁰³ Thus, the relatively low fees paid by commercial paper issuers would provide little incentive for a bank to extend high-risk credit to a company attempting to continue to place its paper.

The promotional pressure on a bank is no greater in the commercial paper context than in other traditional bank credit transactions. In loan participations and syndications, for example, the lead bank solicits lenders who are willing to extend credit to a particular borrower and prepares a financial summary of the borrower for the prospective lenders.¹⁰⁴ The lead bank receives a fee from the borrower for arranging the loan participation or syndication.¹⁰⁵ In addition, the lead bank charges the participant banks a fee for managing the arrangement.¹⁰⁶ Loan participations and syndications, however, are not securities under the Act or under the securities laws.¹⁰⁷

Bank participation in the commercial paper market is unlikely to create conflicts of interest that unduly impair a bank's ability to act as a disinterested advisor to its customers. The possible conflicts of interest that would result from dealing in commercial paper¹⁰⁸

investment banking fee of \$8,000 per \$1 million of debt sold. See D. DARST, *THE COMPLETE BOND BOOK* 239 (1975). The fee paid by the commercial paper issuer "would provide scant incentive to a bank to risk its assets by making unwise loans to companies." *ICI*, 450 U.S. at 67-68 n.40.

¹⁰³ See Lowenstein, *supra* note 99, at 132.

¹⁰⁴ See Pollock, *Notes Issued in Syndicated Loans—A New Test to Define Securities*, 32 *BUS. LAW.* 537, 538 (1977).

¹⁰⁵ See Note, *Loan Participation Agreements as Securities: Judicial Interpretations of the Securities Act of 1933 and the Securities Exchange Act of 1934*, 24 *WM. & MARY L. REV.* 295, 297 (1983).

¹⁰⁶ See Pollock, *supra* note 104. Furthermore, loan participations and syndications frequently involve nonbank lenders. *E.g.*, *American Fletcher Mortgage Co. v. United States Steel Credit Corp.*, 635 F.2d 1247, 1248-49 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981).

¹⁰⁷ See, *e.g.*, *Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1179-85 (6th Cir. 1981) (bank's attempt to classify loan participation as a security "must fail"), *cert. denied*, 454 U.S. 1124 (1981); *American Fletcher Mortgage Co. v. United States Steel Credit Corp.*, 635 F.2d 1247, 1253-55 (7th Cir. 1980) ("Congress did not intend to regulate commercial loan transactions that would have no impact on the securities markets."), *cert. denied*, 451 U.S. 911 (1981).

¹⁰⁸ See generally *TWENTIETH CENTURY FUND, ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS* (1980); Note, *A Conduct-Oriented Approach to the Glass-Steagall Act*, 91 *YALE L.J.* 102, 104-06 (1981) (discussing conflicts of interest arising when a commercial bank underwrites commercial paper).

Banks face three types of conflicts of interest when they deal in commercial paper. They may encourage corporate clients to issue commercial paper to generate distribution profits for the bank even though the distribution was not needed. They may encourage an unnecessary issue to generate cash which the issuer can use to pay off an outstanding loan to the bank. Finally, banks may be inclined to lend money to custom-

would not differ from those arising in traditional banking activities. Traditional activities create

the potential for trust department investment based upon material inside information obtained from the bank's commercial activities, preferential trust or commercial department accommodation of an important bank customer to the detriment of less-valued bank customers, and unproductive cash accumulation in trust department accounts which increases the loanable reserves of the bank.¹⁰⁹

Nevertheless, internal rules and procedures prevent commercial banks from abusing these conflicts of interest.¹¹⁰ Similarly, internal rules and procedures would effectively deal with the conflicts of interest that result from dealing in commercial paper.

The primary concern underlying the conflict of interest consideration is fairness to all parties.¹¹¹ If all parties had perfect information, conflicts of interest would never arise because the bank would never be put in a position where it could benefit one person at the expense of another. In a perfectly informed market, the bank would serve all customers equally because the market would react negatively to a bank's misdealing. Thus, the concern over conflicts of interest is a function of the perceived disparity of information in the market.

Commercial paper is not offered for sale to the general public, but only to large, financially sophisticated purchasers that regularly purchase in the commercial paper market. Major purchasers include money market funds, bank trust departments, life insurance companies, pension funds, nonprofit organizations, and nonfinancial corporations.¹¹² Conflicts of interest are therefore only a slight concern because purchasers have the resources to obtain sufficient

ers who issue commercial paper even when that customer is not a sound credit risk. See *supra* note 90 and accompanying text.

¹⁰⁹ Hunsicker, *Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions*, 50 S. CAL. L. REV. 611, 613 (1977). See generally E. HERMAN, *CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENT* (1975).

¹¹⁰ See Note, *Restrictions on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation*, 97 HARV. L. REV. 720, 730 (1984). Large commercial banks with trust departments develop "chinese walls" to prevent abuse of conflict of interest situations. "Chinese walls" refer to internal procedures which are designed to prevent certain information from being used by different bank departments. See Herzel & Colling, *The Chinese Wall Revisited*, 6 CORP. L. REV. 116, 119 (1983); Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459, 462 (1975) ("the Chinese Wall is generally the best solution to the inside information problems created by a single multi service firm's performing potentially conflicting roles").

¹¹¹ See Edwards, *Banks and Securities Activities: Legal and Economic Perspectives on the Glass-Steagall Act*, in *THE DEREGULATION OF THE BANKING AND SECURITIES INDUSTRIES* 282 (L. Goldberg & L. White eds. 1979).

¹¹² See Hurley, *supra* note 3, at 334.

information to assess the risk of the issue and thereby protect their own interests.

The *SIA II* Court's transactional approach characterizes a financial instrument as a security only if a bank's role in selling the instrument would produce the hazards that the Glass-Steagall Act sought to prevent. Although this approach promotes the Act's underlying objective of separating investment banking from commercial banking, to successfully accomplish this objective all variables affecting a bank's role in transacting the instrument must be considered. The Court in *SIA II* failed to consider one important variable affecting a bank's role in dealing with commercial paper: its functional characteristics. As a result, the *SIA II* Court's transactional analysis was defective, and the Court erroneously characterized commercial paper as a security under the Glass-Steagall Act.

CONCLUSION

Applying a two-part analysis, the Court in *SIA II* determined that the Glass-Steagall Act prohibits commercial banks from underwriting and distributing third party commercial paper. A critical analysis reveals, however, that the Court's approach is seriously flawed. The Court's literal analysis merely applies inappropriate analogies rather than considering the underlying objective of the Act, to separate commercial banking from investment banking. Although the *SIA II* Court's transactional analysis focused on whether the bank's role in dealing with commercial paper conflicts with the Act's objective, the approach is flawed because it disregards the functional attributes of commercial paper and their effect on the bank's transactional role. Because those attributes tend to eliminate the hazards the Act sought to prevent, the Court incorrectly found that the Glass-Steagall Act proscribed commercial banks from dealing in commercial paper. In future cases where the Court must determine whether a particular financial instrument is a security under the Act, the literal analysis should be discarded, and the transactional analysis should properly consider the instrument's functional characteristics.

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