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Commercial Law—Board of Governors of the Federal Reserve System v. Investment Company Institute: The Continuing Conflict Between Commercial and Investment Banking

In 1972 the Board of Governors of the Federal Reserve System (FRB) amended Regulation Y, thereby allowing bank holding companies to serve as investment advisors to closed-end investment companies. Although this action granted bank holding companies access to only a very narrow range of investment banking functions, it nevertheless caused investment bankers to "circle up the wagons" and fight for their territory.


2. The primary difference between a closed-end investment company and an open-end investment company (i.e., mutual funds) is the degree of involvement in the issuance and redemption of fund shares. Typically, an open-end investment company continually issues new shares and stands ready to redeem outstanding shares on request. After its initial organization, a closed-end investment company issues shares at infrequent intervals, if at all, and does not stand ready to redeem these shares on request. Due to these limitations, shares of many closed-end investment companies are traded on the stock market. R. POZEN, FINANCIAL INSTITUTIONS: CASES, MATERIALS AND PROBLEMS ON INVESTMENT MANAGEMENT 187-88 (1978).

3. Effective February 1, 1972, the Board of Governors amended § 225.4(a) of Regulation Y to add "serving as an investment advisor, as defined in section 2(a)(20) of the Investment Company Act of 1940, to an investment company registered under that Act" to the list of activities it has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

12 C.F.R. § 225.125(a) (1982).

Proceedings held during the FRB's consideration of the amendment raised several questions about the broad scope of the investment advisory function in light of the Glass-Steagall Act, 12 U.S.C. §§ 24, 78, 377-378 (1976 & Supp. IV 1980), and the Supreme Court decision in Investment Co. Inst. v. Camp, 401 U.S. 617 (1971). Subsequently, the FRB released an interpretive ruling, 12 C.F.R. § 225.125 (1982), that narrowed the scope of permissible activities. The interpretive ruling forbids bank holding companies from: (1) sponsoring, organizing, or controlling an open-end investment company, (2) acting as an investment advisor to an investment company that can be identified with the bank holding company or its bank subsidiaries by its name or location; (3) purchasing securities of the investment company being advised for the holding company's own account, or, under the bank holding company's sole discretion, for the accounts for which the bank acts as fiduciary or managing agent; (4) extending credit to the investment company being advised, or accepting the investment company's securities as collateral for a loan that is being used for the purpose of purchasing the investment company's securities; (5) engaging directly or indirectly in the sale or distribution of the investment company's securities; and (6) investing the cash funds of the investment company in time deposit or certificate of deposit accounts of any bank affiliate. Id.

4. Investment funds are just one aspect of the securities underwriting and trading activities in which investment banking companies engage. In its interpretive ruling, the FRB further limited the scope of bank holding company involvement in such activities to the organization, operation, and control of closed-end investment companies. See supra note 1. A closed-end investment company does not generally trade its securities after the initial organization and issuance of shares. See supra note 2.

5. The investment banking industry has shown a willingness to challenge commercial bank intrusion into what have traditionally been investment banking activities. During the last two decades the industry has initiated litigation no fewer than four times, with varying degrees of success. See Board of Governors of the Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46 (1981) (1972 amendment to Regulation Y, defining "investment advising" as an activity "closely
once again that a major concern of the investment banking community is the erosion of the protective barrier provided by the Glass-Steagall Act and the subsequent influx of commercial banks into the investment banking industry.\(^6\) The Supreme Court's decision to uphold the FRB's amendment in *Board of Governors of the Federal Reserve System v. Investment Company Institute (FRB v. ICI)*\(^7\) further erodes the protection provided to investment bankers. The decision, however, may have a much broader scope. In upholding the amendment, the Court determined that the Glass-Steagall Act did not require separation between commercial and investment banking and indicated that absent clear violation of congressional objectives, it would defer to the considered judgment of the FRB in matters affecting the banking industry. Decisions of this nature affect the structure and operation of the nation's financial markets by providing greater flexibility for and competition between the entities that compose the financial markets. This, in turn, affects the national economy, which relies heavily on an effective capital market structure to enhance the currently anemic rate of capital formation.\(^8\) With the Glass-Steagall Act receiving severe criticism for its inability to adapt to the changing financial community,\(^9\) the Supreme Court's decision provides additional support for those who call for a complete revamping of the current regulatory structure.

To better understand the decision and its impact on the regulation of financial markets, it is necessary to analyze the legislative history of the Glass-Steagall Act and subsequent efforts by Congress and the courts to enforce it. The enactment of the Glass-Steagall Act in 1933 was one of the prophylactic measures taken in reaction to the banking system's breakdown during the Great Depression. While the liquidity crisis that induced the depression was brought about by the culmination of several reinforcing influences within the


8. Over the past decade the United States ranked last among major industrial nations in productivity and in share of gross national product invested in expanding and upgrading the stock of productive capital. See Bowen, *How to Regain Our Competitive Edge*, 103 *FORTUNE*, Mar. 9, 1981, at 74, 82; see also *The Reindustrialization of America*, BUS. WK., June 30, 1980, at 55.

United States and international economies, the lack of control over practices in the banking and securities industries was a major factor in bringing about the stock market crash of 1929. These imprudent banking practices further deflated what was already a decelerating economy.

After the stock market crash, public attention focused on the security affiliates of banks. A Senate committee concluded that stock market loans made by banks played a major role in fueling the speculative excesses that contributed to the market's collapse. At the heart of the problem was what one investigator called "a shocking corruption in our banking system, a widespread repudiation of old-fashioned standards of honesty and fair dealing in the creation and sale of securities, and a merciless exploitation of the vicious possibilities of intricate corporate chicanery."

Congressional investigators identified two serious problems that were caused by the affiliation between the banking and securities industries: concentration of economic power and conflicts of interest. The danger inherent in the concentration of economic power was realized during the Great Depression. Banks and security companies had become so interrelated that the stock market collapse exerted great pressure on commercial banks, contributing to an unprecedented number of bank failures. The conflicts of interest problem was twofold. First, public confidence in national banks was threatened by permitting banks to have security affiliates. The close identification between the bank and its security affiliate had the potential either to lower confidence in the bank or to decrease the speculative nature of the securities market in the eyes of the public. Second, self-interest pressured the banks to support the market price of stocks in companies in which they had a financial stake. Both of these problems were exacerbated and finally uncovered by the collapse of the stock market. Each fed off the other and the combination resulted in the exploitation of "trusting" investors.

10. Problems in the international economic system, the structure of internal debts within the United States, and overextension of credit in the real estate industry all contributed to the economic decline in the early 1930s. M. Lee, Macroeconomics: Fluctuations, Growth, and Stability 175-88 (5th ed. 1971).
11. Id. at 172-73. For a general review of the events surrounding the stock market's collapse in 1929, see J. Galbraith, The Great Crash (1954).
13. F. Pecora, Wall Street Under Oath 283 (1939). The author, Ferdinand Pecora, was counsel to the Senate Committee on Banking and Currency from 1933 to 1934. In this capacity he conducted the Senate investigation into banking and stock market practices.
17. Id. To protect securities issued by their securities affiliates, banks might be used as receptacles for unsuccessful securities issuances or be compelled to make undesirable loans to either the security affiliate or the issuing company. Peach, The Security Affiliates of National Banks, in 58 Johns Hopkins University Studies in Historical and Political Science No. 3, at 113-14 (1941).
18. See supra notes 12-13 and accompanying text.
The Glass-Steagall Act of 1933\(^1\) was designed to help cure these deficiencies in the financial markets by divorcing commercial banks from their security affiliates. The three primary objectives of the Glass-Steagall Act were: "(1) to restore public confidence in banking following the 1929 stock market crash and the accompanying widespread bank failures; (2) to ensure and maintain general economic stability by prohibiting unsound and imprudent bank investments; and (3) to forestall potential conflicts of interest between commercial and investment banking operations."\(^2\) To these ends, the four sections of the Act limit commercial bank involvement in securities underwriting. Section 21 contains the basic restriction that prohibits any entity engaged in the business of issuing, underwriting, selling, or distributing securities from simultaneously engaging in commercial banking.\(^3\) Sections 20 and 32 prevent a company from circumventing the basic prohibition by means of an affiliate or an interlocking directorate.\(^4\) Section 16 defines the types of securities-related services that commercial banks are authorized to perform.\(^5\) These include an agency function through which banks may buy and sell securities as an agent for the account of a customer (but not for its own account), an investment portfolio function that permits the bank to purchase selected investment securities for its own account, and the unrestricted ability to deal in federal, state, and municipal obligations for their accounts.\(^6\)

Despite the attempt by Congress to partition the financial community through the Glass Steagall Act, the lure of higher revenues and greater liquid-

\(^{19}\) Although Glass-Steagall is often used synonymously in reference to the entire Banking Act of 1933, the Glass-Steagall Act only encompasses the four sections within the Banking Act that limit bank involvement in securities underwriting. See Clark & Saunders, supra note 6, at 725; infra notes 20-24 and accompanying text.

The importance of the Glass-Steagall Act's separation is evidenced by the Congressional exemption of commercial banks from most legislation regulating the securities markets. The Securities Act of 1933 excluded banks from provisions requiring registration of new securities. Similarly, the Securities and Exchange Act of 1934 excluded banks from its statutory definitions of "broker" and "dealer." In 1940, the Investment Company Act and the Investment Advisors Act excluded commercial banks from the definitions of "investment company" and "investment advisor." See R. Pozen, supra note 2, at 512.

\(^{20}\) Clark & Saunders, supra note 6, at 725.

\(^{21}\) The statutory language provides that it is unlawful:

[f]or any person, firm, corporation, association, business trust, or other similar organization engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor . . . .


\(^{22}\) Section 20 prohibits the use of affiliates to circumvent section 21. 12 U.S.C. § 377 (1976). Due to the statutory definition of "affiliate," however, bank holding companies could avoid divestment of securities affiliates by not voting their bank subsidiary shares. A bank could own or control less than a majority of the voting shares of the affiliate or less than 50% of the shares voted for the election of directors and, under the statutory definition, avoid classification of the security affiliate as an "affiliate." See 12 U.S.C. § 221(b) (1976); 450 U.S. at 69-70.

Section 32 prohibits affiliation between securities companies and banks by means of officers, employees, partners, or interlocking directorates. 12 U.S.C. § 78 (1976); see Clark & Saunders, supra note 6, at 726-27.


\(^{24}\) Id.
ity has enticed commercial banks to enter certain aspects of the securities business. The initial means of circumventing the Act was through the use of bank holding companies, which could easily escape the Act's coverage. Congressional concern about the potential detrimental effects of bank holding companies led to the passage of the Bank Holding Company Act of 1956, which required bank holding companies with two or more banks to divest themselves of their non-bank assets. A major exception to this requirement allowed bank holding companies to retain or acquire companies of a financial, fiduciary, or insurance nature that engage in activities determined by the FRB to be "closely related to the business of banking or managing or controlling banks."

In 1970, amendments to the Bank Holding Company Act gave the FRB the ability to expand permissible bank holding company activities by deleting the congressionally imposed requirement that an activity be of a financial, fiduciary, or insurance nature and giving the FRB in section 4(c)(8) full discretion to determine whether an activity is "so closely related to banking or managing or controlling banks as to be a proper incident thereto."

Karmel, supra note 9, at 632.

During the 1960s banks began to offer a variety of investment services, including collectively managed agency accounts, automatic investment services, dividend reinvestment plans, individual portfolio management services, advisory services to investment companies, and private placement services for customers. See Edwards, Bank and Securities Activities: Legal and Economic Perspectives on the Glass-Steagall Act, in The Deregulation of the Banking and Securities Industries 273 (L. Goldberg & L. White, ed. 1979); Clark & Saunders, supra note 6, at 724; Clark & Saunders, supra note 9; Note, The Legality of Bank-Sponsored Investment Services, 84 Yale L.J. 1477 (1975).

The Act was only applicable to bank holding companies that voted their shares in subsidiary banks and whose banks were members of the Federal Reserve System. See supra note 22.

The main purpose of the amendments was to close a loophole by bringing one-bank holding companies within the provisions of the Act. The FRB and the Comptroller of the Currency testified before Congress in favor of the one-bank definition when the original legislation was passed in 1956. The Act did not conform to the FRB's position, however, until the amendments were passed. M. JESSEE & S. SEELEG, supra note 12, at 10.

In addition to removing the requirement that a company's activities must be of a financial, fiduciary, or insurance nature, Congress also deleted the phrase "closely related to the business of banking," [emphasis added] and replaced it with "closely related to banking." This is consistent with Congress's intent to provide the banking industry with the flexibility to expand into bank-related activities that pass muster with the FRB. See 450 U.S. at 76 n.58; M. JESSEE & S. SEELEG, supra note 12, at 20.
required the FRB to consider whether the benefits produced by the affiliate’s
activities would outweigh possible adverse effects in making its determina-
tion. In effect, the legislative changes gave the FRB increased discretionary
power to make qualitative decisions concerning what types of services offered
by bank holding companies are best for the public and curtailed bank holding
company expansion into the investment banking industry without regulatory
approval from the FRB.

Another means by which banks could gain entry into the securities indus-
try was through the expansion of trust activities into the area of investment
funds. This occurred during the mid-1930s when bank trust departments
began to operate common trust funds. By merging the assets of several small
to medium-sized trust accounts into one investment fund, a bank could reduce
its administrative costs and provide a more diversified investment portfolio for
those trust accounts.

The FRB eventually became concerned with the growth of common trust
funds and the use of this investment tool by national banks in their fiduciary
capacity. Before the FRB could tighten regulations governing these funds,
however, the banking industry convinced Congress to place control of trust
functions with the Comptroller of the Currency. The Comptroller immedi-
ately revised the rules governing collective investment of trust funds to permit
the use of managing agency accounts.

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In determining whether a particular activity is a proper incident to banking or managing
or controlling banks the Board shall consider whether its performance by an affiliate of a
holding company 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 competi-
tion, conflicts of interest, or unsound banking practice.

33. The common trust fund involved the merger of smaller trust accounts into one fund for
collective management. The practice gained popularity when the Revenue Act of 1936 provided
that all funds complying with the FRB’s rules and regulations on the collective investment of trust
funds by national banks would be tax-exempt. Revenue Act of 1936, ch. 690, 49 Stat. 1648, 1708
rules in 1937 to permit national banks to operate common trust funds when they were in further-
ance of “bona fide fiduciary purposes.” See Lybecker, Bank-Sponsored Investment Management
Services: Consideration of the Regulatory Problems, and Suggested Legislative and Statutory Re-
Commingling, 37 COLUM. L. REV. 1384 (1937).

34. See Lybecker, supra note 33, at 988-89; Note, supra note 33, at 1384.

35. In 1960 the FRB proposed tightening regulations governing common trust funds in re-
sponse to bank utilization of common trust funds as a vehicle to provide customers the opportu-
nity to invest in risk securities. See Lybecker, Bank-Sponsored Investment Management Services:
A Legal History and Statutory Interpretive Analysis (pt. 1), 5 SEC. REG. L.J. 110, 151-52 (1977); see
also Judd, Common Trust Funds Under New Regulation 9, 102 TR. & EST. 569, 570 (1963).

36. The banking industry was strongly opposed to the FRB’s proposed limitations on com-
mon trust fund activities. The industry initiated a massive campaign to place the regulatory con-
tral of trust activities into friendlier hands. See Lybecker, supra note 35.

37. The Comptroller amended existing trust regulations in 1963 to include the pooling of
managing agency accounts as a fiduciary activity and deleted the corresponding requirement that
the bank and trust account must be for a bona fide fiduciary purpose. Amendment to Regulation
Proposed: Comptroller Outlines Tentative Rules on Bank Fiduciary Powers and Collective Invest-
ment Funds, 102 TR. & EST. 95, 136-37 (1963).
"investment advisory or investment management arrangements where something less than the usual trustee type relationship is created; they are the functional equivalent of investment advisory services provided by broker-dealers or investment advisors."

By allowing these accounts to be pooled, the Comptroller effectively permitted banks to operate mutual funds under the guise of a trust service. Since the operation of mutual funds is a significant part of investment banking, this put commercial banks in direct competition with investment banks. The timeliness of the Comptroller's action was perfect for the commercial banking industry:

By the end of 1961, there were 511 common trust funds with assets exceeding $3.5 billion, 48 F.R.B. 528 (May, 1962), and the first of the modern "bull" markets was clearly getting underway. Thus, the collective investment management mechanisms were available and the equity securities market was primed for delivering profits if the banks could only get a larger share of the total investment management action.

The Securities and Exchange Commission took a dim view of this strategem. Despite the industry's contention that commingled managing agency accounts were exempt from SEC regulation under the trust fund exclusion, the Commission considered the accounts to be a vehicle for public investment that required the protection of the federal securities laws. After nearly a decade of debate over this issue, the controversy was settled by the Supreme Court in Investment Company Institute v. Camp. In Camp the Court held that sections 16 and 21 of the Glass-Steagall Act prohibited banks from offering commingled managing agency accounts to the public. Writing for the Court, Justice Stewart stated that the Act clearly prohibited banks from operating mutual funds. Characterizing commingled managing agency ac-

38. Lybecker, supra note 35, at 153-54.
39. Banks had long been permitted to operate managing agency accounts for their customers, but not on a collective basis. When offered on a collective basis, the service becomes tantamount to operating a mutual fund. See infra note 42 and accompanying text. By offering commingled managing agency accounts as part of their trust services, banks attempted to avoid SEC regulation of their activities. See Lybecker, supra note 33.
40. Lybecker, supra note 35, at 152-53 n.130.
43. 401 U.S. 617 (1971).
44. Id. at 639; see also supra notes 21-24 and accompanying text.
45. Justice Stewart observed that it was legal for a bank to act as a managing agent or to commingle trust funds. Nevertheless, "the union of these powers gives birth to an investment fund whose activities are of a different character." 401 U.S. at 625.
counts as mutual funds, Justice Stewart indicated that the differences between these accounts and conventional open-end mutual funds were “subtle at best,” and that the agency accounts were “in direct competition with the mutual fund industry.”

The FRB took the next step in the movement toward reuniting investment and commercial banking through expansion of the bank holding company concept. On August 12, 1971, the FRB issued notice of its intentions to amend Regulation Y by expanding the list of activities it considered to be “closely related” to banking, thereby increasing the scope of bank holding company activities. The proposed amendment permitted bank holding companies to serve as investment advisors to the investment companies registered under the Investment Company Act of 1940. In addition to managing the investment company’s portfolio, investment advisors usually sponsor, organize, and ultimately control the investment company. Due to the intimate relationship between investment companies and their advisors, strong opposition to the FRB proposal was voiced by the Department of Justice, which claimed that allowing bank holding companies to serve as investment advisors would be equivalent to permitting securities underwriting by banks. The securities industry, another opponent of the amendment, argued that the proposed amendment was contrary to the Supreme Court’s decision in Camp because it opened the door to the “more subtle hazards” created by the commingling of investment and commercial banking services.

The FRB adopted the amendment, but subsequently narrowed its scope in an interpretive ruling. The ruling identified the concerns of the Depart-

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46. *Id.* The Court’s decision was based on the definitional issue whether a commingled managing agency account was a “security” as defined by the federal securities laws. Having determined that such an account is a security, the Court did not need to decide whether the operation of a commingled managing agency account would be governed by the SEC, the Comptroller of the Currency, or the FRB.

47. The FRB voiced dissatisfaction with the actions taken by the Comptroller of the Currency in 1963. *See supra* note 37; *Lybecker, supra* note 35, at 156-57. By employing the bank holding company concept, however, the commercial bank was not directly involved in the securities transactions. *See infra* note 70 and accompanying text.


49. Section 225.4 of Regulation Y identifies specific activities in which a bank holding company or one of its affiliates may engage. These are activities that the FRB (pursuant to its authority under the Bank Holding Company Act) has determined to be “closely related to banking or managing or controlling banks.” 12 C.F.R. § 225.4 (1982); *see supra* notes 31-32 and accompanying text.

50. *See supra* note 3.

51. *See 12 C.F.R. § 225.125(e) (1982).*


53. *Id.; see also supra* note 43-46 and accompanying text; 450 U.S. at 65.

54. 12 C.F.R. §§ 225.4(a)(5)(ii), 225.125 (1982). In addition to the primary restriction that limits bank holding company advisory activities to closed-end investment companies, *see id.* § 225.125(f), the interpretive ruling stated that a bank holding company and its bank and nonbank subsidiaries should not: (1) be readily identifiable with the investment company by name or location; (2) purchase securities of the investment company for their accounts, or in their sole discretion purchase such securities for a trust or managing agency account; (3) extend credit to the investment company, or accept securities of the investment company as collateral for a loan that is for the purpose of purchasing securities of the investment company; (4) engage directly or indi-
ment of Justice and the securities industry, and concluded that the Glass-Steagall Act forbids a bank holding company from sponsoring, operating, or controlling a mutual fund.\textsuperscript{55} The FRB stated, however, that the Act's restrictions were inapplicable to closed-end investment companies, which, unlike mutual funds, "are not primarily or frequently engaged in the issuance, sale and distribution of securities."\textsuperscript{56}

Dissatisfied with the FRB's interpretive ruling, the Investment Company Institute (ICI), a trade association of mutual funds, petitioned the District of Columbia Court of Appeals for a direct review of the amendment and the accompanying interpretive ruling.\textsuperscript{57} The ICI charged that the FRB's action was inconsistent with sections 16 and 21 of the Glass-Steagall Act and was unauthorized by the Bank Holding Company Act of 1956.\textsuperscript{58} In vacating the amendment, the court held that the FRB's action was not in violation of the Glass-Steagall Act,\textsuperscript{59} but that section 4(c)(8) of the Bank Holding Company Act did not empower the FRB to authorize such activities.\textsuperscript{60}

The court reviewed the legislative history surrounding the Glass-Steagall Act and determined that the policy underlying the Act required a complete separation of investment and commercial banking.\textsuperscript{61} The court concluded that since the Bank Holding Company Act was designed to prevent the banking industry from circumventing the Glass-Steagall Act by means of the bank holding company, Congress did not intend to undermine the purpose of the Act by authorizing the FRB to permit bank holding companies to operate security affiliates.\textsuperscript{62}

Upon review by the Supreme Court, Justice Stevens, writing for the Court, concluded that the amendment did not exceed the FRB's statutory authority since it was consistent with the Bank Holding Company Act,\textsuperscript{63} was not

\hspace{1em}rectly in the sale or distribution of the investment company's securities; or (5) maintain excess demand deposit balances in the investment company account, or invest cash funds of the investment company in a time deposit account. \textit{Id.} § 225.125(f)-(i).

\textsuperscript{55} \textit{Id.} § 225.125(f).

\textsuperscript{56} \textit{Id.; see supra note 2.}

\textsuperscript{57} The Investment Company Institute consists of 356 open-end investment companies, together with their 159 investment advisers and 120 principal underwriters. The ICI represents almost 93% of the assets of domestic investment companies. \textit{Investment Co. Inst. v. Board of Governors of the Fed. Reserve Sys.}, 606 F.2d 1004, 1006 n.1 (D.C. Cir. 1979).

\textsuperscript{58} \textit{Id.} at 1006. For a description of these provisions, see \textit{supra} notes 21, 23 & 29-32 and accompanying text.

\textsuperscript{59} The court concluded that a bank holding company with a security affiliate that operates as an investment adviser to a closed-end investment company does not violate the Glass-Steagall Act because the security affiliate does not perform commercial banking services and the bank affiliate does not engage in investment services. 606 F.2d at 1011-14.

\textsuperscript{60} \textit{Id.} at 1015. \textit{See supra} note 32.

\textsuperscript{61} \textit{Id.} at 1016.

\textsuperscript{62} In order to support the view that the objectives of the Glass-Steagal Act are incorporated into the Bank Holding Company Act, the court stressed that "the effect of the Act as viewed by later Congresses" was to divorce investment and commercial banking. \textit{Id.} at 1016 (emphasis in original). The court inferred that Congress would have intended to prohibit a bank holding company from operating a closed-end investment company under the limitations imposed by the FRB's interpretive ruling, but the court failed to review the implications of the FRB's limitations. \textit{Id.} at 1016 n.30 and accompanying text.

\textsuperscript{63} 450 U.S. at 76-77; \textit{see infra} notes 67-69 and accompanying text.
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prohibited by the Glass-Steagall Act,64 and, through the interpretive ruling, avoided the potential hazards that association between bank affiliates and investment companies could create.65 The Supreme Court looked beyond the statutory language to discern the rationale behind the enactment of both the Glass-Steagall and Bank Holding Company Acts. In applying the legislative history of the acts to the situation presented, the Court’s main concern was whether the public would be effectively protected against the abuses that brought about the legislation.66

The Court initially noted that investment advisory services were not significantly different from the fiduciary functions traditionally performed by banks.67 This supported the premise that the service was an activity closely related to banking under section 4(c)(8). Further strengthening the FRB’s position, the Court stated that the FRB’s determination of closely related activities was “entitled to the greatest deference,” because the authority for a specific activity must be preceded by the FRB’s determination that the requested relationship can be expected to provide benefits to the public.68 The Court then determined that banking practices, the deference afforded to the FRB, and a normal reading of the statutory language led to the conclusion that the amendment did not violate the Bank Holding Company Act.69 In its review of possible Glass-Steagall Act violations, the Court held that a bank’s activities as an investment advisor do not necessarily violate sections 16 and 21 of the Act. Even assuming that they did, the Court decided that the activities were allowable within the present context because bank affiliates are not as limited in their activities as banks themselves.70

The Court reviewed the legislative history of section 4(c)(8) of the Bank Holding Company Act,71 on which the court of appeals rested its opinion, and found no evidence that the 1956 Act and the 1970 amendments were “intended to effect a more complete separation between commercial and investment banking than the separation that the Glass-Steagall Act had achieved

64. 450 U.S. at 64-65; see infra note 70 and accompanying text.
65. 450 U.S. at 66; see supra notes 14-17 & 54 and accompanying text.
66. See supra notes 12-17 & 25-27 and accompanying text.
67. The Court noted that “[t]he principal activity of an investment advisor is to manage the investment portfolio of its advisee—to invest and reinvest the funds of the client.” In their capacity as executors, trustees, or managing agents, banks have performed this activity for over a century. 450 U.S. at 55.
68. Id. at 56-57. The Court quoted from the concurring opinion of Justice Rutledge in Board of Governors of the Federal Reserve System v. Agnew, which indicated another reason for deferring to the FRB’s judgment:

Their specialized experience gives them an advantage judges cannot possibly have, not only in dealing with the problems raised by the system’s workings, but also in ascertaining the meaning Congress had in mind in prescribing the standards by which they should administer it. Accordingly their judgment in such matters should by overturned only where there is no reasonable basis to sustain it or where they exercise it in a manner which clearly exceeds their statutory authority.

Id. at 56 n.21 (quoting 329 U.S. 441, 450 (1947)).
69. Id. at 56-58.
70. Id. at 59-64.
71. See supra notes 28-32 and accompanying text.
with respect to banks in sections 16 and 21.\textsuperscript{72} Unlike the lower court, the Supreme Court failed to read into the Bank Holding Company Act a specific limitation on the FRB's discretionary power regarding securities-related activities and concluded that the FRB's discretionary power to approve securities-related activities that it deems are "closely related to banking" is not limited beyond the prohibitions outlined in the Glass-Steagall Act.\textsuperscript{73}

Despite its holding, the Court expressed continued concern for the separation of commercial and investment banking. The Court upheld its decision in \textit{Camp} by distinguishing the present case on the basis of the nature of the activities performed.\textsuperscript{74} In \textit{Camp} banks were permitted to underwrite units of participation that were equivalent to securities; therefore, section 16 of the Glass-Steagall Act was violated.\textsuperscript{75} In \textit{FRB v. ICI}, however, the shares were of a closed-end investment company, and although the shares did fall within the definition of a "security," they were "not issued, sold or underwritten" by the bank under the express prohibition of the interpretive ruling.\textsuperscript{76} By confirming the \textit{Camp} decision in \textit{FRB v. ICI}, the Court reaffirmed its interpretation of the Glass-Steagall Act as prohibiting bank underwriting of securities. In doing so, it identified its concern for protecting the investing public and the banking system from the "danger of banks using bank assets in imprudent securities investments."\textsuperscript{77} The Court also implied that it would police activities that involve the "more subtle hazards of bank-security related functions."\textsuperscript{78} This would ensure that the improprieties which necessitated the Glass-Steagall Act would be sufficiently controlled.\textsuperscript{79}

Recent rumblings from Congress and the current administration indicate that the Glass-Steagall Act, and the separation of investment and commercial banking that it achieved, may be legislatively dismantled. Currently under Senate review is the Bank Holding Company Deregulation Act of 1982,\textsuperscript{80} which was introduced by Senate Banking Committee Chairman Jake Garn. The bill permits bank holding companies to form securities affiliates that oper-

\textsuperscript{72} 450 U.S. at 71. The Court determined that the Bank Holding Company Act was intended to remedy the inadequacy of the Glass-Steagall Act in "severing the connection between bank holding companies and affiliates 'principally engaged' in the securities business." \textit{Id.} This did not support the lower court's proposition that § 4(c)(8) totally prohibited bank holding companies from engaging in any securities-related activities, because "[i]nvestment advisors and investment companies are not 'principally engaged' in the issuance or the underwriting of securities within the meaning of the Glass-Steagall Act." \textit{Id.; see supra} note 60 and accompanying text.

\textsuperscript{73} 450 U.S. at 77.

\textsuperscript{74} \textit{Id.} at 64-68.

\textsuperscript{75} \textit{See supra} notes 42-46 and accompanying text.

\textsuperscript{76} \textit{See supra} note 54.

\textsuperscript{77} 450 U.S. at 65-67.

\textsuperscript{78} \textit{Id.} at 66-67. These subtle hazards include undue reliance by the public on the bank holding company's investment affiliate because of its relationship with the bank, loss of public confidence in the bank, and conflicts of interest that are conducive to unsound banking practices or to the inability to render disinterested investment advice. \textit{Id.} at 66-67 n.38; \textit{see supra} notes 14-17 and accompanying text.

\textsuperscript{79} \textit{See supra} notes 12-20 and accompanying text.

ate mutual funds and underwrite government and municipal securities.\footnote{The introduction to the bill states its purpose: To authorize the formation of a bank securities affiliate to deal in, underwrite and purchase government and municipal securities, to sponsor and manage investment companies and underwrite the securities thereof, to authorize bank holding companies to engage in activities of a financial nature, insurance underwriting and brokerage, real estate development or brokerage, to amend Section 23A of the Federal Reserve Act and for other purposes. \textit{S. 2490, 97th Cong., 2d Sess. (1982).}}\footnote{S. 2490, 97th Cong., 2d Sess. (1982).} The Reagan administration has given its support to similar legislation and has indicated that such proposals are the first in a series of measures which will amend banking laws that currently limit direct competition among banks, thrift institutions, and securities firms.\footnote{The Reagan Administration indicated its support of the Financial Institutions Deregulation and Services Act of 1981, \textit{S. 1720, 97th Cong., 1st Sess. (1981).} See Bacon, \textit{Reagan Outlines Deregulation of Banks}, Wall St. J., Oct. 16, 1981, at 2, col. 2. This bill is a comprehensive piece of legislation introduced by Senator Garn that would allow banks and savings and loan associations to underwrite municipal revenue bonds and operate mutual funds. It would also loosen lending restrictions on banks and savings and loans. \textit{See Pryor, Financial Legislation Prompts Lobbying War: Bill's Fate Rests with Lobbyists}, Legal Times Wash., Oct. 26, 1981, at 29, col. 3.} The SEC has also indicated its approval, stating that "Glass-Steagall concerns need not continue to stand in the way of bank underwriting of municipal revenue bonds and money market fund shares."\footnote{83. \textit{FED. SEC. L. REP.} (CCH) No. 937, at 7 (Oct. 28, 1981). The article summarizes statements made by SEC Commissioner Bevis Longstreth. Commissioner Longstreth objected to the failure of the 1981 bill to authorize bank regulatory agencies to establish standards for the entry of commercial banks into these areas of investment banking. \textit{Id} at 8. The 1982 bill amends the Federal Reserve Act, permitting the FRB to establish regulations for security affiliates of bank holding companies.} The SEC's position is based on the premise that flexible regulation through agencies will better serve the public interest than the rigid barriers that the Glass-Steagall Act imposes.\footnote{The first inroad in the area of deregulatory change was achieved on October 15, 1982, when President Reagan signed the Garn-St. German Depository Institutions Act of 1982. The Act offers remedial assistance to troubled and failing financial institutions by expanding FDIC and FSLIC authority to provide direct and merger-related assistance to insured banks and savings institutions. In addition, the Act directs the Depository Institution Deregulatory Committee to create a new insured deposit account that will be competitive with money market funds. \textit{See Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. — (1982).}}

Underlying the current legislation is a need to make commercial banks more competitive in the financial markets. The growth of money market funds over the past five years has posed a serious threat to depository institutions by causing a significant shift of funds from low-interest deposit accounts to higher paying instruments.\footnote{85. Money market funds were first offered in 1976. Since that time fund assets have increased to over $150 billion, with Merrill Lynch & Co., Inc.'s $31 billion in money market fund assets exceeding the total deposit base of Citicorp/Citibank, N.A. The real threat to banks lies in the shifting of customer deposits to the more attractive money market funds. The funds, which are not subject to Regulation Q's interest rate ceilings, \textit{see} 12 C.F.R. \textsection 217.7 (1982), are able to provide a higher rate of return to their investors than traditional time deposit accounts or certificates of deposit. In addition, the cost of providing money market funds is substantially lower than the cost of maintaining consumer deposit accounts. \textit{See Mulhern, Competition, Restriction Limit Role of Commercial Banks}, Legal Times Wash., Oct. 26, 1981, at 29, col. 1.} Combined with this threat are the recent
moves by nonregulated corporations into the securities industry and investment banking into the commercial banking business. These actions have allowed the commercial banks' competition to expand dramatically their services and to increase in number, while existing regulations have relegated banks to the "bench." In light of these circumstances, only major revisions of the statutory scheme will provide a satisfactory solution to the banking industry's dilemma.

The proposed legislation indicates that if the Glass-Steagall Act is to be discarded, a gradual approach will be taken in dismantling the barrier between commercial and investment banking. This phased approach will allow banks to concentrate their efforts on specific investment banking services to determine whether they are profitable, feasible, and in line with corporate strategy. Likewise, the amalgamation of the two industries would afford Congress and the regulatory agencies an opportunity to determine if the merchant banking system utilized in Great Britain would be beneficial to the United States economy. More importantly, a phased approach to deregulation gives the governing agencies time to develop and test a regulatory scheme that will adequately protect the investing public prior to a full repeal of the Glass-Steagall Act. Unfortunately, the current legislation has caused a great deal of turmoil among the various financial institutions. Due to the lobbying strength of these factions, the legislation will undoubtedly be slow in coming and will involve a great deal of compromise.

*FRB v. ICI* afforded the Court an opportunity to interpret the legislative

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86. Recently, several large corporations have moved into the investment banking area. Perhaps the most threatening of these is the combination of American Express Co. and Shearson Loeb Rhodes, Inc. (an investment banking firm), due to the wide variety of services that the new corporation can offer. In addition, Prudential Insurance Co. of America has acquired Bache Stuart Shields Inc., and Sears, Roebuck & Co. has announced that it will offer a mutual fund. These moves indicate a trend toward the creation of "near bank" conglomerates. *Id.* at 30, cols. 1-4; at 36, col. 1.

87. Investment banking firms have been able to circumvent Glass-Steagall Act prohibitions and provide checking account services (through a commercial bank) for their money market funds or securities margin accounts. Securities firms have been even more direct in foreign markets by acquiring or otherwise affiliating with foreign banks. *See* Edwards, *supra* note 25, at 274-75.

88. Besides being unable to offer competitive services, bank holding companies are delayed, if not deterred, in their efforts to expand services by the approval process required under § 4(c)(8) of the Bank Holding Company Act. *See* Mulhern, *supra* note 85, at 30, col. 3. Some participants in the financial markets (the ICI in particular) believe that the role of banks in the financial system precludes their entry into the securities field. *See* Fink, *No Public Benefits from Banks Entering Mutual Fund Business*, Legal Times Wash., Oct. 26, 1981, at 29, col. 1.

89. Treasury Secretary Donald Regan has indicated that the administration is concerned that immediate full-scale deregulation would cause chaos within the financial markets. To avoid this, the administration supports a gradual phasing in of bank involvement in the securities industry. *Bacon, supra* note 82; *see* Pryor, *supra* note 82, at 36, col. 4.

90. Merchant banking involves amalgamating commercial and investment banking into one homogeneous financial system. For a discussion of how merchant banking would work in the United States, see *Merchant Banking—Is the U.S. Ready for It?*, Bus. Wk., Apr. 19, 1976, at 54.

91. The merger of commercial and investment banking will require a concerted effort by the SEC and FRB. One potential problem with developing a satisfactory regulatory structure will be determining the responsibilities and jurisdiction of each agency. Currently there is no clear delineation in the proposed legislation of how duties will be divided. *See* FED. SEC. L. REP. (CCH) No. 937, at 7-8 (Oct. 28, 1981).
objectives of both the Glass-Steagall Act and the Bank Holding Company Act. In evaluating the legislative intent behind the statutes in the context of today's financial markets, the Court determined that a complete separation between commercial and investment banking was not required. The Court indicated that it will defer to the Federal Reserve Board's judgment in matters concerning the banking industry unless the FRB's actions clearly violate the objectives of congressional mandates. Given pending legislation and the flexibility it offers to regulatory agencies, the Court's decision means that the Federal Reserve Board may become unfettered in its ability to approve bank holding company activities. This places the brunt of the responsibility for guarding the public interest on the agencies that govern financial institutions and necessitates joint action by the FRB and SEC to ensure that deregulation of commercial and investment banking avoids the pitfalls experienced in the 1920s and 1930s. Given the competitive forces at play in the capital markets, this will require an increasingly expansive definition of financial institutions and securities.

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