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Evaluating Bank Commercial Paper Placement Activity Under the Glass-Steagall Act

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EVALUATING BANK COMMERCIAL PAPER
PLACEMENT ACTIVITY UNDER THE
GLASS-STEAGALL ACT

The Glass-Steagall Act\(^1\) ("The Act") generally prohibits commercial banks from engaging in investment banking activities.\(^2\) In response to the recent growth of the financial services market, however, commercial banks have begun to offer services which traditionally the investment banking sector only offered.\(^3\) For example, banks now participate in the commercial paper market. Understandably, the investment banking industry has complained about this activity.\(^4\) The industry has argued that the Act prohibits any bank involvement in the commercial paper market.\(^5\)

The Act prohibits banks from underwriting securities.\(^6\) Although in Securities Industry Association v. Board of Governors (Bankers Trust) the Supreme Court concluded that commercial paper was a security for purposes of Glass-Steagall,\(^7\) it has not ruled whether any bank involvement in the commercial paper market constitutes a "per se" violation of the

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5. See infra notes 73-109 and accompanying text.
6. Di Lorenzo, supra note 2, at § 96.02(1).
7. 104 S. Ct. 2979, 2987 (1984). This was a 6-3 decision. This dissent said that commercial paper did not constitute a "security" for the purposes of the Act. This author agrees with the Court's holding that commercial paper is a security for the purposes of the Act. For criticism of the Court's holding, see Note, Security Under the Glass-Steagall Act: Analyzing the Supreme Court's Framework for Determining Permissible Bank Activity, 70 Cornell L.R. 1194, 1195, 1206-12 (1985); Case Note, Banking Law: Commercial Paper Is a Security Under The Glass-Steagall Act, 1985 Ariz. St. L.J. 799, 809-21.

615
Act's prohibition against underwriting. This Note concludes that limited bank involvement in commercial paper placement is permitted under the Act. This limited involvement is consistent with a literal reading of the Act and does not implicate the concerns expressed in the legislative history and subsequent judicial interpretations of the Act.

Specifically, Part One of this Note focuses on the nature and growth of the commercial paper market. Part Two discusses the history behind the Act and the statutory framework necessary to evaluate bank activity in the commercial paper market. Part Three examines court decisions involving the relevant sections of the Act. Part Four proposes guidelines for evaluating bank activity in the commercial paper market.

I. THE NATURE AND GROWTH OF THE COMMERCIAL PAPER MARKET

Commercial paper consists of unsecured short-term promissory notes which corporations issue to investors either directly or through dealers. The notes are payable to the bearer on a stated maturity date. While the maturity period ranges from one day to nine months, most notes have initial maturities of 60 days or less. The minimum denomination of commercial paper is usually $100,000. Most issuers of commercial paper are large, financially-stable corporations. Due to the overall financial stability of the issuers, these notes are considered relatively risk free. Corporations predominantly use commercial paper proceeds to finance well-defined current operational expenditures. Over the past fifteen years, an increasing number of large corporations have issued commercial paper instead of assuming bank loans to meet short-term credit needs. Some issuers maintain stand-by letters-of-credit at banks, which guarantee that the bank will repay the notes at maturity should the issuer

8. 104 S. Ct. at 2991 n.12. Justice Blackmun, writing for the majority, expressed no opinion whether the commercial paper activity in question constitutes "underwriting" within § 16 of the Act, or the "business of issuing, underwriting, selling or distributing" within § 21 of the Act. Id.
12. Di Lorenzo, supra note 2, at § 93.13(1).
13. Note, The Commercial Paper Market, supra note 3, at 364. But see Hurley, supra note 3, at 532-35 (On June 21, 1970, the Penn Central Transportation Company filed for bankruptcy. Penn Central was the nation's largest railroad and sixth largest nonfinancial corporation. When it filed for bankruptcy, it had $82 million of commercial paper outstanding. The company's default placed a serious stress on the commercial paper market. The market improved by the mid-1970's.).
fail.15

Dealers and brokers sell a substantial portion of the commercial paper.16 This enables the issuer to realize a monetary savings, since the dealers and brokers have a pre-existing distribution network.17 Dealers act as the principal, buying the commercial paper from the issuer and assuming the risk of the market fluctuations.18 On the other hand, brokers act as agents, merely handling the selling arrangements without purchasing the paper.19

Purchasers of commercial paper primarily include institutional investors like insurance companies, pension funds, nonfinancial corporations, and bank trust departments.20 The volume of outstanding commercial paper increased fourfold over the past decade, with over $200 billion currently outstanding.21 The number of issuers nearly doubled during this same period.22

II. THE STATUTORY FRAMEWORK

A. The History of the Glass-Steagall Act

Banking in the United States initially followed the English model which separated commercial banking from investment banking.23 The evolution of the trust company, however, changed the system. Organized under general incorporation laws, trust companies pursued all types of business activity. They offered complete financial services in both commercial and investment banking. Banks protested the intrusion of

15. Di Lorenzo, supra note 2, at § 96.13(1). The letter-of-credit is used by many smaller or lesser-known issuers. The letter-of-credit helps the sale of the issue by substituting the bank's reputation for the issuer's reputation.
16. Id. Dealers and brokers usually charge a fee of one-eighth of one percent of the total issue. Dealers and brokers currently place approximately 40 percent of all outstanding paper. Note, A Construction of Glass-Steagall, supra note 2, at 309.
17. Hurley, supra note 2, at 526. Direct placement is uneconomical unless the issuer's average monthly volume outstanding exceeds $100 million. Id.
18. See Di Lorenzo, supra note 2, at § 96.13(1).
19. Id. This agency activity is sometimes known as a "best-efforts" arrangement. Id.
22. Id.; see also Federal Reserve Board Statement, reprinted in, Fed. Banking L. Rep., (CCH), § 86,270, at pp. 90,835 (1984-85) (There are currently 1,200 commercial paper issuers.).
trust companies into commercial banking areas, and, in turn, received tacit approval to enter into investment banking activities.24 Banks received formal Congressional approval for their securities activities in the McFadden Act in 1927.25 This act authorized banks directly to underwrite investment securities provided that the amount of securities of any single issuer did not exceed twenty-five percent of the bank's capital.26

By 1929, banks had become the dominant force in investment banking. Within four years, though, over 10,000 banks folded.27 After the stock market crash of October 1929, Congress feared that bank involvement in speculative securities activities had damaged the industry. Hearings on proposed legislation to curtail banks' securities activities exposed questionable and unsafe practice. Among the practices that threatened the safety of depositors' funds and the overall strength of the banking system were:

1) Bank-established subsidiaries whose profitability depended on the volume of securities sales, a practice which gave the banks incentives to make unsound loans to prospective purchasers;28
2) bad loans transferred to securities affiliates;29
3) banks devoting extensive resources to promote underwriting activities;30
4) bank support of their own stock by directing securities affiliates to purchase the bank's stock;31
5) unsound and under-collateralized loans to securities affiliates with financial problems.32

Congress feared that banks were using deposits to finance speculative investments.33 Also, public confidence in banks had dropped, because of the apparent risks associated with banks' securities activities.34 At the
same time banks faced a conflict of interest in that they possessed a duty to offer impartial investment advice, while on the other hand desiring to promote their own securities activities.\textsuperscript{35} Congress adopted the Glass-Steagall Act in response to these perceived problems.

Congress faced a key policy choice of whether completely to prohibit banks from engaging in investment banking activities or merely to regulate the potential abuses attendant to banks' securities activities. Congress chose the former because it felt that bank involvement in the promotion of securities was inconsistent with the best interest of banks.\textsuperscript{36} Moreover, Congress believed that total separation of commercial banking and investment banking would restore public confidence in the banking system.\textsuperscript{37}

\textbf{B. The Relevant Provisions of Glass-Steagall}

The Act contains four provisions relating to banks' securities activities.\textsuperscript{38} Sections 16 and 21 apply to banks, while Sections 20 and 32 apply to bank affiliates.\textsuperscript{39} While Section 16 limits banks' securities activities,
Section 21 prohibits investment banking firms from engaging in commercial banking activity.\textsuperscript{40}

These sections address two principle areas of bank activity: bank underwriting of securities and bank purchases of securities for their customers' accounts.\textsuperscript{41} Section 16 generally prohibits banks from underwriting securities. This provision prohibits underwriting in two ways. First, it forbids banks from purchasing securities from issuers with the intent to distribute to investors. Second, it outlaws arrangements where the issuer attempts a public distribution of securities while the bank agrees to purchase any unsold securities at a specified price.\textsuperscript{42} The Act's prohibition of these underwriting activities does not apply to federal or state obligations.\textsuperscript{43}
Section 16 also addresses banks that purchase securities on behalf of their customers. The express language of this section permits banks to purchase securities “solely upon the order, and for the account of customers.” Most commentators believe that this language permits banks to continue to offer “agency-type” securities services to depositors. Congress passed the Banking Act of 1935 in response to conflicting interpretations of Section 16. This act amended Section 16 clearly to permit both equity and debt transactions for customer accounts. The Comptroller of the Currency testified before Congress that the amended version of Section 16 merely clarified the Act because Section 16 never prohibited banks from buying or selling securities for their customers’ accounts. The Congressional committees concurred with the Comptroller’s conclusion, because no bank funds would be invested in these securities transactions.

Section 21(a)(1) compliments Section 16 by prohibiting persons “engaged in the business” of “issuing, underwriting, selling or distributing” securities to engage “in the business of receiving deposits.” The Banking Act of 1935 also amended this section to clarify that Section 21 did not prohibit banks’ dealing in, underwriting, purchasing, and selling securities to the extent allowed in Section 16.

or Environmental Financing Authority or Student Loan Marketing Association; certain obligations of any local public agency secured by an agreement with the Secretary of Housing and Urban Development, or a public housing agency whose obligations are secured as enumerated; obligations issued by the International Bank for Reconstruction and Development, the Inter-American Development Bank; obligations of the Tennessee Valley Authority and United States Postal Service; or obligations issued by states and localities for housing, dormitory, or university purposes-within certain limits.

45. DI LORENZO, supra note 2, at § 96.02(2); HUBER, supra note 21, at § 12.04(8) (citing the Office of the Comptroller of the Currency’s position in 44 WASH. FIN. REP. 887 (1985)).
46. 1935 Banking Act, 49 Stat. 709, § 308(a).
47. Presently codified at 12 U.S.C. § 24 (Seventh) (1988); see supra note 40 and accompanying text.
48. Hearing on H.R. 5357, Before the House Comm. on Banking and Currency, 74th Cong., 1st Sess. 663 (1935): “Section 307(a), . . . makes it clear that Section 16 . . . was not intended to prohibit national banks or member banks from buying or selling stocks solely for the account of their customers.” (Section 307 of the proposed bill became Section 308 of the act as passed.)
49. H.R. REP. No. 1948, 73d Cong., 2d Sess. 2 (1934), and S. REP. No. 1260, 73d Cong., 2d Sess. 2 (1934).

In addition to the Glass-Steagall Act, three federal securities law provisions aid the analysis of bank activities in the commercial paper market. First, Section 2(a)(11) of the Securities Act of 1933 (hereinafter cited as Securities Act) defines “underwriter” as “any person who has purchased from the issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security.” 52 Under this statutory scheme, an underwriter usually does not exist unless a “distribution” exists. Contemporaneous federal agency interpretation and subsequent commentary suggested that a “distribution” is synonymous with a “public offering.” 53 Thus, an “underwriter” usually does not exist without a “public offering.”

The term “underwriter” is not clearly defined in the Glass-Steagall Act. 54 Although the precise purposes of the Act and the Securities Act may differ, 55 these two reforms emerged from the same effort to restructure American financial markets and became law within three weeks of each other. 56 Congress’ use of the term “underwriter” under Glass-Steagall probably indicates an underwriter exists only when a “public offering” of securities exists.

In the same vein, Section 3(a)(3) of the Securities Act exempts from registration any security “which arises out of a current transaction . . .

53. The Federal Trade Commission, the agency originally charged with regulating the securities industry, said that a statutory distribution necessarily involved a public offering. H.R. CONF. REP. No. 1838, 73d Cong., 2d Sess. 41 (1934). See also 1 LOSS, SECURITIES REGULATION 551 (2d ed. 1961) (“distribution” is synonymous with “public offering”).

However, an underwriter may exist in a secondary market transaction. See 17 C.F.R. § 230.144 (1976) (Rule 144), which sets forth the circumstances under which affiliates or persons acquiring shares from a company issued in reliance on the Regulation D exemption can sell such shares publicly without being deemed a statutory underwriter. See generally BLOOMENTHAL, SECURITIES LAW HANDBOOK 226-29 (1986-87 ed.).


56. Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys., 807 F.2d 1052, 1063 (D.C. Cir. 1986); see generally, HUBER, supra note 23, at § 2.06 (A “blizzard of statutes” was enacted in the first three months of President Roosevelt’s administration. The Act and the Securities Act of 1933 were among these statutes.).
and which has a maturity at the time of issuance not exceeding nine months." \(^5^7\) The Securities and Exchange Commission has stated that the Section 3(a)(3) exemption applies only to obligations "of a type not ordinarily purchased by the general public."\(^5^8\) Most commercial paper that banks place qualifies for this exemption from registration.\(^5^9\)

Finally, the Securities and Exchange Commission adopted Rule 3b-9 in 1985, which requires banks to conduct certain securities activities through a broker-dealer registered under the Securities Exchange Act of 1934.\(^6^0\) Among other things, a bank must conduct "best-efforts" underwriting through a registered broker-dealer subsidiary.\(^6^1\) However, Rule 3b-9(b) permits banks to continue commercial paper activities without registering as broker-dealers.\(^6^2\)

### III. Judicial and Agency Interpretations of Glass-Steagall

Court interpretations of the Act are scarce. In *Investment Company Institute v. Camp* the Supreme Court examined Sections 16 and 21.\(^6^3\) The Court focused on the policy objectives of the Act. The Court stated that Congress believed that the dangers of bank involvement in securities

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58. SEC Securities Act Release No. 4412 (September 20, 1961). The Release provides four criteria for determining whether commercial paper is exempt from registration under § 3(a)(3). The paper must be (1) prime quality negotiable paper, (2) of a type not ordinarily purchased by the general public, (3) used to finance well-defined current operational expenses, and (4) discountable at a Federal Reserve bank. *Id.*
60. 50 FED. REG. 23835 (July 12, 1985). "These activities are (1) public solicitation of brokerage business for transaction-related compensation, (2) receipt of transaction-related compensation for providing brokerage services for trust, managing agency or other accounts to which the bank provides advice or (3) dealing in or underwriting securities." *Id.*
61. Best-efforts underwriting occurs when the "securities house" sells the issue for the issuer as an agent, rather than buying the issue from the issuer and reselling as a principal. In a best-efforts underwriting, the "agent" takes its compensation in the form of a commission, rather than through profit on the sale. RATNER, SECURITIES REGULATION 29 (3d ed.).
62. 50 FED. REG. 28391 (July 12, 1985). Under Rule 3b-9(b)(1), a bank may take part in commercial paper transactions without broker-dealer registration. This exception reflects the SEC's intent to avoid disruption of the existing statutory scheme. See also BLOOMENTHAL, supra note 53, at p. cxvi (86-87 ed.). ("The issue of the extent to which banks may participate in the sale of commercial paper without being deemed an underwriter remains an open one, . . . but the bank will not be required to register as a broker-dealer."). *Id.*
63. 401 U.S. 617 (1971).
activities outweighed the benefits. Thus Sections 16 and 21 prohibited bank securities activity which implicated certain "subtle hazards". The "subtle hazards" included the danger:

1) That banks would invest their assets in illiquid or speculative securities;
2) That public confidence would drop if bank securities activities resulted in losses;
3) That issuer proceeds were used to pay back bank loans;
4) That banks would issue loans to facilitate the purchases of securities which the bank had promoted;
5) That banks would extend credit more freely to issuers whose securities the bank promoted;
6) That the bank's promotional interest conflicted with its obligation to offer disinterested financial advice; and
7) That bank depositors would suffer losses on securities they purchased in reliance on the relationship between the bank and the issuer.

Camp thus effectively reduced examination of bank securities activities into two distinct steps. First, the courts scrutinize the activity under the literal language of Sections 16 and 21. Second, they examine the activity against the background purposes of the Act to see if they implicate any of the "subtle hazards" that the Camp Court outlined.

Securities Industry Association v. Board of Governors (Schwab) presented an example of Supreme Court analysis under Section 16. In Schwab, the Court found that brokerage or agency-type securities activities are permissable under Section 16. The Court distinguished the activities of a broker, who merely executes orders for the purchase or sale of a security as an agent, from the activities of an underwriter, who acts

64. Id. at 630.
65. Id.
66. Id. at 630-34.
67. Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys., 807 F.2d 1052, 1067 (D.C. Cir. 1986). After examining the bank activity under the literal language of Section 16, the court said, "[T]he Supreme Court's Glass-Steagall Act cases uniformly consider 'subtle hazards'... Until the Court indicates that it no longer employs this analysis to interpret the Glass-Steagall Act, we too must take such considerations into account." Id.
69. Id. at 3010 n.20. "The permissive phrase found in Section 16 accurately describes securities brokerage and clearly distinguishes that activity from the activities of 'dealing in, underwriting, and purchasing for its own account investment securities that are prohibited elsewhere in that section.' Id. The Court said that banks have a long history of arranging the purchase and sale of securities as an accommodation to their customers. The Court said that Congress endorsed this service when enacting Section 16. Id. at 3008.
as a principal and actually buys the securities from the issuer. The Court found that the key distinction is that an underwriter assumes all risk from possible market fluctuations, while in an agency-type transaction, the issuer and the customer bear the risk of loss.

The analysis of bank commercial paper placement under both the literal terms of the Act and its policy objectives has produced inconsistent results. On the same day that it handed down Schwab the Supreme Court decided a completely different case with the same name. For clarity’s sake this Note refers to this case as Bankers Trust. In Bankers Trust the Bankers Trust Company had solicited commercial paper issuers to use the bank’s selling services. The bank advised issuers about rates and maturities of proposed issues. If the client wished to issue commercial paper, Bankers Trust privately solicited institutional purchasers and acted as the agent of the issuer by placing the paper. The bank did not purchase the issue itself, but it did offer to lend issuers an amount of money that equalled the value of paper being sold at a comparable interest rate.

The Supreme Court failed to analyze Sections 16 and 21 completely when it examined Bankers Trust’s activities in the commercial paper

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70. Id. at 3010.
71. Id. at 3010 n.18. But see Securities Indus. Ass’n v. Board of Governors of the Fed. Res. Sys., 627 F. Supp. 695, 703 (D.D.C. 1986). The Bankers Trust court found a distinction between a broker in the secondary market, as the party in Schwab was, and a bank which assisted in the initial issuance of commercial paper. The typical broker’s profit depends on the volume of securities sold. However, a bank which placed commercial paper depends on the profitability of the particular issue involved. Thus the court said that the bank had a “salesman’s stake” in the paper it sold. Id. at 703. For a general discussion of this court’s analysis and holding, see infra notes 86-99 and accompanying text.
72. The controversy began in January 1979. A national securities industry trade association and a commercial paper dealer petitioned the Federal Reserve Board to prohibit Bankers Trust from selling commercial paper. The petitioners alleged the activity violated the Act. In September 1980, the Board responded by saying that the commercial paper being placed was not a security for the purposes of the Act, and therefore, not subject to the Act’s prohibitions.
market.  

The Court noted that the Act contained a flat prohibition on bank involvement in investment banking activity.  

The Court also found little evidence to suggest that the Act's prohibitions depended on the strength of the particular issue or the sophistication of the investor.  

The Court also concluded that commercial paper is a security under Sections 16 and 21 of the Act, and therefore, subject to the prohibition on underwriting.  

The Court, however, left open the issue of whether Bankers Trust's particular activity constituted “underwriting” under Section 16 or “the business of issuing, underwriting, selling or distributing” within Section 21.  

On remand, the Federal Reserve Board found Bankers Trust's activities permissible under the language of Section 16.  

The Board interpreted the Act's underwriting prohibition not to extend to agency transactions where the bank did not commit any of its funds.  

The Board then relied on federal securities provisions to distinguish the prohibited underwriting activity from the permissible agency-type activities.  

The Board found it significant that under federal securities law an underwriting usually would involve a public offering of securities.  

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75. Id. at 2985. “The Act merely reflects Congress' view that those investment banking activities that it determined to be incompatible with prudent commercial banking . . . justify a broad prohibition.” Id. at n.6. The Court said Congress rejected a regulatory approach. Id. at 2985.
76. Id. at 2991. The Court said the Act's underwriting prohibition did not take into account the particular features of an issue. Likewise, the sophistication of the investor was irrelevant. “The Act's prohibition on underwriting is a flat prohibition that applies to sales to both the knowledgeable and the naive.” Id. at 2991.
77. Id. at 2987.
78. Id. at 2991 n.12. The court of appeals had concluded that commercial paper was not a security under the Act. 693 F.2d 136 (D.C. Cir. 1982). The court of appeals never addressed the underwriting issue. The Court decided to express no opinion on this matter. 104 S. Ct. at 2991 n.12. In an order dated October 19, 1984, the district court remanded the case to the Board so that it might consider the underwriting issue.
80. Id. at 90,825-90,826. The Board said that the Section's phrase “selling such securities . . . for the account of, customers” authorized banks to sell securities as agents for their customers. Id.
81. Id. at 90,829-90,833. The board conceded that securities law interpretations were not controlling for the purposes of interpreting the Act. The Board, however, felt securities law interpretations provided guidance.

The Board said that the Supreme Court had looked to securities law interpretations when it decided that commercial paper was a security for the purposes of the Act. The Board concluded that the Court's reliance on securities law interpretations in that situation suggested it would be appropriate to rely on these interpretations in defining underwriting. Id. at 90,830.
Board noted that Bankers Trust only arranged private sales to institutional investors. Also, the commercial paper qualified for exemption from registration under Section 3(a)(3) of the Securities Act. By analogy to federal securities law, the Board concluded that the bank’s agency activity was not part of a public offering, and thus, removed from Glass-Steagall's underwriting prohibition. Finally, the Board said that Bankers Trust’s activity was permissible even under the “subtle hazards” analysis because, placement of commercial paper as an agent was not “likely” to implicate the concerns that Camp identified.

The Securities Industry Association challenged the Board’s decision in federal district court. The district court held to the contrary—that Section 21 prohibited Bankers Trust’s commercial paper placement because the activity constituted an impermissible selling, underwriting, and distribution of securities. The court said that the bank sales of commercial paper on behalf of issuers were within the literal terms of Section 21, which prohibited banks from “selling” securities. The court acknowledged, however, that the Section 21 prohibition did not prohibit activity which Section 16 permitted. Thus it examined whether Bankers Trust’s activity fell within Section 16’s permissive phrase.

The court said that Bankers Trust’s activity did not fall within the “agency” exception of Section 16 because the activity implicated “subtle hazards”, such as promotional pressures and conflicts of interest, which the Act meant to prevent. The Board had concluded that it was “un-

82. Id. at 90,831.
83. Id. at 90,832-90,836.
84. Id. at 90,832. The Board acknowledged that the “subtle hazards” were “possibilities.” The Board, however, said that agency transactions were fundamentally different from those transactions where a bank acts as a principal and commit its own funds. In agency transactions, the rewards are small and commensurate with these small rewards, the risks are minimal. Id. at 90,833. For a criticism of the Board’s approach of assessing the “likelihood” of the risks arising, see infra notes 92-93 and accompanying text.
85. 627 F. Supp. 695 (D.D.C. 1986). The Securities Industry Association contended that the Board’s interpretation of the Act was incorrect as a matter of law and that its ruling must therefore be set aside.
86. Id. at 711.
87. Id. at 699.
88. Id. “The Securities Industry Association ignores the Supreme Court’s observations that sections 16 and 21 ‘seek to draw the same line.’” Id. The court continued and said the Board’s construction of Section 21, which effectuated the permissive phrase, was reasonable. Id.
89. The court agreed with the Board that Bankers Trust’s activities fit within the literal language of Section 16. Id. at 701. The court, though, found it necessary to review the Board’s “subtle hazard” analysis. Id. at 704-06.
90. Id. at 706.
likely” that any danger would result from the bank’s activity. The court, however, ruled that this approach was improper, because the Act sought to eliminate any potential hazards. Thus, according to the court, the Board’s opinion adopted a regulatory approach toward bank securities activity while the Act demanded a flat prohibition.22

This conclusion could have disposed of the issue. The court, however, went on to examine Section 21’s prohibition on underwriting securities. The court said that the Board’s reliance on federal securities law to interpret the term “underwriting” was misplaced.23 The court distinguished the policy concerns behind the federal securities laws and Glass-Steagall.24 The court stated that the federal securities laws were designed to prevent fraud and protect investors. The Act, on the other hand, seeks to restore the integrity of the commercial banking system. Because these purposes differ, the fact that “underwriting” under the Securities Act usually required a “public offering” was not relevant to interpreting Glass-Steagall.25 The court ruled that the Act’s underwriting prohibition applied to public or private offerings of commercial paper.26 The court found any attempt to superimpose a private placement exemption in the Act invalid. It believed that the same “subtle hazards” were involved in the public or private placement of commercial paper.27 The court concluded that Bankers Trust’s “best-efforts” or agency-type “underwriting” activity was invalid under the Section 21 underwriting prohibition.28

The D.C. Circuit Court of Appeals reversed.29 Writing for the court,

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91. Id. The court criticized the Board’s approach and labeled it an impermissible “ad hoc analysis of probabilities and likelihoods.” Id. Furthermore, if the Board found potential hazards in Bankers Trust’s activities, it should have invalidated the activities. Id.

92. Id. According to the court, a regulatory approach was “inconsistent with Congress’ desire to separate as completely as possible commercial and investment banking.” Id.

93. See supra notes 52-60 and accompanying text for a discussion of federal securities law provisions.

94. See supra note 55 and accompanying text for a discussion of these policy concerns.

95. 627 F. Supp. at 709.

96. Id. at 708. The court relied heavily on the Supreme Court’s statement that the Act contained a flat prohibition on underwriting. Id.

97. Id. at 709. The court also said that Congress was aware of the different nature of public and non-public offerings of securities, and it explicitly provided for this distinction in the language of the Securities Act. On the other hand, Glass-Steagall was silent with respect to the public/private distinction. “In light of these different statutory structures, the Board’s attempt to create an exemption for non-public distributions where none was provided nor apparently intended, simply cannot be upheld.” Id.

98. Id. at 711.

99. 807 F.2d 1052, 1070 (D.C. Cir. 1986).
Judge Bork stressed that courts must defer to agency interpretations of Congressional Acts when those interpretations are reasonable.\textsuperscript{100} The court then examined the Board's decision under both the literal language analysis and the "subtle hazards" analysis.

Under the literal language analysis, the court noted that Section 21 did not prohibit activity that Section 16 explicitly permitted.\textsuperscript{101} In examining the scope of Section 16 the court found that Bankers Trust's agency activity in the commercial paper market fell within the Section's permissive "selling" phrase.\textsuperscript{102} Furthermore, the court said that examination of the federal securities law does aid in determining what activity Section 16 permitted.\textsuperscript{103} The court hypothesized that in Section 16 Congress could have chosen only to prohibit banks from underwriting public offerings.\textsuperscript{104} Thus, the court found that the Board's determination that Bankers Trust's private placement of commercial paper as the issuer's agent was within the literal language of Section 16 was reasonable.

After reaching this conclusion, the court somewhat reluctantly applied the "subtle hazards" analysis.\textsuperscript{105} The court, agreeing with the board's

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\textsuperscript{100} The court applied the deferential standard of review spelled out in Chevron U.S.A. Inc., v. NRDC, 467 U.S. 837, 843-45 (1984) (if Congress' intent cannot be inferred, the reviewing court must determine if the agency charged with administering the statute has acted reasonably when "filling in the gap"). Here, Judge Bork said that Congress did not clearly address the question of whether activities such as those Bankers Trust conducted fell within the Act's prohibitions. Thus, the reviewing court should only determine whether the Board acted reasonably when "filling in the gap" under the Act. 807 F.2d at 1056.

\textsuperscript{101} See also Board of Governors of the Fed. Res. Sys. v. Agnew, 329 U.S. 441, 450 (1947) (Rutledge, J. concurring). (The Board's) specialized experience gives (it) advantage judges cannot possibly have, not in (the) dealing with problems raised for (its) discretion by the system's working, but also in ascertaining the meaning Congress had in mind in prescribing the standards by which (the Board) should administer it.

\textsuperscript{102} See also Board of Governors of the Fed. Res. Sys. v. Investment Co. Inst., 450 U.S. 46, 63 (1981) (Section 21 was not intended to prohibit activity that Section 16 permitted).

\textsuperscript{103} 807 F.2d at 1058.

\textsuperscript{104} Id. at 1062-63. "[W]e must consider Congress' understanding of the financial terms used in one statute is highly relevant to discovering the meaning attached to similar but ambiguous terms in the other." Id. at 1063. See supra notes 52-63 and accompanying text.

\textsuperscript{105} 807 F.2d at 1064. "While by no means conclusive, this history offers support for the reasonableness of the Board's view. ..." Id.

\textsuperscript{106} The court examined a recent Supreme Court statement from Board of Governors of the Fed. Res. Sys. v. Dimension Fin. Corp., 106 S. Ct. 681, 689 (1986), where the Court said that invoking the background policy of the Glass-Steagall Act at the expense of its literal terms did not take into account legislative compromise. The court noted, however, that all of the Supreme Court's Glass-Steagall Act cases had considered the "subtle hazards" and background purposes of the Act. 807 F.2d at 1067.
findings under this analysis, determined that the bank's commercial paper placement did not implicate the "subtle hazards" the Act sought to eliminate.\textsuperscript{106} Also, the court rejected the district judge's contention that the Board established an impermissible regulatory framework for evaluating the bank's commercial paper activity. The court stated that the Act's flat prohibitions did not eliminate the need to examine particular factual situations to determine on which side of the prohibitory line the bank activity fell.\textsuperscript{107} Finally, the court said that the Board could decide that the realities of a situation made even the potential for conflict "substantially unlikely."\textsuperscript{108}

\textbf{IV. A PROPOSAL FOR EVALUATING BANK PLACEMENT OF COMMERCIAL PAPER UNDER THE CURRENT STATUTORY FRAMEWORK}

Because commercial paper serves as a vital source of short-term credit for corporations,\textsuperscript{109} courts should permit issuers to take advantage of the

\textsuperscript{106} 807 F.2d at 1069. The court understood the Supreme Court to say that the banking activity would be prohibited under the "subtle hazards" analysis only when the activity implicated "each and every one of the hazards." \textit{Id.} The court said that one "subtle hazard" may be present, because some depositors may lose their confidence in the bank. This conclusion, by itself, was not enough to convince the court that the activity was prohibited. \textit{Id.}

\textsuperscript{107} \textit{Id.} at 1067.

\textsuperscript{108} \textit{Id.} "A judgment such as this, . . . is precisely the kind of exercise of delegated expertise that deserves our full deference." \textit{Id.} at 1068.

The day after the ruling, the Board approved an application by Bankers Trust to place commercial paper as an agent through its commercial leasing subsidiary. This activity was held consistent with Section 20. The Board noted that commercial paper placement as an agent did not constitute underwriting or distributing under the Act. While concurring with the Board's order, then Chairman Paul Volcker urged legislative review and update. "I believe legislation should be adopted promptly to give straightforward authority for bank holding companies to engage in certain underwriting activities—underwriting commercial paper, mortgage-backed securities, revenue bonds and mutual funds—with such protections against conflicts of interest and self-dealing as may be appropriate." Federal Reserve Board Order, \textit{reprinted in} Fed. Banking L. Rep., (CCH), ¶ 86,770, at 92,138-92,156 (1987).

Various factions have reacted negatively towards the Board's order. Representative Schumer (R.-N.Y.) urged the Board to reject any applications from banks who seek to add securities services. He said that Glass-Steagall's prohibitions were still needed. 19 SEC. REG. L. REP. (BNA) 201 (1987).

Likewise, Securities Industry Association representative Robert Gerard told the Senate Banking Committee that permitting limited underwriting by banks and bank holding companies would lead to the demise of the laws enacted in the 1930s. \textit{Id.} at 169.

Following the D.C. Circuit's decision, the Securities Industry Association filed a petition for certiorari with the Supreme Court. The Court declined to review the decision, Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys., \textit{cert. denied}, 97 L.Ed.2d 734 (1987). Although the D.C. Circuit's decision stands, the controversy in this area appears unsettled.

\textsuperscript{109} \textit{See supra} notes 9-22 and accompanying text.
efficient distribution networks that banks can provide. While many commentators have suggested that Congress amend Sections 16 and 21 to keep pace with the rapidly changing financial markets,110 the Act's prohibitions, unchanged, could continue to protect depositors and the banking system.

The debate between the securities and banking industries concerning bank agency activity in the commercial paper market revolves around two distinct arguments. The banks have relied on the literal language of the Act, because their involvement apparently fits within the permissive language of Section 16.111 The securities industry, on the other hand, has focused on the policy objectives of the Act112 and argued that the existence of "potential" conflicts arising from bank placement of commercial paper should invalidate the bank activity.

In Bankers Trust the federal courts and the Federal Reserve Board failed to address adequately these two areas of analysis. The Board and the D.C. Circuit emphasized the permissive language of Section 16, while generally discounting possible hazards as "unlikely."113 On the other hand, the district court's broad "subtle hazards" analysis rendered the permissive literal language of Section 16 nugatory.114 Bankers Trust thus failed to give substantial guidance to either banks or the securities industry.115 The courts and the regulatory agency failed to recognize that the

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110. See Note, An Alternative to Throwing Stones: A Proposal For the Reform of Glass-Steagall, 52 Broduklyn L. Rev. 281 (1986) (This commentator says that new technology and a heavy regulatory system make the current financial services industry much different than that of 1929-1933. The restrictions of Glass-Steagall place banks at a competitive disadvantage. This, in turn, prevents improvement of services at lower cost.). Note, Fifty-Two Years After the Glass Steagall Act: Do Commercial Bank Securities Activities Merit a Second Look, 1984 Det. C.L. Rev. 933.

Senate Banking Committee Chairman Jake Garn, (R.-Utah), introduced legislation that would repeal the Act. This action followed Federal Reserve Board Chairman Alan Greenspan's statement that commercial banks must be allowed to compete with the securities industry. St. L. Post-Dispatch, Nov. 20, 1987, 10D.

But see Comment, Securities Industry Association v. Board of Governors of the Federal Reserve System, 31 N.Y.L. Sch. L. Rev. 215 (1986) (The recent number of bank failures suggests the banking industry may be reaching a crisis stage and stricter legislation may be necessary.); Note, Federal Regulation of Bank Securities: Will Congress Allow Glass-Steagall To Be Shattered?, 12 J. Contemp. L. 99 (1985) (History will repeat itself in the commercial banking industry if bank regulation is not more restrictive in the near future.).

111. Huber, supra note 22, at § 12.03(1).

112. Id.

113. See supra notes 79-84, 99-108, and accompanying text.

114. See supra notes 86-92 and accompanying text.

115. See supra note 109. Former Chairman Volcker's plea for legislation suggests the current analytical tools are inadequate.
literal language and the policy objectives of the Act could blend into a workable framework for analyzing bank commercial paper activity.

The starting point for analyzing bank commercial paper placement is Section 16. In considering this section, decision makers should first define the bank's role before dividing permissible and prohibited conduct into two broad areas. If a bank actually purchases commercial paper from an issuer with the intent to resell the issue, its activity falls outside the permissive phrase in Section 16.116 On the other hand, if a bank merely acts as an agent for the issuer, its commercial paper placement fits within the phrase "selling such securities . . . for the account of, customers."117 The language of section 16 then generally permits banks to act as agents.

The second step of this analysis requires examining banks' agency activity under the policy objectives of the Act. This "subtle hazards" analysis is the area where decision-makers have uniformly failed. The legislative history of the Act suggests that certain bank agency commercial paper placement should be prohibited.118 One way to determine whether bank activity comports with the purposes of the Act is to examine the bank's actual function in the transaction.119 This Note proposes that the Act prohibits bank agency commercial paper placement that is the functional equivalent of purchasing the issue because the bank's assumption of a risk or development of an investment banker's pecuniary interest might implicate the "subtle hazards".120

In determining whether bank agency activity rises to the level of the functional equivalency, the following guidelines, while not exhaustive,


118. Senator Bulkeley's remarks advocate "removing risks" and "protecting depositors". 75 CONG. REC. 9911-15 (1932). These purposes manifest themselves in the language of Section 16's prohibitions. The permissive "selling" phrase in Section 16 reveals that Congress did not envision similar "hazards" in all agency transactions. It is clear, however, that if substantial risks appear in an agency transaction, Congress may have intended to invalidate this transaction. See Securities Indus. Ass'n v. Board of Governors of the Fed. Res. Sys., 807 F.2d at 1069.

119. When examining Bankers Trust's activities in light of the hazards the Act was intended to prevent, the Board examined investment of bank funds. The Board found that consistency with the Act required that the banks refrain from activity that would "represent the functional equivalent of purchasing . . . commercial paper." Federal Reserve Board Statement, reprinted in FED. BANKING L. REP. (CCH) ¶ 86,270, at 90,833 (1984-85). The Board concluded its opinion by saying its conclusions under the Act may change if the bank "functions . . . are materially altered." Id. at 90,836.

120. See supra notes 65-67 and accompanying text for a discussion of the "subtle hazards."
will be nonetheless effective.\textsuperscript{121} If bank agency commercial paper placement conforms with these guidelines, there will be a presumption that: 1) the activity is not the functional equivalent; 2) the "subtle hazards" are not implicated; and 3) the activity is permitted by Section 16. The guidelines for bank commercial paper placement include the following: 1) banks may not use depositors' funds to purchase commercial paper for prospective resale;\textsuperscript{122} 2) banks may not extend back-up credit to the issuer for the purpose of covering the unsold portion of the issue;\textsuperscript{123} 3) the timing of bank loans to issuers must be independent of the issue—records demonstrating this independence must be maintained;\textsuperscript{124} 4) banks must independently verify the use of issuer proceeds—proceeds must not be used to repay loans to the agent-bank;\textsuperscript{125} 5) banks must only offer commercial paper that is exempt from registration under Section 3(a)(3) of the Securities Act;\textsuperscript{126} 6) upon request, banks must disclose the general

\textsuperscript{121} The Federal Reserve Board had issued commercial paper guidelines in 1980. \textit{Policy Statement Concerning Sale of Third Party Commercial Paper by State Member Banks}, 46 FED. REG. 2933 (1981). These guidelines, however, were issued on the premise that commercial paper was not a security for the purposes of the Act. These guidelines were ultimately withdrawn after the Board's \textit{Bankers Trust} decision on June 7, 1985. Federal Reserve Board Statement, \textit{reprinted in Fed. Banking L. Rep. (CCH)} ¶ 86,270, at 90,836 (1984-85).

\textsuperscript{122} The use of bank funds was identified as the major concern during legislative hearings on the Act. See \textit{supra} notes 33 and 66 and accompanying text.

\textsuperscript{123} By letter dated December 3, 1984, the Board told Bankers Trust that its practice of extending short-term credit to issuers of commercial paper to cover unsold portions of the issue appeared to be the equivalent of buying the unsold issue with the bank's own funds, an activity that would appear to be prohibited by the Act. Federal Reserve Board Statement, \textit{reprinted in Fed. Banking L. Rep. (CCH)}, ¶ 86,270, at 90,824 (1984-85). By January of 1985, Bankers Trust discontinued this prior practice.

When the substance of a back-up credit transaction is examined, it is apparent that banks would be taking risks if the issue is not completely sold.

\textsuperscript{124} Loans that are not independent of the issue are in substance, back-up lines-of-credit, which are beyond the scope of these guidelines. Also, these loans suggest partiality in granting credit. The Board noted that Bankers Trust documented that credit lines extended to issuers were for special purposes, unconnected with the issue. \textit{id}. at 90,834.

\textsuperscript{125} This use of proceeds would be extremely risky for a bank, because it would probably indicate that the issuer was financially unstable. \textit{id}. at 90,835. However, the use of commercial paper proceeds to repay loans to the agent-bank is not likely to occur in practice. An issuer with financial problems will receive low ratings and have difficulty in placing commercial paper in the market, even if it is encouraged by the bank to do so. Presently, at least five independent services rate proposed commercial paper issues. Unrated or lower-rated paper cannot be sold easily. See Hurley, \textit{supra} note 3, at 527-29.

\textsuperscript{126} Section 3(a)(3) applies to obligations "of a type not ordinarily purchased by the public." \textit{See supra} notes 57-59 and accompanying text. Securities falling under the Section 3(a)(3) exemption are usually purchased by sophisticated investors rather than by ordinary investors, \textit{SOWARDS, BUSINESS ORGANIZATIONS—SECURITIES REGULATION}, Vol. II, § 3.04(1), n.20 (1984), thus less protection is required.
nature of their lending relationship with issuers to potential purchasers;127 7) banks must not make loans to facilitate purchases of commercial paper that the bank handles;128 8) bank revenue from commercial paper placement must not exceed five percent of gross revenues;129 and 9) banks may not place commercial paper with individuals.130

Bank agency activity in the commercial paper market within these guidelines presumably falls short of the functional equivalency threshold. In turn, there is a presumption that the "subtle hazards" are not implicated. This presumption is rebutted only by other substantial evidence which indicates that the agency activity is the functional equivalent of purchasing the issue, assuming a risk, or developing an investment banker's pecuniary interest. Given these strict guidelines, however, this burden will be difficult to meet. Conversely, if the bank agency activity violates these guidelines, there is a presumption that the activity meets the functional equivalency threshold and the "subtle hazards" have been implicated. Unless the presumption is rebutted, this agency activity will violate the Act.

It is clear that Congress intended to separate commercial banking

127. This guideline gives protection to both potential purchasers and bank depositors. It allows these groups to determine if the bank has such a unique relationship to the issuer that its lending practices are, in effect, substantially related to the issue of commercial paper.

128. These types of loans signify that the bank has a "salesman's stake" in the issue. This activity goes beyond merely matching a buyer and a seller. It shows the bank has developed an investment banker's pecuniary interest. Also, it signifies that the bank has not been impartial or objective in granting credit (i.e. one of the "subtle hazards"). The Board points out, however, that yields on commercial paper are often lower than rates charged by banks on loans. Therefore, it is not always likely that using borrowed funds to purchase commercial paper would be profitable. Federal Reserve Board Statement, reprinted in FED. BANKING L. REP. (CCH) ¶ 86,270, at 90,834 n.39 (1984-85). When the use of borrowed funds to purchase commercial paper is indeed profitable, it should not be tolerated.

129. This limit prevents banks from focusing too much of their attention on securities activities. If this limit is exceeded, a commercial bank will take on characteristics of an investment bank. See generally supra note 121, Policy Statement Concerning Sale of Third Party Commercial Paper by State Member Banks, 46 FED. REG. 2933 (1981) (The Board often has drawn lines regarding bank revenues from securities activities.).

130. When the bank's agency activity remains restricted to institutional investors, there is little likelihood that the bank can take on the form of an investment bank. Institutional investors have the resources and expertise to make their own judgments about short-term investments. Thus, the bank will be unable to develop an investment banker's pecuniary interest because the potential investors will not require extensive counseling on the merits of the commercial paper issue.

In Bankers Trust, the Board found it significant that commercial paper was placed only with institutional investors. Federal Reserve Board Statement, reprinted in FED. BANKING L. REP. (CCH) ¶ 86,270 at 90,835 (1984-85 Transfer Binder).
from investment banking and that it rejected a regulatory approach. Judge Bork is correct, however, when he notes that even if the Act contains a prohibitory framework, someone has to decide what types of commercial paper activity is prohibited. The literal language test, the functional equivalency test, and the accompanying guidelines do not attempt to regulate bank agency activity in the commercial paper market. This approach merely determines on which side of the prohibitory line the bank activity falls.

V. CONCLUSION

Questions regarding the scope of permissive bank involvement in the commercial paper market cannot go unanswered. The dramatic growth in the number of issuers, the amount of commercial paper outstanding and the number of banks applying for placement approval make the resolution of this issue imperative. Congress had good reasons for prohibiting bank commercial paper placement activity that the Act does not expressly authorize or that implicates legitimate Congressional concerns. However, limited bank agency activity in the commercial paper market is authorized. This limited activity will benefit the issuer, the potential investor, and the bank itself, without harming depositors or the commercial banking industry.

Stuart J. Vogelsmeier

131. See supra notes 36-37 and accompanying text.
132. Securities Indus. Ass'n v. Board of Governors of the Federal Reserve System, 807 F.2d at 1069. Section 16 does have a permissive "selling" phrase. These guidelines determine whether bank activity in the commercial paper market is within this permissive phrase.
133. Members of the banking industry may argue that these guidelines erect an artificial barrier to market entry for banks that desire to place commercial paper as agents. This author believes the guidelines are necessary to determine the scope of activity permitted by Section 16. Restricted market entry was not a concern of Congress and does not obviate the need to protect depositors. If a bank's agency activity is not within the guidelines, it is probably too hazardous to undertake.
134. For a discussion of the nature and growth of the commercial paper market, see supra notes 9-22 and accompanying text.