A Conduct-Oriented Approach to the Glass-Steagall Act
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The Glass-Steagall Act requires that commercial banking be separated from investment banking. Courts and regulatory agencies interpreting the prescribed separation often rely on technical and semantic considerations in deciding whether an investment constitutes a "security" for the purposes of the Act. This Note argues that such a "definitional" approach obscures the Act's purposes. The Note maintains that the applicable provisions of the Act are intended to bar commercial banks from engaging in a particular, identifiable pattern of conduct and that adoption of a "conduct" test for enforcement of the separation provision would serve the Act's legislative objectives better than the current approach. The Note concludes by applying these alternative approaches to a current Glass-Steagall controversy—the legality of commercial banks' underwriting of commercial paper.

Notes


2. See Banking Act of 1933, §§ 16, 21, 12 U.S.C. §§ 24, 378 (1976). The Banking Act of 1933 contained many provisions of great importance to the banking system, such as those creating the Federal Deposit Insurance Corporation. The term "Glass-Steagall Act," however, has generally come to refer exclusively to the sections of the Banking Act that pertain to commercial banks' securities activities. Section 16 of the Glass-Steagall Act approaches the Banking Act's legislative goals from the perspective of the commercial banker and § 21 approaches the legislative goals from the perspective of the investment banker. Section 16 prohibits commercial banks from engaging in "underwriting" or investment banking while § 21 bars organizations "engaged in the business of issuing, underwriting, selling or distributing" securities from receiving deposits. Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst., 101 S. Ct. 973, 976 (1981). This Note addresses the § 16 congressional concerns of commercial bank activity in the investment banking field.


Glass-Steagall Act

I. The Purposes of the Glass-Steagall Act

Congress enacted the Glass-Steagall Act for two purposes. First, and most importantly, it sought to eliminate the conflicts of interest that arise when commercial banks engage in the sale of securities. Second, it sought to prevent loss of public confidence in the banking system, which had led to runs on banks and to bank failures at the start of the Great Depression.

Congress found these problems so compelling that it chose to prohibit banks from engaging in both commercial and promotional activities altogether, rather than just to regulate their activities when they engaged in both businesses. Besides the original Congressional purposes behind Glass-Steagall, however, today the Act serves the additional, important purpose of decentralizing investment activity.

Glass-Steagall safeguards restrict competition between investment and commercial banks, but even the most procompetitive commentators acknowledge that the fiduciary responsibilities of commercial banking operations present unavoidable conflicts of interest with the promotional operations of corporate investment banking. Thus, any competitive benefits that would arise from commercial bank entry into investment banking are outweighed by the "hazards" and "financial dangers" posed by allowing commercial banks to underwrite securities.


9. See UNITED STATES PRESIDENT'S COMM'N, THE REPORT OF THE PRESIDENT'S COMMISSION ON FINANCIAL STRUCTURE AND REGULATION 52 (1971) [hereinafter cited as U.S. PRESIDENT'S COMMISSION REPORT]. The Commission's prime objective was to increase competition among financial institutions. See id. at 121.

Competition may actually be enhanced, however, by separating investment banking from commercial banking. Although commercial banks and investment banks may not offer the same services, they do offer substitutable services. The enforced separation of commercial and investment banking places pressure on each market to innovate in order to compete with the other. The growth of the commercial paper market is an example of the beneficial aspects of bifurcated markets. Commercial paper is an investment banking product that competes with the corporate lending services of commercial paper. See p. 115 infra; Stephen J. Friedman, Investment Management and the Glass-Steagall Act — The Emperors' New Clothes 5 (November 13, 1980) (unpublished remarks to Association of Bank Holding Companies) (on file with Yale Law Journal); cf. Bennett, Corporate Loans Soar at Banks, N.Y. Times, December 16, 1980, § D (Business), at 12, col. 1 (commercial banks are "aggressively cutting prices to compete for business with the commercial paper market").

10. This was the view when Glass-Steagall was passed. See Investment Co. Inst. v. Camp, 401
A. Conflicts of Interest

The Act's prohibition of commercial bank underwriting was also meant to encourage commercial banks to render strictly impartial advice to depositors, correspondent bankers, and other customers. Congress recognized the inherent conflict between the commercial banking role of impartial advisor and the investment banking role of promotional underwriter. Commercial bankers routinely advise corporate clients about whether their corporations should issue debt and about the best structure and timing of debt issues. Congress did not want the impartiality of this advice to be tainted by a desire to profit from the promotion of one particular security over another. Congress wanted this investment advice to be based solely on sound business judgment and to be free of promotional incentives such as sales or distribution commissions.

Investment banks, however, sell securities and promote the debt obligations of third parties in order to earn sales or distribution commissions. Commercial banks therefore face conflicts of interest when they engage in investment banking because of the different institutional roles played by commercial and investment banks.

One set of conflicts arises when the commercial bank attempts to convince corporate customers to make public offerings of securities through the bank. Investment banks require a continuous supply of securities in order to maintain distribution channels, which are difficult and expensive to develop. These distribution channels comprise the most important part of the investment banker's service. The drafters of Glass-Steagall realized that a commercial banker cannot render impartial advice about the

U.S. 617, 630 (1971). It remains the prevailing view today. See U.S. PRESIDENT'S COMMISSION REPORT, supra note 9, at 52; note 28 infra.
11. See note 40 infra.
13. Members of the Glass-Steagall Congress recognized that corporate treasurers rely heavily on the advice of commercial bankers to solve intricate business problems. See 75 CONG. REC. 9912 (1932) (remarks of Sen. Bulkley). Congress sought to construct a financial system in which the commercial banker could be regarded as "confidant and mentor" of his depositors. This relationship was viewed as natural and desirable for both the small depositor and the "great corporation." Id.
16. Investment banking by definition consists of underwriting and selling stocks and bonds. An investment banker is an underwriter who serves as a "middleman" between the corporation issuing securities and the investors who purchase them.
17. Congress recognized at the time Glass-Steagall was passed that it was unreasonable to expect a banker to give impartial investment advice after developing expensive securities distribution systems. Practical business considerations lead inexorably to the biased promotion of those securities in inventory. 75 CONG. REC. 9911 (1932) (remarks of Sen. Bulkley).
Glass-Steagall Act

“necessity and soundness” of a new securities issue if he or she has an incentive to feed the costly distribution channels that the bank has so expensively developed, and that can absorb the new security issue and make a distribution profit for the bank whether or not the issue is needed by the issuer. Prohibiting commercial banks from engaging in investment banking activities alleviates the temptation to exert undue pressure on the corporate customer to issue a security.

A second set of conflicts results from the temptation banks have to promote a securities issue so that the issuing corporation can use the proceeds to repay bank loans or to pay down bank lines of credit. This problem is particularly serious during periods of high interest rates, when the cost of issuing certain securities is low relative to commercial banking rates.

A third conflict of interest problem is that the commercial bank’s stake in an investment banking venture may lead it to make unsound loans or credit advances to companies whose securities it is promoting. The borrowing costs of issuing a debt security are closely linked to the credit rating assigned to that security; the better the rating, the lower the interest rate. A bank that grants a large back-up line of credit to a corporation improves the company’s credit rating and aids the underwriter in the sales of the company’s debt. If commercial banks could conduct an underwriting business, they might be tempted to make unsound loans to the firms whose securities they were promoting.

Separating investment from commercial banking, on the other hand,
provides an "independent and impartial check" on the soundness of the promotional security.25 This impartial check occurs regularly because a commercial bank typically makes a credit check of a corporation that is planning to issue securities for the purpose of determining whether to extend a back-up line of credit.26 This line of credit has become a "traditional safeguard of the market"27 because it provides additional insurance to the purchaser of the corporate debt that the obligation will be repaid.

B. Bank Stability

Congress was convinced that banks' speculative securities promotion28 and perilous underwriting activities29 led to the loss of depositor confidence and customer good will that caused the depression era bank runs.30 The Federal Deposit Insurance Corporation, which was created by the Banking Act of 1933, effectively halted runs on banks and thereby mitigated most depositors' risk of loss from bank failures.31 Thus, the conflicts of interest arising from commercial bank investment banking activity provide the most compelling basis for Glass-Steagall's continued support in Congress32 and the courts.33 The Glass-Steagall Act's prohibition of commercial bank underwriting was designed to promote bank stability by supplementing the role played by deposit insurance in achieving public confidence in the commercial banking system. The Glass-Steagall Act was also

29. See S. REP. NO. 77, 73d Cong., 1st Sess. 10 (1933); 77 CONG. REC. 3835 (1933) (remarks of Rep. Glass).
31. See U.S. PRESIDENT'S COMMISSION REPORT, supra note 9, at 44. Federal deposit insurance coverage is limited to $40,000 per account per bank. Among the losses not covered are losses on securities purchased from member banks.

Federal deposit insurance does not actually prevent bank failures. When failures occur, there is a delay that prevents the depositor from gaining immediate access to his money. [1979] FED. DEPOSIT INS. CORP. ANN. REP. 14-15, 49-60, 131.
Glass-Steagall Act

intended to promote bank stability by preventing commercial banks from being discredited by adverse reactions to promotional, investment banking activity.  

C. Prohibition vs. Regulation

Congress heard much debate over whether the problems posed by commercial banks' securities activities should be solved by regulation or prohibition. It chose outright prohibition because its policy objectives could not be achieved through regulation. It considered regulation to be ineffective because the problems and conflicts inherent in commercial bank participation in the promotion of securities are "so subtle as not to be easily recognized," and because securities underwriting is fundamentally incompatible with commercial banking. The universally recognized means for achieving Congress's objectives was to separate commercial banking from investment banking. The separation was accomplished through section 16, which limits national banks' purchases and sales of securities to agency executions made solely on a customer's order, and through section 21, which makes it unlawful for investment banks to

34. The recent New York City financial crisis exemplifies how promotional investment activity can discredit banks and thus weaken their stability. Commercial banks are permitted by § 16 of the Glass-Steagall Act to underwrite municipal bonds. See p. 109 infra. New York City's commercial banks became deeply involved in the events leading to the city's financial crisis, and were at the center of the controversy because of their allegedly disreputable conduct and motives in dumping deflated New York City bonds on unsuspecting bank customers. N.Y. Times, July 29, 1975, § 1, col. 6.

35. See Hearings on S. Res. 71 Before the Subcomm. on Banking of the Senate Comm. on Banking and Currency, 71st Cong., 3d Sess., Pt. 1, at 19-22 (testimony of J. W. Pole, Comptroller of the Currency); id. at 191-92 (testimony of Albert H. Wiggin, Chairman of the Board, Chase National Bank); id. at 238-41 (testimony of B. W. Trafford, Vice-Chairman, First National Bank of Boston); id. Pt. 2, at 301-04, 318 (testimony of Charles E. Mitchell, Chairman of the Board of National City Bank of New York); id. Pt. 2, at 356, 364-65 (testimony of Owen D. Young, Chairman of the Board, General Electric Co.); id. Pt. 3, at 539 (testimony of Allan M. Pope, Executive Vice-President of First National-Old Colony Corp.).

36. Even those witnesses who opposed the complete separation of commercial and investment banking favored regulation of commercial banks' securities activities. See Perkins, supra note 1, at 506.

37. 75 CONG. REC. 9912 (1932) (remarks of Sen. Bulkley). The Supreme Court has pointed out that Congress "repeatedly focused on the more subtle hazards" that arise when a commercial bank goes beyond the business of acting as fiduciary agent and enters the field of investment banking. Investment Co. Inst. v. Camp, 401 U.S. 617, 630 (1971).

38. See 75 CONG. REC. 9912 (1932) (remarks of Sen. Bulkley) (mere existence of commercial bank securities operation "no matter how carefully and conservatively run is inconsistent with the best interests of the bank as a whole"); Perkins, supra note 1, at 506, 507 (same).


40. Section 16 of the Banking Act of 1933, 12 U.S.C. § 524 (seventh) (1976), provides that: The business of dealing in securities and stock by . . . the [national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of customer, and in no case for its own account, and the [national bank] shall not underwrite any issue of securities or stock.

41. Section 21 of the Banking Act of 1933, 12 U.S.C. § 378(a)(1) (1976), provides that:
D. The Decentralization Function of the Glass-Steagall Act

Analysis of the current function of the fifty-year-old Glass-Steagall Act raises issues that were not considered by the original drafters. Principal among these concerns is whether the Glass-Steagall Act prevents an undue concentration of capital or of authority over capital allocation decisions. Today, Glass-Steagall serves the important political and economic function of decentralizing both capital formation and investment decisionmaking.

Decentralization requires limits on the activities of commercial banks, which, because they dispense credit, have an inherent competitive advantage over other entities that perform the same services. Customers often prefer to give business to a bank that can loan money, even if the bank's price is higher or its performance inferior to that of non-bank competitors. Customers think that they will have easier access to credit if
they buy the other services of the bank,²¹ and this perception leads to "co-
erced or voluntary" tie-in sales.²² This advantage has consistently led to
commercial bank dominance in those areas of the capital market that they
have been able to penetrate.²³

II. The Current Interpretation of Glass-Steagall

The decentralization function and the congressional objectives behind
Glass-Steagall are currently being thwarted because the fixed, historical
definitions presently employed cannot keep pace with the rapidly evolving
capital markets. Since the passage of Glass-Steagall, new securities have
been created⁴ and old securities have changed dramatically in character;⁵⁵
even the securities markets themselves have changed.⁶⁶

A. The Language of the Statute

Section sixteen⁷ is the foundation⁵⁸ of the Glass-Steagall Act, and the
focal point of the current interpretation of the Act.⁵⁹ Section 16 divides the
permissible areas of commercial bank securities into three categories and
provides rules of conduct for each category. First, it allows commercial
banks to buy, sell, or underwrite United States government debt and gen-
eral obligations of states and municipalities.⁶⁰ This provision is unambigu-
ous and has required little clarification;⁶¹ it permits banks to deal in debt
obligations that are subject to the general taxing power of a government
entity.⁶² Second, section sixteen creates a sub-category of securities known
as "investment securities."⁶³ Commercial banks may buy these securities
for their own account, but may not underwrite, distribute, sell, or deal in

52. Id.
53. See Perkins, supra note 1, at 495-96.
54. Karmel, supra note 3, at 636; see Note, supra note 7, at 1490 (term "security" now applied to
everything from interests in condominiums to warehouse receipts).
55. See Note, supra note 26, at 374.
56. See Friedman, supra note 9, at 2. Significant changes include the use of short term obligations
to finance long term capital needs, modern cash management systems, securities issued for arbitrage
purposes, and the continuous "roll-over" of debt obligations.
57. See note 40 supra.
58. Karmel, supra note 3, at 633.
59. The current interpretation of Glass-Steagall focuses on defining the term "security." See note
71 infra; Karmel, supra note 3, at 633-34.
60. The limitations and restrictions herein contained as to dealing in, underwriting and
purchasing for its own account, investment securities shall not apply to obligations of the
United States, or general obligations of any State or of any political subdivision thereof.
61. The clarity of the provision has resulted in a paucity of litigation on the subject. See Baker,
62. The government debt exception rests on long-standing public policy favoring governmental
them. The Comptroller of the Currency has statutory authority to decide which debt instruments fall in this category, and few problems arise in this area. Their third, section sixteen permits banks to buy or sell any security without recourse, solely on the order of and for the account of customers. This agency exception was enacted to enable banks to service communities far from financial centers.

Similarly, banks may engage in private placements of securities without violating Glass-Steagall. Private placements, which may be offered only to a small number of sophisticated investors, do not constitute "underwriting" within the terms of Glass-Steagall because they do not involve a "distribution" of securities.

B. The Present Interpretation of the Statute

The current approach to resolving Glass-Steagall controversies involves two steps. It first requires a definition of the word "security." Because

64. Id.

65. Congress allows banks to purchase investment securities for their own account to provide a means to satisfy the reserve asset requirement of the Federal Reserve Board.


The exception for private placements is consistent with the general policies of the Glass-Steagall Act and therefore with the conduct approach suggested in this Note. A private placement conducted by a bank must conform with the restrictions of § 16. The commercial bank can act only as an agent, in a non-recourse transaction initiated on a customer's order. See Federal Reserve Board Staff, supra (June 1977) (unpublished staff report on file with Yale Law Journal). The issue of whether banks are engaged in "private placements" of securities can best be resolved by examining the conduct of the commercial bank.

69. See SEC v. Ralston Purina Co., 346 U.S. 119 (1953). Private placements are only available to persons who have the same information regarding the issuer that registration would provide, and who are able to fend for themselves. Id. Private placements were intended to permit an issuer to make an isolated, specific sale of securities to a single person. R. JENNINGS & H. MARSH, SECURITIES REGULATION 410 (4th ed. 1977).

70. Cf. 1 LOSS, SECURITIES REGULATION 653-54 n.43 (2d ed. 1961) (there is no underwriting in private placement because there is no distribution); Comptroller of the Currency, Federal Deposit Insurance Corporation, & Federal Reserve Board, Commercial Bank Private Placement Activities 4 (June 1, 1978) (unpublished staff report on file with Yale Law Journal).

71. Karmel, supra note 3, at 632.

One version of the definitional approach is to apply to Glass-Steagall controversies the definition of "security" used in the Securities Act of 1933, ch. 38, 48 Stat. 74 (current version at 15 U.S.C. §§ 77a-77aa (Supp. II 1978)). See Letter from Ralph C. Ferrara, General Counsel, Securities and Exchange Commission, to Neal L. Petersen, General Counsel, Board of Governors of the Federal Reserve System 3 (April 20, 1979) (on file with Yale Law Journal). The rationale for employing the Securities Act definition for Glass-Steagall purposes is that the two laws were enacted within a few weeks of each other and the Senate Committee on Banking and Finance was responsible for both pieces of
Glass-Steagall Act

Glass-Steagall applies only to "securities," the Act is not violated if no security is involved. If the debt instrument in question is found to be a security, an inquiry is then made into whether the bank is underwriting, trading, or dealing in the security.

The current method of resolving Glass-Steagall disputes may lead to underinclusive results. This underinclusiveness is exemplified by the commercial-paper controvery, in which the Federal Reserve Board gave an arbitrary, narrow reading to the word "security" and thus permitted activity that the Act was intended to preclude. The current interpretation could result in an overly broad reading of the term security, which could lead to the proscription of legitimate commercial banking activity.

In addition, the present method of interpreting Glass-Steagall results in the drawing of legal distinctions between interchangeable terms such as "loan" and "security," distinctions that do not arise from the policy objectives of the Act. These legal distinctions are formalistic fictions. As investors and financial markets have evolved and become more sophisticated, market participants increasingly have come to view both securities and loans merely as financing vehicles, and traditional definitional distinctions between them as matters of form rather than of substance.

Under the current interpretation of the Act, the securities markets
shape the laws; the laws do not shape the securities markets. The lack of a principled approach to Glass-Steagall disputes threatens to subvert the goals of the Act by obscuring those provisions that have continuing vitality and preserving only those "regulatory remnants" that are used exclusively to protect market participants from competition.

III. The Conduct Test

This Note proposes a "conduct" test for resolving Glass-Steagall disputes. Unlike the current approach that categorizes debt instruments as securities in a rigid fashion, the conduct test analyzes the conduct of the bank in order to determine whether the activity is to be proscribed. This shift prevents regulatory agencies from ignoring, as they currently do, the purposes and policies behind Glass-Steagall. The conduct test provides a principled way of resolving Glass-Steagall disputes because it is derived from the policies underlying the Act.

A. Statement of the Test

The universally recognized purpose of Glass-Steagall is to separate commercial from investment banking. To achieve this purpose, it is necessary to determine whether the commercial bank is engaging in a pattern of investment banking conduct. Specifically, such conduct entails establishing a sales network for the distribution of debt or equity instruments of third parties, and promoting the sale of those instruments through that network. In most cases, conduct that violates section sixteen also entails active solicitation of corporate issuers to support this sales distribution system.

The described conduct cannot be construed as permissible, traditional commercial bank lending activity. A bank engaged in such conduct does not stand to profit from the interest payments of a corporate borrower, nor...
Glass-Steagall Act

does it stand to lose if the corporation fails to repay the principal. Instead, its only function is to act in a promotional capacity. Therefore, the bank is engaging in impermissible investment banking conduct.\textsuperscript{83}

Implementation of the conduct test changes the two-step approach\textsuperscript{84} currently taken by the Federal Reserve Board and other regulatory agencies in resolving Glass-Steagall controversies.\textsuperscript{85} The proposed test combines the two steps and shifts the initial focus of analysis to the conduct of the bank. Very simply, if a bank has established a distribution system and is earning distribution commissions from the sale of the liabilities of another corporation, it is engaged in conduct that Glass-Steagall should prohibit.

B. The Conduct Test and the Congressional Objectives of Glass-Steagall

The conduct test limits the activities of commercial banks to conduct that is in accordance with the objectives of the Act. The test insures that commercial banks do not engage in the promotional aspects of investment banking.

1. The Conflicts of Interest

The conduct test ensures that commercial banks will render impartial investment advice by removing the incentive to promote securities held by institutions engaging in investment banking. The test distinguishes the impermissible promotion of a debt instrument solely to earn a distribution commission from the permissible banking practice of acting as a financial principal.\textsuperscript{86} Congress sought to prevent banks from forming, developing,
or promoting expensive distribution networks for investments. The operation of bank distribution networks, which inevitably conflicts with the task of giving investment advice to customers, is also forbidden by the conduct test. By eliminating such conflicts, the conduct test permits implementation of Glass-Steagall in the way most consistent with the intentions of Congress.

2. Public Confidence in the Commercial Banking System

The conduct test would bolster public confidence in commercial banks because it prohibits the promotion of questionable securities in order to make an underwriting profit: Congress concluded that securities promotion, by "trading on the good name of the . . . bank," involves conduct that is incompatible with commercial banking. Default or deflation in the value of the securities recommended to a customer damages the reputation of the bank that recommends them, and is therefore not prudent commercial banking. The conduct test provides the guidelines necessary for determining which commercial bank activities are incompatible with Congress's intention to foster prudent banking behavior.

IV. Commercial Paper and Legitimate Commercial Banking Functions

"Commercial paper" is the trade name for short term promissory notes that financial and industrial corporations issue to raise capital. Investment banks vigorously contest the legality of commercial paper sales by commercial banks, claiming that this activity violates the Glass-Steagall Act. Although the current method of interpreting the Act permits such sales, the conduct test would forbid them.

business of banking; by discounting and negotiating . . . evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; [and] by loaning money or personal security . . . " 12 U.S.C. § 24 (seventh) (1976).

87. See p. 104 supra; 75 CONG. REC. 9911 (remarks of Sen. Bulkley); 75 CONG. REC. 9999 (remarks of Sen. Kean).
88. See id.
89. See p. 107-08 supra.
91. Id.
93. See Hurley, supra note 23, at 525; Note, supra note 26, at 372.
95. Other similarly controversial bank activities include equity funding (the combined sale of mutual funds and insurance), real estate syndication, issuance of thrift notes, mortgage guarantee insurance underwriting, the deductible part of bankers' blanket bond insurance, dealings in bankers' ac-
Glass-Steagall Act

A. The Controversy

Commercial paper has become such an important source of short-term financing for publicly held corporations that the last five years have been characterized as the "commercial paper era." During this period, commercial paper has accounted for one quarter of all short-term debts outstanding. Consequently, the commercial paper market seriously encroaches on a traditional profit area of investment banks.

Until July 26, 1978, commercial paper was sold either directly by the issuing corporation, or by one of a handful of investment banks. Then Bankers Trust Company began selling third party commercial paper. On September 26, 1980, the Federal Reserve Board gave commercial paper sales an important stamp of legitimacy by concluding that commercial paper is not a "security" for the purposes of the Glass-Steagall Act, and that the Act therefore does not apply to commercial bank sales of commercial paper. The Federal Reserve Board ruling has prompted other large commercial banks to make final preparations to enter the commercial paper market.


See id. at 48. Corporations generally prefer to raise cash by selling commercial paper rather than by borrowing from commercial banks, because the former usually costs less. The prime lending rate is often 125 basis points (1.25%) higher than the average interest rate of 90-day commercial paper. See id. at 39; Hurley, supra note 23, at 536 n.11. But see Bennett, supra note 9, at 1 (many commercial banks are cutting lending rates below prime to compete with commercial paper market).

See J. Judd, supra note 96, at 43. Profit on commercial paper comes from distribution commissions, which are typically one-eighth of one percent of the face value of the notes. Thus, if a bank sells $100 million of a company's commercial paper, it makes $125,000. See Hurley, supra note 23, at 528.


Federal Reserve Statement, supra note 72, at 6 (Glass-Steagall Act directs that definition of security be resolved by resort to common understanding of Congress, regulatory agencies, and banking industry).

See Bennett, supra note 9, at 1. Morgan Guaranty Trust Company and Citibank both have stated that they will begin placing commercial paper after the legal questions have been clarified. Id. There are indications that at least two other state member banks and two national banks intend to

115
The Present Interpretation of Glass-Steagall as Applied to Commercial Paper

The Federal Reserve Board’s interpretation of the Glass-Steagall Act fails to reflect important changes in the commercial paper market that place commercial banks in the posture of investment banks promoting the sale of investments.104 The Board’s definitional approach frustrates the objectives of the Act.

1. The Federal Reserve Board Interpretation

The Federal Reserve Board takes the position that commercial paper is not a “security” within the meaning of the Glass-Steagall Act and therefore that the Act’s prohibition of underwriting and dealing in securities does not apply to commercial paper.105 The Board arrived at its conclusion by examining the history of commercial paper in the United States.106 Using what it described as “indirect” historical evidence,107 the Board concluded that Congress did not view commercial paper, of the sort in existence when Glass-Steagall was passed, as a “security.”108

The Board’s adoption of this definitional approach in regard to commercial paper has led it to conclude that it is not “necessary to examine the dangers that the Act was intended to eliminate.”109 The Board maintains this position even though it recognizes that such dangers exist110 and that the sale of commercial paper by commercial banks could lead to unsound banking practices.111 Rather than dispute the validity of the policies underlying Glass-Steagall,112 however, the Board seeks to regulate comm-

begin underwriting commercial paper following the lead of Bankers Trust. SECURITIES WEEK, December 18, 1978, at 2.

104. See p. 115 supra.
106. See Letter, supra note 105.
107. See Federal Reserve Statement, supra note 72, at 14.
108. Id.
109. Id. at 25.
110. See Letter, supra note 105, at 3.
111. Id.
112. In order to justify its decision not to examine the policies behind Glass-Steagall, the Board cites Aaron v. SEC, 100 S. Ct. 1945, 1955 (1980), for the proposition that if the language of a provision of the securities laws is “clear in its context,” it is unnecessary to examine additional considerations of policy that may have influenced the formulation of the statute. Federal Reserve Statement, supra note 72, at 25 & n.38. It is impossible to reconcile this statement with the Board’s earlier statement that “the plain meaning of the statute cannot be dispositive of whether commercial paper is a security under the Glass-Steagall Act.” See Federal Reserve Statement, supra note 72, at 25 (emphasis added).

The lack of a clear definition for the term “security” and the lack of any principled means for distinguishing between “loans” and “securities” demonstrate the futility of a purely textual approach
Glass-Steagall Act

mercial bank commercial paper activity,\textsuperscript{113} despite Congress's intention to enact a prophylactic remedy.\textsuperscript{114} The definitional approach taken by the Board, therefore, thwarts the policy objectives of Glass-Steagall because it applies a static method of inquiry to a financial market that has undergone a dramatic evolution over the last fifty years.\textsuperscript{115}

2. The Evolution of the Commercial Paper Market

Today's commercial paper market is strikingly different from the one that existed when Glass-Steagall was written.\textsuperscript{116} The changes place banks in the promotional posture of an investment banker advocating the sale of an investment whenever they sell commercial paper.\textsuperscript{117}

In the 1930's, when the securities laws were enacted, more than ninety-nine percent of all commercial paper was purchased by commercial banks for their own investment portfolios.\textsuperscript{118} Commercial banks held this paper to maturity as an asset.\textsuperscript{119} The banks sought commercial paper in order to receive interest income and to satisfy the Federal Reserve Board's reserve-asset requirement.\textsuperscript{120} Today, only about one percent of commercial paper is held by commercial banks for their own accounts.\textsuperscript{121} Trust departments of banks,\textsuperscript{122} nonfinancial corporations, insurance companies, private pen-
sion funds, and, increasingly, private individuals now purchase commer-
cial paper.\textsuperscript{123}

C. \textit{The Conduct Approach as Applied to Commercial Paper}

The commercial paper controversy demonstrates why the “conduct ap-
proach” provides a principled test with which to resolve Glass-Steagall
controversies in today’s quickly evolving financial markets. In the 1930’s
there was no danger that commercial banks would promote commercial
paper and thereby cause the conflicts of interest that concerned the draft-
ers of the Glass-Steagall Act. Commercial banks had not developed distri-
bution systems for commercial paper. They participated in the commercial
paper market to earn interest income, not commissions. Today they par-
ticipate in the commercial paper market to earn distribution commissions.
To earn these commissions requires exactly the promotional, investment
banking conduct that Glass-Steagall was designed to foreclose to commer-
cial banks. Commissions give commercial banks an incentive to promote
one kind of investment over another.\textsuperscript{124} These commissions can be earned
only by developing costly distribution systems. Once these distribution sys-
tems are established, banks must continuously cultivate both corporate is-
suers to create marketable debt, and purchasers to absorb that debt.\textsuperscript{125} Be-
cause commercial banks conduct themselves like investment banks in
regard to commercial paper, the conduct test would prohibit commercial
banks from selling such paper.

D. \textit{Legitimate Commercial Banking Activity}

The Federal Reserve Board expressed concern that the acceptance of a
definition of “security” broad enough to include commercial paper would
lead to the prohibition of legitimate commercial banking activity.\textsuperscript{126} This

\textsuperscript{123} See Hurley, \textit{supra} note 23, at 529.
\textsuperscript{124} See Letter from James J. Baechle’s Senior Vice President and General Counsel, Bankers
Trust Company, to Neal L. Petersen, General Counsel, Board of Governors of the Federal Reserve
System (December 22, 1978) (on file with \textit{Yale Law Journal}).

Bankers Trust Company, the only bank with an established commercial paper sales operation,
acknowledges that all of the corporations for which it distributes commercial paper were customers of
the bank before the commercial paper services were offered. These corporations remain loan custom-
ers of the bank, and as such are indebted to the bank at the same time the bank is selling the corpora-
tion’s commercial paper. \textit{Id.} Consequently, the temptation to convince a corporate customer to issue
corporate debt unnecessarily, or to pay back outstanding bank loans, is present here. In addition,
Bankers Trust Company had lines of credit in place to most of the issuers that currently use Bankers
Trust Company’s commercial paper distribution services. \textit{Id.}

\textsuperscript{125} Distribution channels are crucial to the success of a firm that hopes to win a share of the
commercial paper market. The Bankers Trust commercial paper advertising materials demonstrate
that widespread distribution is a major element in its commercial paper marketing approach. See
Bankers Trust Brochure, \textit{supra} note 117, at 1-5.

\textsuperscript{126} Commercial banks may engage in activities that are “a proper incident of banking” unless
Glass-Steagall Act

corresponds specifically to certificates of deposit, banker’s acceptances, and loan participations. The conduct test does not lead to the prohibition of commercial bank involvement in these activities. Instead it illuminates the basic distinction between these transactions and modern commercial paper financings. In each of these transactions, banks are the ultimate lender or borrower. The transactions do not promote the development of distribution networks or place banks in a position where they will put pressure on corporate clients to issue securities for the purpose of realizing underwriting or distribution profits. Instead, trading or distribution is only incidental to commercial bank lending services.

The congressional ban on commercial banks’ promotion of securities applies when distribution commissions provide the motivation for entering the market, as in the case of commercial paper. When commercial banks

that activity violates § 16 of the Glass-Steagall Act. Fed. Reserve Sys. v. Investment Co. Inst., 101 S. Ct. 973, 979 (1981); 12 C.F.R. § 225.125. The commercial banks that advised the closed-end investment funds at the center of the Board of Governors litigation earned an “advisory fee” for providing investment advice to the investment companies. 101 S. Ct. at 979. This advisory fee differs significantly from the sale or distribution commissions earned by promoting investments as described by the conduct test. In the case of the advisory fee “[the bank could not stray from its obligation to render impartial investment advice.” Id. at 987 n.39. Banks engaged in activity that violates the conduct test necessarily stray from their obligation to render disinterested investment advice, and therefore violate § 16 of the Glass-Steagall Act. See pp. 112-13 supra.

127. A certificate of deposit is a written acknowledgment by a bank of the receipt of a sum of money on deposit that the bank agrees to pay (with specified interest) to the bearer at a later date. 1 BANKING L.J., BANKING LAW JOURNAL DIGEST § 220 (6th ed. 1962). A certificate of deposit is similar to a savings deposit at a bank except that it has a fixed maturity date and is evidenced by a certificate instead of a passbook entry. G. MUNN, ENCYCLOPEDIA OF BANKING AND FINANCE 144-45 (4th ed. 1937). The banking practices of issuing certificates of deposit and discounting them are specifically authorized by the Glass-Steagall Act. See 12 U.S.C. § 24 (seventh) (1976).

128. A banker’s acceptance is a guarantee by a commercial bank that its customer will pay for goods purchased on credit. It is identical to a guaranteed line of credit, except that the goods purchased serve as collateral for the bank. Banker’s acceptances expedite transactions in which the contracting parties are unfamiliar with each other but have confidence in the bank’s guarantees. See 1 BANKING L.J., supra note 127; G. MUNN, supra note 127, at 47-48.

129. See note 83 supra. Loan participations provide an example of how the traditional interpretation of Glass-Steagall could serve to prohibit commercial banks from engaging in permissible conduct. The Securities and Exchange Commission has recently written that “absent greater elaboration, sales of loan participations may raise questions under the Glass-Steagall Act.” See Letter from Ralph C. Ferrara, General Counsel to the Securities and Exchange Commission, to Neal L. Petersen, General Counsel to the Board of Governors of the Federal Reserve System 6 (June 26, 1979) (on file with Yale Law Journal). The SEC reached this conclusion because of its view that the broad definition of “security” in the Securities Act of 1933 is appropriate for use in interpreting the Glass-Steagall Act. Id.

130. There is an important distinction for Glass-Steagall purposes between transactions in which a commercial bank sells a note that it intends to guarantee and redeem, as in the case of a banker’s acceptance or a certificate of deposit, and a transaction in which the bank sells a note in order to earn a commission, with no obligation to guarantee the payment, as in the case of the sale of commercial paper. In the former case, no conflicts of interest are likely to exist. If the commercial banker must guarantee the full payment of any default, his investment advice will undoubtedly be based solely on sound business judgment. Similarly, there is no danger that the commercial banker will be tempted to promote a securities issue and use the proceeds to pay back bank loans if the bank is at risk in both transactions. Thus, none of the conflicts that arise when banks sell commercial paper arise when banks issue certificates of deposit or bankers acceptances. See pp. 104-06 supra.
are primarily guaranteeing credit,\textsuperscript{131} taking deposits,\textsuperscript{132} or making loans,\textsuperscript{133} Glass-Steagall proscriptions should not apply. Unlike the sale of commercial paper, these activities do not entail conduct that is incompatible with the purposes of the Glass-Steagall Act.

Conclusion

The conduct approach proposed in this Note provides a principled method for determining when commercial banks are violating the Glass-Steagall Act. The current use of a technical rather than a substantive method of resolving Glass-Steagall disputes has eroded the barrier that the Act seeks to build between commercial and investment banking. The adoption of the conduct test will ensure that legitimate commercial banking activity will not be endangered by overzealous regulatory agencies misapplying the Act. The conduct approach will also provide the flexibility necessary for the Act to keep pace with the swift evolution of financial instruments and markets.

\textsuperscript{131} See note 128 \textit{supra}.
\textsuperscript{132} See note 127 \textit{supra}.
\textsuperscript{133} See notes 83 and 129 \textit{supra}.