



6-1-1970

# Commingled Investment Accounts: Banks v. Securities Industry

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## Recommended Citation

Rudolph J. Gerber & Harry L. Henning, *Commingled Investment Accounts: Banks v. Securities Industry*, 45 Notre Dame L. Rev. 746 (1970).

Available at: <http://scholarship.law.nd.edu/ndlr/vol45/iss4/7>

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## COMMINGLED INVESTMENT ACCOUNTS: BANKS V. SECURITIES INDUSTRY

On July 1, 1969, First National City Bank of New York [Citibank] received appellate court approval of its plan to operate a commingled investment account for its customers.<sup>1</sup> Judicial approval necessitated granting the bank major exceptions from certain securities provisions of the Glass-Steagall Act and the Investment Company Act. Citibank's commingled account is doubly significant. At the practical level, it will offer vigorous competition to the mutual fund industry, whose structures, unlike its fees, it closely parallels. At the theoretical level, the account raises the vexacious question of the degree to which federal securities law can and should be applied to recent banking forays into the securities field.

### I. The Rise of the Common Trust Fund

The demarcation between the banking and securities industries is no longer as simplistic as it may have been for the stereotype mentality which once viewed banks as unsure repositories for the conservative pinchpenny and investments in equity securities as get-rich-quick schemes for the flamboyant speculator. In the late 1920s, the common trust fund [Type I] developed as a convenient vehicle by which a bank could administer the funds of small trusts.<sup>2</sup> Basically, the Type I trust is a pool of small trusts operated by a bank for the collective investment of funds held by the bank as trustee.<sup>3</sup> The first such common trust fund of this type was organized in 1927 by the Security National Bank Savings and Trust Company of St. Louis.<sup>4</sup> By 1930, eleven such funds existed, with assets of approximately \$24,000,000.<sup>5</sup>

The Type I trust fund arose historically in response to the banks' administrative difficulties with small trusts. Indeed, banks still find it unprofitable to administer small trusts on a personal, individual basis. Since the expense of managing a trust fund does not decrease in proportion with a decrease in the size of the assets, banks are forced to charge a small trust (usually anything under \$100,000) an abnormally high service fee grossly out of proportion to the trust's income.<sup>6</sup> Thus the Type I fund allows banks to reduce administrative costs through the combination of individual trusts in a common investment entity. Instead of individual management, the bank treats the assets of the small trusts as a single investment entity, with participants in the fund sharing the

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1 National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).

2 For a survey of the development of common trust funds, see SEC, REPORT ON COMMINGLED OR COMMON TRUST FUNDS ADMINISTERED BY BANKS AND TRUST COMPANIES, H.R. DOC. NO. 476, 76th Cong., 2d Sess. 406 (1939); Stephenson, *Participating Investments—The Common Trust Fund Device*, 12 OHIO ST. L.J. 522, 523-527 (1951); Note, *Regulation of Bank-Operated Collective Investment Funds—Judicial or Legislative Resolution of an Administrative Controversy?* 73 YALE L.J. 1216 (1964).

3 See 3 SCOTT, TRUSTS § 227.9, at 1683 (2d ed. 1956).

4 SEC, REPORT ON COMMINGLED OR COMMON TRUST FUNDS ADMINISTERED BY BANKS AND TRUST COMPANIES, H.R. DOC. NO. 476, 76th Cong., 2d Sess. 4 (1939).

5 *Id.*

6 *Hearings on S. 2704, Collective Investment Funds, Before a Subcommittee of the Senate Committee on Banking and Currency, 89th Cong., 2d Sess. 3 (1966)* [hereinafter cited as *1966 Senate Hearings*].

earnings and losses in proportion to their stake in the venture. In this way, the beneficiary of the small trust gains the advantages of professional trust service and investment diversification at a relatively low cost, while the bank, for its part, achieves many of the economics of scale associated with a larger trust.<sup>7</sup>

During its initial stages of inception, the Type I trust fund required enabling legislation to overcome the common-law rule prohibiting a trustee from commingling assets of differing trusts.<sup>8</sup> Prior to the passage of state statutes legalizing common trust funds of this type, the banks found authority to commingle funds only in the instrument creating the trust estate. Gradually, however, the equitable notion that trust funds must be "earmarked" or segregated by the trustee yielded to legislative and judicial permission to commingle trust estates for various investment purposes such as mortgage participation and, eventually, stock participation.<sup>9</sup>

In its early legal form, a Type I trust fund could be either a trust functioning pursuant to a trust indenture or a corporation operating under a charter and bylaws. In the far more commonplace trust type, the trust institution would hold the legal and usually also the equitable title, since the fund would consist of several individual estates over which the holding institution acted as trustee. The beneficiaries of the common trust would have only an equitable interest in an equitable interest. The trust institution would manage the assets of the entire fund in accord with the policy and restrictions in the trust indenture, whose provisions simulate the indenture provisions of management investment companies of the common-law trust type.<sup>10</sup>

Though the Type I or "common" trust fund is neither a new nor a novel development in the banking industry, certain economic factors of the recent years in the late 1960s have accelerated not only banks' but also insurance companies' creative envy at the security industry's newest precocity: the burgeoning mutual fund market.<sup>11</sup> Inflation is undoubtedly one of the reasons for the envy. Investors are understandably less likely to deposit their funds in savings accounts whose return is measured in dollars doomed to rapidly depreciate in purchasing power. To avoid the hardships of inflation and to gain the benefits of capital appreciation, many small investors have rallied to the mutual fund industry. In response to this interest in mutual funds,<sup>12</sup> banks and insurance companies have shown a definite trend toward formulating two closely related competitive models. The first is the offering to customers of an opportunity to participate

7 At first, common trust fund participation was limited to trusts in which the settlor or testator authorized such participation in the trust instrument. This caution was dictated by common-law prohibitions against commingling the funds of a trust with other funds held by the trustee. This and other common-law objections to the use of common trust funds have been overcome in practically every American jurisdiction by enabling statutes which authorize use of the common trust fund device, even in the absence of specific instructions by the grantor. See 3 SCOTT, TRUSTS § 227.9 (2d ed. 1956). See also Note, *Regulation of Bank-Operated Collective Investment Funds*, 73 YALE L.J. 1249, 1250 (1964).

8 RESTATEMENT (SECOND) OF TRUSTS § 179 (1959).

9 H.R. DOC. NO. 476, 76th Cong., 2d Sess. 5 (1939).

10 *Id.*

11 For a comprehensive study of the mutual fund industry see *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAWYER 732 (1969).

12 On the growing interest in mutual funds, see *Hearings on S. 1659 Before the Senate Comm. on Banking Currency*, 90th Cong., 1st Sess., pt. 1, at 3 (1967) [hereinafter cited as *1967 Senate Hearings*].

in various insurance and/or retirement investment plans. The second is the offering of investment vehicles that are carbon copies of mutual funds themselves.<sup>13</sup>

Both banks and insurance companies now offer investment services for insurance and retirement purposes. Commingled individual retirement funds [Type II] offer participating interests to individual customers, with the resources coming from investment in common stocks. The insurance industry offers an analogous benefit in the variable annuity. In its simplest form, the plan requires the annuitant to pay into the fund on a regular basis. His contributions are then invested by the insurance company in a pool of common stocks. At maturity the appreciated value of his contribution is translated into a number of annuity units proportionate to his share of the total value of the fund. The annuitant then receives a payout of a fixed number of units per month, based on an actuarial computation of his life expectancy.<sup>14</sup> The value of each payment to the annuitant naturally gyrates as the value of the securities in the paying institution's pool increases and decreases over time. Both the banking and the insurance company variations of Type II investments have recently been given careful legislative attention.<sup>15</sup>

A "collective investment account" such as Citibank proposes is indicative of the banks' more recent gravitation toward the mutual fund field. Instead of shares, this Type III account offers each investor "participating interests" in a pool of common stocks. Like shares in a mutual fund, interests in the pool vary with the overall value of the pooled stocks. The Type III account is distinguished from its Type II counterpart by its lack of pay-in and pay-out periods. Shares in the Type III account may be purchased and redeemed on a "lump sum" basis. In this respect, except for a stock certificate and some restrictions on redemption, the Type III account is functionally and definitionally indistinguishable from the commingling operations of a mutual fund.<sup>16</sup>

In effect, the three types of funds described above—the older common trusts, the various insurance-retirement funds, and the newer collective investment accounts — all indicate that the insurance and banking industries are anxious to see that the challenges posed by the investment company industry, particularly its mutual fund sector, do not go unanswered. In determining the application of securities regulations to such new banking proposals as that of Citibank, it is a phlegmatic but pragmatic exercise of sobriety to recall the manifold abuses in the banking industry resulting from its previous flirtation with securities in the predepression era.

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13 On this dual offering of competitive plans, see Note, *Commingled Trust Funds and Variable Annuities: Uniform Federal Regulation of Investment Funds Operated by Banks and Insurance Companies*, 82 HARV. L. REV. 435 (1968).

14 See generally Bartlett, *Variable Annuities: Evolution and Analysis*, 19 STAN. L. REV. 150 (1966); Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345 (1965).

15 Most notably, see the Smathers-Keogh ("H.R. 10") Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809, amending INT. REV. CODE of 1954, § 401, which redefines "employee" so as to include self-employed individuals, thus permitting them to receive tax deferral benefits similar to those available to employees.

16 See 12 C.F.R. §§ 9.18(b)(4), (13) (1969); notes 212-15, 371-74 *infra* and accompanying text.

## II. Predepression Banking Abuses

Much of the general opposition to the banks' incursions into the securities market, and to the Citibank plan in particular, stems from still-warm memories of previous disastrous entanglements between commercial and investment banking.

After the creation of the Federal Reserve System in 1913,<sup>17</sup> the nation's bank supervisory structure became doubly complex.<sup>18</sup> National banks became chartered, examined, and supervised by the Comptroller of the Currency, with certain areas of their activity also controlled by the Federal Reserve Board. State banks were chartered and examined by state supervisory agencies, while the Federal Reserve Board also could examine state bank members of the Federal Reserve System. This separation of bank chartering and supervising activities into federal and state hybrids is often referred to as the "dual" banking system.<sup>19</sup>

By the mid-twenties, the banking structure in the United States had become disorganized to the point of libertine chaos. Individual states had imposed varying degrees of supervision and privileges on banks operating within their jurisdictions. The Federal Reserve System had only limited power to supervise state-granted permissions to state banks to enter the securities field and to establish "security affiliates" to handle their investments. Indeed, the National Bank Act of 1874 conceived the Federal Reserve Board merely as the fiscal agent of the federal government,<sup>20</sup> and consequently it was not blessed with specific authority to control local banking transactions. Similarly, state supervisors were unwilling to test their own limited powers to prevent interlocking directorates between state banks and nonbanking securities affiliates. Tightly locked directorates and resulting conflicts of interest began to spread ominously across the banking horizon of the late twenties.<sup>21</sup>

Among the causes for bank failures following the market crash was excessive speculation by big city banks. Offering high rates of interest on time deposits, such banks could persuade their customers to transfer demand balances to long-term time accounts. With these large protected funds at their disposal, the banks made increasing investments in long-term bonds and stocks of highly speculative and equally dubious quality. The banks' flirtations with the securities markets became further complicated with their loans of large sums on the col-

17 Federal Reserve Act, 12 U.S.C. § 226 (1964). This act was passed in the wake of the money panic of 1907 following the study of the congressionally created National Monetary Commission, S. Doc. No. 243, 62d Cong., 2d Sess. (1912). See generally Treiber, *The Federal Reserve System After Fifty Years*, 20 BUS. LAW. 247 (1965).

18 For a thorough account of this complexity, see generally Lehr, *The Affiliation of Commercial Bank and Mutual Fund Personnel*, 10 ST. LOUIS L.J. 190 (1965).

19 References to the then current literature criticizing the dual banking system are collected in Note, 47 HARV. L. REV. 325 n.2 (1933). For a discussion of national bank regulations, the functions of the comptroller, and the relationship between national banks and the national banking structure, see Hackley, *Our Discriminatory Banking Structure*, 55 VA. L. REV. 1421 (1969).

20 The National Bank Act, 12 U.S.C. § 38 (1964).

21 *Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 4314*, 73d Cong., 1st Sess. 15, 48, 123, 216 (1933). See also *Hearings Before the Senate Committee on Banking and Currency on S. 875*, 73d Cong., 1st Sess. 82 (1933).

lateral of inflated securities and by their selection of other investments of risky quality.<sup>22</sup>

Many banks, especially the national banks, not only invested heavily in speculative securities but also entered the business of investment banking by buying original issues for public resale. These large banks became the originators, issuers, or underwriters of securities "on a more comprehensive and omnivorous scale than the older unincorporated houses of issue."<sup>23</sup> The correspondent relation between the large city banks and the country banks furnished an inviting system of distribution. "The country banks were becoming increasingly aware of the desirability of diversifying their own portfolios with marketable securities and also aware of opportunities to retail securities to their customers."<sup>24</sup> The city banks thus became wholesalers and the country banks retailers of securities issues, with immediate financial fruits for the city banks, which could turn a handsome profit by unloading their own securities through the instrumentality of the country banks.

It was bank security affiliates, however, which posed the central problem.<sup>25</sup> These "affiliates" of large city banks were not federally chartered organizations, as were the national banks, nor were they under any federal jurisdiction, as were the Federal Reserve member state banks. They were state corporations subject to neither state nor federal banking laws, yet intimately involved in banking activities on both levels. In effect, each affiliate was a separately incorporated Mr. Hyde without the inhibitions of the commercial Dr. Jekyll.<sup>26</sup> Affiliated banks usually dominated these affiliates through the use of interlocking directorates, trustee-held stock, and common ownership of stock. Banks obviously organized the affiliates to escape the common-law prohibition against the investment by a bank of its own funds in common stocks. Through the medium of bank loans to the affiliate, secured by the securities held by the affiliate or by bank credit to

22 The rapid deflation in security prices after 1929 was, of course, only one factor in the problem of "frozen assets" that faced the banks in the early 1930s.

When the general economic structure of the country became weakened by the manifold causes which preceded the break in the fall of 1929, it was to be expected that our banks would have trouble. Depressed security, agriculture, commodity and real estate values, followed by a sharp reduction in our national income, left many banks with investments which were fundamentally sound but badly frozen. At the same time, there was a steadily increasing demand from depositors who were compelled to draw upon their reserve to meet the problems caused by reduced incomes and unemployment. Thus, the banks were drained of their normal liquid resources, and forced to rely upon their frozen assets at great sacrifices to themselves and to their communities, in order to maintain their position. As this steadily progressing liquidation continued, their remaining assets became more badly frozen, more greatly depressed. The general economic decline weakened our banks . . . .

Excerpt from a speech delivered by Hon. L. E. Birdzell, General Counsel of the FDIC (June 22, 1934), quoted in Note, 23 GEO. L.J. 842, 846 n. 35 (1935). See also Galbraith, *THE GREAT CRASH* 179-91 (1954).

23 75 CONG. REC. 9909 (1932).

24 *Id.* at 9910.

25 The first important security affiliate was the First Securities Company, organized by the First National Bank of New York in 1908. For a general discussion of their origin and subsequent development, see Osterweis, *Security Affiliates and Security Operations of National Banks*, 11 HARV. BUS. REV. 124 (1932). The Glass-Steagall Act of 1933 § 20, 12 U.S.C. § 221a(b) (1964) defines an affiliate as an organization of which a member bank owns or controls more than fifty percent of the voting shares, or controls the election of a majority of directors, which is controlled by the shareholders who control the bank, or which has a majority of directors who are directors of the member bank.

26 See generally Note, 33 COLUM. L. REV. 324, 325 (1933).

the affiliate, these organs utilized the monies held by the bank "to devote themselves in many cases to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock . . . ." <sup>27</sup>

The risky character of the banks' securities investments early became visible to the Comptroller of the Currency. As early as 1920, his annual report to Congress observed, with a poignancy only the hindsight of a depression can give:

Some "securities companies" operating in close connection with, and often officered by, the same men who managed the national banks with which they are allied, have become instruments of speculation and headquarters for promotions of all kinds of financial schemes. Many of the flotations promoted by the "securities corporations" which are operated as adjuncts to national banks have proven disastrous to their subscribers, and have in some instances reflected seriously not only upon the credit and the standing of the "securities companies" by which they are sponsored but also in some cases have damaged the credit and reputation of national banks with which the "securities companies" are allied.

In times of rising prices and active speculation, some of these auxiliary corporations have made large profits through their ventures and syndicate operations, but their losses in other periods have been heavy, and they have become an element of increasing peril to the banks with which they are associated. The business of legitimate banking is entirely separate and distinct from the kind of business conducted by many of the "securities corporations" and it would be difficult if not impossible for the same set of officers to conduct safely, soundly, and successfully the conservative business of the national banks and at the same time direct and manage the speculative ventures and promotions of the ancillary institutions. <sup>28</sup>

The Comptroller's warning went unnoticed in the din of busy adding machines.

By using security affiliates, the state and national banks could avoid the restrictive legislative provisions that would otherwise prevent them from operating directly in the brokerage and underwriting business. Although security affiliates occasionally acted as finance companies, or even as real estate holding companies, their most important function, especially in large cities, was underwriting bank investments, a task they performed with an enthusiasm as breathless as it was blind. By 1930, such affiliates accounted for the origin of about thirty-nine percent of all new bond underwriting, twenty-eight percent of which was sponsored by national banks. <sup>29</sup>

The incestuous relationship between banks and their securities affiliates formed a cycle of interdependent risk. Security affiliates depended for their working capital on loans from banks, the proceeds of which financed their own underwriting and distribution of securities. These loans were largely secured by stock owned by the security affiliates. This collateral, often consisting of the related

27 S. REP. NO. 77, 73d Cong., 1st Sess. 10 (1930).

28 1 ANN. REP. OF THE COMPTROLLER OF THE CURRENCY 55 (1920).

29 In addition to the origination of bond issues, bank security affiliates participated in bond issues of other underwriters to an even greater extent. By 1930, about fifty-four percent (of which thirty-four percent were national bank affiliates) of all bond issues were distributed in part by such affiliates. These figures for originating and participating affiliates were assembled from those companies which originated at least \$20 million per year. *Hearings Before a Subcommittee of the Committee on Banking and Currency of the United States Senate, 71st Cong., 3d Sess. 299 (1931)* [hereinafter cited as *1931 Hearings*].

bank's stock, was frequently supported by the affiliate's purchase of shares of the collateral security on the open market, thus building up larger inventories for which more borrowed funds were needed. Among the types of abuses uncovered were activities of affiliates in supporting the bank's own stock; the use of the affiliate as a receptacle for the bank's doubtful assets, with the probability that the bank would loan the affiliate funds to purchase the assets; and the dumping of distressed securities on affiliated banks by the securities companies.<sup>30</sup>

Not surprisingly, the identity of control between the bank and the affiliate encouraged the latter's reliance on the lending opportunities of the former. Evidence from the predepression period indicates that about fifty percent of the affiliates' short-term borrowings came from related banks, and that the affiliates which acted as finance, holding, or investment companies showed a greater tendency to operate with borrowed funds than did similar companies unaffiliated with banks.<sup>31</sup>

The hybrid commercial and investment banking eventually bore its own poisonous fruit. Between 1921 and 1929, about 7,500 banks (more than twenty percent of all banks extant at that time) ceased operation. From 1930 to 1933, another 5,000 banks failed. The cumulative record from 1921 to 1932 indicates that failures were most pronounced for state, nonmember banks, and somewhat better for state bank members of the Federal Reserve System. National banks, which by law were and still are required to be members of the Federal Reserve System, weathered the tempest best of all.<sup>32</sup>

The failures were there on the record and in the pocketbook, as were the investment abuses that spawned them. Obviously, remedial legislation was imperative to guard banks from the temptation to eat again of the tree of investment knowledge.

### III. Legislative Surgery on Banking Abuses

Faced with a picture of large investor losses and a neglect of depositors' confidence, the depression-era Congress performed corporate surgery in decreeing a number of far-ranging legislative remedies. The remedial legislation included provisions that placed limitations on bank advertising practices, effected the general separation of commercial from investment banking, divorced banks from their straw man affiliates, curbed the use of interlocking directorates between banks and securities organs, and compelled the registration of a bank's securities issues

30 For the characteristics of these operations in terms of group and branch banking, see generally CAGLE, BRANCH, CHAIN, AND GROUP BANKING IN BANKING STUDIES (1941); 1931 Hearings 1058.

31 1931 Hearings 1059-63. The Banking Act of 1933 attacked the general borrowing-by-affiliate problem with a provision stating that no member bank shall receive from or make available to affiliates funds which exceed ten percent of the capital stock and surplus of the bank, and that any loan made within the foregoing limitation shall be secured by collateral having a market value at least twenty percent greater than the loan. 12 U.S.C. § 371c (1964).

32 SENATE COMMITTEE ON BANKING AND CURRENCY, OPERATION OF THE NATIONAL AND FEDERAL RESERVE BANKING SYSTEMS, S. REP. NO. 77, 73d Cong., 1st Sess. 3-7 (1933). For an analysis of the record, see Kent, *Dual Banking Between the Two World Wars*, in BANKING AND MONETARY STUDIES 43, 55-57 (1963). Cf. FRIEDMAN & SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867-1960, 299-406 (1963), who advance the thesis that the monetary collapse, which was a major cause of the depression, resulted from the unwise actions of those guiding the Federal Reserve System.



and the concomitant disclosure of a bank's financial affairs. Remedies were needed to protect banks, the securities markets, and, not least at all, the disenchanted investing public who absorbed an estimated loss of \$25 billion by purchasing securities that later proved to be worthless when the crash took its toll.<sup>33</sup> Accordingly, in the period from 1933 to 1940, Congress shaped four important pieces of legislation directly touching on banks' involvement in the securities market in general and on Citibank's Type III account in particular.

#### A. The Securities Act of 1933

Against the jolting background of the depression, Congress hastened to protect the investor by shoring up the fiduciary and disclosure responsibilities of the securities industries. The initial practical protection was spelled out in the Securities Act of 1933.<sup>34</sup>

The 1933 Act attempts to protect investors against sharp selling practices on the part of persons and corporations engaged in selling securities. The Act requires disclosure of important financial information to prospective investors and provides that selling offers be preceded by issuance of an official prospectus. As stated in its preamble, the general aim of the Act is "to provide full and fair disclosure of the character of securities . . . and to prevent frauds in the sale thereof . . . ."<sup>35</sup> President Franklin D. Roosevelt expressed its rationale in his message to Congress on March 29, 1933: "This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller alone beware.' It puts the burden of telling the whole truth on the seller."<sup>36</sup>

The Act's basic prohibitions are found in two substantive provisions. Section 5 deals with the problem of compelling full disclosure, and sections 17 and 12(2) relate to fraudulent interstate sales of securities, the former providing criminal and the latter civil sanctions. The pivotal provision, however, is section 5. That section requires that new issues of securities offered through the mails or through other channels of interstate commerce be registered with the Securities and Exchange Commission, and that a prospectus, filed as part of the registration statement, be furnished to the purchaser. By requiring that a prospectus accompany any written offer to buy or sell a security, the Act effectively limits almost all written advertising before the effective date of the registration statement to the document on file with the Securities and Exchange Commission.<sup>37</sup>

One of the distinguishing features of the 1933 Act is its intricate inclusion-exclusion framework. After setting out a broad and sweeping definition of a security,<sup>38</sup> the Act excludes certain types of securities and transactions, some by virtue of the nature of the offeror-offeree relationship, others by the identity of

<sup>33</sup> See N.Y. Times, May 28, 1933, § 1, at 2, col. 1.

<sup>34</sup> 15 U.S.C. § 77a-aa (1964).

<sup>35</sup> Ch. 38, 48 Stat. 74 (1933).

<sup>36</sup> H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933).

<sup>37</sup> See, e.g., SEC Securities Act Rule 134, 17 C.F.R. § 230.134 (1969), governing the use of "tombstone" advertisements.

<sup>38</sup> 15 U.S.C. § 77b(1) (1964) provides:

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral—trust certificate, pre-organization certificate or subscription, transferable

the offeror, and still others by the needs of the parties. For example, section 4 excludes transactions by persons other than the broker, dealer, or underwriter from the provisions of section 5. Thus the formal structure of the Act sharply constricts its applicable range.

### B. The Banking Act of 1933

A more specific congressional attack on the abuses within the banking industry also resulted from the 76th Congress in the form of the Banking Act of 1933, popularly known as the Glass-Steagall Act.<sup>39</sup> The Act concentrates on the dangers inherent in a bank's speculation in securities for its own account and condemns the intent to make "an originating profit or a trading profit or any combination of such profits."<sup>40</sup> Apart from the special problems confined to affiliates, there existed at least three well-defined evils flowing from the combination of investment and commercial banking.<sup>41</sup> Accordingly, Congress was concerned with (1) barring banks from investing their own assets in securities with consequent risk to commercial and savings deposits. Congress was also troubled by (2) the danger that unsound loans would be made in order to shore up the price of securities or the financial position of companies in which a bank had invested. Finally, the Act's draftsmen were aware (3) that the commercial banks' financial interest in the ownership, price, or distribution of securities inevitably tempted bank officials to press their customers into investing in issues which the bank was under pressure to sell because of its pecuniary stake in the transaction.

The Banking Act of 1933 sought to remedy these abuses by divorcing investment from commercial banking—a distinction central to the eventual arguments on both sides of the Citibank proposal. Since the predepression banks had successfully evaded banking regulations by setting up affiliates to buy and sell stocks, section 20 of the Act sought to prohibit bank affiliation with business organizations "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities.<sup>42</sup> Section 21 contains the obverse prohibition: corporations in the business of "issuing, underwriting, selling, or distributing" securities may not engage in commercial banking.<sup>43</sup> Thus the clear-cut separation of banks from the securities markets involves the isolation of commercial and investment banking into separate spheres of activity and regulation.

Section 32 of the Act is also of central importance. To avoid any interlocking directorates through dual employment with a bank and a security organization, the Act provides that no officer, director, or employee of an organization

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share, investment, contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The definition in the Investment Company Act of 1940 is identical. 15 U.S.C. § 80a-2(35) (1964).

<sup>39</sup> Ch. 89, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.).

<sup>40</sup> 75 CONG. REC. 9912 (1932).

<sup>41</sup> See Comment, *Banks, Trusts and Investment Companies: The Commingled Investment Fund*, 115 U. PA. L. REV. 1276, 1294 (1967).

<sup>42</sup> 12 U.S.C. § 377 (1964).

<sup>43</sup> 12 U.S.C. § 378 (1964).

“primarily engaged in the issue, flotation, underwriting, public sale, or distribution” of securities may also be an officer, director, or employee of a member bank of the Federal Reserve System. Section 32 does permit the Federal Reserve Board to allow dual employment when “it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.”<sup>44</sup>

It seems likely that section 32 was written with the bank security affiliates of predepression days primarily in mind. In its committee report on the Act, the Senate Committee on Banking and Currency observed in 1933:

There seems to be no doubt anywhere that a large factor in the overdevelopment of security loans, and in the dangerous use of the resources of bank depositors for the purpose of making speculative profits and incurring the danger of hazardous losses, has been furnished by perversions of the national banking and state banking laws, and that, as a result, machinery has been created which tends toward danger in several directions.

The greater of such dangers is seen as the growth of “bank affiliates” which devote themselves in many cases to perilous underwriting operations, stock speculations, and maintaining a market for the bank’s own stock often largely with the resources of the parent bank.<sup>45</sup>

### C. The Investment Company Act of 1940

This legislation, together with the Investment Advisers Act of 1940, resulted from a study of the activities of investment companies and investment advisors conducted by the SEC pursuant to direction of Congress. The results of this study were transmitted to Congress in a series of reports filed in 1938, 1939, and 1940.

Under the 1940 Act,<sup>46</sup> the activities of companies engaged primarily in the business of investing, reinvesting, and trading in securities are subject to regulation to prevent various abuses not covered by the Securities Act and the Glass-Steagall Act of 1933. Whereas the Glass-Steagall Act sought to separate commercial from investment banking, the Investment Company Act left the basic investment company industry’s structure unchanged but created an extensive network of regulatory provisions dealing with disclosure, corporate officers’ qualifications, management contracts, pyramiding securities, and interlocking directorates.

A paramount purpose of the 1940 Act is to prevent a recurrence of conflicts of interest, active and potential, as they relate to the directors and officers of investment companies and their affiliates. Specifically, the Act seeks to end abuses whereby some investment companies were operated primarily for the benefit of their promoters, investment advisors, or underwriters, rather than for the benefit of their public security holders.<sup>47</sup>

44 12 U.S.C. § 78 (1964).

45 S. REP. No. 77, 73d Cong., 1st Sess. 9-10 (1933).

46 15 U.S.C. §§ 80a-1 to 80a-52 (1964).

47 15 U.S.C. § 80a-1(b) specifically states that the policy and purposes of the Act, among other things, are to mitigate and, so far as is feasible, to eliminate the adverse effects on the national public interest and the interest of investors “when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of insiders rather than in the interest of all classes of such companies’ security holders.”

Investigations preceding the Act's passage revealed numerous abuses of managerial discretion on the part of those operating investment companies. That the abuses were severe and widespread is implicit in an SEC official's observation that of a total investment of \$7 billion, the American public incurred a capital shrinkage, over and above the crash's effect on stock prices, of "at least \$1,100,000,000 . . . attributable to mismanagement, looting, or other improper actions of managements in their own interest to the detriment of shareholders."<sup>48</sup> Obviously, investment companies were particularly prone to such exploitation because their assets, consisting largely of cash and securities, were readily negotiable.

The Investment Company Act deals specifically with a variety of such situations proven to be inimical to the interests of individual investors. A central safeguard, prominent in the Citibank debate, provides that a specified percentage of the boards of directors of registered investment companies be persons who are neither employees of nor otherwise affiliated with the company.<sup>49</sup> These provisions, plus those authorizing the SEC to enjoin gross misconduct, have had the effect of incorporating into federal law and reinforcing in the courts the ideals of fiduciary obligation traditionally imposed on corporate officers and directors.<sup>50</sup>

One of the Act's broadest regulatory provisions is the section 17(2) prohibition of affiliated persons from selling property to or purchasing or borrowing property from an investment company.<sup>51</sup> The Commission is required to exempt a transaction prohibited by section 17(a) if the transaction meets the standards of fairness and consistency with the policy of the investment company and the Act's purpose. The SEC's scrutiny of the transaction thus protects the investment company and its security holders against the possibility that the investment company's portfolio might be used as a dumping ground for a sponsor or manager's distressed securities.<sup>52</sup>

As the Citibank proposal indicates, the force of section 17 depends considerably on the definition of an "affiliated" person and on its extension to an affiliated person of an affiliated person of an investment company.<sup>53</sup> The ideal, of course, is that the investment company's board of directors should include a number of totally independent directors. Specified percentages of the boards of directors must be unaffiliated with the company's management—i.e., its investment advisor, principal underwriter, regular broker, or bank. The key provision in section 10(a) specifies that no more than sixty percent of the directors may be persons who are investment advisors, affiliated with investment advisors, or

48 *Hearings on S. 3580 Before the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., pt. 1, at 797 (1940). *Cf.*, *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAWYER 732, 767-808 (1969). Some of the speculative promotions described are reminiscent of the naiveté of investors at the time of the South Sea Bubble who subscribed for shares in a company "for carrying on an undertaking of great importance, but nobody to know what it is." MELLVILLE, *SOUTH SEA BUBBLE* 97 (1926).

49 15 U.S.C. §§ 80a-10(a), (b), (c) (1964).

50 *Brown v. Bullock*, 194 F. Supp. 207, 234 (S.D.N.Y. 1961); Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW AND CONTEMP. PROB. 777, 780 (1964).

51 15 U.S.C. § 80a-17 (1964).

52 See note 322 *infra*.

53 The persons affected are described as "any affiliated person or promoter of or principal underwriter for a registered investment company . . . or any affiliated person of such person, promoter or principal underwriter, acting as principal . . ." 15 U.S.C. § 80a-17(a) (1964).

officers and employees of the fund.<sup>54</sup> This section seeks to guard against self-dealing by fund directors in their dual capacities as managers or distributors. An additional provision in 10(b) and (c) requires that a majority of the board must not be persons who are or were affiliated with the principal underwriter or regular broker of the fund, nor may they be affiliates of an investment banker or officers or directors of any one bank. An exemption is made, however, for certain investment advisors principally engaged in rendering advice to individual clients, as opposed to advising investment companies.<sup>55</sup>

In explaining the overall purpose of section 10(a) during the House hearings on the Act, David Schenker, the Commission's counsel, commented:

You can see that the manager has a pecuniary interest in the method of running the trust, because his management fees may depend on the performance of the trust. In order to furnish an independent check on the management, the provision is made that at least 40% of the board must be independent of the management, officers, and employees.<sup>56</sup>

#### D. Regulation 9

Although the Glass-Steagall Act effectively terminated operation of separate affiliates for carrying on investment banking, banks continued to buy and sell securities in their capacity as trustees. Indeed, the managing of individual trust funds had long been recognized as a proper exercise of banking powers. In such management, the bank was regulated by strict, judicially developed concepts of fiduciary responsibility and investment conservatism. However, as states relaxed prohibitions against the commingling of trust assets, banks began to pool contributions of individual trusts to create larger, more efficient units. In practice, the Type I variety trust funds were generally formed by consolidation of existing trusts and the addition of new ones acquired in the bank's capacity as fiduciary. However, under the Federal Reserve Board's original regulation F, as amended in 1937,<sup>57</sup> the banks were severely limited in operating and investing customers' funds held in their capacity as trustee. The Federal Reserve Board's most recent ruling on the use of common trust funds as a managing agency account stated:

Authorization of revocable trusts for common trust fund participation should be preceded by particularly careful determination of the bona fides of their use and purpose to avoid improper use of the common trust fund as a medium attracting individuals primarily seeking investment management of their funds.<sup>58</sup>

The practical effect of this and earlier rulings under regulation F was to

54 15 U.S.C. § 80a-10(a) (1964). In addition, a majority of the board must not be persons who are or were affiliated with the principal underwriter or regular broker of the fund nor may they be affiliates of an investment banker or officers or directors of any one bank. 15 U.S.C. §§ 10(b), (c) (1964).

55 *Id.*

56 *Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 109 (1940).*

57 2 Fed. Reg. 2976 (1937).

58 42 FED. RES. BULL. 228 (1956).

prohibit banks from offering participation in the common trust fund as a vehicle for investment.<sup>59</sup>

Limited to operating Type I funds for the traditional bona fide fiduciary purposes, the banks were unable to offer participating interests as vehicles for Type III investments on the same basis as the swiftly proliferating mutual funds.<sup>60</sup> Successive rulings of the Federal Reserve Board reinforced this limitation, until in 1962 a chafing banking industry succeeded in having control over the trust powers of the national banks transferred to the Comptroller of the Currency.<sup>61</sup>

The shift of power to the Comptroller is a chapter in itself. In December, 1960, the Federal Reserve Board had proposed an amendment to regulation F forbidding the use of the Type I trust fund to manage revocable inter vivos trusts in which the settlor was the income beneficiary.<sup>62</sup> Two years after this amendment was proposed, however, the banking industry suggested that "a more logical distribution of supervisory authority"<sup>63</sup> would be achieved by transferring the regulatory authority over trust powers of national banks from the Federal Reserve Board to the Comptroller of the Currency. Congress agreed.<sup>64</sup> Soon after the enabling legislation, the Comptroller convened a committee of banking industry representatives to propose amendments to the new regulation 9 which would provide for a more "up-to-date" regulation of the trust powers of the national banks.<sup>65</sup>

Regulation 9 was taken wholly from the original regulation F. But in April of 1963, the newly named regulation was itself further amended by the deletion of the "bona fide fiduciary purposes" requirement for the Type I trust fund.<sup>66</sup> The amendment set up a trinary classification of trusts and authorized for the first time the commingling of managing agency accounts. In the permitted classification, the first category includes the traditional Type I or common trust.<sup>67</sup> The second category comprises the tax-exempt retirement funds of Type II variety.<sup>68</sup> The third allows the banks to operate collective investment accounts

59 See generally Note, 115 U. PA. L. REV. 1276, 1278 (1967).

60 See Note, 73 YALE L.J. 1249, 1250-51, 1257 (1964). For a treatment of the difference between trust and agency relationships in the banking area, see A. SCOTT, LAW OF TRUSTS § 8-8.1 (3d ed. 1967).

61 See Note, 82 HARV. L. REV. 435, 442 (1968).

62 The Federal Reserve Board proposed to add the following language to regulation F:

The funds of an inter vivos trust revocable by the settlor and providing for the payment of the principal of the trust to the settlor's estate at his death may not be invested in a Common Trust Fund established and maintained under this section. 25 Fed. Reg. 12479 (1960).

63 Hearing on H. R. 12577 and H. R. 12825 Before a Subcommittee of the House Committee on Banking and Currency, 87th Cong., 2d Sess. 19 (1962). The quoted words are those of F. A. Gunther, speaking on behalf of the American Bankers Association.

64 12 U.S.C. § 92a (1964).

65 The quoted phrase is that of James J. Saxon, Comptroller of the Currency, at the Mid-winter Trust Conference of the American Bankers Association, February 4, 1963.

66 The meaning of "bona fide fiduciary purpose" is clarified in a ruling of the Federal Reserve Board: "trusts created and used by individuals primarily seeking the benefits to be derived from corporate fiduciary management." 41 FED. RES. BULL. 142 (1955).

67 This category is described as "a common trust fund maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as executor, administrator, guardian or trustee under a will or deed." 12 C.F.R. § 9.18(a)(1) (1969).

68 This category is described as "a fund consisting solely of assets of retirement, pension, profit-sharing, stock bonus, or other trusts which are exempt from Federal income taxation under the Internal Revenue Code . . ." 12 C.F.R. § 9.18(a)(2) (1969).

of the Type III variety. The investment vehicle sanctioned in the latter category was described as: “[A] common trust fund maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as managing agent . . . .”<sup>69</sup>

Regulation 9 imposes certain substantive limitations on the operation of Type II and Type III accounts. Section 9.12 forbids investments and purchases in situations in which a bank has a personal interest that might improperly affect its impartiality.<sup>70</sup> The purpose is to avoid self-dealing in a broad sense. Accordingly, it forbids investments and purchases by a trust fund in any situation “in which there exists such an interest as might affect the exercise of the best judgment of the bank in acquiring the property.”<sup>71</sup> The introductory sentence of section 9.12, however, would permit the investor to waive the protections. In this respect, it is inferior as a protective device to the mandatory provisions of the Investment Company Act. Finally, another important provision in section 9.18(b)(1)(a) prohibits a bank from having “any interest in such a fund other than in its fiduciary capacity,” which probably means no more than that a bank may not own shares in the common fund.<sup>72</sup>

The amendment deleting the Federal Reserve Board’s requirement that the Type I trust fund be used only for bona fide fiduciary purposes created controversy even before its role in the Citibank proposal. Its deletion caused the Commissioner of Internal Revenue to question the applicability of the pass-through treatment accorded common trust funds by section 584 of the Internal Revenue Code. After several conferences between the two agencies, the IRS ruled that

moneys received by a bank in its capacity as managing agent . . . under a managing agency agreement expressly providing that such moneys are received by the bank in trust, when placed in a common fund with other similar funds, will be contributed to the common fund by the bank in its capacity as “trustee” as that word is used in Section 584 of the Code.<sup>73</sup>

A revised version of regulation 9, published about ten months later, added to the definition of the Type III fund the words, *inter alia*, “under a managing agency agreement expressly providing that such monies are received by the bank in trust.”<sup>74</sup> At that time, the Comptroller apparently did not desire to dispute the Commissioner’s contention that a managing agency was not the trust relationship referred to in Section 584.

In any case, regulation 9’s authorization for pooling of managing agency accounts and the corresponding deletion of the bona fide fiduciary requirement allowed the banks to invest collectively funds contributed for the sole purpose of investment. Thus by 1965 the issue was well framed: are new collective invest-

69 12 C.F.R. § 9.18(a)(3)(1969).

70 12 C.F.R. § 9.12 (1969).

71 *Id.*

72 *See* 12 C.F.R. § 9.18(b)(8)(i) (1969).

73 Rev. Rul. 64-59, 1964-1 CUM. BULL. 194.

74 29 Fed. Reg. 1719 (1964). The definition now reads: “a common trust fund, maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as managing agent under a managing agency agreement expressly providing that such monies are received by the bank in trust . . . .” 12 C.F.R. § 9.18(a)(3) (1969).

ments of this Type III variety subject to securities regulations? More precisely, is a Type III plan under regulation 9, such as Citibank's, contemplated by the Glass-Steagall or Investment Company Acts?

#### IV. The Citibank Plan

On August 25, 1965, First National City Bank of New York filed a commingled investment proposal<sup>75</sup> with the SEC involving requests for exemptions from the securities provisions of sections 10(b)(3), 10(c), 10(d), 15(a), 16(a), 17(f), 17(g), and 32(a)(2) of the Investment Company Act of 1940 and significant reinterpretations of the amalgam of regulations in the Securities and Glass-Steagall acts of 1933 and the new version of regulation 9. In effect, the bank's plan involved permission to manage a Type III fund without succumbing to all the regulations governing such funds as securities.

The bank had for many years offered to customers an investment advisory service in the form of a managing agency account whereby the bank exercised a power of attorney over the funds consigned to its investment discretion. However, because of the diseconomies involved in managing accounts of humble size the smallest managing agency account that the bank would accept was \$200,000.<sup>76</sup> Since the bank had successfully operated commingled funds under the predecessor of regulation 9 and the aegis of the Federal Reserve Board, it expressed interest in the operation of a commingled account under the expanded regulation of the Comptroller, in order to make management services available to smaller investors. Prior to 1963, national banks were not permitted to commingle managing agency accounts. The innovation was introduced by the Comptroller following transfer to him of regulatory authority over the fiduciary functions of national banks.

Details of the Citibank plan deserve exhaustive note.<sup>77</sup> The fund was to be known as the "commingled investment account of First National City Bank." The "managing agency account" language was used to describe what Citibank termed a "fiduciary account." The bank would provide safekeeping for the customer's funds and securities and manage the investments in the account pursuant to a power of attorney giving the bank broad investment discretion. Citibank indicated that only national banks authorized to exercise trust and other fiduciary powers could act in the capacity as managing agent, and gave evidence of its own status as such a bank.

According to the bank's interpretation, the revised form of regulation 9 cleared the way for the bank to develop its proposal for a Type III account. Aware, however, that the account needed to be registered under the Investment Company Act as an investment company and that interests in it would have to be registered as securities under the Securities Act, the bank proposed a collective

<sup>75</sup> First National City Bank, SEC Investment Co. Act Release No. 4638 (March 9, 1966).

<sup>76</sup> Brief of Respondent SEC at 13, National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).

<sup>77</sup> The following description is closely parallel to that found in the Brief for Intervenor First National City Bank, National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).



investment fund for managing agency accounts as described under the third of the permitted classifications of the revised form of regulation 9.<sup>78</sup>

The commingled account would work in the following way. A Citibank customer who wished to give the bank custody and investment discretion over at least \$10,000 of his funds would turn the cash over to the bank pursuant to a broad authorization making the bank the customer's managing agent. At the outset, there would arise a strict fiduciary relationship of principal and agent as between the customer and the bank. The authorization would give the bank specific power to invest the funds together with those of other customers who had given the same authorization to Citibank.

The customer's interest in the account would be expressed in terms of units of participation redeemable at any time at net asset value. Each customer would have one vote for each unit of participation. Units would be transferable only to persons who had validly appointed the bank as their managing agent. Because of the underlying agency relationship, the interest of a participating customer or participant would terminate on his death or incompetency. No broker or dealer would underwrite or distribute participations, and no sales load or redemption charge would be imposed.

The account's operation would be subject to the supervision of a committee initially appointed by Citibank but thereafter elected annually by the participants. As originally envisioned, at least one of the committee members would at all times be a person unaffiliated with the bank, while the others would be officers in the bank's trust and investment division.

The formulation and implementation of the investment program consistent with the investment policy of the account would be carried out by the bank as investment advisor, pursuant to a management agreement subject to the approval of the participants at their first annual meeting and renewable only if approved annually by the committee. In accord with the management agreement, the bank planned to provide custody for the portfolio securities of the account and to furnish the administrative and clerical services necessary for its operation. For all of these services, the bank would receive an annual fee equivalent to one-half of one percent of the account's average net assets. No other charges were to be made.<sup>79</sup>

On May 10, 1965, the Comptroller of the Currency specifically approved the proposal for the account, pursuant to section 9.18(c)(5) of regulation 9.<sup>80</sup> Following the bank's request for exemptions on August 25, the SEC issued, on September 2, its notice of the filing of the request and gave any "interested person" an opportunity to submit a request in writing for a hearing on the

78 See note 74 *supra*.

79 It goes almost without saying that these minimal charges would bring the Citibank account into nearly crippling competition with mutual funds, whose "sales load" charge is usually eight and one-half percent. See notes 309-12 *infra* and accompanying text.

80 12 C.F.R. § 9.18(c)(5) (1969). A national bank may establish a collective investment fund without the Comptroller's approval if the fund takes one of the forms specified in section 9.18(a) of regulation 9, 12 C.F.R. § 9.18(a) (1969). Because Citibank's commingled account took a somewhat different form, the specific approval provided for in section 9.18(c)(5) was requested. The account was expected to comply with each of the restrictive provisions of section 9.18(b) of regulation 9, relating generally to collective investment funds, except in the few instances where compliance with the 1940 Act made it difficult or impossible to conform to regulation 9.

matter. Belatedly, on October 1, the National Association of Securities Dealers, a mutual-fund oriented trade association, filed a request. The NASD's motivation for contesting Citibank's proposal clearly was a well-founded fear of severe competition by banking interests to the mutual fund market.<sup>81</sup>

The bank had sought exemptions principally from three subparagraphs of section 10 of the Investment Company Act: subparagraphs (b)(3), (c), and (d)(2). The desired relief would authorize all but one of the members of the board of directors of the account to be officers or directors of the bank. In the absence of the exemption, section 10(b)(3) would preclude the account from having a majority of its board comprised of persons who are officers, directors, or employees of the bank, since the bank becomes an investment banker in its participation in syndicates underwriting United States Government and municipal obligations. Similarly, in the absence of an exemption, section 10(c) would preclude persons serving as the bank's officers or directors from holding a majority of the board positions. The bank also sought an exemption from a condition of section 10(d). The condition that the bank sought to have waived was that contained in paragraph (2), requiring that the investment advisor be registered under the Investment Advisers Act and engaged principally in the business of rendering investment supervisory services, a requirement that Citibank could not meet.

On March 9, 1966, the SEC granted the exemptions from sections 10(b)(3) and 10(c). It denied the request under section 10(d). Subsequently, by an amended order, the Commission granted an exemption from section 10(b)(2).<sup>82</sup> In effect, section 10(b)(2) would have prohibited a majority of the committee from being composed of persons who were officers or directors of the account's principal underwriter, i.e., the bank itself. As a result of the SEC's determination, the makeup of the committee would be governed by section 10(a) of the Investment Company Act, which provides that no more than sixty percent of the committee's members could be officers, directors, or employees of the account's investment advisor. Hence, the SEC concluded that the least forty percent of the members of the Committee would be persons not affiliated with the bank.

With respect to section 10(d), the SEC concluded that the bank had shown "that substantial safeguards are present here against the conflicts of interest which could arise as a result of the bank's commercial banking activities." With respect to the request for exemption from 10(b)(3), the SEC found "no basis for concern that the bank, qua investment banker, can or will use the account to its advantage, particularly since the account is primarily a stock fund and the bank is limited to underwriting debt securities of government authorities." Finally, the SEC concluded that the same reasons made an exemption "necessary or appropriate" from section 10(b)(2) "in view of the no-load character of the account."<sup>83</sup>

Following SEC approval, the account was registered with the SEC on April

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<sup>81</sup> See generally Brief for Petitioner National Association of Securities Dealers, Inc., National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).

<sup>82</sup> 15 U.S.C. § 80a-10(b)(2) (1964). Granting the exemption requested under section 10(d)(2) would have automatically exempted the bank from section 10(b)(2).

<sup>83</sup> See Brief for Respondent SEC at 16, National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).

20, 1966, as an open-end investment company, pursuant to the provisions of the 1940 Act. It began operation in June of 1966, the effective date of the registration statement filed under the Securities Act of 1933.

Meantime, on April 25, 1966, the Investment Company Institute, an organization that counts over three hundred mutual funds among its membership, brought suit to invalidate both regulation 9.18 and the Comptroller's approval of the account. Obviously the ICI's motivation paralleled that of the NASD: fear of detrimental if not destructive competition from the Citibank plan. The ICI sought in its suit two specific demands: (1) a declaratory judgment invalidating so much of regulation 9 as permits a national bank to invest individual managing agency accounts through a commingled trust fund; and (2) injunctive relief against the issuance or continuance of any approval under regulation 9.18, which, according to the ICI, exceeded the authority conferred upon the Comptroller by 12 U.S.C. § 92a (1964).<sup>84</sup>

The district court entered judgment on November 9, 1967, invalidating portions of regulation 9 and requiring the Comptroller to rescind the approval given Citibank to establish the account, already in full operation.<sup>85</sup> In effect, the court held that regulation 9 permitted the operation of a Type III account in contravention of the restrictions laid down by sections 16, 20, 21 and 32 of the Glass-Steagall Act. Specifically, the district court rested its opinion on two precepts: (1) section 9(a) does not allow the Comptroller to permit commingling of managing agency accounts because such activities, in the court's view, are not carried on in a "fiduciary capacity," nor are such accounts legal in the state of New York.<sup>86</sup> Furthermore, (2) the court implied that the units of participation were "securities" within the meaning of the 1933 Act and the Glass-Steagall Act and that the account was an entity separate from the bank rather than a single entity, thus violating interlocking directorates between banks and securities companies.<sup>87</sup>

## V. The Appellate Decision

For its part, Citibank argued (1) that its commingled account did indeed constitute a fiduciary relationship, both in its own structure and also in the light of recent applications of New York state banking laws; and (2) that the operation of the account did not violate sections 16, 20, 21, or 32 of the Glass-Steagall Act, since the account was not the separate affiliate contemplated by the drafters of the Glass-Steagall Act.<sup>88</sup> In reversing the district court, the appellate court of the District of Columbia agreed essentially with these contentions.

### A. A Fiduciary Relationship?

The district court had held that the Citibank account was not a fiduciary

<sup>84</sup> National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).

<sup>85</sup> *Investment Co. Institute v. Camp*, 274 F. Supp. 624 (D.D.C. 1967), *rev'd sub nom.* National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).

<sup>86</sup> *Id.* at 640-41.

<sup>87</sup> *Id.* at 641-45.

<sup>88</sup> See Brief of First National City Bank at 15, National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).

account for two reasons, one theoretical, the other practical: (1) a managing agency account does not constitute a fiduciary relationship, and (2) New York state banking laws, as read by the district court, do not permit state banks to commingle managing agency accounts as fiduciary accounts.

On the theoretical issue, Citibank claimed that the right of a national bank to receive property as a managing agent derives directly from the provisions of 12 U.S.C. § 92(a),<sup>89</sup> which authorizes a national bank to act not only as trustee but also "in any other fiduciary capacity" permitted under state law to a state-chartered bank. The district court had reasoned that although the duties of a managing agent were fiduciary in character, those duties were different from those of a true trustee. Since the relationship between the customer and Citibank was only one of managing agency and not of trust, the court concluded that "a managing agency relationship does not fall within the traditional fiduciary powers as determined in 12 USC, § 92(a)."<sup>90</sup>

In response, Citibank argued that "the agreement to act on behalf of the principal causes the agent to be a fiduciary, that is, a person having a duty, created by his undertaking to act primarily for the benefit of another in matters connected with his undertaking."<sup>91</sup>

Support for Citibank's contention can be found in such elemental sources as the *Restatement (Second) of Agency*. Furthermore, the phrase "in any other fiduciary capacity" clearly indicates that the powers conferred on the bank are not limited to the Type I common trust fund but extend to "other" accounts of a bank. Both the *Restatement* and the language of title 12 indicate that the essential characteristic of a fiduciary relationship is that the bank act for the benefit of the customer-investor, rather than for itself, in all matters connected with the customer's account. Citibank profusely indicated its intent to manage the account accordingly.

For its answer, the appellate court looked to precedent in its own district. In *Brown v. Christman*,<sup>92</sup> the court had held that an agent collecting rents for numerous principals properly discharged his fiduciary obligation in putting the funds of all principals in a single investment account. The *Brown* court reasoned that despite the commingling, the account deposit itself was "sufficient to segre-

89 12 U.S.C., § 92(a) (1964) provides:

(a) The Comptroller of the Currency shall be authorized and empowered to grant by special permit to national banks applying therefor, when not in contravention of State or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardian of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which State banks, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the State in which the national bank is located.

(b) . . . The Comptroller of the Currency is authorized and empowered to promulgate such regulations as he may deem necessary to enforce compliance with the provisions of this section and the proper exercise of the powers granted therein.

90 See 274 F. Supp. at 639-40.

91 RESTATEMENT (SECOND) OF AGENCY, § 13, comment a (1958). Citibank argued that fiduciary relationships are not limited to trusts either at common law or under section 92a. Support for this position can be found in certain distinguished treatise authors. Professor Austin W. Scott, from whose treatise the district court quoted to distinguish the trust and fiduciary functions of a bank, prefaces his discussion with the observation that "an agent is in a fiduciary relation to his principal." A. SCOTT, LAW OF TRUSTS § 8, at 73 (3d ed. 1967).

92 126 F.2d 265 (D.C. Cir. 1942).

gate them in trust." The appellate court found *Brown* clear support for Citibank's argument:

The differences between the traditional trust relationship of trustee, executor, or administrator and the contractual principal-agent relationship do not, in my view, make the agent any less a fiduciary, nor does commingling of funds, subject to the principal's authorization, change the fiduciary character of the duty owed to each.<sup>93</sup>

On the practical interpretation of New York state banking laws, the district court had maintained that section 100 of that law contains no specific grant of authority to banks to commingle funds held as a managing agent. The court was apparently concerned that an agency relationship places fewer duties and liabilities upon the agent than does a trust upon the trustee. The court concluded that the absence of such authority constituted an implied state prohibition on Type III accounts such as that operated by Citibank.

Fortunately for Citibank at this juncture, two of its major competitors came unwittingly to its aid. Subsequent to the district court decision, the New York State Banking Department had given formal permission to two New York City banks to operate commingled managing agency accounts identical with that operated by Citibank. Obviously, the State Banking Department felt that the operation of these Type III accounts was sanctioned by sections 100(1) and (5) of the Banking Law, which confer general power upon banks to act as agents for any lawful purpose. Approval of the commingled accounts of Manufacturers Hanover Trust and the Bank of New York thus gave considerable unexpected support to Citibank's rationale that the Type III account complied fully with New York banking law. The appellate court could hardly fail to agree:

Prior to the Comptroller's issuance of revised Regulation 9, no state banks operated commingled managing agency accounts. Still, the Banking Department's action cannot fairly be dismissed as merely following the Comptroller's lead. The question of whether collective accounts are a proper fiduciary activity for banks appears to have been open under both Federal and New York law, and both banking agencies could reasonably have resolved it the same way.<sup>94</sup>

Thus on the fiduciary question, the appellate court found in the provisions of the *Restatement of Agency* and in the opinion of the New York Banking Department overlapping support for its conclusion that the Citibank account constituted a true fiduciary relationship. There seems good reason for this holding. The major difference between the bank's relationship to the account customers and its relationship to the beneficiaries of other management and trust services lies in the absence of an individually negotiated agreement. Though there is a "package deal offered to all comers" proffering \$10,000 to the bank,<sup>95</sup> the

93 420 F.2d at 87.

94 *Id.*

95 This was one reason why the SEC required registration of the account. *See 1966 Senate Hearings* 132-38. Although there was no individually negotiated agreement between the bank and the unit holders as in other areas of bank investment management, the court held

interest of these "comers" in the account expresses itself in common possession of a measure of voting control over the management of their money. Accordingly, the court could hold that the fiduciary aspects of the "package" account would be properly safeguarded through "dual regulation by the Comptroller and the Commission."

## B. Do Securities Laws Contemplate Type III Accounts?

A literal reading of the provisions of sections 16, 21, 20, and 32 of the Glass-Steagall Act and of section 10(c) of the Investment Company Act provided the NASD and the ICI with the legal scaffolding supporting the district court's conclusion that Type III accounts were prohibited by the express language of the Securities Act of 1933, the Glass-Steagall Act of 1933, and the Investment Company Act of 1940. In response, Citibank argued that the legislative history of these acts indicates that their prohibitions primarily envision abuses resulting from the predepression alliance between separate bank and securities affiliates — a relationship, according to the bank, not parallel to that between Citibank and its own account. In sum, the argument centers upon the most explicit of the securities laws, the Glass-Steagall Act, and upon the meaning and intent of sections 16, 21, 20, and 32.

### 1. Sections 16 and 21

Section 16 of the Glass-Steagall Act of 1933 provides that the business of dealing in securities and stock by national banks "shall be limited to purchasing and selling . . . for the account of customers."<sup>96</sup> It also forbids a national bank to "underwrite any issue of securities or stock" for its own account.<sup>97</sup>

Citibank argued that section 16 prohibits a bank only from buying and selling securities for its own account and, by implication, permits a bank to buy and sell securities for its customers' account. Since Citibank had no interest in the account or in the units of participation (since it could not buy units for its own account), the bank could derive neither profit nor loss from the distribution of the securities in the account. Accordingly, the bank contended that it "does not underwrite any issue of securities" in violation of section 16.<sup>98</sup>

Based on the legislative history of the Glass-Steagall Act, the bank's contention seems well founded. On the one hand, section 16 prohibits a national bank from "dealing in securities" for "its own account,"<sup>99</sup> obviously referring to instruments of the type commonly sold in securities markets and in which the bank might have an interest. On the other hand, section 16 does not affect transactions on behalf of customers in which the bank itself has no financial

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that the account participants as a group could keep the managers of the investment account responsive to their interest. In addition to being subject to the regulatory provisions applying to mutual funds, the bank is also accountable to the Comptroller. In effect, investors in the Citibank plan are better protected than shareholders in traditional investment companies.

<sup>96</sup> 12 U.S.C. § 23 (1964).

<sup>97</sup> *Id.* § 378 (1964).

<sup>98</sup> Brief of First National City Bank at 29, *National Ass'n of Sec. Dealers v. SEC*, 420 F.2d 83 (D.C. Cir. 1969).

<sup>99</sup> See note 96 *supra*.

interest. The Citibank account thus escapes the three possible abuses at which the Seventy-sixth Congress aimed the Glass-Steagall Act: (1) the bank, which owns no securities in the commingled account, incurs no investment risk;<sup>100</sup> (2) it is under no pressure to make loans to shore up its investment because it cannot suffer loss itself;<sup>101</sup> and (3) there is no temptation to give bad advice to customers because the bank has nothing to sell them.<sup>102</sup> In effect, then, the provisions of section 16 draw a line between stock speculation and investment banking on the one hand, and commercial banking on the other, the latter being permitted, the former prohibited.

The court of appeals agreed with Citibank's interpretation of section 16:

The bank's interest in earning a regulated fiduciary charge bears little resemblance to its interest in earning an indeterminate distributing profit from securities which it owns or underwrites, and the interest forbidden by § 16 is the latter.<sup>103</sup>

Section 21 of the Glass-Steagall Act prohibits banks from engaging "in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities."<sup>104</sup> Section 21 intends to extend the prohibitions of section 16 to the non-national bank members of the Federal Reserve System. Congress did not intend to bar those banks from buying and selling securities "for the account of customers." The words in the quoted text immediately above confine themselves to the activities prohibited by section 16: dealing for profit in the kinds of investments normally marketed through investment bankers and other security dealers. Thus section 21 speaks not of issuing a security but of "the business" of issuing and underwriting. In effect, section 21 draws the same line as section 16 between stock speculation and investment banking, which it prohibits, and commercial banking, including the fiduciary activities of trust departments, which it allows. If anything, the language of section 21 confirms

100 Congress was concerned to bar banks from investing their own assets in securities with consequent risk to commercial and savings deposits. This concern is stated in the report of the Senate Banking and Currency Committee. S. REP. No. 77, 73d Cong., 1st Sess. 8 (1933) in which it indicates, in part:

The outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans, and of over-investment in securities of all kinds. . . .

. . . [A] very fruitful cause of bank failures, especially within the past three years, has been the fact that the funds of various institutions have been extensively tied up in long-term investments.

101 See note 157 *infra*.

102 See 75 CONG. REC. 9912 (1932):

The banker ought to be regarded as the financial confidant and mentor of his depositors. This underlying relationship is a natural and desirable one. . . .

Obviously, the banker who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit or a distribution profit or a trading profit or any combination of such profits.

103 420 F.2d at 90.

104 Section 21 provides criminal penalties for willful violations. The attorney general is charged with prosecutions under section 21, and has indicated that, while it is not clear whether the operation of the account would involve criminal liability, the approval of the banking agencies precludes a prosecution against Citibank. See 1966 Senate Hearings 588.

the view that Congress was concerned in both provisions with prohibiting bank dealing in speculative securities for the traditional and direct form of distribution profit.<sup>105</sup>

Consequently, there seems good reason for the court's reading of sections 16 and 21 together. Their close relationship reflects the history of the deliberations over the Act. Section 16 deals with national banks alone. Section 5(c) makes section 16 applicable to other members of the Federal Reserve System.<sup>106</sup> The prime function of section 21 is to extend section 16's prohibition against dealing in and underwriting securities to private commercial bankers not members of the Federal Reserve System. The link is further demonstrated by the first proviso of section 21, added in 1935, which makes it plain that other commercial banking institutions are not prohibited from dealing in "investment securities" to the limited extent permitted to national banks by section 16.<sup>107</sup> Under these circumstances, section 21 cannot reasonably be read to erase the distinction section 16 plainly draws between stock speculation and investment banking for a bank's own profit, on the one hand, and the management of investments as a fiduciary agency for its customers, on the other. The two sections are in *pari materia*, as Citibank argued, and should accordingly be construed together, as the appellate court found it proper to do.

## 2. Sections 20 and 32

Congress supplemented sections 16 and 21 of the Glass-Steagall Act, which bar banks from direct speculative investments, with sections 20 and 32, which require the separation of commercial banks from their securities affiliates and bar indirect involvement in investment banking through interlocks or affiliation. Section 20 provides:

no member bank . . . shall be affiliated with any . . . organization engaged principally in the issue, flotation, underwriting, public sale or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities . . . .<sup>108</sup>

The aim of section 20 is to forbid certain types of bank affiliation with any organization "engaged principally" in the same brand of securities dealing forbidden as a direct bank activity by section 21. One type of prohibited affiliation, defined in section 21(a)(b)(3), exists when a majority of the directors of a securities organization are also directors of any one member bank.

Section 32 supplements the provision of section 20. It makes it an offense for an officer, director, or employee of such an organization to be an officer, director, or employee of a national bank. The language of section 32 describing

<sup>105</sup> Congress' sense of relationship between the two sections is apparent in the committee reports explaining that the proviso was added so that section 21 "should not be construed as prohibiting banks, bankers, or financial institutions from engaging in securities activities within the limits expressly permitted in the case of national banks under section 5236 of the Revised Statutes [i.e., Glass-Steagall Act, section 16]. S. REP. No. 1007, 74th Cong., 1st Sess. 15 (1935). See also H.R. REP. No. 742, 74th Cong., 1st Sess. 16 (1935).

<sup>106</sup> 12 U.S.C. § 335 (1964).

<sup>107</sup> See note 105 *supra*.

<sup>108</sup> 12 U.S.C. § 377 (1964).



the activities from which bank officials are barred is virtually identical to the description in section 20. The intent of both sections is only to bar national and other member banks from interlocks or affiliation with organizations principally engaged in the kinds of securities activities from which banks themselves are barred by sections 16 and 21. Thus, where section 20 speaks of "engaged principally," section 32 uses "primarily engaged."<sup>109</sup> Section 32 merely omits the specification of "debentures" and "notes."

Citibank argued that sections 20 and 32 were written with the predepression relationship of banks and their securities affiliates uppermost in mind. The language of "interlocking" would seem to support this interpretation. Accordingly, since all the activities under the Citibank plan would be carried on by a single organization, i.e., the bank itself, there could be no interlock or affiliation.

Ultimately, the dispute about the intent of sections 20 and 32 thus resolves itself into the query whether Citibank's account is a "single entity" along with the bank. The district court felt there were two entities involved. Citibank disagreed, arguing that its intent was identification of the account with the bank. The Federal Reserve Board so interpreted the relationship when the question came to its attention in October, 1965. In applying section 32 in earlier cases, the Board had "asked whether, under all the circumstances, there was such functional unity among the organizations forming the group that they should be regarded as a single entity for purposes of Section 32."<sup>110</sup> The Board answered in the affirmative, holding that the account was nothing more "than a department or division of the bank."<sup>111</sup> The appellate court agreed, holding that as long as the account remained under the effective control of the bank, there would be "no prohibited interlock" because there would be but one entity.

Under the single entity theory, the Bank cannot interlock with itself, but that is not really the point. The clear purpose of §§ 20 and 32 is to prevent banks from entering into prohibited forms of securities dealing by the back door. We have held that the bank may enter the business of operating the account by the front door. The organizational pattern imposed to satisfy the requirements of the Investment Company Act does not in this context create a prohibited interlock or affiliation any more than the Account itself constitutes a forbidden excursion into the securities business.<sup>112</sup>

### 3. *Section 10 of the Investment Company Act*

On appeal, the ICI and NASD argued strenuously that the Comptroller had exceeded his authority in granting Citibank an exemption from section 10 of the Investment Company Act. The effect of that exemption was to permit sixty percent of the directors of the account to be bank personnel.

Section 10 of the Act was enacted to protect shareholders of investment companies from exploitation by insiders with conflicting interests in other companies by requiring that a certain percentage of directors be free of affiliation

109 In *Board of Governors v. Agnew*, 329 U.S. 441 (1947), it was held that "primarily" is satisfied if the underwriting business is substantial.

110 30 Fed. Reg. 12836 (1965).

111 1966 *Senate Hearings* 588.

112 420 F.2d at 91.

involving divided loyalties. Without the exemptions, section 10 would preclude the account from having a majority of directors, officers, or employees of (1) a principal underwriter, (2) investment banks, or (3) a single bank. While the bank's plan fits each of these statutory categories, the overriding issue, according to the court, was the propriety of the exemption granted from section 10(c) of the Act, permitting a maximum of three instead of two bank officers to serve on the five-member account committee.

In agreeing with the SEC's approval of the exemption, the appellate court observed that the account differs on the one hand from the bank-dominated securities affiliates of the twenties whose abuses inspired section 10 and, on the other, from open-end investment companies (mutual funds) not subject to the supervision of the Comptroller. For these reasons, it was appropriate to consider whether the bank-sponsored Type III fund equalled a type of investment company requiring the standard measure of unaffiliated directors or whether exemptions were justified by its novel characteristics. The appellate court concluded, as did the Commission, that the risks of conflict of interest would be adequately controlled by the provisions of the Investment Company Act still applicable, supplemented by the Comptroller's regulations, and that the exemptions would permit the establishment of a desired new investment medium with novel characteristics.

Following the Commission's lead, the court reviewed four possible danger zones:<sup>113</sup>

*(a) Retention of Substantial Cash Deposits for the Account of the Bank*

The SEC discounted the danger that the bank might retain an unwarranted portion of the account's assets in cash in order to earn money for the bank. Similarly, the court felt that the temptation to leave some funds uninvested would be contrary to the account's stated policy of investment for long-term growth of capital and income, as well as opposed to the bank's own interest in having the fund's assets grow. Presumably, the bank's interest in increasing the assets in the fund would dictate not only that funds already held be invested in growth securities but also would create pressure to increase the number of participants.

The court referred specifically to the Comptroller's regulation stating that funds held by a bank in a fiduciary capacity should not be uninvested for a period longer than is reasonable for proper management.<sup>114</sup> The court concluded that the Comptroller's examination of trust departments every eight months would be sufficient to prevent the bank, if it were so inclined, from unduly holding the account's assets in cash.

*(b) Use of Account Investments to Shore Up Bank Loans*

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<sup>113</sup> The dangers were cited by former Chairman William L. Cary, in testimony before Congress recommending regulation of collective investment funds. See *Hearing on Common Trust Funds — Overlapping Responsibility and Conflict in Regulation, Before a Subcomm. of the House Comm. on Government Operations, 89th Cong., 1st Sess. 11-12 (1963)*.

<sup>114</sup> 12 C.F.R. § 9.10(a) (1969). See 12 U.S.C. § 481 (1964).

The court also considered the possibility that the bank might make unsound loans to shore up companies in which it had made investments. A letter from William McChesney Martin, then Chairman of the Federal Reserve Board, explained why this risk was not significant:

In the case of managing agency funds, an additional safeguard is the prophylactic restrictions and requirements of the Investment Company Act of 1940, particularly publicity of the financial transactions of registered investment companies, which almost inevitably would expose such malfeasance. A further deterrent would be the adverse impact on a collective fund's performance — its comparative financial record — if any of its resources were used to make unprofitable investments; the detrimental effect on sales of participants might outweigh any benefits the bank could reasonably expect from its breach of fiduciary duty.<sup>115</sup>

The letter was ample warrant, at least to the court, that the margin for misconduct by shoring up bank loans was only a minimal danger because it would be self-destructive of Citibank's account.

*(c) Purchase by the Account of Securities Underwritten by the Bank*

The court felt that the account would be of no use for furthering Citibank's limited investment banking business. The account is primarily a performance-oriented stock fund. As such, it is not permitted to purchase any securities from the bank, nor can the account purchase government securities from another member of a syndicate where the bank is principal underwriter. Once again, the ever-watchful eye of the Comptroller and of the SEC would insure Citibank's conformity to these explicit prohibitions, of which Citibank was fully aware.

*(d) Allocation of Brokerage to Existing or Potential Bank Customers*

Citibank's stated objective in placing orders would obviously be to obtain the most favorable prices and execution of orders and, secondly, to deal with brokers and dealers who provide the bank with supplementary research and statistical information. To the appellate court, the bank's assurances were not wholly convincing, since brokerage might be improperly distributed in the course of the bank's already extensive securities purchases for the account of customers. Nonetheless, the court reasoned that Congress apparently did not consider this threat to be of critical importance when it exempted common trust funds from the Investment Act entirely.

The court observed that the bank-affiliated directors' interest in attracting more customers coincided with the interests of investors and to some degree counteracted the incentive to hold the fund's assets in the form of commercial deposits. According to the court, the restrictions on bank underwriting and bank transactions with the account "make it unlikely that the bank can profit

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<sup>115</sup> *Hearings Before the Senate Banking and Currency Committee on Amendment No. 438 to S. 1659, 90th Cong., 1st Sess. 1223-26 (1968).*

by using the fund to unload or backstop its bad or indifferent investments."<sup>116</sup>

Bank entry into the mutual fund market is another example of adaptation of traditional banking activity by congeneric expansion aimed at putting banks into ever-widening spheres of financially related activity. Authorization by the courts of Type III accounts permits banks to sell the knowledge and capabilities they possess as by-products of traditional banking activities, thereby generating additional income at low marginal cost. Although the mutual fund industry faces the prospect of severe if not crippling competition, the legitimate advantages to both banks and the general investment public would seem to make Type III accounts a decidedly welcome addition to an investment picture too long situating the sales load directly in its center.

## VI. Parameters for Decision

The problem presented by the Citibank proposal, as seen, had complicated origins. Thus far we have attempted to trace the major currents in this development, with emphasis on the critical areas where the major issues that the account raises will be resolved. With this background in mind, the remainder of this study will trace the various attempts that have been made to resolve the issues that are present. Some of these activities have been coincidental with the court actions that were discussed, others have been subsequent to the various court activities. All of the activity weaves an interesting pattern reflecting the interdependence of the various activities.

Through the development of the background data, certain issues were seen to have developed. Among the more material are the initial conflict in jurisdiction between the Federal Reserve Board and the Securities and Exchange Commission, the overall applicability of the Securities Act of 1933, the underlying policy of the Glass-Steagall Act and whether this was contravened by the authorization to establish Type III accounts, and the relevance of the Investment Company Act of 1940. The policy issues of additional conflicts of interest and the dangers of increased concentration are also essential to the full consideration of the advisability of Type III accounts.

These issues were not thrust before the Congress and the courts instantaneously; rather they have been the product of the interaction of the multifaceted maneuvers of the various interested parties and the governmental agencies. This gradual development may be seen, somewhat, in the preceding portions; care should be taken to note that many of these issues will reach their apex and die, leaving only a very few as viable contenders with the parties asserting the need for banking entry into this field.

## VII. Discussion of the Issues

### A. Introduction

While the legislative activity associated with the enactment of the various securities and banking acts was extremely meaningful, the total amount of

activity was restrained. During the past decade congressional activity has been anything but restrained in the area of investment companies and related banking activities. In the seven years since the Comptroller issued regulation 9,<sup>117</sup> there have been, in addition to innumerable bills, no fewer than eight major legislative hearings on the subject.<sup>118</sup> They have not produced an enacted law.

In the previous section, mention was made of the interactions between the Congress and the courts and the activities of the vested interests. This becomes patently clear when one takes a brief overview of the relationship between the various hearings and the judicial decisions. Because of the jurisdictional conflict between the Comptroller and the SEC, there was little activity in the commercial banking world. After a compromise,<sup>119</sup> in August of 1965, First National City Bank filed an application with the SEC<sup>120</sup> for permission to operate a commingled managing agency account. In March of 1966, hearings were being held before the Senate Subcommittee of the Committee on Banking and Currency on proposed legislation which would permit banks to engage in Type III activity.<sup>121</sup> In the very middle of these hearings, on the second day of the hearings, SEC issued its findings in the Citibank application, granting the requested exemptions<sup>122</sup> and literally pulling the carpet out from under the hearings. Hearings on what could have been a very controversial subject ended four days after they began, partly because several witnesses had withdrawn, partly because witnesses were unavailable,<sup>123</sup> and in all actuality from the fact that the void had been filled and the legislation was no longer desired. There was little direct activity in the area for almost a year and a half. Then suddenly, on September 27, 1967, the district court decision in *Investment Company Institute v. Camp*<sup>124</sup> came down. Almost at once, on November 16, hearings were initiated in the Senate on an amendment to S. 1659.<sup>125</sup> The regular hearings on S. 1659 had concluded on August 2, 1967. The very contiguity of these events compels

117 Comptroller of the Currency, Regulation 9, 12 C.F.R. § 9 (1969).

118 *Hearings on Common Trust Funds — Overlapping Responsibility and Conflict in Regulation Before a Subcomm. of the House Comm. on Government Operations*, 88th Cong., 1st Sess. (1963) [hereinafter cited as 1963 House Hearings]; *Hearings on H.R. 8499 and H.R. 9410 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 88th Cong., 2d Sess. (1964) [hereinafter cited as 1964 House Hearings]; *1966 Senate Hearings*; *1967 Senate Hearings*; *Hearings on H.R. 9510 and H.R. 9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess. (1967) [hereinafter cited as 1967 House Hearings]; *Hearing on Amendment No. 438 to S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. (1967) [hereinafter cited as 438 Hearing]; *Hearings on S. 34 and S. 296 Before the Senate Committee on Banking and Currency*, 91st Cong., 1st Sess. (1969) [hereinafter cited as 1969 Senate Hearings]; and *Hearings on H.R. 11995, S. 2224 and others Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. (1969) [hereinafter cited as 1969 House Hearings]. Related hearings were also held on bank holding companies during 1969. *Hearings on H.R. 6778 Before the House Comm. on Banking and Currency*, 91st Cong., 1st Sess. (1969) [hereinafter cited as *One-Bank Hearings*].

119 See text accompanying note 125 *infra*.

120 *1966 Senate Hearings* 180.

121 *1966 Senate Hearings*.

122 First National City Bank, SEC Investment Co. Act Release No. 4538 (March 9, 1966) [hereinafter cited as *Citibank Release*].

123 *1966 Senate Hearings* 132. The hearings never were ended officially; they recessed subject to a call of the chair that never came. *Id.*

124 274 F. Supp. 614 (D.D.C. 1967), *rev'd per curiam sub nom.* National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).

125 *438 Hearing*.

the conclusion that as soon as the banking interests had been rejected, they wasted no time in locating an appropriate Congressional avenue to secure the fruit that the district court denied them.

Aside from the factually intriguing interrelationships that exist, the various hearings did serve to temper the issues. This section will treat those issues in depth, with a summation of the positions taken by the various interests and an evaluation of these arguments in terms of the underlying policies of the affected legislation or in terms of the relevant considerations that must be faced in the evolved financial and banking communities.

### B. Conflict of Jurisdiction

One of the very early issues was whether the Securities and Exchange Commission had jurisdiction over the commingled managing agency account. The issue was most argued in 1963.<sup>126</sup> It was the subject of legislative action in 1964<sup>127</sup> in a bill which would have resolved the conflict by placing the Comptroller over the Type III accounts entirely.<sup>128</sup>

Underlying the argument that the Type III account should be subject to the SEC was the presumption that the Type III account constituted a security within the meaning of the Securities Act of 1933.<sup>129</sup> The banking community, on the other hand, argued that the account was not a security.<sup>130</sup> The underlying rationale that the bankers rely on is that the Type III account is not, per se, a participation in the commingled fund, but that it is an individually negotiated contract with an individual relationship at its focus. The commingling was viewed not as an essential element of the relationship, but rather as an adjunct—a mere administrative convenience to permit the bank to economically invest the funds from the various accounts. Of course, if the account could be established as without the scope of the federal securities laws, there would be little problem in permitting the banks to engage in this activity.

This issue was not settled through legislation; rather, as happens to so many of the issues before Congress, the parties were able to reach an agreement and settle the need for the legislation.<sup>131</sup> Under the compromise, Citibank registered its account as a security with the SEC but would also be subject to jurisdiction of the banking authorities.<sup>132</sup> With this compact, the issue of jurisdiction was terminated; however, it does retain importance, in a historical context, as having precipitated the determination of whether the account was a security within the meaning of the federal securities laws and thus subject to the SEC.

### C. Relevance of the Securities Act of 1933

<sup>126</sup> 1963 House Hearings.

<sup>127</sup> 1964 House Hearings.

<sup>128</sup> *Id.* at 13.

<sup>129</sup> 1963 House Hearings 38.

<sup>130</sup> 1964 House Hearings 46.

<sup>131</sup> See 1966 Senate Hearings 132 (statement of the Comptroller of the Currency); *id.* at 37.

<sup>132</sup> See *id.* at 132.

## 1. Introduction

As discussed in section III, the Securities Act was intended to provide certain protections to the investor. The selected vehicle was adequate disclosure of critical financial information in order to provide the investor with a meaningful basis for making a decision.<sup>133</sup> The Act, if applicable to Type III accounts, would impose the traditional prospectus requirements on the offerings. This would include, in addition to disclosure, the increased protection to the consumer through the remedy of rescission under section 12 of the Act.<sup>134</sup>

## 2. Definition of security

The Securities Act describes a security as

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, . . . any interest or instrument commonly known as a "security," or any certificate of interest or participation in, . . . or right to subscribe to or purchase, any of the foregoing.<sup>135</sup>

As with any statutory language, there is more to the definition than would appear at first blush. Perhaps one of the clearest examples of the activity the Act was meant to cover came forth in the decision in *SEC v. Howey Co.*<sup>136</sup> There, the SEC claimed that a contract involving the purchase of certain citrus acreage under a land sales contract was a security within the meaning of the Act. The sale involved small plots which were to be, in most cases, developed by the seller for the purchasers.<sup>137</sup> In holding that the contracts were "investment contracts" within the meaning of the Act, the Court stated:

[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.<sup>138</sup>

Even if the account were a security, however, other problems exist. The Act, in section 3(a)(2), specifically exempts from the registration requirements "[a]ny security issued or guaranteed by . . . any national bank, or by any banking institution organized under the laws of any State or Territory or the District of Columbia . . . ."<sup>139</sup> So, argue the bankers, even if this is a security within the meaning of the Act, we are exempted from registration.<sup>140</sup>

In order to have the security come within the registration requirements,

133 See text accompanying notes 34-38 *supra*.

134 Securities Act of 1933 § 12, 15 U.S.C. § 77l (1964).

135 *Id.* § 2(1), 15 U.S.C. § 77b(1) (1964).

136 328 U.S. 293 (1946).

137 *Id.* at 299-300.

138 *Id.* at 299.

139 Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1964).

140 See, e.g., 1966 Senate Hearings 33 (statement of Robert Ferguson).

thereby incurring SEC supervision, it cannot have been issued by the bank. Fortunately for the SEC and fund industry sources, substantial authority existed in a recent Third Circuit decision, *Prudential Insurance Company of America v. SEC*.<sup>141</sup> There, Prudential was offering a variable annuity contract<sup>142</sup> to members of the public. The SEC contended that this was a security within the Act, and required registration. Prudential conceded that the annuity contracts were securities within the meaning of the Act, but contended that they were not subject to the registration requirements of the securities laws. At this point in the *Prudential* decision, an interrelation between the securities laws came into play, and in particular the issue revolved around whether the annuity contract was a security subject to registration within the meaning of the Investment Company Act of 1940. This was important to Prudential, because the Investment Company Act contains a specific exemption from the definition of an investment company for insurance companies.<sup>143</sup> This is important in context of the underlying rationale that was instrumental in convincing the Third Circuit that Prudential's annuity contract was not part of the insurance company but was a separate entity. According to the court, the rationale relied on by the SEC was that Prudential, while not in itself an investment company, had created one and was acting as the fund's investment advisor and principal underwriter. The exemption that applies to insurance companies would be irrelevant in this context.<sup>144</sup> This analysis has been termed by many as the "ectoplasmic theory." It is important to consideration of the Securities Act and Type III accounts in that exactly this rationale has been sought to be applied to the accounts.

As established,<sup>145</sup> in order to make the account subject to the registration requirements of the Act, it cannot be a security issued by the bank. Therefore, the "ectoplasmic theory" finds a convenient application in the Type III account, or so the SEC contends. The bankers, on the other hand, violently contended—at least in their early arguments—that "it has no practical application in the day-to-day operation of a bank's trust department."<sup>146</sup>

While the bankers were strongly arguing that their account was not a security, they had already admitted to the SEC that they were within the scope of the registration requirements of the Act. This is manifest from the fact that the day after the preceding statement was made, the SEC issued its infamous release, granting in part and denying in part First National City Bank's application for registration.<sup>147</sup>

In analyzing the nature of the account, there can be little doubt that it fits easily into the definition of a security as established by *Howey*.<sup>148</sup> It is certainly an investment of money in a common enterprise, although not in form but in

141 326 F.2d 383 (3d Cir.), cert. denied, 377 U.S. 953 (1964).

142 For a discussion of the nature and consequences of variable annuities see *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAWYER 732, 761-63, 877-80 (1969) [hereinafter cited *Survey*].

143 Investment Company Act of 1940 § 3(c)(3), 15 U.S.C. § 80a-3(c)(3) (1964).

144 326 F.2d at 386 n.3.

145 See text accompanying note 141 *supra*.

146 1966 *Senate Hearings* 33 (statement of Robert Ferguson).

147 *Citibank Release* was dated March 9, 1966; Mr. Ferguson made his statement on March 8, 1966.

148 *SEC v. Howey Co.*, 328 U.S. 283, 299 (1946); see text accompanying note 138 *supra*.



substance. The investor clearly expects to reap profits from the investment efforts of the bank. The fact that a formal certificate is not required by *Howey* only militates further in favor of viewing it as a security. The only possible difference of opinion could come with the applicability of the "ectoplasmic theory." However, the SEC had earlier contended, quite correctly, that the security that the account represents is not the type of security which the Act sought to exempt. Rather it was viewed as a separate entity "because it is not a claim *against the bank*. . . . It is a right to a pro rata portion of this pool of funds—not one of the bank's assets as such."<sup>149</sup>

As the "ectoplasmic" rationale has, in effect, been accepted by Citibank, there is little merit to any further evaluation of whether or not the account constitutes a separate entity for the purposes of the Act. The effects of registration are, of course, important to the investor. Rather than being provided with a brief outline of the plan, he is now presented with a full prospectus.<sup>150</sup> Most important, however, the investor has the protections of the Act's civil and criminal liabilities sections for false registration statements.<sup>151</sup> If the account had not been subject to the Act, regulation 9 would not have provided any specific remedies and the investor would have been compelled to seek a remedy at common law for breach of trust. The breadth of the federal remedies alone offers a substantial increase in investor protection from the common-law actions. There are also additional remedies through other laws, such as protections from insider profits,<sup>152</sup> which would be easier for the investor to recover under than would the common-law approach.

#### D. Objectives of the Banking Act of 1933

##### 1. Introduction

In the preceding subsection, we discussed the applicability of the Securities Act of 1933 and concluded that because it is applicable it affords the investor considerable additional protection. The Glass-Steagall Act of 1933,<sup>153</sup> otherwise known as the Banking Act of 1933, sought to prevent the recurrence of the manifest evils that permeated the entire banking structure just prior to the collapse of the system. In particular, the Act concentrates on the evils which result from permitting banks to invest their own assets in speculative securities.<sup>154</sup> One of the "forbidden fruits" for banks is engaging in investment banking. Investment banking refers to a system of distribution of securities through underwriting intermediary outlets known as investment bankers. The

149 1963 *House Hearings* 25 (statement of William L. Cary, Chairman, SEC); 1966 *Senate Hearings* 133 (statement of Manuel F. Cohen, Chairman, SEC).

150 Securities Act of 1933 § 10, 15 U.S.C. § 77j (1964).

151 Sanctions under the Securities Act are found in section 11, imposing civil liability for false registration statements, section 12, imposing civil liabilities for false prospectus data, and section 24, imposing criminal penalties, 15 U.S.C. §§ 77k, l, x (1964).

152 Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964). The applicability of the Securities Exchange Act is discussed at notes 200-2 *infra*.

153 The Glass-Steagall Act of 1933, ch. 89, 48 Stat. 184 (codified in various sections of 12 U.S.C.).

154 See text accompanying note 99 *supra*.

investment banker traditionally purchases an issue from the issuing corporation and resells it at a higher price, reaping his profit. The difference in price is commonly known as the "spread." Today, investment bankers, in addition to their traditional function, may also serve as advisors and assist the issuer in placing all or part of an issue with a private investor.<sup>155</sup>

The inherent dangers involved in commingling commercial and investment banking, as demonstrated in predepression activities of banks, included multifarious conflicts of interests which spawned some of the most inept banking decisions ever made.<sup>156</sup> Because of the direct investments of bank assets in speculative securities, pressure existed to make loans to shore up investments; and additionally the pecuniary interest in recovering the spread led larger banks to encourage their customers to make unwise investments.<sup>157</sup> These dangers and the evils associated therewith led the Congress to specifically forbid commercial banks from engaging in this form of investment activity.<sup>158</sup>

Another nefarious bit of conduct, much akin to the actual underwriting of securities, was the establishment of a securities affiliate of the bank. These cavalier organizations would accomplish many of the same tasks that the bank might wish to accomplish in a direct manner, including some rather speculative investments. Their activities were summed up in hearings late in the 1930s:

The sphere of activity of these security affiliates embraced the wholesaling and retailing of security issues; serving as holding and finance companies in carrying blocks of securities, for control or otherwise, which the bank could not or would not list among its own investments; assuming such loans and investment of the parent bank which might prove doubtful and nonliquid; supporting the market in the bank's own stock; and finally acting as investment companies in buying and selling securities for investment or speculative purposes.<sup>159</sup>

These abuses, in addition to those previously discussed, were the moving factors behind the banking legislation. When one evaluates the applicability of these laws, the overriding purpose sought in 1933 is essential to the determination of their proper application.

## 2. Sections 16 and 21

The Banking Act contains a dual approach to forbidding commercial banks from entering into the investment banking field. Section 16<sup>160</sup> forbids banks from dealing in securities except for the account of customers; it also provides

155 S. ROBBINS, *THE SECURITIES MARKETS: OPERATIONS AND ISSUES* 171 (1966).

156 *See, e.g.*, 75 CONG. REC. 9887-88, 9904-6, 9909-13 (1932); 77 CONG. REC. 3835-36, 3907, 3953-55 (1933); S. REP. NO. 77, 73d CONG., 1st Sess. 9-10 (1933); S. REP. NO. 1455, 73d CONG., 2d Sess. 185 (1934).

157 *See Hearings Pursuant to S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 71st Cong., 3d Sess. 1055-66 (1931) [hereinafter cited as *1931 Senate Hearings*]; 75 CONG. REC. 9912 (1932) (address of Senator Buckley).

158 Section 16 of the Glass-Steagall Act prohibits banks from dealing in securities except for the account of customers; section 21 prohibits a bank from acting as an underwriter. 12 U.S.C. §§ 24 (Seventh), 378 (1964).

159 SEC, *INVESTMENT TRUSTS AND INVESTMENT COMPANIES, PART ONE*, H.R. DOC. NO. 707, 75th Cong., 3d Sess. 94 (1939).

160 Glass-Steagall Act of 1933 § 16, 12 U.S.C. § 24 (Seventh) (1964).

that banks may not underwrite "any issue of securities or stock."<sup>161</sup> According to the legislative history of the Glass-Steagall Act, this section was meant to serve three ends — the prevention of the investment of the bank's own assets in speculative securities; the elimination of pressure, resulting from such investments, to encourage customers to invest in ill-advised securities; and elimination of the temptation for the bank to make loans to shore up its investments, or vice versa.<sup>162</sup> From the nature of the Type III account, there would be little danger that any of these situations would arise. There is, at the outset, no direct investment of the bank's assets in securities. Therefore, the underlying premise that the danger is precipitated by the fact that the assets of the bank are involved cannot be found in the Type III account. Moreover, the bank is actually performing an approved investment function — dealing in securities "for the account of customers." Since the bank is not selling participations to correspondent banks, and also because there is no direct involvement of the assets of the bank, the older evil of having the bank force its correspondents to purchase risk securities from the bank would not be present. There would also be little pressure on the part of the bank to make loans to shore up investments, since there is, again, no involvement of the bank's assets.

### 3. Sections 20 and 32

These sections are aimed at eliminating the dangers and evils which were associated with the use of bank-affiliated investment houses. The prohibitions were aimed directly at the evils of that period.

Section 20<sup>163</sup> prohibits bank affiliation with organizations which are principally engaged in the type of securities dealings which would be prohibited to banks as a direct activity under sections 16 and 21. This is bolstered by section 32,<sup>164</sup> which prohibits directoral interlocks between the bank and any securities affiliate. The relevance to the Type III account is apparent if the account is considered a separate entity from the bank for the purposes of the Glass-Steagall Act. If so, then section 32 is automatically violated in any organization which is comparable to that founded by Citibank.<sup>165</sup>

This critical problem was alleviated when the Federal Reserve Board, in 1966, decided that it would consider the account as a single entity with the bank.<sup>166</sup> The Board stated that this ruling would hold firm even though the account might be considered as being a separate entity within the purview of the securities laws requiring independent directors.<sup>167</sup>

The banking industry has continually argued that the Type III account would not constitute a violation of the banking laws. This position was af-

161 *Id.*

162 See 1931 Senate Hearings 1055-66; 75 CONG. REC. 9912 (1932) (address of Senator Buckley).

163 Glass-Steagall Act of 1933 § 20, 12 U.S.C. § 377 (1964).

164 *Id.* § 32, 12 U.S.C. § 78 (1964).

165 See text accompanying notes 44-45 *supra*.

166 Fed. Res. Reg. R, 12 C.F.R. § 218.111(j) (1969). See also 1966 Senate Hearings 584-85.

167 National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83, 90 n.11 (D.C. Cir. 1969).

firmed as early as 1965, when the Federal Reserve Board issued a statement on its views toward the Citibank proposal.

The Board concluded, based on its understanding of the proposal and on the general principles that have been developed in respect to the application of section 32, that the bank and Account would constitute a single entity for the purposes of section 32, at least so long as the operation of the Account conformed to the representations made by the bank . . .<sup>168</sup>

In comparing the operation of the Citibank account to the "ectoplasmic theory" approach in *Prudential*, the Federal Reserve has stated:

Even if the fund involved in the *Prudential* case were essentially the same in all respects to the commingled account proposed by the First, it could not safely be argued that Account should be regarded as separate and distinct from the First for the purposes of section 32, merely because Account would be so regarded under the Investment Company Act of 1940.<sup>169</sup>

This rationale finds support from the Supreme Court in its decision in *Board of Governors v. Agnew*.<sup>170</sup> There the Court expressly recognized that "Congress did not go the whole way" in prohibiting interlocks between banks and the securities industry.<sup>171</sup> The Court noted:

Section 32 is directed to the probability or likelihood, based on the experience of the 1920's, that a bank director interested in the underwriting business may use his influence in the bank to involve it or its customers in securities which his underwriting house has in its portfolio or has committed itself to take.<sup>172</sup>

While the banking industry was rather well armed on this issue, the majority of the fund industry arguments centered around the allegation that the Type III would violate the principles of the Glass-Steagall Act in that it would return the commercial bankers to the securities business.<sup>173</sup> However, in one prepared approach, the funds argued that one of the new dangers which would be present and which would constitute a violation of the principles of the Glass-Steagall Act would be that the bank would have a form of pressure to "sell" participations in the account as opposed to the normal trust account where there is no pressure to sell.<sup>174</sup> The fund industry found considerable support from the District Court in *Investment Company Institute v. Camp*.<sup>175</sup> There, the action was brought by the Investment Company Institute [ICI] to enjoin the Comptroller from authorizing national banks to commingle managing agency accounts. In the opinion, Judge McGarraghy expressed his conclusory views on the Glass-Steagall Act:

168 Fed. Res. Reg. R, 12 C.F.R. § 218.111 (1965).

169 1966 Senate Hearings 584-85.

170 329 U.S. 441 (1967).

171 *Id.* at 447.

172 *Id.* at 449.

173 *See, e.g.,* 1966 Senate Hearings 126 (statement of Robert W. Haack).

174 *See* 438 Hearing 50-52 (statement of Robert L. Augenblick).

175 274 F. Supp. 624 (D.D.C. 1967), *rev'd per curiam sub nom.* National Ass'n of Sec. Dealers v. SEC, 420 F.2d 83 (D.C. Cir. 1969).

The obvious purpose of these legislative enactments was to divorce the banking business from the securities business.

... There can be little doubt as to what Congress intended to do by the enactment of the Glass-Steagall provisions . . . .

... [T]his court holds the provision of Regulation 9 which allows commingling of managing agency accounts do not comply with the statutory provisions of the Glass-Steagall Act and are, therefore, illegal.<sup>176</sup>

To properly evaluate whether the provisions of the Glass-Steagall Act were, in fact, intended to cover the potential evils of the Type III account, one must first look to the abuses that caused Congress to enact the statute.<sup>177</sup> From a review of these abuses, including the more flagrant use of the bank's own assets — which was in itself probably the prime motivating factor behind the growth of the other abuses — the conclusion is that the Type III account does not contain the same dangers as were present in the minds of the enacting legislators. Coupled with the expertise of the Federal Reserve Board in its view that the account proposed by Citibank would not constitute an entity separate from the bank for the purposes of the Glass-Steagall Act, there is little hesitation in concurring with the banking industry that the Type III account is not within the prohibitions of the banking laws.

## E. The Investment Company Act of 1940

### 1. Introduction

The Investment Company Act of 1940<sup>178</sup> was an outgrowth of the early abuses within the investment company industry.<sup>179</sup> The Act is, at heart, regulatory and sought to deal with the specific abuses then present.<sup>180</sup> If the Type III account is a security for the purposes of the Securities Act of 1933, it may also be within the regulatory scheme of the Investment Company Act.

The management investment company has been described as

a voluntary organization that issues securities to the public representing a pro rata share in the assets held by the company, which primarily consist of securities issued by corporate enterprises. Management investment companies are usually corporations or trusts, and are designed to provide a service — professional management of the company's "portfolio securities," typically common stocks — in the interest of achieving a yield including capital appreciation, for their shareholders.<sup>181</sup> (Footnotes omitted.)

The management investment company is the most prevalent class of investment company<sup>182</sup> and the one under which the bank would be classified. For

176 *Id.* at 645-48.

177 See text accompanying notes 17-32 *supra*.

178 Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52 (1964).

179 For a detailed review of these abuses see *Survey* 787-92.

180 *1967 Senate Hearings* 3.

181 *Survey* 740-41.

182 *Id.* at 740.

purposes of the Investment Company Act, section 3 provides that the coverage extends to any issuer which "is engaged or proposes to engage in the business of investing . . . in securities."<sup>183</sup> The section specifically exempts banks and insurance companies from its coverage.<sup>184</sup> At first blush, one would conclude that with a specific exemption the banks need not worry about coverage of the Act. The issue was settled quite to the contrary in *Prudential Insurance Co. v. SEC*.<sup>185</sup> There, Prudential attempted to raise the defense to an order for registration under the Act. The court relied on the "ectoplasmic theory" when it stated that the investment fund, and not Prudential, was the "issuer" of the securities.

The major argument to extend this rationale to the banks was summarized by the SEC in a prepared statement which was presented in 1966.

[A]lthough securities such as bank stocks or debentures which are issued by, or represent obligations of, banks, are exempt from the registration requirements of the . . . Investment Company Act primarily in reliance upon Federal and State bank regulation, participations in these accounts represent a different type of security. In essence they represent an interest not in bank securities but in a pool or fund of securities of other enterprises which are selected by the banks. This type of interest is not now . . . exempted as a bank security.<sup>186</sup>

The banking industry retort to the application of the ectoplasmic theory, in 1966, was that it was "an esoteric legal concept." They noted that while the theory had been applied to insurance companies it was not applicable to the "day-to-day operation of the bank's trust department."<sup>187</sup> When making these statements the banking industry was involved in a classic case of burning the candle at both ends. Banks had seen the light from the *Prudential* decision and, concurrently with their grand allegations that the ectoplasmic theory was completely inapposite to the "day-to-day operations of the bank's trust department," had filed an application with the SEC for certain exemptions from the Investment Company Act.<sup>188</sup>

Within the framework of the Act, there are two provisions which have an important effect on the operation of a Type III account; they are sections 10 and 17. Section 10<sup>189</sup> is the basic management safeguard provision; it is an attempt by Congress to maintain some degree of independence on the investment company's board of directors.<sup>190</sup> There are specific prohibitions against a majority of the board of directors consisting of officers or directors of any one bank.<sup>191</sup>

Section 17,<sup>192</sup> on the other hand, deals with prohibited transactions with insiders. As has been noted in one study, while section 10 may have been

183 Investment Company Act of 1940 § 3(a)(3), 15 U.S.C. § 80a-3(a)(3) (1964).

184 *Id.* § 3(c)(3), 15 U.S.C. § 80a-3(c)(3) (1964).

185 326 F.2d 383 (3d Cir.), *cert. denied*, 377 U.S. 953 (1964).

186 1966 Senate Hearings 133.

187 *Id.* at 34.

188 See 1966 Senate Hearings 182.

189 Investment Company Act of 1940 § 10, 15 U.S.C. § 80a-10 (1964).

190 For an evaluation of the role of independent directors in the fund industry, see *Survey* 909-16.

191 Investment Company Act of 1940 § 10(c), 15 U.S.C. § 80a-10(c) (1964).

192 *Id.* § 17, 15 U.S.C. § 80a-17 (1964).

drafted "to close the corridor of control that led to incestuous advisor-company relationships, section 17 represents a far more direct approach."<sup>193</sup> The Act prohibits transactions between the company and an insider, or any person or company controlled by the registered company.<sup>194</sup>

If the Type III account is to be operated, then, under the present regulatory standards, there must be a consideration of the purposes and effect of the regulatory measures in the Act. In particular, because section 10(c) prohibits a majority of the board of an investment company from being interlocked with any one bank, the advisability of making an exemption will be examined.

## 2. *Independent Checks on Management*

Section 10 contains an interweaving of provisions, with a definite inclusion-exclusion framework. The section can first be discussed from the standpoint of whether the investment company is or is not a "no-load."<sup>195</sup> If it is a no-load fund, then section 10(d) would permit one unaffiliated director,<sup>196</sup> whereas otherwise no more than sixty percent could be affiliated.<sup>197</sup> The bank, however, could not profit from the section 10(d) provision because of an additional requirement that the investment advisor<sup>198</sup> be engaged principally in the business of rendering investment supervisory services.<sup>199</sup>

Citibank had requested that it be granted an exemption from the preceding requirement and also the requirement that, as investment advisor, it be registered under the Investment Advisers Act. The main arguments on this were presented in the briefs of the parties before the SEC;<sup>200</sup> they were very legalistic. While recognizing that the Citibank plan is a no-load fund, the SEC denied the request for exemption. The SEC's rationale was that the exemption was not necessary to operate the fund under the rulings of the banking agencies.<sup>201</sup> The SEC was not moved by the bank's argument that the account was similar to the no-load funds for which the section was designed.<sup>202</sup>

Once the initial hurdle of the load-no-load argument is overcome, it is possible to consider the more important aspects of whether the actual relationships that would be present between the account and the bank would be similar to those sought to be precluded by the Act.

Without the availability of section 10(d), the provisions of section 10(a) be-

193 *Survey* 802.

194 *See Hearings on S. 3580 Before the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 1116 (1940) (statement of David Schenker).

195 "Load" is the industry term to refer to a percentage sales charge extracted from the wary or unwary investor. "No-load" funds, therefore, are those on which no sales charge is levied. The major difference, other than direct cost to the investor, is that the "load" funds have great numbers of salesmen out encouraging investment. For a discussion of selling tactics see *Survey* 828-33.

196 Investment Company Act of 1940 § 10(d), 15 U.S.C. § 80a-10(d) (1964).

197 *Id.* § 10(a), 15 U.S.C. § 80a-10(a) (1964).

198 For a definition of "investment advisor," see *id.* § 2(a)(19), 15 U.S.C. § 80a-2(a)(19) (1964). Note that section 2(a)(11) specifically excludes banks from the definition of investment advisor. 15 U.S.C. § 80a-2(a)(11) (1964). Also, the Investment Advisers Act in section 202(a)(11) specifically excludes banks from its definition. 15 U.S.C. § 80b-2(a)(11) (1964).

199 Investment Company Act of 1940 § 10(d)(2), 15 U.S.C. § 80a-10(d)(2) (1964).

200 The briefs presented by the parties are reprinted in *1966 Senate Hearings* 187-579.

201 *Id.* at 87.

202 *Id.*

come applicable. Section 10(a) provides that no more than sixty percent of the directors of an investment company can be affiliated.<sup>203</sup> The provision is quite broad and includes within its prohibitions even the association of the employees of the advisor. Without any exemption from this section the provisions would apply full force to any advisory board for a Type III account. No one has argued the applicability of this section; although Citibank assumed, in its original application, that because of its requested exemption from section 10(d) the provision would not be applicable.<sup>204</sup>

Section 10(b)<sup>205</sup> contains a juxtaposition of requirements relating to the composition of the board in relation to the investment company's broker, underwriter, or any investment banker. This provision is a furtherance of the overall aim to maintain a more independent board of directors by divorcing it from unnecessary relationships with individuals who are primarily engaged in active securities dealings. In particular, the primary evil sought to be eliminated was the situation where the advisor or other "inside" group gained control over the board then established a long-term management contract with the advisor — to the advisor's, not the fund's, benefit. Through retained control and assorted renewal clauses, there was an effective perpetuation of management.<sup>206</sup>

There are three basic prohibitions in section 10(b) generally prohibiting a majority of the board of the investment company from being associated with any regular broker of the company, the principal underwriter of the company, or with investment bankers.<sup>207</sup> The first prohibition, that of association with any regular broker of the investment company, is of little application to the internal management structure of the proposed Type III accounts. This provision would not, per se, preclude the existence of the account.

The requirement that a majority of the board not be associated with any principal underwriter, however, might just preclude such an account. Section 10(d) contained an exemption from section 10(b)(2); but if the provisions of section 10(d) are not available, then section 10(b)(2) will prohibit the existence of the account under the present regulations which establish the authority for banks to operate such an account.<sup>208</sup>

Within the Act, the term "underwriter" means, *inter alia*, a person who has a direct or indirect participation in the distribution of a security.<sup>209</sup> The bank, as previously discussed, is dealing with a security.<sup>210</sup> Since the account is a security and the bank is engaged in distributing it — that is, the bank is the one who is obtaining "purchasers" for the security — the bank falls within the

203 Investment Company Act of 1940 § 10(d), 15 U.S.C. § 80a-10(d) (1964).

204 1966 Senate Hearings 180.

205 Investment Company Act of 1940 § 10(b), 15 U.S.C. § 80a-10(b) (1964).

206 See Survey 800-801. See also SEC INVESTMENT TRUSTS AND INVESTMENT COMPANIES, PART THREE, H.R. DOC. NO. 279, 76th Cong., 3d Sess. 1921 (1940) [hereinafter cited as INVESTMENT TRUSTS III].

207 Investment Company Act of 1940 §§ 10(b)(1), (2), (3), 15 U.S.C. §§ 80a-10(b), (1), (2), (3) (1964).

208 Regulation 9 requires that the bank administering a collective investment fund have exclusive management of the account. 12 C.F.R. § 9.18(b)(12) (1969).

209 Investment Company Act of 1940 § 2(a)(38), 15 U.S.C. § 80a-2(a)(38) (1964).

210 The definitions of the word "security" in the Securities Act and in the Investment Company Act are identical. Compare Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1964) with Investment Company Act of 1940 § 2(a)(35), 15 U.S.C. § 80a-2(a)(35) (1964).



meaning of the term "underwriter" for the purposes of the Act. As an underwriter, the bank would therefore be prohibited from having control of the board of the account.

The purpose of the section, however, was to prevent the evils of perpetuation of control. To justify any exception, either these evils must not be present in the structure of the Type III account or there must be sufficient additional safeguards to warrant a departure from this requirement. Is the nature of the account such that the danger of a "rubber-stamp" management is likely? As a practical matter, the various opponents have not considered this question, and the exemption granted Citibank was an afterthought amounting almost to an admission of oversight. When the SEC granted the Citibank application, but denied the section 10(d)(2) exemption, it failed, at that time, to grant the section 10(b)(2) exemption. Five days after the original exemption was granted, SEC added an exemption for section 10(b)(2).<sup>211</sup> This, however, does not speak to the propriety of the exemption.

The first of the two possible reasons for excepting the account from section 10(b)(2), that of the account not containing the evils sought to be prevented, would appear to be one solution. The Type III account is, at least in the mind of the bankers, somewhat different than the traditional mutual fund. It is not administered or governed with the same philosophy. The Type III account can be distinguished in that there is no active selling effort to encourage customer investment, there are no commissions, there is no management charge against the fund, the account is not subjected to the daily evaluations which are characteristic of mutual funds, there is no traditional certificate of ownership, and there is a minimum participation requirement.<sup>212</sup> To this, one may add that there is no ease of redemption commonly found in the more popular open-end investment companies.<sup>213</sup> These differences, though not sufficient to constitute a creature different in substance from the traditional investment company, do indicate that there is some inherent difference. To this, one must add the consideration that the Type III account will be part and parcel of a bank trust department and as such will be subject to extensive review by the banking authorities<sup>214</sup> — a review on a standard of care which is far above that ordinarily imposed on the traditional mutual fund. Under the Act, the investment advisor, *inter alia*, would be liable if the SEC found "gross misconduct or gross abuse of trust."<sup>215</sup> The trust department of a bank is, on the other hand, subjected to the trustee's fiduciary standards.

Because of this higher standard of duty applied to the trust account, it would be safe to assume that the evils of self-perpetuation of management would be less opportune. There is additional weight to be attached to the difference between the Type III account and an investment company in the method of supervision that the federal laws provide. The securities laws are basic disclosure laws and rely on this medium for investor protection. The banking laws,

211 1966 Senate Hearings 81.

212 *Id.* at 45-46.

213 COMMINGLED INVESTMENT ACCOUNT OF FIRST NATIONAL CITY BANK, PROSPECTUS, December 31, 1968, at 12 [hereinafter cited as CITIBANK PROSPECTUS].

214 See 1963 House Hearings 43 (statement of James J. Saxon).

215 Investment Company Act of 1940 § 36, 15 U.S.C. § 80a-36 (1964).

on the other hand, are closely associated with in-depth examinations of the operation of the bank trust department to assure that it is operating in a proper manner.<sup>216</sup> These more meaningful and more detailed checks of the operation of the trust department would provide a greater means of investor protection, even without the safeguards provided by section 10(b)(2).

The second possible reason for permitting the exception, that additional safeguards would exist, has thus also been answered by the very nature of the account and the supervision that exists to protect the investor. From this, it is then safe to conclude that an exemption from section 10(b)(2) — permitting the account to have a majority of its directors from its principal underwriter — would be permissible.

The third prohibition of section 10(b) is that the investment company cannot have a majority of its board from investment bankers or affiliated persons of an investment banker.<sup>217</sup> This prohibition, too, was meant to eliminate the evils associated with perpetuation of the investment advisor through domination of the investment company's board.

An "investment banker" for purposes of the Act refers to any person who is engaged in underwriting securities issued by other persons.<sup>218</sup> Since the banks are authorized to underwrite federal and municipal bonds,<sup>219</sup> they are "investment bankers" within the meaning of the Act and therefore by the literal language of the Act precluded from holding a majority of the board in the Account. The purpose of this section was made quite clear by David Schenker, a Commission spokesman before the House hearings on the bill that eventually became the Act:

Still another example, which is akin to the type of abuse or deficiency prevailing in the broker relationship is where the company is controlled by an investment banker. The investment banker may be impelled to have the investment company make an investment, not based upon investment quality of that investment, but because the particular investment may give him an "in" to get the banking business from the company whose securities the investment company bought.<sup>220</sup>

The argument of the banking industry is that while the prohibition might appear to preclude their activity, the investment banking activity of the bank is so limited that there would be no possibility "of the Bank's underwriting the type of unsound speculative investments which led to some of the abuses of the 1920's and 1930's."<sup>221</sup> Moreover, the banks assert that the additional provisions of section 10(f) will afford the necessary protection.<sup>222</sup>

Section 10(f)<sup>223</sup> provides that an investment company may not acquire any security during the existence of an underwriting syndicate where the prin-

216 See 1964 House Hearings 104 (statement of William McChesney Martin).

217 Investment Company Act of 1940 § 10(b)(3), 15 U.S.C. § 80a-10(b)(3) (1964).

218 *Id.* § 2(a)(20), 15 U.S.C. § 80a-2(a)(20) (1964).

219 1966 Senate Hearings 397.

220 Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 110 (1940) [hereinafter cited as 1940 House Hearings].

221 1966 Senate Hearings 212.

222 *Id.*

223 Investment Company Act of 1940 § 10(f), 15 U.S.C. § 80a-10(f) (1964).

principal underwriter is also associated with the investment company. This, as the fund industry aptly points out, does not cover the situation where the bank is acting as a mere underwriter, and not principal underwriter<sup>224</sup> — a function which the Act distinguishes. In granting the exemption from this section, the SEC noted:

We do not think there is any basis for concern that the Bank, *qua* investment banker, can or will use the Account to its advantage, particularly since the Account is primarily a stock fund and the Bank is limited to underwriting debt securities of governmental authorities.<sup>225</sup>

This would appear to be a rational approach to the issue presented. The underlying evil was the foisting of highly speculative securities on the investment company, and this would seem hardly likely where the bank's underwriting is limited to high-grade municipal and government bonds. The arguments presented against this exemption were to the point of being moot. The underlying intent of the section should be the determinative factor in granting any exemption; this is the approach taken by the SEC.

To summarize, then, the provisions of section 10 constitute a broad range of prohibitions aimed at divorcing investment companies from the evils which proved themselves to be so present when those associated with the underwriting and distribution of speculative securities became associated with a large institutional purchaser. The banks have sought several exemptions, mainly from the provisions which prohibit them, as underwriters of the "security" of the fund and as investment bankers underwriting government bonds, from engaging in Type III account activity. The exemptions have been granted, one on the basis of clear rationale, while the other was an action necessitated by the overall granting of permission to engage in such activities. They do not constitute a major obstacle to permitting banks to engage in this type of activity, they only appear to do that because of the intermingling of several provisions within the one.

### 3. *Prohibitions Against Self-dealing*

Section 17<sup>226</sup> prohibits a multitude of transactions between certain affiliated persons and underwriters. These prohibitions include specified sales, purchases, and loans between a controlled person and the underwriter or a person affiliated therewith; the other provisions are very detailed and, while applicable, have no bearing on whether or not the Type III account should be permitted to operate within its intended sphere.

At the outset, it must be established that Citibank and the banking industry in general have not sought exemption from these provisions; the fund industry has not alleged that they would per se exclude the accounts from operating. What is important, then, is that in promulgating regulation 9, the Comptroller established certain criteria which came very close to violating the spirit of these prohibitions.

224 1966 Senate Hearings 281, 326-31.

225 *Id.* at 81.

226 Investment Company Act of 1940 § 17, 15 U.S.C. § 80a-17 (1964).

In section 9.12 of regulation 9,<sup>227</sup> the Comptroller has provided that banks with fiduciary accounts, which includes Type III accounts, may sell assets held by it as fiduciary in one account to another account, or may make a loan from one account to another account, or may make a loan from the bank's own assets to the account and take as security the assets of the account.<sup>228</sup>

Section 17 applies to transactions between the investment company and the underwriter or any person affiliated therewith. Under the Act,<sup>229</sup> an affiliated person is one who is controlled, either actually or through a set five percent stock ownership, or by being an officer or director of the other person, or as an investment advisor of the other person, or finally as a depositor of the other person where the other person is an investment company. As applied to the Type III account, it would be "affiliated" with the bank because the bank serves as an investment advisor. If the bank held two or more Type III accounts, these would be affiliated persons because they are both under the control of the bank, thereby meeting the definitional requirements. Because the Type III account meets the requirements of the section, the prohibitions therein are applicable; and any transaction under the authority of regulation 9.12 would be unauthorized. This is specifically prohibited under section 17(a)(1). The Act does contain a provision whereby such transactions can be exempted; this is found in section 17(b).<sup>230</sup>

The importance of this subsection consideration to the account is that the apparent carte blanche authority granted to the banks in regulation 9, as to dealings with other fiduciary accounts, will not be as readily available to the Type III account as to Type I or II accounts.

#### 4. Board Domination by Bankers

Under section 10(c),<sup>231</sup> a majority of the board may not be persons who are officers or directors of any one bank. This section could have been treated under the discussion on independent checks on management; however, because of its peculiar applicability to the Type III account, it is being treated separately. It is nothing more than an additional provision which continues the policy that the investment company should not be dominated by a special interest group.

Congress had a special interest in inserting this provision. As stated by David Schenker, SEC spokesman, in hearings before the House subcommittee considering what would eventually become the Act:

Subsection (c) . . . was inserted not only on the basis of our study, but after conferences with the Federal Reserve Board. There were very undesirable consequences flowing from interlocking directorships or interlocking relationships between commercial banks and investment companies. Some of the worst examples of abuses we had in the whole study arose out of that rela-

227 Regulation 9, 12 C.F.R. § 9.12 (1969).

228 *Id.* § 9.12(d), (e), (f) (1964).

229 Investment Company Act of 1940 § 2(a)(3), 15 U.S.C. § 80a-2(a)(3) (1964).

230 Section 17(b) provides: "(b) Notwithstanding subsection (a) of this section, any person may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of said subsection." 15 U.S.C. § 80a-17(b) (1964).

231 Investment Company Act of 1940 § 10(c), 15 U.S.C. § 80a-10(c) (1964).

tionship and the Federal Reserve Board, as well as ourselves, felt that in the future there should not be that close relationship.<sup>232</sup>

This position was among the more formidable offered by the fund industry. After citing a number of quotations which would indicate that Congress intended that an investment trust should not be an adjunct to another business, the fund industry concluded:

The foregoing demonstrates with a certainty that Congress intended the flat and inexorable prohibition contained in section 10(c) . . . . The statute expresses the Congressional determination that an investment company shall not have a board dominated by the directors and officers of any one bank.<sup>233</sup>

In raising this argument, the fund industry introduced a concept not yet dealt with — that of the investment trust. This term, because of some rather loose terminology in the pre-1940 period, is synonymous with the term investment company.<sup>234</sup>

The banking industry, in its arguments, recognized that this was the underlying purpose of the section; but it countered with the contention that to properly understand the section one should look into the nature of the abusive organizations, the securities affiliates.

Such companies were essentially security affiliates, primarily engaged in long-term capital financing, underwriting and other investment banking operations, but also engaged in some investment company activities such as buying and selling securities for investment or speculative purposes . . . .

[T]he experience of some bank-affiliated investment companies was analyzed. Abuses were disclosed which were substantially of the same character as those disclosed with respect to many investment banking houses . . . .

The Commingled Account bears no resemblance to these earlier investment trusts.<sup>235</sup>

Rather, the banks argue, the Type III account is more akin to the common trust fund which was specifically exempted by the Act.<sup>236</sup> And, since the account bears such a similarity in characteristics, they argue, it too should be eligible for an exemption.<sup>237</sup> This contention that the account bears no resemblance to the earlier trusts was supported by the SEC's Division of Corporate Regulation. In its brief, it noted that in the very hearings on which the fund industry relied there had been definite reference to the activities being those of the securities affiliates.<sup>238</sup>

When the SEC granted an exemption from section 10(c) in the Citibank application, it relied on the fact that

232 1940 House Hearings 110-11.

233 1966 Senate Hearings 317-18.

234 See Survey 737 n.4, for a full explanation of the interrelation between the terms "mutual fund," "investment company," and "investment trust."

235 1966 Senate Hearings 220-22.

236 Investment Company Act of 1940 § 3(c)(3), 15 U.S.C. § 80a-3(c)(3) (1964).

237 1966 Senate Hearings 222-23.

238 *Id.* at 389.

[i]t does not appear that it was directed at the type of open-end investment company represented by the Account . . . . Moreover . . . it is clear that the Account is substantially different, both in purpose and nature of operation, from the bank-dominated investment companies described in this Commission's Report . . . which led to the passage of the Act, and in the testimony at the Congressional hearings.<sup>239</sup>

The SEC's findings are worthy of consideration. As has been established, one of the prime areas of abuse by the banks was the misuse of the securities affiliate. It has been established that the bank-sponsored investment company was part and parcel of this affiliate in many instances. With this as a background to the enactment of the section, there can be little doubt that Congress sought to prohibit these abuses. Also, there is considerable weight to the argument, asserted by the banks, that the Type III account is in substance similar to the already exempted common trust fund. The common trust fund is, as a practical matter, a commingling of the assets of trusts held under a true trust relationship — that is, without an investment motive being the prime objective. The only substantive similarity between the two is that the Type III account has, at its origin, the investment motive whereas the common trust fund, or Type I account, has a "bona fide fiduciary purpose" at its origin.<sup>240</sup>

Therefore, it is apparent that there was considerable rational authority behind the exemption granted by the SEC when it permitted the Citibank Account to operate without meeting the requirements of section 10(c). Many of the exemptions granted by the SEC may not seem, to a particular individual, to be the best decision. However, it must be remembered that the overall operation of the account, its overriding purpose, had been approved by the banking authorities as a normal extension of banks' activities, and there was no good reason for the SEC to attempt to prevent that which another responsible agency felt, in its best judgment, did not constitute a violation of its peculiar laws. This does not, because of the advantages of dual regulation, constitute anything akin to the dangers sought to be prevented by the securities laws; and the SEC was entirely justified in granting these limited exemptions.

#### F. Conflicts of Interest

Thus far, the major concern has been the applicability of various statutes; these statutes might have prevented the operation of the Type III account. According to the interpretation given them by the various agencies and the courts, they have not been so applied. In addition to this consideration, the Congress could at any time act to change any provision of the statute in question so as to permit the operation of the account. These statutes reflect no more than the public policy toward certain activities as it existed at the time the statute was enacted; whether this public policy is a viable force today is another question. The remaining two areas — those of conflicts of interest and dangers of concentration — may well be the testing ground for that question.

The term "conflict of interest" is, by and large, one of the most commonly

<sup>239</sup> *Id.* at 85.

<sup>240</sup> 1963 *House Hearings* 37 (statement of James J. Saxon).

used hypergeneralities in this field. An occasional reference to it is, to some, the same as a devilish incantation which will bring to the hearer's mind the appropriate concepts of those with vested interests secretly plotting to deprive those with whose interest they are charged of that which is rightfully due to them — often conceived and implemented in small, dimly lit, cigar (the one-dollar variety)-smoke-filled rooms somewhere within the bowels of Wall Street.

The arguments that the bank commingled managing agency accounts would raise serious conflicts have fallen into several discernible categories of undesirable conflicts that might exist between the bank as trustee of the account and the bank as an ongoing business. The major arguments were summarized in Chief Judge Bazelon's concurring opinion in *NASD v. SEC*.<sup>241</sup> They include the dangers associated with retention of substantial cash deposits of the account, the use of the account funds to shore up loans, purchase of securities underwritten by the bank, and allocation of brokerage.

Before discussing each of these areas individually, it should be noted that one prominent attorney, familiar with the mutual fund industry, has raised some question as to the validity of their asserting that the bank would be subject to serious conflicts of interest. He has recently stated:

[M]utual funds, unique of all corporate creatures in America, are just rife with conflicts of interest. All companies have some of it, . . . but conflict of interest is a very specific affliction of the mutual fund . . . .

. . . .  
So, you have a built-in conflict of extraordinary proportions, and the records of my litigations and the records before you show that these men have not been modest or temperate . . . .<sup>242</sup>

However unworthy the fund industry to raise the issue, it is nevertheless one which must be considered. The areas of conflict outlined have been long recognized as the principal ones which must be dealt with if the banks are to operate these accounts.<sup>243</sup>

### 1. *Excess Cash Holdings*

The possible danger in this connection is that the bank could possibly hold excess amounts of cash from active investment; the detriment to the fund would be lack of capital appreciation or dividends, while the bank could gain because the deposits could be used to establish or affirm its needed cash reserves with the Federal Reserve. This argument has not been actively pursued by the funds themselves, but has rather been the carry-over from that original statement of Chairman Cary in 1963.<sup>244</sup>

The opinion of Chief Judge Bazelon dismissed the contention by noting that the keen competition with the mutual fund industry would be a negative factor militating against the bank's pursuit of this objective.<sup>245</sup> This argument, while

241 *National Ass'n of Sec. Dealers v. SEC*, 420 F.2d 83 (D.C. Cir. 1969).

242 *1969 Senate Hearings* 168 (statement of Abraham Pomerantz).

243 *1963 House Hearings* 11-12 (statement of William L. Cary).

244 *Id.*

245 420 F.2d at 93.

perhaps practically of some significance, does not assure the investor that the bank might not opt for the higher return on loans over the modest return on trust investments. The better answer is that, first, the provisions of regulation 9 specifically provide that such funds "held in a fiduciary capacity by a national bank awaiting investment or distribution shall not be held uninvested or undistributed any longer than is reasonable for the proper management of the account."<sup>246</sup> In addition, the account offered by Citibank, for example, specifically states that its investment policy "is to invest in securities which offer the opportunity for long-term growth of capital and of income."<sup>247</sup>

While the provisions of regulation 9 would be applicable to investors who dealt with national banks and assure those investors of adequate protection, the general provisions of the prospectus would also serve to protect all of the investors. Since the Type III account is a security within the meaning of the Securities Act of 1933,<sup>248</sup> must be registered under that Act,<sup>249</sup> and protective remedies would be available to the investor under section 12,<sup>250</sup> which would allow the injured investor to seek rescission.

In granting the original exemptions, SEC commented that it believed that "substantial safeguards are present here against conflicts of interest which could arise . . . ." <sup>251</sup> The Commission felt that the fiduciary responsibilities of the bank would provide the additional safeguards necessary to assure that investors were afforded adequate protection.<sup>252</sup>

There is little discussion of the use of cash reserves throughout the various opinions and hearings. The initial reaction is that the issue is no longer one of major concern; but the more likely answer is that the fund industry has found a new and better method of attacking the approval of such account. There would seem to be little doubt that the periodic examinations which the Comptroller makes of national bank trust departments<sup>253</sup> would be an effective means of securing adherence to the regulation 9 provisions.

While there would be some form of inspection and therefore some safeguards for the investors through a national bank, there remains the issue of the protections which would be available to the investor under state banks. At the outset, it must be clearly established that regulation 9 does not authorize state banks to establish commingled investment accounts. The regulation deals exclusively with national banks. In setting forth the powers which are available to the national bank acting as a fiduciary, the regulation provides that "a national bank may be authorized to act . . . as . . . managing agent or in any other

246 Regulation 9, 12 C.F.R. § 9.10(a) (1969).

247 CITIBANK PROSPECTUS 2.

248 See text accompanying note 148 *supra*.

249 Registration is required under the Securities Act, section 5, 15 U.S.C. § 77e (1964). The Investment Company Act, section 24, provides certain exemptions for registered investment companies from registering under the Securities Act, which the investment company may elect in lieu of the requirement under the Securities Act. These provisions are generally designed to accommodate the nature of the investment company. 15 U.S.C. § 80a-24 (1964). See SEC Investment Co. Act Release No. 40-2621 (November 5, 1957).

250 Securities Act of 1933, section 12, provides civil remedies for false or misleading statements of material facts. 15 U.S.C. § 77l (1964).

251 1966 Senate Hearings 85.

252 *Id.* at 86.

253 National bank trust departments are examined at least three times every two years. Glass-Steagall Act of 1933 § 28(a), 12 U.S.C. § 481 (1964). See also 1964 House Hearings 77.



fiduciary capacity which state banks . . . coming into competition with the national bank may exercise under local law . . . .<sup>254</sup> Therefore, the national bank's powers are predicated on the banks of the particular locality having that power under state law. However, if state law does permit the state banks to operate the Type III account, there may still be federal protection for the investor. Under the Federal Reserve Act,<sup>255</sup> section 9 provides that one of the conditions of membership is that the member bank will be subject to examinations by the Board of Governors of the Federal Reserve System.<sup>256</sup> Since the proposed account and the legislative and legal arguments are centered entirely in the national sphere, discussion of the aspects of the state-chartered banks will be limited to the foregoing.

The danger of excess cash holdings would be present in any trust account operation. According to the Comptroller's office:

The pooling by banks of small fiduciary accounts into more economically manageable units . . . is nothing more than the combination of two financial services which the banks have made available to their customers for many years. . . . We have supervised these activities for years and believe that the record shows that no abusive practices have developed. We are confident that the extension of these services . . . can be done without danger of abuse developing.<sup>257</sup>

There are protections available to the investor, including the federal examinations of the bank's activities on a rather intensive scale. Moreover, the investor has the protection of the available remedies under the Securities Act of 1933<sup>258</sup> for rescission, or under the Investment Company Act,<sup>259</sup> were that the registration vehicle. It would therefore appear that, for those dangers which might be present, there are either existing remedies available to assure investor protection or that the experience of the banking officials has been that such practices are not prevalent.

## 2. *Loans to Shore Up Investments*

Within this abuse there is also the possibility of the reverse — investments to shore up loans which the bank may have made. These abuses are not new. They constitute a real threat; the fact that the bank has discretionary investment powers will itself be sufficient to constitute the threat. There were no formal fund industry arguments based on this point. Under regulation 9, the banks are prohibited from self-dealing without authority in the instrument creating the relationship, or by local law, or by special court order.<sup>260</sup> The prohibitions against self-dealing include investment in

stock or obligations of, or property acquired from, the bank or its directors,

254 Regulation 9, 12 C.F.R. § 9.1(c) (1969).

255 Federal Reserve Act of 1913, 12 U.S.C. §§ 221-522 (1964).

256 *Id.* § 9, 12 U.S.C. § 325 (1964).

257 438 *Hearing* 1229 (statement of Dean E. Miller).

258 Securities Act of 1933 § 12, 12 U.S.C. § 77l (1964).

259 Investment Company Act of 1940 § 49, 15 U.S.C. § 80a-49 (1964).

260 Regulation 9, 12 C.F.R. § 9.12(a) (1969).

officers, or employees, or individuals with whom there exists such a connection, or organizations in which there exists such an interest, as might affect the exercise of the best judgment of the bank in acquiring the property, or in stock or obligations of, or property acquired from affiliates of the bank or their directors, officers or employees.<sup>261</sup>

This rationale was sufficient protection, in the eyes of the SEC, to authorize Citibank to operate the Type III account.<sup>262</sup> It would offer the investor protection against such discovered activities, and the rather thorough examination procedure applied against the national banks would assure some additional protection. There would be additional protection from the Investment Company Act. Section 17<sup>263</sup> of the Act would prohibit certain transactions between the company and certain affiliated individuals and underwriters. Moreover, section 21 of the Act prohibits loans from the investment company either where the stated investment policies do not permit it or where the borrower is under common control with the investment company. Thus, account funds could not be used, per the Act, in a loan to the bank or any other account where there was common control.

The Board of Governors has indicated that it does not consider the dangers that might be present to be significant.

In the case of managing agency funds, an additional safeguard is the prophylactic restrictions and requirements of the Investment Company Act of 1940, particularly the publicity of the financial transactions of registered investment companies, which almost inevitably would expose such malfeasance. A further deterrent would be the adverse impact on a collective fund's performance — its comparative financial record — if any of its resources were used to make unprofitable investments . . . .<sup>264</sup>

The federal agencies have recognized that the operation of Type III accounts by banks would involve certain risks, but they contend that this would be true whenever a bank or other organization expands the scope of its services.<sup>265</sup>

With respect to the instant proposal, the Board of Governors concludes that the probable benefits to the public from increased competition are substantial and that the risks are relatively less significant. The Board therefore favors the objective of the Amendments to authorize banks to establish and operate investment funds similar to conventional mutual funds.<sup>266</sup>

### 3. *Purchase of Underwritten Securities*

One of the evils encountered in the growth of the investment company industry was the number of abuses which surrounded self-dealing transactions. One of the more common was the use of the investment company as a "dumping ground" for securities.<sup>267</sup> These abuses are akin to those associated with the

261 *Id.*

262 1966 *Senate Hearings* 86.

263 Investment Company Act of 1940 § 17(a), 15 U.S.C. § 80a-17(a) (1964).

264 1969 *House Hearings* 133.

265 438 *Hearing* 1225 (statement of William McChesney Martin).

266 *Id.*

267 *See* INVESTMENT TRUSTS III 2589-2624.

discussion of section 10(b)(3).<sup>268</sup> This would be particularly true in the "dumping" situation.

The SEC granted the bank an exemption from section 10(b)(3) with little or no discussion. It concluded that the same reasons for granting the exemption would apply to the argument that there were "dumping" dangers.<sup>269</sup> In addition to this shoddy rationale, there are additional safeguards available to the investors.

The provisions of regulation 9, those applicable to the dangers that banks would use the funds to shore up loans, would also be applicable here.<sup>270</sup> So would the protective provisions of section 17 of the Investment Company Act.<sup>271</sup> There is the additional consideration that the underwriting authorized for national banks is that of debt securities of governmental authorities, and not the more speculative securities which were inherent in the abuses of the pre-1940 era. It can hardly be contended that the investment in this type of security represents the highly speculative activity which precipitated much of the trouble leading up to the passage of the Investment Company Act.

#### 4. Allocation of Brokerage

This brief phrase is representative of a practice whereby an institutional investor schedules the purchase of securities through select brokerage houses, or in some instances through what is termed reciprocal business.<sup>272</sup> With banking funds, this takes on something more sinister. Not only might the bank demand special services, such as a special effort in selling the bank's own equity securities, but there could also be instances where the bank might insist that the brokerage house maintain substantial cash deposits on reserve, thus furthering the bank's reserve stature and making loan funds more available.

Under the Investment Company Act, a company may register in one of two ways. It may either file Form N-8B-1 under section 8(b), or it may rely on a registration previously made under the Securities Act of 1933. In either of these approaches, the investment company will be required, by the Securities Act of 1933, to have a prospectus prepared and use the prospectus in all solicitations.<sup>273</sup> Part of the data required in the prospectus is the plan for allocation of brokerage.<sup>274</sup> These statements of brokerage policy, while differing in form, are all carefully worded to permit a wide range of activities.

268 See text accompanying notes 217-25 *supra*.

269 1966 Senate Hearings 86-87.

270 See text accompanying note 260 *supra*.

271 Investment Company Act of 1940 § 17, 15 U.S.C. § 80a-17 (1964).

272 In its simplest form, reciprocal business in the "practice of executing investment company portfolio transactions through the broker to be rewarded." *Survey* 883 n.1012. See also H.R. REP. NO. 2337, 89th Cong., 2d Sess. 162 (1966) [hereinafter cited as PUBLIC POLICY STATEMENT]. The practice of customer-directed "give-ups" was voluntarily ended in December, 1968, under pressure from the SEC. There has been a recent effort by the smaller dealers, who were the ones to suffer from the elimination of the "evil," to recover some of the lost funds. These securities brokers have banded into a cooperative known as IBDA Inc., and it began operation in March of 1970. The intent is to attract brokerage business from the funds and other institutional investors. See *Wall Street Journal*, March 30, 1970, at 4, col. 3.

273 Securities Act of 1933 § 5(b)(1), (2), 15 U.S.C. § 77e(b)(1), (2) (1964). See SEC Securities Act Release No. 4697 (May 28, 1964).

274 Under the requirements of Form S-1, one of the mandatory items in all prospectuses is

Dealers who sell fund shares may receive or participate in brokerage commissions on purchases and sales of portfolio securities by the Fund and may receive portions of such commissions given up . . . . Primarily, the Management Corporation will seek the most favorable prices and execution of orders. As secondary considerations, however, the Management Corporation may consider the relative sales of Fund shares and the furnishing of statistical and research information and publications, assistance in promoting the sale of Fund shares, and other services . . . .<sup>275</sup>

Although quite indefinite, this statement is perhaps one of the most definite and outspoken that the investor could encounter. Consider:

The primary consideration in all portfolio security transactions is execution at the most favorable prices and in the most effective manner possible . . . . When this primary consideration has been satisfied, the Fund will, in the allocation of portfolio brokerage commissions, consider statistical and other factual information and services provided by broker-dealers to the Fund.<sup>276</sup>

Ironically, they both mean the same thing. The statement prepared by FNCFB is comparable:

In placing orders . . . the Bank's primary objective is to obtain the most favorable prices and execution of orders available. While there is no undertaking or agreement to do so, it is the Bank's practice to place a major portion of such brokerage business with brokers and dealers who supply supplementary research and statistical information or market quotations to the Bank's Investment Management Group.<sup>277</sup>

There would appear to be considerable leeway in this statement too—does the fact that a brokerage firm supplies market quotations entitle it to special consideration in placing portfolio orders?

In any event, there is some disclosure of the actual allocation policy of the fund. Any remedy available to the investment company shareholder is under section 36 of the Act, which provides a federal standard of fiduciary duty amounting to "gross abuse of trust."<sup>278</sup> This falls somewhat short of the fiduciary duty of a trustee. The remedy in the statute, section 36(2),<sup>279</sup> is an authorization for the SEC to seek an injunction against the individual or company from acting in the capacity of officer, director, underwriter, etc., for a specified period.

The real protection for the investor in this area is in alleging that the concerned individual has breached a fiduciary duty owed him. This is not, however, actionable under the Investment Company Act; in *Brouk v. Managed Funds, Inc.*,<sup>280</sup> the argument was made that the Act impliedly set out a cause of action for a civil remedy. After investigating the legislative history of the Act, the court concluded:

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the plan of distribution of securities. See also Investment Company Act of 1940 § 8(b)(1), 15 U.S.C. § 80a-8(b)(1) (1964).

275 THE ONE HUNDRED AND ONE FUND, INC., PROSPECTUS, January 9, 1969, at 9.

276 MASSACHUSETTS INVESTORS SPECIAL FUND, PROSPECTUS, July, 1968, at 7 (red hering).

277 CITIBANK PROSPECTUS 8-9.

278 Investment Company Act of 1940 § 36, 15 U.S.C. § 80a-36 (1964).

279 *Id.* § 36(2), 15 U.S.C. § 80a-36(2) (1964).

280 286 F.2d 901 (8th Cir. 1961), *vacated as moot*, 369 U.S. 424 (1962).

The Act they rely on not only contains no such provision but plainly negates any intent to create such an innovation. The reliance upon implication to support the jurisdiction [of the court] is not justified in the face of legislative intent to exclude it.<sup>281</sup>

As applied to the Type III account, allocation represents as real a problem as it does when applied to the traditional investment company; it also poses the additional problems of bargaining for deposits. There has been pitifully little discussion of this issue; again the fund industry seems to have found a more effective approach.

The dangers represented by allocation are, of course, also present where the bank has other trust department business. The protections available to the *cestuis* of those accounts lies in the duty the bank owes them as trustee. This, alone, has been sufficient to protect these investments; there should be little doubt that there would be any increased danger in the area of allocation where a bank also enters the field of commingled managing agency accounts. There has certainly been no allegation that the account itself would constitute a greater danger; rather the allegation made in all of the arguments is that the account, as an investment company, is dangerous.

There was some contention that the Type III account would not be one within the parameters of a trust relationship.<sup>282</sup> The contention of the Investment Company Institute was that, according to Scott, there was a difference between an agency agreement with a customer to manage an investment account and the responsibilities of an institution as trustee.<sup>283</sup> The contention was that without an express agreement that there was a trust relationship, the bank acting as agent would not be held to the strict trustee standards. While this argument is persuasive at first blush, the Institute seemingly ignored the provisions of regulation 9:

(a) Where not in contravention of local law, funds held by a national bank as *fiduciary* may be invested collectively:

(3) In a common trust fund, maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as managing agent under a managing agency agreement *expressly providing that* such monies are received by the bank *in trust . . .*<sup>284</sup> (Emphasis added.)

In addition to the protections afforded by the duty of trustee, the investor in the Type III account would also be able to assert certain remedies under the Securities Exchange Act of 1934.<sup>285</sup> Under rule 10b-5, certain manipulative devices, if used within the provisions of the Act, are unlawful.<sup>286</sup> If the investor can

281 *Id.* at 918.

282 1966 Senate Hearings 526.

283 *Id.*

284 Regulation 9, 12 C.F.R. § 9.18(a)(3) (1969).

285 Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1964).

286 Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

establish the jurisdictional grounds, he might then assert that the provision in the prospectus on brokerage allocation constituted an untrue statement of material fact or a scheme to defraud. While the Act and the rule do not specifically provide for a civil remedy under these provisions, the courts have been in accord that such exists.<sup>287</sup> A third remedy exists for the investor under the provisions of regulation 9; the bank would be violating the self-dealing provisions of the regulation.<sup>288</sup>

Therefore, it is manifestly apparent that there are more than adequate protections available to the investor in a Type III account. He would have the protection of the Investment Company Act, the Securities Act, the Securities and Exchange Act, and regulation 9. In addition, he would be able to assert a breach of fiduciary duty against the bank. The ordinary mutual fund investor would not have the protections of regulation 9, and certainly would not be able to assert the protections afforded by the fiduciary standard. If anything, the Type III investor would be in a far more advantageous position.

### 5. *Summary of Conflicts of Interest*

The contention that the account would raise certain conflicts of interest is, as has been demonstrated, a valid contention. However, each of these conflicts is also present whenever a bank operates any type of discretionary investment account for customers through its trust department. There is little doubt that the totality of bank trust department activity, considered as a percentage of the total activity in the securities markets, is considerable.<sup>289</sup> The banking authorities have been able to exert sufficient influence, through their regular examinations, to assure some degree of safety for the present trust accounts. It would not be possible to establish any investment activity, or for that matter any activity, of a commercial bank that did not involve some degree of risk. The banking authorities are aware of this; they rely on a balancing process whereby the probable gain is weighed against the probable harm and the available protective measures are considered. If the net effect is that the proposal will ultimately be of a significantly greater benefit than risk, it is approved.<sup>290</sup> This approach permits the agencies to carefully sift and evaluate the proposal and to make certain informed value judgments. It also permits the agency to prepare to bring the new venture into the regulatory scheme with some degree of control applied. As long as there are adequate prophylactic measures, there should be little hesitation in permitting the activity.

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- (1) To employ any device, scheme, or artifice to defraud,
  - (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
  - (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5 (1969).  
 287 See, e.g., *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947); *Robinson v. Difford*, 92 F. Supp. 145 (E.D. Pa. 1950); *Northern Trust Co. v. Essaness Theatres Corp.*, 103 F. Supp. 954 (N.D. Ill. 1952).

288 Regulation 9, 12 C.F.R. § 9.12(a) (1964).

289 See 1969 House Hearings 458.

290 See text accompanying note 266 *supra*.

## G. Dangers of Concentration

### 1. Introduction

The term "concentration," like "conflicts of interest," is an overgeneralization. It too can evoke emotional responses entirely out of proportion to the true meaning of the objection raised. According to the Investment Company Institute, which first made an ado about it, the term refers to the potential that banks have to dominate the commercial and financial affairs of the nation.<sup>291</sup>

This issue was not raised until late in the struggle between the fund and banking industries; it was first made a serious matter of contention in the quickly called hearings which occurred immediately after the district court rule that the operation of Type III account was contrary to the Glass-Steagall Act. It was raised again in the 1969 Senate hearings<sup>292</sup> and the House hearings<sup>293</sup> of that year; it was also made a serious contention in the 1969 hearings on amending the bank holding company legislation.<sup>294</sup> It is an issue which has not been answered, and in fact has almost been ignored entirely by the Congress. In the report which followed the hearings on S.34, the 1969 Senate bill, there was no consideration given to the argument, although the committee did make some comments about the arguments that were presented over the past three years.<sup>295</sup>

One of the reasons that the committee may not have considered that there was a meaningful issue is that the statement relating to concentration dangers was:

The questions raised, on which the experts may well take differing views, relate to (1) the further concentration of economic power in banks by permitting them to conduct an increasing number of businesses . . . which go beyond normal bank activities . . . .<sup>296</sup>

This was the totality of the argument; there can really be little criticism leveled at Congress for not picking such an isolated statement out of the hearings. In the House hearings, conducted at the end of the year, the statement was a little longer. However, the only meaningful portion stated:

If banks were permitted to control additional large holdings of equity securities through their investment companies, we believe that there could be extremely undesirable concentration of control over election of corporate directors, corporate affairs, American Industry and our economy.<sup>297</sup>

This statement, too, fails to evoke any truly startling results; it even fails to stand out from all of the pleas and allegations that the fund industry made. In these hearings, they were fighting to preserve their load figures, their management

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291 *438 Hearing* 1249 (statement of Robert L. Augenblick).

292 *1969 Senate Hearings* 90.

293 *1969 House Hearings* 458.

294 *One-bank Hearings* 335.

295 S. REP. NO. 91-184, 91st Cong., 1st Sess. 1-4 (1969).

296 *1969 Senate Hearings* 90 (statement of Robert L. Augenblick).

297 *1969 House Hearings* 458 (statement of Alger B. Chapman, Jr.).

charges, and a host of other rather profitable benefits. It is little wonder that they were not able to make their concentration argument better heard.

If the fund industry arguments were weak, they cannot be overly castigated; the banking industry was not able to muster a single argument in these hearings to counter the concentration objection. It was almost as though they were being quiet and hoping the threat would go away.

## 2. *The Concentration Issue*

When the concept of concentration is approached, parallel thoughts immediately turn to the concept of control. Where any one holder has amassed considerable holdings of a particular company or even industry, there is always the potential for exercising some degree of control or domination.

Concentration, in terms other than equity shareholdings, is an economic way of life in America. The 200 largest corporations are responsible for over half of the industrial operations in the United States; the top 500 control some seventy percent of these industrial operations.<sup>298</sup> There is the possibility of additional concentration through what are commonly called "one-bank holding companies." These are holding companies which, because of a loophole in the Bank Holding Company Act,<sup>299</sup> are able to include a single bank within a framework of non-banking corporations—something which would not be possible were the holding company to have more than one bank under its wing.<sup>300</sup> The potential dangers in a one-bank holding company have been brought to the attention of Congress.

There is no question that a one-bank holding company, with the resources of its bank, with the stockholding power in the bank's trust department, and especially if it also acquires control of mutual funds which have further stock interests, can probably attain control of any corporation in the country it really wants to get, aside from a few of the very large giants . . .<sup>301</sup>

There must be some distinction drawn here between the potential control that the one-bank holding company could initially obtain and that which the individual bank could acquire through its trust department. The essential difference lies in the fact that the holding company may acquire and actively control the management of one or more firms within a particular industry, whereas the bank trust department could only acquire stock holdings in the industry. The

298 *One-bank Hearings* 15.

299 Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-60 (1964).

300 *Id.* § 2(a)(1), 12 U.S.C. § 1841(a)(1) (1964), provides in part:

(a) "Bank Holding Company" means any company

(1) which directly or indirectly owns, controls, or holds power to vote, 25 percentum or more of the voting shares of each of two banks . . .

301 *One-bank Hearings* 9. Recent government statistics indicate that the rate of growth of one-bank holding companies has been nothing short of spectacular. In the past four years, the number of one-bank holding companies has increased tenfold. The effect of these recent hearings is reflected in a statement made public by the Federal Reserve Board, noting that the number of one-bank concerns had

accelerated sharply during the latter half of 1968 and in 1969 when many of the largest banks in the nations [*sic*] converted their corporate structure to include a one-bank holding company. *Wall Street Journal*, March 31, 1970, at 8, col. 2. There can be little doubt that the proposed legislation, with the proposed grandfather clause, stimulated many of these reorganizations.



difference in that aspect is that the bank's trust department might not be able to acquire sufficient stock holdings in the companies without the inherent danger of being locked in to the industry and unable to extricate itself in the event of a market downturn. The holding company, on the other hand, is not investing with any concept of appreciation of invested funds; rather it is actually "buying" its way into the industry and holds the equity securities purely as a control device with only secondary consideration given to investment appreciation. Because of this inherent difference, the holding company would be more likely to acquire the dominance necessary and be able to couple it with bank trust holdings to exert sufficient control throughout an entire industry.

The foregoing must not be construed to mean that a particular bank could not exert the same control as a holding company might. Banks can exert control over a corporation in any one of three ways, or more likely a combination thereof. They may inject their influence as a supplier of debt capital, through holdings of equity securities in the trust department, and through directoral interlocks.<sup>302</sup> As a supplier of capital financing, the bank can exert significant control. Although the texts do not contain any objective proof, there can be little doubt that one of the easiest ways to establish a directoral interlock is by a casual comment during loan negotiations. There are also established practices which include covenants in the loan agreement that the company will, *inter alia*, limit dividends, restrict further debt, maintain specified levels of working capital, and the like.<sup>303</sup>

The exact power that can be wielded is awesome when taken in a specific situation. According to a report of a House subcommittee staff:

The percentage of stock held in major companies by the Cleveland Trust Co. is indeed impressive. Ranging up to a single stockholding of as much as 80 percent, Cleveland Trust's potential for seriously restraining competition within a particular industry because of its interests in competing companies is quite clear. For example, Cleveland Trust holds between 10.7 percent and 38.6 percent of the common stock of three major iron ore companies [in the Cleveland area] . . . . In addition, it has a director interlock with . . . another important iron ore producer; Cleveland Trust also has director interlocks with the three other companies in which it is a major holder of common stock. Therefore, through its interlocking stockholding and director relationships this bank is in an ideal position to gather information and significantly influence, if not dominate, the activities of four competing iron ore companies.<sup>304</sup>

Thus, there is a potential for combining the various means of control to effectively amass the potential for control. In the Cleveland Trust situation, if the bank was also a major supplier of debt financing, the control would be almost complete—stock holdings in significant amounts, carefully placed director interlocks, and a stranglehold on the pocketbooks of the various firms within the

302 STAFF OF SUBCOMM. ON DOMESTIC FINANCE, HOUSE COMM. ON BANKING AND CURRENCY, 90TH CONG., 2D SESS., COMMERCIAL BANKS AND THEIR TRUST ACTIVITIES: EMERGING INFLUENCE ON THE AMERICAN ECONOMY 23-24 (Subcomm. Print 1968) [hereinafter cited as CONCENTRATION REPORT].

303 *Id.* at 23.

304 *Id.* at 632. For a discussion of the activities of the Hartford National Bank and some very intriguing interlocks in Hartford see *id.* at 666; for a similar pattern in Philadelphia see *id.* at 544.

industry, all neatly tied up in a picture of quiet domination. The companies might not even realize that they were so controlled, if it did exist.

Accepting, then, that banks do have the raw power to exert some significant degree of control over a particular industry or several industries, the relevant consideration is the extent that Type III accounts would add to this potential. Present data indicates that of the approximate \$1 trillion held by all institutional investors at the end of 1967, commercial banks hold one-fourth, or \$250 billion, in their trust departments.<sup>305</sup> This total figure can then be broken down into holdings by type of account.

#### Trust Assets by Type of Account<sup>306</sup>

Type of Account	Amount*	Percent of Total
Employee benefit accounts	\$72.9	28.8
Private trust accounts	126.2	49.8
Agency accounts	54.2	21.4
Total	\$253.3	100.0

\*Amount in billions

From this data, it is apparent that the private trust accounts presently dominate the type of holdings. It has been estimated that the pension or employee benefit accounts will constitute a major growth factor within the next decade. One projection indicates that these accounts should aggregate something in excess of \$200 billion by 1980.<sup>307</sup> This would be a healthy 175 percent increase. There has been no attempt to estimate the growth of agency accounts with the additional impact of Type III accounts. From the meager data available, it is possible to construct somewhat of a reliable estimate on the holdings by type of account in 1963.

#### 1963 Trust Assets by Type of Account<sup>308</sup>

Type of Account	Amount*	Percent of Total
Employee benefit accounts	\$43.0	29.8
Private trust accounts	75.0	52.0
Agency accounts	26.2	19.2
Total	\$144.2	100.0

\*Amount in billions

Any attempt to correlate this data without additional authority for the 1963 data would be highly speculative at best. Projections attempted from the indicated growth patterns would be inaccurate because there is no present data

305 *Id.* at 1.

306 *Id.* at 34.

307 *Id.* at 1.

308 *Cf. 1963 House Hearings* 32. This data is an estimate based on the data presented there, including their estimates, *see id.* at 32 n.10.

on the various elements which would be critical to the development of trend factors. There is no present indication of the anticipated growth of trust accounts with the advent of Type III accounts.

Since the bank is severely limited in advertising the account,<sup>309</sup> it would seem that there would be no mass movement to this investment medium. In 1967, it was indicated that ninety-three percent of mutual fund transactions were below the \$10,000 level.<sup>310</sup> Moreover, the no-load funds, which the Type III account more nearly resembles, do not represent a significant share of the mutual fund business.<sup>311</sup> There can be little doubt that the sales load has been an important factor in the growth of the fund industry.<sup>312</sup> Moreover, it is a logical conclusion that between two funds, the one with the sales force depending on the sales of the fund for its income will be the one that is sold in greater numbers. If the fund must rely on the initiative of the individual investor to seek it out, there is little likelihood that the investors will be flocking to its door. This is not completely apposite for Type III accounts, for the bank has a "captive market" in its present customers and would be able to inform them of the availability of the service through normal, periodic mailings that it would be performing in any event. The effectiveness of this low-key selling as compared to the high-pressure tactics of the mutual fund salesman would be speculative at best. There would be some rational basis for asserting, then, that the Type III account would probably not constitute a significant factor in the investment scheme in the near future.

The fact that the Type III accounts may not immediately constitute a significant force in relation to the fund industry is no answer to the potential problem that the addition of these gross investment amounts may create in the overall issue of concentration of banking power. Although there is no definitive data available to say just how much the Type III will add, this does not preclude a consideration of the various devices which are available to protect the public from untoward effects.

The initial reaction to thoughts of concentration should be the Sherman Act and the Clayton Act. Unfortunately, the antitrust laws have not yet been applied in this area to any significant extent.<sup>313</sup> The problem has been recognized in legal writings.

[T]he Federal antitrust laws, while not dealing specifically with control,

309 Regulation 9 prohibits advertising other than incidentally in bank trust department advertisements. 12 C.F.R. § 9.18(b)(5)(iv) (1969).

310 1967 House Hearings 155.

311 On June 30, 1966, the total of all mutual fund assets was approximately \$38 billion; no-loads accounted for slightly more than \$2 billion, or slightly over five percent. PUBLIC POLICY STATEMENT 52.

312 See *Survey* 808-851.

313 In late March, the Justice Department initiated its first suit to stop just such abuses. The suit was filed against Cleveland Trust for probable anticompetitive effects resulting from stock holdings in and directoral interlocks with four tool manufacturers. Cleveland Trust's response was that the suit "represents a startling departure from existing law." The Justice Department's statement was equally as naive, explaining that such a suit had never been filed because "the situation never came up where a bank's trust department had interests in a number of competitors." The Justice Department was quoted as having further commented that this holding of stock of competing firms appears to be a unique situation. *Wall Street Journal*, March 27, 1970, at 4, col. 2.

naturally embrace it where the consequences are unlawful restraints of trade. For example, an institutional investor that found itself in control of two competitors, whose market position was such that common management of them would not be permitted, might be in a rather awkward position. A similar situation might arise where an institution controlled one company at the same time that it has on its board a director of a competitor of the controlled company . . . . Another major problem might arise where an institutional investor controlled a company which is also a customer.<sup>314</sup>

In addition to the availability of the antitrust laws, Type III accounts would also be subjected to some additional restraint under regulation 9. Under its provisions, the individual fund would be limited to a maximum investment of ten percent of the asset value of the fund in stock or other security of any one corporation. While it would not assure that the bank could not achieve control through a combination of account purchases, it would serve as somewhat of a restraint. Moreover, the additional restraints against the bank's dealing where it would have some interest would also be prohibitory, and be of some additional protection.

Additionally, under section 5 of the Investment Company Act,<sup>315</sup> a management investment company is under the classification of "diversified" when, with respect to seventy-five percent of its assets, not more than five percent are invested in any single company's assets, or it does not own more than ten percent of the voting stock of any single company. While the classification has no effect on the application of the Act, once a company is classified as "diversified" or "non-diversified" it cannot change classifications without shareholder approval.<sup>316</sup>

The Citibank prospectus contains the following statement on investment restrictions:

The Commingled Account will not acquire any security or other property if immediately after such acquisition . . . at least 75% of the total assets in the Commingled Account . . . do not represent more than 10% of the voting securities of such issues or more than 5% of the value of the total assets in the Commingled Account.<sup>317</sup>

This is a diversified account. The restrictions on exceeding this set limit, that is shareholder approval under section 13(a)(1),<sup>318</sup> would be applicable.

The Investment Company Act restrictions on maintaining a diversified status apply to only seventy-five percent of the asset value of the fund, the remaining twenty-five percent, for the purpose of the Act, might all be concentrated in the securities of any one issuer.<sup>319</sup> For the Type III account, this liberality would be eliminated by regulation 9. Therefore, the restrictions placed on the bank would be stricter than on the typical fund.

314 Enstam & Kamen, *Control and the Institutional Investor*, BUS. LAW., Jan., 1968, at 296-97.

315 Investment Company Act of 1940 § 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (1964). Section 5(c) of the Act provides an exception for acquisition other than by original purchase. 15 U.S.C. § 80a-5(c) (1964).

316 *Id.* § 13(a)(1), 15 U.S.C. § 80a-13(a)(1) (1964). For a discussion of the tax consequences, see *Survey* 746.

317 CITIBANK PROSPECTUS 3.

318 See note 316 *supra*.

319 See note 315 *supra*.

It would be possible for a bank with more than one Type III account to run afoul of the diversification provisions if the two accounts were not maintained as completely separate entities. However, this would not provide any real additional protection for the public from the dangers of concentration of power.

Thus, it is seen that there are provisions which would serve as a deterrent to bank concentration of power; these are chiefly in the Investment Company Act and through the parallel provisions of regulation 9. The only statutory protection, in a direct sense, is through the antitrust laws.<sup>320</sup> To date, though, these have not been effectively applied against the danger arising from bank concentration. The closest application has been in preventing bank mergers which would cause undue concentration of banking power in a given community. There may be some hope for further application provided that the essential data can be compiled which would support a case.

### 3. *Conclusions on Concentration*

The dangers presented by concentration of power in the banking community are significant. At the present time it is impossible to determine the exact extent of such concentration. There is no source, other than the banks themselves, from which a detailed report of each bank's trust holdings, directoral interlocks, and interlocking loans can be acquired. The efforts of the Justice Department in investigating the extent of concentration are apparently not too extensive; this is probably due in a large part to the unavailability of the necessary data.<sup>321</sup>

The additional power that the Type III accounts would give banks would not appear, at least in the immediate future, to significantly increase the dangers of concentration of power. There would be no assurance that this would continue to be the case as the Type III accounts gained momentum in the informed segment of the investment community. It should also be noted that the danger will be present without the addition of Type III accounts to the spectrum of services that the bank may offer. It would therefore seem that prohibition of the activity would not cure the evil it represents. What is needed is an effective method of insuring against the overall danger of concentration—not just the slight additional danger represented by the Type III accounts. Any meaningful federal program to do this could and should include adequate provisions to deal with the dangers the Type III represents. The exact nature of such protection will be discussed later.

### H. Summary of the Issues

The major problem areas facing the introduction of Type III accounts can be divided into two classes—those with a statutory origin, and those with public policy ramifications. The two areas are necessarily interdependent, but only to a limited extent. The statutes represent an expression of a public policy relative to a certain evil within a given historical context. For example, the provisions of

320 See text accompanying note 385 *infra*. See note 313 *supra*.

321 They have also apparently ignored such data sources as the CONCENTRATION REPORT.

section 32 of the Glass-Steagall Act<sup>322</sup> were to eliminate the problems that had occurred when investment banks also acted as commercial bankers, and more particularly, to prevent investment bankers from using banks as a convenient "dumping ground." It is therefore not unreasonable to permit banks to act as investment bankers and underwriters for high-grade governmental debt securities — this was not the evil to be prohibited. Thus, in considering the interrelationships between the statutory and public policy issues, the statutory prohibitions are applicable only as far as they were originally intended to go, and should not be applied to cover potential problems with a 1970 origin.

For the most part, the objections that can be raised under the various statutes involve stretching the meaning of the statute to fit the 1970 situation. There was no thought given, in the enactment of any of these statutes, to a commingled managing agency account. This is a brainchild of the mid-twentieth century. The Type III account should therefore be evaluated in light of the dangers it presents today and the public policy that the modern era requires. It must also be considered that, even should the statutory prohibitions exist as a preventative to such accounts, it would be possible, in fact probable, that the legislature would seek to make exemptions. Therefore, current considerations of public policy will necessarily determine whether such accounts should exist.

The public policy considerations are, for the most part, twofold — the dangers inherent in conflicts of interest, and the newly asserted dangers associated with concentration of economic power in the banking community. They represent valid considerations, and pose questions that must be answered before the banks should be allowed to operate Type III accounts on an extensive basis.

The current dangers in each of these areas will also interweave.<sup>323</sup> Inherent in the dangers of concentration are certain conflicts of interest which take on very large proportions. It can hardly be doubted that a trust official, or other responsible officer of a bank, who directs investment of trust assets in an industry or corporation with the thought of control is engaging in a serious breach of the fiduciary duty imposed on him. This would also apply where a bank would have significant stock holdings in one industry firm and director interlocks with another, and then use this combination to directly or indirectly restrain trade.

Moreover, the dangers in conflicts, other than through concentration, are significant in the area where the bank could interweave its investment policies and lending practices to assure that the loans would be more stable. There would be some additional conflict possibilities where the bank used its leverage with securities purchases to demand that the particular broker do a significant portion of its business with the bank.

These dangers, however, are not new to the Type III account and exist presently in all operations of the trust department where securities investment activities are undertaken. Since they are not new, and since the initial size of the Type III activity should not introduce any significant increase in these dangers, to rely on them as a basis for excluding this activity would be a *non sequitur*.

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322 See text accompanying notes 164-172 *supra*.

323 See text accompanying note 375 *infra*.

Rather, the proposal of this form of activity has merely served to point up some serious problems that currently exist and that should be remedied.

### VIII. Current Legislative Proposals

The emphasis in the preceding section was on analysis of the principal issues surrounding the use of Type III accounts by commercial banks. In this portion, the various attempts which were made, during 1969, to obtain legislative approval of the accounts will be discussed. The legislative activity during 1969 was unparalleled. During the preceding six years, never more than one set of hearings was held in any year dealing expressly, even though not exclusively, with Type III accounts. In 1969, both the Senate<sup>324</sup> and the House<sup>325</sup> held hearings on bills which would have authorized Type III accounts. In addition, hearings were also held in the House<sup>326</sup> on amendments to the Bank Holding Company Act; these hearings had a serious side effect on the future of Type III accounts. As would be the case, the Bank Holding Company Act hearings came between the Senate and House hearings.<sup>327</sup> In order to appreciate the hearings which deal directly with Type III accounts, first consideration will be given to the Bank Holding Act hearings; they may then be understood in the context of their effect on the Type III hearings.

#### A. One-Bank Hearings

The Bank Holding Company Act of 1956<sup>328</sup> provided that certain holding companies, those holding twenty-five percent or more of the stock of two or more banks, could not also hold ownership or control in a nonbanking corporation.<sup>329</sup> The Act, by definition,<sup>330</sup> excluded one-bank holding companies. In the thirteen years following the enactment of that legislation, some 783 one-bank holding companies, representing commercial bank deposits of \$108.2 billion, were operating in an unregulated status.<sup>331</sup> To correct this problem, a bill was introduced on February 17, 1969, to extend coverage of the Act to one-bank holding companies.<sup>332</sup>

Hearings on the bill were held during the latter half of April.<sup>333</sup> Although there were only a few references to the Type III account, it cannot be said that the hearings did not have a profound effect. The major issue in the hearings was that of concentration.<sup>334</sup> The overall concern for the extent of these activities was expressed by Abbot L. Mills, a former member of the Board of Governors of the Federal Reserve:

324 *1969 Senate Hearings.*

325 *1969 House Hearings.*

326 *One-bank Hearings.*

327 *1969 Senate Hearings* were held April 15-18; the *One-bank Hearings* were held April 15-25; and the *1969 House Hearings* were held November 12 to December 11, 1969.

328 Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-48 (1964).

329 *Id.* § 4(a), 15 U.S.C. § 1843(a) (1964).

330 *Id.* § 2(a), 15 U.S.C. § 1841(a) (1964).

331 *One-bank Hearings* 1.

332 *Id.* at 3.

333 The *One-Bank Hearings* ran from April 15 to April 25, 1969.

334 *See, e.g., One-Bank Hearings* 9 (statement of Professor Adolph A. Berle).

I am concerned that the newly organized free-wheeling, one-bank holding companies, if not carefully restricted in their operations, will break down the legal and conventional barriers that have prevented commercial banks from intruding into activities that are foreign to the principles on which they were chartered.<sup>335</sup>

During the hearings, testimony of the Treasury Department indicated that the administration was not satisfied with a major portion of the proposed amendment — that relating to the approved activities of the various subsidiaries of the bank holding company. The particular objection was that the bank holding company would be permitted to operate in the mutual fund or insurance field,<sup>336</sup> something that was actively opposed by the major industrial forces at the hearings.<sup>337</sup> This view prevailed, and when the bill was reported out of committee it contained a provision which would prohibit subsidiaries of bank holding companies from being in the securities business. The committee report noted:

Two specific prohibitions were added to the Board's approval authority under the revised section 4(c)(8) . . . . The other, would specifically prohibit a bank holding company from engaging in the underwriting, public sale, or distribution of mutual funds.

It should be emphasized that these two prohibitions apply only to the bank holding company and its nonbanking subsidiaries, and not to the bank subsidiaries of bank holding companies whose insurance agency and mutual fund operations are governed by other Federal and State laws. This is in keeping with the original concept of the 1956 act which was to regulate bank holding companies and not their subsidiary banks.<sup>338</sup>

These good intentions were, however, for naught. A committee minority statement indicated that there was some doubt, in their minds at least, as to the validity of prohibiting an activity to one subsidiary of the bank holding company, but permitting the bank itself to engage in that very activity.<sup>339</sup> When the bill reached the floor of the House, Congressman Blackburn — who supported the majority in the committee and was not a signatory of the dissent — introduced an amendment which would extend the prohibition to the banking subsidiary of a holding company.<sup>340</sup> Not only did Congressman Blackburn pop up out of nowhere as an opponent to such activity, he did it at a time when 360 members of the 435-member House were absent. The amendment passed the House and became part of the bill sent to the Senate, by a vote of fifty to twenty-five.<sup>341</sup> Unfortunately, the American public may never know what the true feelings of the House were.

The major impact that this legislation will have on subsequent legislation

335 *Id.* 305-6. See also note 301 *supra*.

336 *One-bank Hearings* 86-90 (statement of Charles E. Walker).

337 See, e.g., *id.* at 369.

338 S. REP. NO. 91-387, 91st Cong., 1st Sess. 15 (1969).

339 *Id.* at 24-25.

340 115 CONG. REC. H10554 (daily ed. Nov. 5, 1969).

341 *Id.* at H10559. Mr. Blackburn expressed what appears to be his overriding philosophy during the hearings:

And I recall a great furor once when one of our Cabinet officers made the statement that what's good for General Motors is good for the country. Well, now, I might agree that what's good for the banks is good for the country, depending on which side of the issue I am on, or who has hired me . . . . *One-bank Hearings* 428.



is that there was an expression of one of the chambers of the Congress to the effect that the House did not approve of the use of Type III accounts. When that point is argued by the fund industry, the fact that the membership of the House was not present will never be brought out by them. It was indeed a shrewd tactic.

### B. Investment Company Hearings

The hearings began in the Senate Committee on Banking and Currency on April 15, 1969.<sup>342</sup> The bills then under consideration, S. 34 and S. 296, would have legislatively granted the exemptions to Type III accounts that the SEC did. The differences between S. 34 and S. 296 were restricted completely to the area concerning mutual funds, and the provisions relating to Type III accounts were identical.<sup>343</sup> There are two essential provisions in the bills which relate to Type III accounts. The first, section 5(d),<sup>344</sup> would exempt Type III accounts from the provisions of sections 10(a), 10(b)(2) and (3), and from section 10(c)<sup>345</sup> of the Investment Company Act. The bills would also add a new subsection, section 22(h), to the Act. This section would provide that no provision of law is to be interpreted as prohibiting the operation of a registered investment company by a bank when done in compliance with the regulations of the Comptroller.<sup>346</sup> The remaining provisions of these bills, though affecting some of the trust activities of the banks, are not applicable here.

The 1969 hearings, and particularly those in the Senate, represented a consolidation of the previous arguments by both sides. By this time, the practice in previous hearings and in the courts had provided a fertile testing ground; and, for the most part, only the valid arguments were presented. Those representing the banking industry generally asserted that the bill would accomplish a primary objective in clarifying the effect of the Glass-Steagall Act on Type III accounts and would "provide confirmation that the Banking Act of 1933 does not prevent the operation of these funds by banks . . . ."<sup>347</sup> According to the Department of the Treasury:

This bill would not involve any novel activity for banks. Banks have been acting in fiduciary capacities for over a century. They have been operating formalized common trust funds [Type I] for the collective investment of moneys held in these capacities since 1937. Banks have been administering pension trusts [Type II] in one form or another since they were first established . . . . Banks have administered managing agency accounts since the early 1930's. The only activity they have not heretofore been able to carry

<sup>342</sup> 1969 Senate Hearings.

<sup>343</sup> *Id.* at 4.

<sup>344</sup> S. 34, 91st Cong., 1st Sess. § 5(d) (1969); S. 296, 91st Cong., 1st Sess. § 5(d) (1969). The 1969 bills were identical in this requirement.

<sup>345</sup> For a discussion of the provisions, see text accompanying notes 195-225 *supra*. It should be noted that the SEC exemption granted Citibank did not include an exemption from section 10(a); these provisions would, thus, treat the Type III account exactly the same as a "no-load" fund. The bills would accomplish this by granting an exemption under section 10(d). 15 U.S.C. § 80a-10(d) (1964).

<sup>346</sup> SENATE COMM. ON BANKING AND CURRENCY, 91ST CONG., 1ST SESS., ANALYSIS OF S. 34 at 12 (Comm. Print 1969).

<sup>347</sup> 1969 Senate Hearings 43.

on has been the collective investment of moneys of these [managing agency] accounts.<sup>348</sup>

The banking industry also received testimonial support from Professor Paul A. Samuelson. In evaluating the question of whether the Glass-Steagall Act would prevent the use of Type III accounts, he commented that if he "were an absolute believer in the Glass-Steagall Act and its philosophy 100 percent, I could, with absolute good conscience, say it should not stand in the way of this particular reform feature."<sup>349</sup>

The final supporting testimony came from the Federal Reserve Board. It indicated complete support of the provisions of the bill, and fairly well summarized its position by repeating verbatim its position taken at earlier hearings.<sup>350</sup> The Fed has long supported the use of Type III accounts; its position has been that the account does not constitute a violation of the Glass-Steagall Act and that the dangers of conflicts of interest that are present do not constitute a sufficient danger to preclude the use of these accounts.<sup>351</sup>

The fund industry retorted with the same basic arguments that have heretofore been evaluated as issues. Their arguments included contravention of the policy of the Banking Act, conflicts of interest, dangers of concentration, and, for a change, no lack of competition in the mutual fund industry.<sup>352</sup> The contention of no lack of competition was an unusual twist, but it was meant to counter the assertion that the entry of banks would help bring the sales load charges extracted by funds, and their management fees, down to a more reasonable level through competitive pressure.<sup>353</sup> Other than citing the fact that there are some 500 mutual funds presently competing, the industry made no other argument on the matter.<sup>354</sup> The contention did not even deserve that much effort.

After the committee hearings adjourned, the SEC and the fund industry held several meetings to resolve their differences;<sup>355</sup> these agreements were embodied in S. 2224; there were no changes in relation to the Type III accounts.<sup>356</sup> The prior bills, S. 34 and S. 296, died in committee, and S. 2224 was reported out on May 23, 1969.<sup>357</sup> The report's recommendations contained the same provisions as were found in the bills involved in the hearings.<sup>358</sup> The reported bill was passed unanimously on May 26, 1969.<sup>359</sup>

The bill was considered by a House subcommittee in late November; the hearings ran into mid-December.<sup>360</sup> As previously discussed, just prior to these

348 *Id.*

349 *Id.* at 67.

350 *Id.* at 289-90. *See also* 438 *Hearing* 1225.

351 1969 *Senate Hearings* 288-90.

352 *Id.* at 197-99 (statement of Andrew Melton, Jr.). Much the same arguments were presented by the Investment Company Institute, *id.* at 90-91.

353 *See, e.g., id.* at 75-76.

354 *Id.* at 199.

355 1969 *House Hearings* 174.

356 *See* S. 2224, 91st Cong., 1st Sess. §§ 5(d), 12(d) (1969).

357 S. REP. No. 91-184, 91st Cong., 1st Sess. (1969).

358 *Compare* S. 34, 91st Cong., 1st Sess. §§ 5(d), 12(d) (1969) *with* S. 2224, 91st Cong., 1st Sess. §§ 5(d), 12(d) (1969).

359 115 *CONG. REC.* S5565 (daily ed. May 23, 1969).

360 1969 *House Hearings*.

hearings, the House had passed the one-bank legislation with a proviso that bank holding companies could have no affiliations with funds, either through a direct subsidiary or through such an activity by the bank subsidiary in a Type III account.<sup>361</sup> The House was considering its own bill, H.R. 11995, which was identical to S. 2224.<sup>362</sup> The arguments against the approval of Type III accounts were almost identical to those presented in the Senate,<sup>363</sup> with one exception. The Investment Bankers Association, which raised the argument of no lack of competition in the Senate hearings,<sup>364</sup> added a new twist — that the authorization of such accounts would divert funds from the mortgage and housing markets and would thus be a “disservice to the public and damaging to our economy . . . .”<sup>365</sup> It was rapidly becoming apparent that the fund industry was ready to use anything, even the kitchen sink, to defeat the bill.

The banking industry presented the same methodically effective arguments which had been successful previously. They asserted, through the Fed, that the funds would not violate the policy underlying the Glass-Steagall Act and that the dangers that were present were minimal compared to the benefits which would accrue to the investing public.<sup>366</sup> As the banking industry did not attempt to establish an answer to the concentration argument, it apparently was hoping that the committee would simply lose track of it in all the data presented.

Apparently part of the compromise reached in the negotiations which led to S. 2224 went by the board. According to SEC Chairman Hamer H. Budge, the Investment Company Institute, after agreeing to the provisions of S. 2224 — which were for the most part applicable to sales loads, management fees, and the like — had suddenly backed out on their agreement.<sup>367</sup> The Investment Company Institute’s position on the Type III was based on the provisions of the one-bank bill:

Since the House has now restated a position that bank entry in the mutual fund business is not in the public interest, we think it appropriate that the provision of H.R. 11995 which would permit bank entry in the mutual fund business should be reversed so as explicitly to bar bank entry into the mutual fund business in conformity with the recent House vote.<sup>368</sup>

As a result of the hearings and action by both houses, Congress now has before it two conflicting bills. One of them, S. 2224, is based on some well-reasoned and carefully studied arguments. The other, H.R. 6778 — the one-bank holding company bill — contains provisions that were obtained as a result of chicanery. The American system must be a source of amazement to the uninitiated.

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361 See text accompanying notes 340-41 *supra*.

362 1969 House Hearings 4.

363 *Id.* at 457-59.

364 See note 352 *supra*.

365 1969 House Hearings 459. This argument was countered with the position that the banks would rather have demand deposits than trust business; the former is far more profitable. *Id.* at 492.

366 *Id.* at 132-35.

367 *Id.* at 853-54.

368 *Id.* at 432. After hearing the statement, one can visualize a smirk on Congressman Blackburn’s face; see text accompanying note 341 *supra*.

### C. Conclusions on the 1969 Legislative Activity

When the fund industry resorts to arguments such as the one on depletion of available funds for the mortgage and housing industry, and when it relies on less than forthright measures to secure Congressional consideration of a measure, there can be little doubt that it is fighting hard to avoid the Type III account. Its arguments, the legitimate ones, raise issues that are certainly worthy of consideration; unfortunately they are not sufficient to outrightly prohibit the Type III activity. Throughout the hearings, the various federal agencies have been solidly behind the introduction of Type III accounts. They recognize the shortcomings of the present legislation, but clearly indicate that there are a sufficient number of safeguards to protect the investing public.<sup>369</sup>

The major objections to the Type III account remain the dangers of conflicts of interest and the concentration of economic power. They cannot be answered any better after these hearings than before. If any one thing can be said about the legislative reactions to date, it would be that there has been no proposal forthcoming which would help to assure that these dangers, dangers which are present at this time in every trust account and every trust department, could be better averted.

## IX. Evaluation

### A. Introduction

The Congressional reactions to Type III accounts have not been overly assuring. The fact that some six separate hearings have been held on the matter without generating some meaningful legislation is distressing. All the blame cannot be put on Congress, however; the banking industry let a good chance slip by in 1966 when it allowed the Senate to abandon the hearings after the favorable decision from the SEC. If it does the same thing with the potential of S. 2224 because of the favorable decision in *NASD v. SEC*, it has again lost an excellent opportunity to secure legislative affirmation of the appropriateness of the Type III account. If the banks are waiting, hoping for a favorable decision from the Supreme Court, and they lose there, they will have to again go running back to Congress with their tail tucked neatly and conservatively between their pinstripe-clad legs. Even if they do win the case in the Court, there is still the strong possibility that the fund industry will pursue its gain in the one-bank holding company legislation and seek to have the Type IIIs outlawed in at least the holding companies. This could be devastating. For one, Citibank is presently within a one-bank holding company.<sup>370</sup> If serious consideration were given to the provisions of the one-bank legislation, as it now stands, Citibank would certainly be the first to be knocking on the door seeking relief.

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369 See, e.g., 1969 House Hearings 170 (Treasury Department); 438 Hearing 1228 (Comptroller); 1969 House Hearings 132 (Federal Reserve Board).

370 One-bank Hearings 444.

## B. Granting the Exemption

The provisions of S. 2224 are basically sufficient to cover, in a *carte blanche* manner, the authority for banks to enter the mutual fund arena. It must be remembered that the Type III account is, in reality, quite different from the typical mutual fund. The basic differences include multiple agency control,<sup>371</sup> more frequent audits and examinations,<sup>372</sup> lack of sales load, and the imposition of a fiduciary standard.<sup>373</sup> This fiduciary standard may, however, also be applicable to the typical fund.<sup>374</sup>

What the proposed legislation has failed to do, then, is to meet the real dangers that are present even without the existence of the Type III account. The provisions of the one-bank legislation outlawing the acquisition or use of a fund hardly meet the question. Even without the use of Type IIIs, there is more than likely sufficient economic power to exert considerable influence on the economy. *A fortiori* the dangers of conflicts of interest are significant. To raise either of these as justification for not permitting the banks to use Type III accounts is to ignore the forest fire while you snuff out the cigarette.

## C. Additional Provisions Needed

There are two primary dangers which must be eliminated, whether or not the Type IIIs are permitted. These are the dangers present through concentration of economic power and those present and attributable to certain conflicts of interest that remain within the present banking structure as ever present dangers. As previously established, these dangers are interrelated and cannot be entirely separated.<sup>375</sup> Any solutions, therefore, will necessarily have to take into account these interdependencies.

### 1. Disclosure

One of the traditional measures to assure that the system to be regulated is so regulated is through a disclosure requirement; this was the entire purpose of the Securities Act of 1933. It did not work; the Securities Exchange Act of 1934 then sought to regulate. Disclosure without some enforcement mechanism and without applying that mechanism is fool's gold.

Under the Investment Company Act, there are some disclosure requirements, under section 30,<sup>376</sup> on a quarterly basis. This disclosure is accomplished on Form N-1Q, generally referred to as the "Q Report." Under these reporting requirements, investment companies must presently disclose changes in portfolio securities, matters submitted to shareholders for vote, changes in investment policies, legal proceedings in which the fund is involved, changes in debt

371 The account would be under the SEC through the Securities Act and the Investment Company Act; it would be subject to the Comptroller under the Glass-Steagall Act.

372 See text accompanying note 253 *supra*.

373 See text accompanying note 284 *supra*.

374 See *Survey* 940-45.

375 See text accompanying note 323 *supra*.

376 Investment Company Act of 1940 § 30, 15 U.S.C. § 80a-30 (1964).

structure, and several other requirements not pertinent here. These reports would, however, apply only to the Type III account, and not to the remainder of the bank itself.<sup>377</sup> There are no requirements that the bank make any additional disclosure; with the demonstrated tendency toward concentration, a continuation of this policy could be disastrous.

The interrelationships between a bank and its holdings involve a multiplicity of federal agencies. The banking structure itself is regulated by the Comptroller, for national banks. The securities issued by the bank are exempted from registration under the Securities Act.<sup>378</sup> The Type III account would, however, under the SEC decision, as affirmed in *NASD v. SEC*, and by the provisions of S. 2224, be under the SEC.<sup>379</sup> Any disclosure requirement placed on the bank would involve both agencies; legislation designed to provide for additional disclosure would have to be structured with this consideration in the forefront.

There is a need for the disclosure to include more than that traditionally found in the Q Report. The interrelationships between a commercial bank and various commercial firms cannot be gleaned from the very basic data presented in that report, even if extended to the entire bank. Three areas where a bank can exert influence over outside corporations have been discussed; they are through loans, by directorial interlocks, and through holdings of equity securities in the bank's trust department.<sup>380</sup> Any disclosure must be designed to provide data in these areas. More particularly, the banks should be required to report, on a periodic basis, all loans to corporations, all directorial interlocks, and the aggregate of securities holdings by company held in the trust department. The data on securities holdings should be further reclassified as to those shares which the bank votes and those which the bank merely holds in a non-voting capacity.

The requirement that the holdings of equity securities be made in an aggregate by company is designed to avoid the argument that the bank, as a trustee, has a confidential relationship with the *cestui* which precludes disclosure of the holdings. This argument provides a shield for the bank to raise in any request for data on securities holdings in the trust department. If, however, the banks are willing to lower the shield for disclosure under the Investment Company Act,<sup>381</sup> and since they assert that this is a trust relationship,<sup>382</sup> the overall validity of this argument can be seriously questioned. It would make little sense to assert that you cannot reveal such information without a breach of trust and then to willingly make the release in order to provide additional services.<sup>383</sup>

The depository for this information is another important question. We have

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<sup>377</sup> There are also disclosure requirements under sections 13 and 15(d) of the Securities Exchange Act, 15 U.S.C. §§ 78m, 78o(d) (1964). These requirements may be waived under section 30(c) of the Investment Company Act, 15 U.S.C. § 80a-30(c) (1964).

<sup>378</sup> Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1964).

<sup>379</sup> See *Citibank Release*.

<sup>380</sup> See text accompanying note 302 *supra*.

<sup>381</sup> Investment Company Act of 1940 § 30, 15 U.S.C. § 80a-30 (1964).

<sup>382</sup> Regulation 9, 12 C.F.R. § 9.18(a)(3) (1969).

<sup>383</sup> For an interesting view on the ability to shift positions, see 1969 *Senate Hearings* 55-56 (views of Professor Samuelson).

established that both the Fed and the SEC would be interested in the data.<sup>384</sup> The Justice Department would hopefully also be interested in obtaining and using the data in possible antitrust suits. Therefore, any provision as to the compilation of the data should include reporting to a central source where all interested agencies could obtain it. If it is retained within the banking agencies or by the SEC, without informing the Justice Department, the only existing protection against the dangers of concentration will be thwarted.<sup>385</sup>

Disclosure, with adequate analysis, could easily point out trends in concentration which might be undesirable. The data could also indicate possible areas where conflicts of interest might be present. This would, however, depend entirely on the proper analysis of an unusually large amount of data. The only effective means of accomplishing this would be by requiring that the data disclosed be reported on standardized computer forms, perhaps even to the requirement that the data be submitted on punched cards or fed to the central computer through telephone data transmission — something already in wide use in the business community. The data ingested by the central computer could then be analyzed by the computer; and through management exception reporting, only the questionable relationships need ever be brought to the attention of the respective federal authorities.

Disclosure without effective regulation is not, however, going to stop abusive practices. The present SEC and Federal Reserve enforcement techniques would generally be adequate. The SEC could attack through section 20(c),<sup>386</sup> which provides that investment companies cannot establish these interlocks with other companies through mutual stock holdings. The more effective agency action would be by the Fed in applying the prohibitions in regulation 9 against self-dealing and activities against the interest of the *cestui*.<sup>387</sup> The most effective action, that of the *cestui*, would also be available under state law. However, this could be substantially improved by enacting legislation which would generally provide the same beneficial use of a prior judgment or decree as prima facie evidence against the bank as is presently found under the antitrust laws.<sup>388</sup> This would, in effect, create a federal cause of action for breach of trust by improper use of trust assets. There has been strong contention that the private action provision of the antitrust laws is the most important protection afforded by those laws;<sup>389</sup> there is no reason why it could not be such a device in enforcing a policy against unwarranted concentration.

## 2. Enforcement

Enforcement must run hand-in-hand with disclosure. The principal means of enforcement would be a dual threat by the respective agency and the investor. Antitrust suits by the Justice Department could be initiated on the basis of the

384 See text accompanying notes 378-79 *supra*.

385 See text accompanying note 320 *supra*. See note 313 *supra*.

386 Investment Company Act of 1940 § 20(c), 15 U.S.C. § 80a-20(c) (1964).

387 Regulation 9, 12 C.F.R. § 9.12(a) (1969).

388 Clayton Act of 1914 § 5(a), 15 U.S.C. § 16(a) (1964).

389 See Loewinger, *Private Action — the Strongest Pillar of Antitrust*, 3 ANTITRUST BULL. 167 (1958).

data revealed, and the affected investor, if provisions were made,<sup>390</sup> would also have a cause of action.

Were the banking authorities to uncover abuses of trust, their actions,<sup>391</sup> combined with those of the injured *cestuis*, could serve as a strong deterrent.

Without attempting to detail all of the necessary legislative requirements, it is possible to see that adequate safeguards against the dangers of concentration and conflicts of interest, with or without Type III accounts, can be established.

## X. Conclusion

This Note has attempted to trace the development of an innovative banking service, one that represents a combination of the prior practices of managing agency accounts and those of common trust funds. The hybrid which evolves, the Type III account, has caused some considerable apprehension among the powers in the mutual fund industry. They have expended considerable effort to defeat the entry of commercial banks into competition with the funds, perhaps for strong economic reasons. The availability of the investing expertise<sup>392</sup> of commercial banks to the investing public would be welcomed by many investors who are of the opinion that the funds are not providing the services that they should, or at least at a reasonable price.<sup>393</sup>

The existing legislative framework would not directly prohibit the use of Type III accounts. It cannot be denied that the rationale behind these laws could be twisted to interpret them as prohibiting the accounts; but this would not be accurate. They were not enacted to cover the Type III account, and they should not be so applied. The account can fit within the existing legal framework with little or no difficulty. It would be wise to have the accounts under the Investment Company Act; this act affords significant protection through its requirements for unaffiliated directors, shareholder participation, and prohibitions against self-dealing. There can be little doubt that the rationale applied in *Prudential*, the ectoplasmic theory, would apply to bring the Type III within the Act. The result is a unique creature, regulated by both the SEC and the Fed, and proceeding to compete with the funds.

The battle has raged not only in the investment market but more vitally in the courts and in Congress. The major contentions which have survived out of the legislative and judicial arenas are that there are certain dangers in conflicts of interest and also in concentration of economic power. The first portion of this Note traced the development of the major abuses that led to the enactment of the existing banking and securities laws. The abuses traced there, while capable of grouping under the category of conflicts of interest, in no way resemble the type of conflicts that exist today. Neither was there any considera-

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390 Private actions under section 4 of the Clayton Act would appear to be limited to those involving business injuries — at least from the cases litigated to date — although the language of the section would be broad enough to cover actions in the investment situation. Specific legislation would, however, be more desirable. *Cf. Atlantic City Elec. v. General Elec. Co.*, 226 F. Supp. 59 (S.D.N.Y. 1959).

391 Under the National Bank Act, section 53, violations can cause forfeiture of the banking franchise and subject the involved individuals to personal liability. 12 U.S.C. § 93 (1964).

392 See 1969 Senate Hearings 43.

393 See 1969 House Hearings 765 (statement of Abraham L. Pomerantz).



tion in this past legislation as to the dangers of concentrated economic power. In the Great Depression concentration of economic power was the farthest thing from the minds of the legislators — concentration as we are using it here. There may indeed have been some consideration of concentration indirectly as the thing that made the abuses of the 1920s and 1930s possible.

The proposed Type III accounts have, then, been a catalyst which has brought to the fore certain considerations relating to the modern abuses that exist within the powerful trust departments in many commercial banks. Whether or not the catalyst survives is not meaningful to those abuses, for they will survive. If the catalyst adds nothing to the magnitude of the abuses, and if we have a choice of letting it survive or not, and finally if the catalyst in surviving would produce a valuable entity, then it should survive. That is the case with the Type III account — it will not materially increase the abuses in the immediate future, we do have a choice, and it will offer the investing public a meaningful alternative to the typical mutual fund. If the stock exchanges continue to make investment unattractive for the smaller investor by raising the cost of his brokerage<sup>394</sup> they will drive him to the funds. If they have a captive market, we have only ourselves to blame.

*Rudolph J. Gerber*  
*Harry L. Henning*

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394 Wall Street Journal, March 20, 1970, at 2, col. 2.