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Bankers Trust II: Underwriting, Commercial Paper Placement, and the Risk of Loss Under the Glass-Steagall Act

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Bankers Trust II: Underwriting, Commercial Paper Placement, and the Risk of Loss Under the Glass-Steagall Act

The purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe. They have a right to expect of Congress the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with reasonable expectation of being able to get them out again upon demand.*

INTRODUCTION

The financial industry is undergoing a period of great change and uncertainty. Even before the stock market crash of 19 October 1987, commercial banks experienced depressed profits.

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1 The stock market crash of 19 October 1987 amply illustrates this observation. See Stocks Plunge 508 Points, A Drop of 22.6%, N.Y. Times, October 20, 1987, at 1 (nat'l ed.).

2 Commercial banks are those institutions chartered to receive deposits subject to repayment, make loans, discount and negotiate promissory notes, and perform other activities related to deposit banking. Investment Co. Inst. v. Camp, 401 U.S. 617, 629 (1971); see Warren v. Shook, 91 U.S. 704, 710 (1875) ("Having a place of business where deposits are received and paid out on checks, and where money is loaned upon security, is the substance of the business of a banker."). For a thorough discussion of the distinction between banks and nonbanks, see generally Note, Independent Bankers Association v. Conover: Nonbank Banks Are Not in the Business of Banking, 35 Am. U.L. Rev. 429 (1983-86).

and shifting markets. In the period between 1972 and 1982, the market share of the flow of credit controlled by depository institutions declined 38.1 percentage points. After an increase to 11.33 percent return on equity in 1985, profits of commercial banks again fell to 10.23 percent return on equity in 1986. In 1981, banks represented only two of the top five consumer lenders of retail mortgage, consumer installment, and revolving loans.

In addition to declining profits and shifting markets, commercial banks also face competition from outside the commercial banking industry. One of the most significant new developments within the securities business was the 1979 introduction of the Merrill Lynch Cash Management Account. The Cash Management Account offers weekly declared dividends on a mutual fund account, third-party check writing privileges, and a credit card which supplies a line of credit equal to the amount by which securities deposited with Merrill Lynch could be margined. This activity directly competes with checking accounts

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4 F. Oppen, Securities Activities of Commercial Banks 48 (1981) ("[B]anks are clearly losing their share of municipal securities. This loss is largely because New York City's problems and Proposition 13-type initiatives have made the issuance of general obligation bonds more difficult.").

5 Depository institutions captured 70 percent of the flow of credit in 1972. In contrast, the market share of depository financial institutions was 45.4 percent in 1979, 44.2 percent in 1980, and only 31.9 percent in 1982. There is evidence to suggest that the financial innovations developed in recent periods may have permanently reduced the market share of depository financial institutions.


6 See Danker & McLaughlin, supra note 3, at 618.


8 K. Cooper & D. Fraser, supra note 5, at 199-200 (citing Rosenblum & Siegel, Competition in Financial Services: The Impact of Nonbank Entry, 83-1 Federal Reserve Bank of Chicago, Staff Study, at 17) (As of December 31, 1981, the top consumer lenders of retail mortgage, consumer installment, and revolving loans were: 1) General Motors through its General Motors Acceptance Corporation, 2) BankAmerica Corporation, 3) Citicorp, 4) Sears, and 5) Ford Motor Company.); see E. Bowden & J. Holbert, Revolution in Banking 245 (2d ed. 1984) (In the first part of the 1980's, General Motors Acceptance Corporation "had more consumer installment credit outstanding than the three biggest banks in the nation.").

offered by commercial banks. The corporate combinations of non-bank financial institutions and the spread of multi-national banking have also greatly increased the competitive atmosphere for commercial banks.

As a result of these competitive pressures and in spite of the Congress' long established policy of separating commercial banking from investment banking, the banking industry has in-

The name Merrill gave to its new account, introduced in 1979, was Cash Management Account (CMA); the bells and whistles on this new account, which requires a minimum deposit of $20,000 in cash or securities, are (1) a CMA checking account (with checks cleared through Bank One of Georgia) that pays interest at money market rates, (2) a weekly sweep of monies coming from a client's brokerage account into his CMA account, and (3) a free VISA card with a line of credit equal to the full amount by which any securities the client has deposited with Merrill could be margined.

Id. The banking community argues that the use of margin security credit as a source of capital for making commercial loans to margin account customers, accessible with a bank credit card and in combination with a money-market fund, is essentially the equivalent of deposit banking. Karmel, Glass-Steagall: Some Critical Reflections, 97 Banking L.J. 631, 636 (1980). For an informative discussion of the relation of money market mutual funds to the separation of the commercial banking and investment banking industries, see generally Adams, Money Market Mutual Funds: Has Glass-Steagall Been Cracked?, 99 Banking L.J. 4 (1982).

See K. Cooper & D. Fraser, supra note 5, at 5.

The financial services revolution has recently entered an accelerated phase with the acquisition of major investment banking concerns by two of the nation's largest nonbanking financial institutions, which are equal in size to the very largest U.S. banks and provide most of the bank's services. The two combined institutions, American Express-Shearson Loeb Rhoades and Prudential-Bache, illustrate, with graphic clarity, the enormous size, power and geographic scope of the nonbanking financial service companies.

Id. The banking community argues that the use of margin security credit as a source of capital for making commercial loans to margin account customers, accessible with a bank credit card and in combination with a money-market fund, is essentially the equivalent of deposit banking. Karmel, Glass-Steagall: Some Critical Reflections, 97 Banking L.J. 631, 636 (1980). For an informative discussion of the relation of money market mutual funds to the separation of the commercial banking and investment banking industries, see generally Adams, Money Market Mutual Funds: Has Glass-Steagall Been Cracked?, 99 Banking L.J. 4 (1982).

See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5. See K. Cooper & D. Fraser, supra note 5, at 5.
creased its efforts to expand services into securities related activities. Recent developments include investment advisor services to closed-ended investment companies, discount brokerage services, money market deposit accounts, and Super-NOW accounts. The money market deposit accounts quickly proved to be quite successful, exceeding $370 billion in total deposits just over one year after their introduction.

One particular struggle in the banking industry has taken place over the private placement of securities by banks to a

Act) "separated commercial and investment banking, gave increased regulatory authority to the Federal Reserve System, prohibited payment of interest on demand deposits, and established the Federal Deposit Insurance Corporation (FDIC)." K. Cooper & D. Fraser, supra note 5, at 51; see infra notes 45-56 and accompanying text.

Recent activities which test the limits of current regulation include collectively managed agency accounts, automatic investment services, dividend reinvestment plans, individual portfolio management services, advisory services to investment companies, and private placement services for issuers of securities. Edwards, supra note 12, at 274; see K. Cooper & D. Fraser, supra note 5, at 210 ("The best example of banking organizations seeking new product lines perhaps is the expansion into discount brokerage."); see generally Securities Industry Association, Public Policy Issues Raised by Bank Securities Activities, 20 San. Diego L. Rev. 339 (1982-83) (discussing conflict between banking and securities industries).


Authorized by the Depository Institutions Deregulation Committee (hereinafter DIDC), under the Garn-St. Germain Depository Institutions Act of 1982, the money market deposit account (hereinafter MMDA) consists of an FDIC insured money market fund which allows six transactions per month, three of which may be made by check. M. Stigum, supra note 9, at 681. One advantage of the MMDA over most money market mutual funds is that no required minimum exists for checks written against the MMDA. K. Cooper & D. Fraser, supra note 5, at 133-34. In addition, as of January 1, 1986, no minimum balance requirement exists for the MMDA itself. Id. at 133.

The Super-NOW account (negotiated order of withdrawal) was also authorized by the DIDC under the Garn-St. Germain Depository Institutions Act of 1982. The DIDC allowed depository institutions to offer an account with unregulated interest rates and with unlimited checking. Like the MMDA, the Super-NOW account required a $2500 minimum balance. "In contrast to the MMDA, which is treated as a savings account for reserve requirement purposes, the Super-NOW account [acts] as a transactions account and carry[es] a 12 percent reserve requirement." K. Cooper & D. Fraser, supra note 5, at 134; see M. Stigum, supra note 9, at 681.

K. Cooper & D. Fraser, supra note 5, at 133, 141.
limited number of sophisticated investors. Because of their frequent contacts with corporate banking customers, commercial banks are "uniquely equipped" to serve as financial intermediaries in these placements, to bring buyers and sellers together, and to negotiate terms of the transactions. At least with regard to commercial paper securities that are placed by banks, the decision of the United States Court of Appeals for the District of Columbia Circuit in Securities Industry Association v. Board of Governors of the Federal Reserve System (Bankers Trust II) resolved the conflict.

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21 Note, Commercial Bank Private Placement Activity: Cracking Glass-Steagall, 21 CATH. U.L. REV. 743, 745 (1978). Sophisticated investors for securities-related purposes are those investors who do not need the protection of the 1933 Securities Act, because they are in such a position with respect to the issuer that they actually have, or have access to, the information a registration statement under the Act would disclose. See Securities & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 125-27 (1953).

2 Note, supra note 21, at 745. A study by the Federal Reserve Board [hereinafter FRB] described private placement advisory services as follows: making recommendations regarding the terms and the timing of the transaction; assisting in the preparation of the financing documents; contacting a limited number of potential institutional investors; arranging meetings between the issuer and potential investors; and assisting in subsequent negotiations. [T]he issuer has responsibility for providing financial and operating data, the accuracy of which is typically subject to independent review by the investor in analyzing the issuer's financial soundness and future prospects. The final contract is signed by the investor and the issuer, and the proceeds of the sale go directly to the issuer.

Golden, Corporate Law for Financial Institutions, 102 BANKING L.J. 483, 484 (1985) (citing FED. RESERVE BD. STAFF STUDY, COMMERCIAL BANK PRIVATE PLACEMENT ACTIVITIES 27 (1977)).

22 "Commercial paper" refers generally to unsecured, short-term promissory notes issued by commercial entities. Such a note is payable to the bearer on a stated maturity date. Maturities vary considerably, but typically are less than nine months." Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve, 468 U.S. 137, 140 n.1 (1984) [hereinafter Bankers Trust I]. Consistent with the short maturity of commercial paper, the proceeds must be used in "producing, purchasing, carrying, or marketing goods," "meeting current operating expenses," or "carrying current operating obligations of the United States." G. MUNN & F. GARCIA, ENCYCLOPEDIA OF BANKING AND FINANCE 196 (8th ed. 1983); see J. HAWKE, JR., COMMENTARIES ON BANKING REGULATION 153 (1985) ("Commercial paper—prime quality, unsecured short-term promissory notes issued by large business corporations—trades in the nation's money markets at rates that may be competitive with such money market instruments as large negotiable certificates of deposit, bankers acceptances and Treasury obligations.").

The origin of the complex litigation leading up to *Bankers Trust II* began in 1978, when Bankers Trust Company, a New York-chartered member bank of the Federal Reserve System, began placing the commercial paper of several of its corporate customers. In January of 1979, the Securities Industry Association (SIA), a national securities industry trade association, and A.G. Becker, Inc., a dealer in commercial paper, petitioned the Board of Governors of the Federal Reserve System (FRB) to prohibit Bankers Trust from placing commercial paper. SIA and Becker alleged that Bankers Trust's activities violated the Glass-Steagall Act. In a September, 1980, statement, the FRB ruled that because the commercial paper being placed by Bankers Trust was not a security for purposes of the Glass-Steagall Act, the "restrictions of the Act against underwriting and dealing in securities thus do not apply." SIA and Becker sought judicial review of the FRB's ruling in the United States District Court for the District of Columbia, which reversed the agency's decision. After the United States Court of Appeals for the District of Columbia reinstated the FRB's ruling, the FRB was reversed by the United States Supreme Court in *Securities Industry Association v. Board of Governors of the Federal Reserve System*

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26 The Federal Reserve System includes the 12 Federal Reserve banks and their 25 branches, 37 automated clearinghouses, and 46 regional check processing centers; national banks; state-chartered banks and trust companies which elect to become members of the system; and other depository institutions "brought under the jurisdiction of the Board of Governors of the Federal Reserve System for reporting and reserve maintenance purposes." G. Munn & F. Garcia, *supra* note 23, at 365. The Board of Governors of the Federal Reserve System is responsible for the general supervision and coordination of the Federal Reserve System, including the determination of discount rates charged by the Federal Reserve Banks on their discounts and advances, the supervision of mergers and consolidations, and the regulation of bank securities-related activities. *Id.* at 347, 350.

27 *See September 1980 Statement, supra* note 25, at 84,749.

28 *Id.* at 84,750.

29 *Id.*


The Supreme Court held that commercial paper was a security under the Glass-Steagall Act, and therefore subject to the Act's prohibitions on the underwriting of securities. On remand, the FRB decided that although commercial paper was a security for purposes of the Glass-Steagall Act, the activities of Bankers Trust constituted "selling activities" expressly exempted from the Act's general prohibitions against the selling, underwriting, or distribution of securities, and therefore were not prohibited by Glass-Steagall. After the United States District Court for the District of Columbia invalidated this FRB ruling, the United States Court of Appeals for the District of Columbia Circuit reversed, and upheld the FRB ruling in Bankers Trust II, the final disposition of the action. The Supreme Court denied certiorari on the matter.

The Bankers Trust II opinion, written by Judge Bork, held that the FRB reasonably approved the placement of commercial paper by Bankers Trust. The court examined Bankers Trust's placement of commercial paper as described in this Statement does not constitute the "selling," "underwriting," or "distributing" of commercial paper securities for purposes of the Act. The Board finds that Bankers Trust's commercial paper operations are selling activities that are expressly authorized by the Act, since the bank places commercial paper only as an agent of the issuer, not directly or indirectly for its own account, and the paper is placed without recourse against the bank and solely on the order of the customer, the issuer of the paper.

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32 468 U.S. 137.
34 The Board concludes that Bankers Trust's placement of commercial paper as described in this Statement does not constitute the "selling," "underwriting," or "distributing" of commercial paper securities for purposes of the Act. The Board finds that Bankers Trust's commercial paper operations are selling activities that are expressly authorized by the Act, since the bank places commercial paper only as an agent of the issuer, not directly or indirectly for its own account, and the paper is placed without recourse against the bank and solely on the order of the customer, the issuer of the paper.

35 Id. at 90,823.
37 Bankers Trust II, 807 F.2d at 1052.
39 Bankers Trust II, 807 F.2d at 1069-70. In reviewing the FRB decision, the court of appeals determined that it owed the agency's decision "'the greatest deference.'" Id. at 1056 (quoting ICI, 450 U.S. 46, 56 (1981)). The court also determined that since
placement activities on three levels. First, since commercial paper was a security for purposes of the Glass-Steagall Act, the court determined whether Bankers Trust's activities fell within the limited exception for "selling" securities established by section 16 of the Act.\textsuperscript{42} Second, the court resolved whether Bankers Trust's activities constituted "underwriting," in which case they would not fall within the protection of section 16.\textsuperscript{41} Third, the court determined whether the activities approved by the FRB gave rise to "subtle hazards" in light of the policies of the Act\textsuperscript{42} as interpreted by the Supreme Court in Investment Company Institute v Camp.\textsuperscript{43} The Court of Appeals concluded that although some of the hazards outlined in Camp were present, the FRB reasonably determined that Bankers Trust's placement activities fell within the permissive language of section 16 of the Glass-Steagall Act permitting sales of securities and did not violate the language prohibiting the "underwriting" of securities.\textsuperscript{44} This Comment will examine the Bankers Trust II decision and the court of appeals' three-part analysis in applying the Glass-Steagall Act to the commercial paper activities of Bankers Trust Company.

I. THE GLASS-STEAGALL ACT

Two weeks after the enactment of the Securities Act of 1933, and within the first hundred days of Roosevelt's presidency,\textsuperscript{45} the

"Congress has not clearly addressed the question of whether activities such as those conducted by Bankers Trust fall within the prohibitions of the [Glass-Steagall] Act," the FRB's ruling must be reasonable in light of Congressional silence. \textit{Id.}, see Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843 ("[W]hen the legislative delegation to an agency on a particular question is implicit rather than explicit a court may not substitute its own construction for the reasonable interpretation made by the administrator of an agency.") (emphasis added), reh'g denied, 468 U.S. 1227 (1984).

\textsuperscript{40} \textit{Id.} at 1058-62; see infra notes 57-102 and accompanying text.

\textsuperscript{41} Bankers Trust II, 807 F.2d at 1062-66; see infra notes 103-54 and accompanying text.

\textsuperscript{42} Bankers Trust II, 807 F.2d at 1066-69; see infra notes 155-80 and accompanying text.

\textsuperscript{43} 401 U.S. 617 (1971).

\textsuperscript{44} Bankers Trust II, 807 F.2d at 1069-70.

\textsuperscript{45} The Securities Act of 1933 was signed by President Roosevelt on May 27, 1933. M. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 70 (1970). The Glass-Steagall Act of 1933 was signed by President Roosevelt on June 16, 1933. S. KENNEDY, THE BANKING-CRISSES OF 1933 222 (1973).
Glass-Steagall Act was enacted to protect commercial banks and their depositors, and to prevent any repetition of the extensive bank closings that occurred during the Great Depression. The 1933 Congress believed that their “fixed purpose” was to ensure that deposits were not “diverted into speculative operations by the aggressive and promotional character of the investment banking business.” The failure of the Bank of United States in 1930, widely attributed to that bank’s securities activities, was cited as proof that the soundness of the entire banking system had been eroded by bank involvement in the securities markets. In essence, Congress sought to accomplish three basic goals through the enactment of the Glass-Steagall Act: to restore public confidence in the safety of banks as depository institutions; to eliminate potential conflicts of interest that arise when commercial banks enter the securities business; and to make commercial banks more financially sound and susceptible to less risk.

47 “From June 30, 1929 to June 30, 1933, the number of commercial banks declined from 24,970 to 14,208, and total bank deposits dropped 35 percent (from $49.4 billion to $32.1 billion).” K. Cooper & D. Fraser, supra note 5, at 50; see Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46 (1981).
Congress was persuaded that speculative activities, partially attributable to the connection between commercial banking and investment banking, had contributed to the rash of bank failures. Firms affiliated with banks had engaged in perilous underwriting operations, stock speculation, and maintaining a market for the bank’s own stock, often with the bank’s resources.
Id. at 61-62 (footnotes omitted).
49 Note, supra note 21, at 748.
50 Ianni, “Security” Under the Glass-Steagall Act and the Federal Securities Act of 1933 and 1934: The Direction of the Supreme Court’s Analysis, 100 Banking L.J. 100, 103 (1983); see Securities Indus. Ass’n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137, 150 (1984) [hereinafter Bankers Trust 1] (“Congress enacted the Glass-Steagall Act as one of several pieces of legislation collectively designed to restore public confidence in financial markets.”); H.R. Rep. No. 150, 73d Cong., 1st Sess. 6-7 (1933) (“We must resume the use of bank credit if we are to find our way out of our present difficulties. ‘Credit will not expand again until confidence is restored.’ ”) (statement of Dr. Thomas Nixon Carver).
51 Camp, 401 U.S. at 630-31.
52 Russel v. Continental Ill. Nat’l Bank & Trust Co., 479 F.2d 131, 133-34 (7th Cir.), cert. denied, 414 U.S. 1040 (1973); see Ianni, supra note 50, at 103; Note, supra note 21, at 747.
The provisions of the Glass-Steagall Act primarily responsible for the separation of commercial and investment banking are found in sections 16 and 21 of the Act. Section 16 provides in relevant part:

The business of dealing in securities and stock by the [national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [national bank] shall not underwrite any issue of securities or stock.4

Section 21(a)(1) of the Glass-Steagall Act provides that it is unlawful "for any person or .. organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time in the business of receiving deposits."5

As the Supreme Court has observed, Congress sought "[t]hrough flat prohibitions  'to separat[e] as completely as possible commercial from investment banking.'"6

II. DISCUSSION

A. Private Placement as "Selling" Commercial Paper


54 Id. at § 24 (Seventh). Section 16 creates several exceptions to the general prohibition against underwriting and dealing in securities. For example, a national bank may underwrite and deal in obligations of the United States, general obligations of states or political subdivisions of states, and obligations of or guaranteed by certain government agencies. Id. State member banks are also subject to the same limitations and the same exemptions of this section. Id. at § 335.

55 Id. at § 378(a)(1).

Because commercial paper is a security for purposes of the Glass-Steagall Act, the United States Court of Appeals for the District of Columbia in Bankers Trust II first determined whether Bankers Trust’s activities fell within the “permissive language” of section 16. If a particular sale of securities meets the requirements of section 16, then the activity cannot be prohibited by section 21’s broad pronouncements against “issuing, underwriting, selling, or distributing.”

Section 16 of the Glass-Steagall Act allows banks to sell securities provided that (1) the securities are not sold for the bank’s own account, (2) the securities are bought or sold without recourse to the bank, and (3) the bank acts solely on the order and for the account of a customer. Before addressing this “permissive language,” the court first decided that the “business of dealing in securities” language in section 16 was not limited to the secondary trading market. The Bankers Trust II court concluded that under the guidelines established by the FRB, Bankers Trust’s placement activities were not for the bank’s account; that section 16 did not require a preexisting customer relationship; and that the advertising and soliciting activities of

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79 Id. at 1058.
81 Bankers Trust II, 807 F.2d at 1058-59.
82 Id. at 1067; see infra notes 65-78 and accompanying text.
83 Bankers Trust II, 807 F.2d at 1059-60; see infra notes 90-94 and accompanying text.
Bankers Trust did not prevent the placement from being upon the order of the customer.64

1. *Not for the Bank's Account*

Section 16 of the Glass-Steagall Act requires that "the business of dealing in securities and stock by the [national bank] shall be limited to purchasing and selling such securities and stock in no case for [the bank's] own account."65 In reviewing Bankers Trust's current practices,66 the FRB relied upon the bank's description of its activities,67 as well as the agency's own

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64 Bankers Trust II, 807 F.2d at 1060-62; see infra notes 95-97 and accompanying text.
65 12 U.S.C. at § 24 (Seventh); see note 54 and accompanying text.
66 Bankers Trust's placement methods had changed since the FRB first reviewed the bank's commercial paper activities. See generally September 1980 Statement, supra note 25, at 84, 749. Upon second hearing of the case, the FRB found that Bankers Trust's prior practice of extending short-term credit to issuers of commercial paper placed by the bank to cover unsold portions of the issue at rates of interest equal to or near the rates borne by the commercial paper [was] the economic equivalent of buying some of the unsold issue with the banks own funds.

June 1985 Statement, supra note 34, at 90,823-824. The purpose of this practice by Bankers Trust was to bolster the efficiency of the placement service. Id. at 90,826. The bank would decide at the end of the selling day whether or not to extend credit to the issuer when the degree of success of the bank's placement efforts became known. Id. Because most maturing commercial paper is paid off through a process called rolling, in which new paper is sold to raise capital to pay off maturing paper, most issuers of commercial paper keep such lines of credit available in the event paper sales fall below the needed quota. M. Strum, supra note 9, at 632.

67 See June 1985 Statement, supra note 34, at 90,824 ("According to the description of its activities in the material submitted to the FRB, Bankers Trust's current method of placing commercial paper differs significantly from its prior method.").

Bankers Trust has discontinued its prior practice of lending short-term funds to issuers of paper the bank places, at or near the rate of interest of the commercial paper being placed, taking back a commercial paper note. Neither Bankers Trust nor any affiliated company purchases or repurchases commercial paper placed by the bank. The bank does not inventory commercial paper overnight, takes no ownership interest in the paper being placed, and, contrary to its prior practice, does not make loans on the paper it places or otherwise take the paper as collateral for loans. Bankers Trust enters into no repurchase agreement, endorsement, or other guarantee arrangement with the purchasers of commercial paper placed by the bank.

Id.
assumptions regarding Bankers Trust’s loan activities. On appeal, the Bankers Trust II court rejected an argument by SIA that these assumptions amounted to agency regulation inconsistent with Supreme Court precedent.

In the June 1985 statement, the FRB assumed that any loans extended by Bankers Trust to the issuer under a line of credit took place “under different terms, at different times, and for different purposes than if the bank had purchased unsold commercial paper for resale.” The FRB also assumed that Bankers Trust provided no letter of credit to support issues of paper placed by the bank. To help banks comply with the “terms, times, and purposes” requirement, the FRB “suggested” that a bank should keep records to demonstrate that credit to issuers was extended independently of the bank’s commercial paper activities. A bank should also generally “assure itself” that funds advanced under a line of credit were not “used to repay any commercial paper of the issuer placed by the bank or to cover an unsold portion of a commercial paper issue placed by the bank.” The court of appeals characterized the FRB’s “reliance on such representations” as merely a determination of “which side of the prohibitory line” factual situations fall, and not as agency regulation.

See infra notes 70-71 and accompanying text.

Bankers Trust II, 807 F.2d at 1067 (SIA “argues that the Board’s reliance on such representations amounts to ‘regulation’ in a statute that Congress meant to operate through ‘flat prohibitions.’ This argument is without merit.”); see supra note 56 and accompanying text. The Supreme Court has also observed that “Congress rejected the view of those who preferred legislation that simply would regulate the underwriting activities of commercial banks.” Bankers Trust I, 468 U.S. at 147.

June 1985 Statement, supra note 34, at 90,026.

Id. at 90,027 n.13 (“The Board’s analysis is premised on the assumption that Bankers Trust does not provide its letter of credit to support a particular issue of commercial paper placed by the bank, as is sometimes the practice in the commercial paper market.”).

The term “suggested” is used here because of the ambiguity inherent in the text of the FRB opinion concerning these points. The FRB uses the language “[t]o this end it would be reasonable to expect…” in reference to the statement discussed infra at text accompanying note 73. Id. at 90,026. The FRB also uses the language “[i]t would be appropriate and necessary for the bank to assure itself” in reference to the statement quoted infra at text accompanying note 74. Id. at 90,027

Id. at 90,026-27.

Id. at 90,027.

Bankers Trust II, 807 F.2d at 1067.

See supra note 69 and accompanying text.
While Bankers Trust II specifically prohibits commercial banks that place commercial paper from engaging in lending practices economically equivalent to purchasing unsold portions of an issue on the bank's own account, the decision fails to clearly establish what lending arrangements do fall within this prohibition. One is left only to surmise that bank lines of credit and letters of credit are prohibited for purposes of backing a commercial paper issue, as the court merely "assumes" Bankers Trust was not engaging in these practices. With respect to other loan arrangements, the distinction between bank credit that replaces commercial paper as the corporation's financing medium, and bank credit that supports an issue of commercial paper, remains blurred at best. Ultimately, the records requirement adopted by the FRB will ensure that credit is extended independently of commercial paper activities.

2. Without Recourse

Although not addressed by the Bankers Trust II court, section 16 of the Glass-Steagall Act requires that banks may only sell securities "without recourse" to themselves. A brief discussion of this provision will facilitate a broader understanding of section 16.

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77 The Bankers Trust II decision neither expressly approved nor prohibited bank lines of credit and letters of credit. See supra notes 67, 71 and accompanying text. See Bankers Trust II, 807 F.2d at 1052.

Bankers Trust has, since the Supreme Court decided [SIA I], adopted a policy of providing no back-up credit or guarantees to facilitate the acceptance of commercial paper; any line of credit now granted to an issuer must have substantially different timing, terms, conditions and maturities from the commercial paper being placed. Id., 807 F.2d at 1067.

78 Issuers generally back their commercial paper with lines of credit for two reasons. First, because an "adverse turn in events" might make it very difficult for the issuer to sell new paper to retire maturing paper, a bank line of credit reduces the risk of loss to both issuer and investor. M. SroIUM, supra note 9, at 632. For example, when Penn Central went bankrupt, the company had $82 million in commercial paper outstanding. Id. Second, investors will only buy commercial paper backed by a bank line of credit. Id. For an informative discussion of credit practices used in connection with commercial paper, see generally Hurley, The Commercial Paper Market Since the Mid-Seventies, 68 FED. RESERVE BULL. 327 (1982).

79 12 U.S.C. at § 24 (Seventh).
Section 16 of the Glass-Steagall Act limits bank securities dealings to the buying and the selling of securities "without recourse."\(^{80}\) In 1935, the Supreme Court in *Awotin v Atlas Exchange Bank*,\(^ {81}\) construed section 16 as a "prohibition of liability, whatever its form, by way of 'recourse' growing out of the transaction of the business."\(^ {82}\) Today, some commentators interpret the "without recourse" provision as shifting the risk of secondary liability on the security investment to the investor.\(^ {83}\) The FRB has held, without contradiction by the Supreme Court, that the "without recourse" provision in section 16 prohibits a bank from assuming the liability of endorser or maker with respect to the securities the bank buys and sells as an agent for its customer.\(^ {84}\) The Second Circuit Court of Appeals has followed the FRB position on this matter.\(^ {85}\)

3. **On the Order of Customers**

Under section 16 of the Glass-Steagall Act, banks are limited to purchasing and to selling securities "solely upon the order of customers."\(^ {86}\) In *Bankers Trust II*, the court of appeals, through an analysis of two separate questions,\(^ {87}\) held

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\(^{80}\) [Id.]


\(^{82}\) [Id. at 214.]

\(^{83}\) See Yanni, *supra* note 50, at 106.


\(^{85}\) See Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 716 F.2d 92, 100 n.4 (2d Cir. 1983), aff'd, 468 U.S. 207 (1984) ("[W]e do not think that Schwab trades 'without recourse' simply because it faces the kind of incidental liability to which SIA I refers."); see also G. Munn & F Garcia, *supra* note 23, at 994 ("'Without recourse' is a qualified endorsement by which the endorser does not assume the general contract of endorser specified in Section 3-414(1) of the Uniform Commercial Code."). For an in depth discussion of endorser liability arising from the use of bank countersignatures on presigned commercial paper, see Jennings, *Corporate Commercial Paper Issued Through Banks: The Banks' Hidden Liability*, 103 BANKING L.J. 563, 576 (1986) ("Unless Section 3-410 of the UCC is expressly revised to remove the possibility for countersignatures to be acceptances, such security measures will by themselves impose direct liability on the bank.").


\(^{87}\) See *Bankers Trust II*, 807 F.2d at 1059-62.
that Bankers Trust had acted solely on the order of its customers. First, the court asked whether section 16 only permits transactions as an accommodation to existing customers who use other services of the bank.88 Second, the court asked whether the advertisement of placement services and the solicitation of buyers for commercial paper by Bankers Trust was solely on the order of its customers.89

With regard to the first question, the Bankers Trust II court held that the Glass-Steagall Act does not require a preexisting relationship between the bank and the customers of services allowed under section 16 of the Act.90 Congress intended section 16 of the Glass-Steagall Act to permit banks "to purchase and sell investment securities for their customers to the same extent as heretofore."91 Prior to the enactment of the Glass-Steagall Act, banks offered the securities brokerage services both to individuals with an existing customer relationship and to persons with no preexisting customer relationship with the banks.92 The court of appeals refuted SIA's argument that section 16 was only intended "to permit such services as had been traditionally performed as an accommodation to preexisting customers of the bank."93 Since brokerage transactions to the general public ex-

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88 Id. at 1059.
89 Id. at 1060-62.
90 Id. at 1059.
92 Bankers Trust II, 807 F.2d at 1060; Securities Indus. Ass'n v. Comptroller of the Currency, 577 F Supp. 252, 255 (D.D.C. 1983), aff'd per curiam, 758 F.2d 739, 740 (D.C. Cir. 1985), cert. denied, 474 U.S. 1054 (1986) ("[P]rior to the passage of Glass-Steagall banks offered brokerage services to members of the general public, and not just to existing customers."). For example, in Greenfield v. Clarence Sav. Bank, 5 S.W.2d 708 (Mo. Ct. App. 1928), Greenfield, who had no account with the bank, "went there for the sole purpose of purchasing bonds as an investment." Id. at 709.
93 Bankers Trust II, 807 F.2d at 1060 ("SIA again reads too much into Schwab. Since nothing in the language or legislative history of section 16 even remotely suggests that the Act meant to freeze particular functions in place as of 1933, we decline to read that meaning into the Act."). The SIA had based its argument upon the Supreme Court's statement in Schwab, 468 U.S. at 215, that "[b]anks long have arranged the purchase and sale of securities as an accommodation to their customers." (emphasis added). The Schwab court also stated that the fact that section 16 of the Glass-Steagall Act allows banks to engage directly in the kind of brokerage services at issue here, to accommodate
listed when the Glass-Steagall Act was passed, section 16 does not require a preexisting customer relationship with regard to commercial paper activities as well.\textsuperscript{94}

Addressing the second question, the court of appeals determined that despite the advertisement of placement services and the solicitation of buyers of commercial paper by Bankers Trust, paper sold by the bank occurred solely upon the order of its customers.\textsuperscript{95} The court reasoned that "[i]t would strain credulity" to assert that the bank could not make its services known.\textsuperscript{96} The court further pointed out that such a construction of section 16 would require banks to "passively wait for orders."\textsuperscript{97}

At first glance, the Bankers Trust II court's ruling that Bankers Trust acted solely upon the order of its customers seems to conflict with the congressional policy behind the Glass-Steagall Act. The Glass-Steagall Act seeks to separate "as completely as possible commercial from investment banking."\textsuperscript{98} In addition, Congress was concerned that maintaining a securities-distribution system, along with salespeople and fixed expenses, would cause a bank to be overly concerned with profit and violate its fiduciary duties to its customers.\textsuperscript{99} The Supreme Court has recognized, however, that commercial banks dealt to some extent in

\textit{its customers}, suggests that the activity was not the sort that concerned Congress in its effort to secure the Nation's banks from the risks of the securities market.

\textit{Schwab}, 468 U.S. at 221 (emphasis added).

* Id.

\textsuperscript{95} Id. at 1060-62.

\textsuperscript{96} Id. at 1061.

\textsuperscript{97} Id. at 1062.

\textsuperscript{98} \textit{See Bankers Trust I}, 468 U.S. at 147 ("Through flat prohibition, the [Glass-Steagall] Act sought to separate as completely as possible commercial from investment banking.") (quoting Board of Governors of the Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46, 70 (1981)).

\textsuperscript{99} \textit{See Bankers Trust I}, 468 U.S. at 146 ("Some legislators noted that this conflict [between impartial advice and profits] is exacerbated by the considerable fixed cost that a security dealer must incur to build and maintain a securities-distribution system. 'In order to be efficient a securities department had to be developed; it had to have salesmen. . . .'") (quoting 75 \textit{Cong. Rec.} 9912 (1932) (statement of Sen. Bulkley)); 75 \textit{Cong. Rec.} 9911 (1932) (statement of Sen. Bulkley) ("It was necessary in some cases to seek for customers to become makers of securities when the needs of those customers for long-term money were not very pressing.").
commercial paper before the enactment of the Glass-Steagall Act. Thus, Congress might have intended that such activities should continue. Though concerned with the fixed expenses that accompany a securities sales department, Congress was not adverse to all sales of securities by banks.

B. Private Placement as "Underwriting" or "Distributing"

Section 16 of the Glass-Steagall Act provides that "national banks shall not underwrite any issue of securities or stock." In Bankers Trust II, the court found that because "underwriting" under section 16 occurs only if a public offering is involved, a private placement of securities does not constitute statutory "underwriting."

Although the Glass-Steagall Act does not define "underwriter," the court of appeals found Congress' understanding of the term in the Securities Act of 1933 "highly relevant" in determining its definition under Glass-Steagall. Section 2(11) of the Securities Act defines "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." The court also asserted that the Supreme Court in Bankers Trust I made it very plain that the meaning of a term in other legislation passed roughly at the same time as the Glass-Steagall Act with the shared purpose of restoring confidence in the

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100 See Bankers Trust I, 468 U.S. at 160 ("The history of commercial-bank involvement in commercial paper prior to the [Glass-Steagall] Act is not well documented; evidently, commercial banks occasionally dealt in commercial paper, but their involvement was overwhelmingly in the role of discounter rather than dealer.").

101 See supra note 91 and accompanying text.

102 See supra note 93 and sources cited therein.


104 Bankers Trust II, 807 F.2d at 1062; see June 1985 Statement, supra note 34 at 90,823, 90,829-30.


107 Bankers Trust II, 807 F.2d at 1063. The court of appeals found that the distribution between public offerings and private placements "derives support from congressional interest embodied in contemporaneous securities legislation and reasonably relates to concerns that the Glass-Steagall Act sought to meet." Id. at 1062.

nation's financial markets provided "considerable evidence" of the ordinary meaning Congress attached to the same term in the Glass-Steagall Act itself.\textsuperscript{110}

The Bankers Trust II court's holding that "underwriting" under the Glass-Steagall Act connotes "public offering" may be addressed on two levels: in relation to contemporaneous securities legislation,\textsuperscript{111} and in light of the legislative history of the Act.\textsuperscript{112}

1. \textit{Contemporaneous Securities Legislation}

In support of its determination that Congress intended the term "underwrite" in the Glass-Steagall Act and in the Securities Act of 1933 to connote "public offering,"\textsuperscript{113} the court of appeals cited as authority the Supreme Court's treatment of "security" in Bankers Trust I.\textsuperscript{114}

The Supreme Court in Bankers Trust I held that because "considerable evidence [existed] to indicate that the ordinary meaning of the terms 'security' and 'note' as used by the 1933 Congress encompassed commercial paper,"\textsuperscript{115} "security" under

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110 \textit{Bankers Trust II}, 807 F.2d at 1062-63 (quoting \textit{Bankers Trust I}, 468 U.S. at 150).
111 \textit{See infra} notes 113-20 and accompanying text.
112 \textit{See infra} notes 121-54 and accompanying text.
113 \textit{See Bankers Trust II}, 807 F.2d at 1062 ("[T]he Board reasonably concluded that an 'underwriting' defeats the section 16 exemption only if it includes a public offering; private placements therefore do not for this purpose constitute statutory 'underwriting.' ").
114 When faced with similar ambiguity surrounding the definition of the terms "security" and "note," [t]he Court in SIA I made it very plain that the meaning of a term in other legislation passed roughly at the same time as the Glass-Steagall Act with the shared purpose of restoring confidence in the nation's financial markets provided "considerable evidence" of the "ordinary meaning" Congress attached to the same term in the Glass-Steagall Act itself.

\textit{Id.}
115 \textit{Bankers Trust I}, 468 U.S. at 150. The Supreme Court discussed several statutes collectively designed to restore public confidence in financial markets, including the Banking Act of 1933, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935. \textit{Id.} at 150-51. The Court noted that in each of these statutes other than the Banking Act, "the definition of the term 'security' includes commercial paper, and each statute contains explicit exceptions where Congress meant for the provisions of an Act not to apply to commercial paper." \textit{Id.}
\end{flushleft}
the Glass-Steagall Act included commercial paper.\textsuperscript{116} The court of appeals in \textit{Bankers Trust II} similarly held that the "congressional intent embodied in contemporaneous securities legislation" indicated that "underwriting" under the Glass-Steagall Act connotes a "public offering."\textsuperscript{117}

The analysis of the \textit{Bankers Trust II} court, however, differs from that of the \textit{Bankers Trust I} Court in significant ways. While the Supreme Court supported its interpretation of "security" with "considerable evidence" contained in contemporaneous legislation, only one contemporaneous statute supporting the court of appeals' interpretation of "underwriting" existed.\textsuperscript{118} The Supreme Court had also cited legislative history which clearly established that the drafters of the Glass-Steagall Act were aware that the term "security" under the Securities Act included commercial paper.\textsuperscript{119} The \textit{Bankers Trust II} court provided no evidence that the same drafters were aware that the term "underwriter" under the Securities Act connoted a "public offering."\textsuperscript{120}

2. Legislative History

In its analysis of "underwriting," the court of appeals conceded that the distinction between a private and a public

\textsuperscript{116} Id. at 139-40.
\textsuperscript{117} \textit{Bankers Trust II}, 807 F.2d at 1062.
\textsuperscript{118} \textit{See Bankers Trust II}, 807 F.2d at 1063 ("Only the Securities Act of 1933 defines the term 'underwriter' "). The court of appeals also cited a subsequent Federal Trade Commission finding that a "statutory 'distribution' necessarily involved a 'public offering,' thus making it clear that one could not be an 'underwriter' in the absence of a public offering." Id. at 1064 (citing H.R. Conf. REP. No. 1838, 73d Cong., 2d Sess. 41 (1934)). In addition, the \textit{Bankers Trust II} court cited a subsequent commentator for the proposition that a distribution was "more or less synonymous with" a public offering. Id. (citing 1 L. Loss, \textit{Securities Regulation} 551 & n.307 (2d ed. 1961)); see supra note 109 and accompanying text.

While conceding the validity of the authority used by the \textit{Bankers Trust II} court, the author nonetheless asserts that because the drafters of the Glass-Steagall were unaware of the subsequent novel treatment of "underwriting" in the Securities Act of 1933, Congress intended "underwriting" in the Glass-Steagall Act in the term's traditional sense of insurance against risk of loss on an issue of securities. See infra notes 125-53 and accompanying text.

\textsuperscript{119} \textit{See Bankers Trust II}, 468 U.S. at 151 ("During the hearings on [the Securities Act of 1933], Senator Glass expressed dissatisfaction with the definition of 'security' because it plainly did encompass commercial paper.").

\textsuperscript{120} \textit{See infra} notes 125-53 and accompanying text. \textit{See generally Bankers Trust II}, 807 F.2d at 1062-66.
offering was one which "seems highly plausible that Congress might have drawn" in section 16, and that the history in support of the court's holding was "by no means conclusive." The court also based its holding upon the absence of "any contrary indication." Yet, evidence exists that the drafters of Glass-Steagall were unaware of the novel treatment of "underwriting" in the Securities Act of 1933; Congress likely intended "underwriting" under the Glass-Steagall Act in its traditional sense of incurring risk of loss on an issue of securities. The Congress that enacted the Glass-Steagall Act and the Securities Act of 1933 had little understanding of the legislation they voted upon. Congress passed the Securities Act and the Glass-Steagall Act during the famous Hundred Days of the Roosevelt Administration, a fourteen-week period during which fifteen statutes were enacted. As one commentator points out, only a handful of individuals participated actively in writing the Emergency Banking Act, the Agricultural Adjustment Act, the National Recovery Act, or the Securities Act. Few legislators understood fully the details of any two pieces of legislation passed during the Hundred Days. Senator Carter Glass was typical. He made a brief appearance at the House-Senate conference on the Securities Act. When informed that the bill did not mention the Federal Reserve Board, he left and never returned.

See supra notes 104-05 and accompanying text.

Bankers Trust II, 807 F.2d at 1066 (emphasis added).

Id. at 1064 (emphasis added).

Id. at 1063 (emphasis added).

M. Parrish, supra note 45, at 112.

Id. From March 9, 1933 through June 16, 1933, Congress enacted the Emergency Banking Act (March 9) and the Economy Act (March 20); established the Civilian Conservation Corps (March 31); abandoned the gold standard (April 19); enacted the Federal Emergency Relief Act (May 12), the Agricultural Adjustment Act (May 12), the Emergency Farm Mortgage Act (May 11), the Tennessee Valley Authority Act (May 18), and the Truth-in-Securities Act (May 27); abrogated the gold clause in public and in private contracts (June 5); enacted the Home Owners' Loan Act (June 13), the National Industrial Recovery Act (June 16), the Glass-Steagall Banking Act (June 16), the Farm Credit Act (June 16), and the Railroad Coordination Act (June 16). A. Schlesinger, The Coming of the New Deal 20-21 (1959).

M. Parrish, supra note 45, at 112. Senator Glass was, however, acquainted with the provision of the Securities Act relating to "security," as he raised objections to this provision in hearings before the Senate Banking and Currency Committee. Bankers Trust I, 468 U.S. at 151-52 (quoting Securities Act: Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess., 98, 120 (1933)).
Of the Senate Committee Hearings on the Securities Act held March 31, 1933, to April 8, 1933, Glass attended only one day, Monday, April 3.\footnote{Securities Act: Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess., 69 (1933) ("Present: Senators Fletcher (chairman), Glass, Wagner, Barkley, Bulkeley, Gore, Byrnes, Adams, Norbeck, Goldsborough, Townsend, Carey, Stewer, and Kean."). Adding to the lack of knowledge among members of Congress was an agreement among the members of the House subcommittee on the Securities Act that "no publicity of any nature would be given to [the Act] until a draft satisfactory to the subcommittee was reported out to the full committee." Landis, Legislative History of the Securities Act, 28 Geo. Wash. L. Rev. 29, 38 (1959-60).}

Although the Glass-Steagall Act was signed into law by President Roosevelt over two weeks after the Securities Act of 1933,\footnote{See supra note 45.} Glass-Steagall was actually developed under the Hoover administration.\footnote{R. Moley, The First New Deal 317 (1966). The Glass-Steagall Act of 1933 can hardly be classed as a New Deal measure. Roosevelt was sympathetic, but had no active part in pressing for its passage. Most of the people who were close to the White House in April and May were so busy with their own legislative programs that Glass was left to his own devices. Id., Perkins, The Divorce of Commercial and Investment Banking: A History, 88 Bank L.J. 483 (1971).} The Senate had approved the Glass Bill over a month before even the earlier versions of the Securities Act had been drafted. Hearings on the Glass Bill took place before the Glass Banking and Currency subcommittee in the winter of 1931 and before the full committee a year later.\footnote{Id., Perkins, supra note 130, at 505-06 ("Hearings on the Glass Banking Bill were held on two occasions; once before the Banking and Currency subcommittee chaired by Senator Glass in the winter of 1931 and then again one year later before the full committee.").} The Glass Banking Bill was introduced to the Senate on April 18, 1932,\footnote{H. Burns, The American Banking Community and New Deal Banking Reforms 1933-1935 17 (1974) ("Opposition continued and additional redrafting took place. This resulted in a third [Glass] bill which was introduced [to the Senate] on April 18.").} and approved by the Senate on January 25, 1933.\footnote{Id., Perkins, supra note 130, at 521.} Roosevelt
was sworn into office on March 4, 1933.\(^\text{134}\) Preoccupation in the House of Representatives in the final days of the Hoover administration delayed the enactment of the Glass Bill, which did not gain final passage until Glass agreed to incorporate the Steagall Bill\(^\text{135}\) (the basis for the F.D.I.C.) into his own.\(^\text{136}\) President Roosevelt signed the Glass-Steagall Act into law on June 16, 1933.\(^\text{137}\)

The Securities Act of 1933 resulted from the work of Huston Thompson, former chairman of the Federal Trade Commission, and Felix Frankfurter, later a Justice of the United States Supreme Court.\(^\text{138}\) Thompson drafted his version of the Securities Act in the days surrounding March 19, 1933,\(^\text{139}\) well after the January 25 adoption of the Glass Bill by the Senate. The first draft of the Frankfurter version, which replaced the Thompson version, was produced on April 8, 1933.\(^\text{140}\) The April 29 draft of the Frankfurter version was introduced in the House of Representatives on May 3 and passed on May 5, 1933.\(^\text{141}\) President Roosevelt signed the Securities Act of 1933 into law on May 27, 1933.\(^\text{142}\)

\(^{134}\) S. Kennedy, *supra* note 45, at 152.

\(^{135}\) See *M. Parrish, supra* note 45, at 132, at 18.

\(^{136}\) See id. at 17 ("The passage of [the Glass Bill] through the Senate was to be long and stormy. It was eventually approved and sent to the House of Representatives."); id. at 32 ("Reports circulated that last minute House action would be taken on the Glass banking bill. President Hoover, in a final plea to Congress, urged its passage, but no recommendation was made by the president-elect. The bill remained in committee."); Perkins, *supra* note 130, at 522 (The delay in acting on the Glass Bill resulted from "preoccupation in the spring of 1933 with the possible effects of two even more ominous threats the movements that lead to the creation of the F.D.I.C. and the passage of the Securities Act of 1933.").

\(^{137}\) See *supra* note 45.

\(^{138}\) See *M. Parrish, supra* note 45, at 42-48.

\(^{139}\) See id. at 46-47 ("Miller and Butler prepared the first draft of possible legislation. Thompson studied the measure for several days [and] presented the proposed bill to FDR on March 19. Roosevelt told the press on March 21 that securities legislation would soon be introduced.").

\(^{140}\) See id. at 57 ("Roosevelt, informed of the deteriorating situation, eased Thompson out of the picture by persuading him to oversee pending government litigation against Muscle Shoals power companies and Henry Ford. By Saturday night, April 8, the Frankfurter group had produced a new bill.").

\(^{141}\) See id. at 66 (The second House subcommittee print of April 29 was basically the bill Rayburn formally introduced on May 3 and the House passed on May 4.).

\(^{142}\) See *supra* note 45.
The drafters of the Securities Act took a novel approach to "underwriting." Before the enactment of the Securities Act, the financial community understood the term "underwriting" in the insurance sense, as one who takes the risk of loss on an issue of securities by obligating himself to purchase all unsubscribed securities. The term "distribution" therefore had a meaning separate from "underwriting." Similarly, the Glass-Steagall Act's prohibitions also represent "a general policy against commercial banks assuming investment or speculative risks," in addition to containing separate prohibitions against "underwriting" and "distribution."

In contrast, the terms "underwriting" and "distribution" have been viewed as substantially synonymous with "public offering" under the Securities Act of 1933. In Securities In-

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143 Gourrich, Investment Banking Methods Prior to and Since the Securities Act of 1933, 4 LAW & CONTEMP. PROBS. 44, 49 (1937).

The banking group was frequently formed about the same time as, or prior to, the formation of a selling group. It distributed the risks assumed by the purchase group over a larger number of firms than the ten or fifteen, and sometimes less, who participated in such purchase groups. This function might be performed by this banking group agreeing to take up any securities which the purchase group might fail to sell to or through the selling group; i.e., "underwrite" such sale.

Id. Douglas & Bates, The Federal Securities Act of 1933, 43 YALE L.J. 171, 201-02 ("Sound underwriting requires that the risk be so spread that all who participate will be able to bear it conservatively.").

144 See Gourrich, supra note 143, at 46.

Investment bankers' participation in the distribution of new securities has taken two major forms: (1) the distribution of securities to the public after the banker has purchased the issue from the issuer, or received an option thereon, or with the banker acting as selling agent; (2) the "underwriting" of an offering of securities by a corporation to its security holders, by which the banker obligates himself to purchase all unsubscribed securities.

Id.

145 Janm, supra note 50, at 100; see 12 U.S.C. at § 24 ("The business of dealing in securities shall be limited to purchasing and selling such securities without recourse, solely upon the order, and for the account of, customers, and in no case for its own account.") (emphasis added); Gourrich, supra note 143, at 49 (During syndication prior to the Securities Act, the "banking" group, who functioned to "underwrite" the sale, was responsible for bearing the risks of the trading account in the new issue.).

146 See 12 U.S.C. at § 21(a)(1) (It is unlawful "for any person or organization, engaged in the business of issuing, underwriting, selling, or distributing to engage in the business of receiving deposits.").

147 "Since 2(11), 15 U.S.C. § 77b(11), defines an 'underwriter' as 'any person who has purchased from an issuer with a view to distribution of any security' and since
dustry Association v Board of Governors of the Federal Reserve System [Schwab], the Supreme Court noted that "[i]n the typical distribution of securities, an underwriter purchases securities from an issuer [and distributes] these securities to the public." The Securities Act therefore effected a change in the scope of the term "underwriter" from its common meaning in financial circles. "Underwriter" expanded from one who bore the risk of loss on an issue of securities, to anyone who sold securities in connection with a distribution. Because the distribution of securities is much like merchandising, "underwriter" under the Securities Act includes not only the bankers who bear any risks of the trading account in the new issue, but also those who merely pass the security along without incurring any risk on the issue. The Securities Act represents a general policy of

a 'distribution' requires a 'public offering' the question is whether there was a 'public offering' Gilligan, Wills & Co. v. Securities & Exch. Comm'n, 267 F.2d 461, 466 (2d Cir. 1959); see Securities & Exch. Comm'n v. Ralston Purina, 346 U.S. 119, 125 (1953) ("An offering to those who are shown to fend for themselves is a transaction 'not involving any public offering.' "). The determination of who is an "underwriter" under the Securities Act is important because "[u]nderwriters are subject to civil liability under [section] 11 of the Securities Act for deficiencies in the registration statement." L. Loss, supra note 118, at 547.

148 Schwab, 468 U.S. at 217 n.17 (quoting L. Loss, supra note 118, at 172).

149 See Orrick, Regulation Problems Under the Federal Securities Act: Resales Following Rule 133 and Exchange Transactions, 10 HASTINGS L.J. 1, 4 (1968) ("In the context of the Securities Act, the term 'underwriter' has a scope far broader than its common meaning in financial parlance."); see also Douglas & Bates, supra note 143, at 198-99 ("The introduction into the [Securities Act] of the business term 'underwriter' necessitated definition, and the definition employed includes many more persons than have hitherto been comprehended in that term."); id. at 202 n.173 ("It is hardly possible that 'distributors' would be interpreted as being synonymous with 'underwriters' "). For a contemporaneous discussion of the various functions of "underwriters", see generally Douglas & Bates, Some Effects of the Securities Act upon Investment Banking, 1 U. CHI. L. REV 283 (1933).

150 L. Loss, supra note 118, at 164.

The issuer simply sells the entire issue outright to a group of securities firms, represented by one or several "managers" or "principal underwriters" or "representatives" [who] in turn sell at a price differential to a larger "selling group" of dealers [who] sell at another differential to the public. In a very limited sense the process is comparable to the merchandising of beans or automobiles or baby rattles.

Id.

151 See Douglas & Bates, supra note 143, at 199 n.159 ("[E]ven its broadest usage [underwriting] does not encompass all those included under the [Securities] Act—such, for example, as the small retail dealer who solicits and confirms orders in a security for
providing investors with complete, material information about securities offered for public sale and protecting investors from misrepresentation and other fraudulent practices in the sale of securities.\textsuperscript{152}

In summation, before the Securities Act of 1933, the financial community understood "underwriter" as one who took the risk of loss on an issue by obligating himself to purchase unsubscribed securities. Because the drafting of the Glass-Steagall Act occurred prior to the enactment of the Securities Act and because Congress enacted a very large volume of legislation during the Hundred Days, the drafters of the Glass-Steagall Act were likely unaware of the novel treatment of "underwriting" in the Securities Act of 1933. Thus, the drafters likely intended "underwriter" as was generally understood before the Securities Act: as one who assumed the risk of loss on an issue by committing to purchase unsubscribed securities.\textsuperscript{153}

\textsuperscript{152} See Ralston Purina, 346 U.S. at 124 ("The design of the [Securities Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."); Securities & Exch. Comm'n v. Chinese Consol. Benevolent Ass'n, Inc., 120 F.2d 738, 741 (2d Cir. 1941) ("The aim of the Securities Act is to protect the public by requiring that it be furnished with adequate information upon which to make investments."); Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (current version at 15 U.S.C. at § 77a) ("To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes."); Orrick, supra note 149, at 4 ("The basic concept of the Securities Act is to require registration of securities offered for sale in interstate commerce by issuers, underwriters or dealers unless some exemption is available.").

\textsuperscript{153} The author's theory follows from the fact that the Glass-Steagall Act was drafted before the Securities Act, see supra notes 131-42 and accompanying text; from the fact that Senator Glass was generally unaware of the provisions of the Securities Act save those dealing with "security," see supra notes 119, 125-28 and accompanying text; from the massive amount of legislation that was hurriedly sent through Congress during the Hundred Days period, see supra note 126 and accompanying text; from the the general emphasis of the Glass-Steagall Act against commercial banks assuming investment related risks, see supra note 145; and from the fact that "underwriter" before the enactment of the Securities Act of 1933 connoted one who assumed the risk of loss by committing to purchase all unsubscribed securities. See supra note 143 and accompanying text. For an opposing viewpoint, see Glidden, Bank Sales of Commercial Paper Under the Glass-Steagall Act: The Hazards of the Bankers Trust Decisions, 42 Bus. Law 1, 19-26 (1986-87). For an overview of "underwriting" under the Glass-Steagall Act, see generally Note, Securities Activities Under the Glass-Steagall Act, 35 Emory L.J. 464 (1986).
The precise definition of "underwriter" becomes critical when determining when credit arrangements between banks and issuers occur "on the bank's own account."\(^{154}\) The *Bankers Trust II* decision leaves unresolved the validity of loan arrangements between a bank and an issuer of commercial paper the bank does not place. Under the court of appeals approach, a corporation could theoretically have its commercial paper placed by one bank and backed with a line of credit from another, since no distribution occurs. The bank extending the credit would not be engaging in "the business of issuing, underwriting, selling or distributing" securities so the general prohibitions of section 21 of the Glass-Steagall Act would not apply. If "underwriter" were understood in its classic insurance sense, as was the likely intent of the drafters of the Act, then Glass-Steagall would prohibit any extension of credit economically equivalent to purchasing unsold portions of an issue on the bank's own account, because the bank would be incurring the risk of loss on an issue of securities. A corporation would thus be precluded from placing its commercial paper through one bank, and backing the paper with a line of credit through another.

C. Private Placement and the Subtle Hazards Analysis

The final step of the court of appeals' analysis of Bankers Trust's activities under the Glass-Steagall Act concerned the application of the "subtle hazards" public policy analysis\(^{155}\) developed by the Supreme Court in *Investment Company Institute v Camp*.\(^{156}\) The legislative history of the Glass-Steagall Act reveals that in addition to the obvious risk that a bank could lose money by imprudent investment of its funds in speculative securities, Congress also sought to address "the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business."\(^{157}\) The *Camp* decision outlined potential conflicts of interest that may arise as a result of the

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\(^{154}\) See *supra* notes 65-78 and accompanying text.

\(^{155}\) *Bankers Trust II*, 807 F.2d at 1066-70.

\(^{156}\) 401 U.S. 617 (1971).

\(^{157}\) Id. at 630.
combination of these two industries. In *Bankers Trust II*, the court of appeals discussed the impact of Bankers Trust's placement of commercial paper on the bank's role as an impartial source of credit, and on the bank's fiduciary role as a disinterested advisor.

1. *Bank's Role as an Impartial Source of Credit*

The court of appeals first addressed the potential conflicts of interest involved when a bank loans funds to an issuer of commercial paper the bank is placing. The court held that Bankers Trust's private placement activities did not conflict with the bank's role as an impartial source of credit because the commission earned on the placement was too small to warrant making an unsound loan. The court found that the placement

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158 The catalogue of "subtle hazards" outlined in *Camp* includes the following:

1. the danger that banks might invest their own assets in "frozen or otherwise imprudent stock or security investments";
2. the creation of "promotional" pressures on banks that might tempt them to shore up, through unsound loans or other aid, an affiliate engaged in the securities business;
3. the danger that public confidence in a bank might be impaired if its security affiliate fared badly;
4. the danger that banks might make their credit facilities more freely available—or that unsound loans might be made—to companies in whose securities the banks' affiliates had invested;
5. the danger that the bank depositors might suffer losses on the investments they purchased in reliance on the relationship between the bank and its security affiliate;
6. the danger that banks' reputations "for prudence and restraint" might be undercut if they were to assume the "risks necessarily incident to the investment banking business";
7. the danger that banks might make loans to customers to facilitate the purchase of securities in which the banks had the interest of an investment banker; and
8. the "conflict between the promotional interest of the investment banker and the obligation of the commercial banker to render disinterested investment advice"—in particular, the danger that bank trust departments might be used to "unload excessive holdings" of security affiliates.

of commercial paper "will not lead to the lending of money to 'shore up' customers of the bank's commercial paper service." Such reasoning does not accord with standard industry practice.

The commercial paper market is predominantly a wholesale market. While issuers sell commercial paper in amounts as small as $25,000 to $50,000 to individuals and small firms, most issuers require a minimum denomination of $100,000. Distribution of commercial paper in amounts exceeding $1,000,000 occurs frequently. Dealers charge a standard fee of 1/8 of one percent for the private placement, which brings the bank approximately $3.47 per one-million dollars worth of commercial paper placed per day. Rating services determine the quality of the commercial paper by conferring a rating which indicates the "relative repayment capacity of rated issuers." Paper backed by letters of credit from banks and insurance companies or paper guaranteed by parent companies usually receives a rating equivalent to the rating agency's assessment of the bank or the guarantor. Because issuers receive the rating of the bank or the guarantor, the quality of their rating is directly proportional to the amount of credit a company has available. Banks, there-

163 Id.
164 M. STIGUM, supra note 9, at 625-26.
165 Id.
166 Id.
167 Id. at 639; see Bankers Trust II, 807 F.2d at 1068.
169 "In assigning ratings to" issuers whose "Commercial Paper obligations are supported by another entity or entities, Moody's evaluates the financial strength of the indicated affiliated corporations, commercial banks, insurance companies, foreign governments or other entities, but only as one factor in the total rating assessment." Moody's Investors Service, supra note 168, at 122.
170 Id.

Issuers rated Prime-I (or related supporting institutions) have a superior capacity for repayment of short-term promissory obligations. Prime-I repayment capacity will normally be evidenced by the following characteristics:

- Leading market positions in well established industries.
- High rates of return on funds employed.
- Conservative capitalization structures with moderate reliance on debt
fore, have a strong incentive to offer such credit to support an issue; the bank gets a fee for the placement, and the extension of credit enhances the marketability of the paper placed by the bank.\textsuperscript{171} Banks also benefit from the continued patronage and the repeat business generated by dealing in short-term paper. Because investors will only purchase commercial paper backed by lines of credit, entry into the commercial paper market is nearly conditioned upon a bank's extension of credit.\textsuperscript{172} Finally, because a smaller sales staff is needed to sell higher grades of paper, banks benefit from the reduced labor costs produced by the high paper ratings that accompany bank lines of credit.\textsuperscript{173}

2. Bank's Fiduciary Role as Disinterested Advisor

The Bankers Trust II court also discussed two "subtle hazards" that concern the bank's fiduciary role as a disinterested advisor.\textsuperscript{174} First, the possibility exists that "the bank will give unsound financial advice to the issuer in order to reap the profits from placement of the issuer's commercial paper."\textsuperscript{175} The court of appeals ruled that this possibility was "insignificant" because

- Broad margins in earnings coverage of fixed financial charges and high internal cash generation.
- Well established access to a range of financial markets and assured sources of alternate liquidity.

Id. (emphasis added). Moody's Bond Record rates commercial paper according to four categories: Prime-1, Prime-2, Prime-3 and Not Prime. Under such rating system, issuers receive one of the three prime ratings only if "ample alternate liquidity is maintained." Moody's Investors Service, supra note 168, at 122. See M. Stigum, supra note 9, at 632 ("[O]ne reason] issuers pay to acquire bank lines [of credit] is that investors will buy only paper backed by bank lines. Most issuers attempt to maintain 100% line backing for their paper."); Jennings, supra note 84, at 576 ("In order to get a rating on commercial paper from Moody's Investor's Service or Standard & Poor's Creditweek, it is necessary for corporate commercial paper to be 'backed up' by a line of credit by a bank.").

\textsuperscript{171}See Bankers Trust I, 468 U.S. at 155.
\textsuperscript{172}See supra note 78.
\textsuperscript{173}See M. Stigum, supra note 9, at 643 ("A firm with a top credit rating can sell a huge amount of commercial paper through a small sales force—three to six people.").
\textsuperscript{174}Bankers Trust II, 807 F.2d at 1068-69.
\textsuperscript{175}Id. at 1068.
the low profit from the placement would not justify the potential damage to the bank’s reputation and goodwill caused by the bank giving “deliberately unsound advice.” 176

Second, the Bankers Trust II court addressed the possibility that depositors purchasing securities through the bank might lose confidence if an issuer using the bank’s securities services defaulted.177 Here, the court disagreed with the FRB’s argument that the sophisticated business investors who buy commercial paper “would be unlikely to blame their bank for what really amounts to [the investor’s] own error in judgment.”178 The Supreme Court in Bankers Trust I held that the Glass-Steagall Act makes no distinctions on the basis of financial expertise and that the loss of confidence of a few large depositors “would be especially severe.”179 The court of appeals concluded “that despite the existence of this one ‘subtle hazard,’ it must still affirm the FRB decision.”180

CONCLUSION

The impact of Bankers Trust II on the banking community cannot be overstated. The industry is desperately seeking new measures and new products to bolster its ever decreasing profits. With regard to congressional intent to “separate as completely as possible commercial from investment banking,”181 allowing commercial banks to place commercial paper significantly weakens the Glass-Steagall wall between the two industries. In addition, the court of appeals decision leaves several questions unanswered.

First, the scope of the permissible extension of credit by a bank to an issuer of paper placed by the bank remains undefined. The FRB and the court of appeals addressed this issue

176 Id. at 1068-69.
177 Id. at 1069.
178 Id.
179 See Bankers Trust I, 468 U.S. at 156.
180 Bankers Trust II, 807 F.2d at 1069.
with only vague language, thus leaving the business community to interpret only "assumptions" and "suggestions." 182

Second, while Bankers Trust II holds that "underwriting" under the Glass-Steagall Act connotes "public offering," evidence exists suggesting that the drafters of Glass-Steagall intended "underwriting" to connote incurring risk of loss on an issue of securities. 183 Congress may very well revise the Glass-Steagall Act before the Supreme Court has an opportunity to reconcile this discrepancy.

Finally, in applying the Camp "subtle hazards" analysis, the Bankers Trust II court found that a hazard occurred without finding a statutory violation. 184 The court expressed reservation as to the validity of the "subtle hazards" analysis, 185 but until the Supreme Court decides to the contrary, courts must continue to use the Camp test to analyze activities under the Glass-Steagall Act.

Bankers Trust II allows banks to go one step further into the securities industry. The fate of the Glass-Steagall Act itself is uncertain, as FRB Chairman Greenspan has called for its repeal. 186 As was aptly summarized by retired FRB Chairman

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182 See supra notes 65-78 and accompanying text.
183 See supra notes 121-54 and accompanying text.
184 See supra note 180 and accompanying text.
185 See Securities Indus. Ass'n v. Board of Governors of Fed. Reserve Sys., 807 F.2d 1052, 1056 (D.C. Cir. 1986), cert. denied, 107 S. Ct. 3228 (1987) (The "subtle hazards" approach "admittedly seems at odds with the recent statement by the Supreme Court that 'application of broad purposes of legislation at the expense of specific provisions ignores the complexity of the problems Congress is called upon to address and the dynamics of legislative action.' "); see also H. Bloomenthal, Securities Law Handbook, 16 (1987) ("Several justices may share Judge Bork's skepticism about the appropriateness of the 'subtle hazard' approach.").

Volcker, "[c]ongressional action is needed in order to provide a firm foundation of specifically applicable new law for the conduct of [commercial paper placement], as well as to provide the Board with full authority to establish the necessary prudential framework."

Richard Douglas Martin

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187 June 1985 Statement, supra note 34, at 90,837 (concurring statement of Chairman Volcker).