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Orphan of Invention: Why the Gramm-Leach-Bliley Act Was Unnecessary

We are taught since childhood the old proverb "Necessity is the mother of invention."[1] Perhaps so, where survival is at stake, or where commercial motivations create a premium for inventiveness. Motivations are quite different in the legislative arena, however, and "necessity" takes on a whole new meaning in political contexts.

A frequently invoked principle of statutory construction is the judicial presumption that legislatures do not enact unnecessary statutes.[2] The premise underlying this presumption is that legislative lucubrations must have some judicially discernible meaning, if only one looks hard enough or long enough to find it. At the same time, the concept of unnecessary legislation is scarcely unknown, though the frequency with which it is encountered in the legal literature depends upon how broad an interpretation of "unnecessary" one chooses.

If, for example, one chooses to stretch the "necessity" point a bit, one could even say that the phenomenon of "unnecessary" legislation is fairly commonplace in a variety of constitutional law

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[1] For the politically correct, the phrase goes at least as far back as Roman times, and thus may be forgiven any lurking gender bias. Gender balance may be found in the existence of other parturition-oriented proverbs, such as, "The word is father to the deed."

[2] Hence, courts are loathe to construe a statute in a manner that would render some or all of its provisions superfluous or unnecessary. *See*, *e.g.,* Ratzlaf v. United States, 510 U.S. 135, 141 (1994); Pa. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 562 (1990).

contexts, where the doctrinal treatment of statutes subject to an "intermediate scrutiny" standard of judicial review is to strike them down if their scope is "broader than necessary" to serve a legitimate governmental interest.[3] Even without stretching the point, however, it is not unusual to find opponents of a bill under consideration arguing that, for one reason or another, the legislation is simply unnecessary.[4]

This Article argues that the Gramm-Leach-Bliley Act (GLEBA),[5] was, in fact, unnecessary for the banking industry,[6]

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[3] *E.g.*, Sec'y of State of Md. v. Joseph H. Munson Co., 467 U.S. 947, 967-68 (1984) (First Amendment); New York v. Ferber, 458 U.S. 747, 768 (1982) (First Amendment); United States Fid. & Guar. Co. v. McKeithen, 226 F.3d 412 (5th Cir. 2000) (Takings Clause).

[4] For example, in 1949 the Department of Justice opposed legislation to resuscitate the notion of contributory infringement by cutting back on judicial applications of the patent misuse doctrine. "Represented by John C. Stedman, Chief, Legislation and Clearance Section, Antitrust Division, the Department argued that legislation was unnecessary because the *Mercoid* decisions were correct, because they had not produced as much confusion as the proponents of the new legislation claimed, and because the legislation would produce new interpretive problems." Dawson Chem. Co. v. Rohm & Haas Co., 448 U.S. 176, 208 (1980) (citing *Hearings on H.R. 3866 Before Subcomm. No. 4 of the House Comm. on the Judiciary*, 81st Cong. 50-56 (1949)). Similarly, the Justice Department opposed the McCarran-Ferguson Act on the ground that *Parker v. Brown*, 317 U.S. 341 (1943), made that legislation unnecessary. *See* Cantor v. Detroit Edison Co., 428 U.S. 579, 609 (1976) (Blackmun, J., concurring). Somewhat more notorious were the Reconstruction Era arguments by certain members of Congress that the Fifteenth Amendment and enfranchising legislation were unnecessary because the Fourteenth Amendment already prohibited racial discrimination in voter qualifications. *See* Oregon v. Mitchell, 400 U.S. 112, 194-95 (1970) (Harlan, J., with Brennan, White, Marshall & Stewart, JJ., concurring in part and dissenting in part).

[5] Gramm-Leach-Bliley Act (GLEBA), Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[6] Saying that a piece of legislation is "unnecessary" does not necessarily encompass an assessment of its *wisdom* as a matter of public policy. That assessment is beyond the modest scope of the present discussion. The wisdom or folly of GLEBA is best left as the subject of another article.

Moreover, that GLEBA was unnecessary from the banking industry's point of view does not suggest that it was not desirable for other constituencies, including, in no particular order, (1) the Federal Reserve, which wished to be *primus inter pares* as a financial regulator, and which dearly wished to have the Comptroller of the Currency's operating subsidiary initiative, *see* discussion *infra* notes 273-93 and accompanying text, curtailed; (2) the insurance industry, which wished to turn back the clock on gains by banks (principally national banks, with the aid of innovative OCC interpretations, as discussed in Part II, *infra*) in penetrating the insurance business; (3) the SEC, which finally succeeded in getting rid of the bank exemptions from the federal securities laws, *see infra* notes 459-74 and accompanying text; (4) Citigroup, which wished to legalize, post hoc, the merger of Citicorp and Travelers without having to unscramble the omelette a few years later with the divestitures that would have called into question the business sense of the original transaction (nonconforming operations conducted by Travelers that accounted for approximately twenty-five

because the so-called "financial modernization" wrought thereby was already available to the vast majority of commercial banking organizations[7] without incurring the social costs that are invariably the statutory "price tag" accompanying congressional grants of new powers to regulated industries. If necessity is the mother of invention, then that which is unnecessary is merely an unwanted offspring, or, to coin a phrase parallel to (but the opposite of) the metaphor in the proverb, an "orphan of invention." GLEBA putatively lifted existing "barriers" to bank entry into the securities and insurance businesses. This Article will demonstrate that those barriers were illusory and that GLEBA is largely an orphan of the invention, responsive to the diversification needs of the banking industry, that had gone before.

Two broad regulatory principles inform this analysis. The first is *functional equivalence*; the second is *affiliation*. Each of these represents a fundamental theme—an *Urlinie*,[8] to borrow an analogy from music theory—from which basic tenets of financial services regulation unfold.

The thesis of this Article is that application of these two princi-

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percent of its assets and forty percent of its revenues, *see* Travelers Group, Inc., 84 Fed. Res. Bull. 985, 988 (1998)); and (5) to some extent, the securities industry, which desired to change the one-way street of increased bank penetration of their business into a two-way street (and, though this was foiled at the last minute during the legislative process, the possibility of doing so through wholesale financial institutions that could avoid the more heavy-handed varieties of Federal Reserve holding company regulation, *see* Marc Selinger & Kenneth Talley, *Financial Services Reform: Wholesale Bank Provision Dropped From Financial Services Modernization Bill*, BNA BANKING DAILY, Oct. 28, 1999).

[7] In fact, the statute was only "necessary" to justify, ex post, the 1998 merger of Citicorp and The Travelers Corporation to form Citigroup. *See* Travelers Group, Inc., 84 Fed. Res. Bull. at 988. To justify its gamble, Citigroup reportedly made a huge amount of political contributions and lobbying expenditures in Congress (estimated at about $300 million!). *See*, *e.g.*, Robert Scheer, *Robert Rubin's Great Good Fortune; Isn't the Former Treasury Secretary's Windfall at Citicorp a Wee Bit Fishy?,* PITTSBURGH POST-GAZETTE, Mar. 23, 2000, at A21; Robert Scheer, *We Sleep As Mammoths Gambol: Heavily Lobbied Bill Being Pushed Through This Week Will End Measures Put in Place in the Depression*, L.A. TIMES, Nov. 2, 1999, at B9; Dean Anason, *Advocates, Skeptics Face Off on Megadeals*, AM. BANKER, Apr. 30, 1998, at 1-2 (quoting Rep. Maurice D. Hinchey as saying that Citigroup was "essentially playing an expensive game of chicken with Congress").

[8] The term refers to an analytic concept developed by the famous German music theorist Heinrich Schenker to denote a "fundamental line" constituting a key element of the background level of musical composition (for tonal music, at least) from which Schenker postulated all such works are "composed out." For English language discussion of Schenker and his theories, see FELIX SALZER, STRUCTURAL HEARING: TONAL COHERENCE IN MUSIC (1952); ALLEN FORTE & STEVEN E. GILBERT, INTRODUCTION TO SCHENKERIAN ANALYSIS (1982).

ples (or, in the case of the latter, its obverse, which we shall call "disaffiliation") to banking law and regulation, as they had evolved to the point in 1999 when GLEBA was enacted, would have allowed commercial banking organizations[9] to engage as *full* competitors in the securities and insurance businesses, thereby obviating the need for financial services legislation, which exacts so high a price tag from the industries affected (and possibly for the economy as a whole).[10] Part I of this Article will briefly introduce and define the two principles; Part II will review the progress of commercial banking organizations' penetration of the insurance business and demonstrate how the Comptroller of the Currency's application of the principle of "functional equivalence" had, by 1999, already positioned commercial banking organizations to be full competitors with insurance providers; Part III will apply principles of "affiliation" to demonstrate that commercial banking organizations, even under the Glass-Steagall Act[11] regime, could avail themselves of utterly unfettered access to the wholesale securities business;[12] and Part

[9] By "commercial banking organizations," reference is made to the entire universe of the commercial banking business participants, of which bank holding companies are but a subset (though clearly the most important subset, on the basis of percentage of commercial banking assets in holding company form).

[10] *See infra* notes 419-24 and accompanying text.

[11] The Glass-Steagall Act is the name commonly used to refer to certain sections of the Banking Act of 1933, ch. 89, 48 Stat. 162, particularly sections 16, 20, 21, and 32 (codified as amended at 12 U.S.C.A. § 24 (Seventh) (West 2001); 12 U.S.C. § 377 (1994) (repealed 1999); 12 U.S.C.A. § 378 (West 2001); 12 U.S.C. § 78 (1994) (repealed 1999)).

[12] The term "wholesale" is used to refer to non-brokerage securities activities, including especially those activities identified in section 20 of Glass-Steagall, 12 U.S.C. § 377 (repealed 1999), namely the "issue, flotation, underwriting, public sale, or distribution of securities." Retail activities by both banks and bank holdings companies, such as discount brokerage, *see* Sec. Indus. Ass'n v. Bd. of Governors, 468 U.S. 207 (1984); *In re* Sec. Pac. Nat'l Bank, [1982-1983 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284 (Aug. 26, 1982), *aff'd sub nom*. Sec. Indus. Ass'n v. Comptroller of the Currency, 577 F. Supp. 252 (D.D.C. 1983), *aff'd,* 758 F.2d 739 (D.C. Cir. 1985), and full-service brokerage, *see* Decision of the Comptroller of the Currency Concerning an Application by Am. Nat'l Bank of Austin, Tex., to Establish an Operating Subsidiary to Provide Investment Advice, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,732 (Sept. 2, 1983); OCC Interp. Letter No. 386, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,610 (June 19, 1987); Nat'l Westminster Bank PLC, 72 Fed. Res. Bull. 584 (1986), *aff'd sub nom.* Sec. Indus. Ass'n v. Bd. of Governors, 821 F.2d 810 (D.C. Cir. 1987) (institutional customers); Bank of New England Corp., 74 Fed. Res. Bull. 700 (1988) (retail customers), had long since ceased to be controversial. Indeed, they had long been on the Federal Reserve Board's Regulation Y laundry list of pre-approved activities. *See* 12 C.F.R. § 225.25(b)(15) (1998).

IV will briefly summarize the key changes wrought by GLEBA and the price exacted from the industry.

I

A. Functional Equivalence

As the term suggests, *functional equivalence* is a conclusory statement, expressing the view that two different things should be regarded as substantially the same, if not identical, for a particular purpose. The concept is as commonplace in everyday life as it is in analytic-theoretic discourse in a variety of academic disciplines.[13] Trivial examples would be to say, for example, that what is variously called a "wrap" or a "rollup" at the lunch counter is functionally equivalent to a sandwich, even though two

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[13] The term is often used in the natural sciences. *See, e.g.,* Rockefeller University, Blobel's Contributions to the Field of Intracellular Protein Trafficking, *at* http://www.rockefeller.edu/pubinfo/timeline.html (last updated Jan. 18, 2000) (summarizing biological research of Günter Blobel, including 1978 work providing "the first example of an integral membrane protein shown to contain an NH_2 terminal sequence extension that is the structural and *functional equivalent* of the signal sequence of presecretory proteins") (emphasis added); Ocean Drilling Stratigraphic Network, About the Plate Tectonic Maps, *at* http://www.odsn.de/odsn/services/paleomap/about_map.html (last visited May 21, 2002) (referring to digitized projections of plate tectonic maps as the "functional equivalent" of a reverse transformation of stereographic projection developed and used to convert digitized data); Ian R. Adams & John V. Kilmartin, *Localization of Core Spindle Pole Body (SPB) Components During SPB Duplication in Saccharomyces Cerevisiae*, 145 J. CELL. BIOL. 809 (1999) (stating that SPB is the "functional equivalent" of the centrosome in yeast); Univ. of Cal., Davis, Section of Microbiology, Protein-Nucleic Acid Interactions, *at* http://www-mic.ucdavis.edu/sklab/physical.htm (last visited May 21, 2002) ("the RP-A protein is presumably the *functional equivalent* of the SSB protein") (emphasis added); Ralph S. Quatrano, Mechanisms of Cellular Differentiation During Plant Embryogenesis, *at* http://www.biology.wustl.edu/ faculty/quatrano.html (last visited May 21, 2002) ("Projects concerned with study of the ABA-regulated Em gene are now focused on the regulatory protein VP1 from maize (and ABI3, its *functional equivalent* in *Arabidopsis*) . . . .") (emphasis added). However, the term is also encountered on the intersection of disciplines, such as science and religion, *see*, *e.g.*, Victor J. Stenger, The Functional Equivalent of God (1998), *at* http://www.infidels.org/library/modern/vic_stenger/ross.html (last visited May 21, 2002) (book review by physics and astronomy professor of HUGH ROSS, THE CREATOR AND THE COSMOS: HOW THE GREATEST SCIENTIFIC DISCOVERIES OF THE CENTURY REVEAL GOD (1995)), as well as in pure humanistic or political discourse, *see*, *e.g.*, Stephen P. Weldon, Secular Humanism: A Survey, *at* http://www.humanist.net/frh/rh/weldon3.html (last visited May 31, 2001) (secular humanism is a "functional equivalent" of traditional religious views); Libertarian Party Online, Against Censorship, *at* http://www.lp.org/lp-blue-ribbon.html (last visited June 4, 2002) ("[e]lectronic bulletin boards, communications networks, and other interactive electronic media as we hold them to be the *functional equivalent* of speaking halls and printing presses") (emphasis added).

pieces of bread are not being used, or that a cruller is functionally equivalent to a donut, even though the donut is round and has a hole in the middle. Even in the legal system, the concept of functional equivalence is used in not very profound contexts.[14] To be sure, one finds judges occasionally making casual use of the expression.[15]

This discussion concerns itself with a deeper application of the concept, one that has substantial legal significance. For present purposes, by "functional equivalence" we mean an overtly *analytical* process leading to a conclusion that is the result of what is quintessentially a factual inquiry. The purpose of that factual inquiry is to ascertain whether there is sufficient support for the proposition that two superficially disparate items should be treated identically by the law. It is potentially dispositive in the same familiar way that, in our common law system, judicial findings of fact are often dispositive of the court's conclusions of law. Hence, in its legally significant avatars, functional equivalence might be preliminarily defined as follows:

"Functional equivalence" is a determination of "fact"[16] that leads to two different items receiving the same (or substantially similar) legal treatment.

In more symbolic terms, suppose X and Y have in common that they can be described by the same generic noun or noun phrase—e.g., each represents a course of conduct, a pharmaceu-

[14] For example, under the Federal Rules of Civil Procedure, a motion to dismiss under Rule 12(b)(6), if supported by matters outside the pleadings, can be the functional equivalent of a motion for summary judgment or partial summary judgment under Rule 56, or a letter from counsel can be treated as the functional equivalent of a stipulation by the parties, e.g., "that the number of interrogatories each party may serve upon the other may exceed 25 in number." Williams v. N.Y. Univ. Med. Ctr., No. 01 Civ. 871 (CSH), 2001 U.S. Dist. LEXIS 12467, at *2 (S.D.N.Y., Aug. 2, 2001).

[15] *E.g.*, Carmell v. Texas, 529 U.S. 513, 534 n.24 (2000) ("Though he squandered the opportunity [to make a confession to the King] by authoring a plain contrivance, [Sir John] Fenwick could have reasonably assumed that a sincere confession would have been rewarded with leniency—the *functional equivalent* of a plea bargain.") (emphasis added).

[16] As used here, a determination of "fact" means what most lawyers would normally think of when they envision the familiar judicial factfinding technique. Such "findings of fact" may, from time to time depart from what one would consider purely objective fact. To the extent, however, that any such finding of fact is inevitably laden with or informed by the idiosyncratic values of the judicial factfinder, as a critical legal studies approach would postulate, then functional equivalence would perhaps be more accurately described as a mixed determination of fact and law. I am indebted to Duncan Kennedy for this clarification.

tical product, a financial instrument—but are otherwise dissimilar, and that X is subject to a particular legal rule, R. Based on an analysis leading to the *factual* conclusion that Y is the "functional equivalent" of X, the *legal* conclusion to be reached is that R should be applied to Y. Explication is also possible using a modified form of the familiar logical tool, the syllogism, as follows:

(1) X is subject to regulatory treatment R;
(2) Y is the functional equivalent of X;
(3) Therefore, Y should likewise be subject to R.

A series of examples will illustrate the application of this principle in a variety of concrete settings.

Functional equivalence is often invoked in the criminal law. For example, omission, misdescription, or conclusive presumption of an element of the offense in jury instructions can be harmless error where other facts necessarily found by the jury are the "functional equivalent" of the omitted, misdescribed, or presumed element.[17] A more complex example: In dismissing the indictment in the second prosecution[18] of former Clinton administration Associate Attorney General Webster Hubbell by the Independent Counsel investigating possible violations of law relating to the Whitewater Development Corporation, the Supreme Court concluded that even a prosecution that did not intend to introduce any of the documents produced by Hubbell pursuant to a grand jury subpoena under a grant of use immunity would make "derivative use" of the information contained

[17] Sullivan v. Louisiana, 508 U.S. 275, 281 (1993). *But see* Neder v. United States, 527 U.S. 1, 14 (1999) (questioning the application of such an approach).

[18] The first prosecution was terminated pursuant to a 1994 guilty plea by Webster Hubbell to charges of mail fraud and tax evasion arising out of his billing practices as a member of the Rose Law Firm in Little Rock, Arkansas from 1989 to 1992. Pursuant to that plea agreement, Hubbell was sentenced to a prison term, but in exchange for some leniency "promised to provide the Independent Counsel with 'full, complete, accurate, and truthful information' about matters relating to the Whitewater investigation." United States v. Hubbell, 530 U.S. 27, 30 (2000). The second prosecution resulted from the Independent Counsel's attempt to determine whether Hubbell had breached that agreement when, after being granted immunity to compel his compliance with a grand jury subpoena, he then produced a whopping 13,120 pages of documents and records and responded to a series of questions that established that those were all of the non-privileged documents in his custody or control that were responsive to the subpoena. *Id.* at 31. The contents of those documents provided the Independent Counsel with the information that led to this second prosecution for various additional tax offenses, mail fraud, and wire fraud. *Id.*

therein.[19] The Court observed:

> It is apparent from the text of the subpoena itself that the prosecutor needed respondent's assistance both to identify potential sources of information and to produce those sources. . . . Given the breadth of the description of the 11 categories of documents called for by the subpoena, the collection and production of the materials demanded was tantamount to answering a series of interrogatories asking a witness to disclose the existence and location of particular documents fitting certain broad descriptions. The assembly of literally hundreds of pages of material in response to a request for "any and all documents reflecting, referring, or relating to any direct or indirect sources of money or other things of value received by or provided to" an individual or members of his family during a 3-year period . . . *is the functional equivalent of the preparation of an answer to either a detailed written interrogatory or a series of oral questions at a discovery deposition*. Entirely apart from the contents of the 13,120 pages of materials that respondent produced in this case, it is undeniable that providing a catalog of existing documents fitting within any of the 11 broadly worded subpoena categories could provide a prosecutor with a "lead to incriminating evidence," or "a link in the chain of evidence needed to prosecute."[20]

Hence, a prosecution based on information that the government could not establish it would have obtained independently of the leads contained in the immunized documents was the *functional equivalent* of a prosecution based on immunized testimony, and therefore forbidden.

In another example, the Court held that the collection of a state tax imposed on the possession and storage of drugs ran afoul of the protections of the Double Jeopardy Clause[21] as "the *functional equivalent* of a successive criminal prosecution,"[22] because the tax, inter alia, (1) was "remarkably high"; (2) had "an obvious deterrent purpose"; (3) was "conditioned on the commission of a crime"; (4) was "exacted only after the taxpayer had been arrested for the precise conduct that gives rise to the tax obligation"; (5) was unnecessary to the state's asserted civil interest in raising revenue, where that interest could be equally well served by increasing the fine imposed on the activity; and (6) departed radically from "normal revenue laws" by taxing contra-

[19] *Id.* at 41-43.

[20] *Id.* at 41-42 (emphasis added).

[21] U.S. Const. amend. V.

[22] Dep't of Revenue of Mont. v. Kurth Ranch, 511 U.S. 767, 784 (1994) (emphasis added).

band goods perhaps destroyed before the tax was imposed.[23]

Functional equivalence has also been seen in a variety of civil contexts, including some of constitutional moment. *Clinton v. City of New York*[24] held the Line Item Veto Act unconstitutional as violative of the Presentment Clause;[25] the Court found that cancellations by the President pursuant to that statute "are the *functional equivalent* of partial repeals of Acts of Congress that fail to satisfy Article I, § 7."[26] In another example, holding that an artist's First Amendment rights were implicated when Amtrak refused to display his political advertisement on a billboard in New York's Pennsylvania Station,[27] the Supreme Court concluded that Amtrak (a government corporation formally known as the National Railroad Passenger Corporation) was the "functional equivalent" of a federal government agency for purposes of constitutional guarantees of individual rights against the federal government.[28] Central to this conclusion was that Congress created Amtrak by special law,[29] for the furtherance of governmental objectives, and retained for the government permanent authority to appoint a majority of that corporation's directors.[30] An example in the civil procedure context: A case dealing with jurisdiction and the requirement of minimum contacts noted that while periodic business trips to New York to solicit business did not confer jurisdiction, "renting a hotel room . . . on a systematic and regular basis might be the *functional equivalent* of an office in New York and therefore be sufficient to establish presence within the state."[31]

Functional equivalence is an oft-spotted denizen of the financial regulatory thicket as well and has been invoked by the Securities and Exchange Commission (SEC) in a variety of litigation and regulatory contexts. For example, during the 1980s, the SEC

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23 *Id.* at 780-84.

24 524 U.S. 417 (1998).

25 U.S. Const. art. I, § 7, cl. 2.

26 Clinton v. City of New York, 524 U.S. 417, 444 (1998).

27 Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374 (1995). The Court expressed no opinion on whether the artist's First Amendment rights had, in fact, been violated. *Id.* at 400.

28 *Id.* at 394; *see also id.* at 404 (O'Connor, J., dissenting).

29 *See* Rail Passenger Service Act of 1970, 45 U.S.C. §§ 501-658 (1994 & Supp. III 1997).

30 *Lebron*, 513 U.S. at 384-86, 397-98.

31 Landoil Res. Corp. v. Alexander & Alexander Servs., Inc., 918 F.2d 1039, 1043, 1046 n.10 (2d Cir. 1991) (emphasis added); *accord* Wiwa v. Royal Dutch Petroleum Co., 226 F.3d 88, 98-99 (2d Cir. 2000).

urged the Supreme Court to reject an argument that fraud claims brought against brokerage firms by investors under section 10(b) of the Securities and Exchange Act of 1934[32] and the SEC's Rule 10b-5 thereunder,[33] as well as under the Racketeer Influenced and Corrupt Organizations Act,[34] were not arbitrable despite customer agreements between the parties providing for arbitration of any controversy relating to the accounts. The Commission argued successfully as *amicus curiae* that although Congress intended to protect investors through the provision of a judicial forum for the enforcement of their rights under the federal securities laws, this intention would not be contravened by sending such claims to arbitration because arbitration had become the "functional equivalent" of the courts.[35]

The concept of functional equivalence arises in diverse securities and commodities regulatory contexts. In *Basic, Inc. v. Levinson*,[36] for example, the Court noted that silence was not actionable because it was not "misleading" under Rule 10b-5, absent a duty to disclose, and that "no comment" statements in the context of press inquiries during confidential, preliminary merger discussions are the "functional equivalent" of silence.[37]

A somewhat more complicated example: Regulations imposing disabilities on investment transactions by members and employees (and former members and employees) of the Commodity Futures Trading Commission (CFTC) include a prohibition on such a transaction involving an actual commodity if the transaction is effectuated not only by an instrument regulated by the CFTC but also by an instrument "functionally equivalent" to an

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32 15 U.S.C. § 78j(b) (1994).

33 SEC General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (2001).

34 18 U.S.C. §§ 1961-1968 (1994 & Supp. IV 1998). The RICO statute provided an attractive adjunct to securities fraud claims because of the availability of treble damages under 18 U.S.C. § 1964(c).

35 Brief of Amicus Curiae Securities and Exchange Commission at 12, Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44). The Court agreed with that position, but was influenced to accept the functional equivalence point in no small part by the Commission's aggressive regulatory posture ensuring that disclosures accompanying arbitration clauses in customer agreements prepared by brokerage houses were adequate. Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 232, 233-34 (1987); *see also id.* at 257 & n.14 (Blackmun, J., with Brennan & Marshall, JJ., dissenting in part).

36 485 U.S. 224 (1988).

37 *Id.* at 239 n.17.

instrument regulated by the CFTC.[38] Similar investment disabilities apply, in differing degrees, to employees (more restrictive) and to governing board and committee members (less restrictive)[39] of commodities self regulatory organizations (SROs),[40] and the latter restrictions are also applicable to individuals who, while not technically members of the governing board, are, deemed to be the "functional equivalent" of governing board members.[41] In another context, namely that of the SEC's 1996 revisions to its rules regulating money market funds,[42] the Commission, when considering the put diversification standards of Rule 2a-7,[43] concluded that issuer-provided demand features[44] should be excluded from those diversification requirements[45] because they were properly viewed as the "functional equivalent"

[38] Regulation Concerning Conduct of Members and Employees and Former Members and Employees of the Commission, 58 Fed. Reg. 52,656, 52,657 n.3 (Oct. 12, 1993) (codified at 17 C.F.R. § 140.735-2(b)(2)(ii) n.3 (2001)). The CFTC noted:

> A transaction involving an instrument that is the "functional equivalent to an instrument regulated by the [CFTC]" would include, for example, but is not limited to, a transaction in a stock index effectuated through the purchase or sale of an option traded on a national securities exchange where the stock index also underlies a futures contract regulated by the [CFTC].

Id. at 52,657 n.3.

[39] Under CFTC Regulation 1.59, employees are absolutely prohibited from trading in any commodity interest traded on or cleared by their employing contract market or clearing organization, while governing board members and committee members, on the other hand, are prohibited only from using material, non-public information for any purpose other than the performance of their official duties. The disparity in treatment exists because the CFTC believes that inclusion in the regulatory definition of "employee" of salaried governing board members might create disincentives for competent individuals to serve in that capacity. Final Rules Concerning Amendments to Insider Trading Regulation, 65 Fed. Reg. 47,843, 47,844 (Aug. 4, 2000).

[40] Examples of commodities SROs include, in no particular order, the Chicago Mercantile Exchange, the Chicago Board of Trade, the New York Mercantile Exchange, and the Minneapolis Grain Exchange.

[41] Insider Trading Regulation, 65 Fed Reg. at 47,844. Again, the rationale is that such individuals (e.g., ex officio members and emeritus members) can, by dint of their experience, "provide valuable guidance to the governing board" but would be disinclined to do so if subjected to broader restrictions on trading. *Id.*

[42] Revisions to Rules Regulating Money Market Funds, 61 Fed. Reg. 13,956 (Mar. 28, 1996).

[43] The put diversification standards under Rule 2a-7 apply to "securities issued by or subject to Puts from the institution that issued the Put." SEC Rule 2a-7(c)(4)(v)(A), 17 C.F.R. § 270.2a-7(c)(4)(v)(A) (2001).

[44] These are puts by the issuer of the underlying securities.

[45] If not so excluded, the fund would have to aggregate an issuer-provided put with the security subject to the put for purposes of determining compliance with the put diversification requirements of Rule 2a-7.

of short-term securities that are rolled over periodically.[46]

Elsewhere, the Commission granted an exemption under section 6(c) of the Investment Company Act of 1940, as amended,[47] from the definition of "investment company" under the standards for such exemption as set forth in Rule 3a-5.[48] In granting the exemption, the Commission considered an arrangement, necessitated by the tax laws of a foreign country, whereby notes issued under a trust indenture qualifying under Rule 144A would be issued,[49] with proceeds payable to the foreign parent company and with the indenture trustee being able to proceed directly against the parent[50] in the event of a default on the notes.[51] This arrangement, the SEC concluded, was the "functional

[46] Revisions to Rules Regulating Money Market Funds, 61 Fed. Reg. at 13,963.

[47] 15 U.S.C. §§ 80a-1 to 80b-21 (1994 & Supp. IV 1998) [hereinafter 1940 Act].

[48] SEC Rules and Regulations, Investment Company Act of 1940, 17 C.F.R. § 270.3a-5 (2001). The rule provides an exemption from the definition of investment company for certain companies organized primarily to finance the business operations of their parent companies or companies controlled by their parent companies. *Id.* One of the provisions requires that debt securities of the entity seeking the exemption be guaranteed by the parent. *Id.* § 270.3a-5(a)(1).

[49] SEC Rule 144A, 17 C.F.R. § 230.144A (2001), creates a safe harbor that allows the sale of privately placed securities to "qualified institutional buyers" without requiring that the securities be registered under the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994 & Supp. IV 1998) [hereinafter 1933 Act]. The intent of the rule is to promote liquidity in the private placement market and to enhance the attractiveness of the United States market for foreign issuers by eliminating the barriers which forced United States investors to purchase foreign securities overseas rather than through United States intermediaries. *See*, *e.g.*, Lisa K. Bostwick, Note, *The SEC Response to Internationalization and Institutionalization: Rule 144A Merit Regulation of Investors,* 27 GEO. J.L. & POL'Y INT'L BUS. 423, 431 (1996); EDWARD GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES MARKETS: A GUIDE FOR DOMESTIC & FOREIGN ISSUERS & INTERMEDIARIES 141-42 (2d ed. 1993). For purposes of Rule 144A, a "qualified institutional buyer" is an institution that owns or invests on a discretionary basis $100 million of securities and is an insurance company; an investment company; an investment advisor; a corporation, partnership, or business trust; an employee benefit plan sponsored by a governmental entity; an employee benefit plan under the Employee Retirement Income Security Act of 1974; a non-profit organization; a small business investment company; a broker or dealer that owns or invests more than $10 million; a U.S. or foreign bank or savings association with an audited net worth of at least $25 million; or any other organization all of whose beneficial owners are themselves qualified institutional buyers. 17 C.F.R. § 230.144A(a)(1).

[50] In the governing documents, the foreign parent had specifically consented to jurisdiction in New York and had appointed an agent for service of process there.

[51] In the event of a default on note payments, the indenture trustee, a commercial bank, was empowered to declare the outstanding amount of the notes and any accrued but unpaid interest with respect to the loan to be immediately due and payable. Furthermore, under the terms of the trust indenture agreement, if the trustee did not exercise its rights following a default, holders of at least twenty-five percent

equivalent" of a guaranty by the parent[52] (thereby qualifying for the exemption).[53]

Functional equivalence is no stranger to banking regulation either. It has featured prominently in a number of contexts, particularly, as we shall see, in the adumbration by the Office of the Comptroller of the Currency (OCC) of what constitutes the "business of banking" under the National Bank Act.[54] A particularly contentious example was *Investment Company Institute v. Camp*,[55] where the "managing agency accounts" offered for sale by Citibank (then First National City Bank of New York) and approved by OCC were held to be the *functional equivalent* of an open-end investment company.[56] Another example took place at the dawn of interstate banking,[57] when bank holding companies, facing a sea of legislative and regulatory uncertainties,[58] ad-

in aggregate principal amount of the outstanding notes could direct the trustee to exercise the rights or could themselves accelerate the notes.

52 *See* SEC, Investment Company Act Release No. 24786, 65 Fed. Reg. 77,939 (Dec. 13, 2000).

53 *See supra* note 48 and accompanying text.

54 12 U.S.C.A. § 24 (Seventh) (West 2001); *see generally infra* notes 170-74 and accompanying text.

55 401 U.S. 617 (1971).

56 *Id.* at 622-23. That conclusion rendered the arrangement unlawful under sections 16 and 21 of the Glass-Steagall Act, 12 U.S.C. §§ 24 (Seventh), 378.

57 Nowadays, nearly twenty years after the earliest state statutes that proliferated in the mid-1980s and that authorized regional or nationwide acquisitions by out-of-state bank holding companies, with interstate branching having been permitted for almost a decade by the Office of Thrift Supervision (OTS) for federally chartered thrift institutions, *see* OTS Statements of Policy, 12 C.F.R. § 556.5 (2001), and with the enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338, permitting interstate branching for commercial banks, much of the novelty has worn off. Indeed, the banking law students of today find the Douglas Amendment to the BHCA, branching restrictions, and unit banking to be so terribly old-fashioned, even anachronistic, that they can scarcely credit that these things existed during their lifetimes.

58 At the time, both the prospects for widespread enactment of state regional interstate banking laws and the constitutionality of such laws were in doubt. Most such statutes were regional in scope and required reciprocal treatment for the state's own banking organizations to be effective; initially only Arizona enacted a nationwide interstate banking statute, and then shortly thereafter California amended its statute to provide for a national trigger in 1987. The validity of various state enactments was tested, and ultimately they survived both constitutional and statutory construction challenges. *See* Northeast Bancorp v. Bd. of Governors, 472 U.S. 159 (1985); Indep. Cmty. Bankers Ass'n, Inc. v. Bd. of Governors, 820 F.2d 428 (D.C. Cir. 1987). *But cf.* Indep. Cmty. Bankers Ass'n of S.D. v. Bd. of Governors, 838 F.2d 969 (8th Cir. 1988) (holding unconstitutional South Dakota statute authorizing entry by out-of-state bank holding company, subject to certain conditions on the operation of the bank it acquired in South Dakota).

dressed the business aspect of the problem with so-called "stakeouts"—nonvoting equity investments (preferred stock or nonvoting common stock) in banks or bank holding companies located in states other than the home states of the investing bank holding companies. The Board viewed many of these nonvoting equity interests as the *functional equivalent* of voting control, and prescribed standards to be followed for stakeout investments to avoid "control" problems.[59]

This by no means exhaustive series of examples demonstrates that functional equivalence is alive and well in legal doctrine and is applied across a broad spectrum of factual circumstances and legal disciplines. An understanding, based on the preliminary definitions of the functional equivalence concept given above, would be incomplete, however, for failure to take into account certain limitations on its application.

The principal limitation is that functional equivalence analysis is inappropriate where the result would be inconsistent with specific statutory definitions enacted as part of the regulatory scheme. The Federal Reserve learned this lesson to its chagrin when, in the mid-1980s, it endeavored to regulate "nonbank banks" under the Bank Holding Company Act (BHCA). Prior to the enactment of the Competitive Equality Banking Act of 1987 (CEBA),[60] section 2(c) of the BHCA defined the term "bank" to include only those institutions that *both* accepted deposits that the depositor had a legal right to withdraw on demand

Likewise not free from doubt, even years later, was the validity of OTS's interstate branching policy, but this, too, was ultimately upheld on judicial review. Conference of State Bank Supervisors v. OTS, 792 F. Supp. 837 (D.D.C. 1992).

59 *See*, *e.g.*, Statement of Policy on Nonvoting Equity Investments by Bank Holding Companies, 47 Fed. Reg. 30,966 (July 16, 1982) (codified at 12 C.F.R. § 225.143 (2001)). Prior to the Board's Policy Statement, a number of stakeout agreements had been announced, e.g., Citicorp/Central National Chicago, Chemical/Florida National, Chase Manhattan/Equimark, First National Boston Corp./Casco-Northern, Marine Midland/Industrial Valley, First Bank System/Bank of Iowa, Marine Midland/Centran, and the tripartite AmSouth/Trust Co. of Georgia/South Carolina National.

For a discussion of stakeout investments and the Board's response, see generally Michael S. Helfer & Russell J. Bruemmer, *Interstate Nonvoting Equity Agreements and "Control" Under the Bank Holding Company Act: The Impact of the Federal Reserve Board's 1982 Policy Statement,* 39 BUS. LAW. 383 (1984); *cf*. United States v. Citizens & S. Nat'l Bank, 422 U.S. 86, 137 (1975) (Brennan, J., with Douglas & White, JJ., dissenting) (noting that "the 'functional equivalent' of a holding company-subsidiary relationship could perhaps be created through informal affiliation").

60 Competitive Equality Banking Act of 1987 (CEBA), Pub. L. No. 100-86, 101 Stat. 552.

and engaged in the business of making commercial loans. Banking products that were *functional equivalents* of demand deposits and commercial loans did not come within this narrow definition, and "nonbank banks" were simply institutions that featured one or the other (but not both) prongs of the statutory definition, while offering products that were functional equivalents of the remaining prong (e.g., making commercial loans but offering Negotiable Order of Withdrawal or "NOW" accounts rather than demand deposit accounts). In 1984, the Board endeavored to bring those institutions within its BHCA jurisdiction by amending its regulation implementing the BHCA (Regulation Y)[61] using a functional equivalence approach, i.e., the Board promulgated new rules providing that nonbank banks offering the functional equivalent of traditional banking services would thereafter be regulated as banks. First, the Board sought to expand the definition of "commercial loan" by bringing within its compass "the purchase of retail installment loans or commercial paper, certificates of deposit, bankers' acceptances, and similar money market instruments, [as well as] the extension of broker call loans, the sale of federal funds and the deposit of interest-bearing funds,"[62] all of which the Board characterized as functional equivalents of commercial lending. Second, the Board sought to expand the definition of "demand deposit" to include functional equivalents of checking accounts, encompassing all interest-bearing transaction accounts (including "NOW" accounts).[63]

These attempts at reinterpretation of the key components of the statutory definition of "bank" were successively invalidated by decisions of the United States Court of Appeals for the Tenth Circuit[64] and ultimately by the Supreme Court in *Board of Governors v. Dimension Financial Corp.*[65] The Court concluded that it was not a legitimate exercise of the Board's interpretive authority under the BHCA to redefine by regulatory fiat what Con-

[61] Fed. Res. Sys. Bank Holding Companies and Change in Bank Control (Regulation Y), 12 C.F.R. §§ 225.1-225.200 (2001).

[62] Bank Holding Companies and Change in Bank Control; Revision of Regulation Y, 49 Fed. Reg. 794, 818 (Jan. 5, 1984) (promulgating now-superseded 12 C.F.R. § 225.2(a)(1)(B)).

[63] *Id.* (promulgating now-superseded 12 C.F.R. § 225.2(a)(1)(A)).

[64] *See* Dimension Fin. Corp. v. Bd. of Governors, 744 F.2d 1402 (10th Cir. 1984), *aff'd,* 474 U.S. 361 (1986); First Bancorporation v. Bd. of Governors, 728 F.2d 434 (10th Cir. 1984).

[65] 474 U.S. 361 (1986).

gress had expressly defined in legislation. What constituted a demand deposit "as a matter of practice" was not the same as what Congress had specified in so many words: deposits that the depositor "has a legal right to withdraw on demand."[66] Nor were "commercial loan substitutes" that were essentially money market transactions appropriate proxies for what the financial community (and, by extension of that parlance, the Congress) understood was within the purview of the term "commercial loan."

For present purposes, the key point is that the use of functional equivalence in these contexts is institutionally (and constitutionally) impermissible in our system of separation of powers, even if the agency acts in good faith to implement what it perceives as the overarching purpose of the statute:

> 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. Congress may be unanimous in its intent to stamp out some vague social or economic evil; however, because its Members may differ sharply on the means for effectuating that intent, the final language of the legislation may reflect hard-fought compromises. Invocation of the "plain purpose" of legislation at the expense of the terms of the statute itself takes no account of the processes of compromise and, in the end, prevents the effectuation of congressional intent.[67]

The Court concluded by emphasizing this fundamental limitation on the regulatory use of the functional equivalence technique:

> Without doubt there is much to be said for regulating financial institutions that are the functional equivalent of banks. NOW accounts have much in common with traditional payment-on-demand checking accounts; indeed we recognize that they gen-

[66] *Id.* at 368.

> The Board would now define "legal right" as meaning the same as "a matter of practice." But no amount of agency expertise—however sound may be the result—can make the words "legal right" mean a right to do something "as a matter of practice." A *legal* right to withdraw on demand means just that: a right to withdraw deposits without prior notice or limitation. Institutions offering NOW accounts do not give the depositor a legal right to withdraw on demand; rather, the institution itself retains the ultimate legal right to require advance notice of withdrawal. The Board's definition of "demand deposit," therefore, is not an accurate or reasonable interpretation of § 2(c) [of the BHCA].

Id.

[67] *Id.* at 373-74.

> erally serve the same purpose. Rather than defining "bank" as an institution that offers the functional equivalent of banking services, however, Congress defined with specificity certain transactions that constitute banking subject to regulation. The statute may be imperfect, but the Board has no power to correct flaws that it perceives in the statute it is empowered to administer. Its rulemaking power is limited to adopting regulations to carry into effect the will of Congress as expressed in the statute.[68]

A similar result was reached when, after the dramatic entry of banks into the discount brokerage business in the early 1980s, the SEC sought to subject them to broker-dealer regulation *in pari materia* with non-bank securities brokers.[69] In 1985, the SEC promulgated Rule 3b-9 under the Securities Exchange Act of 1934 (the 1934 Act), in order to require banks engaged in the securities brokerage business for compensation to register as broker-dealers under the 1934 Act,[70] with all the additional regulation that that entailed.[71] Like the Board in *Dimension*, however,

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[68] *Id.* at 374.

[69] Discount brokerage services fall within the ambit of permissible agency activities under section 16 of the Glass-Steagall Act, 12 U.S.C. § 24 (Seventh). Early interpretations of that statute by the OCC had limited these activities to purchases and sales for actual, pre-existing customers of the bank, 1 Bull. Comptroller Currency ¶ 36 (Oct. 26, 1936), and had forbidden banks from receiving commissions or other compensation for the brokerage, *id*. ¶ 10, allowing them only to provide the service as an accommodation, even for trust customers, *id.* ¶ 35. (Actually, the Comptroller believed himself constrained to issue that interpretation because he mistakenly believed that the language of section 16 absolutely prohibited banks from brokering stocks even if done, as the statute allowed, "without recourse" and only "upon the order, and for the account of, customers." Yet, because he did not believe that Congress intended to reach this result, the Comptroller was around the same time urging Congress to amend Glass-Steagall explicitly to allow these bank brokerage activities. *See* Harold James Kress, *The Banking Act of 1935,* 34 MICH. L. REV. 155, 177-78 (1935) (citing 1933 Annual Report of the Comptroller of the Currency)).

In any event, that limiting administrative construction was abandoned in the 1980s by both the Federal Reserve, *see* discussion *infra* notes 80-98 and accompanying text, and the OCC, *see In re* Sec. Pac. Nat'l Bank, [1982-1983 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284 (Aug. 26, 1982).

[70] *See* Applicability of Broker-Dealer Registration to Banks Exchange Act Release No. 34-22,205, 50 Fed. Reg. 28,385 (July 12, 1985).

[71] Thus in addition to registration as a broker-dealer, Rule 3b-9 would have (1) subjected bank employees, as persons associated with broker-dealers, to the requirements of being licensed and passing examinations before they could sell securities or become involved in the management of a securities firm, *id.* at 28,387; (2) imposed on the banks an affirmative duty adequately to supervise their employees in order to prevent violations of federal securities laws, *id.* at 28,388; (3) subjected the banks to rules on abusive sales practices (e.g., "churning" customer accounts in order to increase brokerage commissions), *id.* at 28,388, 28,390; (4) required compliance with specific advertising guidelines, *id.* at 28,388; (5) subjected banks to periodic SEC

the SEC faced a tiny statutory obstacle: the 1934 Act excluded banks from the statutory definitions of "broker"[72] and "dealer."[73] The SEC sought to remedy this[74] by using Rule 3b-9 to redefine the term "bank" to exclude those banks engaging in brokerage business for profit from the meaning of "bank" in the statutory definitions of "broker" and "dealer."[75]

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broker-dealer examinations and inspections, *id.* at 28,394. Additional consequences of subjecting banks to broker-dealer regulation would have included (6) compelling banks to become members of the Securities Investor Protection Corporation, an entity with potentially conflicting authority with the Federal Deposit Insurance Corporation (FDIC); and (7) imposing upon banks the SEC's net capital requirements for broker-dealers, which conceivably could conflict with the capital requirements established for banks by the appropriate Federal banking agency.

[72] At that time, section 3(a)(4) of the 1934 Act provided that "the term 'broker' means any person engaging in the business of effecting transactions in securities for the account of others, *but does not include a bank*." 15 U.S.C. § 78c(a)(4) (1982) (amended 1999) (emphasis added).

[73] Similarly, section 3(a)(5) provided at that time in pertinent part that "the term 'dealer' means any person engaged in the business of buying or selling securities for his own account . . . *but does not include a bank* . . . ." 15 U.S.C. § 78c(a)(5) (1982) (amended 1999) (emphasis added).

[74] The SEC's regulatory rationale was that Congress, when drafting the statutory definitions in the 1934 Act, acted under the misimpression that Glass-Steagall prohibited banks from engaging in any kind of brokerage activities. (While the 1934 Act was being considered and debated, there was, in fact, some congressional testimony to this effect by Thomas Corcoran, then General Counsel to the Reconstruction Finance Corporation and a proponent of bank exemption from broker-dealer regulation. *See* Am. Bankers Ass'n v. SEC, 804 F.2d 739, 747-748 (D.C. Cir. 1986) (citing *Stock Exchange Practices: Hearings Before the S. Comm. on Banking and Currency*, 73d Cong. 6470 (1934); *Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8270 Before the House Comm. on Interstate and Foreign Commerce,* 73d Cong. 86 (1934)). As that understanding turned out to be incorrect, it was incumbent upon the Commission to give effect to the intent of Congress, manifest in the overarching purpose of the federal securities laws, by regulating banks that engaged in retail brokerage.

As the D.C. Circuit later pointed out, the weakness in this reasoning—even apart from its substitution of perceived congressional intent for the actual language Congress enacted—is that it assumes "that if Congress had only known how the Comptroller and the courts were going to interpret the Glass-Steagall Act, Congress would not have exempted banks from the SEC's broker-dealer regulation. There is absolutely no evidence in the legislative history supporting (or negating) this assumption." *Am. Bankers Ass'n*, 804 F.2d at 749.

[75] Rule 3b-9 did this by providing that the term "bank" as used in the definition of "broker" and "dealer" in sections 3(a)(4) and (5) of the Act did not, subject to exceptions not here pertinent, include a bank that: "(1) Publicly solicits brokerage business for which it receives transaction-related compensation . . .; (2) Directly or indirectly receives transaction-related compensation for providing brokerage services for trust, managing agency, or other accounts to which the bank provides advice . . . ." SEC General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.3b-9(a)(1)-(2) (1986).

"Bank," however, was likewise a defined term in the statute.[76] The case thus became indistinguishable from *Dimension*, and Rule 3b-9, when challenged by the banking industry, was ultimately[77] struck down on a substantially identical rationale.[78] "The manner in which Congress defined "broker," "dealer," and "bank" in the 1934 Act reflects a purposeful decision on its part that the SEC should not have oversight jurisdiction with respect to banks . . . ."[79] Therefore, we must modify our syllogism to read as follows:

(1) X is subject to regulatory treatment R;
(2) Y is the functional equivalent of X;
(3) Therefore, Y should likewise be subject to R, UNLESS doing so would be inconsistent with the legislative definition of X under the pertinent statutory scheme.

Yet even this narrowing of our working concept of functional equivalence fails to account fully for the institutional significance of statutory definitions. For even when the pertinent statutory scheme contains no legislated definition of the term in question, the existence of such a definition in *another* statutory scheme may be sufficient to undermine a functional equivalence analysis. While this may make little sense in the abstract, it may have some force at least where the second statutory scheme is related in subject matter to the first one and is roughly contemporaneous with it, thus raising at least the possibility that Congress may

[76] Section 3(a)(6) of the 1934 Act provided in pertinent part:

> The term "bank" means (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act, as amended, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this chapter . . . .

15 U.S.C. § 78c(a)(6) (1982) (amended 1987).

[77] Initially, the district court had granted summary judgment for the SEC. While acknowledging the clear exclusion of "bank" from the statutory definitions of "broker" and "dealer," the district court accepted the SEC's regulatory rationale. *See* Am. Bankers Ass'n v. SEC, Civil Action No. 85-02482, slip op. (D.D.C.), *rev'd*, 804 F.2d 739 (D.C. Cir. 1986); *see also supra* note 74. Finding that rationale unpersuasive as well as inimical to separation of powers considerations in the interpretation of statutes, the D.C. Circuit reversed. *Am. Bankers Ass'n*, 804 F.2d at 748-49.

[78] *Am. Bankers Ass'n*, 804 F.2d at 749 (citing *Dimension*).

[79] *Id.* at 744.

have had in mind the legislated definition in the second scheme when using the term in the first. Consider, as a prime example, the Bankers Trust commercial paper case.

In 1978, Bankers Trust Company (Bankers), a money-center state member bank, took the first major step down the long road leading to dismantling the Glass-Steagall Act by entering into the business of privately placing commercial paper[80] with selected institutional purchasers as agent for the corporate issuers.[81] These issuers had traditionally been banks' best commercial loan customers who had discovered the cost-advantage of funding short-term debt through the commercial paper market[82] as opposed to bank loans. Endeavoring to retain at least some of this corporate business, commercial banks, led by Bankers, sought to compete in the commercial paper business with the investment banking firms,[83] which petitioned the Board to commence enforcement action to stop Bankers' commercial paper placement activities. This petition was denied by the Board,[84] based on its analysis of

[80] The term "commercial paper" refers to prime quality, negotiable promissory notes with short maturities, typically sixty days or less. *See* Evelyn M. Hurley, *The Commercial Paper Market*, 63 Fed. Res. Bull. 525 (1977); *see also* Kenneth V. Handal, Comment, *The Commercial Paper Market and the Securities Acts,* 39 U. Chi. L. Rev. 362, 364 (1972) ("[ma]turities range from one day to nine months, but most paper carries an original maturity between thirty and ninety days").

[81] This activity was initially being done in the bank itself. After litigation made the future viability of bank commercial paper private placement uncertain, Bankers decided to hedge its bets by applying under section 4(c)(8) of the Bank Holding Company Act (BHCA), 12 U.S.C. § 1843(c)(8), to conduct the selfsame activities in BT Commercial, a nonbank subsidiary of the holding company, Bankers Trust New York Corporation (BTNY). This led directly to the section 20 applications by Citicorp, J.P. Morgan & Co., Inc., and BTNY. Indeed, the Board's decision approving the BT Commercial application was the first pronouncement on the meaning of "engaged principally" under section 20 of the Glass-Steagall Act, 12 U.S.C. § 377. Bankers Trust N.Y. Corp., 73 Fed. Res. Bull. 138 (1987). For discussion of the BT Commercial decision and its progeny, see generally Keith R. Fisher, *Reweaving the Safety Net: Bank Diversification into Securities and Insurance Activities,* 27 Wake Forest L. Rev. 123, 149-59 (1992).

[82] "Commercial paper is sold, in denominations averaging one million dollars or more, to large, sophisticated purchasers—money market mutual funds, bank trust departments, insurance companies and pension funds." A.G. Becker Inc. v. Bd. of Governors, 693 F.2d 136, 138 (D.C. Cir. 1982).

[83] Actually, this was less than full competition. Investment banking houses were free to underwrite issues of commercial paper. National banks and state member banks were forbidden from doing so by section 16 of the Glass-Steagall Act, 12 U.S.C. § 24 (Seventh). In fact, whether Bankers' commercial paper private placement activities constituted proscribed underwriting was the central issue of the second stage of that litigation, from 1984 to 1987. *See* Sec. Indus. Ass'n v. Bd. of Governors, 628 F. Supp. 1438 (D.D.C.), *rev'd*, 807 F.2d 1052 (D.C. Cir. 1986).

[84] Federal Reserve System, Statement Regarding Petitions to Initiate Enforce-

commercial paper and its conclusion that commercial paper was the *functional equivalent* of a short-term loan and ought to be treated as such for regulatory purposes, rather than as a "security" for purposes of the Glass-Steagall Act.[85]

Judicial review was sought by the securities industry. Ruling in their favor, the district court rejected the Board's functional analysis and concluded that the "plain language" as well as the "broad framework" of the Glass-Steagall Act prohibited commercial banks from trading in commercial paper.[86] The court of appeals, however, in a detailed and scholarly opinion,[87] reversed the decision, concluding that the district court had given insufficient deference[88] to the Board's expertise, and finding that the language, legislative history, and policies of Glass-Steagall supported the Board's analysis[89] and its functional equivalence

ment Action (Sept. 26, 1980). This request by A.G. Becker & Co. and the Securities Industry Association (SIA) for enforcement action arose from a decision of the Board's general counsel, which, "after extensive discussion with Becker, SIA, Bankers Trust and the SEC, issued an opinion declaring that commercial banks may lawfully act as agent for the issuer in the sale of commercial paper, 'provided that the sales . . . are limited to purchasers to whom commercial banks normally sell participations in loans.'" A.G. Becker Inc. v. Bd. of Governors, 693 F.2d 136, 138 n.8 (citing Legal Div., Bd. of Governors of the Federal Reserve Sys., Commercial Paper Activities of Commercial Banks: A Legal Analysis (June 28, 1979)). Both Federal Reserve documents were reprinted in the joint appendix of the parties to the *Becker* litigation in the D.C. Circuit. *See id.* at nn.3, 8.

[85] *A.G. Becker Inc.*, 693 F.2d at 139.

[86] A.G. Becker Inc. v. Bd. of Governors, 519 F. Supp. 602, 612-16 (D.D.C. 1981), *rev'd*, 693 F.2d 136 (D.C. Cir. 1982).

[87] A.G. Becker Inc. v. Bd. of Governors, 693 F.2d 136 (D.C. Cir. 1982). The D.C. Circuit's panel decision was a majority opinion, not a unanimous one. Judge Wilkey, joined by Judge Tamm, wrote the opinion for the panel. Judge Robb filed a dissenting opinion agreeing substantially with the district court. *Id.* at 152-55 (Robb, J., dissenting).

[88] Deference was especially appropriate, in the D.C. Circuit's view, because of (1) Congress's having vested in the Board a broad scope of authority for administering federal regulation of the banking system, (2) the Board's considerable expertise and specialized knowledge, (3) the Board's application of general, undefined statutory terms (i.e., "notes and securities") to particular facts, and (4) the extent of the Board's factual inquiry, the thoroughness of its review and analysis of the facts and the relevant legal and policy considerations, as well as the clarity of the agency's findings, conclusions, and rationale. *Id.* at 140-41.

[89] The case was decided well before *Dimension*, but even had it not been, the latter case would not have been controlling. Here, the court of appeals emphasized the absence of a statutory definition of the key term "securities," characterized that sort of statutory drafting as "leav[ing] the agency with the task of evolving definitions on a case-by-case basis," *id.* (citing Puerto Rico v. Blumenthal, 642 F.2d 622, 635 (D.C. Cir. 1980); Chisholm v. FCC, 538 F.2d 349, 358 (D.C. Cir. 1976)), and observed that "[t]he regulatory structure of the banking laws must be permitted to adapt to the changing financial needs of our economy," *id.* at 141 (citing M&M

approach.[90]

As part of its analysis, the court of appeals considered and rejected SIA's argument that the definition of "security" in two statutes roughly contemporaneous with Glass-Steagall—the Securities Act of 1933 and the 1934 Act[91]—should inform the determination of what Congress intended the term to mean in Glass-Steagall itself. The D.C. Circuit emphasized the disparate purposes of the enactments—Glass-Steagall to protect banks and their depositors and the securities laws to eliminate abuses in a hitherto unregulated securities market, prevent fraud, and protect investors—and concluded that different interpretations of the term "securities" "may follow upon the differing regulatory purposes behind the Acts."[92] The court of appeals also relied on the Supreme Court's decision in *Marine Bank v. Weaver*,[93] which considered the character of the underlying instrument and the economic and regulatory realities surrounding it in conjunction with the underlying investor protection purposes of federal securities regulation, and found that "[a] different focus of analysis is called for under the Glass-Steagall Act, which aims at protecting the integrity of banks and the financial resources of depositors rather than investors."[94]

Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377, 1382 (9th Cir. 1977) (banking laws construed to permit "use of new ways of conducting the very old business of banking")).

90 In reaching these conclusions, the D.C. Circuit conducted a searching, de novo review of the language, structure, and legislative history of the Glass-Steagall Act. *A.G. Becker Inc.*, 693 F.2d at 142-46. Furthermore, in an extensive discussion reviewing and approving the Board's functional equivalence analysis, *id.* at 147-51, the court of appeals relied on the Supreme Court's classic pronouncement in *Investment Co. Institute v. Camp*, 401 U.S. 617, 629-30 (1971), that Glass-Steagall represented a congressional determination that policies which otherwise might support bank entry into the investment banking business were outweighed by certain "hazards" and "financial dangers," *A.G. Becker Inc.,* 693 F.2d at 148, and concluded that "[o]nly if commercial paper displayed the *economic* characteristics of a 'security' would [its] marketing . . . by Bankers Trust cause the hazards [that Glass-Steagall] was designed to prevent." *Id.* Thus the Board "correctly focused on whether the commercial paper marketed by Bankers Trust functioned economically as a loan or as a security." *Id.*

91 Both statutes encompass commercial paper because both define "security" to include "any note." *See* 15 U.S.C. § 77b(1) (1994 & Supp. IV 1998) (1933 Act); *id.* § 78c(a)(10) (1934 Act).

92 *A.G. Becker Inc.*, 693 F.2d at 146.

93 455 U.S. 551 (1982) (holding that bank certificate of deposit is not a "security" for purposes of the federal securities laws). For more on *Weaver*, see *infra* notes 104-05 and accompanying text.

94 *A.G. Becker Inc.*, 693 F.2d at 147. The *Weaver* opinion's emphasis on the need

After so much extensive analysis by the Board, with its vaunted expertise, and so scrupulous and detailed an opinion by the D.C. Circuit,[95] the Supreme Court's reversal[96] came as a surprise to many. The Court declined to defer to the Board's interpretation of the undefined term "securities"—an interpretation that the Court found unduly narrow[97]—and preferred a broader reading informed by the more expansive definition (which clearly encompassed commercial paper) employed by Congress in the contemporaneous securities laws:

> There is . . . considerable evidence to indicate that the ordinary meaning of the terms "security" and "note" as used by the 1933 Congress encompasses commercial paper. Congress enacted the Glass-Steagall Act as one of several pieces of legislation collectively designed to restore public confidence in financial markets. See the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.); the Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77a *et seq.*; the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78a *et seq.*; and the Public Utility Holding Company Act of 1935, 49 Stat. 803, 15 U.S.C. § 79a *et seq.* In each of these other statutes, 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. These explicit exceptions demonstrate congressional cognizance of commercial paper and Congress' understanding that, unless modified, the use of the term "security" encompasses it.[98]

Thus a second modification to our syllogism on functional equivalence is needed.

(1) X is subject to regulatory treatment R;

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for careful economic analysis of the underlying instrument or transaction bolstered the D.C. Circuit's view that the sort of careful, functional analysis of commercial paper and the commercial paper market that had been performed by the Board was appropriate–indeed, necessary–to resolution of the case.

[95] The panel majority's slip opinion encompassed more than fifty pages of detailed analysis.

[96] Sec. Indus. Ass'n v. Bd. of Governors, 468 U.S. 137 (1984).

[97]
> [W]e find unpersuasive the notion that Congress used the terms "notes . . . or other securities" in the narrow sense that respondents suggest. First, the Court noted in [*ICI v.] Camp* that "there is nothing in the phrasing of either § 16 or § 21 that suggests a narrow reading of the word 'securities.' To the contrary, the breadth of the term is implicit in the fact that the antecedent statutory language encompasses not only equity securities but also securities representing debt."

Id. at 150 (citing Inv. Co. Inst. v. Camp, 401 U.S. 617, 635 (1971)).

[98] *Id.* at 150-51 (footnote omitted).

(2) Y is the functional equivalent of X;
(3) Therefore, Y should likewise be subject to R, UNLESS doing so would be inconsistent with the legislative definition of X under the pertinent statutory scheme OR a closely related statutory scheme.

Another limitation arises when the conclusion of functional equivalence carries with it a regulatory burden that the courts deem duplicative or otherwise unnecessary.[99] This is particularly true when private litigants (or, on occasion, the SEC) have sought to engraft an additional layer of securities regulation onto a pre-existing regulatory structure. The two leading cases for this proposition are *International Brotherhood of Teamsters v. Daniel*[100] and *Marine Bank v. Weaver*.[101]

Daniel held that a noncontributory pension plan was not a security subject to regulation under the federal securities laws.[102] Central to that holding was that the substantive terms of the pension plan were comprehensively regulated by another federal statutory scheme, the Employee Retirement Income Security Act of 1974 (ERISA), which also mandated certain disclosures, thereby making it unnecessary to subject pension plans to the requirements of the federal securities laws as well. "The existence of this comprehensive legislation governing the use and terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans."[103] Similarly, *Weaver* held that a bank certificate of deposit was not a security. There, the instrument in

[99] There is an overlay of this principle in the Rule 3b-9 decision too. *See* Am. Bankers Ass'n v. SEC, 804 F.2d 739, 744-45 (D.C. Cir. 1986).

[100] 439 U.S. 551 (1979).

[101] 455 U.S. 551 (1982).

[102] *Daniel* involved a challenge by an employee who was denied a pension upon retirement because a break in his overall twenty years of service rendered him ineligible under the plan, which required twenty years of *continuous* service. 439 U.S. at 553-55. The pension plan, which had been entered into under a collective-bargaining agreement between a labor union and several employers, required all employees to participate in the plan but not to pay anything into it. *Id.* Daniel, the aggrieved employee, claimed that the union and petitioner trustee of the pension fund had made material misrepresentations and omissions of fact with respect to the value of a covered employee's interest in the pension plan, and that such misstatements and omissions constituted a fraud in connection with the sale of a security in violation of section 10(b) of the 1934 Act (and Rule 10b-5 thereunder) and section 17(a) of the 1933 Act. *Id.*

[103] *Id.* at 569-70.

question was a bank deposit[104] subject to another comprehensive system of regulation, the federal banking laws. "It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws."[105]

The SEC has encountered the very same obstacle in connection with efforts to extend its jurisdiction[106] over instruments or

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104 The owners of the $50,000 certificate of deposit in *Weaver* had pledged it to the issuing bank in order to guarantee a $65,000 loan made by the bank to a third party corporation that already owed the bank money and was overdrawn on its checking accounts. 455 U.S. at 552-54. The guarantors entered into a contract with the owners of the borrower, whereby, as consideration for their guaranty, they would receive, inter alia, an interest in the profits of the business. *Id.* Allegedly, the bank told the guarantors that the proceeds of the new loan would be used by the borrower for working capital, but in reality they were applied first to pay off the borrower's pre-existing, past due indebtedness to the bank. *Id.* When the borrower went bankrupt and the bank announced its intention to use the certificate of deposit to satisfy the guaranty obligation, the guarantors filed suit claiming, inter alia, that the bank had violated the antifraud provisions of the 1934 Act by soliciting the loan guaranty, while knowing but not disclosing either the borrowing company's financial condition or the bank's plans to repay the past due indebtedness to itself from the proceeds of the guaranteed loan. *Id.*

105 *Id.* at 559.

106 That the SEC had grounds for some optimism can be traced to *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65 (1959) [hereinafter *VALIC I*]. Although that case did feature an argument about SEC jurisdiction being unnecessary because it would duplicate an existing scheme of regulation (namely, state insurance regulation), it was not a functional equivalence case at all, but a statutory definition case. *VALIC I* concerned whether a variable annuity contract was a "security" as defined in the 1933 Act and whether a company offering such variable annuity contracts was an "investment company" as defined in the 1940 Act. The 1933 Act explicitly exempted "insurance" or "annuity" contracts from the definition of "security," and the 1940 Act explicitly exempted an institution which met the definition of an "insurance company" from the definition of "investment company." Except for these exemptions, the variable annuity contract and the companies that offered them would clearly fall within the 1933 Act's definition of "security" and the 1940 Act's definition of "investment company." (The 1933 Act did not actually contain a definition of "insurance" or "annuity contract" but merely stated that its provisions did not apply to "any insurance . . . or annuity contract . . . issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State . . . ." 15 U.S.C. § 77c(a)(8) (1994).)

While the exemptions for annuities and insurance companies in *VALIC I* were plainly designed in terms of existing supervision by other agencies, the Court held that variable annuity contracts and the companies that offered them were not exempt from the statutory definitions in question ("security" and "investment company") and hence were subject to SEC regulation. The *ratio decidendi* turned on the fact that a variable annuity contract contained markedly distinct features from a traditional fixed-dollar annuity contract, which had been the only type of annuity Congress had been aware of when enacting the statutes in question (since variable

activities within the purview of banking. The *Banco Español de Credito v. Security Pacific National Bank*,[107] for example, involved the sale of "loan notes" which were touted in the 1980s by money center banks as an alternative to commercial paper.[108] The factual setting is exemplary of the kind of "invention" that had helped banks adapt to significant changes in the financial services marketplace.[109] These "loan notes" were part of the market phenomenon that Marcia Stigum has dubbed banks "get[ting] out of their old make-a-loan-and-hold-it business into a new business, namely, the make-a-loan-and-distribute-it business."[110] Short-term unsecured loans to corporate borrowers were participated to a variety of purchasers,[111] typically in minimum denominations of $1 million, with recourse not against the

annuities weren't developed until the late 1950s). The holder of a variable annuity, as opposed to a fixed annuity, "participate[s] on an 'equity' basis in the investment experience of the enterprise," just like the owner of a share of company stock or a mutual fund does. *VALIC I*, 359 U.S. at 79 (Brennan, J., concurring). Thus, although a variable annuity contract by name might fit a literal reading of "any insurance . . . or annuity contract," the Court concluded that Congress, in exempting insurance-type contracts from SEC regulation, did not intend to exempt what were essentially equity shares, however they might otherwise be denominated.

VALIC I is just as important for what it did hold as for what it might have held but did not. Central to the Court's conclusion was the lack of precision in the statutorily undefined term "insurance," an imprecision that provided enough latitude to permit the Court to decide that a variable annuity did not fall within the term. *VALIC I* was emphatically *not* a case holding that although the products fell within a statutory exemption, sound regulatory policy counseled subjecting them (and the companies that offered them) to SEC oversight.

[107] 973 F.2d 51 (2d Cir. 1992).

[108] For more on commercial paper, see *supra* notes 80-84 and accompanying text.

[109] *See supra* note 83 and accompanying text.

[110] MARCIA STIGUM, THE MONEY MARKET 1085 (3d ed. 1990). As part of the banking industry's efforts to retain a share of credit-related business diminished by large public corporations—traditionally commercial banks' best loan customers—accessing the commercial paper market, banks began to mass market loan participations to sophisticated purchasers (typically institutional purchasers, such as pension funds or mutual funds, as well as wealthy individuals) that were not themselves in the lending business. *Id.* at 1086. This distinguished these "loan notes" from garden variety loan participations, where the purchasers were other lending institutions fully capable of making their own assessments of the borrower's creditworthiness and, in many cases, of negotiating the terms of the participation "*mano a mano*" with the lead bank. *See*, *e.g.*, Am. Fletcher Mortgage Co. v. U.S. Steel Credit Corp., 635 F.2d 1247, 1254-55 (7th Cir. 1980) (emphasizing independent credit review and retained contractual rights of loan participant); Union Planters Nat'l Bank v. Commercial Credit Bus. Loans, Inc., 651 F.2d 1174, 1178 (6th Cir. 1981).

[111] In *Banco Español*, the purchasers were foreign banks, domestic banks, thrift institutions, treasury or money management portfolio departments of corporations, pension and retirement funds, insurance companies, and mutual funds. 973 F.2d at 57 (Oakes, C.J., dissenting).

bank but only against the borrowers.[112] Purchasers of "loan notes" differed from participants in loan syndications or participations[113] in that the former were not generally in a position to evaluate the borrower's creditworthiness or to negotiate individually with the selling bank the terms of the offering. For these reasons, the SEC believed such purchasers needed the protection of the federal securities laws.

Plaintiffs in *Banco Español* thought so too. They had originally found the loan notes congenial investments, because the notes provided a short-term vehicle in which to place excess cash for an excellent return, albeit with scant opportunity (or, for that matter, incentive) to inquire into the creditworthiness of the corporate borrowers.[114] But when one of the borrowers defaulted on over $75 million of notes, the plaintiffs sued for rescission[115] under section 12(2) of the Securities Act of 1933 (1933 Act).[116]

The linchpin of the plaintiffs' case was, of course, that the loan notes constituted "securities" subject to the protections of the 1933 Act. After the district court granted summary judgment on the ground that the loan notes were not securities under the four-pronged test established by the Supreme Court in *Reves v. Ernst*

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112 Banco Español de Credito v. Sec. Pac. Nat'l Bank, 763 F. Supp. 36, 38-39 (S.D.N.Y. 1991), *aff'd*, 973 F.2d 51 (2d Cir. 1992).

113 Traditional loan participations were not generally considered securities. *See*, *e.g.*, First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., 919 F.2d 510, 516 (9th Cir. 1990); McVay v. W. Plains Serv. Corp., 823 F.2d 1395, 1399 (10th Cir. 1987); Union Nat'l Bank of Little Rock v. Farmers Bank, 786 F.2d 881, 885 (8th Cir. 1986); *Union Planters*, 651 F.2d at 1181; *Am. Fletcher*, 635 F.2d at 1255; Developer's Mortgage Co. v. TransOhio Sav. Bank, 706 F. Supp. 570, 575 (S.D. Ohio 1989); Deauville Sav. & Loan Ass'n v. Westwood Sav. & Loan Ass'n, 648 F. Supp. 513, 518 (C.D. Cal. 1986). *But see* Lehigh Valley Trust Co. v. Cent. Nat'l Bank of Jacksonville, 409 F.2d 989, 992 (5th Cir. 1969) (holding that a loan participation was a security); Commercial Disc. Corp. v. Lincoln First Commercial Corp., 445 F. Supp. 1263, 1268 (S.D.N.Y. 1978); *cf.* NBI Mortgage Inv. Corp. v. Chem. Bank, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,066, at 91,800 (S.D.N.Y. 1977) (suggesting that a loan participation *might* be a security).

For more detailed discussion of loan participations, see generally Jeffrey D. Hutchins, *What Exactly Is a Loan Participation?*, 9 RUTGERS-CAM. L.J. 447 (1978); Debora L. Threedy, *Loan Participations—Sales or Loans? Or Is That the Question?*, 68 OR. L. REV. 649 (1989).

114 *Banco Español,* 973 F.2d at 60 (Oakes, C.J., dissenting).

115 *Id.* at 57-58 (Oakes, C.J., dissenting).

116 Section 12(2) of the 1933 Act permits a right of rescission for misrepresentations and omissions in a "prospectus." 15 U.S.C. § 77*l*(2) (1994). Since the Supreme Court's decision in *Gustafson v. Alloyd Co., Inc.,* 513 U.S. 561 (1995), courts have held that section 12(2) applies only to initial public offerings.

& Young,[117] plaintiffs appealed, and the SEC filed a brief amicus curiae acknowledging that courts typically excluded loan participations from the scope of the federal securities laws but arguing that the loan notes at issue were different, because "the non-financial entities among the purchasers clearly were not acting as commercial lenders, and even the banks that purchased generally did so not through their lending departments but through their investing and trading departments."[118] The Commission also took issue with the district court's analysis under the *Reves* test, emphasizing the investment purpose of the purchases by the participants and the dissimilarity to traditional loan participations in that the purchasers had far less than the normal amount of information about the creditworthiness of the borrower and no opportunity independently to verify information about the borrower. Instead, the Commission argued, the loan notes were "offered and sold to numerous entities in a market that meets the *Reves* Court's definition of 'common trading for speculation or investment' . . . [and] were promoted in language used in securities markets, and as the 'equivalent' of commercial paper . . . ."[119]

In short, the SEC advanced a "functional equivalence" argument: Because the loan notes were marketed as investments, were bought by purchasers acting from an investment motivation and with the benefit of only the type and quantum of publicly available information typically available to investors (as opposed

[117] 494 U.S. 56 (1990). Although the *Reves* test "begin[s] with a presumption that every note is a security," *id.* at 65, that presumption may be rebutted in two ways: (A) by demonstrating that the note in question bears a "strong resemblance" to any instrument on the laundry list of obligations that the Court previously had determined not to constitute securities (for example, notes delivered in consumer financing, notes secured by residential mortgages, short-term notes secured by liens on small businesses or assets thereof, short-term notes secured by assignments of accounts receivable, notes that simply formalize open-account debt incurred in the ordinary course of business, and notes evidencing loans by commercial banks for current operations), *id.*; or (B) by persuading the Court under the four-pronged test announced in the case that the note *ought* to be on that laundry list, *id.* at 67. The four factors are: (1) an "examin[ation of] the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it," *id.* at 66; (2) whether the note "is an instrument in which there is 'common trading for speculation or investment,'" *id.* (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)); (3) "the reasonable expectations of the investing public," *id.*; and (4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary," *id.* at 67.

[118] Brief of Amicus Curiae Securities and Exchange Commission at 3, Banco Español de Credito v. Sec. Pac. Nat'l Bank, 973 F.2d 51 (2d Cir. 1992) (No. 91-7563).

[119] *Id.* at 4-5.

to that commonly available in loan participations), the notes had all the indicia of securities and should receive the investor protection benefits of the federal securities laws. Unimpressed with those arguments, a divided panel of the court of appeals affirmed on the reasoning of the district court, but when the Commission persisted in joining the plaintiffs' petition for rehearing, the Second Circuit, while denying rehearing, did modify the opinion somewhat to clarify that "even if an underlying instrument is not a security, the manner in which participations in that instrument are used, pooled, or marketed might establish that such participations are securities."[120] Here, however, the court of appeals emphasized the fact that sale of the notes was limited to sophisticated purchasers having "the capacity to acquire information about the debtor" and enjoying, in the main, the protections of an alternative scheme of regulation.[121]

Thus, on the basis of *Daniel*, *Weaver*, and *Banco Español*, a final modification must be made to our syllogism on functional equivalence:

(1) X is subject to regulatory treatment R;
(2) Y is the functional equivalent of X;
(3) Therefore, Y should likewise be subject to R, UNLESS doing so would be (A) inconsistent with the legislative definition of X under the pertinent statutory scheme OR a closely related statutory scheme, OR (B) duplicative of protections afforded by an independent regulatory regime.

B. Affiliation

Like "functional equivalence," the concept of "affiliation" runs the gamut from the colloquial to the technical, and from the legally trivial to the legally significant. Trivial examples used in common parlance typically refer to rather loosely-defined relationships, such as mere membership, as when one is described as being "affiliated" with an organization,[122] an institution,[123] or a

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[120] *Banco Español*, 973 F.2d at 56.

[121] *Id.* at 55; *see also* John V. Murray & Anthony F. Vittone, *The Banking and Securities Businesses and the Recondite Line Between Them,* 110 BANKING L.J. 388, 420-21 (1993); *cf.* Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808 (2d Cir. 1994) (holding that interests in mortgage notes sold to the general public merit investor protections of the federal securities laws and should be treated as securities).

[122] Examples of such affiliation include tennis clubs in England that are "affiliated" with the Lawn Tennis Association (such affiliation being an advantage for the club members in terms of getting access to tickets for the annual tournament at

political party or other politically motivated group;[124] a franchise-type relationship, as when a television network refers to its local "affiliates";[125] or an employment relationship, as when one is described as being "affiliated" with a particular company or firm.[126] Such relationships may carry with them no particular legal significance, as is usually the case with membership in an organization,[127] or they may become subject to legal regimes ranging from contract law to labor and antidiscrimination laws (as with employment) or antitrust laws (as with franchising).[128] But these are not legal regimes based on *"affiliation"* as the term is typically understood from the Latin derivation of the word,[129] which denotes the existence or creation of an extremely close relationship, akin to one's relationship to a son or daughter—nothing at all like membership or employment relationships.[130]

Wimbledon). *See* Vivek Chaudhary, *Wimbledon Stands By Its Ticket Policy*, GUARDIAN (London), June 25, 2001, at 2.

123 *See*, *e.g.*, Josh Fischman, *Facing Down a Killer Disease,* U.S. NEWS & WORLD REP., June 25, 2001, at 59 (quoting, *inter alia*, a physician at the Joslin Diabetes Center said to be "affiliated with Harvard Medical School").

124 *See*, *e.g.*, Peter Baker & Kamran Khan, *Kidnapped Reporter Is Dead; Tape Relayed to U.S. in Pakistan Said to Show American's Execution*, WASH. POST, Feb. 22, 2002, at A1 ("Saeed, a native of Britain *affiliated* with the Jaish-i-Muhammad terrorist group fighting India's rule in Kashmir, shaved his beard . . . .") (emphasis added).

125 *E.g.*, Ted Loos, *A Little-Known Award That Is a Big Deal to Insiders*, N.Y. TIMES, June 24, 2001, § 2, at 25 (referring to KHOU in Houston, a local CBS "affiliate").

126 *See*, *e.g.*, *Who Are the Nation's Realtors? A Survey Holds the Answers*, L.A. TIMES, June 24, 2001, at K13 (describing a realtor as "affiliated with the same brokerage company for five years").

127 *But cf.* Killian v. United States, 368 U.S. 231, 234 (1961) (prosecution of union official for making false statement in an affidavit, then required by section 9(h) of the National Labor Relations Act, 29 U.S.C. § 159(h) (1958) (repealed 1959), to the effect that he was "not a member of the Communist Party *or affiliated with* such party") (emphasis added); Bridges v. Wixon, 326 U.S. 135, 140 n.1 (1945) (alleged violation of federal statute providing for the deportation of aliens "who are members of *or affiliated with* any organization, association, society, or group, that believes in, advises, advocates, or teaches: (1) the overthrow by force or violence of the Government of the United States") (emphasis added).

128 For a recent decision construing the word "affiliate" as used in a release that the National Football League demanded the former owner of the New England Patriots sign before he was allowed to sell the team, see VKK Corp. v. NFL, 244 F.3d 114, 130 (2d Cir. 2001).

129 The word derives from "*ad filum*" or "*ad filiam*," meaning "to or toward a son" or "to or toward a daughter," respectively, or "*affiliare*," meaning "to adopt." *See* WEBSTER'S NEW WORLD DICTIONARY OF THE AMERICAN LANGUAGE 24 (1966); OXFORD ENGLISH DICTIONARY, *available at* http://dictionary.oed.com (last visited Oct. 11, 2001).

130 The most recent edition of *Black's Law Dictionary* defines "affiliate," some-

Whereas the "functional equivalence" concept has its roots deeply embedded in the common law, "affiliation" regimes—by which I include not only affiliates in the common equity ownership sense but also similar concepts such as "interested persons"[131] and "related interests"[132]—impose legal restrictions or disabilities[133] solely as a result of the relationship and are fundamentally statutory[134] in nature.[135] We can therefore posit a

what unhelpfully, as "being close in connection, allied, associated, or attached as a member or branch." BLACK'S LAW DICTIONARY 59 (7th ed. 1999).

131 This is a concept used in the 1940 Act. *See infra* note 150.

132 *See* 12 U.S.C. § 375b (1994 & Supp. IV 1998) (regulating extensions of credit by a bank to its executive officers, directors, principal shareholders, or their "related interests"); *id.* § 375b(9)(G) (defining "related interest"). The same concept is used in the anti-tying provisions of the BHCA. *Id.* § 1972.

133 On rare occasions, the result of affiliation can be the conferral of a *benefit*, such as the provision of the tax laws permitting life insurance companies under specified circumstances to file consolidated returns with affiliated non-life companies (and thereby avail themselves of the net operating losses rather typical of, e.g., property and casualty companies). I.R.C. §§ 1501, 1503-1504 (1994 & Supp. III 1997); *see also* Conn. Gen. Life Ins. Co. v. Commissioner, 177 F.3d 136 (3d Cir. 1999).

134 Occasionally one encounters "affiliation" as a concept defined and applied in agency regulations, where the statute may or may not be silent on the subject, but this is typically where the legislature has expressly granted interpretive authority to the agency to further the legislative goal of the particular statute. *See*, *e.g.*, 12 U.S.C. § 84(d) (1994) (giving the OCC authority to "prescribe rules and regulations to administer and carry out the purposes of" the national bank lending limit, *id.* § 84(d)(1), including express authority to define terms used in the statute and authority "to determine when a loan putatively made to a person shall for purposes of this section be attributed to another person," *id.* § 84(d)(2); some of the ways OCC has implemented this authority are cited in note 151, *infra*); *id.* § 371c(b)(1)(E) (giving the Board authority, as part of statutory definition of "affiliate" in section 23A of the Federal Reserve Act, to determine by regulation or order that a particular company has a relationship with a member bank or subsidiary or affiliate thereof that should be treated as though that particular company were itself an "affiliate" as defined in the earlier subparagraphs of the statute).

135 They may, however, have as a distant cousin a common law antecedent, namely the concept of vicarious liability that developed in tort law, *see* RESTATEMENT (THIRD) OF TORTS § 23 (1998), and that can also be found in the contemporary statutory regime of the federal securities laws, *see* 15 U.S.C. § 78t (1994 & Supp. IV 1998) (imposing secondary liability for violation of the 1934 Act or rules or regulations thereunder upon persons controlling the person committing the violation).

Courts typically have held that this statutory vicarious liability under the 1934 Act does not foreclose alternative liability at common law. *See*, *e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1576-77 n.27 (9th Cir. 1990) (en banc); *In re* Atl. Fin. Mgmt., Inc., 784 F.2d 29, 35 (1st Cir. 1986); Paul F. Newton & Co. v. Tex. Commerce Bank, 630 F.2d 1111, 1115-19 (5th Cir. 1980); Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980). Doubt has been cast on this proposition, however, by *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 184 (1994), where the Supreme Court noted that Congress's decision in section 20 "to impose some forms of secondary liability, but not others, indicates a deliberate con-

working definition of the concept as follows:

Affiliation is a statutorily defined index of relatedness that subjects one or both related entities to a particular legal treatment.

There is, however, no single, "one size fits all" definition of that index of relatedness that applies to all statutory schemes. Typically, each different regulatory regime is predicated upon an explicit statutory definition of what the legislature means by "affiliate."[136] Most frequently, such definitions are expressed in terms of percentage of stock ownership,[137] which may or may not

gressional choice with which the courts should not interfere." *See also id.* at 201 n.12 (Stevens, J., dissenting); Dinco v. Dylex, Ltd., 111 F.3d 964 (1st Cir. 1997). *But see* Seolas v. Bilzerian, 951 F. Supp. 978, 984 (D. Utah 1997) (finding *respondeat superior* liability consistent with remedial purposes of the federal securities laws).

136 Noteworthy exceptions are regulatory regimes created by consent decree, such as the one that effected the breakup of AT&T and its separation from the so-called Bell Operating Companies (BOCs). That consent decree imposed restrictions on, inter alia, the product and service markets that the BOCs may enter. The restrictions were intended to ensure that the BOCs would not use their monopoly control over local telephone exchanges to impede competition in other markets. *See* United States v. AT&T, 552 F. Supp. 131, 186-94 (D.D.C. 1982), *aff'd sub nom*. Maryland v. United States, 460 U.S. 1001 (1983). Specifically, the decree prohibited the BOCs from engaging in certain lines of business, including the manufacture of telecommunications products, either "directly or through any *affiliated enterprise*." *Id.* at 227 (emphasis added). Subsequent litigation posed the question whether this term—which was *not defined* in the decree—encompassed only entities in which a BOC had some level of equity interest or whether it extended to a contractual arrangement whereby a BOC would provide funds to an independent company for product development in exchange for royalties on sales of the product to third parties. The courts held that the term "affiliated enterprise" was not limited to equity holdings but was intended to cover all arrangements in which the BOCs share directly in the revenues of entities engaged in prohibited businesses. *See* United States v. W. Elec. Co., No. 82-0192 1992 (HHG), U.S. Dist. LEXIS 1153 (D.D.C. Jan. 31, 1992), *aff'd*, 12 F.3d 225 (D.C. Cir. 1993).

137 Some regimes do not specify any percentage of ownership, but in those situations the concept of corporate control becomes important. The Small Business Administration, for example, defines affiliation as one or more parties who directly or indirectly control or have the power to control an enterprise. "Affiliation arises where one or more officers, directors or general partners controls the board of directors and/or the management of another concern." SBA Small Business Size Regulations, 13 C.F.R. § 121.103(e) (2001). "Control means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a licensee or other concern, whether through the ownership of voting securities, by contract, or otherwise." *Id.* § 107.50. A similar approach was taken by Congress in the Federal Timber Contract Payment Modification Act, 16 U.S.C. § 618(a)(7)(A)-(B) (1994). *See* Pine Prods. Corp. v. United States, 945 F.2d 1555, 1559-60 (Fed. Cir. 1991). Similarly, under the Federal Election Campaign Act, 2 U.S.C. § 441a(a)(5) (1994), affiliated committees (where the consequences of affiliation are aggregation of campaign contributions) include those that are "established

be tied to some notion (whether or not statutorily expressed) of control.[138]

For example, the Depression-era Illinois public utility statutes, which gave the Illinois Commerce Commission jurisdiction over "affiliated interests having transactions, other than ownership of stock and receipt of dividends thereon, with public utilities under the jurisdiction of the Commission,"[139] defined "affiliated interests" to encompass "[e]very corporation, ten per centum or more of whose voting capital stock is owned by any person or corporation owning ten per centum or more of the voting capital stock of such public utility . . . ."[140] This formulation is rather expansive, as it is well below the level of ownership that would normally constitute control.[141] Indeed, the Illinois statute did not explicitly deal with an ownership interest-related concept of corporate

or financed or maintained or controlled" by the same person or group. 2 U.S.C. § 441a(a)(5). Federal Election Commission regulations implemented this definition with a control approach, including a controlling interest in the voting stock or securities; authority or ability to direct or participate in governance; and "the authority or ability to hire, appoint, demote, or otherwise control the officers, or other decision-making employees." FEC Contribution and Expenditure Limitations and Prohibitions, 11 C.F.R. § 110.3(a)(3)(ii)(c) (2001); *see also* Common Cause v. Fed. Election Comm'n, 906 F.2d 705 (D.C. Cir. 1990).

138 The quintessential "control"-type definition of affiliation is found in a variety of statutes and is formulated as a second person (using the term to refer to juridical as well as natural persons) which controls, is controlled by, or is under common control with, the first person. *See*, *e.g.*, Natural Gas Policy Act of 1978 § 2(27), 15 U.S.C. § 3301(27) (1994); BHCA § 2(k), 12 U.S.C. § 1841(k) (1994); Home Owners' Loan Act of 1933 § 2(9), 12 U.S.C. § 1462(9) (1994); Savings and Loan Holding Company Act (SLHCA), 12 U.S.C. § 1467a(a)(1)(H) (1994); Federal Deposit Insurance Act § 3(w)(6), 12 U.S.C. § 1813(w)(6) (1994); International Banking Act of 1978 § 1(b)(13), 12 U.S.C. § 3101(13) (1994); Government Sponsored Enterprises Act, 12 U.S.C. § 4502(1) (1994).

139 Illinois Public Utilities Act, ILL. REV. STAT. ch. 111 2/3, § 8a(2) (1937), *quoted in* Natural Gas Pipeline Co. v. Slattery, 302 U.S. 300, 303-04 (1937).

140 *Id.* § 8a(2)(c), *quoted in Slattery*, 302 U.S. at 303-04.

141 *But cf.* 12 C.F.R. §§ 5.50(f)(2)(ii), 225.41(c)(2), 303.82(b)(2) (2001) (setting forth regulatory presumptions of control at ten percent ownership of any class of voting stock under the Change in Bank Control Act, 12 U.S.C. § 1817(j) (1994), promulgated by the OCC, the Board, and FDIC, respectively). These are rebuttable presumptions of control that apply if the bank is publicly held or if no other person owns a greater percentage. The OTS has adopted a variation on this rebuttable presumption theme that is triggered when a person *both* acquires more than ten percent of any class of voting stock of a savings association *and* is subject to any "control factor," e.g., where the acquiror would be one of the two largest holders of voting stock of the savings association, or would hold more than twenty-five percent of the total stockholders' equity of the association or more than thirty-five percent of debt and equity combined, or would (together with his representatives or nominees) occupy more than one seat on the board of directors or serve as the chairman of the board, chairman of the executive committee, CEO, CFO, or any other posi-

control, though it did incorporate alternative "substantial influence" elements into its definition of "affiliated interests" that would be recognized today as commonly employed indicia in statutory definitions of control.[142]

An even lower quantum of equity ownership is used in the federal anti-dumping statute, which defines "affiliated persons" as those directly or indirectly owning five percent or more of the voting shares of an organization.[143] That statute also incorporates a "control" standard, by also defining as "affiliated persons" two or more persons controlled by or controlling a common person.[144] Contrast the somewhat higher standard employed under the federal bankruptcy laws, where an "affiliate" is defined as an entity that directly or indirectly owns, controls, or holds with power to vote, twenty percent or more of the outstanding voting securities of the debtor;[145] "control" here refers only to dominion over the securities, not to any concept of corporate control, which is absent from bankruptcy statute's formulation.

Like "functional equivalence," "affiliation" is a concept commonly encountered in financial services regulation, principally as a tool to avoid self-dealing and other conflicts of interest. Typically in the financial services regulatory arena, affiliation is linked to notions of corporate (or similar enterprise) control.

One encounters the concept of affiliation frequently in federal securities laws contexts. For example, the SEC's Rule 12b-2 under the 1934 Act defines these concepts as follows:

> An "affiliate" of, or a person "affiliated" with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified. . . .

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tion with similar policymaking authority in the association. OTS Acquisition of Control of Savings Associations, 12 C.F.R. § 574.4(b)(1)(I), (c) (2001).

142 *Slattery*, 302 U.S. at 303-04 & n.1 (quoting ILL. REV. STAT. ch. 111 2/3, § 8a(2)(f) (1937) (any corporation with one or more directors or elective officers in common with the public utility); ILL. REV. STAT. ch. 111 2/3, § 8a(2)(g) (1937) (any corporation which the Illinois Commerce Commission determined "as a matter of fact after investigation and hearing" to be "actually exercising any substantial influence over the policies and actions of such public utility"); *id.* § 8a(2)(h) (similar to (g), but incorporating an "acting in concert" concept for individuals and companies)); *cf.* 12 U.S.C.A. § 1841(a)(2)(B)-(C) (West 2001) (BHCA's non-equity interest indicia of control).

143 19 U.S.C. § 1677(33)(E) (1994).

144 *Id.* § 1677(33)(F).

145 11 U.S.C. § 101(2)(A) (1994).

> The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.[146]

Affiliation is a key concept in the 1940 Act, among the principal goals of which was to restrict transactions involving investment companies and their affiliates, thereby putting an end to a variety of abusive practices that occurred in the 1920s and 1930s. Section 17 of that statute,[147] for example, contains prohibitions against an array of such transactions, and section 10(f)[148] restricts an investment company's acquisition of securities from an underwriting syndicate comprising certain affiliates. The complex treatment of affiliations with different stages of relatedness (e.g., "first-tier" and "second-tier" affiliates) need not be spelled out in any detail herein[149] for even a casual reader to appreciate the importance to the elucidation of these restrictions and prohibitions of the manner in which affiliation is defined under the 1940 Act. The actual defined term, not "affiliate" but "affiliated person," uses the five percent level of equity ownership, in addition to entity control effected by (1) acting in concert with other equity holders, (2) employment relationships (i.e., director, officer, partner, etc.), or (3) contractual relationships (e.g., the relationship of the investment adviser to the investment company).[150]

If anything, prohibitions and restrictions based on "affiliation"

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[146] SEC General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.12b-2 (2001).

[147] 15 U.S.C. § 80a-17 (1994).

[148] *Id.* § 80a-10(f).

[149] An excellent summary of these provisions is contained in Div. of Investment Mgmt., U.S. Sec. and Exch. Comm'n, Protecting Investors: A Half Century of Investment Company Regulation 475-80 (1992).

[150] Section 2(a)(3) of the 1940 Act defines "affiliated person" to include any person owning five percent or more of the voting securities of an investment company; any person in which five percent or more of the voting securities are owned by the investment company; any person directly or indirectly controlling, controlled by, or under common control with, the investment company; any of the investment company's officers, directors, partners, or employees; the investment adviser and any members of an advisory board; and, in the case of a unit investment trust, the depositor. 15 U.S.C. § 80a-2(a)(3) (1994).

A related concept, to ensure a minimum number of independent (i.e., sans potential conflicts of interest) directors of an investment company, is found in section 10(a) of the 1940 Act, 15 U.S.C. § 80a-10(a), which provides in essence that no more than sixty percent of the members of the investment company's board may be comprised of "interested persons." "Interested persons" include persons who have cer-

in some form are even more prevalent as a regulatory paradigm in banking law than in securities law. Since much of the focus of banking regulation is on the safety and soundness of banking institutions, protecting them from abusive transactions with affiliates ranks high on the list of regulatory priorities, and so the federal banking statutes and regulations are rife with such provisions,[151] and with definitions of the term "affiliate." One finds such definitions in the Bank Holding Company Act,[152] section 23A of the Federal Reserve Act,[153] the Savings and Loan Holding Company Act,[154] the Home Owners' Loan Act,[155] the International Banking Act,[156] the Glass-Steagall Act,[157] the Federal Deposit Insurance Act,[158] the Government Sponsored Enterprises Act,[159] and the Depository Institutions Management Interlocks Act.[160]

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tain relationships to the investment company or to the securities industry generally as well as those with certain relationships with such persons. *Id.* § 80a-2(a)(19).

151 Some of these provisions do not make use of the term "affiliate" but deal with the same concerns using "control" concepts. *E.g.*, Comptroller of the Currency Lending Limits, 12 C.F.R. § 32.5(c)(2)(i) (2001) (setting forth attribution rule, for lending limit purposes, for loans or extensions of credit to borrowers "related directly or indirectly through common control"), *id.* § 32.5(c)(2)(ii) (finding attribution where "substantial financial interdependence exists between or among the borrowers," with such interdependence deemed to exist where, on an annualized basis, fifty percent or more of Borrower A's gross receipts or gross expenditures are derived from transactions with Borrower B), *id.* § 32.5(c)(3) (applying attribution rule where Borrower A and Borrower B each receives loans from the bank to acquire control of a business enterprise, with the control level pegged at fifty percent or more of voting securities or other voting interests), *id.* § 32.5(d)(1) (finding attribution for loans to a "corporate group"). Similar restrictions apply to insider lending restrictions, including loans to "related interests" of executive officers, directors, or principal shareholders of member banks under section 22(h) of the Federal Reserve Act, 12 U.S.C. § 375b(5)(A) (1994 & Supp. IV 1998); the statutory provision defines "related interests" of a person in a manner similar to "affiliate" definitions, covering any company controlled by that person with "company" broadly defined to include various forms of business organization, *id.* § 375b(9)(A) and extending as well to political or campaign committees controlled by, or the assets or services of which benefit, that person, *id.* § 375b(9)(G).

Other, similarly motivated provisions, of course, expressly use and define the term "affiliate." *See*, *e.g.*, Federal Reserve Act § 23(A)-(B), 12 U.S.C. §§ 371c, 371c-1 (1994) (restrictions on transactions between member banks and their affiliates).

152 *See* 12 U.S.C. § 1841(k) (1994).

153 *See id.* § 371c(b)(1)-(2).

154 *See id.* § 1467a(a)(1)(H).

155 *See id.* § 1462(9).

156 *See id.* § 3101(13).

157 *See id* § 221a(b).

158 *See id.* § 1813(w)(6).

159 *See id.* § 4502(1).

160 *See id.* § 3201(3).

In summary, what this abbreviated discussion is intended to demonstrate is that *affiliation* is quintessentially a statutory, not a common law, concept, which is applied to a specific situation targeted by the legislature for a specific purpose. Administrative agency definitions of "affiliation" or related concepts are possible, at least where the statute has expressly conferred such rulemaking or interpretive authority, but, as we have seen earlier in *Dimension*,[161] the agency is not free (absent some very specific[162] statutory authorization, which does not include a generic authority to prevent evasions of the statute[163]) to "redefine" an existing statutory definition.

The consequence of defining Y as an affiliate of X is to apply a specific legal treatment to Y that would not, in the absence of such affiliation, obtain; hence the definition must be carefully tailored to the particular purpose for which the statute has been enacted.

In other words, an "affiliate" for one purpose is not an "affiliate" for another. Certain ramifications of these fundamental, and hopefully unexceptionable, tenets are developed in Part III below.

II

The success of early efforts by the insurance industry (particularly trade associations of insurance agents) to keep banks out of the insurance business[164] retarded the development of bank insurance powers during much of the era of rapid financial homogenization that commenced in the late 1970s. Nevertheless the OCC, ever a cheerleader for expanding powers of its national

161 Bd. of Governors v. Dimension Fin. Corp., 474 U.S. 361 (1986); *see also supra* notes 60-68 and accompanying text.

162 Invoking the broad purposes of the legislation, as *Dimension* taught us, will not do. 474 U.S. at 373-74.

163 *Id.* at 373 n.6 (rejecting the Board's contention that express authority to redefine statutory terms had been granted in section 5(b) of the BHCA, 12 U.S.C. § 1844(b) (1994), which authorized the Board "to issue such regulations and orders as may be necessary to enable it to administer and carry out the purposes of this Chapter and prevent evasions thereof").

164 *See*, *e.g.*, Ga. Ass'n of Indep. Ins. Agents, Inc. v. Saxon, 268 F. Supp. 236 (N.D. Ga. 1967), *aff'd*, 399 F.2d 1010 (5th Cir. 1968); Ala. Ass'n of Ins. Agents v. Bd. of Governors, 533 F.2d 224 (5th Cir. 1976); *see also* Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 601, 96 Stat. 1469, 1536 (codified as amended at 12 U.S.C.A. § 1843(c)(8) (West 2001)).

bank constituency[165] (which, of course, numbered the majority of the larger, more sophisticated banks), refused to acquiesce to these setbacks and developed increasingly better (and increasingly more impervious to judicial review) rationales for bank penetration of the insurance business. These advances by national banks[166] proceeded along two fronts: The transformation of a sleepy statute, the so-called "town of 5,000" provision[167] into a dynamic and potent vehicle for nationwide insurance agency activities, and the employment of "functional equivalence" analysis to empower banks to engage, under the general national bank powers statute,[168] in insurance activities free from the geographic constraints (however rapidly those might be disappearing!) of the town of 5,000 statutory authority.

A. The Bank-Insurance Industry "Tug-of-War"[169] and the Cultivation of the § 92 Power

Since the earliest days in the history of bank holding company

[165] Lest the reader be misled by the somewhat sardonic connotations often associated with the word "cheerleader," the author should clarify that the statement in text is merely descriptive and that no criticism of OCC is intended thereby. Indeed, OCC's concern for its constituency was totally appropriate and amply justified by market developments resulting in increased competition for bank customers by nonbank firms and the dismantling of the cartelized system of regulation that had for so many decades coddled the banking industry. *See* Kenneth Scott, *The Uncertain Course of Bank Deregulation*, 5 REG. 40 (1981) (coining the phrase "cartel banking" to describe the pre-existing regulatory system). Thus banks were beset by mass defections of retail deposits to essentially unregulated money market funds (which offered new products functionally equivalent to transaction accounts but with higher interest rates paid to customers) and of high-quality corporate borrowers to securities firms and the commercial paper market. *See generally* Fisher, *supra* note 81, at 130-36 (1992) (describing market trends in this period of upheaval).

[166] The focus here on national banks should not be read to diminish the sophistication, size, or significance of state bank initiatives. Clearly Bankers Trust Company and Morgan Guaranty Trust Company, two large, state-chartered institutions, were at the absolute forefront of bank entry into the wholesale securities business. *See*, *e.g.*, Fisher, *supra* note 81, at 148-58. Likewise, at least prior to the banking crisis of the late 1980s-early 1990s and the enactment of section 303 of the FDICIA, 12 U.S.C. § 1831a (1994 & Supp. IV 1998) (with its limitation on state bank principal activities essentially to those permissible for national banks), a number of state banks (and state legislatures) pioneered bank insurance powers. Fisher, *supra* note 8l, at 196 & n.379 (noting that by 1991, surveys conducted by the FDIC and the Conference of State Bank Supervisors revealed that more than half the states permitted state-chartered depository institutions some type of insurance powers).

[167] 12 U.S.C. § 92 (1994).

[168] U.S. REV. STAT. § 5136 (1878), 12 U.S.C.A. § 24 (Seventh) (West 2001).

[169] The Fifth Circuit (presciently, in light of later events) characterized the turf battle between the two industries as a "huge commercial tug-of-war." *Ala. Ass'n of Ins. Agents*, 533 F.2d at 231.

regulation, the question of the propriety of commercial banking organizations entering the insurance business has been controversial at each of two organizational levels: the bank itself and the holding company.

At the bank level, there has been an ongoing debate about, first, what the precise contours of the "business of banking"[170] under the National Bank Act[171] are, and second, what the outer limits are to what can be considered "incidental" to that business of banking.[172] Interpreting the meaning of these phrases has engendered an enormous amount of discussion and debate among regulators,[173] commentators,[174] and the courts.[175]

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[170] 12 U.S.C. § 21 provides, in pertinent part: "Associations for carrying on the *business of banking* under this chapter may be formed by any number of natural persons . . . ." 12 U.S.C. § 21 (1994) (emphasis added). (But it does not define what is meant by the "business of banking.") The phrase appears, again without definition, in 12 U.S.C. § 24 (Seventh), which authorizes the institution "to exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the *business of banking* . . . ." 12 U.S.C.A. § 24 (Seventh) (West 2001) (emphasis added).

[171] The meaning of the phrase potentially has significance for all banks—not merely national banks—for two reasons. First, many states have enacted so-called "wild card" statutes giving state-chartered banks parity with national banks in terms of authorized powers. "As a result of wild card authority, state banks in a majority of states [have] piggy-backed national bank authority [with respect to insurance activities] as it was granted [by OCC] . . . ." KAROL K. SPARKS, INSURANCE ACTIVITIES OF BANKS § 3.03[B][1] (1998 & Supp. 2000). Second, section 4(c)(5) of the BHCA permits investments (including controlling investments) in companies engaged in nonbank activities that are "of the kinds and amounts eligible for investment by national banking associations under the provisions of [12 U.S.C. § 24]." 12 U.S.C. § 1843(c)(5) (1994).

[172] In general, the test for what activities are "incidental" to the business of banking within the meaning of 12 U.S.C. § 24 (Seventh) is that set forth in *Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972) (holding that incidental activities are those that "convenient or useful in connection with the performance of one of the bank's established activities"). Among the activities authorized by OCC as "incidental" to the business of banking are acceptance of assignment of a judgment for collection; sale of annuities; interbank borrowing; certifying checks; compromise of debts; data processing services; providing financial advice; sale of mortgage pass-through certificates; and providing municipal bond insurance.

[173] *See*, *e.g.*, OCC Interpretive Letter No. 812, [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-260 (Dec. 29, 1997); OCC Interpretive Letter No. 743, [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-108 (Oct. 17, 1996); OCC Interpretive Letter No. 368, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85-538 (July 11, 1986); OCC Interpretive Letter No. 271, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85-435 (Sept. 21, 1983); OCC Interpretive Letter No. 137, [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85-218 (Dec. 27, 1979); FED. DEPOSIT INS. CORP., MANDATE AND CHANGE: RESTRUCTURING THE BANKING INDUSTRY 26 (1987); James J. Saxon, *Bank Expansion and Economic Growth: A New Perspective*, 8 ANTITRUST BULL. 597 (1963).

At the holding company level, from the original enactment of the BHCA in 1956 to the significant BHCA Amendments of 1970,[176] the Board gave its approval to a variety of insurance sales activities by bank holding company subsidiaries[177] as "closely related to banking" and a "proper incident thereto."[178] The Board continued to do so under the somewhat more stringent standard embodied in the 1970 Amendments,[179] even en-

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[174] *See*, *e.g.*, Jeffrey D. Dunn, *Expansion of National Bank Powers: Regulatory and Judicial Precedent Under the National Bank Act, Glass-Steagall Act, and Bank Holding Company Act*, 36 Sw. L.J. 765 (1982); Henry Harfield, *Sermon on* Genesis *17:20;* Exodus *1:10 (A Proposal for Testing the Propriety of Expanding Bank Services)*, 85 BANKING L.J. 565 (1968); Ralph F. Huck, *What Is the Banking Business?*, 21 BUS. LAW. 537 (1966); Edward L. Symons, Jr., *The "Business of Banking" in Historical Perspective*, 51 GEO. WASH. L. REV. 676 (1983); Rufus J. Trimble, *The Implied Power of National Banks to Issue Letters of Credit and Accept Bills*, 58 YALE L.J. 713 (1949); Walter Wyatt, *Right of National Banks To Act As Transfer Agents*, 7 VA. L. REV. 594 (1921).

For a revisionist view, consistent with OCC's regulatory agenda in the 1990s, see Julie L. Williams & Mark P. Jacobson, *The Business of Banking: Looking to the Future*, 50 BUS. LAW. 783 (1995); Julie L. Williams & James F.E. Gillespie, Jr., *The Business of Banking: Looking to the Future—Part II,* 52 BUS. LAW. 1279 (1997); *see also* James R. Smoot, *Financial Institutions Reform in the Wake of* VALIC, 29 CREIGHTON L. REV. 691 (1996); James R. Smoot, *Bank Operating Subsidiaries: Free at Last or More of Same?*, 46 DEPAUL L. REV. 651 (1997).

[175] *See*, *e.g.*, NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251 (1995); Clarke v. Sec. Indus. Ass'n, 479 U.S. 388 (1987); Franklin Nat'l Bank v. New York, 347 U.S. 373 (1954); Colo. Nat'l Bank v. Bedford, 310 U.S. 41 (1940); First Nat'l Bank v. Hartford, 273 U.S. 548 (1927); First Nat'l Bank v. Missouri, 263 U.S. 640 (1924); First Nat'l Bank v. Nat'l Exch. Bank, 92 U.S. 122 (1875); Merchants Nat'l Bank v. State Nat'l Bank, 77 U.S. (10 Wall.) 604 (1870); First Nat'l Bank of E. Ark. v. Taylor, 907 F.2d 775 (8th Cir. 1990); Sec. Indus. Ass'n v. Clarke, 885 F.2d 1034 (2d Cir. 1989); Nat'l Retailers Corp. v. Valley Nat'l Bank, 604 F.2d 32 (9th Cir. 1979); M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377 (9th Cir. 1977); *Arnold Tours*, 472 F.2d 427; Amer. Ins. Ass'n v. Clarke, 656 F. Supp. 404 (D.D.C. 1987), *aff'd in part and rev'd in part*, 865 F.2d 278 (D.C. Cir.), *vacated in part by* 865 F.2d 278 (D.C. Cir. 1988); Ga. Ass'n of Ind. Ins. Agents v. Saxon, 268 F. Supp. 236 (N.D. Ga. 1967), *aff'd*, 399 F.2d 1010 (5th Cir. 1968).

[176] Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760.

[177] These included various distinctly credit-related lines of insurance, such as credit life, credit accident and health, and mortgage redemption, as well as lines with less of a nexus to credit extension, such as agricultural, travel, workers' compensation, fire, theft, marine liability, and property insurance. *See generally* Howard Baskin & Brian F. Spector, *Permitting Sale of Insurance by Bank Holding Company Subsidiaries: A Revised Analytic Framework*, 32 U. MIAMI L. REV. 543 (1978).

[178] At that time, this test was embodied in section 4(c)(6) of the BHCA, 12 U.S.C. § 1843(c)(6) (1958).

[179] *See supra* note 176. In those amendments, Congress restructured this statutory exception to the nonbanking prohibition as the now-familiar section 4(c)(8), and elaborated on "proper incident" prong of that standard to require proof that performance of a given nonbanking activity "can reasonably be expected to produce

dorsing unrestricted sales of insurance within the holding company system and *underwriting* of certain credit-related insurance in the version of Regulation Y that was in effect prior to the Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469.[180]

The OCC as a champion of expanded bank powers, and in particular with respect to insurance, has, of course, an even longer pedigree. Going back to the World War I era, a time when life in America was considerably more bucolic than today,[181] we find Comptroller of the Currency John Skelton Williams drafting and forwarding to Congress the legislation that ultimately became enacted as 12 U.S.C. § 92,[182] the so-called "town of 5,000" statute.

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benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices." 12 U.S.C. § 1843(c)(8) (1994) (amended 1999). Courts have accorded substantial deference to the Board's findings in this regard. *See*, *e.g.,* Bd. of Governors v. Inv. Co. Inst., 450 U.S. 46 (1981).

The "closely related to banking" prong of the test has been analyzed under a tripartite test initially adumbrated in *National Courier Ass'n v. Board of Governors*, 516 F.2d 1229 (D.C. Cir. 1975) and subsequently endorsed explicitly by the Board, *see*, *e.g.*, Barnett Banks of Fl., Inc., 71 Fed. Res. Bull. 648, 649 (1985), and tacitly by the Supreme Court, *see* Sec. Indus. Ass'n v. Bd. of Governors, 468 U.S. 207, 210-11 & n.5 (1984). Insurance activities generally fell under the first two elements of that test (i.e., whether banks generally have in fact provided the proposed services, and whether banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed services, *see Nat'l Courier*, 516 F.2d at 1237).

180 *See* 12 C.F.R. § 225.22(b)(9)(I), (10) (1981).

181 Indeed, it was the phenomenon of rural isolation that gave rise to Comptroller John Skelton Williams' concern about the long-term viability of small-town national banks, particularly in areas where the paucity of available deposits was forcing some banks to charge "excessive and in some cases grossly usurious" interest rates in order to survive. 53 Cong. Rec. 11,001 (1916). While not condoning usury, Williams was sympathetic to the plight of these banks and sought to provide them with "additional sources of revenue" so that they could compete more effectively "with local State banks and trust companies which are sometimes authorized . . . to do a class of business not strictly that of commercial banking." *Id.* Allowing small town national banks to sell insurance was part of Williams' solution to augment their profitability. *Id.; see generally* Nat'l Ass'n of Life Underwriters v. Clarke, 736 F. Supp. 1162, 1169 (D.D.C. 1990), *rev'd on other grounds sub nom.* Indep. Ins. Agents, Inc. v. Clarke, 955 F.2d 731 (D.C. Cir. 1992), *rev'd sub nom.* U.S. Nat'l Bank of Or. v. Indep. Ins. Agents of Am., 508 U.S. 439 (1993), *aff'd on remand sub nom.* Indep. Ins. Agents, Inc. v. Ludwig, 997 F.2d 958, 960 (D.C. Cir. 1993).

182 Act of Sept. 7, 1916, ch. 461, 39 Stat. 752. Longstanding controversy over whether this provision had inadvertently been repealed by the Act of Apr. 5, 1918, ch. 45, § 20, 40 Stat. 512, *compare*, *e.g.*, Comm'r v. First Sec. Bank, 405 U.S. 394, 401, 401 & n.12 (1972), First Nat'l Bank v. Smith, 610 F.2d 1258, 1261 n.6 (5th Cir. 1980), Saxon v. Ga. Ass'n of Indep. Ins. Agents, Inc. 399 F.2d 1010, 1013 (5th Cir. 1968) (all

In 1963, Comptroller of the Currency James Saxon declared that, in order to use the § 92 authority, a national bank need not have its main office in a town of 5,000; merely a branch office would do.[183] As branching in that era was heavily circumscribed[184] (and even prohibited altogether in certain states),[185] this interpretation was regarded at the time as essentially a non-event. A challenge was ultimately brought years later, when branching restrictions had been loosened considerably, but was dismissed on the ground of laches.[186]

Also in the early 1960s, Comptroller Saxon, an aggressive exponent of national bank powers, ruled that national banks had the authority under the incidental powers clause to act as agent in the issuance of insurance incidental to banking transactions.[187] The ruling was challenged by the Georgia insurance agents, who argued that under § 92 national banks were implicitly forbidden to engage in any insurance activities in areas with a population greater than 5,000.[188] The district court agreed, holding that the

assuming continued existence of § 92), *and* Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 403, 96 Stat. 1469, 1511 (purporting to amend 12 U.S.C. § 92), *with* David W. Roederer, *Nonexistent Banking Law Warrants Closer Scrutiny*, LEGAL TIMES, Jan. 9, 1984, at 12 (arguing that § 92 is no longer part of the laws of the United States), *and* Indep. Ins. Agents, Inc. v. Clarke, 955 F.2d 731, 735 (D.C. Cir. 1992) (having raised *sua sponte* an issue not raised by the parties and having demanded supplemental briefing, the Court ultimately held that the statute had been repealed), was finally resolved when the Supreme Court held that the provision remained on the statute books and was good law. *U.S. Nat'l Bank of Or.*, 508 U.S. at 439.

183 This 1963 ruling was ultimately published in the *Federal Register* in 1971, Interpretive Rulings, 36 Fed. Reg. 17,000, 17,015 (Aug. 26, 1971), and is now codified among OCC's regulations at 12 C.F.R. § 7.1001.

184 *See*, *e.g.*, First Nat'l Bank of Logan v. Walker Bank & Trust Co., 385 U.S. 252, 253 (1966) (describing restrictive Utah branching law, UTAH CODE ANN., tit. 7, ch. 3, § 6 (Supp. 1965)); First Nat'l Bank in Plant City v. Dickinson, 396 U.S. 122, 124-25 (1969) (noting Florida law prohibited branch banking altogether). Parochial state branching persisted even into the heyday of financial modernization. *See*, *e.g.*, Indep. Bankers Ass'n of N.Y., Inc. v. Marine Midland Bank, 757 F.2d 453, 456 (2d Cir. 1985) (describing New York's "home office protection" statute, section 105 of the New York Banking Law, as prohibiting branching in any community with a population of 50,000 or less where another bank has its principal office).

185 Florida (as described in *Plant City*, 396 U.S. at 124-25), Michigan, and West Virginia were examples of such "unit banking" states.

186 Nat'l Ass'n of Life Underwriters v. Clarke, 736 F. Supp. 1162, 1165 & n.11 (D.D.C. 1990) (holding twenty-three-year delay unreasonable) (citing Indep. Bankers Ass'n of Am. v. Heimann, 627 F.2d 486, 488 (D.C. Cir. 1980) (holding twelve-year delay unreasonable)).

187 *See Saxon*, 399 F.2d at 1011.

188 *See* Ga. Ass'n of Indep. Ins. Agents, Inc. v. Saxon, 268 F. Supp. 236, 237 (N.D. Ga. 1967), *aff'd*, 399 F.2d 1010 (5th Cir. 1968).

more specific § 92, rather than the more general incidental powers clause of § 24 (Seventh), constituted the exclusive source of authority for national banks' insurance activities.[189] That holding was affirmed by the Fifth Circuit, which specifically declared that OCC's expansive construction of the incidental powers clause was contrary to congressional intent.[190]

With the rationale of *Saxon* as an impediment to expanding into the insurance business, the banking industry turned to holding company affiliates as an alternative path for new insurance authority. This maneuver proved a modestly successful strategy at first. Not that the Board's expansive interpretations with respect to insurance powers under section 4 of the BHCA, noted above,[191] did not go unchallenged by the insurance industry; indeed they were challenged, and with some success, by regional and national trade association of insurance agents. Their initial challenge was a judicial one that met with mixed results in an appellate decision invalidating only the broad insurance powers within the holding company system but leaving intact the credit-related insurance powers.[192]

Rather than continue to fight about the net public benefits (under the "proper incident" prong of section 4(c)(8)) on a given application before a largely inhospitable agency decisionmaker and on a case-by-case basis, the insurance agents switched their focus to Capitol Hill where, in Title VI of Garn-St Germain, they secured an amendment to section 4(c)(8) declaring that a variety of insurance activities were conclusively *not* "closely related to banking,"[193] subject to seven statutory exceptions.[194] The non-

[189] *Id.* at 238.

[190] *Saxon*, 399 F.2d at 1016.

[191] *See supra* notes 176-80 and accompanying text.

[192] Ala. Ass'n of Indep. Ins. Agents v. Bd. of Governors, 533 F.2d 224 (5th Cir. 1976), *modified on reh'g*, 558 F.2d 729 (5th Cir. 1977).

[193] Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 601, Pub. L. No. 97-320, 96 Stat. 1469, 1536 (codified as amended at 12 U.S.C.A. § 1843(c)(8) (West 2001)).

[194] The seven exceptions included: (1) providing life, disability, and involuntary unemployment insurance, provided it is limited to assuring repayment of outstanding balances on specific extensions of credit by a bank holding company or its subsidiary; (2) acting as agent in the sale of property insurance on loan collateral, where the coverage is limited to assuring repayment of the outstanding balance on the loan; (3) engaging in general insurance activities in towns with a population of 5,000 or less; (4) engaging in "grandfathered" insurance activities (antedating May 1, 1982); (5) acting as a managing general agent over retail agents who sell insurance coverage to the holding company; (6) engaging in any insurance activity if the bank holding company has less than $50 million in assets, except that such holding compa-

bank, holding company affiliate route was now effectively foreclosed.

A sense of urgency, occasioned by increasing insurance industry penetration of the banking business,[195] drove OCC back to the drawing board. Structurally, of course, the Garn-St Germain prohibition applied only to activities covered by section 4 of the BHCA (governing activities of nonbank subsidiaries of a bank holding company), not section 3 (governing bank holding company acquisitions of banks but not governing, despite the Board's self-aggrandizing efforts to the contrary, what those banks—or, indeed, their subsidiaries—were permitted to do).[196]

Thus in the mid-1980s, OCC approved the request of United States National Bank of Oregon to sell insurance from a branch in a sparsely populated town not only to existing customers of the bank but to potential customers located anywhere in the country.[197] The challenge brought by the insurance agents' trade association was ultimately[198] rejected by the D.C. Circuit on

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nies are restricted to selling life insurance or annuities; and (7) continuing to engage in activities grandfathered under the Bank Holding Company Act Amendments of 1970 (i.e., activities approved by the Board prior to January 1, 1971, the effective date of those amendments). 12 U.S.C. § 1843(c)(8) (1994).

For more detailed discussion of Garn-St Germain and the seven exceptions, see SPARKS, *supra* note 171, §§ 4.02-4.03.

[195] One of the earliest forays was the development of competing products, such as guaranteed investment contracts (GICs) which were functionally similar to bank certificates of deposit. Then, in the 1980s, the insurance industry launched more direct attacks, first by establishing so-called "nonbank banks" (before that loophole was closed with the passage of CEBA), and second by acquiring savings and loan subsidiaries, because, unlike the restrictive regime under for bank holding companies, federal law did not limit the activities of unitary thrift holding companies. *See* 12 U.S.C. § 1467a(c)(3) (1994).

Note that GLEBA has now eliminated, prospectively, the so-called unitary thrift holding company "loophole." No company, other than a grandfathered unitary thrift holding company, may after May 4, 1999 acquire control of an insured savings association other than one that will engage only in the activities permissible for a financial holding company, *see infra* notes 370-401 and accompanying text, or a multiple thrift holding company. GLEBA § 401(a), 12 U.S.C.A. § 1467a(c)(9) (West 2001).

[196] *See* Indep. Ins. Agents of Am., Inc. v. Bd. of Governors, 890 F.2d 1275 (2d Cir. 1989); Citicorp v. Bd. of Governors, 936 F.2d 66 (2d Cir. 1991); Fisher, *supra* note 81, at 197-214. For an analysis, prior to the Citibank Delaware case, of the Board's authority under the BHCA to regulate the activities of subsidiaries of holding company banks, see Keith R. Fisher, *Federalism Contra Federal Reservism: Bank Holding Companies and State Bank Powers*, 23 U.S.F. L. REV. 317 (1989).

[197] OCC Interpretive Letter No. 366, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,536 (Aug. 18, 1986).

[198] This was the litigation that led to the momentary hiccough over whether 12 U.S.C. § 92 was still on the statute books of the United States. *See supra* note 182.

Chevron deference grounds[199] vis-a-vis OCC's conclusion that 12 U.S.C. § 92 placed no limitation on the geographic scope of the insurance business that might be conducted by a national bank out of a town of 5,000 or less.[200] A similar result was reached when the Indiana Insurance Commissioner limited the insurance agency license of a national bank to sales within the small town where the bank's branch was located.[201] There, the Seventh Circuit likewise concluded that the Commissioner's license limitation could not be upheld because, when it came to national banks, Congress had implicitly given OCC discretion to define the geographic scope of the § 92 authority.[202]

That it sufficed to locate a mere branch in the small town did not answer the question whether the branch could be essentially a sham or a "mail drop" or whether genuine functions relating to the insurance agency business had to be housed there. OCC ultimately provided guidance on that point in a 1996 letter to First Union National Bank, where the agency required the small town office to be bona fide and to constitute the "front office" for the entirety of the insurance operation, including licensing, receipt and payment of commissions, processing policy applications, and recordkeeping.[203] OCC also suggested, though stopped short of actually opining in the First Union Letter, that the bank should be able to maintain offices of the insurance agency in other locations *in pari materia* with what other insurance agencies operating from small towns in the state were authorized to do.[204]

199 Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984). *Chevron* embodies a two-step procedure. In the first step, the reviewing court ascertains whether Congress has directly spoken to the issue in the statute in question. If so, the court ascertains the meaning of the statutory language without any deference to the agency's interpretation, because courts have just as much expertise in statutory construction as do administrative agencies. If not, the court must defer to the substantive expertise of the agency except in the rare instance where the agency's decision is either so unreasonable or so manifestly inconsistent with the statutory policy that the court could responsibly conclude that the agency decision violates the intent of Congress. *Id.* at 842-45.

200 Indep. Ins. Agents of Am. v. Ludwig, 997 F.2d 958, 961 (D.C. Cir. 1993).

201 NBD Bank, N.A. v. Bennett, 67 F.3d 629 (7th Cir. 1995).

202 *Id.* at 631; *accord* Shawmut Bank Conn., N.A. v. Googins, 965 F. Supp. 304 (D. Conn. 1997).

203 OCC Interpretive Letter No. 753, [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,107 (Nov. 4, 1996) [hereinafter First Union Letter].

204 *Id.* This position was solidified somewhat in a 1999 letter to Kirk Flores, Counsel of ANB Amro North America, Inc. There, OCC requested opinions from the Illinois and Michigan insurance regulators and satisfied itself that, notwithstanding the absence of any express statutory authority in those states, insurance agencies

Furthermore, customer solicitations (whether by mail, telemarketing, or canvassing by agents), were not limited to the small town.[205]

A variation on the theme of satellite offices arose in connection with national bank acquisitions of existing insurance agencies. If the agency in question were located in a town with more than 5,000 inhabitants, OCC would permit the acquisition but would condition its approval on the bank's relocating the insurance agency to a town of 5,000 within two years.[206]

Towns of 5,000 or less are not as numerous as they were in those halcyon days when § 92 was first enacted. Of course, with the advent of interstate branching,[207] national banks need no longer look for such communities only within their own state. Still, with continuing urbanization and population growth, the long-term utility and significance of 12 U.S.C. § 92 would be doubtful, but for an expansive and as yet unchallenged OCC interpretation. Though known as the "*town* of 5,000" provision, this statute, which remains on the books even after GLEBA, provides that a national bank "located and doing business in any *place* the population of which does not exceed five thousand inhabitants . . . may, under such rules and regulations as [OCC may prescribe] . . ., act as the agent for any fire, life or other insurance company authorized . . . to do business in [the state where the bank is located] . . . ."[208]

Use of the word "place" rather than "town" in the statute has led OCC, in response to an inquiry from the Florida Department

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there could operate through satellite offices. Accordingly, OCC permitted the bank's insurance agency subsidiary in a town of 5,000 to open satellite offices on an interstate basis in both states. *See* OCC Interpretive Letter No. 864 (May 19, 1999), *available at* 1999 OCC QJ LEXIS 286.

205 First Union Letter, *supra* note 203. Indeed, in another letter, OCC concluded that solicitation and selling of insurance could be conducted in any manner permissible for non-bank affiliated insurance agencies in the state, so long as the principal office of the insurance operation was housed in a town of 5,000. OCC Interpretive Letter No. 844, [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,299 (Oct. 20, 1998).

206 *See*, *e.g.*, Katharine Fraser, *OCC: Small-Town Insurance Loophole Not an Open Door*, AM. BANKER, Oct. 13, 1999, at 3 (reporting OCC's conditional approval of an application by National Bank of Commerce of Mississippi, Starksville, Mississippi).

207 Interstate branching was authorized by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338. For interstate branching by national banks, see 12 U.S.C. § 36(g) (1994).

208 12 U.S.C. § 92 (1994) (emphasis added).

of Insurance, to declare that the statute applies to any area designated a "place" by the United States Bureau of the Census.[209] OCC's analysis centered on so-called "census designated places," which, as defined by the Bureau of the Census, include densely settled concentrations of population that are identifiable by name but legally are not separately incorporated places.[210] "The import of this decision is clearly not in rural areas—small towns abound. The import is that a small place for § 92 purposes may be in the middle of metropolitan centers, thus bringing national bank small town insurance initiatives literally into the big city."[211]

Finally, no summary of developments under § 92 would be complete without mentioning the *Barnett* litigation. There, the Florida insurance regulators challenged insurance sales pursuant to § 92 by a national bank, Barnett Bank. Florida had on its statute books an anti-affiliation law,[212] which prohibited sales of in-

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209 OCC Interpretive Letter No. 823, [1997-98 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,272 (Feb. 27, 1998); *see also* OCC Interpretive Letter No. 824, [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,273 (Feb. 27, 1998).

210 U.S. BUREAU OF THE CENSUS, 1990 CENSUS OF POPULATION AND HOUSING, at A-9 (1995). To qualify as a census designated place, the unincorporated community must, if located in a rural area, have at least 1,000 people and, if located in an urbanized area, have at least 2,500 people.

211 SPARKS, *supra* note 171, § 3.02[B][6].

212 At the time of the *Barnett* litigation, a significant number (roughly half) of the states had enacted anti-affiliation statutes. *Compare id*. § 5.03 (identifying twenty states with anti-affiliation provisions (Arkansas, Colorado, Connecticut, Florida, Georgia, Illinois, Kentucky, Louisiana, Maine, Massachusetts, Mississippi, Nebraska, Nevada, New Hampshire, New Mexico, Pennsylvania, Rhode Island, Tennessee, Vermont, and West Virginia) and another five (Alaska, Arizona, New York, Ohio, and Texas) with similar statutory limitations on bank insurance activities), *with* Michael P. Malloy, *The Sound of Two Hands Flapping: Insurance-Related Activities of National Banks*, 41 ST. LOUIS L.J. 75, 79 & n.44 (1996) (identifying fifteen states with "statutory provisions that prohibit commercial banks from selling insurance" and another nine with laws that "may be interpreted as imposing similar limitations") (citing Linda Greenhouse, *Ruling Backs Banks' Sales of Insurance*, N.Y. TIMES, Mar. 27, 1996, at D-1).

These state anti-affiliation laws had previously shown themselves to be remarkably impervious to constitutional challenge. Among the better known anti-affiliation statutes was Pennsylvania's, which prohibited companies selling insurance in that state (which was the fourth largest insurance market in the country) from affiliation with a variety of depository institutions and their holding companies, regardless of whether the depository institution existed in, or even did business in, the state. 40 PA. CONS. STAT. ANN. § 281 (West Supp. 1994). Ford Motor Company and United Services Automobile Association, each a savings and loan holding company, challenged the statute on the grounds that it violated the Supremacy Clause and the Commerce Clause of the Constitution. Ford Motor Co. v. Ins. Comm'r, 874 F.2d 926 (3d Cir. 1989). The Third Circuit held that the Pennsylvania statute was preempted

surance by banks and their subsidiaries, affiliates, and employees,[213] and the principal legal issue was whether that anti-affiliation statute was preempted by § 92. The Eleventh Circuit upheld the Florida statute,[214] and the litigation went up to the Supreme Court in order to resolve a conflict among the lower courts.[215]

Ordinarily, state laws that conflict with a scheme of regulation as pervasive as the federal banking laws[216] or that stand as an obstacle to achieving Congress's purpose in enacting a particular federal statute[217] will be held preempted under the jurisprudence that has arisen under the Supremacy Clause of the Constitution. Normal preemption rules do not apply with respect to insurance regulation, however, because in the 1940s Congress enacted a special "reverse preemption" regime known as the McCarran-Ferguson Act.[218] Under that regime, general purpose federal statutes that happen to cause or encounter some interference or conflict with state insurance laws do not preempt those laws but are themselves preempted.[219] If, however, the federal statute "specifically relates to the business of insurance," then the reverse preemption rule is inapplicable and, as one would normally expect, the federal statute preempts the state insurance law.[220]

The precise contours of what constitutes the "business of insurance" for this purpose are complex and beyond the scope of this

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only to the extent that it would prohibit acquisitions of failing thrift institutions, but not healthy ones, and sustained the statute against the Commerce Clause challenge as well. *Id.* at 928. No preemption attack predicated on 12 U.S.C. § 92 was involved in that case, however.

213 "No [Florida licensed] insurance agent . . . who is associated with, . . . owned or controlled by . . . a financial institution shall engage in insurance agency activities . . . ." FLA. STAT. ANN. § 626.988(2) (West Supp. 1996). The term "financial institution" was defined for this purpose to include "any bank . . . [except a] bank which is not a subsidiary or affiliate of a bank holding company and is located in a city having a population of less than 5,000 . . . ." *Id.* § 626.988(1)(a).

214 Barnett Bank of Marion County, N.A. v. Gallagher, 43 F.3d 631 (11th Cir. 1995).

215 *See* Owensboro Nat'l Bank v. Stephens, 44 F.3d 388 (6th Cir. 1994) (holding Kentucky statute preempted); *see also* First Advantage Ins., Inc. v. Green, 652 So. 2d 562 (La. Ct. App. 1995) (holding that Louisiana statute was not preempted).

216 *See*, *e.g.*, Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947). The underlying notion here is that the scheme of federal regulation is so pervasive that there is no room for supplementation by state law, and hence one can infer Congressional intent to preempt inconsistent state laws.

217 *See*, *e.g.*, Hines v. Davidowitz, 312 U.S. 52, 67 (1941).

218 15 U.S.C. §§ 1011-1015 (1994).

219 15 U.S.C. § 1012(b).

220 *Id.*

discussion.[221] Nonetheless, if 12 U.S.C. § 92 does not "specifically relate[ ]" to the "business of insurance," it is difficult to imagine a statute that does. The Supreme Court in *Barnett* reached the same conclusion. Deciding first that the state law stood as an obstacle to the accomplishment of the congressional purpose in enacting § 92,[222] the Court found McCarran-Ferguson inapplicable because § 92—which permits national banks to solicit insurance, sell insurance policies across a wide spectrum, and receive insurance commissions—specifically relates to the business of insurance and constitutes an intentional[223] federal adjustment of state insurance regulation.[224]

Barnett thus immunized § 92 against state anti-affiliation statutes and, in so doing, established a standard for assessing the vitality of § 92 vis-a-vis other types of state laws: A state law will be preempted if it prevents or significantly interferes with or sig-

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221 The Supreme Court has evolved somewhat inconsistent frameworks here. *See*, *e.g.*, Dept. of Treasury v. Fabe, 508 U.S. 491 (1993); Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119 (1982); Group Life and Health Ins. Co. v. Royal Drug, 440 U.S. 205 (1979); SEC v. Nat'l Sec., Inc., 393 U.S. 453 (1969).

222 The Court found the same sort of "irreconcilable conflict" in *Barnett* as had been found in *Franklin National Bank v. New York*, 347 U.S. 373 (1954), where a state law prohibiting commercial banks from using the word "savings" in their advertising was held preempted by a federal statute permitting national banks to accept savings deposits. *See* Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, 34-35 (1996).

223 Relying on one of the expressed statutory statements of purpose, namely that "silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of [the business of insurance] by the several States," 15 U.S.C. § 1011, the Court construed McCarran-Ferguson as being intended to protect state insurance regulation from *inadvertent* federal preemption. *Barnett*, 517 U.S. at 39.

224 *Id.* at 41. The Court rejected Florida's argument that § 92 is predominantly related to banking, not insurance, and therefore did not satisfy McCarran-Ferguson's "specifically relates" formulation:

> [A] statute may specifically relate to more than one thing. Just as an ordinance forbidding dogs in city parks specifically relates to dogs and to parks, so a statute permitting banks to sell insurance can specifically relate to banks and to insurance. Neither the McCarran-Ferguson Act's language, nor its purpose, requires the Federal Statute to relate predominantly to insurance. To the contrary, specific detailed references to the insurance industry in proposed legislation normally will achieve the McCarran-Ferguson Act's objectives, for they will call the proposed legislation to the attention of interested parties, and thereby normally guarantee, should the proposal become law, that Congress will have focused upon its insurance-related effects.

Id. at 41-42; *see also id.* at 41 ("The language of [§ 92] is not general. It refers specifically to insurance. Its state regulatory implications are not surprising, nor do we believe them inadvertent . . . .").

nificantly impairs the ability of a national bank to sell insurance from a town of 5,000.[225] As perhaps the only aspect of the pre-1999 bank-insurance regime that survived enactment of GLEBA, this standard will continue to have significant implications for any state law with an impact on small town insurance marketing activities by national banks.[226]

B. Resurgence of § 24 (Seventh) and the Efficacy of "Functional Equivalence" Analysis

Over time, the *Saxon* holding rejecting the incidental powers clause as authority for insurance activities[227] became the object of frequent criticism[228] and did not ultimately prove to be an ironclad bar to national bank insurance activities under the "incidental powers" rationale. Thus, notwithstanding the Fifth Circuit's decision, OCC in 1977 promulgated regulations affirming its position that national banks could sell credit life insurance by virtue of the incidental powers clause[229] and was upheld on judicial review.[230] Building upon this success in the realm of *sales*, OCC took another step when it approved the acquisition by a national bank of an operating subsidiary which was already engaged in *underwriting*, as a reinsurer, credit life and credit accident and health insurance—all predicated on the "convenient or useful" standard of the restrictive *Arnold Tours* interpretation of 12 U.S.C. § 24 (Seventh).[231]

Indeed, OCC evolved a narrow interpretation of *Saxon* as prohibiting banks from engaging in insurance activities (other

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225 *Id.* at 33.

226 The implications extend even more broadly in those states that have "wild card" statutes permitting state-chartered banks to exercise the same powers as national banks. *See* SPARKS, *supra* note 171, § 3.03[B][1].

227 *See supra* notes 187-90 and accompanying text.

228 *E.g.*, Indep. Ins. Agents of Am., Inc. v. Bd. of Governors, 736 F.2d 468, 477 n.6 (8th Cir. 1984); Indep. Bankers Ass'n of Am. v. Heimann, 613 F.2d 1164, 1170 (D.C. Cir. 1979).

229 Disposition of Credit Life Insurance Income, 42 Fed. Reg. 48,518 (Sept. 23, 1977) (codified at 12 C.F.R. §§ 2.1-2.5 (2001)). OCC reasoned that credit life insurance was a form of security for loans and thus permissible under as incidental to the power to lend.

230 *Heimann*, 613 F.2d at 1170. Significantly, the court rejected the contention that § 92 implicitly prohibits national banks from engaging in insurance activities such as selling credit life insurance apart from the town of 5,000 setting and indicated express disagreement with the *Saxon* decision.

231 OCC Interpretive Letter No. 277, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,441 (Dec. 21, 1983).

than as permitted under § 92, of course) where *both* (A) the activities were "incidental" to the business of banking (i.e., were not themselves the business of banking)[232] *and* (B) the bank did not act as an "insurance agent." In determining what constituted acting as an insurance agent, OCC identified several factors: (1) the existence of an agency agreement; (2) receipt of commissions; (3) selling a variety of lines of insurance; (4) risk evaluation; (5) engaging in general insurance counseling; (6) investigation of applicants; (7) assumption of certain underwriting risks; (8) handling of claims; and (9) issuance of the certificate of coverage.[233] Based on this interpretation, OCC incrementally permitted further bank penetration of the insurance business, on the ground that the activities in question were not "agency" activities.[234]

The road was neither straight nor unobstructed, however, and OCC suffered occasional setbacks. For example, criticism of *Saxon* by the Eighth and D.C. Circuits led OCC to believe the door was open for a further narrowing of its interpretation of that decision, most notably in the area of title insurance. Here again, OCC took the approach, analogous to the one taken with credit life insurance, of characterizing title insurance as a unique product directly connected to a national bank's lending activities, because lenders typically required mortgage applicants to secure title insurance in order to protect the lender's security interest in the mortgaged property.[235] From sales of title insurance, it was

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232 This was an important qualification, as it allowed OCC subsequently to categorize certain traditional insurance products as "financial products" and hence part of the "business of banking" itself under § 24 (Seventh). *See infra* notes 170-75 and accompanying text.

233 OCC Interpretive Letter No. 241, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,405 (Mar. 26, 1982).

234 These included (1) entering into a percentage lease with an unaffiliated insurance agency, OCC Interpretive Letter No. 274, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,438 (Dec. 2, 1983); (2) offering life insurance as an inducement to customers to open IRAs or certificates of deposit, OCC Interpretive Letter No. 241, *supra* note 233; (3) disseminating health insurance literature with monthly statements of account, *id.*; (4) furnishing an insurance company with lists of borrowers and active credit card holders, OCC Interpretive Letter No. 316, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,486 (Dec. 4, 1984); and (5) referring customers to an insurance agency and sharing in any resulting commissions, Unpublished Letter from William B. Glidden, Asst. Dir., OCC Legal Advisory Services Division (May 8, 1986), except that the latter activity could not be carried on in states with insurance laws prohibiting commission splitting.

235 OCC Interpretive Letter No. 368, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,538, at 77,836 (July 11, 1986). In addition to the nexus to the core lending function and increased one-stop shopping for the bank's customer, OCC

but a small step to authorizing underwriting by a national bank's operating subsidiary under the selfsame rationale.[236] This time, however, after an abortive attempt at judicial review within the Fifth Circuit[237] (brought there, no doubt, to take advantage of the *Saxon* precedent), a challenge to OCC's approval of a proposal by Chase Manhattan Bank, N.A. was sustained by the Second Circuit, which resuscitated the *Saxon* rationale.[238]

Another, more recent, setback for OCC was its authorization for national banks to sell crop insurance in connection with loans to farmers.[239] From OCC's perspective, this was a natural adjunct to the "business of banking" (to wit: agricultural lending)[240] and could be undertaken pursuant to the general authority of 12 U.S.C. § 24 (Seventh), and therefore without any of the geographic restrictions of § 92. The courts took another view, however: a result that might well have been averted had OCC been scrupulous about characterizing the product as something other than "insurance."[241] Slamming the agency for flouting "both common sense and two traditional rules of statutory interpretation: the presumption against surplusage and *expressio unius est exclusio alterius*,"[242] the D.C. Circuit, affirming the

noted that thrift institutions were allowed to sell title insurance, thereby calling into play considerations of competitive equilibrium. *Id.* at 77,839.

236 OCC Interpretive Letter No. 377, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,601 (Feb. 6, 1987).

237 The American Land Title Association challenged the ruling not only on *Saxon* grounds but also on the ground that the activities were forbidden for operating subsidiaries by the BHCA. (Interestingly, in another case, the Board felt compelled by Garn-St Germain to disapprove title insurance activities by bank holding companies, except in relatively rare cases of grandfathering. *See* Am. Land Title Ass'n v. Bd. of Governors, 892 F.2d 1059 (D.C. Cir. 1989).) The district court declined to address the merits, however, and dismissed the case on the somewhat dubious procedural grounds that the OCC interpretive letters, as staff opinions rather than opinions of the Comptroller himself, did not constitute final agency action subject to judicial review under the Administrative Procedure Act, and further that the matter was not ripe for adjudication because OCC had expressed a willingness to consider new facts bearing on its interpretation, an attitude the court also deemed indicative of a lack of finality. Am. Land Title Ass'n v. Clarke, 743 F. Supp. 491 (W.D. Tex. 1989).

238 Am. Land Title Ass'n v. Clarke, 968 F.2d 150 (2d Cir. 1992).

239 OCC Interp. Letter No. 812, [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,260 (Dec. 29, 1997).

240 OCC authorized sales of crop insurance and hail/fire insurance regardless of whether insurance proceeds were assigned to the bank as collateral for a loan or were simply part of the credit underwriting process (i.e., a factor bearing on the farmer's ability to repay). *Id.*

241 *See infra* notes 256-57 and accompanying text.

242 Indep. Ins. Agents of Am., Inc. v. Hawke, 211 F.3d 638, 643 (D.C. Cir. 2000); *see also id.* at 642 ("Though the OCC is surely familiar with its past defeats, it seems

lower court's application of *Saxon*,[243] refused to defer to OCC under *Chevron* because the court found the language and structure of the National Bank Act clear and unambiguous.[244]

Notwithstanding these occasional setbacks, OCC's non-acquiescence in the *Saxon* rationale led it to more creative efforts, culminating in what was clearly the most promising (and, to the insurance industry, doubtless the most threatening) approach of all: *functional equivalence*. Once it can be established that a particular product that has been marketed as "insurance" is, in fact, the functional equivalent of a banking or financial product, then its characterization as "insurance" can successfully be jettisoned and the *Saxon* rationale (and result) averted. (Clearly, OCC had made no showing that title insurance or crop insurance were functional equivalents of any traditional or pre-existing banking or financial product.)

OCC's first successful outing in the courts with this more promising approach was rendered a bit chaotic because of the temporary intrusion of BHCA issues,[245] but the fundamental Na-

determined to repeat them," referring to *Saxon*, *American Land Title*, as well as holdings to the same effect in *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966), and *First Security Bank of Utah, N.A. v. Commissioner*, 436 F.2d 1192 (10th Cir. 1971), *aff'd on other grounds,* 405 U.S. 394 (1972)).

243 Indep. Ins. Agents of Am., Inc. v. Hawke, 43 F. Supp. 2d 21 (D.D.C. 1999), *aff'd*, 211 F.3d 638 (D.C. Cir. 2000) (adopting *Saxon* and *American Land Title* rationale).

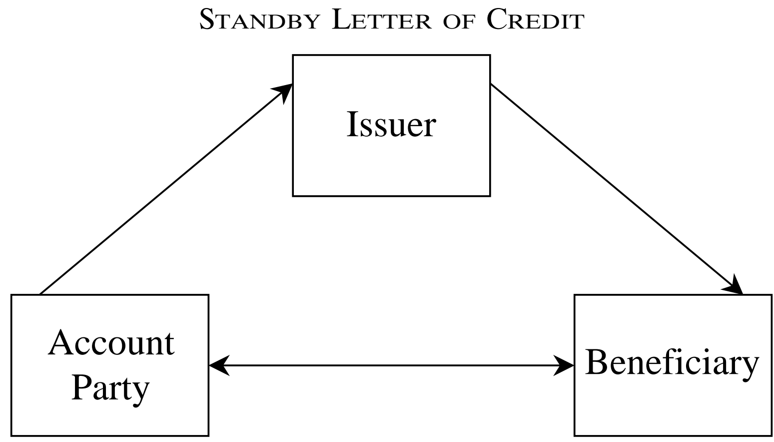
244 *Hawke*, 211 F.3d at 645 (referring to the *Saxon* analysis that § 92 precludes any possibility of interpreting the "incidental powers" clause of § 24 (Seventh) as encompassing insurance activities). The Court relied on similar reasoning in *Texas & Pacific Railway Corp. v. Pottorff*, 291 U.S. 245, 257-59 (1934), which held that national banks had no incidental power under § 24 (Seventh) to pledge their assets to secure private deposits; had this power existed, there would have been no need for Congress later to enact 12 U.S.C. § 1290 to provide a limited power to pledge. The D.C. Circuit also hedged its *Chevron* position by concluding that, even if any statutory ambiguity as to the meaning of "incidental" remained, OCC's interpretation was not reasonable, in view of the pedigree of crop insurance as an insurance product and the fact that the bank is not customarily the beneficiary of such insurance (distinguishing the credit-life product the same court had earlier upheld in *Independent Bankers Ass'n of America v. Heimann*, 613 F.2d 1164, 1170 (D.C. Cir. 1979)).

245 The issue was whether a subsidiary of a bank controlled by a holding company could engage in a new activity without prior Board approval. The original D.C. Circuit panel reached out to decide an issue not raised by the parties, i.e., that OCC did not have discretion to fail to condition its approval of Citibank's proposed acquisition on subsequent approval by the Board under the BHCA, even though no BHCA application had ever been filed and none was required. Am. Ins. Ass'n v. Clarke, 854 F.2d 1405, 1412-13 (D.C. Cir.), *vacated in part* by 865 F.2d 278 (D.C. Cir. 1988). Shortly thereafter, however, the panel granted rehearing and ultimately va-

tional Bank Act analysis enjoyed ready judicial acceptance. Citibank proposed to acquire, as an operating subsidiary of the national bank, the American Municipal Bond Assurance Corporation (AMBAC), purveyor of a product that had been marketed as municipal bond insurance. Citibank's position was that this activity was incidental to the business of banking within the meaning of 12 U.S.C. § 24 (Seventh)[246] because it was functionally equivalent to a traditional banking product, the standby letter of credit.[247]

Letters of credit, whether commercial or standby, are triangular relationships. The purpose of a letter of credit is to facilitate an underlying transaction by substituting the known credit of a reputable bank, the "issuer" of the letter of credit, for the more uncertain (or lesser-known) credit of the bank's customer, the "account party." This enhances the creditworthiness of the account party in the eyes of the other party to the underlying transaction, the "beneficiary" of the letter of credit. Each leg of the triangle represents a separate and independent contract.

STANDBY LETTER OF CREDIT



cated the BHCA portion of its earlier decision, having concluded that the BHCA question had not been appropriately before the court. Am. Ins. Ass'n v. Clarke, 865 F.2d 278, 287-88 (D.C. Cir. 1988). For discussion of the AMBAC case, see Fisher, *supra* note 196, at 318-23.

246 OCC has a long-standing position that the provision of financial support for the transactions of others is fundamental to the business of banking. *See* Am. Ins. Ass'n v. Clarke, 656 F. Supp. 404, 409 (D.D.C. 1987), *aff'd in part, rev'd in part*, 854 F.2d 1405 (D.C. Cir. 1988) (citing Letter from James E. Smith, Comptroller of the Currency, [1973-1978 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 96,301, at 81,417 (July 1, 1974)).

247 OCC Interpretive Letter No. 338, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,508 (May 2, 1985).

In a standby letter of credit, the contractual undertaking of the issuer is to pay the beneficiary on the letter of credit upon the default[248] of the account party on the underlying transaction.[249] The standby letter of credit is thus a variant that performs the functions served by a commercial guaranty[250] or, more to the point, an insurance policy.

This similarity lay at the heart of the functional equivalence approach in the AMBAC case, as shown in the following diagram.

[248] This is the difference between the standby letter of credit and the commercial letter of credit, where the issuer typically pays on the letter of credit upon presentation by the beneficiary of documentation tending to show performance of, rather than default on, the underlying obligation. For more on letters of credit, the classic work remains HENRY HARFIELD, BANK CREDITS AND ACCEPTANCES (5th ed. 1974). *See also* BORIS KOZOLCHYK, COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS: A COMPARATIVE STUDY OF CONTEMPORARY COMMERCIAL TRANSACTIONS (1966).

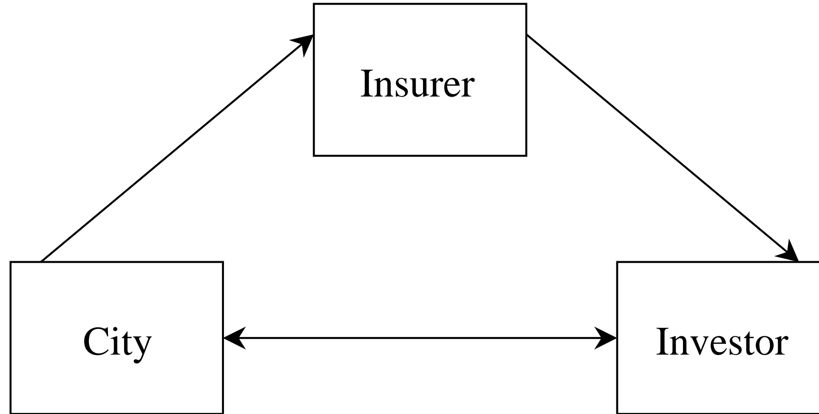
[249] FDIC regulations define a standby letter of credit somewhat more broadly to include

> any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer: (1) To repay money borrowed by or advanced to or for the account of the account party, or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make payment on account of any default (including any statement of default) by the account party in the performance of an obligation.

FDIC Unsafe and Unsound Banking Practices, 12 C.F.R. § 337.2(a) (2001). A footnote in the regulation clarifies that this definition does not include "commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer, which do not 'guaranty' payment of a money obligation of the account party and which do not provide that payment is occasioned by default on the part of the account party." *Id.* § 337.2 n.1

[250] Indeed, as national banks are forbidden from providing guaranties, the propriety of their issuing standby letters of credit was at one time in doubt. *See*, *e.g.*, Republic Nat'l Bank of Dallas v. Northwest Nat'l Bank of Fort Worth, 578 S.W.2d 109 (Tex. 1978).

MUNICIPAL BOND ASSURANCE



Here, the notion is that insurance, which pays off only upon the default of the municipality on its bond obligation, acts as a credit enhancement to the marketability of bonds issued by municipalities with lower debt ratings that would otherwise find it difficult to attract investors to their bonds. In this way, as Citibank urged and the Comptroller found, the business of municipal bond insurance is the functional equivalent of a banking product, the standby letter of credit, and therefore was a part of the business of banking under 12 U.S.C. § 24 (Seventh) and permissible activity for Citibank to engage in via acquisition of AMBAC. The reviewing courts had no trouble deferring to the Comptroller's conclusion on this point.[251]

Functional equivalence lay at the heart of an even more significant case for bank penetration of the insurance business. Through interpretive rulings beginning in the 1980s, OCC facilitated national bank entry into the lucrative area[252] of brokering and selling fixed and variable annuities.[253] Even though issued by insurance companies, these products were declared not to be

251 Am. Ins. Ass'n v. Clarke, 656 F. Supp. 404, 408 (D.D.C. 1987), *aff'd in relevant part*, 854 F.2d 1405, 1409-11 (D.C. Cir. 1988).

252 The competitive impact on the insurance industry can be gauged from trade press articles at the time the judicial challenge to OCC's interpretations was mounted. *See*, *e.g.*, *Annuities Sales by Banks: An Up and Coming Business*, ABA CONSUMER BANKING DIG., Sept.-Oct. 1989, at 4-9 (projecting bank annuity sales for the following year at $10 billion); *Bank Annuity Sales Expected to Double in '89*, NAT'L UNDERWRITER LIFE & HEALTH/FIN. SERVICES, Jan. 2, 1989, at 3.

253 OCC Interpretive Letter No. 331, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,501 (Apr. 4, 1985); OCC Interpretive Letter No. 499, [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,090 (Feb. 12, 1990).

insurance for purposes of § 92 and the *Saxon* rationale. In the case of variable annuities, of course, there was a securities feature,[254] so that variable products, despite their annuity feature, were essentially a form of a mutual fund share.[255]

More fundamentally, however, OCC distinguished annuities in general from insurance by characterizing the former as containing a feature that renders them functionally financial instruments and not classical insurance: the risk was characterized as essentially an investment risk, not an insurance risk.[256] Purchasers of annuities, according to this analysis, seek not a pool of assets against a catastrophic risk (e.g., death) but a guaranteed, long-term, and often tax-advantaged return on their assets. In short, purchasers of annuities are buying a financial instrument of the type long brokered by banks and clearly authorized by 12 U.S.C. § 24 (Seventh).[257]

As icing on the cake, OCC further observed that "it is well recognized that insurance and annuity contracts are significantly

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[254] *See VALIC I*, 359 U.S. 65 (1959).

[255] OCC Interpretive Letter No. 331, *supra* note 253. This of course made a variable annuity a security for purposes of the Glass-Steagall Act, but OCC had little difficulty authorizing brokerage and sale as consistent with the authorization for agency activities in section 16 of that statute, 12 U.S.C. § 24 (Seventh). *Cf.* Inv. Co. Inst. v. Clarke, 793 F.2d 220 (9th Cir. 1986) (finding sale of commingled IRA trust funds permissible); Inv. Co. Inst. v. Conover, 790 F.2d 925 (D.C. Cir. 1986); Inv. Co. Inst. v. Clarke, 789 F.2d 175 (2d Cir. 1986); *see also* OCC Interpretive Letter No. 386, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,610 (June 19, 1987) (authorizing national bank subsidiary to make recommendations to customers from broad range of secondary market securities and collective investment securities products, combining discount brokerage and investment advisory services); OCC Interpretive Letter No. 403, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,627 (Dec. 9, 1987); OCC Interpretive Letter No. 370, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,540 (Apr. 16, 1986) (approving bank's proposal to offer brokerage and investment advisory services); OCC No-action Letter No. 85-1, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,001 (July 30, 1985) (allowing combination of financial planning service and brokerage service within the bank).

Even with fixed annuity certificates, OCC's treatment of the product as "financial investment instruments" (i.e., as securities) necessitated obeisance to section 16 of Glass-Steagall. OCC Interp. Letter No. 499, [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,090 (Feb. 12, 1990).

[256] OCC Interpretive Letter No. 331, *supra* note 253.

[257] *Id.* Relying on the cases critical of *Saxon*, *e.g.*, Indep. Bankers Ass'n of Am. v. Heimann, 613 F.2d 1164, 1170 (D.C. Cir. 1979); Indep. Ins. Agents of Am., Inc. v. Bd. of Governors, 736 F.2d 468, 477 (8th Cir. 1984), OCC reiterated its position that although 12 U.S.C. § 92 might authorize some otherwise impermissible insurance activities for small town banks, it does not prohibit a national bank from conducting "insurance-related" activities if these are otherwise authorized by the National Bank Act. OCC Interpretive Letter No. 331, *supra* note 253.

different in their operation and the Supreme Court has stated that the two are 'opposites.'"[258] In a sense this is true. In a typical life insurance situation, the insurer assumes the risk that the insured will live a briefer life span than actuarial calculations in mortality tables would predict. An annuity typically involves payment by the issuer of income for a period defined by the annuitant's life, and there the insurance company (or other issuer) assumes the risk that the annuitant will live a longer life span than the actuarial calculations would predict. On the other side of the transaction, the annuitant is hedging against the risk of a long life, just as someone who buys a life insurance policy is hedging against the risk of a short one. In both situations, mortality risk is of paramount concern, though the two products represent opposite sides of the coin.[259]

OCC's approval of sales of both fixed and variable annuities by a national bank operating subsidiary[260] was challenged, for obvious strategic reasons, in the same judicial circuit that decided *Saxon*, albeit with some jurisdictional and venue-related maneuvering.[261] The district court deferred to OCC's interpretation,[262] but the Fifth Circuit, justifying the plaintiff's venue-based predic-

[258] OCC Interpretive Letter No. 331, *supra* note 253 (citing Helvering v. Le Gierse, 312 U.S. 531, 539-41 (1941) (stating that "[t]he fact remains that annuity and insurance are opposites"; combined purchase of life insurance policy with annuity negated the risk transfer inherent in insurance)); Carroll v. Equitable Life Assurance Soc'y, 9 F. Supp. 223, 224 (W.D. Mo. 1934) ("An examination of the authorities does not warrant the conclusion that an annuity contract is an insurance contract"); 1 JOHN ALLEN APPLEMAN, INSURANCE LAW AND PRACTICE § 84 (1981) ("Annuity contracts must . . . be recognized as investments rather than as insurance.").

[259] *VALIC I*, 359 U.S. at 71 ("The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense.").

[260] In general, approval by OCC under a § 24 (Seventh) rationale potentially has wider ramifications, inasmuch as it (A) satisfies (in the case of principal activities) the requirements of section 24 of the Federal Deposit Insurance Act, 12 U.S.C. § 1831a (1994 & Supp. IV 1998); (B) opens the door for state-chartered banks in states with "wild-card" statutes to engage in the same activity; and (C) renders it a permissible nonbanking activity for bank holding companies under section 4(c)(5) of the BHCA, 12 U.S.C. § 1843(c)(5) (1994). In the particular case of annuities, it was not long before the Board approved an application for a bank holding company to act as an agent through a subsidiary in the sale of variable and fixed-rate annuities based on OCC's approval for national banks to do so. *See* Norwest Corp., 76 Fed. Res. Bull. 873 (1990).

[261] *See* Nat'l Ass'n of Life Underwriters v. OCC, No. A90-CA-884 (W.D. Tex. filed Sept. 12, 1990), *refiled sub nom.* Variable Annuity Life Ins. Co. v. Clarke, No. H-91-1016 (S.D. Tex. filed Nov. 22, 1991).

[262] Variable Annuity Life Ins. Co. v. Clarke, 786 F. Supp. 639 (S.D. Tex. 1991),

tion, reversed, rejecting OCC's functional equivalence approach and holding that annuities were, in fact, insurance within the purview of § 92, thereby setting the stage for adherence to the *Saxon* rationale.[263] However, the insurance industry's jubilation was short-lived since the Supreme Court not only took the case but resoundingly (and unanimously) reversed.[264]

Apart from its unanimity, the Supreme Court's decision was a tremendous shot in the arm for OCC's functional equivalence approach. Under the deferential *Chevron* approach, where the National Bank Act was silent on the key issue of what constitutes insurance for purposes of § 92, the Court was prepared to accord substantial deference to OCC as the agency charged with interpretation of that statutory scheme. The Court regarded OCC's classification—based on tax deferral and investment features—of annuities as "at least reasonable" and noted with approval OCC's observation that "annuities serve an important investment purpose and are *functionally similar* to other investments that banks typically sell."[265]

The victory of OCC's functional equivalence approach was made all the more resounding by the remarkable footnote two in Justice Ginsburg's opinion for the Court: "We expressly hold that the 'business of banking' is not limited to the enumerated powers in § 24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated."[266] The Court did, however, point out that OCC's discretion is not unbounded: "Ventures distant from dealing in financial investment instruments—for example, operating a general travel agency—may exceed those bounds."[267] Whatever the precise outer limits of the "business of banking" may be, it is clear from this footnote that financial instruments and invest-

rev'd, 998 F.2d 1295 (5th Cir. 1993), *rev'd sub nom.* Nationsbank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251 (1995).

263 Variable Annuity Life Ins. Co. v. Clarke, 998 F.2d 1295 (5th Cir. 1993), *rev'd sub nom.* Nationsbank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251 (1995).

264 Nationsbank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251 (1995) [hereinafter *VALIC II*].

265 *Id.* at 263-64 (emphasis added).

266 *Id.* at 258 n.2.

267 *Id.* The unmistakable reference is to the seminal First Circuit decision in *Arnold Tours, Inc. v. Camp,* 472 F.2d 427 (1st Cir. 1972) (holding that operating a travel agency is not "incidental" to the "business of banking" within the meaning of § 24 (Seventh)).

ment vehicles are well within those boundaries and, in the absence of any definition of "insurance" for purposes of the National Bank Act, the Comptroller's reinterpretation of traditional insurance products as "financial" or "banking" products would enjoy nothing less than the imprimatur of the United States Supreme Court.

Shortly after OCC's victory in *VALIC II*, an article co-authored by the agency's chief counsel proclaimed that defining the contours of the business of banking was an evolutionary process that should be sufficiently flexible to respond to changes in the financial markets and to the needs of bank customers.[268] The article suggested a tripartite inquiry for ascertaining whether a particular activity should be considered part of the business of banking: (1) whether the activity is functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) whether the activity is responsive to the needs of customers or otherwise will benefit the bank or its customers; and (3) whether the activity involves risks similar in nature to those already assumed by the bank.[269] The first factor embodied the functional equivalence concept, the second intimated that OCC will expand the scope of the business of banking with changes in technology and the marketplace, and the third signaled that not merely agency activities but principal activities might be included.

This approach was subsequently adopted as the official interpretive position of the agency in connection with its authorization of the next insurance-related banking power: reinsurance of private mortgage insurance.[270] Here, the reinsurance function is not merely an agency activity but a principal activity[271] because the reinsurer takes on underwriting risk. Nonetheless, OCC's analytical approach was to deem that risk the functional equivalent of the normal credit risk undertaken when a bank underwrites a mortgage loan. Therefore, this activity was author-

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268 Julie L. Williams & Mark P. Jacobsen, *The Business of Banking: Looking to the Future,* 50 BUS. LAW. 783 (1995).

269 *Id.* at 785.

270 This product typically is used with so-called "jumbo" mortgage loans (where the purchaser of the property puts up less than twenty percent of the purchase price as a down payment) and is designed to protect the investor holding the note against default by the borrower. Mortgage lenders frequently purchase the insurance directly from an insurer and then pass the cost thereof on to the borrower.

271 Hence, for this product, no exercise or interpretation of the § 92 authority would be availing, as that statute authorizes only agency activity. 12 U.S.C. § 92 (1994).

ized as being consistent with 12 U.S.C. § 24 (Seventh).[272]

C. The Terra Incognita *of Bank Operating Subsidiaries*

The concept of subsidiaries of national banks has always been surrounded by controversy. Part of the problem surrounds the differing interpretations of what constitutes the "business of banking" under the National Bank Act, which provides, in pertinent part, a national bank may exercise

> all such incidental powers as shall be necessary to carry on the *business of banking*; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.[273]

The interpretive question is whether the phrases that follow the emphasized language, and that are separated therefrom by a semicolon, constitute a delineation of what constitutes the "business of banking," indicating (under an *expressio unius est exclusio alterius* approach) that items not mentioned in the statute are *not* part of that business, or are merely exemplary, indicating (under an *ejusdem generis* approach) that omitted items may nonetheless be considered part of that business. The former represents the so-called "narrow view" of the business of banking, the latter the so-called "broad view."[274]

The narrow view, that national banks are statutory creatures of limited powers and can exercise only those powers expressly granted them in the National Bank Act, is analogous to the traditional view in constitutional law that the federal government is a government of limited powers and those powers not expressly granted to the federal government in the Constitution are reserved to the States and the people.[275] Under this view, national banks are not authorized to have subsidiaries absent a specific statutory authorization. Far from providing such an authorization, section 5136, as amended by section 16 of the Glass-Steagall

[272] OCC Interpretive Letter No. 743, [1996-97 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,108 (Oct. 17, 1996).

[273] 12 U.S.C.A. § 24 (Seventh) (West 2001) (emphasis added).

[274] *See* Symons, *supra* note 174, at 678-80.

[275] This is the familiar language of the Tenth Amendment to the U.S. Constitution, which has undergone something of a Renaissance in recent years. *See*, *e.g.*, Printz v. United States, 521 U.S. 898 (1997); New York v. United States, 505 U.S. 144 (1992).

Act, expressly limits the power of a national bank by forbidding its ownership of stock for its own account.[276] If a national bank cannot own stock for its own account, how can it possibly own a subsidiary?

The OCC has traditionally taken a more expansive view. Beginning in 1964, the OCC permitted a national bank to own the stock of a subsidiary, variously known as an "operations subsidiary" or "operating subsidiary," provided that it would not perform any function that the bank could not perform directly. In other words, activities conducted by operating subsidiaries were treated the same as those conducted directly by the bank itself, subject to the same limitations and restrictions as were applicable to the bank.[277] These mid-1960s OCC pronouncements on operating subsidiaries engendered public disagreement on the subject between OCC and the Board, which took the position that section 16 of Glass-Steagall forbade any such subsidiary.[278] Ultimately, however, the Board reached an entente with OCC and reversed its position on the subject:

> [A] bank [is permitted] to organize its operations in the manner that it believes best facilitates the performance thereof. One method of organization is through departments; another is through separate incorporation of particular operations. In other words, a wholly owned subsidiary corporation engaged in activities that the bank itself may perform is simply a convenient alternative organizational arrangement.[279]

Consistent with the competition in regulation process that has long been a hallmark of our dual banking system, similar powers were granted to subsidiaries of state banks under state law.

Although the House Banking Committee held hearings on this

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[276] "The business of dealing in securities and stock by the association 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* . . . ." 12 U.S.C. § 24 (Seventh) (emphasis added). This language immediately follows the language quoted *supra* in the text accompanying note 273.

[277] This, at least, was OCC's approach prior to the revisionist history position it adopted in 1994. *See*, *e.g.*, 12 C.F.R. § 5.34 (1993) (former OCC operating subsidiary regulation).

[278] *See Member Bank Purchase of Stock of "Operation Subsidiaries"*, 52 Fed. Res. Bull. 1151 (1966).

[279] Fed. Res. Sys. Miscellaneous Interpretations, 12 C.F.R. § 250.141(c) (2001). The Board even went so far as to oppose legislation that would have prohibited a national bank from engaging directly or indirectly in any activity that the Board had determined by regulation or order to be an improper activity for BHCs. *See Competition in Banking Act of 1980: Hearings Before the S. Comm. on Banking, Housing and Urban Affairs*, 96th Cong. 14 (1980).

subject,[280] Congress never took action to alter OCC's position through legislation. To the contrary, in the 1978 amendments to the BHCA, when operating subsidiaries were already a common organizational device, Congress acknowledged the existence of operating subsidiaries and provided that they were definitely not within the purview of the Board's regulatory power under the BHCA, even where they were second-tier subsidiaries of a BHC.[281] Those amendments added a new section 5(e) to the BHCA:

> [T]he Board may, whenever it has reasonable cause to believe that the continuation by a bank holding company of any activity or of ownership or control of any of its nonbank subsidiaries, *other than a nonbank subsidiary of a bank*, constitutes a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank and is inconsistent with sound banking principles . . ., order the bank holding company or any such nonbank subsidiaries . . . to terminate such activities or to terminate . . . its ownership or control of any such subsidiary . . . .[282]

Similarly, Congress excluded banks and their subsidiaries from the cease-and-desist authority granted to the Board under section 8(b) of the Federal Deposit Insurance Act, as also amended in 1978:

> Nothing in this subsection [cease-and-desist proceedings] or in subsection (c) of this section [temporary cease-and-desist proceedings] shall authorize any Federal banking agency, other than the Board of Governors of the Federal Reserve System, to issue a notice of charges or cease-and-desist order against a bank holding company or any subsidiary thereof (*other than a bank or subsidiary of that bank*).[283]

Congress was therefore satisfied with the operating subsidiary

280 *See generally Federal Reserve Rules Regarding Loan Production Offices and Purchases of Operating Subsidiaries: Hearings Before the House Comm. on Banking and Currency,* 90th Cong. (1968).

281 An interesting parallel may be drawn with OCC's approval of the establishment of a discount brokerage subsidiary by a national bank, which was itself a subsidiary of a BHC, at a time when discount brokerage had not yet been determined to be a permissible activity under section 4 of the BHCA. In the litigation engendered by the discount brokerage applications, it was never suggested that a BHC-owned bank, which in turn established a subsidiary to conduct an activity that OCC had determined the bank itself could conduct, would cause the parent BHC to be in violation of the BHCA. *See* Sec. Indus. Ass'n v. Comptroller of the Currency, 577 F. Supp. 252 (D.D.C. 1983), *aff'd,* 758 F.2d 739 (D.C. Cir. 1985).

282 12 U.S.C. § 1844(e) (1994) (emphasis added).

283 *Id.* § 1818(b)(3) (emphasis added).

concept as it had been administered by the OCC under the National Bank Act and by the state bank supervisors under state law. Central to that concept was the treatment of the operating subsidiary as simply a convenient organizational alternative to a department of the bank. Indeed, in the Garn-St Germain amendments to section 23A of the Federal Reserve Act, Congress created the express statutory distinction between loans by a bank to a subsidiary, which are not treated as loans to an affiliate, and loans by a bank's subsidiary to an affiliate of the bank, which are treated as loans *by the bank* to that affiliate.[284]

In the mid-1990s, however, OCC announced an expansion on its already expansive view. Emboldened by *VALIC II,* which featured the use of an operating subsidiary to sell annuities and which, as we have seen, suggested that OCC enjoyed significant latitude in determining what sort of activities might be "incidental" to the "business of banking" under § 24 (Seventh), OCC promulgated a revised operating subsidiary regulation[285] that contemplated authorizing activities for such subsidiaries that were *not* permissible for the parent national bank.[286]

This proposal sent shock waves[287] through the financial ser-

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[284] *See* Garn-St Germain Depository Institutions Act of 1982, § 410, Pub. L. No. 97-320, 96 Stat. 1469, 1515-16 (amending 12 U.S.C.A. § 371c (West 2001)).

[285] Rules, Policies, and Procedures for Corporate Activities, 59 Fed. Reg. 61,034 (Nov. 29, 1994). The revisions to Part 5 of OCC's regulations originated in 1994 as part of a comprehensive overhaul of the agency's regulations in an effort to "update and streamline" them, pursuant to the mandate of section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994, 12 U.S.C. § 4803 (1994).

[286] OCC proposed to exempt operating subsidiaries from statutory restrictions on the conduct of certain activities by the parent national bank where the agency believed the restriction to be not necessarily applicable to the subsidiaries. Rules, Policies, and Procedures for Corporate Activities, 59 Fed. Reg. at 61,039.

[287] The revised Part 5 operating subsidiary regulation was widely seen to be an end-run around Glass-Steagall and insurance restrictions, as well as other activities (e.g., real estate) forbidden to national banks themselves. *See generally OCC Seeks Comment on Easing Bank Rules, Opening Door for New Sub Power Requests,* 63 Banking Rep. (BNA) 815 (Dec. 5, 1994). It was even suggested that these rules would open the door to European-style "universal banking" in the United States. Robert M. Garsson, *OCC's Paperwork Rewrite Paves the Way for Banks To Expand Their Powers*, AM. BANKER, Jan. 20, 1995, at 3. These impressions of the potential breadth and significance of the operating subsidiary proposal persisted even two years later, when the regulation was ultimately finalized. *See* Olaf de Senerpont Domis, *Banks Rush To Embrace New Freedoms,* AM. BANKER, Nov. 25, 1996, at 1-2 (describing how, availing themselves of new Part 5 Rules, national banks plan to propose new or expanded activities involving insurance, equipment leasing, municipal revenue bond underwriting, real estate brokerage, and management and information processing).

vices industries and the halls of Congress and was denounced as exceeding the scope of OCC's statutory authority.[288] Initially promulgated in 1994, the operating subsidiary proposal was shelved in the 104th Congress, partly in response to the wave of critical reaction and partly in the hopes that it would be mooted by enactment of a precursor to GLEBA,[289] the proposed Financial Services Competitiveness Act of 1995.[290] However, when banking reform legislation failed to pass with the 104th Congress,[291] the proposal was dusted off and issued as a final regulation.[292]

There, OCC declared that it would entertain, on a case-by-case basis, proposals for operating subsidiaries to engage in activities that, while part of the "business of banking" or "incidental" thereto, were nonetheless beyond the authority of the parent banks themselves. In light of the breadth of the Comptroller's discretion after *VALIC II* and the judicial deference it would enjoy thereafter, confining those activities to what constitutes the "business of banking" and its incidents was no limitation at all—at least with respect to a broad array of securities and insurance products and activities.[293] The newly constituted operating sub-

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288 For a more sympathetic view, see James R. Smoot, *Bank Operating Subsidiaries: Free at Last or More of the Same?*, 46 DEPAUL L. REV. 651 (1997). The rhetoric from Capitol Hill and various trade associations was decidedly more negative, however. *See id.* at 653, 673-74 (recounting responses from House Banking Committee Chairman Leach, former House Energy and Commerce Committee Chairman Dingell, and others).

289 *See* Olaf de Senerpont Domis, *OCC May Get Upper Hand in Bid To Expand Activities Allowed in Bank Subsidiaries*, AM. BANKER, Feb. 12, 1996, at 4 (reporting OCC Chief Counsel Julie L. Williams as saying the agency was in a "holding pattern" on the proposed Part 5 Rules and was "monitoring what Congress [was] doing").

290 *See* H.R. 18, 104th Cong. (1995). One month after his introduction of this legislation, House Banking Committee Chairman Leach introduced a second version of the same bill, H.R. 1062, 104th Cong. (1995), which became the principal vehicle for banking reform legislation during that session of Congress and the bill that was marked up by both the House Banking Committee and the House Commerce Committee.

291 *See* Justin Fox, *Hopes for Wider Powers Now Pinned on Courts, Regulators—Not Congress,* AM. BANKER, Jan. 2, 1996, at 1.

292 Rules, Policies, and Procedures for Corporate Activities, 61 Fed. Reg. 60,342 (Nov. 26, 1996).

293 For example, within a year after the regulation was finalized, OCC relied on it to permit a subsidiary of Zions First National Bank, Salt Lake City, Utah, to engage in municipal revenue bond underwriting. OCC Conditional Approval No. 262 (Dec. 11, 1997), *available at* 1997 OCC Ltr. LEXIS 127. Municipal revenue bonds are state or local bonds not backed by the full faith and credit of the issuing authority, and as such could not (at that time, i.e., prior to GLEBA) be underwritten by na-

sidiary thus represented yet another, and potentially awesome, weapon in the OCC's arsenal in aid of moving banks into the realm of insurance.

In summary, penetration by banks into the insurance business was proceeding apace, and on three fronts. The first was the reinvigoration of the § 92 authority with the demise of state anti-affiliation laws, the *Barnett* "prevent or significantly interfere with" standard,[294] and OCC's expansive interpretation of what constitutes a "place of 5,000." Impressive as this amount of progress was in a few short years, it was still linked to a statutory authority with both geographical restrictions and product restrictions (i.e., limited to insurance agency activities). Nonetheless, from the perspective of the insurance agents (and their trade associations and lobbyists), the prospect of fierce competition from banks, with their already well-developed and extensive retail distribution networks, was all too real and daunting enough that a number of established insurance agencies looked for opportunities to be acquired by banks.

The second front for the advancement of banks into insurance was the successful marshaling of "functional equivalence" analysis to redefine traditional insurance products—whether they be municipal bond insurance or annuities—as financial products and the explicit license from the Supreme Court to consider such products part and parcel of the business of banking. From the perspective of the insurance companies, this was potentially a dire threat. Property and casualty companies offered, and were likely to develop in the future, a variety of products that look like standby letters of credit, making it relatively easy for banks, using a functional equivalence analysis, to "poach" on their turf. Life insurance companies were most concerned about the prospect that banks could not merely sell but also *underwrite* fixed[295]

tional banks, which were limited by § 24 (Seventh) to underwriting only general obligation state and municipal bonds. Interestingly, the Act amended that provision to authorize underwriting, dealing in, and purchasing (i.e., for the bank's own account: purchases as agent were already permitted) various state and municipal revenue bonds, limited obligation bonds, and other obligations that satisfy the requirements of § 142(b)(1) of the Internal Revenue Code. GLEBA § 151, 12 U.S.C.A. § 24 (Seventh) (West 2001).

294 Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, 33 (1996).

295 Underwriting variable annuities was seen as somewhat less of a threat because they had to be registered as securities, *see VALIC I*, 359 U.S. 65 (1959), thus making it impossible for banks themselves under section 16 of Glass-Steagall. Underwriting variable annuities would have been quite possible for section 20 affiliates, however,

annuities and do so outside the purview of insurance regulators to boot (with annuities having been blessed by no less than the Supreme Court as a financial, not an insurance, product). Annuity underwriting was a growth area for the life insurance business and was widely used in the pension market. Thus, even though *VALIC II* took no position on national banks underwriting annuities, the road was open for OCC to approve such an application, and the life insurance industry could foresee its imminence.

The third front was the potentially open-ended authority for operating subsidiaries of national banks, enlarging upon the functional equivalence approach, to engage in insurance activities that would be forbidden to their bank parents. Anointed with the imprimatur of the Supreme Court in *VALIC II* and Justice Ginsburg's famous footnote two, indicating the degree of judicial deference that could be expected, OCC's discretion to delineate the contours of the "business of banking" was easily broad enough to encompass a vast array of insurance products and services.

Prior to GLEBA, then, the prospects for banks to continue to earn substantial revenues from the insurance business were bright indeed.

III

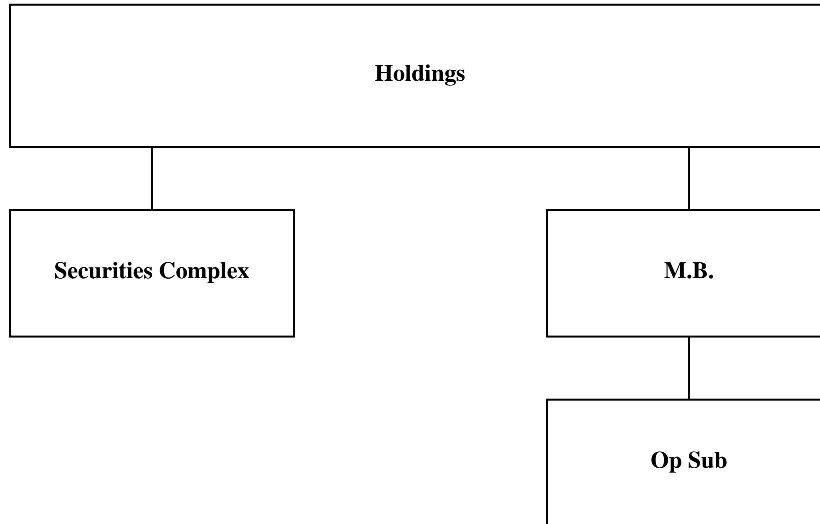
A. Introduction

Let us posit, prior to enactment of GLEBA, a commercial banking organization, which we shall generically label "Holdings." Holdings is registered as a bank holding company under the BHCA by reason of its control of a member bank in the Federal Reserve System (abbreviated here as "M.B."). M.B. has an operating subsidiary (Op Sub). In addition, Holdings directly or indirectly controls one or more securities affiliates engaging in a variety of securities activities to a limited extent, consistent with section 20 of Glass-Steagall and the Board's orders. Under then-current law, these activities may have included underwriting and dealing in commercial paper, municipal revenue bonds, mortgage-related securities, consumer receivable-related securities, and corporate debt and equity securities, as well as providing investment advisory services, full service securities brokerage, the

albeit subject to gross revenues constraints; and as Part III will demonstrate, that business could even have been done by a commercial banking organization *without* any gross revenues constraints through a disaffiliated underwriting entity.

provision of any number of back office or support services for a private label fund, and so forth. This entity or group of entities, which would include, at a minimum, a registered broker-dealer and possibly also a registered investment advisor and other entities subject to regulation by bodies other than the Board and the other bank regulatory agencies (e.g., by the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the National Association of Securities Dealers (NASD), etc.), could have been structured in any number of ways (second-, third-, and any higher ordinal number-tiered subsidiaries) on Holdings' organization chart. For present purposes, we shall conceptualize this company or group of companies as a single, first-tier subsidiary of Holdings which we will label "Securities Complex." (Diagram A.)

DIAGRAM A



Suppose Holdings had wished to unfetter its securities business from the gross revenues limitation imposed by the Board's interpretation of the term "engaged principally" in section 20 of Glass-Steagall.[296] This portion of the article will describe how Holdings could acquire one or more corporations engaged in various securities activities that could not, under section 16 of the Act, be performed by M.B. itself or, because they were engaged

[296] *See infra* note 360 and accompanying text.

"principally" within the meaning of section 20, by an affiliate of M.B.

The methodology suggested here contemplates restructuring certain of Holdings' first- and second-tier subsidiaries so that M.B. would not be an "affiliate" (for Glass-Steagall purposes) of Securities Complex. This restructuring will be referred to herein as "disaffiliation." As explained in more detail below, the approach outlined herein is consistent with the rules of statutory construction[297] articulated in numerous cases by the Supreme Court of the United States and by the lower federal courts, including the United States Court of Appeals for the District of Columbia Circuit (which is always a permissible venue for seeking judicial review of actions by the Board and the other federal bank regulatory agencies).[298]

B. Affiliation

Section 20 of Glass-Steagall generally barred any affiliation between a member bank and a company engaged principally in certain securities activities. An "affiliate" for Glass-Steagall purposes is a defined term comprised of four components, as delineated in section 2(b) of that statute, which provides:

> Except where otherwise specifically provided, the term "affiliate" shall include any corporation, business trust, association, or other similar organization—
> (1) Of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 per centum of the number of shares voted for the election of its directors, trustees, or other persons exercising similar functions at the preceding election, or controls in any manner the election of a majority of its directors, trustees, or other persons exercising similar functions; or
> (2) Of which control is held, directly or indirectly, through stock ownership or in any other manner, by the shareholders of a member bank who own or control either a majority of the shares of such bank or more than 50 per centum of the number of shares voted for the election of directors of such bank at

[297] The approach described herein was previously incorporated in two requests for interpretation submitted several years ago by the author on behalf of a client, to two federal regulatory agencies. Both agencies analyzed and adopted this "disaffiliation" analysis in approving those requests. As the company involved was not a bank holding company, no interpretation was sought from the Board. Suitably redacted copies of these agency interpretations are on file with the author.

[298] *See*, *e.g.*, 12 U.S.C. § 1818(h)(2) (1994) (judicial review of enforcement actions); *id.* § 1848 (judicial review of orders under the BHCA).

> the preceding election, or by trustees for the benefit of the shareholders of any such bank; or
> (3) Of which a majority of its directors, trustees, or other persons exercising similar functions are directors of any one member bank; or
> (4) Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more than 50 per centum of the number of shares voted for the election of directors of a member bank at the preceding election, or controls in any manner the election of a majority of the directors of a member bank, or for the benefit of whose shareholders or members all or substantially all the capital stock of a member bank is held by trustees.[299]

Each of these components independently is sufficient to establish an "affiliate" relationship for purposes of the Act. Indeed, this definition of affiliate is applicable (as one might infer from the situs of its codification within the Federal Reserve Act and from the introductory phrase, "Except where otherwise specifically provided") to other Federal Reserve Act (but non-Glass-Steagall) provisions, such as section 24A, governing investments in bank premises.[300]

For purposes of clarity, the four categories of relationships delineated in Glass-Steagall section 2(b) are diagramed below, with each diagram number corresponding to the numbered paragraph in the section 2(b) definition.

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299 *Id.* § 221a(b).

300 12 U.S.C. § 371d provides:

> No national bank or State member bank shall invest in bank premises, or in the stock, bonds, debentures, or other such obligations of any corporation holding the premises of such a bank, or make loans to or upon the security of the stock of any such corporation . . . unless the bank receives the prior approval of the Comptroller of the Currency (with respect to a national bank) or the Board (with respect to a State member bank [or] unless the aggregate of all such investments and loans, together with the amount of any indebtedness incurred by any such corporation which is an *affiliate of the bank,* is less than or equal to the amount of the capital stock of such bank. . . .

12 U.S.C. § 371d (1994 & Supp. IV 1998) (emphasis added).

DIAGRAM 1

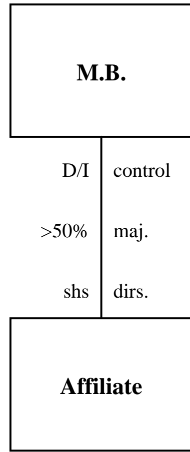
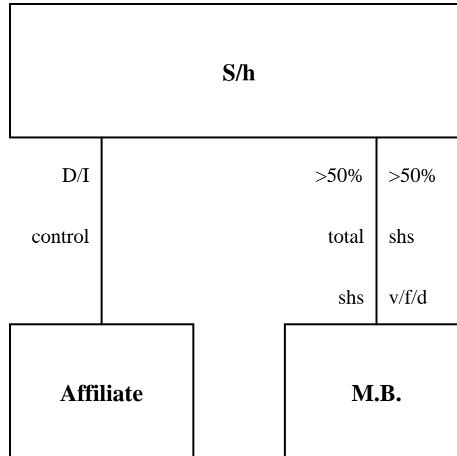


DIAGRAM 2



Legend

M.B. = member bank
maj. = majority
S/h = shareholder(s)
D/I = directly or indirectly
dirs. = directors
v/f/d = voted for directors
shs = shares

DIAGRAM 3

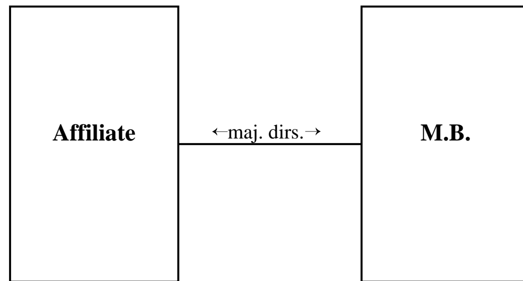
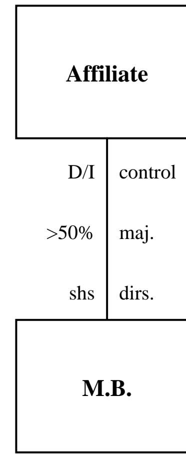


DIAGRAM 4



Legend

M.B. = member bank
maj. = majority
S/h = shareholder(s)
D/I = directly or indirectly
dirs. = directors
shs = shares

Of the four component paragraphs in the Glass-Steagall definition of “affiliate,” three (i.e., paragraphs (1), (2), and (4)) revolve around concepts of share ownership and control (or the coordinate concept of controlling the election of a majority of directors) and one (paragraph (3)) deals with a majority director interlock. As paragraph (3) is not structural, it is the most easily

dealt with from the point of view of ensuring that Securities Complex and M.B. are not "affiliates" within the meaning of the Act. The interlock in question relates *only* to M.B. and Securities Complex, so the relatively common existence of a majority director interlock between a bank and its parent holding company would have no effect.[301]

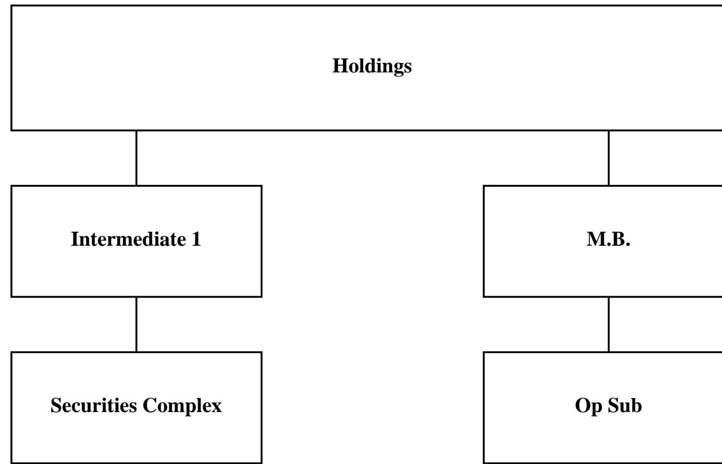
C. "Disaffiliation"

1. Impact of Structural Alterations on Statutory Definition

If we return to Diagram A we find that (1) Holdings is an affiliate of M.B. and of Securities Complex under section 2(b)(4); (2) Securities Complex is an affiliate of M.B. under section 2(b)(2); and (3) Op Sub is an affiliate of M.B. under section 2(b)(1). The key affiliation, of course, is that of Securities Complex and M.B. under section 2(b)(2).

This Glass-Steagall problem would not be alleviated if we merely interposed an intermediate holding company ("Intermediate 1") between Holdings and Securities Complex, as shown in Diagram B:

DIAGRAM B

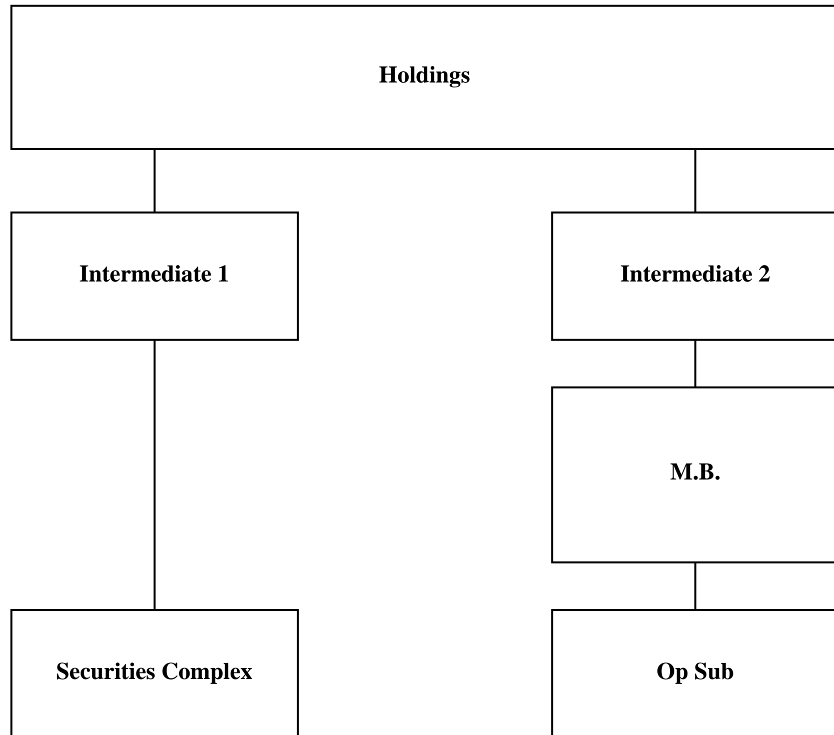


[301] In short, so long as a majority of directors of M.B. do not also sit as directors of Securities Complex, section 2(b)(3) of Glass-Steagall does not apply. We shall make the simplifying assumption throughout this article that none of the entities under discussion has a majority director interlock with any other entity under discussion (including M.B. and Holdings), in order that we may focus on the structural aspects of the "affiliate" definition.

Under the literal language of section 2(b)(2), Securities Complex and M.B. are still affiliates, because the former is controlled "*directly or indirectly* . . . by the shareholder[ ] of a member bank . . .," i.e., by Holdings.

We now expand on this structure by introducing another first-tier subsidiary of Holdings ("Intermediate 2") between Holdings and M.B. (Diagram C):

DIAGRAM C



This relatively simple structural alteration produces a dramatic result. Under a careful reading of section 2(b)(2)—and provided that Intermediate 2 does not exercise (or have the power to exercise) control over Securities Complex by any means different from stock ownership—Securities Complex is *not* an affiliate of M.B. because control of Securities Complex is not held "directly or indirectly, through stock ownership or in any other manner, by the shareholder[ ] of" M.B.[302]

[302] 12 U.S.C. § 221a (1994).

Section 2(b)(2) does not modify the word "shareholder[ ]" with the phrase "directly or indirectly."

Therefore the shareholder of M.B. is now *Intermediate 2, not Holdings*. Intermediate 2 does not control Holdings and consequently does not, "directly or indirectly, through stock ownership or in any other manner,"[303] control Securities Complex; hence any subsidiary of Securities Complex would likewise not be an affiliate of M.B.

Before embarking on the detailed statutory analysis of disaffiliation, it should be noted that the approach set forth here would only have been necessary for a bank holding company controlling one or more *member* banks. It has been clear since 1933 that all of the substantive provisions of Glass-Steagall other then section 21[304] apply only to member banks and not at all to nonmember banks.[305] (Thus, if Holdings controlled only State nonmember banks, no disaffiliation would have been necessary.)

2. *Construction of Plain Meaning of Section 2(b)(2) of Glass-Steagall*

Of the various control relationships described in the three paragraphs of section 2(b) under consideration, all but one in-

[303] *Id.*

[304] Section 21 of Glass-Steagall, which remains good law even after GLEBA, prohibits any person engaged in the business of issuing, underwriting, selling, or distributing securities from engaging at the same time in deposit taking. 12 U.S.C. § 378 (1994). This provision interdicts engaging to any extent whatever—and not merely "principally" as in section 20, 12 U.S.C. § 377 (1994) (repealed 1999), or "primarily" as in section 32, *id.* § 78 (repealed 1999)—in the listed securities activities *in the bank itself*. Section 21 has no effect on conducting such activities through affiliates, which prior to GLEBA were governed by section 20.

[305] Actually, there was a brief period (several months in duration) following the enactment of the Competitive Equality Banking Act of 1987 (CEBA), Pub. L. No. 100-86, 101 Stat. 552, when section 20 of Glass-Steagall was made applicable to state nonmember banks and to thrift institutions. Section 106 of CEBA established a moratorium on affiliations between all insured depository institutions and firms principally engaged in wholesale securities activities. The method by which Congress effected this moratorium was to apply the provisions of sections 20 and 32 of the Act to institutions that were not member banks, i.e., state nonmember banks and thrifts, as though they were member banks for purposes of the Act. Congress further provided that the moratorium would, unless reenacted, sunset by its own terms on March 1, 1988. It was during the period between enactment of CEBA (August 10, 1987) and the moratorium sunset date that the interpretations, *supra* note 297, were sought, and each of those interpretations makes reference to, and independently construes, the moratorium provision. On March 1, 1988, however, the moratorium and its Glass-Steagall extension sunset and were never reenacted.

volve the concept of owning or controlling "directly or indirectly." The only exception is the relationship of the member bank and its majority shareholders described in paragraph (2), even though, in the selfsame paragraph (2), the relationship of those shareholders and the *affiliate* is covered by the "directly or indirectly" formulation. Returning to the structure illustrated in Diagram C, while Holdings would be the controlling shareholder of Securities Complex, Holdings would not be the shareholder that owns or controls a majority of M.B.'s shares. Rather, Intermediate 2 would be the shareholder owning and controlling a majority of M.B.'s shares. Furthermore, Intermediate 2, which would in fact be the sole shareholder of M.B., would not own or control, directly or indirectly, Securities Complex.

As Congress's use of the adverbial phrase "directly or indirectly" is critical both to the construction of section 2(b) and to the validity of this analysis, a bit more elaboration will be useful here. Each of paragraphs (1), (2), and (4) of section 2(b) uses the "directly or indirectly" formulation. Each also makes use of an "either . . . or" statutory formulation of the concept of control of a particular corporate entity,[306] i.e., ownership or control of either (A) a majority of voting shares or (B) more than fifty percent of the number of shares voted for the election of directors. For ease of reference in the discussion that follows, let us abbreviate this "either . . . or" formulation of the exercise of control, as though it were a mathematical expression, by placing the word "CONTROL" in brackets, *viz.* [CONTROL]. [CONTROL], as

[306] Unlike other federal banking statutes, Glass-Steagall has no formal definition of "control." Other federal banking statutes have definitions of control that largely track the three-pronged approach of section 2(a)(2) of the BHCA, 12 U.S.C. § 1841(a)(2) (1994). Indeed, section 23A of the Federal Reserve Act, which was enacted contemporaneously with Glass-Steagall, has a definition that is virtually coextensive with that of the BHCA. *See* 12 U.S.C. § 371c(b)(3) (1994) (definition of control for purposes of section 23A of the Federal Reserve Act, governing transactions between a member bank and its "affiliate" (also specially defined in section 23A, *see infra* notes 318-23 and accompanying text)); *see also id.* § 375b(9)(B) (definition of control for purposes of section 22(h) of the Federal Reserve Act, governing extensions of credit to executive officers, directors, and principal shareholders, virtually identical to the section 23A version); *id.* § 1813(w)(5) (Federal Deposit Insurance Act definition of control, cross-referencing to the BHCA definition).

Thus it seems sensible to assume that the section 23A/BHCA definition of "control" would be the likeliest guide to the meaning of that term in Glass-Steagall. That, at any rate, would be consistent with the approach the Supreme Court took in the Bankers Trust commercial paper case. *See supra* notes 96-98.

used in the several paragraphs of section 2(b), is modified, in all but one instance, by the adverbial phrase "directly or indirectly."

There is, however, a significant difference between the syntax of paragraphs (1) and (4) on the one hand and paragraph (2) on the other.

- Paragraph (1), for example, starts off by using the formulation "*directly or indirectly* [CONTROL]," and then finishes with a final phrase in the disjunctive ("or controls in any manner the election of a majority of its directors . . ."). Note that, syntactically, the final disjunctive phrase is *not* modified by the earlier adverbial phrase "directly or indirectly" (another adverbial phrase, "in any manner," has been substituted).
- Similarly, paragraph (4) starts off by using a lightly transposed but otherwise identical formulation, *directly or indirectly* [CONTROL], and concludes—once again, as in paragraph (1)—with the same phrase in the disjunctive ("or controls in any manner the election of a majority of its directors . . .") that is, as before, *not* modified by the earlier adverbial phrase "directly or indirectly."

Thus the substance of paragraphs (1) and (4) can be syntactically summarized as follows:

directly or indirectly [CONTROL]	**OR**	*controls in any manner the election of a majority of directors*

Contrast paragraph (2). Here the early adverbial phrase "directly or indirectly" is *not* linked with the [CONTROL] formulation; rather, the [CONTROL] formulation comes later on in the paragraph. Thus, for purposes of paragraph (2), only a *direct* shareholder relationship with a member bank is provided for in the language of the statute. Hence the syntactic summary looks quite different:

control of ***affiliate*** *(*not *member bank) is held,* ***directly or indirectly****, through stock ownership or in any other manner*		*by the shareholder(s) of a member bank who [CONTROL]*

Congress certainly could have drafted paragraph (2) differently to cover a situation like that depicted in Diagram C. For example, Congress could, in paragraph (2), have described a company using the language suggested in the box at the right:

"of which control is held, *directly* or *indirectly*, by the shareholders of a member bank who own or control, directly or indirectly, either a majority of the shares of such bank or more than 50 per centum of the number of shares voted for the election of directors of such bank."

In short, to include a second- or higher ordinal-tier nonbank subsidiary of a holding company as an "affiliate" of a member bank, Congress would have had to include the "directly or indirectly" language in referring to the relationship between the member bank and the holding company. But Congress chose not to do so.

This omission, contextually speaking, was deliberate,[307] as Congress obviously knew how to cover indirect relationships and did so elsewhere in section 2(b). *The effect of the omission is to exclude from the definition of "affiliate" any entity of which control is held by a corporation which is only an indirect shareholder of a member bank*, even though that indirect shareholder is itself an affiliate under the terms of another paragraph of section 2(b), paragraph (4). Furthermore, as discussed below, the omission of language covering indirect ownership of a member bank was demonstrably not through inadvertence.

In Diagram C, therefore, every entity is, for Glass-Steagall purposes, an affiliate of M.B. except Intermediate 1 and its subsidiary, Securities Complex.

3. *Pertinent Case Law on Construction of Definitions in Federal Banking Statutes*

This interpretation of Glass-Steagall section 2(b) is consistent with the rules of statutory construction articulated in numerous cases by the Supreme Court and by the lower federal courts (including in particular the United States Court of Appeals for the

[307] Precisely how deliberate this was can be appreciated from a comparison of the Glass-Steagall definition of "affiliate" with the definition of the same term in the simultaneously enacted section 23A of the Federal Reserve Act. *See infra* notes 318-23 and accompanying text.

District of Columbia Circuit, which has, as noted above, nationwide venue in review of federal banking agency decisions and interpretations).[308] First, the law is settled that "the starting point for interpreting a statute is the language of the statute itself. Absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive."[309] And, in the oft-quoted language of the leading administrative law case on statutory construction and deference to the interpretations of administrative agencies,[310] "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[311]

This rule has been consistently applied by the courts in cases arising out of bank regulatory matters. The statutory language of Glass-Steagall section 2(b) must be taken at its face value because the literal reading thereof constitutes the best reflection of the intent of Congress in having chosen those particular words. Even if there was legislative history that suggested a contrary interpretation (not the case here), that history would not be a more reliable indicator than the carefully crafted statutory text. As Justice (then Judge) Scalia has cogently observed in another banking case:

> Legislative history is a second-best indication, not merely because it is (like the oral statements preceding a written contract) a less formal and authoritative expression of what the party intended; but because it is in addition, in most of its manifestations, not even an expression of the relevant party at all. In the case of legislation that party consists not of witnesses testifying on the bill, or the speakers debating it, or even the committees and floor leaders reporting and present-

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[308] *See supra* note 298.

[309] Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 108 (1980); *accord* United States v. Wells, 519 U.S. 482, 497 (1997); Landgraf v. USI Film Prods., 511 U.S. 244, 295 (1994); Kaiser Aluminum & Chem. Corp. v. Bonjorno, 494 U.S. 827, 835 (1990); United States v. James, 478 U.S. 597, 604 (1986); Bd. of Governors v. Dimension Fin. Corp., 474 U.S. 361, 368; Garcia v. United States, 469 U.S. 70, 75 (1984).

[310] Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

[311] *Id*. at 842-43; *accord VALIC II*, 513 U.S. 251, 257 (1995); ETSI Pipeline Project v. Missouri, 484 U.S. 495, 517 (1988); INS v. Cardoza-Fonseca, 480 U.S. 421, 447-48 (1987); *Dimension Fin. Corp.*, 474 U.S. at 368; FAIC Sec., Inc. v. United States, 768 F.2d 352, 361 (D.C. Cir. 1985); *see also* Caminetti v. United States, 242 U.S. 470, 485 (1917) ("the meaning of a statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain . . . the sole function of the courts is to enforce it according to its terms").

> ing it; but of all the voting members of both Houses of Congress and (unless the bill has been passed over a veto) the President. The best legislative history regarding the intent of one or another of the legislative participants is at most a clue as to what the legislating "party" had in mind; the statute itself is the party's only sure expression. Only where that expression is genuinely ambiguous is the clue likely to shed more light than the text. *See United States v. Missouri Pacific R.R.,* 278 U.S. 269, 277-78 (1929); *Eagle-Pitcher Industries, Inc. v. EPA,* 759 F.2d 922, 929 & n.11 (D.C. Cir. 1985) . . . .[312]

Second, that the provision in question is a *definitional* provision makes it more difficult for a regulator to reject a plain meaning construction of the statute in favor of the agency's own views. That is to say, it would not have been open to the Board to substitute its own, conflicting interpretation of the section 2(b) definition of "affiliate"—an interpretation based on the Board's policy-oriented view of the "overarching purpose" of the Act as a whole—for the interpretation derived from the plain meaning of the language Congress chose to enact. As we have seen, the Board tried that approach once before, in connection with the so-called "nonbank bank" loophole in the BHCA, and was severely chastised for it by a unanimous Supreme Court in the *Dimension* case.[313]

The lower federal courts have likewise been prepared to invalidate decisions of the federal bank regulatory agencies when they have sought to substitute their own views of the purposes of particular regulatory schemes for the language Congress enacted. Some of the more prominent examples from the D&O crisis in recent years have included the following decisions:

- rejecting OCC's contention that it had separate and independent authority, under the pre-FIRREA "affirmative action" language of 12 U.S.C. § 1818(b)(1), unilaterally to impose liability upon directors as an adjunct to a cease-and-desist proceeding, without regard to the requirement in 12 U.S.C. § 93 of instituting suit in the proper district or territo-

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312 *FAIC Sec.*, 768 F.2d at 362. This is the position most often associated with Justice Scalia since he ascended to the Supreme Court bench, though, admittedly, he has not always been successful in persuading his brethren to this point of view. *See, e.g.*, Crosby v. Nat'l Foreign Trade Council, 530 U.S. 363, 390-91 (2000) (Scalia, J., with Thomas, J., concurring).

313 *See supra* notes 65-68 and accompanying text.

rial court;[314]

- rejecting the Board's claimed authority to "remove . . . from office", under the pre-FIRREA removal and prohibition authority of 12 U.S.C. § 1818(e), a director who had previously resigned;[315] and
- rejecting the OTS's interpretation of the (post-FIRREA) affirmative action provision in 12 U.S.C. § 1818(b)(6)(A) to require an insolvent savings bank's holding company and its stockholders to pay the Government $5.6 million on the ground that they were subject to a condition imposed in writing which required them to maintain the savings bank's net worth.[316]

4. *Structure and Legislative History of Glass-Steagall and Contemporaneous Statutes*

Even if the plain meaning were unclear and one were to consult the legislative history of Glass-Steagall and of contemporaneous enactments[317] by Congress for guidance in construing section 2(b), one would come to the same conclusion as is reached by analyzing the plain meaning of the statutory language alone. Consider, for example, section 23A of the Federal Reserve Act,[318] which was enacted as part of the very same Banking Act of 1933 that included the provisions that became commonly known, after the names of the principal congressional sponsors, as the Glass-Steagall Act.[319] In view of their simultaneous enactment, it is enormously significant, from the statutory interpretation point of view, that section 23A has its own definition of

314 Larimore v. Comptroller of the Currency, 789 F.2d 1244 (7th Cir. 1986) (en banc).

315 Stoddard v. Bd. of Governors, 868 F.2d 1308 (D.C. Cir. 1989). The author argued that case before the court of appeals.

316 Wachtel v. Office of Thrift Supervision, 982 F.2d 581 (D.C. Cir. 1993).

317 The Supreme Court has had occasion to consult contemporaneous financial regulatory statutes for guidance on the meaning of terms *undefined* in Glass-Steagall. *See* Sec. Indus. Ass'n v. Bd. of Governors, 468 U.S. 137 (1984) (using Securities Act of 1933 definition of "security" to inform construction of that term in Glass-Steagall Act).

318 12 U.S.C.A. § 371c (West 2001). Section 23A places restrictions on certain transactions (referred to in the statute as "covered transactions") between a member bank and its affiliates.

319 Indeed, section 23A of the Federal Reserve Act was enacted as part of the Banking Act of 1933, ch. 89, 48 Stat. 162 (section 2 of Glass-Steagall was section 2 of that chapter, and section 23A of the Federal Reserve Act was section 13 of that chapter).

"affiliate" that differs in significant respects from that of section 2(b) of Glass-Steagall.

The section 23A definition enumerates several categories of entities that are subsumed within the term "affiliate," and then adds a catch-all provision explicitly giving the Board interpretive authority—by regulation or by order—to determine that a company not so enumerated "[has] a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship to the detriment of the member bank or its subsidiary."[320] The absence of such "legislative" authority for the Board in the Glass-Steagall version of "affiliate" indicates that the Board is not permitted to supplement section 2(b) of the Act with its own notions of what should be covered therein. Obviously Congress not only knew how to grant such authority when it wished to but *did so expressly* in the contemporaneously enacted section 23A.[321]

Moreover, when one compares the enumerated entities in section 2(b) of Glass-Steagall with those in section 23A of the Federal Reserve Act, one sees a striking difference in the choice of language. Section 23A covers, inter alia, three out of the four components of the Glass-Steagall definition (the one exception being a subsidiary of a member bank, unless that subsidiary is itself a bank or the Board makes a determination to include it pursuant to the section 23A catch-all provision),[322] but, in contrast to section 2(b) of the Act, is drafted much more expansively.[323] A side-by-side comparison is instructive:

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320 12 U.S.C. § 371c(b)(1)(E) (1994).

321 Nor, for that matter, does the Board have in Glass-Steagall an analogue to section 5(b) of the BHCA, authorizing the agency to prevent "evasions" of the Act, although, as noted above, the Supreme Court castigated the Board in *Board of Governors v. Dimension Financial Corp.*, 474 U.S. 361, 373 & n.6 (1986), for relying on that provision to supplement the defined terms that Congress enacted.

322 *See* 12 U.S.C. § 371c(b)(1)(B), (b)(2)(A); *supra* note 320 and accompanying text.

323 Prior to GLEBA, section 23A of the Federal Reserve Act defined "affiliate" as follows:

> For the purpose of this section—
>
> (1) the term "affiliate" with respect to a member bank means—
>
> > (A) any company that controls the member bank and any other company that is controlled by the company that controls the member bank;
> >
> > (B) a bank subsidiary of the member bank;

Section 2(b) of Glass-Steagall defines “affiliate” to mean any corporation or similar entity:		Section 23A of the Federal Reserve Act defines “affiliate” to mean:
Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more than 50 per centum of the number of shares voted for the election of directors of a member bank at the preceding election, or controls in any manner the election of a majority of the directors of a member bank, or for the benefit of whose shareholders or members all or substantially all the capital stock of a member bank is held by trustees. 12 U.S.C. § 221a(b)(4) (1994).		[A]ny company that controls the member bank and any other company that is controlled by the company that controls the member bank. 12 U.S.C. § 371c(b)(1)(A) (1994).
Of which a majority of its directors, trustees, or other persons exercising similar functions are directors of any one member bank. 12 U.S.C. § 221a(b)(3).		[A]ny company . . . in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank. 12 U.S.C. § 371c(b)(1)(C)(ii).
Of which control is held, directly or indirectly, through stock ownership or in any other manner, by the shareholders of a member bank who own or control either a majority of the shares of such bank or more than 50 per centum of the number of shares voted for the election of directors of such bank at the preceding election, or by trustees for the benefit of the shareholders of any such bank. 12 U.S.C. § 221a(b)(2).		[A]ny company . . . that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank. 12 U.S.C. § 371c(b)(1)(C)(i).

Note, in particular, the language from section 23A in the last

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(C) any company—
(i) that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank; or
(ii) in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank;
(D) (i) any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or any subsidiary or affiliate of the member bank; or
(ii) any investment company with respect to which a member bank or any affiliate thereof is an investment advisor as defined in section 80a-2(a)(20) of title 15; and
(E) any company that the Board determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its

entry in the right-hand column. There, Congress used the "directly or indirectly" adverbial phrase *twice*, demonstrating beyond cavil that Congress knew how to legislate with that level of precision when it wished to, and in the very same enactment to boot. Congress was also well aware that it was simultaneously enacting in the same bill two separate statutory definitions of the same term, "affiliate," for different purposes in two different statutory schemes.[324] The only reasonable inference to be drawn is that Congress deliberately enacted definitions with different coverage and chose to define the term "affiliate" for Glass-Steagall purposes without the breadth (and without the possibility of regulatory gloss by the Board) that was enacted in section 23A.[325]

> subsidiary with that company may be affected by the relationship to the detriment of the member bank or its subsidiary; and
>
> (2) the following shall not be considered to be an affiliate:
>
> (A) any company, other than a bank, that is a subsidiary of a member bank, unless a determination is made under paragraph (1)(E) not to exclude such subsidiary company from the definition of affiliate;
>
> (B) any company engaged solely in holding the premises of the member bank;
>
> (C) any company engaged solely in conducting a safe deposit business;
>
> (D) any company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and
>
> (E) any company where control results from the exercise of rights arising out of a bona fide debt previously contracted, but only for the period of time specifically authorized under applicable State or Federal law or regulation or, in the absence of such law or regulation, for a period of two years from the date of the exercise of such rights or the effective date of this Act, whichever date is later, subject, upon application, to authorization by the Board for good cause shown of extensions of time for not more than one year at a time, but such extensions in the aggregate shall not exceed three years . . . .

12 U.S.C. § 371c(b)(1)-(2).

[324] That awareness is clear from the introductory language of section 2(b) of Glass-Steagal: "*Except where otherwise specifically provided,* the term 'affiliate' shall include . . . ." 12 U.S.C. § 221a(b) (1994) (emphasis added).

[325] Congress has used still other formulations for the definition of "affiliate" in other bank regulatory statutes. For example, section 2(k) of the BHCA defines the term, for purposes of that statute, as "any company that controls, is controlled by, or is under common control with another company." 12 U.S.C. § 1841(k) (1994). (Several other statutes have incorporated the BHCA formulation. *E.g.*, 12 U.S.C. § 1462(9) (1994) (Home Owners' Loan Act); *id.* § 1467a(a)(1)(H) (Savings and Loan Holding Company Act (SLHCA)); *id.* § 1813(w)(6) (Federal Deposit Insurance Act); *id.* § 3101(13) (International Banking Act); *id.* § 4502(1) (Government Sponsored Enterprises Act); *see also* Depository Institution Affiliation Act, S. 337, 104th Cong. § 101(a)(4) (1995) (introduced by Senate Banking Committee Chairman Alfonse M. D'Amato (R-N.Y.)); H.R. 814, 104th Cong. (1995) (companion bill

5. *Responses to Potential Objections*

As discussed above, effecting the disaffiliation of M.B. from Securities Complex in this manner is premised on a literal reading of the plain meaning of section 2(b)(2) of Glass-Steagall. Against this approach, a common sense objection may be interposed: Why, if this construction of the statute existed since its enactment in 1933, did no one ever advance this interpretation before?[326]

The answer to this objection is two-fold, and the two components roughly bisect the sixty-six-year history of Glass-Steagall (up to enactment of GLEBA). The first one takes us from 1933

introduced by Rep. Richard H. Baker (R-La.))). The BHCA definition makes use of two other terms separately defined in the BHCA, "control" and "company"; use of the latter term makes it arguable that, within the meaning of the BHCA, a "bank" (as defined therein) cannot be an "affiliate" (i.e., because a "bank" is arguably not a "company") and therefore that, even for BHCA purposes, M.B. and Securities Complex would not be affiliates. That determination is not, however, necessary to the disaffiliation analysis herein, or even particularly pertinent thereto other than to underscore what has already been illustrated with respect to section 23A of the Federal Reserve Act—namely that Congress has used disparate approaches to defining the term "affiliate" even within the limited universe of federal banking regulation.

By way of further illustration, Congress adopted yet another, and different, approach in the Depository Institution Management Interlocks Act of 1978, 12 U.S.C. §§ 3201-3208 (1994 & Supp. IV 1998). There Congress has defined the term "affiliate" to include (A) the relationship between a depository holding company and its subsidiary or between two "subsidiaries" (as defined in the BHCA or the SLHCA, as the case may be) of the same depository holding company; (B) the relationship between two corporations, more than twenty-five percent of the voting stock of each of which is beneficially owned by the same person or group; (C) the relationship between a mutual savings bank shareholder and a trust company all of the stock of which was owned, as of November 10, 1978, by one or more mutual savings banks; (D) the relationship between an insured, state-chartered bankers' bank and its bank shareholders; and (E) the relationship between an insured, state-chartered bankers' bank and its shareholders who are officers of other banks. 12 U.S.C. § 3201(3). Under this approach, M.B. and Securities Complex *would* be affiliates for Interlocks Act purposes.

[326] This same type of objection was raised by the securities industry trade groups (the Securities Industry Association and the Investment Company Institute) against the construction of section 20 of Glass-Steagall advanced by Citicorp, J.P. Morgan & Co., Inc., and Bankers Trust New York Corporation in connection with their path-breaking applications under section 4(c)(8) of the BHCA to engage to a limited extent, through subsidiaries, in underwriting and dealing in certain categories of securities. The Board rejected the protestants' objection and concluded that activation of "until now dormant provisions in section 20" was merely the result of applying "a statute adopted over 50 years ago in very different circumstances to a financial services marketplace that technology and other competitive forces have altered in a manner and to an extent never envisioned by the enacting Congress." Citicorp, 73 Fed. Res. Bull. 473, 475 (1987), *aff'd sub nom.* Sec. Indus. Ass'n v. Bd. of Governors, 839 F.2d 47 (2d Cir. 1988).

to the BHCA Amendments of 1966, and the second takes us to the Board's section 20 interpretations, together with court of appeals decisions on petitions for review thereof, dating from the late 1980s and early 1990s.

First, the advantages of "disaffiliation" used to be all but nonexistent because of an initially enacted but later-repealed provision of Glass-Steagall, section 19(e).[327] Although difficult to imagine after sixty-five years of expansive, post-New Deal commerce clause jurisprudence,[328] Congress in 1933 doubted its constitutional authority to regulate bank holding companies because they were chartered under state law.[329] Hence the original definition of "affiliate" in section 2(b) lacked the present paragraph (4), which was not added until 1966, ten years after enactment of the BHCA (when Congress's authority over bank holding companies was no longer in doubt).[330] Back in 1933, however, in order to exert *some* control over securities activities of bank holding companies, Congress enacted section 19(e) of the Act, which prevented a bank holding company from voting the shares of a member bank it controlled unless it had first obtained a permit from the Board. To obtain such a permit, the holding company had to agree to divest itself, within five years, of ownership or control of any corporation or similar organization formed for the purpose of, or engaged principally in, the same litany of securities activities as was found in section 20.[331]

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[327] Banking Act of 1933, ch. 89, 48 Stat. 162, 188 (formerly codified at 12 U.S.C. § 61(e)).

[328] After 1937, the Supreme Court consistently regarded congressional power under the Commerce Clause as plenary and upheld federal regulation of even local activity. *See*, *e.g.,* Hodel v. Va. Surface Mining & Recl. Ass'n, Inc., 452 U.S. 264 (1981); Perez v. United States, 402 U.S. 146 (1971); Katzenbach v. McClung, 379 U.S. 294 (1964); Heart of Atlanta Motel, Inc. v. United States, 379 U.S. 241 (1964); Maryland v. Wirtz, 392 U.S. 183 (1968); Wickard v. Filburn, 317 U.S. 111 (1942); United States v. Darby, 312 U.S. 100 (1941); NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937). *But cf.* United States v. Morrison, 529 U.S. 598 (2000) (invalidating provision of the Violence Against Women Act of 1994 as seeking to regulate non-economic activity and thus not within Congress's commerce power); United States v. Lopez, 514 U.S. 549 (1995) (invalidating Gun-Free School Zones Act of 1990 as not implicating economic activity and therefore exceeding Congress's commerce power).

[329] *See*, *e.g.*, S. REP. NO. 73-77, at 10 (1933).

[330] Section 19(e) of the Act was repealed at the same time. *See* Act of July 1, 1966, Pub. L. No. 89-485, § 13, 80 Stat. 236, 242.

[331] These were, of course, "the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . . ." 12 U.S.C. § 377 (1994) (repealed 1999).

Thus, until 1966, affiliation of a member bank with other subsidiaries of its holding company, including any entity that held majority control of a member bank *directly or indirectly*, was dealt with in a separate and independent statutory provision. Even if interposition of another corporation between a bank holding company and a member bank it controlled would have relieved the original parent from the requirements of section 20, this effort would have been unavailing because the provisions of section 19(e) were still stricter.[332]

Indeed, the presence of section 19(e) in the original structure of Glass-Steagall demonstrates that Congress did not intend the combination of section 20 and section 2(b)(2) to regulate relationships in a multi-tiered holding company system in which a parent company, such as Holdings, *indirectly* owns a member bank. Thus Glass-Steagall's own history supports the literal construction of section 2(b)(2) advanced herein.

Second, this construction of Glass-Steagall would have been of purely theoretical interest and no practical utility if an attempt to make use of it could have been vitiated because of the nonbanking prohibitions of the BHCA. The opportunity to take advantage of this interpretation first arose—for bank holding companies, at least[333]—only after the Board determined as a matter of law, and was sustained by the courts on petitions for judicial review, that engaging in the congeries of securities activities listed in section 20 of the Act was permissible for bank holding companies under the "closely related" and "proper incident" prongs of section 4(c)(8) of the BHCA. That determination was not made, as to commercial paper, municipal revenue bonds, mortgage-related securities, and consumer receivable-related securities, until 1987 (and sustained by the Second Circuit in

[332] The language of section 19(e) with respect to affiliation via a bank holding company was stricter than that of section 20 with respect to affiliation via a member bank's majority shareholders. Section 19(e) conditioned issuance of a voting permit on the absence of *any interest* in a corporation engaged in section 20 activities; section 20 merely prohibited the majority shareholders from having *control* of such an affiliate.

[333] The two previously referenced interpretations, *supra* note 297, were issued to a company that was *not* a bank holding company within the meaning of the BHCA, because the bank it owned did not meet the pre-CEBA definition of "bank." Thus, for that company, the opportunity to make use of disaffiliation first arose in the latter part of 1987, after the validity of nonbank banks had been confirmed by the Supreme Court in *Dimension* and grandfathered (or, as the case may be, enabled, with the expansion of statutory exceptions to that definitional provision in 12 U.S.C. § 1841(c)(2)—e.g., credit card banks) by Congress in CEBA.

1988),[334] and, as to corporate debt and equity securities, until 1989 (and sustained by the District of Columbia Circuit in 1990).[335]

A second potential objection, which shall, for convenience, be called "reverse control," raises the question whether, looking at Diagram C, the Board might draw an arrow (representing the exercise of control) from M.B. up through Intermediate 2 and Holdings, then looping over to the left and downward to Intermediate 1 and thence to Securities Complex. This is a serious concern that might occur to any experienced bank regulatory lawyer,[336] and it therefore deserves to be addressed.

It is, of course, possible, given the BHCA definition[337] of "control," for P to control Q and Q simultaneously to control P, but that situation would seem to arise only where there was mutual stock ownership. The mere fact of identically constituted boards of directors ought not to be enough for mutual control under circumstances where P controls Q by virtue of ownership of all of Q's stock but Q does not own a controlling interest in P's stock. In fact, identity of board membership between bank and parent holding company is quite common throughout the U.S. banking system, and it would create quite a shock wave were the Board to assert that each and every one of those banks controlled its parent.

Moreover, the legal implications of a bank being said to control its holding company would threaten to stand our system of banking regulation on its head. A bank charter is entirely a "different animal" from the charter of a general business corporation. Under the laws of most states, a bank, while subject to certain provisions of the state's general corporation laws, is subject to other provisions uniquely applicable to its charter and may not exercise many of the powers of a general business corporation. In particular, there typically are severe restrictions on the types of activities in which a bank may engage and in the types of

334 Citicorp, 73 Fed. Res. Bull. 473, 475 (1987), *aff'd sub nom.* Sec. Indus. Ass'n v. Bd. of Governors, 839 F.2d 47 (2d Cir. 1988).

335 J.P. Morgan & Co., Inc., 75 Fed. Res. Bull. 192 (1989), *aff'd sub nom.* Sec. Indus. Ass'n v. Bd. of Governors, 900 F.2d 360 (D.C. Cir. 1990).

336 Indeed, this notion was suggested to the author by a friend and colleague on the Banking Law Committee of the American Bar Association.

337 As noted earlier, the Glass-Steagall Act has no "control" definition of its own, but we can assume, *arguendo*, that the section 23A/BHCA definition of that term is the likeliest guide to its meaning for Glass-Steagall purposes. *See supra* note 306.

entities a bank may control. The same is generally true for national banks under the National Bank Act. Recall also that, under the BHCA, a company that controls a bank holding company is itself a bank holding company. Thus, if the Board were suddenly to assert that a bank controlled its parent holding company, there would be a need for immediate divestitures (1) pursuant to the BHCA, because the bank had never applied for prior approval to own all of the companies owned by the holding company or to engage in all of the activities in which the holding company directly or indirectly engaged; and (2) pursuant to the National Bank Act, because a national bank is simply not permitted to engage in most of those activities. The potential havoc wrought by such a theory renders it untenable, even if it is in some sense theoretically possible.

Moreover, such an assertion would be antithetical to the rationale underlying the structural firewalls[338] established in connection with the Board's approval of section 20 affiliates.[339] Requiring that underwriting and dealing activities be conducted in a corporation over which affiliated banks and thrifts have no ownership and no financial, managerial, or operational control would simply make no sense if the banks and thrifts were deemed to control their holding companies.

Finally, cognoscenti of Glass-Steagall jurisprudence might query whether disaffiliation would run afoul of the "subtle hazards" invoked by the landmark 1971 Supreme Court decision in *Investment Company Institute v. Camp*.[340] While noting that Congress had sought in the Glass-Steagall Act to avoid the obvi-

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338 "Firewalls" are limitations designed to mitigate the potential adverse effects of permitting the affiliation of commercial banks with firms engaged in certain nonbanking activities, such as underwriting and dealing in securities. These limitations typically include credit-related, structural, and operational restrictions on the relationship between the bank and the affiliate in order to guard against potential conflicts of interest, unsound banking practices, undue concentration of economic power, undue risk of loss, and other adverse effects.

339 Firewalls were a prominent feature of the Board's section 20 orders and embraced issues like capital adequacy, credit restrictions, corporate separateness, cross-marketing activities, investment advisory and fiduciary activity restrictions, disclosure requirements, and restrictions on affiliate transactions. Moreover, the Board prohibited reciprocal arrangements with other bank holding companies for the purpose of evading firewall restrictions. For a list of the firewalls in place as of 1991 and a comparison with statutory firewalls proposed in various provisions considered (but not ultimately enacted) in the legislation that ultimately became FDICIA, see Fisher, *supra* note 81, at 264-76.

340 401 U.S. 617 (1971). The "functional equivalence" significance of *Camp* was discussed *supra* notes 55-56 and accompanying text.

ous danger of imprudent securities investments by banks that would impair their capital (a hazard not implicated by the facts in *Camp*),[341] the Court's opinion found that Congress also had in mind a number of so-called "subtle hazards." These included the peril of loss of public confidence in the bank, the risk that the bank might engage in imprudent or anticompetitive activity (because the integrity and impartiality of credit judgment could easily be undermined) occasioned by promotional pressures and the bank's "salesman's stake" in the success of its securities affiliates, and the danger of conflicts of interest between the promotional interest of the investment banker and the obligation of the commercial banker to render disinterested investment advice. Such conflicts could include the misuse of confidential customer information and the threat of the bank being driven to unload excessive or worthless holdings through its trust department.[342]

However, subsequent pronouncements by the Supreme Court and the U.S. Court of Appeals for the District of Columbia Circuit have called into question the continued validity of the subtle hazards analysis. In *Camp*, the Supreme Court relied heavily upon statements inserted in the legislative history by Senator Bulkley, but that approach to statutory construction is now disfavored by the Court and has been supplanted by *Chevron* and its progeny, as discussed above.[343] In addition, as later judicial decisions have noted, Senator Bulkley was advocating a more complete separation of investment from commercial banking than Congress actually adopted. The final version of Glass-Steagall was a compromise that did not contain certain major provisions advocated by Senator Bulkley, thereby depreciating significantly any weight that might otherwise be accorded his remarks.[344]

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[341] *Investment Company Institute v. Camp* involved a challenge by the ICI to an OCC interpretation whereby Citibank (then First National City Bank of New York) could permit common trust fund assets to be comprised 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." 401 U.S. at 622 n.7 (quoting the then-existing version of 12 C.F.R. § 9.18(a) (1970)). The bank sought to create and market to investors a fund which the SEC required to be registered as an open-end investment company under the Investment Company Act of 1940 and shares of which had to be registered as "securities" for purposes of the Securities Act of 1933. The facts presented no cause for concern from the capital impairment point of view about imprudent bank investments. *Id*. at 622-23.

[342] *Id*. at 630-38.

[343] *See supra* notes 310-11 and accompanying text.

[344] *See*, *e.g.*, Sec. Indus. Ass'n v. Bd. of Governors, 847 F.2d 890, 896 (D.C. Cir. 1988). A similar fate befell remarks of Congressman McFadden, in terms of judicial

Furthermore, closer analysis reveals that in the various Glass-Steagall cases considered by the Supreme Court, resort to a "subtle hazards" analysis has been critical only in cases where *both* (1) the statutory language did not resolve the question presented—unlike the case with disaffiliation—*and* (2) the agency decisionmaker failed to furnish an administrative record to which the Court could defer concerning those hazards.[345] Even then, as Judge Bork aptly observed in the Bankers Trust commercial paper case:

> [T]he "subtle hazards" addressed in *Camp* and returned to in [later cases] have never alone caused the Supreme Court to hold that Glass-Steagall permits or prohibits any particular banking practice. Rather, analysis of the hazards in those cases simply reinforced the Court's conclusion that, as a matter of statutory interpretation, Glass-Steagall permitted or prohibited the questioned practice.[346]

The post-*Camp* case law on "subtle hazards" also reflects the following principles:

- A subtle hazard need not be "totally obliterated" in order to make a practice permissible; avoidance of the hazard "to a large extent" will suffice.[347]
- Supreme Court cases have "concluded that 'subtle hazards' counsel prohibition of a banking practice only when the practice gave rise to *each and every one of the hazards*."[348]
- Any subtle hazards analysis is subservient to the *Chevron* principle requiring deference to reasonable agency construc-

views of their reliability as guides to construction of the Act that bears his name, between the pre-*Chevron* days of statutory construction in *First National Bank of Logan, Utah v. Walker Bank & Trust Co.*, 385 U.S. 252 (1966), and the post-*Chevron* era in *Clarke v. Securities Industry Ass'n*, 479 U.S. 388 (1987).

345 *See Camp*, 401 U.S. at 617; Sec. Indus. Ass'n v. Bd. of Governors, 468 U.S. 137 (1984); *see also* Sec. Indus. Ass'n v. Bd. of Governors, 807 F.2d 1052, 1069 (D.C. Cir. 1986) [hereinafter *Bankers Trust*] (binding force of Supreme Court's "subtle hazards" analysis unclear where agency failed to offer the court any rationale concerning those hazards to which the Court could defer); Bd. of Governors v. Inv. Co. Inst., 450 U.S. 46, 68 (1981) (distinguishing *Camp* on that ground).

346 *Bankers Trust*, 807 F.2d at 1069.

347 *Id*. (citing *Inv. Co. Inst.*, 450 U.S. at 67 n.39).

348 *Bankers Trust*, 807 F.2d at 1069; *accord* Sec. Indus. Ass'n v. Bd. of Governors, 821 F.2d 810 (D.C. Cir. 1987) [hereinafter *NatWest*] (affirming Board's approval of application by National Westminster Bank PLC and NatWest Holdings, Inc. to form a de novo subsidiary to provide a combination of portfolio investment advice, securities brokerage, and general economic information and advice to institutional customers).

tion of the statute.[349]

- The Board may rely on commitments or conditions in approving a Glass-Steagall application as a means of assuaging concern about any particular hazard.[350]

This last point is noteworthy in that to the extent the "subtle hazards" retain any viability at all, they have been reincarnated as "firewalls"—the term commonly used to refer to conditions imposed by the Board to minimize or eliminate perceived risks associated with combining commercial banking and investment banking activities under the same holding company umbrella.[351] Indeed, firewalls have been a prominent feature of the Board's section 20 orders and have embraced issues like capital adequacy,[352] credit restrictions,[353] corporate separateness,[354] cross-

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349 *See* Inv. Co. Inst. v. Conover, 790 F.2d 925, 931-33 (D.C. Cir. 1986).

350 Inv. Co. Inst., 450 U.S. at 66-67; *NatWest*, 821 F.2d at 818; *Bankers Trust*, 807 F.2d at 1067.

351 *See supra* note 338.

352 For example, deduction from a bank holding company's regulatory capital of (i) the capital investment in the section 20 affiliate and (ii) any credit the bank holding company or any nonbank subsidiary thereof extends directly or indirectly to the section 20 affiliate.

353 Examples include prohibitions on (i) credit extended by an insured depository institution (IDI) to its section 20 affiliate (other than daylight credit in connection with clearing U.S. and Canadian government securities); (ii) credit for bank-ineligible securities underwritten or distributed by the affiliate; (iii) credit, during the underwriting period, to a customer of the section 20 affiliate if the credit was secured by, or for the purpose of purchasing, any bank-ineligible security underwritten by the affiliate or in which it made a market; (iv) credit to a customer of the section 20 affiliate for the purpose of repaying credit extended by the affiliate; (v) credit or credit support directed at enhancing the creditworthiness or marketability of any ineligible securities issue underwritten or distributed by the section 20 affiliate; (vi) with respect to an issuer of ineligible securities *underwritten* by the section 20 affiliate, credit to finance payment by the issuer of principal, interest, or dividends on such securities; and (vii) with respect to an issuer of ineligible securities *placed* by the section 20 affiliate *as agent* for the issuer, credit to finance the issuer's repayment of the principal amount of the securities, unless (A) at least three years had elapsed since placement of the securities, (B) the credit met prudent and objective standards, and (C) the lender—whether an insured depository institution ("IDI") or other affiliate of the bank holding company—maintained detailed documentation with respect to the credit, the collateral, and compliance with section 23B of the Federal Reserve Act, 12 U.S.C.A. § 371c-1 (West 2001).

In addition, the Board required the holding company to implement appropriate procedures with respect to the exposure of the holding company on a consolidated basis to any issuer of securities underwritten or dealt in by the section 20 affiliate, and proscribed discriminatory treatment with respect to unaffiliated securities firms (e.g., where an IDI extended or denied credit to create a competitive advantage for its section 20 affiliate).

354 The Board required separate offices for the bank and the section 20 affiliate

marketing activities,[355] investment advisory and fiduciary activity restrictions,[356] disclosure requirements,[357] and restrictions on affiliate transactions.[358]

Regardless of whether firewalls, either individually or as a group, were good public policy, it seems fairly clear—given the way more onerous restrictions in GLEBA have been embraced by the banking industry—that a bank holding company, like Holdings, would have been willing to commit voluntarily to some firewalls (pursuant to the "proper incident" prong of BHCA § 4(c)(8)) in order to avail itself of the manifest benefits of disaffiliation in terms of largely unfettered participation in the securities business. Also, it was unlikely that the Board would have imposed more draconian firewalls than those imposed on section 20 affiliates. This is so for two reasons.

First, doing so would stand athwart a trend toward relaxing, rather than augmenting, the restrictions on section 20 affili-

and went beyond the requirements of section 32 of Glass-Steagall by proscribing any officer, director, or employee interlocks between the section 20 affiliate and any IDI within the holding company system. Section 32 prohibited such interlocks where the securities affiliate was "primarily engaged" in the "issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities." 12 U.S.C. § 78 (1994) (repealed 1999). The firewall went beyond section 32 in two respects: (A) section 32 by its terms applied only to member banks, whereas the firewall extended to any IDI, and (B) by definition, no section 20 affiliate was "primarily engaged" in these activities, because the Board had construed that phrase and "engaged principally" (for section 20 purposes) *in pari materia*.

355 Examples include prohibitions on marketing activities by an IDI on a section 20 affiliate's behalf and on active or passive distribution of prospectuses or other sales literature.

356 The Board prohibited an IDI from advising or expressing opinion on the value or advisability of the purchase or sale of ineligible securities underwritten or dealt in by the section 20 affiliate and forbade the purchase of such securities for fiduciary accounts during the underwriting period and for sixty days thereafter.

357 The Board required disclosure describing to the section 20 affiliate's customers the difference between the affiliate and any IDI(s) controlled by the bank holding company and explaining that securities sold, offered, or recommended by the affiliate were not insured deposits. The Board also limited disclosure from an IDI to its section 20 affiliate of nonpublic customer information, except where the customer consented.

358 Examples include prohibiting (i) a section 20 affiliate underwriting ineligible securities from selling to any affiliated person during the underwriting period and for sixty days thereafter (except for simultaneous cross-border underwritings); (ii) the purchase (for its own account or the account of a subsidiary) by any IDI or nonbank subsidiary of the bank holding company of securities underwritten by a section 20 affiliate; and (iii) the purchase (by the holding company and nonbank subsidiaries *only*) of more than fifty percent of an issue of securities placed by a section 20 affiliate as agent for an issuer.

ates.[359] With respect to the gross revenues percentage demarcating "engaged principally" for section 20 purposes, the Board began at five percent,[360] then increased that level from five to ten percent, then loosened the restriction further by permitting section 20 affiliates to elect an indexed revenue test to measure compliance with that ten percent limitation,[361] and subsequently was willing to supplement the gross revenues measure by adding *as an alternative* either asset values or sales volume or a combination of the two.[362] The Board ultimately raised the gross revenues ceiling to twenty-five percent.[363]

Other developments of a liberalizing nature have included (1) permitting a broker-dealer subsidiary of an affiliated bank to act as a riskless principal or broker for customers in buying and selling bank-eligible securities that the section 20 affiliate underwrites or deals in,[364] (2) acting as a dealer-manager in connection with cash tender and exchange offer transactions,[365] and (3) a combination of (1) plus (2) plus the following: (A) acting as a broker or agent with respect to transactions in interest rate and currency swaps, caps, floors, collars, and swap derivative products, (B) acting as an advisor to institutional customers regarding financial strategies involving such financial instruments, (C) acting as principal in the resale of bank-ineligible securities pursuant to SEC Rule 144A, (D) offering FCM execution, clearance,

359 Indeed, the Board had under consideration for several years the wish-list of the (then) Association of Bank Holding Companies with regard to section 20 affiliates, and that wish-list contemplated the dismantling of a number of the firewalls. *See* Notice, 55 Fed. Reg. 28,295-02 (July 10, 1990). The Board ultimately did so. *See* Notice, 61 Fed. Reg. 57,679 (Nov. 7, 1996).

360 *See*, *e.g.*, Bankers Trust N.Y. Corp., 73 Fed. Res. Bull. 138, 140 (1987); Chase Manhattan Corp., 73 Fed. Res. Bull. 367, 367 (1987), *aff'd sub nom*. Sec. Indus. Ass'n v. Bd. of Governors, 847 F.2d 890 (D.C. Cir. 1988); Citicorp, 73 Fed. Res. Bull. 473, 475 (1987), *aff'd sub nom.* Sec. Indus. Ass'n v. Bd. of Governors, 839 F.2d 47 (2d Cir. 1988).

361 Under that indexed revenue test, current interest and dividend revenues from eligible and ineligible securities were adjusted to approximate the revenues that would have been derived if interest rate conditions were those that existed in September 1989. Accordingly, interest and dividend revenues for each quarter were increased or decreased by an adjustment factor provided by the Board according to the average duration of a section 20 affiliate's eligible and ineligible securities portfolios. *See* Order Approving Modifications to Section 20 Orders, 79 Fed. Res. Bull. 226, 227 (1993).

362 *See* Notice, 59 Fed. Reg. 35,516 (July 12, 1994).

363 Notice, 61 Fed. Reg. 68,750 (Dec. 30, 1996).

364 BankAmerica Corp., 79 Fed. Res. Bull. 1163 (1993); Chem. Banking Corp., 80 Fed. Res. Bull. 49, 50 n.5 (1994).

365 *Id*.

and advisory services, and (E) engaging in certain options, futures, and options on futures transactions in bank-eligible and bank-ineligible securities for hedging purposes in accordance with the Board's policy statement on derivative transactions.[366]

Note, incidentally, that all of this chipping away at the Glass-Steagall barrier between commercial and investment banking remained subject, of course, to the gross revenues limitation of section 20, which, during most of that period, was pegged at ten percent. For most commercial banking organizations, this was rather like commanding a large army but being pinned down by smaller but better positioned forces. The advantage of disaffiliation is that it would have eliminated section 20 altogether, which, to continue the military analogy, would be rather like General Patton in World War II Sicily, breaking out from the position where his army had been pinned down and beating Field Marshall Montgomery to Palermo.

Second, the Board deemed the existing battery of firewalls sufficient to satisfy the "proper incident" prong of the analysis under section 4(c)(8) of the BHCA. The firewalls comprehensively covered various components of that analysis.[367] By agree-

[366] Saban, S.A., 80 Fed. Res. Bull. 249 (1994).

[367] Many of the firewalls constituted a structural framework established in order that securities underwriting and dealing activities be conducted in a corporation over which affiliated banks or thrifts had no ownership and no financial, managerial, or operational control. Thus, those activities were required to be conducted in a company that was controlled by the parent holding company and not by the affiliated bank or thrift institution, that did not have any officer, director, or employee in common with the bank or thrift affiliate, that had separate offices from any affiliated bank or thrift, and that maintained capitalization in accordance with securities industry norms (which capitalization was provided by the parent holding company from its own funds and not from the resources of its bank or thrift subsidiaries or, indeed, from the resources that the holding company, under the Board's "source of strength" doctrine, needed to support those bank or thrift subsidiaries). Other firewalls were designed to prevent conflicts of interest and unfair competition, e.g., by preventing certain credit or credit support by a bank or thrift for the section 20 affiliate, its customers, or the issuers of securities it underwrote; prohibiting the transfer of confidential customer information; prohibiting credit treatment of an unaffiliated securities firm less favorable than that accorded an affiliated underwriting subsidiary unless the extension or denial of credit were based on objective criteria and was consistent with sound business practices; and requiring disclosure to customers of the section 20 affiliate concerning the lack of federal deposit insurance with respect to securities sold, offered, or recommended by that affiliate. Yet another category of firewalls was addressed to safety and soundness considerations and mandated the implementation by the affiliated banks and thrifts of policies and procedures designed, inter alia, to limit overall exposure, on a consolidated holding company basis, to any single underwriting client of the section 20 affiliate as well as to limit aggregate exposure to all such borrowers.

ing to conduct the activities of the disaffiliated securities firm in a manner consistent with those firewalls, Holdings would clearly have defused any and all legitimate "proper incident" concerns the Board might have, with the possible exception—but only in the event of a *major* acquisition of a securities firm—of unfair competition and undue concentration of resources.[368] Addressing those factors might have entailed some antitrust analysis in Holdings' application.[369]

In that connection, it should be remembered that the securities business is an international business, so the relevant geographic market should have been no smaller than the entire United States and arguably much larger, e.g., the U.S. + Canada + Western Europe + most of Asia. Moreover, the securities business is likely to be relatively unconcentrated, even when examined on the basis of U.S. firms alone. The transaction that resulted in the formation of Citigroup conjoined Citicorp's pre-existing securities business with the combination of Salomon Brothers and Smith Barney, with nary a raising of competitive eyebrows.[370]

Using modes of legal analysis that, while not unsophisticated,

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[368] Those factors of the "proper incident" analysis did not need to be addressed by any firewalls because the section 20 affiliates' entry into the securities business was de novo and because, given the ten percent gross revenues limitation, the likelihood that any bank holding company would be able to achieve market domination was virtually nil. In addition, there was no evidence that in the areas where banking institutions competed with securities firms, such as underwriting Eurobonds and the private placement of securities, banking institutions had achieved a dominant position.

It should be recalled, moreover, that in the original section 20 order, the Board imposed, in addition to the gross revenues limitation, a market share limitation. Citicorp, 73 Fed. Res. Bull. 473, 474 (1987), *rev'd sub nom.* Sec. Indus. Ass'n v. Bd. of Governors, 839 F.2d 47 (2d Cir. 1988). However, that market share limitation was challenged by the applicants and struck down on appeal. Sec. Indus. Ass'n v. Bd. of Governors, 839 F.2d 47 (2d Cir. 1988).

[369] Note that there has been a fair amount of confusion as to the standard to be applied by the Board when evaluating the undue concentration of resources factor for purposes of section 4(c)(8) of the BHCA. In many instances, the Board has lumped this together with traditional competitive considerations. There is, however, authority for the proposition that "undue concentration of resources" is not limited to antitrust considerations, so that it is possible for the Board to find a concentration of resources problem without finding an antitrust violation. *See*, *e.g.*, Ala. Ass'n of Ins. Agents v. Bd. of Governors, 533 F.2d 224, 251 (5th Cir. 1976), *amended and reh'g denied*, 558 F.2d 729 (5th Cir. 1977); Citicorp, 64 Fed. Res. Bull. 321 (1978) (concerning application to retain control of Advance Mortgage Corporation, the fourth largest mortgage company in the country). Nevertheless, with respect to disaffiliation the underlying concerns appear to have been addressed fairly comprehensively by the existing regime of firewalls.

[370] Travelers Group, Inc., 84 Fed. Res. Bull. 985, 988 (1988).

were certainly not unusual in financial institutions circles, this section has demonstrated that disaffiliation technique would have yielded commercial banking organizations essentially unfettered access to the securities business, free from the strictures of Glass-Steagall and, even if (in a worst-case analysis) subject to certain firewalls, without the enormous (and to a certain extent still incalculable) regulatory burdens and costs that accompanied GLEBA's grant of congruent securities powers. The following section will summarize key GLEBA provisions and provide an intimation of those regulatory burdens and costs.

IV

Signed into law on November 12, 1999 (but with effective dates for various provisions staggered thereafter over more than two years), GLEBA effected sweeping changes to several federal regulatory schemes and removed prohibitions against the combination of banking, securities, and insurance.[371] While the Act covers a broad statutory landscape,[372] this section will naturally focus only on those provisions of GLEBA that are pertinent to the topics under consideration.

A. Financial Holding Companies

The Act contemplates a bifurcated structure for commercial banking organizations to diversify into other (mainly financial) activities but permits complete[373] financial services diversification only through a holding company structure, adapting the existing model of holding company-level regulation familiar to cognoscenti of the BHCA. The primary scheme amends the BHCA to permit a qualifying bank holding company to elect to

[371] These provisions are found in Title I of the Act. Titles II and III of the Act focus on so-called "functional" regulation of bank-affiliated securities and insurance enterprises.

[372] The Act suspended further diversification via the unitary savings and loan holding company vehicle, GLEBA § 401(a), 12 U.S.C.A. § 1467a(c)(9) (West 2001), while, at the same time, effecting the first breach in the wall between banking and commerce by allowing, for the first time, commercial banking organizations to engage in merchant banking activities. GLEBA § 103(a), 12 U.S.C.A. § 1843(k)(4)(H) (West 2001). Furthermore, the Act took what appears to be the initial legislative step in creating comprehensive regulation of financial privacy, as adumbrated in Title V.

[373] Less than complete diversification is possible through the use of bank subsidiaries. *See infra* notes 423-61 and accompanying text.

become a "financial holding company" (FHC)[374] and thereby engage, directly or through a nonbank subsidiary, in any activity that is "financial in nature"[375] or that is incidental or complementary thereto.[376] To qualify for these expanded powers, each and every one of the depository institutions controlled by the bank holding company must meet three criteria: Each must be (1) "well capitalized" (within the meaning of standards adopted under the Federal Deposit Insurance Act[377]) for the "Prompt Corrective Action" provisions thereof,[378] (2) "well managed,"[379]

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[374] GLEBA § 103(a), 12 U.S.C.A. § 1843(*l*)(1)(C)(i) (West 2001).

[375] *See infra* notes 384-96 and accompanying text.

[376] *See infra* notes 397-98 and accompanying text.

[377] 12 U.S.C. §§ 1811-1835a (1994 & Supp. IV 1998).

[378] GLEBA § 103(a), 12 U.S.C.A. § 1843(*l*)(1)(A). As used in the prompt corrective action provisions of section 38 of the Federal Deposit Insurance Act (FDIA), which were added by the Federal Deposit Insurance Corporation Improvements Act of 1991 (FDICIA), Pub. L. No. 102-242, § 131, 105 Stat. 2236, 2253-67, a bank is "well capitalized" if it has and maintains capital equal to or exceeding those prescribed by each and every applicable capital adequacy regulation or guideline applicable to the bank. 12 U.S.C. § 1831*o* (1994 & Supp. IV 1998). Thus, for example, under the Board's capital regulations applicable to state member banks, to be "well capitalized" each such bank must have leverage capital of at least five percent, Tier I risk-based capital of at least six percent, and total risk-based capital of at least ten percent, and must not be subject to any supervisory agreement or action related to capital adequacy. Fed. Res. Sys. Membership of State Banking Institutions in the Federal Reserve System (Regulation H), 12 C.F.R. § 208.43 (2001). For more detailed discussion of the terminology and methodology of bank capital regulation, see generally 2 KENNETH M. LAPINE ET AL., BANKING LAW ¶¶ 23.01-.09 (1986 & Supp. 2000) and KEITH R. FISHER, MERGERS AND ACQUISITIONS OF BANKS AND SAVINGS INSTITUTIONS § 3.16 (1993).

Note that the Act does not mandate any consolidated capital at the holding company level as a precondition to qualifying as a FHC. In contrast, the Board's Regulation Y contains capital standards applicable at the holding company level. *See* Fed. Res. Sys. Bank Holding Companies and Change in Bank Control (Regulation Y), 12 C.F.R. pt. 225, apps. A-E (2001). To the extent that every FHC is also a bank holding company, this creates something of an ambiguity, though arguably the Board should, given the evident intent of Congress in the Act, seek to avoid disqualifying a bank holding company from FHC status that otherwise meets the statutorily prescribed standards in new section 4(*l*) of the BHCA, 12 U.S.C.A. § 1843(*l*) (West 2001). Indeed, given that the "well capitalized" factor for the depository institutions is an element of the statutory definition, any more stringent requirement might arguably be invalid under *Board of Governors v. Dimension Financial Corp.,* 474 U.S. 361 (1986).

[379] GLEBA § 103(a), 12 U.S.C.A. § 1843(*l*)(1)(B). Management is one of the factors assessed by bank examiners in the safety and soundness examination, which uses a five-tier rating system—known as a CAMEL rating based on an acronym for separate ratings of Capital Asset Quality, Management, Earnings, and Liquidity—with "1" as the highest rating and "5" as the lowest. A bank is "well managed" within the meaning of the Act if in its most recent examination it has received a composite CAMEL rating of 1 or 2 *and* the management component of that rating

and (3) possessed of a Community Reinvestment Act[380] rating of "[s]atisfactory" or better[381] at its most recent CRA examination.[382] To implement these powers, the bank holding company need only file a certification and declaration with the Board, after which—and without having to await any formal or informal regulatory approval—the new FHC may directly or indirectly engage in any of the congeries of permissible expanded activities, either de novo or by acquisition.[383]

The expanded scope of activities permissible for FHCs (i.e., activities that are "financial in nature,") is significantly broader

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(the "M" in the CAMEL acronym) is also a 1 or 2. *See* 12 U.S.C. § 1841(*o*)(9) (1994 & Supp. IV 1998).

380 12 U.S.C.A. §§ 2901-2907 (West 2001). For a synopsis of the Community Reinvestment Act (CRA) and its applicability to bank and bank holding company acquisitions, see FISHER, *supra* note 376, §§ 3.6, 3.18; ROLAND E. BRANDEL & DAVID E. TEITELBAUM, THE COMMUNITY REINVESTMENT ACT: POLICIES AND COMPLIANCE §§ 7.01-.04 (2d ed. 1994).

In contrast to the "well capitalized" and "well managed" eligibility criteria for a FHC, which are set forth in paragraph (1) of new section 4(*l*) of the BHCA, 12 U.S.C. § 1843(*l*)(1), and which therefore constitute the exoskeleton of the statutory definition of "financial holding company" set forth in section 103(c) of GLEBA (adding new section 2(p) of the BHCA, 12 U.S.C.A. § 1841(p) (West 2001)), the CRA criterion is set forth in paragraph (2) thereof, 12 U.S.C.A. § 1843(*l*)(2), and thus is not an element of that statutory definition.

381 GLEBA § 103(a), 12 U.S.C.A. § 1843(*l*)(2). Note that, pursuant to new § 1843(*l*)(2)(B), this requirement is inapplicable to acquiring ownership interests in companies pursuant to the Act's merchant banking or insurance company investment provisions in new section 1843(k)(4)(H)-(I). Section 103(b) of GLEBA also adds a new section 804(c) to the CRA, 12 U.S.C.A. § 2903(c) (West 2001), that mandates rejection of a notice of election to become a FHC where any depository institution (DI) controlled by the would-be FHC does not have at least a "Satisfactory" CRA rating. A statutory exception is created for a would-be FHC that flunks this CRA test because of a DI that was acquired within the previous twelve months, so long as the holding company has submitted an "affirmative plan" to bring that DI up to at least a "Satisfactory" rating to the "appropriate Federal banking agency" (as that term is defined in section 3(q) of the FDIA, 12 U.S.C. § 1813(q) (1994)) and that agency has accepted the plan (hereinafter referred to as AFBA). GLEBA § 103(b), 12 U.S.C.A. § 2903(c)(2).

Unlike the one-to-five scale used for the CAMEL rating and its components, CRA is judged under a four-tiered system, with possible ratings of "Outstanding," "Satisfactory," "Needs Improvement," and "Substantial Noncompliance."

382 CRA ratings are usually given not as part of the periodic safety and soundness examination but as part of a separate compliance examination of the bank.

383 GLEBA § 161. On January 25, 2000, the Board, acting pursuant to explicit statutory authority in the Act, issued interim and proposed regulations setting forth the procedures for FHC elections. Bank Holding Companies and Change in Bank Control, 65 Fed. Reg. 3785 (Jan. 25, 2000). These have since been finalized. *See* Fed. Res. Sys. Bank Holding Companies and Change in Bank Control (Regulation Y), 12 C.F.R. § 225.82 (2001).

than the scope of activities permissible to bank holding companies under the "closely related to banking"/"proper incident to banking" standard of section 4(c)(8) of the BHCA[384] In fact, certain activities previously[385] impermissible[386] for bank holding companies under the BHCA are enumerated in the Act as incontrovertibly[387] "financial in nature." These include:

- underwriting or dealing in securities (including market-making), without gross revenues limitations;[388]
- organizing, sponsoring, distributing, or advising a mutual fund;[389]
- merchant banking—i.e., investing as principal in businesses without regard to the separation of banking and commerce

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[384] 12 U.S.C.A. § 1843(c)(8) (West 2001). Note, however, that any activity previously determined by the Board, by regulation or order, to be permissible for bank holding companies under the section 4(c)(8) standard, as of the day before enactment of GLEBA, is also among the enumerated activities in the Act that are definitively deemed "financial in nature."

[385] Even after enactment of GLEBA, these activities are *still* impermissible for those bank holding companies that do not elect FHC status or fail to qualify therefor (or, having previously qualified and elected, subsequently fail to maintain those qualifications and ultimately lose FHC status).

[386] Certain previously permissible activities are also enumerated in the Act as among the congeries of activities that are "financial in nature." These include previously approved activities under section 4(c)(8) of BHCA, *see supra* note 384; providing financial, investment, or economic advisory services (including advising an "investment company" as that term is defined in section 3 of the Investment Company Act of 1940, 15 U.S.C. § 80a-3 (1994 & Supp. IV 1998)); and, of course, familiar banking and custodial activities such as lending, exchanging, transferring, investing as agent, and safeguarding money or securities.

[387] Because these activities are specifically listed in the statute and represent a congressional determination as to their essentially "financial" character, there is no requirement for the Board and the Secretary of the Treasury to pronounce them as such pursuant to the consultative regulatory process spelled out in the Act for activities not so listed. *Compare* new BHCA § 4(k)(4), 12 U.S.C.A. § 1843(k)(4) (enumerating activities determined by *Congress* to be financial in nature), *with* new BHCA § 4(k)(2)-(3), 12 U.S.C.A. § 1843(k)(2)-(3) (establishing consultative process and mandating factors to be considered therein).

[388] *See* new BHCA § 4(k)(4)(E), 12 U.S.C.A. § 1843(k)(4)(E). Section 101(a) of the Act repeals section 20 of the Glass-Steagall Act, 12 U.S.C. § 377 (1994) (repealed 1999), containing the "engaged principally" standard that is the source of the gross revenues limitations previously imposed by the Board on bank holding company securities affiliates. *See* Citicorp, 73 Fed. Res. Bull. 473 (1987), *aff'd sub nom.* Sec. Indus. Ass'n v. Bd. of Governors, 839 F.2d 47 (2d Cir. 1988); J.P. Morgan & Co., Inc., 75 Fed. Res. Bull. 192 (1989), *aff'd sub nom.* Sec. Indus. Ass'n v. Bd. of Governors, 900 F.2d 360 (D.C. Cir. 1990).

[389] *See* new BHCA § 4(k)(4)(C)-(E), 12 U.S.C.A. § 1843(k)(4)(C)-(E).

wrought by the BHCA;[390]

- underwriting insurance (including title insurance) and issuing annuities;[391]
- selling insurance as agent or broker (including title insurance);[392] and

engaging in the United States in any activity which has previously been permissible overseas under the International Banking Act of 1978[393] or the Board's Regulation K[394] and has, pursuant to section 4(c)(13) of the BHCA,[395] been determined by the Board to be usual in connection with the transaction of banking or other financial operations abroad (e.g., management consulting).

Other activities that are not so enumerated in the Act may likewise be determined—albeit administratively, by regulation or order—to be "financial in nature" if either the Board or the Sec-

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390 Thus, subject to the limitations on merchant banking imposed by the Act, a FHC may invest in any type of business enterprise (hereinafter referred to as a "portfolio company"), regardless of the form in which it is organized (corporation, partnership, joint venture, etc.) and regardless of the activities in which the business is engaged. Merchant banking activity must be conducted through a securities or insurance affiliate or another appropriate nonbank affiliate of the FHC. *See* new BHCA § 4(k)(4)(H), 12 U.S.C.A. § 1843(k)(4)(H). The merchant banking authority may not, however, be used to acquire more than a five percent interest in a bank, bank holding company, or thrift. *Compare id., with* 12 U.S.C. § 1842(a)(3) (1994) (prohibiting bank holding company acquisition of more than five percent of the voting shares of a bank), *and id.* § 1843(c)(6) (exemption from nonbanking activity prohibition for ownership of five percent or less of the voting shares of any company).

Whereas under section 4(c)(6) of the BHCA, 12 U.S.C. § 1843(c)(6), a BHC could only invest without restriction in less than five percent of another company, the level of investment pursuant to the merchant banking authority is unrestricted. However, if a FHC's merchant banking investment in a portfolio company exceeds fifteen percent of the company's equity capital, the portfolio company is presumed to be an "affiliate" for purposes of section 23A of the Federal Reserve Act, 12 U.S.C.A. § 371c (West 2001). GLEBA § 121(b), 12 U.S.C.A. § 371c(b)(11). As a consequence, the ability of a depository institution controlled by the FHC to extend credit to that portfolio company would be correspondingly circumscribed.

391 *See* new BHCA § 4(k)(4)(B), 12 U.S.C.A. § 1843(k)(4)(B).

392 *Id.*

393 12 U.S.C.A. §§ 3101-3111 (West 2001).

394 Fed. Res. Sys. International Banking Operations (Regulation K), 12 C.F.R. § 211.1-211.604 (2001). Permissible overseas activities for U.S. banks under Regulation K include travel agency; real estate brokerage for the leasing of real property; management consulting; underwriting, dealing and distributing debt and equity securities (subject to certain limitations); and underwriting life, annuity, pension fund-related, and other types of insurance (again, subject to certain limitations). *See generally* 12 C.F.R. § 211.5 (2001).

395 12 U.S.C. § 1843(c)(13) (1994).

retary of the Treasury, each acting in consultation with the other, initiates the process.[396] The same is true for activities that, while not themselves financial in nature, are "incidental" thereto.[397] Furthermore, an FHC may engage in activities that are "complementary" to financial activities, so long as the Board determines that they do not pose a substantial risk to the safety or soundness of IDIs controlled by the FHC or of the financial system in general.[398]

Nothing in the Act *compels* an existing bank holding company to elect FHC status. Those that do not will, of course, continue to be regulated by the Board as bank holding companies ("traditional BHCs"), and the scope of their permissible nonbanking activities will continue be limited to those that are authorized by the exceptions[399] enumerated in section 4(c) of the BHCA. Sig-

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[396] GLEBA § 103(a), 12 U.S.C.A. § 1843(k)(4). Furthermore, *without* consultation with the Treasury, the Board is directed to define (by regulation or order), "consistent with the purposes of [the] Act," certain activities as "financial in nature" that had been included on a list of pre-approved "financial" activities by the House Banking Committee while considering an earlier (1997) avatar of the legislation that ultimately became GLEBA. The activities included (i) "[l]ending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities"; (ii) "[p]roviding any device or other instrumentality for transferring money or other financial assets"; and (iii) "[a]rranging, effecting, or facilitating financial transactions for the account of third parties." GLEBA § 103(a), 12 U.S.C.A. § 1843(k)(5). These three activities were made subject to this special treatment, placed on the spectrum in the Act in between statutory enumeration and the consultative process with Treasury, because, while undoubtedly "financial" by any reasonable definition of that word, they were subject to concerns by the Board relating to the potential scope of the relationships and activities that might be subsumed within the sphere of permissibility if a blanket approval was enacted in the statute.

[397] There is a long history in federal banking law of regulatory agencies making similar determinations: OCC for activities that are "incidental" to the business of banking under the principal powers provision of the National Bank Act, 12 U.S.C.A. § 24 (Seventh) (West 2001), *e.g.*, Tex. & Pac. Ry. Co. v. Pottorff, 291 U.S. 245 (1934) (holding that pledging assets to secure private deposits not incidental because not "necessary to carry on the business of banking . . . by receiving deposits"); Arnold Tours, Inc. v. Camp, 472 F.2d 427 (1st Cir. 1972) (holding that travel agency business not incidental to the business of banking); M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377 (9th Cir. 1977) (holding that automobile leasing incidental to the business of banking), and the Board for activities that are so closely related to banking as to be a proper incident thereto under section 4(c)(8) of the BHCA, 12 U.S.C. § 1843(c)(8), *e.g.*, Fed. Res. Sys. Bank Holding Companies and Change in Bank Control (Regulation Y), 12 C.F.R. § 225.28 (2001) (setting forth Regulation Y laundry list of permissible nonbanking activities).

[398] The Act purports to look after the integrity of the deposit insurance system by prohibiting the use of deposit insurance funds to benefit any shareholder, subsidiary, or affiliate (other than a depository institution) of a FHC. GLEBA § 117, 12 U.S.C.A. § 1821(a)(4)(B) (West 2001).

[399] These are exceptions to the general prohibition against nonbanking activities

nificantly, however, the most important of those exceptions—the "closely related/proper incident to banking" exception in section 4(c)(8)[400]—will not continue to evolve through Board orders and regulations,[401] as it has since its original enactment in the BHCA, but will remain in effect only as applied and interpreted by pertinent Board orders and regulations in effect on November 11, 1999.[402] Thus, in a sense, GLEBA has, to borrow Professor Michael Malloy's felicitous phrase, "shifted the center of gravity in the BHCA from the 'closely related' exemption of section 4(c)(8) to the 'financial in nature' concept of the FHC authorization."[403] Notwithstanding this "shift," a variety of circumstances remain in which a holding company would prefer to file a section 4(c)(8) application rather than avail itself of the FHC provision alternatives.[404]

(i.e., a prohibition against a bank holding company acquiring direct or indirect ownership or control of any voting shares of any "company" that is not a "bank," as those terms are defined in the statute) set forth in section 4(a) of the BHCA, 12 U.S.C. § 1843(a) (1994).

400 12 U.S.C.A. § 1843(c)(8) (West 2001) (activities the Board has determined by regulation or order to be "so closely related to banking or managing or controlling banks as to be a proper incident thereto"). This statutory phrase evolved into a two-pronged inquiry. The first, or "closely related," prong "ask[ed] only whether the activities in question are generally of a kind that Congress, having concluded that 'banking and commerce should remain separate,' forbade bank holding companies to engage in, without regard to the merits of such engagement in a particular case." Nat'l Courier Ass'n v. Bd. of Governors, 516 F.2d 1229, 1233 (D.C. Cir. 1975). The second, or "proper incident," prong did reach the merits of the particular case and required the Board to determine that performance of *this particular* activity by *this particular* applicant, in the words of the pre-GLEBA version of the statute, could "reasonably be expected to produce benefits to the public such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices." *Id.* at 1232. An activity that was found to be "closely related" to banking could nonetheless be found not to have been a proper incident thereto. For an outmoded application of this distinction, see D.H. Baldwin Co., 63 Fed. Res. Bull. 280, 287 (1977) (denying acquisition of healthy thrift institutions, although their activities are closely related to banking, because operation thereof found not to be a proper incident to banking).

401 *E.g.*, 12 C.F.R. § 225.28 (providing amendments to the Board's Regulation Y "laundry list" of permissible nonbanking activities).

402 GLEBA § 102(a). Thus, the scope of permissible nonbanking activities under section 4(c)(8) for traditional BHCs is frozen as of the day prior to the date of enactment of the Act.

403 *See* Michael P. Malloy, *Banking in the Twenty-First Century,* 25 J. CORP. L. 787, 801 (2000).

404 Acquisitions made under the FHC authority enacted by GLEBA implicate antitrust review by not just the Board and the Antitrust Division of the Department of Justice but by the Federal Trade Commission (FTC) as well, with pre-merger notification filings required under the Hart-Scott-Rodino Antitrust Improvements Act of

The consequences of a FHC's failure to maintain the above-described eligibility criteria will differ depending upon the nature of the regulatory default. Failure to maintain "well capitalized" and "well managed" status for all depository institutions as set forth in section 4(l)(1) is, as one would expect, more serious than failure to maintain a satisfactory CRA rating.

The Act requires the Board to notify a FHC that fails to satisfy the two section 4(l)(1) requirements of the conditions giving rise to the noncompliance,[405] and the FHC then has forty-five days[406] to enter into an agreement with the Board to correct the perceived deficiencies.[407] Until those corrections have been made, the Board is authorized to "impose such limitations on the conduct or activities of that [FHC] or any affiliate of that company as the Board determines to be appropriate under the circumstances and consistent with the purposes of [the BHCA]."[408] If the deficiencies have not been corrected within six months,[409] however, the Board may require the FHC either (A) to divest control of its DI's or, (B) at the FHC's option, to cease any activ-

1976 § 201, 15 U.S.C.A. § 18a (West 1997 & Supp. 2002). *See* GLEBA § 131, 12 U.S.C.A. § 1849(b)(1) (West 2001) (amending the BHCA to reflect FTC waiting periods for certain section 4 applications); GLEBA § 132, 12 U.S.C.A. § 1828(b) (providing for interagency data sharing with the FTC in M&A transactions and specifying confidentiality requirements for the information involved); GLEBA § 133, 15 U.S.C.A. § 417 note (West Supp. 2001), 15 U.S.C.A. § 18a(c)(7)-(8) (clarifying FTC jurisdiction and making conforming amendments to Hart-Scott-Rodino). This is clearly part of the price of reform exacted by GLEBA. *See infra* note 417. Filings under section 4(c)(8) of the BHCA, in contrast, are exempt from Hart-Scott-Rodino, and thus have the virtue of saving the applicant considerable expense.

405 The Board turns the tables in its financial holding company regulations and requires the FHC to provide notification to the Board as soon as the FHC becomes aware that any of its DI's is no longer in compliance with the "well capitalized" or "well managed" requirements. 12 C.F.R. § 225.83(b).

406 The Board has authority to grant an enlargement of this time period. *Id.* § 225.83(c).

407 GLEBA § 103(b), 12 U.S.C.A. § 1843(m)(2) (West 2001) (adding new section 4(m)(2) of the BHCA). In its regulation, the Board adds that the agreement in question must be "acceptable to the Board." *See* Bank Holding Companies and Changes in Bank Control, 66 Fed. Reg. 400, 403 (Jan. 3, 2001) (to be codified at 12 C.F.R. pt. 225).

408 GLEBA § 103(b), 12 U.S.C.A. § 1843(m)(3) (adding new section 4(m)(3) of the BHCA).

409 More precisely, the actual time period is 180 days after the date the FHC has received the notice under new section 4(m)(1) of BHCA. The Board also has discretion to enlarge this time period for compliance with the supervisory agreement. GLEBA § 103(b), 12 U.S.C.A. § 1843(m)(4) (adding new section 4(m)(4) to the BHCA).

ities not permissible for "traditional" BHCs.[410] Any of the actions taken by the Board under this new section 4(m) of the BHCA must be done in consultation with "all relevant Federal and State regulatory agencies and authorities."[411]

Less potentially draconian consequences attend failure to maintain a satisfactory or better CRA rating. In that situation, the only disability imposed on the FHC[412] will be on expanding, directly or indirectly, into any new financial activities[413] (either de novo or via direct or indirect acquisition of control of a company or DI, subject to certain exceptions)[414] until CRA noncompliance has been cured. In contrast to default on the safety and soundness eligibility criteria, there is no prescribed curative period and no disability when it comes to making additional portfolio investments under the merchant banking, investment banking, or insurance company investment authority granted to FHCs under GLEBA.[415]

Though on its face apparently less severe a consequence than that attending failure to maintain "well capitalized" or "well managed" status, the CRA noncompliance disability—unlike the notice and remedial action via agreement with the Board, which might very well be a fairly mild curative—yields no leeway for

410 *Id.* The actual statutory language refers only to "an activity that is permissible for a bank holding company under subsection (c)(8)," though presumably *any* permissible nonbanking activities under the other paragraphs of section 4(c) of BHCA ought to be unobjectionable. *Id.*

411 GLEBA § 103(b), 12 U.S.C.A. § 1843(m)(5) (adding new section 4(m)(5) of the BHCA). *See* discussion *infra* notes 462-500 and accompanying text for a discussion of functional regulation.

412 The Board is not the sole enforcement authority here. Instead, the disability imposed can be either at the holding company level or at the IDI level and will be done by the AFBA.

413 These include any new activity authorized under new sections 4(k) or 4(n) of the BHCA, new section 5136A(a) of the U.S. Revised Statutes (added by GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a) (West 2001), and relating to so-called "financial subsidiaries" of national banks, see *infra* notes 423-61 and accompanying text), or new section 46(a) of the FDIA (added by GLEBA § 121(d) and relating to comparable investment authority for insured state-chartered banks, see *infra* notes 438-42 and accompanying text). GLEBA § 103(b), 12 U.S.C.A. § 1843(*l*)(2) (adding new section 4(*l*)(2) of the BHCA).

414 New BHCA § 4(*l*)(2)(B), 12 U.S.C.A. § 1843(*l*)(2)(B). The exceptions are for investments made pursuant to the merchant banking and insurance company portfolio investment provisions of new section 4(k)(4)(H)-(I) or under section 122 of GLEBA (contemplating the addition, no sooner than five years after date of enactment, of merchant banking authority for "financial subsidiaries" of banks, comparable to that permitted to their FHC affiliates under section 4(k)(4)(H)).

415 *See* new BHCA § 4(k)(4)(H)-(I), 12 U.S.C.A. § 1843(k)(4)(H)-(I).

agency discretion, as it is an automatically imposed statutory bar. No comparable bar on engaging in new "financial" activities is necessarily implicated in the remedial action for capital or managerial deficiencies, unless the Board imposes such restrictions in the supervisory agreement.

Having described the "payoff" for electing FHC status, one can now begin to appreciate the extent of the "price tag." Apart from the novel financial privacy provisions of GLEBA, which themselves entail significant new compliance costs (costs which may, in fact, become enormous if state privacy laws and regulations evolve in a manner that causes a balkanized privacy compliance landscape),[416] and the substantial additional costs (and uncertainty) associated with pre-merger notification to the FTC under Hart-Scott-Rodino,[417] there is the onus of maintaining a

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416 Title V of GLEBA imposes a brand new "affirmative and continuing obligation" upon all firms engaging in financial services, including not only DIs but also securities firms, insurance companies, and others, but excluding farm credit institutions and entities subject to the jurisdiction of the Commodity Futures Trading Commission or the Federal Agricultural Mortgage Corporation, *see* GLEBA § 509(3), 15 U.S.C.A. § 6809(3) (West Supp. 2002)—and firms engaging in activities "incidental" to financial activities to safeguard the privacy of consumers by establishing detailed policies and procedures and by providing privacy disclosures about the sharing of "nonpublic personal information" with affiliates and with third parties, together with affording the consumer an "opt-out" for disclosure of information to unaffiliated third parties. *See generally* GLEBA §§ 501-503, 15 U.S.C.A. §§ 6801-6803 (West Supp. 2002). The Act requires each of the pertinent federal regulatory agencies (including the bank and thrift regulators, the National Credit Union Administration, the Secretary of the Treasury, the SEC, and the Federal Trade Commission) to promulgate, after consultation with representatives of the State insurance regulators designated by the National Association of Insurance Commissioners, regulations designed to carry out the privacy provisions of Title V. GLEBA § 504(a), 15 U.S.C.A. § 6804(a) (West Supp. 2002). Detailed regulations have already been promulgated by those agencies, and regulated institutions were expected to be in full compliance by July 2001.

GLEBA also is explicit that its privacy provisions do not supercede, alter, or affect any state law or regulation in the area, except to the extent inconsistent with the provisions of the Act, and then only to the extent of the inconsistency. GLEBA § 507(a), 15 U.S.C.A. § 6807(a) (West Supp. 2002). For this purpose, however, "a State statute, regulation, order, or interpretation is *not inconsistent* with the provisions of [the Act] if the protection such statute, regulation, order, or interpretation affords any person is *greater* than the protection provided under [the Act] . . . ." GLEBA § 507(b), 15 U.S.C.A. § 6807(b) (emphasis added). The states remain free, therefore, to create financial privacy protections for consumers well in excess of what is required under federal law and regulation.

The breadth and implications of these new financial privacy requirements are beyond the scope of this article, other than to note that they are obviously part of the political price that financial institutions had to pay for the increased powers granted to FHCs.

417 The fee for filing a Premerger Notification and Report Form is currently

careful watch upon the capital adequacy, managerial, and CRA compliance areas for each and every DI under the holding company umbrella and, in the (far from unlikely) event of a default some day, the open-ended nature of what the Board may require by way of remedial action. The agreement required in new section 4(m)(2) must, as noted above, be "acceptable to the Board." Nothing prevents the Board from imposing in that agreement requirements above and beyond what is necessary to cure the regulatory default.[418] While the "club" of divestiture may only be applicable to failure to correct only the conditions that gave rise to the default,[419] the agreement with the Board is, after all, a "written agreement entered into with the agency" within the purview of section 8 of the FDIA,[420] and failure to comply with other provisions the Board might impose therein would subject the FHC to the full panoply of enforcement authority under that statute,[421] as well as under the BHCA itself.[422]

B. Financial Subsidiaries

GLEBA also contemplates a less complete diversification through the bank itself, on a track that is largely, but not completely, parallel to that of the FHC structure, and without the necessity of making a FHC election.[423] The Act amends the National Bank Act by adding to the Revised Statutes a new section

$45,000 if the size-of-transaction is valued at greater than $50 million but less than $100 million; $125,000 if the size-of-transaction is valued at $100 million or greater but less than $500 million; and $280,000 if the size-of-transaction is valued at $500 million or greater. The acquiror is responsible for the payment of the fee at the time of filing by electronic wire transfer or, if necessary, by bank cashier's check or certified check. *See* The Most Frequently Asked HSR Questions, *at* http://www. ftc.gov/bc/hsr/faq.htm (last visited May 24, 2002).

418 Indeed, the statute grants the Board the rather open-ended authority to "impose such limitations on the conduct or activities [of the FHC] or any affiliate [thereof] *as the Board determines to be appropriate under the circumstances* and consistent with the *purposes* of this [Act]." New BHCA § 4(m)(3), 12 U.S.C.A. § 1843(m)(3) (West 2001) (emphasis added). The "purposes" of the Act are multifarious and, like Scripture, are susceptible to interpretations of enormous latitude.

419 New BHCA § 4(m)(4), 12 U.S.C.A. § 1843(m)(4).

420 12 U.S.C. § 1818 (1994 & Supp. IV 1998).

421 *E.g.*, *id.* § 1818(b) (cease-and-desist authority); *id.* § 1818(e) (removal and prohibition authority); *id*. § 1818(i)(2) (civil money penalties).

422 *See* 12 U.S.C. § 1847 (1994) (enforcement provisions of the BHCA).

423 This is so because the "financial subsidiary" is authorized not under the BHCA but under a separate statute, the National Bank Act, with parallel authorization under the FDIA for state-chartered banks. GLEBA § 121(a)(2), 12 U.S.C.A. § 24a (West 2001) (amending the National Bank Act); GLEBA § 121(d), 12 U.S.C.A. § 1831w (West 2001) (amending the FDIA).

5136A[424] authorizing the creation of a new type of subsidiary of a bank known as a "financial subsidiary."[425] The format is substantially similar to the FHC model.[426] These financial subsidiaries, which are subject to size limitations,[427] are authorized only for national banks that are "well capitalized" and "well managed," provided that all of their depository institution affiliates[428] are likewise "well capitalized" and "well managed"[429] (using those concepts *in pari materia* with the coordinate requirements governing FHC qualifications[430]) and that have a CRA rating of at least "[s]atisfactory."[431]

Banks meeting these criteria may engage through financial

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[424] Section 121(a)(1) of GLEBA redesignated the pre-existing section 5136A of the Revised Statutes as section 5136B, and 121(a)(2) of GLEBA enacted an entirely new section 5136A of the Revised Statutes.

[425] Section 121(a)(2) of GLEBA defines a "financial subsidiary" as a company controlled by one or more insured depository institutions, other than (A) a national bank operating subsidiary (in the statutory language, a subsidiary engaged "solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks") or (B) a subsidiary authorized under sections 25 or 25A of the Federal Reserve Act, 12 U.S.C. §§ 601-604, 611-631, or the Bank Service Company Act, 12 U.S.C. §§ 1861-1867. GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(g)(3).

[426] *Compare* GLEBA § 121(a), 12 U.S.C.A. § 24a(a)(2)(A)(I) (authorizing national bank to control a financial subsidiary that engages in "activities that are financial in nature or incidental to a financial activity"), *with* GLEBA § 103(a), 12 U.S.C.A. § 1843(k)(1)(A) (West 2001) (authorizing a FHC to engage in any activity that the Board determines "to be financial in nature or incidental to such financial activity").

[427] The aggregate consolidated assets of all of a bank's financial subsidiaries may not exceed the lesser of forty-five of the parent bank's consolidated total assets or $50 billion. GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(2)(D).

[428] For this purpose, the term "affiliate" is defined (as, for that matter, are the terms "company," "control," and "subsidiary") by cross-referencing the definitional provisions of the BHCA. GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(g)(1); *see also* 12 U.S.C. § 1841(k) (1994) (defining "affiliate").

[429] GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(2)(C) (imposing requirement), 12 U.S.C.A. § 24a(g)(5)-(6) (defining terms).

[430] *Compare* GLEBA § 103(a), 12 U.S.C.A. § 1843(*l*)(1)(A)-(B) (West 2001), *with* GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(2)(C) (adumbrating "well-capitalized" and "well managed" requirements). Note that for capital adequacy compliance purposes, the bank must deduct from assets and tangible equity the amount of its outstanding equity investment, including retained earnings, in all financial subsidiaries, GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(c)(1)(A), and is prohibited from consolidating the assets and liabilities of financial subsidiaries with those of the bank, GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(c)(1)(B). Furthermore, this information must be separately laid out in any publicly disclosed financial statement of the national bank. GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(c)(2).

[431] GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(7) (cross-referencing new section 4(*l*)(2) of the BHCA, 12 U.S.C.A. § 1843(*l*)(2)).

subsidiaries in most, but not all, of the activities that are "financial in nature" or those that are "incidental to a financial activity."[432] Those activities that are available to FHCs[433] but prohibited for financial subsidiaries are underwriting insurance or providing or issuing tax-deferred annuities,[434] real estate investment and development,[435] insurance company portfolio investments,[436] and merchant banking.[437] National bank financial subsidiaries thus possess a range of powers somewhere in the middle of the continuum between the powers authorized to national banks themselves and those authorized to FHCs.

State banks may have financial subsidiaries too (assuming they are permissible under state law).[438] GLEBA adds a new "safety and soundness" provision to the FDIA mandating that a state bank with a subsidiary that "engages in activities as principal that would only be permissible for a national bank to conduct through a financial subsidiary" meet four of the requirements applicable to national banks with such subsidiaries: (1) the state bank (and all DI affiliates) must be well-capitalized (after the requisite capital haircut in the next item);[439] (2) the state bank complies with the same capital deduction and financial disclosure requirements;[440] (3) the state bank complies with the same risk management requirements;[441] and (4) the state bank's financial subsidiary will have the same treatment for purposes of the re-

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[432] GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(2)(A)(i).

[433] *Compare* GLEBA § 103(a), 12 U.S.C.A. § 1843(k)(4) (detailing financial activities of FHCs), *with* GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(2)(B)(i) (specifying financial activities of bank's financial subsidiaries).

[434] GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(2)(B)(i). A tax deferred annuity is an annuity the income of which is subject the tax treatment accorded under I.R.C. § 72.

[435] GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(2)(B)(ii).

[436] GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(2)(B)(iii).

[437] *Id.* Merchant banking may, however, become an authorized activity for financial subsidiaries in the not-too-distant future. The Act authorizes the Board and the Secretary of the Treasury, five years after enactment, to decide to permit financial subsidiaries to engage in merchant banking activities, subject to such conditions as the Board and the Secretary may jointly impose by regulation. GLEBA § 122; *see also* 12 U.S.C.A. § 1843 (West 2001).

[438] Many states have long permitted their banks to have subsidiaries, and often to engage through those subsidiaries in activities not permissible for the banks themselves. This has long been a feature of our dual banking system. At times, it has erupted into controversy. *See*, *e.g.*, Citicorp v. Bd. of Governors, 936 F.2d 66 (2d Cir. 1991).

[439] GLEBA § 121(d), 12 U.S.C.A. § 1831w(a)(1) (West 2001).

[440] GLEBA § 121(d), 12 U.S.C.A. § 1831w(a)(2); *see also supra* note 430.

[441] GLEBA § 121(d), 12 U.S.C.A. § 1831w(a)(3); *see also infra* note 453.

strictions on transactions with affiliates.[442]

A few noteworthy special rules apply to financial subsidiaries. First, the Act makes transactions between a national bank and a financial subsidiary subject to the affiliate transaction restrictions of sections 23A and 23B of the Federal Reserve Act.[443] Normally, as we have seen,[444] a subsidiary of a bank is not deemed an "affiliate" as defined in those provisions,[445] but GLEBA treats a financial subsidiary as an "affiliate" and not a "subsidiary" for these purposes.[446] Nonetheless, section 23A's limitation on covered transactions with a single affiliate[447] is not applicable to covered transactions with a financial subsidiary.[448] The Act also contains an "anti-evasion provision" reconfiguring any purchase of or investment in the securities of a financial subsidiary by an affiliate of the bank as a purchase or investment by the bank itself,[449] and authorizing the Board to determine that an extension of credit by an affiliate of the bank in the financial subsidiary shall be considered as an extension of credit by the bank itself.[450] Moreover, GLEBA treats a financial subsidiary as an affiliate of the holding company for purposes of the anti-tying provisions of the BHCA.[451]

Unlike the counterpart FHC provisions, which posit merely an election of FHC status by qualifying BHCs and a notice regime (i.e., no prior Board approval) thereafter for all activities that are "financial in nature," the national bank must receive the prior approval of OCC for the financial subsidiary to engage in such activities.[452] In addition, the national bank must implement risk management safeguards as a condition to establishing or maintaining a financial subsidiary.[453] The financial subsidiary author-

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442 GLEBA § 121(d), 12 U.S.C. § 1831w(a)(4); *see also infra* notes 443-50 and accompanying text.

443 GLEBA § 121(b)(1) (amending the coverage of 12 U.S.C. §§ 371c, 371c-1 (1994)).

444 *See supra* note 322 and accompanying text.

445 *See* 12 U.S.C.A. § 371c(b)(2)(A) (West 2001).

446 GLEBA § 121(b)(1), 12 U.S.C.A. § 371c(e)(1)-(2).

447 That limitation is ten percent of capital and surplus. 12 U.S.C.A. § 371c(a)(1)(A).

448 GLEBA § 121(b)(1), 12 U.S.C.A. § 371c(e)(3)(A).

449 GLEBA § 121(b)(1), 12 U.S.C.A. § 371c(e)(4)(A).

450 GLEBA § 121(b)(1), 12 U.S.C.A. § 371c(e)(4)(B).

451 GLEBA § 121(c), 12 U.S.C.A. § 1971 (West 2001).

452 GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(2)(F) (West 2001).

453 These safeguards are designed to assure that:

(1) the procedures of the national bank for identifying and managing fi-

ity is also subject to certain debt rating requirements when engaged in by the nation's largest banks.[454]

Regulatory default in the case of a national bank's financial subsidiary leads to similar consequences. Failure to maintain either of the capitalization and management criteria, or the risk management safeguards,[455] would result in issuance of a notice by OCC identifying the deficiency or deficiencies in question and initiating a similar forty-five-day period in which to execute an agreement with OCC.[456] Until the deficiencies are cured, OCC "may impose such limitations on the conduct or activities of the national bank or any subsidiary [thereof] as [OCC] determines to be appropriate under the circumstances and consistent with the purposes of this section,"[457] and failure to correct the problem within six months may result in required divestiture of any financial subsidiary.[458] Finally, with respect to the debt rating requirements applicable to the 100 largest banks,[459] failure to maintain such ratings will disable the national bank from purchasing or acquiring, directly or indirectly, any additional equity capital[460]

> nancial and operational risks within the national bank and the financial subsidiary adequately protect the national bank from such risks;
>
> 2) the national bank has, for the protection of the bank, reasonable policies and procedures to preserve the separate corporate identity and limited liability of the national bank and the financial subsidiaries of the national bank; and
>
> 3) the national bank is in compliance with this section.

GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(d).

454 Each of the top fifty insured banks, to have a financial subsidiary, must have at least one issue of outstanding eligible debt currently rated within the three highest investment grade rating categories. GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(3)(A)(i). Banks among the second fifty largest must meet either the same eligible debt criterion or any alternative criteria established by the Board and the Treasury. GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(a)(3)(A)(ii).

455 *See supra* notes 428-30, 453 and accompanying text. Also, by virtue of the new provision codified at 12 U.S.C. § 24a(a)(7), failure to meet the CRA eligibility criterion will be treated the same as in the FHC context: Such failure will not result in OCC taking any remedial action but will disable the bank from expanding into new financial activities until a "Satisfactory" or better rating is restored.

456 GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(e)(1)-(2). Any affiliated state-chartered DI must execute an agreement with the AFBA (i.e., the Board in the case of a state member bank, the FDIC in the case of a state nonmember bank). GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(e)(2).

457 GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(e)(3)(A). Likewise, the AFBA may impose similar limitations on the conduct or activities of any relevant state-chartered IDI affiliate or subsidiary thereof. GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(e)(3)(B).

458 GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(e)(4).

459 *See supra* note 454.

460 For this purpose, "equity capital" is defined to include not only any equity

of any financial subsidiary until the bank is again in compliance with the rating requirement.[461]

Thus, the price tag of financial reform under GLEBA to the banking industry includes not only the eligibility maintenance and other criteria outlined above but also forgoing much (if not all) of the potential for expanded powers under the approach taken in OCC's 1996 Op. Sub. regulation. This limitation on functional equivalence and other creative approaches arises from the new statutory definition of "financial subsidiary" in the Act.[462]

C. Functional Regulation

GLEBA implements a regime of "functional regulation," an approach reflecting the conviction that similar activities should be regulated by the same sort of regulator regardless of where those activities may be conducted. This was not traditionally the case. Prior to GLEBA, for example, bank securities activities were not regulated by the SEC because of exemptions enacted into the federal securities laws.[463] Under functional regulation, by contrast, in whatever nook or cranny of the holding company structure that an activity may be housed or conducted, it will be subject, if it is a securities activity, to regulation by the SEC (and occasionally state securities regulators); if a banking activity, it will be subject to regulation by the appropriate federal and state bank regulators; if an insurance activity, it will be regulated by state insurance regulators; if a commodities activity, it will be subject to regulation by the Commodities Futures Trading Com-

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instrument but also "any debt instrument issued by a financial subsidiary, if the instrument qualifies as capital of the subsidiary under any Federal or State law, regulation, or interpretation applicable to the subsidiary." GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(f)(2).

[461] GLEBA § 121(a)(2), 12 U.S.C.A. § 24a(f)(1).

[462] 12 U.S.C.A. § 24a(g)(3). The wording of this definition suggests that, besides a financial subsidiary, the only types of subsidiaries that may legitimately exist for national banks are subsidiaries that "engage[ ] solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks[,]" *id*. § 24a(g)(3)(A), or those "specifically authorized by the express terms of a Federal statute [other than § 24a], and not by implication or interpretation," such as an Edge Corporation or Agreement Corporation (pursuant to sections 25 or 25A of the Federal Reserve Act, 12 U.S.C.A. §§ 601-604 (West 2001)) or a bank service corporation (pursuant to the Bank Service Company Act, 12 U.S.C.A. §§ 1861-1867 (West 2001)), 12 U.S.C.A. § 24a(g)(3)(B).

[463] *See supra* notes 72-75 and accompanying text.

mission and appropriate state regulators, and so forth.[464]

The Act embroiders the functional regulation concept by anointing the Board as the "umbrella supervisor" of diversified financial services organizations that are BHCs or FHCs. This means that the Board can examine the holding company and can also, albeit under limited circumstances, examine the functionally regulated components of the holding company. Normally, however, the Board is required to rely upon reports from the functional regulators.[465]

One of the corollaries of functional regulation under the Act in the securities arena is that the bank exemptions under the federal securities laws have largely been repealed. Thus, for example, GLEBA basically eliminates the bank exemption from the definitions of "broker" and "dealer" under the 1934 Act,[466] but retains a few exemptions for the purpose of facilitating certain traditional bank activities.[467] GLEBA also renders unto banks that which is banking by expressly permitting banks to continue to effect transactions in "identified banking products."[468] How-

[464] For an insightful critique of GLEBA's functional regulation model, see Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act,* 25 J. CORP. L. 723, 776-84 (2000).

[465] GLEBA § 111, 12 U.S.C.A. § 1844(c)(1)-(2) (West 2001).

[466] GLEBA §§ 201-202, 15 U.S.C.A. § 78c(a)(4)-(5) (West Supp. 2002).

[467] *Id.* Examples include trust activities, sweep accounts, private placements, safekeeping and custodial services, issuing asset-backed securities, derivatives transactions, third party networking arrangements, and so forth. *See* GLEBA § 221, 15 U.S.C.A. §§ 77c(a)(2), 78c(a)(12)(A)(iii) (establishing treatment of bank common trust funds under the 1933 Act and 1934 Act, respectively). Note in that connection that GLEBA exempts from the definition of "broker" a bank that effects transactions in a fiduciary capacity in a department (which may or may not be the bank's trust department) that is subject to examination for compliance with fiduciary regulations and standards, but only so long as (A) the bank is "chiefly compensated" for these transactions via pre-set fees (e.g., trust administration fees), a percentage of assets under management, flat or capped per order fees (representing the bank's cost of execution), or any combination thereof; and (B) the bank does not publicly solicit brokerage business other than by advertising, in connection with marketing of its trust services, that it effects transactions in securities for customers. GLEBA § 201, 15 U.S.C.A. § 78c(a)(4)(B)(ii)(I)-(II). Similarly, the Act exempts from the definition of "dealer" a bank that purchases or sells securities for investment purposes, whether for its own account or as agent for a trust customer. GLEBA § 201, 15 U.S.C.A. § 78c(a)(5)(C)(ii).

[468] These include various forms of deposit account (including certificates of deposit and other deposit instruments issued by a bank); banker's acceptances; letters of credit; debit accounts from credit card originations or similar arrangements; loan participations, but only those where the bank or an affiliate that is not a broker or dealer participates and where the participation is sold to a "qualified investor" or other sophisticated person that has the opportunity to review and assess any mate-

ever, with respect to new products that may functionally be hybrids of banking and securities,[469] the Act establishes what congressional staff referred to as a "jump ball" procedure whereby the SEC may, after consultation with the Board, initiate a rulemaking proceeding designed to declare the hybrid a "security."[470] This may have the effect of "acing" a sympathetic regulator like OCC out of the process of declaring something with security-like characteristics a "banking" product.

GLEBA has replaced securities laws definitional exemptions for a type of institution (i.e., banks) with exemptions for specified bank products and services. A corollary to this new ap-

rial information and the capacity to evaluate it, *cf.* Banco Español de Credito v. Sec. Pac. Nat'l Bank, 973 F.2d 51 (2d Cir. 1992); and swap agreements (including credit or equity swaps) where the swap is sold only to a qualified investor, GLEBA § 206, 15 U.S.C.A. § 78c note.

The term "qualified investor" is defined to include a variety of institutional investors, such as registered investment companies; issuers exempt from the definition of investment company under section 3(c)(7) of the 1940 Act, 15 U.S.C. § 80a-3(c)(7) (1994 & Supp. IV 1998); banks; savings associations; securities brokers and dealers (whether or not registered with the SEC); insurance companies; business development companies (as defined in section 2(a)(48) of the 1940 Act, 15 U.S.C. § 80a-2(a)(48) (1994 & Supp. IV 1998)); small business investment companies; state-sponsored employee benefit plans and ERISA employee benefit plans (but not including individual IRAs), the investment decisions for which are made by a bank, savings association, insurance company, or registered investment advisor as fiduciary; trusts with investment discretion reposed in one of the entities just listed; market intermediaries exempt under section 3(c)(2) of the 1940 Act, 15 U.S.C. § 80a-3(c)(2) (1994 & Supp. IV 1998); associated persons (other than a natural person) of a broker-dealer; foreign banks; foreign governments; government entities and political subdivisions thereof that invest on a discretionary basis at least $50 million; and multinational or supranational entities or agencies and instrumentalities thereof. *See* 15 U.S.C.A. § 78c(a)(54) (West Supp. 2002). The term also includes corporations, companies, partnerships, or natural persons that own and invest on a discretionary basis at least $25 million, or $10 million if in connection with loan participations and transactions involving certain asset-backed instruments. *Id*.

[469] Examples of such products include those that were neither subjected to SEC regulation as "securities" prior to GLEBA nor "identified banking products" as defined by GLEBA. *See supra* note 468. Also, equity swaps (within the meaning of section 206(a)(6) of GLEBA) do not qualify as a "new hybrid product" under the Act.

[470] GLEBA § 205, 15 U.S.C.A. § 78*o*(i) (West Supp. 2002). In the pre-rulemaking consultation, the Commission "shall consider" the Board's views and the implications for the banking industry of declaring the product a security. Such a declaration, following a rulemaking, may be challenged by the Board in the D.C. Circuit, with such a challenge having the effect of staying the SEC's determination until the case is adjudicated; however, neither agency's views are to be accorded deference by the court. *Id.* Other parties besides the Board may, if aggrieved by the rulemaking, also challenge the Commission's determination, but that challenge does not effect an automatic stay. *Id.*

proach is that banks that have conducted a broader range of brokerage or dealing will have to "push out" those kinds of activities into an affiliated broker-dealer, inasmuch as compliance problems arising from regulatory conflicts between the federal banking laws and the federal securities laws (e.g., the SEC's net capital rule for broker-dealers) would render their retention in the bank impractical.

Banks have also lost certain exemptions and exclusions under the 1940 Act and the Investment Advisers Act of 1940 (Advisers Act).[471] The SEC has been given authority to regulate (after consultation with, and taking into consideration the views of, the federal banking agencies) the hitherto largely unregulated practice of a bank serving as custodian of an affiliate management investment company or affiliated unit investment trust[472] and bank loans to an affiliated investment company.[473] Moreover, the pre-existing prohibition on a majority of the directors of an investment company being persons who are officers, directors, or employees of any one bank has been extended to cover affiliates and subsidiaries of the bank or any one bank holding company and its affiliates.[474] In addition, the 1940 Act's definition of "interested person"[475] has been expanded to cover any person (or affiliated person thereof) that during the preceding six-month period executed any portfolio transaction for, engaged in any principal transaction with, distributed shares of, or loaned any money to, (1) the investment company, (2) another investment company having the same adviser, or (3) an account over which the investment company's adviser has brokerage placement discretion.[476] Finally, GLEBA eliminates the exclusion of banks and bank holding companies from the key definition of "investment adviser" in the Advisers Act,[477] thereby requiring banks and bank holding companies performing this function to register with the Commission (or else to register a separately identifiable department or division if appropriate and if adequate to constitute com-

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471 15 U.S.C.A. §§ 80b-1 to 80b-21 (West 2001).

472 GLEBA § 211, 15 U.S.C.A. §§ 80a-17(f), 80a-26 (West Supp. 2002).

473 GLEBA § 212, 15 U.S.C.A. § 80a-17(a).

474 GLEBA § 213(c), 15 U.S.C.A. § 80a-10(c) (West Supp. 2002).

475 *See supra* note 150.

476 GLEBA § 213(a), 15 U.S.C.A. § 80a-2(a)(19)(A) (West Supp. 2002). Conforming changes were also made to the definition of "interested person" of an investment adviser and principal underwriter. GLEBA § 213(b), 15 U.S.C.A. § 80a-2(a)(19)(B).

477 GLEBA § 217(a), 15 U.S.C.A. § 80b-2(a)(11).

pliance).[478] The Commission and the AFBA are directed to share with each other reports of examination and similar information relating to the investment advisory activities of banks and bank holding companies.[479]

Functional regulation on the insurance side of the house means, of course, regulation and supervision by state insurance commissioners.[480] Thus, regardless of whether insurance activities are being conducted out of banks or their subsidiaries (e.g., pursuant to the "town of 5,000" authority),[481] out of securities firms, or out of traditional insurance companies or agencies, state regulation will prevail.

Once again, these provisions exact a price on the industry. Activities that commercial banking organizations might have preferred to continue to carry on in the banks must, because of the loss of securities act exemptions, be "pushed out" into affiliates, and regulatory compliance costs attributable to the multiplicity of regulation and regulatory regimes are undoubtedly higher.

Furthermore, the Act effectively forecloses the possibility that national banks or their subsidiaries might engage in insurance activities as principal,[482] apart from a handful of "authorized banking products"[483] and the limited "competitive equality" exception for national banks selling title insurance only where state law authorizes state banks to do so.[484] Nor is an "end run" around

478 GLEBA § 217(b), 15 U.S.C.A. § 80b-2(a)(26).

479 GLEBA § 220, 15 U.S.C.A. § 80b-10(a) (West Supp. 2002).

480 GLEBA § 301, 15 U.S.C.A. § 6711 (West Supp. 2002).

481 The Act makes explicit reference to the town of 5,000 authority under § 92 ("a national bank exercising its power to act as agent under the eleventh undesignated paragraph of section 13 of the Federal Reserve Act"). *Id.*

482 GLEBA § 302(a), 15 U.S.C.A. § 6712(a) (West Supp. 2002).

483 GLEBA § 302(b), 15 U.S.C.A. § 6712(b). An authorized banking product is one that OCC had officially determined, as of January 1, 1999, to be something a national bank could provide as principal (or where, as a matter of practice, national banks were in fact lawfully providing said product), provided that no court had overturned such an OCC determination by that date and provided further that neither title insurance (somewhat superfluously, given the Second Circuit's pre-January 1999 decision in *American Land Title Ass'n v. Clarke*, 968 F.2d 150 (2d Cir. 1992)) nor a tax-advantaged annuity can qualify as such a product. *Id.* The only possible benefit of this provision to national banks would be the resurrection of crop insurance, given that the court decisions overturning OCC's determination in that regard were rendered after the cut-off date of January 1, 1999 and might therefore be regarded as legislatively overruled by this provision. *See supra* notes 239-44 and accompanying text.

484 GLEBA § 303(b)(1), 15 U.S.C.A. § 6713(b)(1) (West Supp. 2002). The state law in question must be an affirmative authorization, however. State wild card statutes do not constitute the requisite authority. GLEBA § 303(b)(2), 15 U.S.C.A.

these provisions by OCC (or any other bank regulator) to expand what banks themselves may offer via resort to a "functional equivalence" approach any longer available. As the discussion in Part I of this Article has established, functional equivalence treatment is frequently negated by the adoption of statutory definitions. So too here, where, for the first time, a statutory definition of "insurance" has been enacted that is binding on the federal bank regulatory agencies.

GLEBA enacted a three-part definition of insurance that includes (1) "any product regulated as insurance as of January 1, 1999, in accordance with the relevant State insurance law, in the State in which the product is provided";[485] (2) any product first offered thereafter that a state insurance regulator determines to be insurance because it "insures, guarantees, or indemnifies against liability, loss of life, loss of health, or loss through damage to or destruction of property, including, but not limited to, surety bonds, life insurance, health insurance, title insurance, and property and casualty insurance,"[486] subject to an exception for certain statutorily enumerated bank products;[487] or (3) "any annuity contract, the income on which is subject to tax treatment under" I.R.C. § 72.[488] The definition is expanded even further by a so-called "rule of construction" providing that offshore insurance or

§ 6713(b)(2). This is reminiscent of the old Douglas Amendment to the BHCA, 12 U.S.C. § 1842(d) (1988), which, prior to its repeal by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338, required that interstate ownership or control of banks by bank holding companies acting pursuant to state law authorization be pursuant to a state statute with "language to that effect and not merely by implication."

485 GLEBA § 302(c)(1), 15 U.S.C.A. § 6712(c)(1).

486 GLEBA § 302(c)(2)(A), 15 U.S.C.A. § 6712(c)(2)(A). This includes "private passenger or commercial automobile, homeowners, mortgage, commercial multiperil, general liability, professional liability, workers' compensation, fire and allied lines, farm owners multiperil, aircraft, fidelity, surety, medical malpractice, ocean marine, inland marine, and boiler and machinery insurance." *Id.*

487 This bank products exception excludes from the statutory definition of insurance any bank product or service that is "(i) a deposit product; (ii) a loan, discount, letter of credit, or other extension of credit; (iii) a trust or other fiduciary service; (iv) a qualified financial contract (as defined in or determined pursuant to [FDIA § 11(e)(8)(D)(i), 12 U.S.C. § 1821(e)(8)(D)(i))]; or (v) a financial guaranty." GLEBA § 302(c)(2)(B), 15 U.S.C.A. § 6712(c)(2)(B). This exception is inapplicable, however, with respect to certain products that include an "insurance component" and that, if offered by a bank as principal, would either qualify as a life insurance contract under I.R.C. § 7702 or (in the case of any product other than "a letter of credit or other similar extension of credit, a qualified financial contract, or a financial guaranty") for treatment of losses under I.R.C. § 832(b)(5). *Id.*

488 GLEBA § 302(c)(3), 15 U.S.C.A § 6712(c)(3). This component of the defini-

reinsurance "that insures, guarantees, or indemnifies insurance products provided in a State or that indemnifies an insurance company with regard to insurance products provided in a State" is deemed to be providing insurance as principal in that State.[489] Thus, hearkening back to our syllogism, even if an insurance company product X is the functional equivalent of a banking product Y, the presence of a new statutory definition of X *as insurance* forecloses a different regulatory treatment by OCC or any other bank regulator.

Throwing salt in the wound caused by the surgical excision of functional equivalence as a regulatory tool to expand bank penetration of the insurance business, GLEBA has not only preserved—indeed, reaffirmed—the primacy of the McCarran-Ferguson Act reverse preemption regime[490] but has also largely eliminated the possibility that banks can rely on judicial deference to federal banking agency interpretations in this area.[491] Thus, in the case of a regulatory conflict over insurance and reverse preemption issues between a state insurance regulator and a federal regulator, either side may, subject to a special statute of limitations,[492] seek expedited[493] judicial review in the appropriate federal circuit court, but such review must be "without unequal deference."[494] In general, the deference issue was a political "hot button" and led to this compromise position, though the im-

tion legislatively overrules that portion of *VALIC II* that found that annuities are not "insurance."

489 GLEBA § 302(d), 15 U.S.C.A. § 6712(d).

490 GLEBA § 104(a), 15 U.S.C.A. § 6701(a) (West Supp. 2002) (stating that the McCarran-Ferguson Act "remains the law of the United States"); *see also supra* notes 219-22 and accompanying text.

491 Recall the level of deference accorded by the Supreme Court in *VALIC II* to OCC's determination that annuities were financial products, not insurance products. *See supra* notes 265-67 and accompanying text.

492 A special, and rather abbreviated, limitations period is provided for. No challenge to an order, ruling, determination, or other action of a state insurance regulator or a federal regulator may be filed after the later of the end of (i) the twelve-month period beginning on the date the first public notice of such order, ruling, determination, or other action is made in its final form, or (ii) the six-month period beginning on the date when such order, ruling, determination, or other action becomes effective. GLEBA § 104(d), 15 U.S.C.A. § 6714(d) (West Supp. 2002).

493 The court of appeals has no more than sixty days to render its judgment, unless all parties stipulate to an enlargement. GLEBA § 304(b), 15 U.S.C.A. § 6714(b). Any petition for Supreme Court review of the appellate court's judgment "shall be filed . . . as soon as practicable after such judgment is issued." GLEBA § 304(c), 15 U.S.C.A. § 6714(c).

494 GLEBA § 304(e), 15 U.S.C.A. § 6714(e). The court must decide the matter "based on its review on the merits of all questions presented under State and Fed-

plementation of a functional regulation regime, the enactment of a federal definition of "insurance," and the reaffirmation of McCarran-Ferguson already made it clear that the federal bank regulators[495] would have a much more difficult time approving bank entry into insurance without the regulatory input of state insurance commissioners. Be that as it may, it is clear that under such a "without unequal deference" standard, no longer will the banking industry be able to benefit from cases like *VALIC II*.

Deference still plays a part, however, with respect to state laws dealing with the solicitation, sale, or cross-marketing of insurance, at least those laws that were enacted prior to September 3, 1998. Disputes may still arise between a federal banking agency and state insurance regulators with respect to state laws that might seek to restrict insurance sales activities by commercial banking organizations. GLEBA preserves the *Barnett* standard to a degree[496] and provides that such state laws may not "prevent" or "significantly interfere" with the insurance sales activities of commercial banking organizations,[497] a determination by the appropriate regulatory agency that is entitled to normal *Chevron* deference. With respect to such state laws that were enacted after September 3, 1998, however, the "no unequal deference" regime applies.[498]

Furthermore, the possibility of federal banking law preemption of state insurance laws—another "hot button" for the various trade associations representing the banking and insurance industries lobbying Congress during its consideration of the Act—has been cut back by the enactment of a safe harbor for thirteen categories of state insurance laws. These laws are not subject to preemption even though they may discriminate against commercial banking organizations.[499]

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eral law, including the nature of the product or activity and the history and purpose of its regulation under State and Federal law." *Id.*

495 By its terms, section 304 of GLEBA applies only to cases brought by a regulator and does not specify the scope of review applicable to cases brought by private litigants. GLEBA § 304(a), 15 U.S.C.A. § 6714(a).

496 GLEBA § 104(d)(2)(C), 15 U.S.C.A. § 6701(d)(2)(C) (West Supp. 2002).

497 In a way, this is a slight expansion of *Barnett*, inasmuch as that decision seemed to cover only federal instrumentalities like national banks, whereas the Act covers state banks, holding companies, and holding company affiliates engaged in these insurance activities as well.

498 GLEBA § 304(e), 15 U.S.C.A. § 6714(e).

499 GLEBA § 104(d)(2)(B), 15 U.S.C.A. § 6701(d)(2)(B). The thirteen areas in which the states have *carte blanche* to regulate include (i) protecting against rejection of insurance policies required in connection with lending transactions solely

There is an ironic and somewhat sad postlude to this mixed bag of differential standards of agency responsibility, judicial deference, and preemption. Far from clarifying the situation, GLEBA has engendered only more uncertainties about the scope of preemption, the parameters of the "prevent or significantly interfere with" standard, and the applicability of the thirteen so-called "safe harbors." Instead of reconciling the law in this area, GLEBA has merely shifted the battleground. National and state trade associations of insurance agents remain in conflict with banking trade associations. Already there have been disputes in several states: Ohio, Massachusetts, Rhode Island, and West Virginia.[500]

One of these is actively in litigation, and another seems headed in that direction. In Ohio, the battle is over two state licensing requirements, and the case is pending in the Sixth Circuit.[501] In

because the insurer is not affiliated with the lender; (ii) prohibiting extra charges on such required insurance if purchased from unaffiliated agents; (iii) restricting advertisements or other promotional materials that might misrepresent the status of any insurance product as being federally insured or guaranteed; (iv) imposing licensing requirements on anyone receiving a commission or brokerage fee from the sale of insurance; (v) prohibiting referral fees to unlicensed providers; (vi) regulating the disclosure of insurance information to third parties without the insured's express written consent; (vii) prohibiting the use of health information from the insured's health records without express written consent; (viii) implementing anti-tying regimes; (ix) requiring anti-tying disclosures; (x) requiring disclosure that the product is not a deposit, is not insured or guaranteed by the federal government or by any financial institution or affiliate and, where appropriate, involves investment risk; (xi) mandating separate documentation for credit and insurance transactions; (xii) prohibiting the inclusion of credit insurance premiums in the primary credit transaction without the customer's consent; and (xiii) mandating the maintenance of separate books and records relating to insurance transactions, including consumer complaints, and the availability of such books and records for inspection by state insurance regulators. *Id.*

500 OCC has requested public comment on whether insurance laws and regulations in these states are preempted. *See*, *e.g.*, Notice of Request for Preemption Determination, 65 Fed. Reg. 57,427 (Sept. 22, 2000) (Rhode Island); Notice of Request for Preemption Determination, 65 Fed. Reg. 43,827 (July 14, 2000) (Massachusetts); Notice of Request for Preemption Determination, 65 Fed. Reg. 35,420 (June 2, 2000) (West Virginia). The Rhode Island dispute clearly antedates GLEBA, however. *See* Preemption Determination, 62 Fed. Reg. 1950 (Jan. 14, 1997) (initial request for comments regarding Rhode Island); Preemption Determination, 62 Fed. Reg. 12,883 (Mar. 18, 1997) (further request for comments regarding Rhode Island).

501 *See* Ass'n of Banks in Ins., Inc. v. Duryee, 55 F. Supp. 2d 799, 809 (S.D. Ohio), *aff'd and remanded by* 270 F.3d 397 (6th Cir. 1999) (concluding that compliance with the Ohio statute might "entail a substantial financial expense which could weigh significantly against the expected revenue from the sale of insurance in [a town of 5,000], and therefore significantly impair the bank's ability to sell insurance"); *see also* Scott A. Sinder, *The Gramm-Leach-Bliley Act and State Regulation of the Busi-*

West Virginia, the battle is over eight provisions of state law, and in October 2001 OCC concluded that four of these are preempted and another one is partially preempted.[502]

The net result is that commercial banking organizations are arguably worse off under the GLEBA regime of functional regulation, McCarran-Ferguson primacy, and "no unequal deference" than they would have been basking in the glow of OCC's preemption victories and the open-textured language of Supreme Court decisions like *Barnett* and *VALIC II*.

Conclusion

Necessity may be the mother of invention, but, from the banking industry's point of view, there was no necessity for the enactment of GLEBA. All that commercial banking organizations could possibly want in the realm of securities activities was available to them under the pre-existing Glass-Steagall framework, particularly in view of the possibility of "disaffiliating" securities firms from member banks. Moreover, aggressive and innovative

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ness of Insurance—Past, Present and . . . Future?, 5 N.C. Banking Inst. 49, 72 & n.107 (2001).

502 *See* Preemption Opinion, 66 Fed. Reg. 51,502 (Oct. 9, 2001). The opinion, dated September 24, 2001, construed sections 33-11A-6, 33-11A-8 to 33-11A-11, and 33-11A-13 to 33-11A-14 of the West Virginia Code. Found preempted were provisions (1) requiring financial institutions to use separate employees for insurance solicitations; (2) restricting the timing of bank employees' referral or solicitation of insurance business from customers with pending loan applications; (3) restricting sharing with bank affiliates (for the purpose of soliciting or offering insurance) information acquired in the course of a loan transaction; and (4) requiring segregation of the place of solicitation or sale of insurance from deposit-taking and lending areas. The three provisions that OCC concluded were not preempted (1) prohibited requiring or implying that the purchase of an insurance product from a financial institution is required as a condition of a loan; (2) prohibited offering an insurance product in combination with other products unless all products are available separately; and (3) required that insurance and credit transactions be completed independently and with separate documentation where obtaining the insurance is a condition to loan approval. The partial preemption determination was made with respect to disclosure requirements: Requirements as to contents of disclosures and obtaining a written acknowledgment, in a separate document, from the customer that the disclosures were made are not preempted, but provisions mandating the manner and timing of certain required disclosures are. *Id.*

The Independent Insurance Agents of America, a frequent litigant against OCC on insurance powers, claims that this preemption opinion is "too important to consumer protection and fair competition for independent agents to leave unanswered." *See* Richard Cowden, *Comptroller Opinion Says GLBA Preempts Some WV Limits on Bank Insurance Sales*, 77 Banking Rep. (BNA) 538 (Oct. 8, 2001). Litigation has already commenced. *See* Lee Ann Gjertsen, *Suit Tests GLB and OCC's View on Insurance Sales*, Am. Banker, Nov. 15, 2001, at 11.

initiatives by OCC, particularly using the "functional equivalence" approach, had already resulted in significant penetration of the insurance business, as well as in impressive Supreme Court victories containing broad and deferential language auguring well for future innovation and development.

GLEBA established an alternate framework for commercial banking organizations to engage in securities and insurance activities but exacted rather a high price. The Act vitiated much of the regulatory flexibility that underlay OCC's initiatives and largely curtailed further development through functional equivalence approaches. In addition, the availability of expanded financial services powers for commercial banking organizations is subject to strict eligibility criteria requiring elevated capital, managerial, and CRA ratings for each and every depository institution under the holding company umbrella; loss of organizational flexibility with the repeal of bank exemptions from the federal securities laws (the "push out" provisions); increased complexity and costs of compliance with the multiplicity of federal and state regulatory regimes occasioned by functional regulation and the addition of the FTC to the mix; and the dawn of a new era of financial privacy regulation with high current compliance costs and the spectre of untold future costs. With all these additional burdens for scant (if any) additional benefit, GLEBA may truly be said to be an orphan of invention.