

The Legality of Bank-Sponsored Investment Services

In recent years, many commercial banks have expanded beyond their traditional role of accepting time and demand deposits and making commercial loans. They now engage not only in these traditional activities but also in mortgage banking, travel services, data processing, and leasing.¹ They also perform a variety of bank-sponsored investment services for small customers including automatic investment services, dividend reinvestment plans, voluntary investment plans, individual portfolio management services, and activities as advisers to investment companies.²

Perceiving these activities as an encroachment upon their professional territory, brokers and investment companies have raised questions about their legality and regulation.³ Opponents have argued both that these services violate the Glass-Steagall Act,⁴ and that, because of the banks' exemptions from several provisions of the federal securities laws, customers using banks do not receive adequate investor protection.⁵ A recent decision of the Securities and Exchange Commission (SEC) to issue a release asking for comments on this problem,⁶ the recent initiation of two lawsuits challenging the validity of these services,⁷ and the introduction of a bill in Congress that would subject these activities to SEC regulation⁸ all indicate the importance of the controversy.

1. See Evans, *Regulation of Bank Securities Activities*, 91 BANKING L.J. 611, 611-12 (1974).

2. In its recent release asking for comments on the legality of bank-sponsored investment services, the SEC described the broad features of each of these plans. Securities Exchange Act Release No. 5491, [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,767, at 84,073-74 (1974) [hereinafter cited as Release No. 5491].

3. These questions have been raised most prominently in two recent complaints filed by the New York Stock Exchange and the Investment Company Institute challenging the legality of two of these services, automatic investment services and bank advisory activities to investment companies. Automatic investment services are the subject of a complaint filed in *New York Stock Exch., Inc. and Inv. Co. Institute v. Smith*, Civil No. 1405 (D.D.C., filed Sept. 24, 1974), [Current Binder] CCH FED. SEC. L. REP. ¶ 94,798 (1974) [hereinafter cited as *NYSE case*]; bank advisory activities are the subject of a complaint filed in *Investment Co. Institute v. Board of Governors of the Fed'l Reserve Sys.*, Civil Action No. 697 (D.D.C., filed May 8, 1974), [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,540 (1974) [hereinafter cited as *Investment Co. case*].

4. See, e.g., Complaint, *NYSE case*, *supra* note 3, at 96,655-58.

5. See, e.g., *id.* at 96,657-58.

6. Release No. 5491, *supra* note 2.

7. See note 3 *supra*.

8. S. 2707, 93d Cong., 1st Sess. (1973), would subject automatic investment services to SEC jurisdiction and all the requirements of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1970).

This Note examines the effect of bank-sponsored investment services on customers and on the securities and capital markets, their legality under the Glass-Steagall Act, and whether customers using the services obtain satisfactory investor protection. It concludes that these services are legally provided under current law, that they are beneficial in attracting small investors and capital to the market, and that because banking regulations provide adequate protection for investors, the SEC should not attempt to regulate bank-sponsored investment services.

I. Description of the Services

A. *Automatic Investment Services (AIS)*

AIS allows a bank's checking account customers to invest in common stock through automatic monthly deductions from their accounts. Although only persons maintaining a checking account with the bank may use this service, the account may be opened simultaneously with participation in AIS.⁹ Banks generally have limited investors' selections to common stock of the 25 corporations having the largest capitalization on Standard & Poor's 425 Industrial Index,¹⁰ though no law or regulation requires this selection method.

The plan's purchasing mechanism is intended to reduce brokerage costs for small investors by pooling their purchases. The monthly deductions of purchasers who have selected a particular stock are pooled, and at least once a month the bank establishes a cutoff date and thereafter purchases as much stock as the pooled funds will buy.¹¹ The period between the cutoff date and the date of purchase—known as the "acquisition interval"—generally does not exceed 30 days.¹² Each participant pays his proportionate share of the applicable brokerage charges and a monthly service charge which has averaged the lesser of five percent of the monthly deduction from his account or \$2 per stock designated for purchase.¹³

9. See Release No. 5491, *supra* note 2, at 84,073.

10. *Id.* The banks believe that in forming the AIS list in this "mechanical" manner they are not recommending any securities and are therefore acting only as agents, not investment managers. See Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411, at 83,185 (SEC). The truth of this contention bears on the question of whether banks should be subject to the suitability rule. See pp. 1500-02 *infra*.

11. Release No. 5491, *supra* note 2, at 84,073; Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411, at 83,183 (SEC).

12. Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411, at 83,183 (SEC).

13. *Id.*; Release No. 5491, *supra* note 2, at 84,073.

The Legality of Bank-Sponsored Investment Services

B. *Dividend Reinvestment Plans (DRP)*

DRP's rationale is to provide an economical and convenient method by which the small investor can invest modest sums on a regular basis. Under this plan, the bank acts as agent for a company's participating shareholders in receiving dividends and investing them in additional shares of the company's common stock. Some plans permit additional cash contributions for stock purchase, and some provide for application of interest or dividends on other securities of the corporation to this purchase.¹⁴ Within 30 days after receipt by the bank, the dividends are combined and used to purchase the maximum possible amount of stock in the particular company.¹⁵ Service fees of the bank and brokerage commissions are deducted from the amounts available for investment; these costs have averaged five percent of the amount invested.¹⁶ A customer may terminate participation in the plan at any time, and upon termination he may either receive the certificates for the full shares in his account or direct the bank to sell his shares.¹⁷

C. *Individual Portfolio Management Services (IPMS)*

IPMS provides investment advice on an individual basis to bank customers who have only moderate amounts of investable resources, which generally must be at least \$10,000.¹⁸ The bank sends a list of recommended stocks to the customer. If the customer agrees with some of the recommendations, he mails his selections to a broker, who then executes the transaction.¹⁹ The typical service charges the customer a fixed rate.²⁰

14. Release No. 5491, *supra* note 2, at 84,073.

15. The SEC requires this condition in order for the dividend reinvestment plan to avoid the creation of a separate security that must be registered under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52 (1970). Lucky Stores, Inc., [Current Binder] CCH FED. SEC. L. REP. ¶ 79,903, at 84,315-16 (SEC 1974).

16. There is no requirement as to the amount of the service fee, but five percent is an approximation of what a typical plan will charge. *See, e.g.*, Chase Manhattan Bank, [1971-72 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,368, at 80,840 (SEC 1972).

17. *Id.* The SEC requires that shareholders may terminate participation at any time for DRP to avoid registration under the Investment Company Act of 1940. Lucky Stores, Inc., [Current Binder] CCH FED. SEC. L. REP. ¶ 79,903, at 84,315-16 (SEC 1974). Upon termination the shareholder receives reimbursement for any fractional shares in cash from the bank. *Id.*

18. Release No. 5491, *supra* note 2, at 84,074; American Bankers Association Response to SEC Inquiry Concerning Bank-Sponsored Investment Services, Aug. 9, 1974, at 11 (on file with *Yale Law Journal*) [hereinafter cited as Bankers Ass'n Response].

19. *See* SEC, SMALL ACCOUNT INVESTMENT MANAGEMENT SERVICES: RECOMMENDATIONS FOR CLEARER POLICIES AND GUIDELINES 9-11 (CCH FED. SEC. L. REPORTS No. 465, Feb. 6, 1973).

20. *Id.* at 13.

D. *Voluntary Investment Plans (VIP)*

Except for the fact that in VIP a broker draws up the list of securities, VIP and AIS operate similarly. After preparing a list of some 30 securities, a participating broker-dealer refers interested customers to a bank. The bank offers these customers a monthly purchase program for whichever stocks the customer selects from the broker's original list. The bank handles the customer's funds, and charges him four to five percent of the total amount invested. One-fourth of this fee then goes to the broker-dealer.²¹

E. *Bank Advisory Services to Investment Companies*

Pursuant to regulations issued by the Federal Reserve Board,²² several banks now act as investment advisers to closed-end and open-end investment companies, providing the same services that fiduciaries and financial advisers have traditionally performed. Their primary function is to provide the investment companies with securities investment advice.²³

II. Effects of Bank-Sponsored Investment Services on Investors and on the Capital Market System

A. *The Effect on Investors*

Over the last five years the market has suffered a large decline in direct public participation in stock trading.²⁴ The tight money market and the prolonged skid in the Dow-Jones average help to explain the decline of the private investor.²⁵ But relatively high commission charges and the decision of many investment houses to direct their attention to large institutional investors have also contributed to his disappearance. Brokerage rates have increased dramatically over the last five years. In 1970 it cost \$21 to buy 100 shares of a \$20 stock.²⁶ As of June

21. This plan is described in Release No. 5491, *supra* note 2, at 84,073-74.

22. 12 C.F.R. § 225.4(a)(5) (1974).

23. The features of this service are described in Release No. 5491, *supra* note 2, at 84,074; *Investment Co.* case, *supra* note 3.

24. In 1973, individual private investors bought and sold nearly 20 percent less stock on national exchanges than in 1968, precipitating a drop of \$20 billion in traded assets. In 1961, individual investors accounted for 61 percent of all dollar trading volume on the New York Stock Exchange; in 1973, they accounted for only 30 percent, while institutions did 70 percent of the trading. Rolo, *The Case of the Vanishing Investor*, N.Y. Times, June 9, 1974, § 6 (Magazine), at 14.

25. See Solomon, *Institutional Investors: Stock Market Impact and Corporate Control*, 42 GEO. WASH. L. REV. 761, 769 (1974).

26. Metz, *Market Place: Fee Rises with Trading Action*, N.Y. Times, June 8, 1974, at 40, col. 3.

The Legality of Bank-Sponsored Investment Services

2, 1975, it costs \$45.²⁷ Many firms have tried to counter this trend by offering special plans with discounts to small investors.²⁸ These plans, however, have often actually resulted in higher commissions, and, in any case, are not geared to attracting new investors.²⁹ The May 1, 1975 move from fixed commissions to competitive rates has resulted in slightly higher fees for small investors.³⁰

Bank-sponsored investment services can play a vital role in attracting many small investors who would not otherwise enter or reenter the marketplace to invest in equity securities. The structure of the services itself indicates that they are geared to small investors, whereas the large brokerage houses are heavily oriented toward institutional investors.³¹ Customers are likely to be attracted to a service which is part of a larger financial institution offering other commercial services since small investors generally find it more convenient to transact all their business at one institution rather than to do some business with a broker, some with a bank, and a portion with an investment company.³² Moreover, the bank is an institution with which almost everyone has an existing business relationship. The savings in transactional costs through these services is another attractive feature for small investors. On a \$500 purchase, for example, the AIS charge is \$7.00, whereas the average brokerage charge is \$12.25.³³

27. Interview with John Kelly, Vice President for Public Relations, Merrill, Lynch, Pierce, Fenner & Smith, Inc., June 2, 1975 (telephone).

28. See Metz, *Market Place: 'Negotiations' in Small Trades*, N.Y. Times, May 16, 1974, at 60, col. 2; Vartan, *Wall Street Baita a Hook*, N.Y. Times, Mar. 31, 1974, § 3, at 1, col. 7; Vartan, *Market Place: Rivals Assess Merrill's Plan*, N.Y. Times, Mar. 28, 1974, at 56, col. 2.

29. Bache & Co., for example, has a plan in which on transactions of \$1,600 to \$2,000 a customer may receive a discount but on purchases worth less than \$1,600 he may actually pay more than he normally would. Metz, *Market Place: 'Negotiations' in Small Trades*, N.Y. Times, May 16, 1974, at 60, col. 3. Even when a customer has joined the plans, he often gains little in the current inactive market because the plans contemplate purchases or sales "at the market," usually at the opening price of the day. What the customer gives up in buying "at the market" is his right to stipulate a particular price he will pay for shares on a purchase, or accept for his shares on a sale. If a customer receives a 25 percent commission rate discount on a purchase of 100 shares at \$20 per share, he would save \$10.45. However, when a customer buys "at the market" he pays the asked price. In a bear market, the chances are that the bid price on this stock was at least a quarter of a point less than what he paid. Even if it were only one-eighth of a point less, he would save \$2.05 if he buys at the bid price as compared with what he paid under the special plan. Metz, *Market Place: New Fee Plan Has Problems*, N.Y. Times, May 24, 1974, at 44, col. 3.

30. Cole, *Rate War Rages Among Brokers*, N.Y. Times, May 30, 1975, at 1, col. 2.

31. The orientation of brokerage firms toward accommodating large institutions and ignoring small investors has been posited as one reason for the latter's flight from the securities market. See, e.g., Cobleigh, *The Flight and Plight of the Small Investor*, 216 COM. & FINAN. CHRON. 1852 (1972).

32. Surveys conducted by banks of AIS participants indicate that the investors are attracted to the service because of its convenience and the fact that small amounts can be invested. Bankers Ass'n Response, *supra* note 18, at 24.

33. Cole, *Wall Street's 'Negotiated Rates' Plans Start Today*, N.Y. Times, Apr. 1, 1974, at 49, col. 3. The brokerage charge is from Merrill Lynch's Sharebuilder Plan, and

Complete statistics on these services are still lacking, but the available data do indicate that they are attracting new investors to the stock market. Over half the customers in automatic investment services have never before purchased common stock.³⁴ Participants in individual portfolio management services, on the other hand, are more experienced, sophisticated investors who are attracted to the convenient, low-cost services that banks offer.³⁵ Although most of these investors have participated in the stock market before,³⁶ a service that they are happy with will induce them to remain in the market and encourage them to increase their investments. Dividend reinvestment plans, by definition, do not attract new investors since participants must already own shares in the issuing company, but they may attract new investments. Currently there are no data on the impact of voluntary investment plans,³⁷ but because of their similarity to AIS it is likely that they will attract new investors to the market.

At present, the total number of investors who are using bank-sponsored services is small, although the services have shown recent gains, and one service, DRP, has experienced significant popularity.³⁸ Uncertainty over the legality of these services and inertia in establishing new investment programs might well explain the generally slow growth. As these problems are resolved, though, the number of investors should increase, and to the extent that any program is capable of luring the small investor to the market, bank-sponsored investment services are likely to play a significant role. That is, if the crucial factor in inducing a number of persons to invest in securities is the lower commission rates and greater convenience that bank-sponsored investment services offer, the services are important because they enhance the public's ability to use their investable resources as they desire.

To a large extent, economic progress depends on sufficient capital

is accurate as of June 2, 1975. Interview with John Kelly, *supra* note 27. AIS rates have remained stable during the last 15 months. Interview with an anonymous clerk in the Chase Manhattan Bank department in charge of AIS, June 2, 1975 (telephone).

34. Bankers Ass'n Response, *supra* note 18, at 22-23.

35. *Id.* at 31.

36. *Id.* at 30-31.

37. The Bankers Ass'n Response, *supra* note 18, at 21, does not contain statistics on the characteristics of VIP participants.

38. Of the 100 largest United States corporations, 39 have dividend reinvestment plans, with an average of nine percent of the shareholders of each company participating. *Id.* at 20. One bank has reported that 50 percent of DRP's participants own less than 100 shares of the issuing company's stock, and another bank has reported the average shareholding of the participants as between 75 and 95 shares. *Id.* Fifty-six percent of AIS investors are in the \$12,000 to \$25,000 income range, and 24 percent of the investors are in the \$25,000 and over range. *Id.* at 23. Total participation in AIS is approximately 15,000. *Id.* at 24. The numbers of investors currently participating in VIP and IPMS are very small, and specific figures are not yet available. *Id.* at 21, 31.

The Legality of Bank-Sponsored Investment Services

formation.³⁹ But it is likely that capital accumulation in the next decade will be insufficient to meet the needs of America's various industrial sectors.⁴⁰ Because bank-sponsored investment services will attract new investors to the market, they should play an important role in increasing the amount of capital available to corporations.⁴¹

B. *The Effect on Capital Markets*

Countering institutionalization. A major issue in evaluating the impact of these services is whether they will result in the increased institutionalization of capital markets, the assumption being that ownership dominance by a narrow ring of institutions is a harmful trend that should be discouraged.⁴² If institutionalization is taken to mean the capacity to effect block trades, the services may increase institutionalization, at least to the extent that AIS, DRP, and VIP develop more rapidly than IPMS, since the banks purchase stock for customers in large, single transactions. This type of institutionalization may hamper market liquidity,⁴³ for decisions to buy or sell a given stock could drastically change its value if enough stock is changing hands in a single block transaction.

A broader meaning often given to institutionalization, though, con-

39. See Wall St. J., Feb. 20, 1975, at 22, col. 1.

40. The New York Stock Exchange estimates that in the next decade there will be a capital shortfall of 13 percent of capital needs, or \$650 billion. *Id.*

41. Whether the services will play this role depends on the resolution of an empirical question for which, at present, there are no data: as to those investors who would not otherwise have invested in the market if these services did not exist, what would they have done with their money? If they would have kept their money in intermediaries like savings deposits which themselves invested in the capital market (though not necessarily in equities), there would be no difference in the amount of capital furnished to corporations, though the form of capital contributions (stock or debt) and the identity of the corporate recipients might be different. Bank-sponsored investment services will have their most important impact if they cause changes in the net impact of capital contributed to corporations, as by changing people's savings-income ratios.

42. A number of financial writers contend that the recent dominance of institutions in the stock market has been harmful. They assert that because institutions tend to concentrate their purchases in a relatively select group of stocks, all other companies find it difficult to raise money by stock issues; that dominance by a few institutions has destroyed all vestiges of "democracy" in the marketplace by which the price of a stock is determined by the "votes" or purchases of a large number of individuals; that liquidity, the ability to buy or sell substantial amounts of stock at prices not too far removed from the prevailing quotations, has also diminished; and that institutions exercise ownership rights such as voting the shares of their customers. See, e.g., *Hearings on Financial Markets Before the Subcomm. on Financial Markets of the Sen. Comm. on Finance*, 93d Cong., 1st Sess., pt. 1, at 178 (1973) (statement of C.V. Wood, Jr., President, McCulloch Oil Corp.); Loomis, *How the Terrible Two-Tier Market Came to Wall Street*, *FORTUNE*, July 1973, at 82; Rolo, *The Case of the Vanishing Investor*, *N.Y. Times*, June 9, 1974, § 6 (Magazine), at 48, 52, 58; *BUSINESS WEEK*, June 2, 1973, at 58; Solomon, *Institutional Investors*, *supra* note 25, at 776-79; U.S. Treas. Dep't, *Public Policy for American Capital Markets*, BNA 1974 SEC. REG. L. REP. No. 239, at D-1, D-12-14 (prepared by James H. Lorie).

43. See note 42 *supra*.

templates the harmful effects resulting from the discretionary management authority of institutions to make securities transactions and to exercise other ownership rights.⁴⁴ Many financial writers have argued that mutual funds have fostered a form of institutionalization in which investment companies possess all the attributes of stock ownership and the individuals participating in the funds have little influence in market decisions.⁴⁵

Individuals purchasing securities through bank-sponsored investment services will exercise greater ownership rights. Except for the banks' ability to control the exact timing of purchases, the services' participants have freedom to buy and sell stock as individuals whenever they desire. The participants may request the bank to deliver their shares to them, in which case they would clearly have the normal ownership rights of voting their individual shares and of receiving annual reports and other shareholder information. If customers choose to let the bank hold their shares, the bank requests voting instructions from each customer, votes shares only upon the request of each customer, and arranges to have each customer receive appropriate shareholder information.⁴⁶

Some financial analysts have stated that because institutions tend to concentrate their purchases in a small number of stocks, a "two-tier" market has developed in which a few stocks favored by institutions sell at artificially high price-earnings ratios while all other companies experience little demand for their stocks and have great difficulty raising capital.⁴⁷ Because bank-sponsored investment services presently are concentrating on a select group of large corporations, according to this theory they may exacerbate the two-tier market.

Several recent studies of the market, however, suggest that institutional block purchases are not responsible for the two-tier market, and that this phenomenon is in any event fading.⁴⁸ Furthermore, it is possible that banks may expand the list of available securities once they realize that they probably cannot avoid suitability requirements

44. The critics of institutional participation in the stock market focus on the effects of their participation rather than on the fact that they effect block trades. See note 42 *supra*.

45. See note 42 *supra*.

46. See Lucky Stores, Inc., [Current Binder] CCH FED. SEC. L. REP. ¶ 79,903, at 84,316 (SEC 1974); Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411, at 83,183 (SEC).

47. See, e.g., Loomis, *supra* note 42; Note, *The Institutional Investor Disclosure Act: An Analysis of the Consumer Benefits*, 83 YALE L.J. 1271, 1272 (1974) [hereinafter cited as Note, *Institutional Investor Disclosure Act*].

48. See Note, *Institutional Investor Disclosure Act*, *supra* note 47, at 1272 nn.7, 9.

The Legality of Bank-Sponsored Investment Services

by offering only a limited number of stocks in their programs.⁴⁹ This development would ensure that bank-sponsored investment services do not contribute to a pattern of selective investments in a small number of securities.

Improving competition. Some arguments by brokers and investment companies against bank-sponsored investment services rest on a concern that efficient banking services may attract a portion of the investing public away from traditional investment agents or that competition between banks and brokers may cause brokers financial hardships.⁵⁰ Such arguments, however, do not comport with prevailing economic theory or traditional government economic policy. Orthodox economic theory maintains that the general welfare may best be served in a given service or mode of production by free competition that promises lower costs and increased efficiency. Special protection given to one competing group or the denial of entry into the competitive marketplace to another group leads only to a decline in innovation, an entrenchment by a limited number of economic groups capable of increasing benefits for themselves at the cost of providing new and more efficient services for the public, and a services structure that often fails to accommodate all consumers at reasonable costs.⁵¹ Even though Congress has recognized that certain regulations are necessary in the securities and banking industries to protect the public from economic abuses, Congress and the courts have acknowledged the importance of preserving competition in the securities industry.⁵²

Anticompetitive aspects of the securities field were seen in the commissions structure that, until 1975, predetermined the rates that small

49. See pp. 1500-02 *infra*.

50. Brokers and investment companies have complained in recent suits that they are losing business because of competition with bank-sponsored investment services. See *NYSE* case; *supra* note 3, at 96,658; *Investment Co.* case, *supra* note 3, at 95,865.

51. House and Senate studies of the securities markets have stressed the value of competition in promoting efficiency among firms serving the public, in lowering the costs incurred by investors, and in eliminating market distortions that prevent the development of a central market system. See SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SECURITIES INDUSTRY STUDY, S. DOC. NO. 93-13, 93d Cong., 1st Sess. 44-51 (1973) [hereinafter cited as SENATE SECURITIES INDUSTRY STUDY]; SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SECURITIES INDUSTRY STUDY, H.R. DOC. NO. 92-1519, 92d Cong., 2d Sess. 141-42 (1972) [hereinafter cited as HOUSE SECURITIES INDUSTRY STUDY].

52. See note 51 *supra*; *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 372 (1963) (emphasizes that even though banking is a highly regulated industry, competition should be allowed to operate within the framework of this regulatory scheme); *Silver v. New York Stock Exch.*, 373 U.S. 341, 359-60 (1963) (discusses the government policy via the antitrust laws of preserving competitive freedom in the securities industry). The SEC's belief that there must be competition in the securities field is reflected in its desire to end fixed commission rates. See note 55 *infra*.

investors paid.⁵³ Some studies have blamed this lack of competition for the complacency that brokerage houses have shown in recent years, evidenced by an unwillingness to allow commission rates to drop to a level at which small investors are able to invest and by a failure to develop innovative programs capable of preventing a rush of investors away from the market during periods of general market stagnation.⁵⁴ The SEC initiated the termination of fixed commission rates, and on May 1, the national securities exchanges adopted a system of negotiated commission rates.⁵⁵ Many brokerage houses, tacitly acknowledging that they have been at least partly responsible for their own present depressed condition, have begun some programs designed to reintroduce investor-oriented service into the brokerage industry.⁵⁶ Most brokers, however, have continued to argue against any changes that might heighten competition by allowing financial institutions to vie for the investor's dollar.⁵⁷

The bank's ability to compete with brokers by offering low-cost bank-sponsored investment services derives in part from the advantages that accrue to diversified institutions. The banks can, for example, often count on customers who are satisfied with existing services to provide patronage for new services; they can also realize the economic gains that derive from a large-scale integration of many ac-

53. Brokerage rates on orders between \$3,000 and \$300,000 were determined by fixed commission rates. Securities Exchange Act Release No. 11019, [Current Binder] CCH FED. SEC. L. REP. ¶ 79,964 (1974) [hereinafter cited as Release No. 11019]. The history of fixed commission rates is reviewed in Securities Exchange Act Release No. 11093, [Current Binder] CCH FED. SEC. L. REP. ¶ 80,007 (1974) [hereinafter cited as Release No. 11093]. In 1 SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 64, 92d Cong., 1st Sess. xxii (1971) [hereinafter cited as IIS REPORT], it was concluded that fixed commissions fostered anticompetitive practices and impeded the development of a central market system.

54. See SENATE SECURITIES INDUSTRY STUDY, *supra* note 51, at 44-51; HOUSE SECURITIES INDUSTRY STUDY, *supra* note 51, at 141-42.

55. On September 19, 1974, the SEC sent a letter to the presidents of the national registered securities exchanges proposing that they eliminate all fixed commission rates by May 1, 1975. Release No. 11019, *supra* note 53. On October 24, 1974, the SEC proposed Rule 19b-3 under the Securities Exchange Act of 1934 to prohibit national securities exchanges from requiring members to charge fixed commission rates, and Rule 10b-22 to make it unlawful for brokers to participate in arrangements that contemplate fixed commission rates. Securities Exchange Act Release No. 11073, [Current Binder] CCH FED. SEC. L. REP. ¶ 79,991 (1974). Negotiated rates began on May 1, 1975. Cole, *Era of Negotiated Rates Presages Uncertainty*, N.Y. Times, May 1, 1975, at 59, col. 6. Because bank-sponsored investment services will compete with brokers for customers and will do so partly by offering more attractive commission rates, they foster the SEC's goal of competition for the investor's dollar.

56. The development of plans offering discounts to small investors is evidence of this. See p. 1481 *supra*.

57. Brokers' organizations were especially active in raising opposition to the SEC's proposal to establish competitive commission rates. See, e.g., BNA 1974 SEC. REG. L. REP. No. 282, at AA-3-4; *id.* No. 281, at AA-1-2; *id.* No. 279, at AA-2-3; *id.* No. 274, at A-2.

The Legality of Bank-Sponsored Investment Services

tivities under one roof.⁵⁸ The SEC's *Institutional Investor Study Report*⁵⁹ identified the trend toward diversification and combination in many types of formerly distinct financial enterprises.⁶⁰ It concluded that this trend, representing a progressive movement based on economies of scale and promising lower costs to investors, should be restricted "only on the basis of demonstrated regulatory necessity."⁶¹

Banks have capitalized on these factors by offering low-cost investment services that should be able to compete successfully with brokers and investment companies for small investors' business. This increase of competition in the securities markets is likely to aid in developing a central market system and in promoting a services structure that can better serve the public.

III. The Legality of Bank-Sponsored Investment Services

A. *The Standards for Legal Analysis*

Within the framework of providing protection for investors and limiting bank activities to the areas permitted by Congress, regulatory bodies should embrace a policy of encouraging low-cost, efficient investment services through competition in the marketplace. If bank-sponsored investment services violate one or more goals of public policy—especially the adequate protection of banks as envisaged by the Glass-Steagall Act or the protection of securities investors as set down by the federal securities laws—the services should be restricted. Otherwise, in determining their legality, the courts and the SEC should be guided by the beneficial effects on small investors and the nation's market system that bank-sponsored investment services seem to promise.

B. *The Glass-Steagall Act*

The Banking Act of 1933,⁶² popularly known as the Glass-Steagall Act, was a response to the bank failures of the Depression. Section 16

58. 8 IIS REPORT, *supra* note 53, at xvii-xviii. Besides offering a greater number of services, banks have responded to their customers' needs by establishing branches in suburbs and by providing 24-hour automated service. See U.S. NEWS & WORLD REP., Mar. 29, 1971, at 78; *Machines Provide 24-Hour Bank Service*, *id.* Jan. 29, 1973, at 74.

59. 8 IIS REPORT, *supra* note 53.

60. Institutions studied by the Commission included investment advisory complexes, bank trust departments, insurance companies, offshore funds, and pension benefit plans. *Id.* at 13-74.

61. *Id.* at xviii.

62. Banking Act of 1933, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.)

authorized national banks to deal in investment securities only upon the order and for the account of customers, restricted the underwriting of securities by national banks, and limited the purchases of investment securities for a national bank's own account.⁶³ Section 21, with certain limited exceptions, prohibited any persons or organizations involved in the business of issuing, underwriting, selling, or distributing securities from engaging in the commercial banking business.⁶⁴ Section 308(a) of the Banking Act of 1935⁶⁵ amended § 16 to make clear that a national bank's ability to engage in agency dealings extended to all securities, including stocks, and that the prohibition on purchasing investment securities referred to purchases for a bank's own account.⁶⁶ Section 303(a) amended § 21(a) of the 1933 Act to emphasize that § 21(a) did not prohibit banks from engaging in securities activities to the extent permitted by § 16.⁶⁷

Nothing in the Glass-Steagall Act itself indicates that bank-sponsored investment services are illegal. Section 16 states that national banks can deal in securities to the extent of purchasing and selling them upon the order and for the account of their customers. Except for bank advisory services to investment companies, which involve advisory activities that are not discussed by the statute, bank-sponsored investment services are based on purchases and sales of securities by banks for their customers. The statute, therefore, would appear to grant unlimited authority to banks to act as agents in purchasing and selling securities.

In order to make an informed decision about the legality of bank-sponsored investment services, however, it is also important to examine the circumstances that surrounded enactment of the 1933 Banking Act. Although Congress, in considering the bills eventually consolidated to become the Glass-Steagall Act, did not devote specific attention to customer purchases by banks,⁶⁸ the House and Senate reports that ac-

63. Banking Act of 1933 § 16, 48 Stat. 184, *as amended*, 12 U.S.C. § 24 (1970). Section 5(c) of the 1933 Act, 12 U.S.C. § 335 (1970), extends the provisions of § 16 to state members of the Federal Reserve System.

64. Banking Act of 1933 § 21(a)(1), 48 Stat. 189, *as amended*, 12 U.S.C. § 378 (1970).

65. Banking Act of 1935, 49 Stat. 684 (codified in scattered sections of 12 U.S.C.)

66. Banking Act of 1935 § 308(a), 12 U.S.C. § 24 (1970). The purpose of the amendment was to make clear that national banks and other member banks could purchase and sell stock for the accounts of their customers but not for their own accounts. H.R. REP. NO. 742, 74th Cong., 1st Sess. 18 (1935) [hereinafter cited as H.R. REP. NO. 742].

67. Banking Act of 1935 § 303(a), 12 U.S.C. § 378 (1970). See H.R. REP. NO. 742, *supra* note 66, at 16, which refers to the purpose of the amendment.

68. S. REP. NO. 77, 73d Cong., 1st Sess. (1933) [hereinafter cited as S. REP. NO. 77]; H.R. REP. NO. 150, 73d Cong., 1st Sess. (1933) [hereinafter cited as H.R. REP. NO. 150]. *Hearings on S. 4115 Before the Senate Comm. on Banking and Currency*, 72d Cong., 1st Sess. (1932) [hereinafter cited as *1932 Senate Hearings*]; *Hearings on H.R. 10241 and 11362*

The Legality of Bank-Sponsored Investment Services

accompanied those bills described the purpose of § 16 as allowing national banks to purchase and sell securities for their customers to the same extent as "heretofore."⁶⁹

In the years before the Glass-Steagall Act, courts often allowed banks to purchase stocks for their customers,⁷⁰ and by 1930 the practice was sufficiently standardized for the New York Court of Appeals to give it judicial notice.⁷¹ Many features of present-day bank-sponsored investment services existed in these pre-1933 purchases. Banks made direct charges against their customers' accounts in purchasing stock for them rather than requiring them to make special deposits for the stock,⁷² charged service fees for these transactions,⁷³ and did not require a customer relationship independent of the agreement to purchase stock.⁷⁴

The existence of these earlier practices is a persuasive indication that the modern services are legal. But it cannot be conclusive; some aspects of bank-sponsored investment services did not exist before 1934. No evidence indicates that banks compiled lists of securities for customers, made large-scale purchases for many customers at once, or advertised as extensively as they now do.⁷⁵ The issue of the legality of

Before the Subcomm. of the House Comm. on Banking and Currency, 72d Cong., 1st Sess. (1932) [hereinafter cited as 1932 House Hearings]; Hearings Pursuant to S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency, 71st Cong., 3d Sess., pt. 7 (1931) [hereinafter cited as 1931 Senate Hearings].

69. S. REP. NO. 77, *supra* note 68, at 16; H.R. REP. NO. 150, *supra* note 68, at 3.

70. *See, e.g.,* Blakey v. Brinson, 286 U.S. 254 (1932) (allowed a bank to purchase bonds for a customer); Mark v. Westlin, 48 F.2d 609 (D. Minn. 1931) (involved a purchase of bonds for a bank customer); Dyer v. Broadway Cent. Bank, 252 N.Y. 430, 433, 169 N.E. 635, 636 (1930) (recognized as a matter of common knowledge that many banks purchase stock for customers).

71. Block v. Pennsylvania Exch. Bank, 253 N.Y. 227, 232, 170 N.E. 900, 901-02 (1930) (per Cardozo, J.).

72. *See, e.g.,* Blakey v. Brinson, 286 U.S. 254, 259 (1932); McNair v. Davis, 68 F.2d 935, 936 (5th Cir. 1934).

73. *See, e.g.,* Blakey v. Brinson, 286 U.S. 254, 259 (1932); Davis v. McNair, 48 F.2d 494, 495 (5th Cir. 1931).

74. *See, e.g.,* Greenfield v. Clarence Sav. Bank, 5 S.W.2d 708 (Mo. Ct. App. 1928) (customer, not a regular bank depositor, left \$2,000 with the bank for the sole purpose of purchasing bonds through the bank).

75. Similarly, the ambiguity surrounding the force of the Comptroller of the Currency's early opinions on § 16 leaves some question as to the proper interpretation of the section. In the years between 1934 and 1936 the Comptroller issued opinions stating that banks could not make profits on stock purchases for customers, and that banks could purchase stocks only for existing bank customers where relationship with the bank existed independently of the particular transaction in which the bank purchased stock for them. *See* 20 FED. RES. BULL. 609 (1934); *Hearings on H.R. 5357 Before the House Comm. on Banking and Currency, 74th Cong., 1st Sess. 663 (1935)*; 1 BULL. OF THE COMPTROLLER OF THE CURRENCY No. 2, at 2-3 (1936), *cited in* Memorandum of the New York Stock Exchange in Support of Request for a Ruling that Operation of Automatic Investment Service by a National Bank is Unlawful, Mar. 22, 1974, at 15-16. These opinions, which probably were based on the Comptroller's Depression-created fear of allowing any banking practices that might draw criticism from people who had seen the speculative banking abuses of the 1920's, are entitled to some weight as contemporaneous interpretations of the Glass-

bank-sponsored investment services can thus best be approached by considering whether the services violate other concerns of the Glass-Steagall Act or jeopardize the goal of adequate protection for investors.

C. *The Creation of Securities*

In an era of new and expanded meanings for the term "security,"⁷⁶ it is possible that automatic investment services involve banks in the creation and distribution of securities—practices prohibited under §§ 16 and 21 of the Glass-Steagall Act. In their current suit against the Comptroller of the Currency, the New York Stock Exchange and the Investment Company Institute have presented this argument.⁷⁷ They contend that, under AIS, monthly deductions from customers' checking accounts are pooled in commingled accounts during the acquisition interval before the actual purchase of the stock. Each customer has an undetermined interest in pooled purchase funds and an interest in an undetermined number of shares to be purchased which constitutes a security, "separate and distinct from the stock which the bank will ultimately purchase under the Plan."⁷⁸ They also maintain that fractional shares, which result from the purchase of whole shares for a large number of customers and the receipt by individual customers of fractional share interests, are likewise securities.⁷⁹ This creation of new securities "in the form of interests in commingled accounts and fractional shares," they conclude, involves the bank in selling, issuing, and distributing securities in violation of §§ 16 and 21.⁸⁰

Steagall Act by an administrative agency. See *Corn Prod. Ref. Co. v. Commissioners*, 350 U.S. 46, 53 (1955); *National Lead Co. v. United States*, 252 U.S. 140, 145-46 (1920).

But two considerations diminish the force of the Comptroller's early rulings as a restriction on bank-sponsored investment services, and create more ambiguity about how § 16 should be interpreted. First, the Comptroller of the Currency no longer adheres to these early opinions. From 1957, the Comptroller has maintained that banks may collect a service charge on stock purchases. See *Bank Automatic Inv. Serv.*, [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,817, at 84,209-10 (Comp. Curr. 1974). Also, recent rulings by the Comptroller have allowed profit oriented stock purchase plans for customers that contained no distinction between new and preexisting customers. See *id.* at 84,205-17; *Investment Data Corp.*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411 (SEC); *Security Pac. Nat'l Bank*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,412 (SEC). Second, these early opinions conflict with Congress's purpose of allowing bank purchases for customers to the extent carried on "heretofore," since in the years before 1934 banks made profits on these purchases and the service was not limited to preexisting customers who showed interest in things other than the service itself.

76. See Clorman, *Condominiums as Securities: A Current Look*, 19 N.Y.L.F. 457 (1974); Note, *Securities—Scotch Whiskey Warehouse Receipts—Held to be Securities under the Securities Act of 1973*, 25 MERCER L. REV. 733 (1974); 39 MO. L. REV. 283 (1974); 26 VAND. L. REV. 874 (1973).

77. See NYSE case, *supra* note 3, at 96,656-57.

78. *Id.* at 96,656.

79. *Id.* at 96,656-57.

80. *Id.* at 96,657.

The Legality of Bank-Sponsored Investment Services

The definition of a security that the courts have thus far formulated, though still an inchoate, imperfectly articulated concept,⁸¹ casts doubt upon these theories. *SEC v. W.J. Howey Co.*,⁸² found that an investment contract—*Howey's* definition of which other courts have used as their definition of a security⁸³—is “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”⁸⁴ The requirement of investment “in a common enterprise” is crucial. Equating common enterprise with the notion of a joint venture, the courts hold that there must be an actual pooling of investor funds; if an investment manager, broker, or agent receives funds from a number of people but does not pool them, there is no common enterprise among the various investors.⁸⁵ Thus, in *Investment Company Institute v. Camp*,⁸⁶ a leading recent case on the limits of bank investment services, the Supreme Court found a common enterprise because each customer bought a “unit of participation” which represented an interest in a collective group of assets.⁸⁷ In *Milnarik v. M-S Commodities, Inc.*,⁸⁸ on the other hand, the court of appeals did not detect a common enterprise in a plan in which various investors, represented by a common agent who had discretion to invest their funds, were not joint participants in the same investment enterprise.⁸⁹

The Supreme Court has established an important principle for applying the *Howey* test: “[I]n searching for the meaning and scope of the word ‘security’ . . . form should be disregarded for substance and the emphasis should be on economic reality.”⁹⁰ It seems clear under this principle that AIS does not involve an undetermined interest in pooled purchase funds or an interest in an undetermined number of shares to be purchased that meets *Howey's* common enterprise cri-

81. See *Student Symposium—Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations*, 6 ST. MARY'S L.J. 95, 96 (1974).

82. 328 U.S. 293 (1946).

83. See, e.g., *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276 (7th Cir.), cert. denied, 409 U.S. 887 (1972); *Investment Co. Institute v. Camp*, 274 F. Supp. 624, 642 (D.D.C. 1967), rev'd on other grounds, 420 F.2d 83 (D.C. Cir. 1969), rev'd on other grounds, 401 U.S. 617 (1971); *Polikoff v. Levy*, 55 Ill. App. 2d 229, 204 N.E.2d 807, 809 (1965).

84. 328 U.S. 293, 298-99 (1946).

85. See *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 277 (7th Cir.), cert. denied, 409 U.S. 887 (1972); *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066, 1067-69 (M.D. Pa. 1972), aff'd, 491 F.2d 752 (3d Cir. 1973); *Stuckey v. duPont Glove Forgan, Inc.*, 59 F.R.D. 129, 131 (N.D. Cal. 1973).

86. 401 U.S. 617 (1971).

87. See *Bank Automatic Inv. Serv.*, [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,817, at 84,212 (Comp. Curr. 1974).

88. 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972).

89. *Id.* at 276-77.

90. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

terion. The common enterprise in *Camp* involved an undetermined interest in pooled funds that lasted from the time of investment to sale of the interest, when the participant would finally sever his interest from the common pool.⁹¹ In AIS, however, except for a short acquisition interval, each customer has an individual, separate ownership of a definite amount of stock; his resources are not pooled with those of his fellow investors.⁹² While the acquisition interval does involve a brief combination of investors' funds and an uncertainty over the exact number of shares which each customer will receive when the purchase is consummated, this does not entail the type of "substance" or "economic reality" that the *Howey* test envisions. The acquisition interval is a bookkeeping device designed to give customers lower brokerage rates through large-scale purchases.⁹³ It does not represent a common enterprise that depends on the permanent pooling of funds for investment success.

Fractional shares do in a sense resemble the customer's interests in pooled funds present in *Camp*,⁹⁴ and perhaps under a technical conceptual approach such fractional interests would be deemed securities. But to strike down investment services simply on the basis of a minor bookkeeping convenience⁹⁵ that is hardly the heart of the plan, would be to exalt form over "substance" and "economic reality." The essence of the plan remains the purchase of whole shares for individual accounts. Moreover, little investor protection would be gained if the services are struck down on this rather technical ground,⁹⁶ since henceforth AIS plans could still be offered with only a superficial change—the bank would have to reimburse to customers any sums insufficient to buy whole shares for individual accounts. The investor would thus

91. See 401 U.S. 617, 622-25 (1971).

92. See Release No. 5491, *supra* note 2, at 84,073; Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411, at 83,183-84 (SEC).

93. See Bank Automatic Inv. Serv., [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,817, at 84,212 (Comp. Curr. 1974).

94. In *Camp*, a customer's investment was added to a fund comprised of other investments, and the customer received a certificate that expressed his proportionate interest in the fund's assets. See 401 U.S. 617, 622-23 (1970). His unit of participation, which did not entail the type of individual ownership of stock found in AIS but rather comprised an interest in a joint enterprise that resembled a mutual fund, was the essence of the collective investment fund. See *id.*

95. See Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411, at 83,183 (SEC).

96. As a policy matter, the only sound reason for finding that an enterprise creates a security is to provide investor protection by subjecting the enterprise to the federal securities laws. If banking regulations already provide the customers of bank-sponsored investment services with adequate investor protection—as this Note argues they do—the public policy rationale for finding the creation of a security is undercut.

The Legality of Bank-Sponsored Investment Services

lose the convenience of fractional shares but gain little in substantive protection.⁹⁷

D. *Conflicts of Interest*

In *Investment Company Institute v. Camp*,⁹⁸ the Court found that a bank-operated pooled investment fund violated the Glass-Steagall Act because such a fund gave rise to several potential conflicts of interest for commercial banks—abuses which Congress had intended to prohibit.⁹⁹ Critics of bank-sponsored investment services have argued that these abuses, found in banking practices of the 1920's and in the collective investment fund in *Camp*, are also found in present bank-sponsored investment services, making them illegal under the Glass-Steagall Act.¹⁰⁰

Several considerations provide a framework for studying this issue. First, a variety of conflicts of interest can be found in banks, financial institutions, and any other institutions that are responsible for servicing more than one customer or that perform at least two functions at the same time. Since conflicts of interest can be conjured up in all aspects of human endeavor, the mere invocation of the unfavorable connotations that attach to this phrase should not constitute a sufficient reason for prohibiting the activity that creates the conflict.

Second, contrived theories that seek to show how a bank or other institution might, under a highly unlikely set of circumstances, engage in illegal or otherwise undesirable activities because of a certain conflict of interest have generally not been accepted by the courts as adequate reasons for imposing liability or prohibiting the underlying activity. The emphasis, instead, has been on situations where abuses actually exist or are almost certain.¹⁰¹

97. The analysis used for AIS can also show that other bank-sponsored investment services do not create securities. DRP, like AIS, pools customer's funds only during the acquisition interval; each customer receives an individual ownership interest in the corporation. Similarly, IPMS involves individual ownership of shares of stock. Since the operation of VIP in this respect is identical to AIS, it does not appear that VIP creates new securities. For investment advisory activities, the issue of the creation of a security is somewhat different, involving the question of whether the relationship between a bank adviser and an investment company is so close that the bank is in effect issuing and distributing the investment company's securities in violation of §§ 16 and 21. See *Investment Co.* case, *supra* note 3, at 95,864. The Court's principle of looking at the substance of the relationship suggests that unless the bank clearly controls the investment company, the two institutions should not be viewed as one unit for purposes of determining whether the bank, rather than the investment company, is really issuing the securities.

98. 401 U.S. 617 (1971).

99. See *id.* at 630-38.

100. See *NYSE* case, *supra* note 3, at 96,655-56.

101. See, e.g., *Phelan v. Middle States Oil Corp.*, 220 F.2d 593, 603 (2d Cir. 1954); *Dabney v. Chase Nat'l Bank*, 196 F.2d 668, 675 (2d Cir. 1952); *York v. Guaranty Trust Co.*, 143 F.2d 503, 514 (2d Cir. 1944).

A third factor to be considered is that the public welfare is not always best served by prohibiting an activity, even if the conflict of interest that it creates is relatively serious. The marginal gains achieved by prohibiting a conflict of interest often are less than the costs to society of losing a valuable service.¹⁰² Congress and regulatory agencies have recognized that it is sometimes better to allow a valuable service riddled with conflicts to exist and to impose preventive rules on it than to prohibit it and run the risk of losing the service's benefits.¹⁰³

Given this method of approaching conflicts of interest, it is suggested that bank-sponsored investment services should not be found illegal under *Camp's* interpretation of the Glass-Steagall Act unless they both involve existing or likely abuses that outweigh their advantageous effects on small investors and the capital market and are not currently subject to regulation.

One of the conflicts of interest found in *Camp* consisted in the unsound loans that 1920's banks often made to corporations in which the bank's affiliates had invested.¹⁰⁴ By analogy, a bank with a promotional interest in an investment program might make unsound loans to corporations in which its customers had invested in order to attract new customers to stocks that were growing in value because of unlimited loans from the bank. However, banks in the 1970's do not have the same promotional interest in making unsound loans as did the 1920's banks. The latter had affiliates with investments in speculative stocks, and could benefit financially if these companies grew through access to investment funds. Through its affiliate, the bank could make underwriting commissions and profits from high market prices sustained by corporate loans.¹⁰⁵ In bank-sponsored investment services, though, it is not reasonable for banks to risk discovery of, and punishment for, such unsound corporate loans by the Federal Re-

102. See Manning, *The Purity Potlatch: An Essay on Conflicts of Interests, American Government, and Moral Escalation*, 24 *FED. B.J.* 239, 248 (1964).

103. In 1936, for example, the SEC acknowledged that "the combination of the broker and dealer functions in the same individual or firm involves a conflict of interest which is provocative of abuse of the fiduciary relationship inherent in the brokerage function." SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER 109 (1936). Yet the SEC realized that broker-dealers performed valuable functions. *Id.* at 24-25, 41-42, 98-108. It therefore recommended regulation, not prohibition, *id.* at 109-14, and today the conflicts of interest created by the dual role of broker-dealers have been handled by imposing suitability and anti-churning rules. Securities Exchange Act of 1934, Rule 15b10-3, 17 C.F.R. § 240.15b10-3; Rule 15c1-7, 17 C.F.R. § 240.15c1-7 (1974).

104. See 401 U.S. 617, 631 (1971).

105. See 1931 *Senate Hearings*, *supra* note 68, at 1063-66; 75 *CONG. REC.* 9912 (1932) (remarks of Sen. Bulkley).

The Legality of Bank-Sponsored Investment Services

serve Board.¹⁰⁶ The bank would be making the apparently irrational decision to make an unsound loan, which it might never recover, solely for the comparatively insignificant increment in commission charges from new investment services customers. Congress, moreover, had much data before it in passing the 1933 legislation showing that banks actually did make large, unsound loans to their affiliates.¹⁰⁷ A recent study by the SEC, however, concluded that no significant relationship existed between loans by a bank's commercial department and holdings by its trust department,¹⁰⁸ and it is the trust department which is responsible for bank-sponsored investment services.

Camp found that Congress had perceived as a second conflict of interest "that when commercial banks were subject to the promotional demands of investment banking, they might be tempted to make loans to customers with the expectation that the loan would facilitate the purchase of stocks and securities."¹⁰⁹ There is the possibility that despite the existence of margin requirements intended to prevent unsound loans,¹¹⁰ of bank agencies that examine bank records for evidence of speculative loans,¹¹¹ and of punishment imposed on banks by the Federal Reserve Board for making these loans,¹¹² banks may make unsound loans to individuals in order to induce them to participate in bank-sponsored investment services. But, as in the case of unsound loans to corporations, a bank would probably not be inclined to make a loan to a customer simply to enable the customer to participate in the service, knowing all along that the money would be invested in a failing company or that the customer's financial condition was such that he could never repay the loan. The bank would not risk its own funds solely to gain a small commission from increased participation in its services.

As a third conflict of interest that concerned Congress, *Camp* cited "the plain conflict between the promotional interest of the investment banker and the obligation of the commercial banker to render disin-

106. 12 U.S.C. § 301 (1970) allows the Federal Reserve Board to suspend a member bank that is making speculative use of its credit from the credit facilities of the Federal Reserve System. Federal reserve banks are instructed to examine the lending patterns of member banks, and to report speculative lending practices to the Federal Reserve Board.

107. Congress recognized that the failure of the Bank of the United States was due to unsound loans to its affiliates. *1931 Senate Hearings, supra* note 68, at 1017. Other banks made huge loans to their affiliates, *id.* at 1018, 1065, and evidence existed that at least one large New York bank had relieved its affiliate of excess holdings by purchasing securities from it, *id.* at 1064.

108. 8 IIS REPORT, *supra* note 53, at 38.

109. 401 U.S. 617, 632 (1971).

110. See 12 C.F.R. § 221 (1974).

111. See note 106 *supra*.

112. *Id.*

terested investment advice."¹¹³ By trying to add new customers to its investment programs, banks may engage in biased investment advice because they would get commissions that increased with the total purchase of stock.¹¹⁴ However, this "bias" exists whenever one attempts to sell services to another person, and all sellers can be expected to give overly optimistic accounts of their products. The benefit of the services would appear to outweigh whatever harm may result from the banks' attempt to promote their services. Only if it were shown that a bank's interest in promoting its services went substantially beyond its interest in increased commissions—as, for example, where the bank was advising investments in a failing company that it had previously lent money to—would a serious abuse be presented.¹¹⁵

113. 401 U.S. 617, 633 (1971).

114. Any temptation to abuse inherent in bank-sponsored investment services is dramatically less than the temptation possible in *Camp*. Under AIS, VIP, and DRP, the bank stands to gain only through its one-time commission charge, levied at the time of purchase. In *Camp*, the bank operating and advising a collective investment fund received for its services, each year, one-eighth of one percent of the average of the net asset value of the fund. *Investment Co. Institute v. Camp*, 274 F. Supp. 624, 631 (D.D.C. 1967). The fund's value, in turn, was determined by the value of the stocks in which it had invested. *See id.* at 627-31. Thus, the bank had a strong interest in ensuring that these stocks increased in value, an interest far more likely to induce a bank to make unsound loans to corporations or to give biased investment advice, than is an interest only in a purchase commission.

115. Three other conflicts of interest, not discussed in *Camp*, deserve analysis. One potential abuse is that the bank offering AIS will take advantage of the acquisition interval or "float"—the time between the withdrawal of funds from the participants' accounts and the purchase of securities with these funds—by prolonging the acquisition interval so it can use the uninvested cash for its own purposes. *See Investment Data Corp.*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411, at 83,183 (SEC). The Comptroller's Regulation 9 provides that funds held by a bank awaiting investment "shall not be held uninvested or undistributed any longer than is reasonable for the proper management of the account." 12 C.F.R. § 9.10(b) (1974). Moreover, examiners look for violations of this requirement. *See 4 CCH FED. BANKING L. REP.* ¶ 59,302, at 37,149-50 (1969). Another of the Comptroller's rules prohibits banks from using these funds in a self-dealing manner. 12 C.F.R. § 9.12 (1974).

A second potential conflict of interest lies in the bank's role in handling multiple clients. Conflict is possible in situations in which, for example, the bank advises its large trust accounts to sell a particular stock, but also advises its IPMS customers to buy it. Each purchase or sale for one account would increase or decrease the price at which the transaction would take place for the other accounts. This conflict, however, exists for all investment advisers, who give different advice to different customers based upon their individual needs, and could probably be eliminated only by prohibiting advisers from working for more than one customer—an obviously impractical solution.

A third conflict involves misuse of inside information. A bank can, theoretically, use inside information on the stock market acquired from its commercial banking department to provide its investment customers with valuable advice. This problem is not unique to banks offering the services since brokerage firms that also underwrite have access to inside information. *See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974). The solution in these contexts has been regulation, not prohibition of the underlying activity, through application of Rule 10b-5, 17 C.F.R. § 240.15b10-5 (1974), which forbids "a person having access to material nonpublic corporate information to trade upon or transmit such information under circumstances where it is foreseeable that it will or might be traded upon and a purchase or sale is in fact executed." *SEC v. Lum's, Inc.*, 365 F. Supp. 1046, 1057 (S.D.N.Y. 1933). This rule applies to banks. *See Carroll v. First Nat'l Bank*, 413 F.2d 353, 358 (7th Cir. 1969), *cert. denied*,

The Legality of Bank-Sponsored Investment Services

E. Comparable Regulation

The banks' exemptions from certain provisions of the federal securities laws¹¹⁶ have led to the argument that banks do not provide investors who participate in bank-sponsored investment services with protection comparable to that provided by brokers under the federal securities laws.¹¹⁷ If correct, this contention suggests that the services should be subject to complete SEC jurisdiction. But if it can be shown that a bank regulatory structure paralleling important features of the federal securities laws exists and is enforced by banking agencies that are especially adept at handling banking problems, and that wherever shortcomings in banking rules or enforcement exist, banking agencies are capable of correcting them,¹¹⁸ SEC regulation would be unnecessary.¹¹⁹

Examination of books and records. Pursuant to its power to examine the records of brokers,¹²⁰ the SEC requires brokers to make records of all securities transactions,¹²¹ to preserve these records for at least six years,¹²² and to make quarterly security counts of all securities held or in transfer.¹²³ There are also provisions for annual reports

396 U.S. 1003 (1970). Another regulatory solution has been the establishment of a "Chinese Wall" to prevent the interchange of material confidential information between the commercial banking and trust departments. See Herman & Safanda, *The Commercial Bank Trust Department and the 'Wall,'* 14 B.C. IND. & COM. L. REV. 21 (1972).

Though the effective enforcement of these rules undoubtedly poses many problems, the alternative approach—the complete divorce of trust departments from commercial banking—would also entail administrative difficulties, and, more importantly, might deprive the public of the beneficial functions performed by trust departments, since these departments might not be able to survive as separate entities. See Lybecker, *Regulation of Trust Department Investment Activities*, 82 YALE L.J. 977, 1001-02 (1973).

116. With respect to the issue of bank-sponsored investment services, the principal exemptions are the banks' exclusions from the definition of the terms "broker" and "dealer," Securities Exchange Act of 1934 §§ 3(a)(4), 3(a)(5), 15 U.S.C. §§ 78c(a)(4), 78c(a)(5) (1970), and from the definition of the term "investment adviser," Investment Advisers Act of 1940, § 202(a)(11)(A), 15 U.S.C. § 80b-2(a)(11)(A) (1970). The exclusions exempt banks from provisions of the securities laws governing the conduct of brokers, dealers, and investment advisers.

117. See NYSE case, *supra* note 3, at 96,657-58.

118. Lybecker has suggested that banking agencies themselves are capable of correcting problems in the regulation of bank trust department investment activities, and that new legislation is unnecessary. See Lybecker, *supra* note 115, at 977-97, 1001-02.

119. The force of this comparison of regulatory schemes must, initially, be tempered by two caveats: first, although the federal securities laws are used as a standard against which to compare banking regulations, the securities laws themselves are not perfect and are not always properly enforced. The SEC's regulation of the New York Stock Exchange, for example, has been subject to criticism. See Note, *Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange*, 80 YALE L.J. 811 (1971). Second, the SEC itself has recognized that regulation need not be duplicated simply to achieve symmetry. See BNA 1974 SEC. REG. L. REP. No. 268, at A-7. Thus, the goal is not to ensure that brokers and banks are subject to identical rules but to guarantee that investors receive comparable protection from both regulatory systems.

120. Securities Exchange Act of 1934, § 17(a), 15 U.S.C. § 78q(a) (1970).

121. Securities Exchange Act of 1934, Rule 17a-3, 17 C.F.R. § 240.17a-3 (1974).

122. Securities Exchange Act of 1934, Rule 17a-4, 17 C.F.R. § 240.17a-4 (1974).

123. Securities Exchange Act of 1934, Rule 17a-13, 17 C.F.R. § 240.17a-13 (1974).

of the financial condition of brokerage firms.¹²⁴ The reports include information about money borrowed by the brokerage firm, its investments, and customers' security accounts.¹²⁵ These regulations ensure that all customers' securities are accounted for, that the brokerage firm is in sound financial condition, and that the SEC has advance warning of potential problems. The SEC has enforced these rules by suspending brokers or revoking their registrations for failure to file timely and accurate reports or for filing misleading information.¹²⁶

Under the Banking Act, the Comptroller of the Currency is required to make at least two examinations every three years of "all the affairs" of national banks, and may make more frequent examinations if necessary.¹²⁷ In the sense that these examinations have the primary goal of ensuring that the bank is in sound financial condition,¹²⁸ they resemble the reports of financial condition that brokerage firms make to the SEC. A large team of bank examiners makes a thorough, unannounced inspection of the bank's loans and collateral.¹²⁹ If the examiners find evidence of too many bad loans, the Comptroller may require the bank to make weekly reports to it, the Comptroller's examiners may be permanently stationed at the bank to supervise its day-to-day activities, or the Comptroller may require the more serious remedies of additional capital or a change in bank management.¹³⁰

Banks, like brokers, are required to file annual reports of financial condition detailing their assets and liabilities.¹³¹ These reports are then published in newspapers for public inspection.¹³² Failure to make a report is punishable by a fine of \$100 for each day that the bank delays making the report.¹³³

A separate set of regulations promulgated by the Comptroller is designed to protect customers' funds and securities held in bank trust departments, which are responsible for the administration of bank-sponsored investment services. The rules require a bank to keep its records of these accounts separate from other records of the bank,¹³⁴ to invest funds within a reasonable period of time,¹³⁵ to use funds awaiting investment in its commercial department only if adequate

124. Securities Exchange Act of 1934, Rule 17a-5, 17 C.F.R. § 240.17a-5 (1974).

125. See 3 CCH FED. SEC. L. REP. ¶ 33,921-38, at 22,801-14 (SEC 1974).

126. See 2 CCH FED. SEC. L. REP. ¶ 26,171, at 19,233-50 (1973).

127. 12 U.S.C. § 481 (1970).

128. See M. MAYER, THE BANKERS 375 (1974); Lybecker, *supra* note 115, at 978.

129. M. MAYER, *supra* note 128, at 368.

130. *Id.* at 369.

131. 12 U.S.C. §§ 161(a), 1827(a) (1970).

132. 12 U.S.C. § 161(a) (1970).

133. 12 U.S.C. § 164 (1970).

134. 12 C.F.R. § 9.8 (1974).

135. 12 C.F.R. § 9.10(a) (1974).

The Legality of Bank-Sponsored Investment Services

collateral is set aside;¹³⁶ to keep the investments of each account separate from the bank's assets;¹³⁷ and to file an annual report with the Comptroller of the Currency listing the securities held by each account.¹³⁸ Like the regulations governing brokers, they are intended to guarantee that each customer's securities are accounted for and properly handled. The Comptroller may proceed in a variety of ways against banks that violate these requirements.¹³⁹

Only a detailed statistical study could answer the question of whether the examination and reporting requirements of one agency protect investors better than those of the other agency. It is clear that both banking and securities agencies have a similar regulatory and enforcement structure which envisions inspections that are similar in frequency, scope, and goals. One shortcoming of the banking system is that enforcement proceedings are not as well publicized as those of the SEC, which announces disciplinary actions relating even to minor infractions such as failure to file reports on time. This inadequacy, however, could easily be corrected. The Comptroller only would need to decide to publicize more widely his enforcement proceedings. Likewise, even critics of the responses of bank regulators to other bank trust department investment practices have recognized that bank examiners have the ability to formulate solutions to such problems, and that legislation subjecting trust departments to examination by other regulatory agencies is unneeded.¹⁴⁰

Protection against insolvency. Should insolvency occur, investors receive comparable protection whether they engage brokers or banks. Pursuant to the Securities Investor Protection Act, a customer's cash held by brokers is insured to \$20,000, and his securities are insured to \$50,000.¹⁴¹ The Federal Deposit Insurance Corporation insures bank deposits to \$40,000.¹⁴² Temporarily held funds that have been deducted from a customer's account for use under any of the services constitute deposits, and are covered by FDIC.¹⁴³ Although FDIC does not insure

136. 12 C.F.R. § 9.10(b) (1974).

137. 12 C.F.R. § 9.13(a) (1974).

138. 12 C.F.R. § 9.102 (1974).

139. The Banking Act empowers the Comptroller to initiate proceedings for cease-and-desist orders, for termination of status as an insured bank, and for the removal of officers, against banks that it believes are violating banking regulations or engaging in unsound practices. 12 U.S.C. § 1818 (1970). These enforcement proceedings resemble those used by the SEC.

140. See Lybecker, *supra* note 115.

141. 15 U.S.C. § 78fff(f)(1) (1970).

142. 88 Stat. 1500, § 102(a)(3) (1974), amending 12 U.S.C. § 1821(a) (1970).

143. 12 U.S.C. § 1813(f)(3). In addition, a bank may not deposit an investor's funds in other accounts in the bank prior to investment unless adequate security is set aside or unless the funds are covered by FDIC insurance. 12 C.F.R. § 9.10(b) (1974).

securities held by banks for customers, the reason that compelled this interim coverage rule for brokers is not applicable to banking practices. Brokers can commingle and otherwise use their customers' funds for their own purposes,¹⁴⁴ with the consequent prior lien by the brokers' creditors on securities purchased with the customers' funds.¹⁴⁵ Banks, however, must segregate all securities held for the services' customers from the assets of the bank, and must keep separate accounts for these securities.¹⁴⁶ Another provision, which gives customers' holdings priority in any insolvency proceedings,¹⁴⁷ minimizes the risk of loss which the customers face in the event of insolvency. This requirement has been enforced in actual insolvency proceedings.¹⁴⁸

The suitability rule. The suitability rule provides that a broker or dealer who recommends to a customer the purchase, sale or exchange of any security must have reasonable grounds to believe that the recommendation is not unsuitable for the customer on the basis of information furnished by the customer after reasonable inquiry concerning his investment objectives, financial situation and needs, and any other information known by broker or dealer.¹⁴⁹ The broker-dealer is in violation of the suitability requirement if he does not make a thorough examination of the customer's financial situation¹⁵⁰ or advises a client to assume risks out of proportion to his financial resources.¹⁵¹ This requirement, which does not apply to banks because of their exemption from the Exchange Act's definition of "broker,"¹⁵² protects investors, who are, in theory at least, assured that they are not committing egregiously unwise investment decisions.

With respect to dividend reinvestment plans, which involve only a mechanical reinvestment of a customer's dividends into a stock that

144. Brokers may use for their own purposes funds arising out of a free credit balance carried on for a customer if adequate notice is given. Securities Exchange Act of 1934, Rule 15c3-2, 17 C.F.R. § 240.15c3-2 (1974). Securities Exchange Act of 1934, Rule 15c2-1, 17 C.F.R. § 240.15c2-1 (1974), allows brokers to hypothecate a customer's securities with other customers' securities if notice is first given.

145. See Securities Exchange Act of 1934, Rule 15c2-1, 17 C.F.R. § 240.15c2-1 (1974).

146. 12 U.S.C. § 92a(c) (1970).

147. 12 U.S.C. § 92a(e) (1970).

148. See, e.g., *Bobbitt v. Oxford Nat'l Bank*, 208 N.C. 460, 181 S.E. 251 (1935). The success of FDIC insurance in preventing the loss of depositors' money is discussed in M. MAYER, *supra* note 128, at 372-73.

149. All brokers and dealers are subject to a suitability requirement under at least one of the following regulations: Securities Exchange Act of 1934, Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1974); NYSE, Rule 405, 2 CCH N.Y.S.E. GUIDE ¶ 2405 (1975); CCH NASD MANUAL ¶ 2152, art. III (National Association of Securities Dealers, Rules of Fair Practice), § 2 (1969); AMEX, Rule 411, 2 CCH A.M.E.X. GUIDE ¶ 9431 (1970).

150. Gerald M. Greenberg, 40 S.E.C. 133, 137-38 (1960).

151. See, e.g., *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968); *Phillips & Co. and Gerald G. Bernheimer*, 37 S.E.C. 66 (1956).

152. Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 78c(a)(4) (1970).

The Legality of Bank-Sponsored Investment Services

he already owns, the suitability rule should not apply. The bank cannot be said either to select or recommend any stock.

AIS involves different considerations. Banks in their AIS contracts customarily state that they are not recommending the purchase of any stock, that they make no representation about the suitability of an investment for a particular individual, and that each participant should make an independent investigation into the merits of each stock.¹⁵³ Relying upon these disclaimers, the Comptroller has announced that AIS does not give rise to a traditional fiduciary relationship, and that the suitability rule therefore is inapplicable.¹⁵⁴ The basis for this position is that because AIS involves a mechanical selection of the 25 largest stocks on Standard & Poor's Index, from which the customer selects his stocks without advice from the bank, the bank is not advising the customer on the investment's suitability.¹⁵⁵

But if the congressional policy of the Exchange Act is to ensure that a customer will not be misled into buying a stock that is unsuitable for him, it seems reasonable to subject AIS to some form of suitability requirement. Even though the list of stocks is arbitrarily selected and despite the presence on the list of well known stocks that many small investors normally buy, the very process of delineating a group of stocks is an act of "holding out" to the customer that each stock is suitable for him. The small investor will understandably believe that most or all of the stocks on the list are suitable investments, even though in reality the 25 largest stocks do not necessarily constitute the 25 most desirable purchases. Public policy is ill-served by a plan which purports to be a way to attract the small investor to the market but which disclaims all responsibility for his investments.

Because of the unique features of automatic investment plans, the requirements of suitability could be imposed on banks by the Comptroller of the Currency without resort to the Exchange Act.¹⁵⁶ The relatively stable nature of the largest 25 stocks, as compared with many of the more speculative stocks that the suitability rule has traditionally covered, would not require a costly inspection of the stock and the

153. Investment Data Corporation emphasized these features in its request for a no-action letter on the validity of automatic investment services. Investment Data Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,411, at 83,182-85 (SEC).

154. Bank Automatic Inv. Serv., [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,817, at 84,215 (Comp. Curr. 1974).

155. *Id.*

156. 12 U.S.C. § 92a(a) (1970) grants to the Comptroller the authority to issue this type of regulation. Pursuant to this authority, the Comptroller has a regulation similar to the suitability rule. See 12 C.F.R. § 9.7(a)(2) (1974). It is not currently applied to AIS. See Bank Automatic Inv. Serv., [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,817, at 84,215 (Comp. Curr. 1974).

customer's financial situation on the part of the bank. But if AIS eventually expands to include more speculative stocks, the Comptroller should require the more detailed inspection that these securities require. A requirement by the Comptroller that banks must have their customers complete information sheets detailing their financial and investment objectives would also help the banks satisfy the suitability rule that brokers are subject to. Finally, if banks are allowed to advertise the advantages of their programs, they should also have to explain the possible disadvantages of selecting stocks from a narrow list of 25 or 30 securities. Such a rule might encourage banks to diversify their lists of offered stocks.

Banks offering individual portfolio management services are already subject to regulations that resemble the suitability requirements of the federal securities laws, and that provide a model for developing suitability rules for other bank-sponsored investment services. Section 9.7(a)(2) of Regulation 9, promulgated by the Comptroller, requires a bank to make a prompt review of a customer's assets when an account is accepted and to perform periodic examinations of the account "to determine the advisability of retaining or disposing of such assets."¹⁵⁷ The Comptroller's examiners check for violations of these requirements,¹⁵⁸ and have the same options available to them for punishing violations as they have under other examination provisions.¹⁵⁹

Regulations governing bank and nonbank advisers to investment companies. The Investment Company Act of 1940¹⁶⁰ subjects banks acting as investment advisers to investment companies to the same regulations as nonbank advisers, since the Act's definition of "investment adviser" does not exclude banks.¹⁶¹ Thus, bank and nonbank advisers are subject to the same regulations in areas such as the qualifications of investment advisers¹⁶² and the preservation of records.¹⁶³

157. 12 C.F.R. § 9.7(a)(2) (1974). The initial review must elicit the same information from the customer that the broker must obtain; namely, purpose of the account, income data, and amounts of other investments. See 4 CCH FED. BANKING L. REP. ¶ 59,295, at 37,142 (1969).

158. See 4 CCH FED. BANKING L. REP. ¶ 59,295, at 37,142 (1969).

159. See p. 1499 *supra*.

160. 15 U.S.C. §§ 80a-1 to 80a-52 (1970).

161. Investment Company Act of 1940 § 2(20), 15 U.S.C. 80a-2(20) (1970).

162. Section 9(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-9(a) (1970), forbids any person who has been convicted of certain kinds of securities laws violations from serving as an investment adviser. Section 9(b), 15 U.S.C. § 80a-9(b) (1970), empowers the SEC to prohibit a person engaging in securities laws violations from further serving as an investment adviser. Section 2(28), 15 U.S.C. § 80a-2(28) (1970), defines "person" as a "natural person or a company."

163. Section 31 of the Investment Company Act of 1940, 15 U.S.C. § 80a-30 (1970), requires investment advisers to preserve accounts and records of their activities for SEC inspection.

The Legality of Bank-Sponsored Investment Services

The Investment Advisers Act of 1940,¹⁶⁴ however, excludes banks from the definition of "investment adviser" for purposes of the Act.¹⁶⁵ Nonetheless, the three key provisions of this Act are all paralleled by other restrictions which do apply to banks.¹⁶⁶ Section 203 requires advisers to register with the SEC and to file information about their qualifications and conduct.¹⁶⁷ The SEC may suspend advisers who have engaged in securities laws violations.¹⁶⁸ Similar restrictions on banks are found in the Investment Company Act¹⁶⁹ and the Banking Act.¹⁷⁰ Second, the Investment Advisers Act requires advisers to maintain records available for SEC inspection.¹⁷¹ Similar duties are imposed on bank advisers by the Investment Company Act¹⁷² and the Comptroller's Regulations.¹⁷³ Third, the Investment Advisers Act prohibits advisers from engaging in manipulative or fraudulent practices.¹⁷⁴ The SEC brings court actions against persons that it suspects have violated this provision.¹⁷⁵ Investment advisers have had their registrations revoked for engaging in fraudulent practices such as misleading advertisements, false statements about material facts concerning the value of certain corporations, and failure to disclose conflicts of interest.¹⁷⁶ This provision is similar to the antifraud section of the Securities Exchange Act of 1934, which applies to banks.¹⁷⁷ A person in violation of any provision of this Act can be fined or imprisoned.¹⁷⁸ Courts have found fraudulent and manipulative practices in violation of the Securities Exchange Act in a wide range of situations involving non-disclosure or misleading disclosure of information, distribution manipulations, and self-dealing.¹⁷⁹

Results of the comparison. To a large extent, there exists a set of

164. 15 U.S.C. §§ 80b-1 to 80b-21 (1970).

165. Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (1970).

166. Section 205 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-5 (1970), is a fourth significant provision, not important in the context of bank-sponsored investment services.

167. Investment Advisers Act of 1940 § 203(c), 15 U.S.C. § 80b-3(c) (1970).

168. Investment Advisers Act of 1940 § 203(e), 15 U.S.C. § 80b-3(e) (1970).

169. See note 162 *supra*.

170. 12 U.S.C. § 1818(g) (1970) empowers banking agencies to expel from office bank officers and directors convicted of felonies.

171. Investment Advisers Act of 1940 § 205, 15 U.S.C. § 80b-4 (1970).

172. See note 163 *supra*.

173. 12 C.F.R. § 9.8 (1974) requires national banks exercising fiduciary powers to maintain books and records for inspection by the Comptroller of the Currency.

174. Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (1970).

175. Investment Advisers Act of 1940 § 209(e), 15 U.S.C. § 80b-9(e) (1970).

176. See 4 CCH FED. SEC. L. REP. ¶ 56,361-96, at 44,090-98 (1974).

177. See *Carroll v. First Nat'l Bank*, 413 F.2d 353, 358 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970) (a bank that participated in a fraudulent scheme to manipulate securities was within the "any person" clause of § 10 of the Securities Exchange Act of 1934 and Rule 10b-5).

178. Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff(a) (1970).

179. See 2 CCH FED. SEC. L. REP. ¶ 22,781-841, at 16,657-910 (1973).

enforced banking regulations that provides bank-sponsored investment services customers with protection comparable to that given by the federal securities laws to investors using brokers. Where shortcomings exist, the Comptroller of the Currency has the present statutory capacity to enact needed regulations and to enforce existing requirements with greater vigor. Subjecting banks to a double set of regulations would undoubtedly raise their costs in supplying bank-sponsored investment services; this would conflict with the goal of providing adequate investor protection at the least possible cost.

Conclusion

Bank-sponsored investment services can attract small investors to the market, increase the amount of capital available to corporations, and help correct the erosion of competition in the securities industry. The services are legal under the Glass-Steagall Act. There is no need for the SEC to regulate these services because investors using banks and brokers already are protected almost comparably, and the Comptroller of the Currency can correct any problems that may exist in the bank regulatory scheme.