Article

The Legal Boundary of Bank Collective Investment Funds: Functional Regulation from the U. S. Perspective

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I. INTRODUCTION

Where the legal boundary should be drawn between commercial banking and investment banking with respect to the bank investment funds? This is an ultimate question one may desire to ask even under the functional regulation of bank mutual fund activities in the new financial modernization era.

The financial service integration has been an international trend within the financial industry in recent years. Such trend of development has gradually reshaped a new structure of financial market by converging different financial services originally offered by banks, security firms or insurance companies. For example, the convergence of the bank and the mutual fund industry reflects one aspect of the rapid-changing dynamics in the financial market. Facing the competition from the mutual fund industry, the bank industry had gradually been unable to benefit from commercial banking business, and tried to step into the field of investment management which had belonged to the mutual fund industry.

Among other countries, the U.S. experiences provide abundant resources for our reflections on such movement which had raised difficult legal issues and caused immense resistances from the mutual fund industry in the U.S. since 1960. Several U.S. cases clearly illustrated the battle between the bank and mutual fund industry with regard to the issue of the legal boundary between commercial and investment banking. Moreover, this trend of development also triggered significant regulatory concerns of bank mutual fund or bank collective investment fund activities. Under such circumstance, a new concept of functional regulation was initiated by the U.S. Congress to address the issue.[1]

In Taiwan, the Financial Supervisory Commission (FSC) has declared a policy objective to achieve financial integration through a mechanism of functional regulation as part of the financial reform. In 2004, the Legislative Yuan enacted the "Securities Investment Trust and Adviser Act" partly in line with the above policy statement.[2] In addition, the FSC has recently proposed the legislation of "Financial Service Act" as a part of the economic project to facilitate the establishment of a regional

1. *See* general, Jane E. Willis, *Banks and Mutual Funds: A Functional Approach to Reform*, 1995 COLUM. BUS. L. REV. 221.

2. During the discussion of the draft of the "Securities Investment and Adviser Act", the Securities and Future Commission faced the question about how far should the Act go in order to integrate relevant financial services and to pave the road for the future development of the assets management industry. In consideration of the impact on various financial industries and the difficulty of reaching a consensus among financial services providers, the Commission regressed to the original plan which merely dealt with the issue between the banks (trust enterprises) and the mutual fund involving securities investment trusts and adviser enterprises. In any event, such limited scope of integration was a good start-point for further integration.

financial service center in Taiwan.[3] One of the policy objectives is to promote the integration of the financial market among various financial service providers such as banks, security houses and insurance companies. Despite the significant current development in Taiwan, this article does not conduct a comparative analysis between Taiwan and the U.S. with respect to the issue of bank collective investment funds but rather focuses on introducing the legal development in the U.S. The purpose of this article is to provide policy-makers with a useful reference concerning the underpinning policy arguments from the U.S. perspective when crafting the future landscape of the financial market in Taiwan.

Under the aforementioned background, the main question I would try to ask in this article is where the line stands between permissible bank trust/fiduciary activities and impermissible bank collective investment activities under current U.S. laws. In other words, where is the line between permissible commercial banking and impermissible investment banking? What criteria would the court use to determine whether certain bank's collective investment funds are permissible or not?

More precisely, some of the collective investment funds operated by banks tend to deviate from the permissible trust or fiduciary activities traditionally operated by banks; some of those deviations however are permissible even if they are not well fitted into the traditional bank trust or fiduciary activities. Then where is the legal boundary between permissible and impermissible bank collective investment activities, i.e., the line between commercial and investment banking? I will try to tackle this problem by focusing on two cases, i.e., *Investment Company Institute v. Camp*[4] (Camp) and *Investment Company v. Conover*[5] (Conover) as specific examples to discuss the bank collective investment plans involved and analyze this legal issue in light of relevant governing statutes and administrative rulings.

In line with my main concern, several related sub-issues will also be addressed in this article. First, what kinds of evil are we trying to prevent banks from engaging in collective investment activities? In other words, why is it so evil from a banking law perspective to allow banks to pool trust assets and act as investment adviser to the fund asset? What kinds of abuses could be engendered if the bank engaged in securities activities that the Congress concerned most when enacting the Glass-Steagall Act (GSA) in 1933?

Second, under what circumstances can we agree that the possible evils are not so hazardous that bank collective investment activities can be

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3. *See* Council of Economic Planning and Development, Executive Yuan, *The Development Guideline and Action Plan of Financial Service Industry*, Brighten Taiwan's Smile, May, 2004.

4. Investment Company Institute v. Camp, 401 U.S. 617 (1971).

5. Investment Company Institute v. Conover, 790 F.2d 925 (DC Cir. 1986)

allowed? What criteria do we need to consider when deciding the legality of a certain bank collective investment funds? To secure a sound and safe banking system, some parameters are needed to explore the line between a permissible bank fund which tends to be riskier than commercial banking but not as risky as investment banking and an impermissible one which is as risky as investment banking.

Third, how does this issue be dealt with in a new financial modernization era? How does the U.S. Congress react in response to such issue with the knowledge of Supreme Court jurisprudence? What are the relevant provisions under Gramm-Leach-Bliley Act of 1999 (GLBA)?[6] Moreover, how does the Securities Exchange Commission (SEC) respond in drafting the rules to implement the GLBA? Do the GLBA and the "Regulation B"[7] proposed by the SEC properly draw a clear line between commercial and investment banking so that makes Camp or Conover no longer applicable in determining the legality of bank collective investment funds?

With above questions in mind, this article attempts to illustrate the legal issues involved during the course of development of bank collective investment activities in the U.S. since 1960, and to examine the battle between banks and the Investment Company Institute (ICI) with a view to explore the meaning of functional regulation adopted in the GLBA later.

The structure of this article is as follows. After a brief introduction to the background problem, Part II will discuss the legality of bank collective investment funds. I will first introduce and compare two plans of bank collective investment funds proposed by Citibank and First National City Bank of New York respectively, i.e., individual retirement account trust funds and commingled managing agency accounts. I will further examine the courts' findings and rationales in Camp and Conover, and discuss the legality of two specific plans in light of relevant governing statutes, administrative rulings and judicial opinions. Based on the court's findings, Part III attempts to possibly delimit the fuzzy line between permissible and impermissible bank activities of collective investment funds. Moreover, Part III will also discuss the regulatory issues of bank collective investment activities, and introduce current development of functional regulation after the GLBA was enacted. The concept and purpose of functional regulation, relevant provisions under the GLBA and the SEC proposed Regulation B will also be briefly addressed in Part III. Finally, Part IV is the conclusion of this article.

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6. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

7. Securities Exchange Act Release No. 49879 (June 17, 2004). 17 C.F.R. § 240 (2004). 17 C.F.R. §§ 242. 710-782 (2004).

II. THE LEGALITY OF BANK COLLECTIVE INVESTMENT FUNDS

A. *Bank Collective Investment Funds*

Before jumping into the issue of legality, I would like to describe the meaning of bank "collective investment fund"[8] by examining and comparing two specific plans operated by FNC Bank and Citibank respectively, i.e., managing agency accounts and individual retirement account trust funds. The legality of these two funds was in fact reviewed by the U.S. Supreme Court and the Court of Appeals of D.C. Circuit respectively in 1971 and 1986.

1. *Managing Agency Accounts Operated by First National City Bank of New York*

In 1965, the First National City Bank of New York (FNC Bank) submitted for the Comptroller's[9] approval a plan for the collective investment of managing agency accounts. The Comptroller promptly approved the plan which became a model for other banks which decided to offer their customers similar collective investment services. The significance of the plan contained following segments.

First, each customer tendered the bank between $10,000 and $500,000, and authorized the bank to be the customer's managing agent.[10] Second, the customer's investment was added to the fund, and a written certificate of participation was issued expressing that in "unit of participation", the customer's proportionate interest in fund assets.[11] Third, units of participation were freely redeemable, and transferable to

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8. Unlike collective investment funds, common trust funds (CTFs) are regarded as traditional banking businesses. "Common trust funds have been authorized by state and federal law merely a pooled investment vehicles for the more convenient and efficient administration of fiduciary assets (i.e., those entrusted to an institution in its capacity as trustee, executor, conservator, guardian or administrator). Applicable laws accordingly have prohibited institutions from using CTFs except for very limited purposes, precluded institutions from charging extra fees or expenses to their CTF customers and restricted the advertising of such funds to the general public." Eugene F. Maloney, *Trust Law Issues Associated with Fiduciaries Investing in Proprietary Mutual Funds*, ALI-ABA Study Materials, Conference on Investment Management Regulation, Oct. 12-13, 1995 Washington, D.C., reprinted in *Investment Management Regulation*, Tamar Frankel and Clifford E. Kirsch, Carolina Academic Press, 461 (1998).

9. The Office of Comptroller of the Currency, referred to as the "Comptroller" or "OCC", is a bureau in the Department of the Treasury. The chief officer of the bureau is called the Comptroller of the Currency charged with the executions of all laws passed by Congress relating to the issue and regulation of a national currency secured by United States bonds. Section 1 of Glass-Steagall Act, 12 U.S.C. § 1. In addition, the Comptroller acts as the regulator or administrator of national banks. 12 U.S.C. § 21.

10. Camp, *supra* note 4, at 622.

11. *Id.*

anyone who had executed a managing agency agreement with the bank.[12] Fourth, unlike the regulation promulgated by the Comptroller, the plan did not provide that the bank receives the customer's money in trust.[13] Additionally, the plan was registered as an investment company under the Investment Company Act of 1940. The Bank was the underwriter of the fund's units of participation within the meaning of that Act.[14]

2. *Citibank's Plan of Individual Retirement Account Trust Funds*

In 1982, Citibank established a common trust fund for individual retirement account (IRA) investors. The Bank acted as a trustee of the individual IRAs and would be directed to invest the assets of the IRA trust funds collectively on behalf of the investors. The IRA trusts were exempted from taxation under Section 408 of the Internal Revenue Code of 1954.[15] This fund was registered with the SEC under the Investment Company Act of 1940 and the Securities Act of 1933.[16] As a trustee, Citibank actually played a role of investment adviser, administrator, custodian and transfer agent of the funds pursuant to an agreement with IRA investors.

There were several features of Citibank's plan of IRA trust fund. First, the plan was styled as a "collective investment trust" which consisted of four separate investment portfolios into which each customer could instruct Citibank to place his or her IRA trust assets.[17] Second, each customer had to conclude a written trust agreement with Citibank, and agreed to pay the ten percent penalty for early redemption.[18]

Third, each customer's ownership interest in the entire IRA trust fund was presented in terms of "units of beneficial interest," which were available only to Citibank IRA-holders and were non-transferable.[19] Fourth, Citibank served as the trustee and the investment advisor to the trust fund and received a monthly fee based in part on the net value of the fund's portfolios.[20] Finally, in order to comply with the SEC's

12. *Id.*
13. *See* footnote 8. *Id.*
14. *Id.* at 623.
15. Conover, *supra* note 5, at 927. I.R.C. § 408 (f)(1).
16. *See* OCC Ruling on Underwriting Collective Investment IRA Funds, Fed. Banking L. Rep. (CCH) ¶99,339, 86,364 (1982). Decision of the Comptroller of the Currency on the application by Citibank, N.A., pursuant to 12 C.F.R. § 9.18 (c)(5) to establish common trust funds for the collective investment of individual retirement account trust exempt form taxation under section 408 of the Internal Revenue Code of 1954.
17. Conover, *supra* note 5, at 928.
18. *Id. See also* I.R.C. § 408 (f)(1).
19. *See id.* IRA assets may, however, be freely transferred among the four portfolios, as well as among any of Citibank's other IRA programs.
20. *Id.*

requirements, Citibank placed the fund under the ultimate control of an independent five-member "supervisory committee," which essentially served as a board of directors.[21] Citibank has marketed its fund as an alternative to, or a competitor of, similar programs now being offered by mutual funds.

3. *Comparison of Managing Agency Accounts and IRA Trust Funds*

Based on the above descriptions, we may find the similarity and difference between the two collective investment plans maintained by FNC Bank and Citibank. It is also helpful to understand the court's reasoning, to be discussed later, on the legality of bank collective investment funds by distinguishing the two collective investment plans as follows.

Several similarities may be seen between the managing agency fund and the IRA trust fund. First, the collective investment funds in each instance were registered under Investment Company Act of 1940, and interests in such funds were also registered as securities under the Securities Act of 1933.[22] Additionally, "each plan involved the collective investment of participant's assets in a fund maintained for the benefit of the participants, as opposed to third-part beneficiaries."[23] Moreover, each plan was based on written agreements signed by each customer authorizing the bank to commingle the fund assets and invest collectively.

We may also find several differences which are essential in deciding the applicability of the GSA. The most significant difference involves what kinds of capacity each bank acted when operating the collective investment funds. FNC Bank received the assets in a "managing agency" capacity; whereas Citibank received the IRA assets in "trust" and acted as a "trustee".[24]

The second difference relates to the amount each customer was permitted to invest. Customers of the managing agency fund were allowed to invest between $10,000 and $50,000. By contract, customers of IRA trust funds can only invest $2,000 per person per year.[25] The third difference associates with the ability to collateralize the units of the funds. Citibank's units of IRA trust fund cannot be used as collateral which is prescribed by ERISA. However, such prohibition cannot be found in the managing agency funds.

The fourth difference regards to the transferability of the units of

21. *Id.*
22. OCC Ruling, *supra* note 16, at 86,370.
23. *Id.*
24. *See id.* at 86,371. *See also* Conover, *supra* note 5, at 930.
25. Such limitation is imposed by ERISA. 26 U.S.C. § 408(a)(1).

shares. Citibank's units of shares are non-transferable, but FNC Bank's units of shares are transferable. In other words, the customers can only redeem their units of interest at Citibank rather than sell them to other third parties. By contrast, the units of participation operated by FNC Bank were not only freely redeemable at Bank, but also transferable to anyone who had executed a managing agency agreement with the Bank. Finally, the restriction on early redemption is also different between the two plans. Customers of Citibank's IRA trust funds would be imposed a ten percent income tax penalty for their early redemption.[26] Similar restriction could not be found in FNC Bank's managing agency funds.

B. *Court's Findings and Rationales in Camp and Conover*

The Comptroller's approvals of FNC Bank's managing agency accounts and Citibank's IRA trust funds were both challenged by the ICI before the court. I would like to expound how the courts decided the legality of bank collective investment activities by examining these two specific cases. I will first identify the essence the Comptroller's rulings contested by the ICI, and then discuss relevant governing statutes before illuminating the courts' findings and rationales in Camp and Conover.

1. *Contested Administrative Rulings and Decisions*

The disputed administrative rulings, including the specific approval of the plan, in each case were both issued by the Comptroller of the Currency. The Comptroller approved the operation of these plans mainly in response to the request by Citibank and FNC Bank, which expected the Comptroller's legal endorsement to avoid running afoul of the law when operating their collective investment funds.

National banks were not allowed to engage in operating collective investment funds until the Comptroller took over the regulatory jurisdiction in 1962. Before then, it was the Board of Governors of the Federal Reserve System (the Board) that had the regulatory jurisdiction over trust activities of national banks.[27] The Regulation F promulgated by the Board provided that national banks were prohibited from offering customers the opportunity to invest in stocks and similar collective investment services. National banks were allowed to engage collective investment of trust assets only for "true fiduciary purposes".[28] Therefore, before 1963, national banks were prohibited from operating a common

26. *See* Conover, *supra* note 5, at 931.
27. Camp, *supra* note 4, at 621.
28. *Id.*

trust fund as an investment trust "for other than strictly fiduciary purposes".[29]

In 1962, the Congress transferred jurisdiction over most of the trust activities of national banks from the Board to the Comptroller. In 1963, the Comptroller promulgated "Regulation 9"[30] in purporting to authorize the banks to operate collective investment funds which were prohibited by various provisions of the GSA. Based on Regulation 9, the Comptroller allowed the collective investment of money delivered to the bank for the investment management purpose, and approved the application of FNC Bank to establish a collective investment fund, i.e., the aforesaid "managing agency accounts".[31] It was the Regulation 9 and the specific approval for FNC Bank that challenged by ICI before the Supreme Court in Camp.

Unlike the approval of FNC Bank's managing agency accounts, the Comptroller approved Citibank's IRA trust funds with a clear and comprehensive reasoning supported in its final decision.[32] The Comptroller's decision addressed three important issues before approving Citibank's application to operate IRA trust funds. One of the issues is whether a national bank had power to collectively invest IRA trust assets.[33] The Comptroller pointed out that a national bank had such power either when a bank acted as a trustee or in a similar fiduciary capacity in operating a common trust fund,[34] or a bank as a fiduciary invested in a fund consisting solely of assets of retirement or similar trusts exempt from federal income taxation.[35] Such power conferred to banks was further confirmed by the Employee Retirement Income Security Act of 1974 (ERISA) which created the IRAs by "providing special tax treatment for retirement trusts established by persons not covered by employer-sponsored qualified retirement plans."[36] The Comptroller also referred to the House Report to support its decision.[37] Based on this

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29. *Id.*

30. 12 C.F.R. § 9 (Part 9: fiduciary activities of national banks).

31. 12 C.F.R. § 9.18(a) provides that: "Where not in contravention of local law, funds held by a national bank as fiduciary may be invested collectively: … (3) In a common trust fund, maintained by the bank exclusively for the collective investment and reimbursement 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 …." *See* Camp, *supra* note 4, at 621 (footnote 7).

32. *See* OCC Ruling, *supra* note 16.

33. *See id.* at 86,365. In addition to the power to invest, the other two reasoning involved the consideration of subtle hazards and the definition of securities under GSA which I would like to address later.

34. *See* 12 C.F.R. § 9.18 (a)(1).

35. *See* 12 C.F.R. § 9.18(a)(2).

36. *See* OCC Ruling, *supra* note 16, at 86,365.

37. The House Report addressed the nature of IRA trusts as follows: "[A]n individual retirement account generally is to be a domestic trust created or organized by a written instrument

analysis, the comptroller approved Citibank's IRA trust plan promptly.

2. *Relevant Governing Statutes and Legislative History*

Looking through the statutory language should be the first step to see if the aforesaid bank collective investment funds are permissible. In the U.S., any person who wants to engage primarily in the business of investing, reinvesting, or trading in securities needs to register as an "investment company" under the Investment Company Act of 1940.[38] Nevertheless, a "common trust fund"[39] and a "collective investment fund"[40] maintained by a bank are excluded from the meaning of an "investment company" with certain conditions attached. Despite those provisions, there is no much dispute over the qualification of these plans as an investment company because they were registered with the SEC under Investment Company Act of 1940 and Securities Act of 1933 anyway. Rather, the main dispute would be whether a bank could legally operate the collective investment funds in light of various provisions of the GSA which clearly prohibited commercial banks from engaging in securities or investment activities.

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for the exclusive benefit of an individual or his beneficiaries …. The balance in an individual retirement account generally may be invested in any assets that are acceptable investments for a qualified plan …. However, account assets generally are not to be commingled with other property except in a common trust fund …. Under the governing instrument, the trustee of an individual retirement account generally is to be a bank." H. R. Rep. No. 93-807, 93d Cong., 2d Sess. (1974)

38. 15 U.S.C. § 80 a-3 (a)(1). Section 3 (a)(1) of the Investment Company Act provides: " … investment company means any issuer which (A) is or hold itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (B) is engaged or proposed to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (c) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an un-consolidated basis. 15 U.S.C. § 80 a-3 (a)(1).

39. Section 3 (c)(3) of the Investment Company Act provides: " … non of the following persons is an investment company within the meaning of this subchapter: (3) … any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian." 15 U.S.C. § 80 a-3 (c)(3). This part of provision has been amended by the GLBA.

40. Section 3 (c)(11) of the Investment Company Act: " … any collective trust fund maintained by a bank consisting solely of assets of such trusts or governmental plans, or both; or any separate account the assets of which are derived solely from (A) contributions under pension or profit-sharing plans which meet the requirement of section 401 of Title 26 or the requirement of deduction of the employer's contribution under section 404 (a)(2) of Title 26, (B) contributions under governmental plans in connection with which interests, participations, or securities are exempted form the registration provisions of section 77e of this title by section 77c(a)(2)(C) of this title, and (C) advances made by an insurance company in connection with the operation of such separated account." 15 U.S.C. § 80 a-3 (c)(11).

In addition to the Investment Company Act, the most contested statute is the GSA of 1933, also referred to as National Bank Act of 1933, a product of the 1929 stock market crash. Many commercial banks were directly or indirectly engaged in the investment banking business when the GSA was passed in 1933. Congress found such practice was the main reason of stock market crash and the ensuing banking collapse. Upon such findings, Congress tried to abolish the securities affiliation with commercial banks and prohibit commercial banks from entering into investment banking business.[41]

For example, Section 16 of the GSA provides in relevant part that "the business of dealing in securities and stock [by a national bank] shall be limited to purchase and sell such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account … . Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by [a national bank] for its own account of any shares of stock of any corporation."[42] It forbids national banks to underwrite or deal in "securities or stock".

In addition, Section 21 of the same Act provides that "it shall be unlawful - (1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of deposit banking."[43] In other words, section 21 prohibits anyone engaging in the business of underwriting, selling or distributing "stocks, bonds, debentures, notes or other securities" from taking deposits.[44]

On its face, Citibank and FNC Bank cannot engage in operating IRA trust funds and managing agency accounts because the units of the fund constitutes "securities" within the meaning of above provision under the GSA. At least, such conclusion could be easily ascertained in Camp when Justice Stewart seemed to reach the conclusion in Part III of the opinion before delving into the subtle hazard test in Part IV of the opinion.[45]

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41. *See* 12 U.S.C. § 377 and § 78. Section 20 prohibits the affiliation with securities underwriting affiliate. Section 32 prohibits the interlocks among officer, director and employee.

42. 12 U.S.C. § 24 (Seventh) (1982)

43. 12 U.S.C. § 378 (a).

44. Based on these provisions, the ICI alleged that a purchase of stock by a bank's investment fund was a purchase of stock by a bank for its own account in violation of Section 16. Moreover, the ICI also contended that the creation and operation of an investment fund by a bank which offers to its customers the opportunity to purchase an interest in the fund's assets constituted the issuing, underwriting, selling, or distributing of securities or stocks in violation of aforementioned sections.

45. *See* Camp, *supra* note 4, at 625.

However, such interpretation is arguably unwarranted because there is no clear definition of the term "securities" in the GSA. In order to determine if the units fall into the scope of security under the GSA, the Court turned to find the legislative history, and came up with the "subtle hazard" test in Camp. Lack of clear definition of "securities" in the GSA might be the reason why Justice Stewart went on reviewing the legislative history and coming up with the subtle hazard test after he seemed to reach the conclusion of the illegality of managing agency accounts.

3. *Subtle Hazard Test under ICI v. Camp*

The subtle hazard test was adopted by the Supreme Court when deciding the legality of managing agency accounts under the GSA in Camp.[46] The issue involved was whether the Comptroller may authorize a national bank to offer its customers the investment fund service complying with banking laws (GSA). The Supreme Court held that "Regulation 9 invalid insofar as it authorizes the sale of interest in an investment fund of the type established by First National City Bank pursuant to the Comptroller's approval".[47] The underlying rationale was that the subtle hazards or potential abuses shown in the legislative history of GSA arose when a commercial bank went beyond the business of acting as a fiduciary or a trustee and entered the investment banking business. In addition to "obvious dangers,"[48] the Supreme Court addressed several "subtle hazards" proscribed by Congress under the GSA.

First, the public confidence in the bank might be impaired if the public perceived the close association between the bank and its securities affiliate, and the affiliate fared badly. In order to preserve the public confidence, the bank might tempt to buttress the affiliate through unsound loans or other aid.[49] Moreover, such temptation to make improvident loans may extend to those companies in whose stocks or securities the affiliate has invested in order to sell a particular investment or make the affiliate successful. In addition, the bank tempted to make loans to customers to purchase securities of issuers whose securities the bank or its affiliate was underwriting. The bank may promote its investment service during the course of making loans to customers. Accordingly, the bank's pressure to promote the investment might impair its ability to function as an impartial source of credit.

The second abuse involved the conflict of interests between

46. *Id*. at 629.

47. *Id*. at 620.

48. For example, a bank might invest its own assets in frozen or otherwise imprudent stock or security investment. A bank's shareholder invests in establishing a security affiliate. *Id*. at 630.

49. *Id*. at 631.

commercial and investment bankers. The promotional interest of investment banker conflicts with the obligation of commercial banker to provide disinterested investment advice.[50] Senator Bulkley stated:

> Obviously, the banker who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit of a distribution profit or a trading profit or any combination of such profits.[51]

Moreover, some evidences showed that the securities affiliates may sell securities through the trust department of the sponsored bank. Such practice might constitute "self-dealing" which violated the trustee's obligation of loyalty. Therefore, it would be improper for a bank's trust department to purchase anything from the banks' securities affiliate.[52] A summary can be made as Justice Stewart indicated in Camp:

> … Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system.[53]

To sum up, the Supreme Court ruled against the Comptroller based on the belief that allowing FNC Bank to operate managing agency accounts will engender potential abuses, such as unsound commercial banking practice and conflict of interests, which the framer of the GSA tried to prevent. Because of the existence of subtle hazards, the managing agency funds sponsored by FNC Bank were impermissible and inconsistent with Section 16 and 21 of the GSA.

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50. *Id*. at 633.
51. *Id. See also* 75 Cong. Rec. 9912.
52. *Id.*
53. *Id*. at 634. *See also* 75 Cong. Rec. 9912.

4. *Deferential Chevron Test under ICI v. Conover*

Unlike Camp, the Court of Appeal of D.C. Circuit adopted a more deferential test when deciding the legality of the Comptroller's approval of Citibank's IRA trust fund in Conover. The ICI argued that Citibank's IRA trust fund was "flatly prohibited" by Camp. In response to such contention, the Court had to address two significant issues before concluding that the Comptroller's approval of Citibank's trust was permissible under the GSA and Camp. First, whether Citibank's trust is governed by Camp? Whether Citibank's trust is totally prohibited under the Supreme Court's ruling in Camp? If not, the second question would be whether the Comptroller's interpretation of the GSA is reasonable that its approval of Citibank's IRA trust is permissible under Chevron.[54]

The Court dealt with the first issue by distinguishing Citibank's IRA trust with the fund at issue in Camp. At the outset, the Court clearly stated that Camp did not prohibit all financial services functionally equivalent to the mutual fund. The existence of direct competition with mutual fund industry could not be a mere reason to ban the bank from engaging in investment services.[55] The Court concluded that Citibank's trust was not prohibited by Camp's ruling because Citibank's trust was distinct from the fund in Camp and, therefore, the units of Citibank's fund was not a security under Camp. In other words, the Court found that Citibank's IRA fund is different from the arrangement in Camp because Citibank receives the IRA trust assets in a "trustee" rather than in a "managing agent" capacity.[56] Based on the authority to commingle funds received in trust, the Court agreed the Comptroller's finding that "the meaning of the term securities under the securities law is not necessarily synonymous with its meaning under the Glass-Steagall Act."[57] That is to say, the Court had to find if certain units of participation fit the meaning of securities under the GSA in light of the subtle hazard test. The Court then proceeded to find that Citibank's IRA funds entail none of the potential abuses indicated in Camp due to its distinct characteristics.[58]

Since Camp was not applicable in the present case, the Court had to decide if the Comptroller's decision and interpretation was consistent with the congressional intent under the GSA. Under Chevron, there are two prong of test the court needs to address. First, the court must determine whether Congress "has directly spoken to the precise question at issue" when reviewing the reasonableness of administrative interpretation of

54. Chevron U.S.A. v. Natural Resources Defense Council, 467 U.S. 837 (1984).
55. Conover, *supra* note 5, at 930.
56. *Id*. at 929.
57. *Id.*
58. *Id.*

statutes. If Congressional intent is unclear, then the court needs to determine whether the agency's interpretation is "permissible" or "reasonable".

The Court concluded that there was no clear indication that Congress intended to prohibit bank's collective investment activities like that of Citibank's trust fund under the GSA based on its ordinary meaning of statutory language and legislative history.[59] Therefore, the Court proceeded to conclude that the Comptroller's interpretation of the GSA was reasonable because its analytical framework was consistent with that in Camp. It was a reasonable interpretation that the Comptroller concluded that the units of participation in IRA trust did not constitute a "security," and the prohibition under the GSA was not applicable.[60] The Court held that units of interest in Citibank's IRA trust were not "securities" within the meaning of the GSA and ruled against the petitioner (i.e. the ICI). Therefore, Citibank's IRA trust fund is a legal banking activity in light of the GSA.

III. FUNCTIONAL REGULATION OF BANK COLLECTIVE INVESTMENT FUNDS

A. *Some Observations on Camp and Conover*

1. *The Fuzzy Line between Commercial and Investment Banking*

Despite those the Courts' opinions, the line remains unclear between commercial and investment banking. If the common trust fund and mutual fund are two extremes, bank collective investment funds must be somewhere in the middle. We are confident that a bank can legally engage in trust and bona fide fiduciary services which are traditionally commercial banking business. However, it is often not the case on the collective investment activities by banks. The bank's collective investment activities often go beyond merely providing fiduciary service and entering into investment services instead. Therefore, it is worth knowing what factor raises our eyebrow when a bank engages in collective investment activities. In other words, what triggers our concerns that particular bank collective investment activity tends toward providing investment services instead of traditional fiduciary services? Put differently, what criteria can we use to determine the line between commercial and investment banking?

To some extent, we may find following factors derived from above

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59. Conover, *supra* note 5, at 933-935.

60. *Id.* at 936. The sole issue as indicated by the Court is whether "units of beneficial interest," or shares, in Citibank's Trust constitute "securities" within the meaning of sections 16 and 21 of the Glass-Steagall Act, 12 U.S.C. §§ 24 (Seventh), 378(a)(1) (1982)

cases are relevant in dealing with above issue. First of all, the type of capacity by bank plays a significant role in determine the issue. The trust capacity has been placed a significant weight by the court in favor of bank's collective investment activity.[61] It won't be the case if the bank acts as agency capacity. In other words, if a bank acts as a trustee, the court tends to permit its operation of fund. The trustee capacity matters because it falls within the realm of traditional commercial banking business.

Second, it is crucial to know the nature of collective investment funds.[62] The characteristics of each collective investment funds are significant factors to determine if such fund bears potential abuses under the subtle hazard test upheld by Camp. In other words, the Court looks into the nature and characteristics of each bank collective investment funds to evaluate the potential risks in order to determine if specific plan involves prohibited potential abuses. Therefore, the level of risk prescribed by the GSA in each fund may affect the court's determination if units of the fund constitute "securities" within the meaning of the GSA under the subtle hazard test in Camp. The riskier the fund is, the more likely the fund is treated as a "security" under the GSA. The relevant factors, as indicated in Conover, in determining the level of risk includes the amount of investment, the transferability of the units, and the restriction of assets and redemption. If the bank is less likely to make improvident loans to customers (that is, the finding of the GSA) or the amount of investment the customer is allowed to invest is relatively small, the court tends to find the fund is permissible under the GSA. In sum, the court looks into the specific substance of each fund to determine if the units of the fund constitute the meaning of "securities" prohibited under the GSA.

Moreover, there are other factors noteworthy although they are not so influential in the court's reasoning. First, it might be of different judgment whether the fund is managed by an independent supervisory committee or is solely sponsored by the trust department of the bank. Arguably, the bank seems to provide investment services, instead of fiduciary services, if the management of the fund is vested in an "independent supervisory committee".[63] Such arrangement looks more like an investment company unless the exclusive management is under the sponsoring bank.

Second, it is also worth noting whether the fund is simply

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61. *See* Conover, *supra* note 5, at 930.

62. The differences between the two plans involve an issue whether the units of fund constitutes a "security" under GSA. The answer to some extent depends on "whether, from the bank's perspective, the product entails the relatively small risks presumably characteristic of commercial banking or … the relatively large risks (either real or apparent) usually associated with investment banking." *Id.*

63. *Id*. at 936.

commingling assets of pre-existing trusts or is actively marketing its units to the public as an investment. The aggressive marketing campaign of the fund tends to provide a good indication that the fund falls in the realm of investment banking.[64]

Third, one may ask whether the bank characterizes its fund as an "investment opportunity" should make any difference on the issue. Some may think the fund go beyond traditional trust services if it is characterized as an "investment opportunity" because the customer may expect the possible return, and is likely to assume the potential risk. However, the court did not accept such argument in Conover.[65]

Finally, whether a bank regulator can rely on its general regulatory power to circumvent the "broad prohibition" of the GSA? The answer is no.[66] In other words, the Comptroller cannot rely on the general regulatory power under 12 U.S.C. 92a in minimizing the importance of the dangers identified in Camp. The Comptroller has to specifically stated that the potential abuses have been reduced based on specific or existing rules rather than its general regulatory power.

Relevant factors in determining the legal boundary of commercial and investment banking are sorted as follows based on aforementioned discussion:

<table>
<tr><th>Citibank's IRA Trust Funds</th><th>FNC Bank's Managing Agency Accounts</th></tr>
<tr><td>Permissible under ICI v. Conover</td><td>Impermissible under ICI v. Camp</td></tr>
<tr><td>Tends toward Commercial Banking
(Trust or Fiduciary Service)</td><td>Tends toward Investment Banking
(Investment Services)</td></tr>
<tr><td colspan="2">Similarities</td></tr>
<tr><td colspan="2">1. Registered with the SEC under Investment Company Act and Securities Act
2. Approved by the Comptroller before operation
3. Commingled fund assets and invested collectively by Bank
4. Maintained for the benefit of participants other than third-party beneficiaries</td></tr>
<tr><td colspan="2">Differences</td></tr>
<tr><td>1. Trust capacity (as a trustee)
2. Less subtle hazards (not a "security" within the meaning of the GSA):</td><td>1. Agency capacity (as an agent)
2. Potential hazards existed (constitutes a "security" within the meaning of the GSA):</td></tr>
</table>

64. *Id.* at 936-937.
65. *Id.* at 937.
66. *Id.*

• The amount a customer can invest is relatively small. ($2,000 annually) Unsound loans to customers are less likely to happen. • Fund assets cannot be used as collateral pursuant to ERISA. Prevent margin selling. • Units of participation are non-transferable. The bank gain more control over the risk of fund. • 10% income tax penalty imposed by ERISA for early redemption reduce the bank's pressure to rescues the fund through measures inconsistent with sound banking. 3. Sponsored by ERISA 4. Established in 1982 5. Comprehensive reasoning provided by the Comptroller before approval	• The amount a customer can invest is relatively large. ($10,000 ~ $500,000) Unsound loans to customers are more likely to happen. • No specific statute provided so. • Units of participation are transferable. The bank gain less control over the risk of fund since the unit can be transferred in an independent market. • No such early redemption restriction provided. 3. No special statute involved 4. Established in 1965 5. Lack of reasoning by the Comptroller before approval

2. *What Factor Really Matters? What Doesn't?*

I want to make two observations which I found most disputable in deciding the legal boundary between commercial and investment banking. One relates to the significance of legal capacity as a trustee or an agent; the other involved the alternative litigation strategy for the petitioner (ICI) to prevail in Conover.

It seemed that the Court in Conover heavily relied on the types of capacity the bank acted in shaping the boundary between commercial and investment banking. A possible conclusion may be drawn that a bank collective investment fund is permissible under the GSA as long as the bank operated in a trust or fiduciary capacity. Such finding can also be shown in the Comptroller's ruling that it is permissible to put IRA assets into common trust funds and collective investment funds. It seems that the Comptroller makes such assertion because a common trust fund is the only collective investment vehicle that a bank can legally operate, and the Comptroller can lawfully supervise.

Although the Comptroller's ruling is well reasoned, one may not be persuaded by the Comptroller's analysis of the GSA prohibition on

securities underwriting, and may wonder if the fact that an IRA involves a "trust" so powerful that it completely distinguishes Camp.[67] I think the Court might put too much weight on the trust capacity when determining the legality of Citibank's IRA trust funds. In addition to the trust capacity, other relevant factors need to be taken into account as well. For example, we need to consider whether a particular investment in fund is directed by customers or by a bank which has discretionary power over investment decisions. We need to consider whether certain transaction has "bona fide fiduciary purpose" or mixes with other than fiduciary purposes such as money management. Moreover, we may also consider if the common trust fund is created and underwritten by the bank. I tend to believe that legal capacity is not the only factor that can dominate the legality of bank collective investment funds. Other characteristics of the funds also demand our attention as I would like to address as follows.

As for the litigation strategy, one may argue that the ICI might have won in Conover if alleging that "it was illegal public underwriting by the bank of securities issued by the collective investment fund instead of arguing that it was a "bad" common trust fund and this covered by Camp".[68] In other words, the ICI could argue that Citibank tended to act as an impermissible "underwriter" by identifying the "public offering" aspect of the IRA trust funds. As we might see, the managing agency accounts and IRA trust funds are seemingly not substantial different types of contract except the difference between the agent and the trustee capacity. To some extent, the banks pool the funds and invest collectively for the participants. Instead of arguing from the common trust fund perspective, the ICI could focus on following dimensions of the bank's collective investment activities.

First, it seems to me that it is impermissible if the bank tries to actively market its funds to the public as an investment. In operating a common trust fund, the bank receives the assets entrusted by its clients and invests the fund based on the trust agreement or applicable law between them. The bank's role in engaging common trust fund activities is more passively or with less discretion than the investment company's role in raising the mutual fund. The investor of a mutual fund demands more protection than the client of bank's common trust fund. The relationship between the bank and its clients in common trust fund is bound more closely than that between the investment company and its shareholders due to the different purposes of trust or fiduciary and investment services. If the bank's marketing plan looks more like an underwriter of the fund,

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67. *See* Martin E. Lybecker, *Teaching Notes for Financial Holding Companies Law Seminar*, Duke Law School, Spring Semester 2006, at 10.

68. *Id.* at 11-12.

we may think such fund tends toward to public offering which is an impermissible investment banking practice. As indicated in Camp, "in short, there is a plain difference between the sale of fiduciary services and the sale of investment (e.g. underwriting?)"[69]

Second dimension relates to the institutional structure of the funds. The ICI may argue that the fund is managed by an entity separated from the bank. In common trust fund, the bank serves as a trustee who bears the obligation to operate the fund for the benefit of its clients. If the bank delegates its duty to other entity, it tends to treat as an impermissible investment banking activities. Therefore, we may look into specific structure of funds to see if there is any creation of a separate entity. If so, the collective investment fund tends toward the impermissible investment banking activities because it deviates too much from nature of common trust fund which is traditionally regarded as the permissible commercial banking business.

3. *Why the Comptroller Prevailed in Conover but Failed in Camp?*

In addition to the substantive reasoning provided by courts, there may be two explanations why the Comptroller prevailed in Conover but failed in Camp. The first explanation involves the comprehensiveness of administrative reasoning provided by the Comptroller, and the second one relates to the trend of integration within the financial market after the Supreme Court's Camp decision in 1971.

The Comptroller failed in Camp partly because it did not provide well-reasoned statement before promulgating Regulation 9 which was the basis of approving FNC Bank's managing agency accounts. As the Supreme Court alluded, "the Comptroller promulgated Regulation 9 without opinion or accompanying statement. His subsequent report to Congress did not advert to the prohibitions of the Glass-Steagall Act."[70] Although the counsel for the Comptroller rationalized the basis of Regulation 9 in the course of litigation, the Court said that it "may not accept appellate counsel's post hoc rationalizations for agency action."[71] Accordingly, the Court believed that the initial approval may seriously impair the enforcement of the banking laws if the Comptroller grants such power to national banks without confidence that the exercise of such power will not violate the intent of the banking laws.[72] To some degree, Camp is fatally poisoned by the failure of the Comptroller to articulate reasons for its positions. By contrast, the Comptroller got the deferential

69. Camp, *supra* note 5, at 638.
70. *Id.* at 627.
71. *Id.* at 628.
72. *See id.*

judgment largely because it provided a detail and comprehensive analysis before the approval of Citibank's IRA trust fund. In determining the reasonableness of statutory interpretation, the Court deferred to the Comptroller's statement analyzed in its ruling. Such difference may partly explain why the Comptroller got different treatment in Camp and Conover.

The second explanation may contribute to the rapid changing development in the financial market since 1971. Some critics has pointed that the Supreme Court interpreted the GSA exceptions for bank securities activities too restrictive to respond the financial trend of bank securities activities. Moreover, Camp decision bore the inherent weaknesses in 1971 and the subtle hazard test needs to be gradually relaxed.[73]

There are reasons for this trend, as indicated by Professor Frankel and Kirsch:

> … (ii) the changing environment of the banking business, (iii) the growing consensus that GSA is no longer justified, and the doubt that bank's failure and the demise of the stock market in the late 1920 were not attributable to bank securities activities, as claimed, (iv) the deficiencies of the GSA as a model structure of financial system, and the bank's place in it, have become more severe with the development of technology and the internationalization of the financial system.[74]

Such trend of development in financial market probably prompted the Court to give more deference to the Comptroller in Conover.

B. *Functional Regulation in New Financial Modernization Era*

1. *Functional Regulation in General*

The concept of functional regulation is proposed partly to address, among other things, the regulatory problem of bank collective investment activities. Under functional regulation, entities seeking to engage in the securities or mutual fund business will subject to the same rules as the traditional participants in the securities or mutual fund markets.[75] In other words, functionally-equivalent activities should be regulated by the same

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73. TAMAR FRANKEL AND CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 456 (Carolina Academic Press 1998).

74. *Id.*

75. Kathryn B. McGrath, *Bank Investment Advisory Services and New Securitization Products*, 556 PLI/CORP 643, 645 (1987).

regulator under the same rule or regulation irrespective of its actors.[76]

Functional regulation is designed to "promote competitive equality, regulatory efficiency, and investor or consumer protection."[77] Functional regulation acquired special meaning for the banking industry in the early 1980's, when the SEC adopted this principle as a justification for expanding its regulatory jurisdiction to include bank mutual fund activities.[78] SEC Chairman John Shad expressed policy arguments when testifying before the Senate Banking Committee in support of the use of functional regulation in the banking and securities industries context.[79]

First, functional regulation allocates to each regulatory agency jurisdiction over those economic functions it knows best.[80] Second, allocating regulatory jurisdiction by function permits the application of a consistent regulatory philosophy.[81] Third, it minimizes regulatory conflict, duplication, and overlap.[82] Finally, some existing competitive inequities can be solved because functional regulation establishes the conditions for equal treatment of competitors,[83] and facilitate competition

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76. Michael P. Malloy, *Banking in the Twenty-First Century*, 25 J. CORP. L. 787, 793 (2000). "Accordingly, banking activities are regulated by federal and state bank regulators, securities activities by federal and state securities regulators, and insurance activities by state insurance regulators. However, the FRB retains its role of "umbrella supervisor" of bank holding companies (BHCs), and it is authorized to examine each holding company and its subsidiaries, including functionally regulated subsidiaries under limited circumstances. The Comptroller of the Currency, the FRB, and the Federal Deposit Insurance Corporation (FDIC) are authorized to adopt "prudential safeguards" governing transactions between a depository institution, its subsidiaries, and its affiliates to avoid, inter alia, significant risk to the safety and soundness of the institution." *Id.* at 794.

77. Melanie L. Fein, *Functional Regulation: A Concept For Glass-Steagall Reform?*, 2 STAN. J.L. BUS. & FIN. 89, 90 (1996).

78. *Id.* at 89. "As envisioned by the SEC, the concept required not only that bank securities activities be subject to regulation under the federal securities laws, but that they also be regulated by the SEC as the agency primarily responsible for administering those laws. *Id.*

79. *Id.* at 91.

80. *Id. see also*, Hearings before the Subcomm. On Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 97th Cong., 2d Sess. 9, 35 (1982) (Statement of John S.R. Shad, Chairman, Securities and Exchange Commission). "The principal concern of the bank regulators is assuring the safety and soundness of the banking system. Their statutory mandate gives priority to the protection of banks and their depositors over protection of investors. Thus their expertise in the protection of investors is not as great as that of the SEC. It is sensible, therefore, to charge the SEC with regulating securities activities and the banking agencies with regulating banking activities." *Id.*

81. *Id.* at 92. "A major thrust of the securities laws is full disclosure. By contrast, bank regulators are concerned about the need for public confidence in banks, and therefore tend more toward confidentially. The result is that the banking regulators' approach to their responsibilities under the securities laws is different from the SEC's. This divergence in approach makes little sense as a matter of either efficiency or fairness." *Id.*

82. *Id.* "A regulatory system based in some respects on regulation by industry segment and in others on functional regulation creates confusion. Jurisdictional lines based on industry categories inevitably become blurred as the industries evolve and economic conditions change." *Id.*

83. Hearings, *supra* note 80. "Although permissible bank [mutual fund] activities are now relatively limited, the different schemes of taxation and regulation under which banks and securities firms now operate already create some competitive inequalities." *Id.*

on the basis of economic merit, rather than regulatory classifications.[84]

Despite those advantages, functional regulation has, in some cases, resulted in competitive imbalances and regulatory excess. The multiple regulators required under a functional regulation system will result in fragmented regulation and duplicative, inconsistent, and excessive regulatory requirements. Functional regulation would also cause artificial structuring of banking operations and impair customer services by impeding the ability of banks to offer "seamless" services.[85]

Functional regulation could result in fragmented regulation of financial institutions, which could then result in duplicative and potentially inconsistent regulatory requirements. As a result, it will increase the compliance cost of banking organization.[86] Moreover, functional regulation can also result in the banks having to deal with a variety of agencies rather than a single one. This can result in added regulatory costs for such banks because they must deal with more than one agency and abide by more than one regulation. Consequently, several alternative approaches have been advanced such as "entity regulation,"[87] "umbrella regulation,"[88] and a form of "reciprocal functional regulation."[89] It is fair to say that functional regulation may not be suitable in every area, and the overall public interest will most likely be obtained through a mix of institutional and functional regulatory programs, rather than a system consisting exclusively of either type of regulation.[90]

2. *Gramm-Leach-Bliley Act of 1999 and SEC-Proposed Regulation B*

As its preamble indicates, the GLBA is enacted "to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers, and for other

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84. McGrath, *supra* note 75, at 645.

85. Fein, *supra* note 77, at 109.

86. *See* Fein, *supra* note 77, at 110.

87. Entity regulation calls for a single regulator to supervise all the activities of a particular entity. *Id.* at 114.

88. Umbrella regulation seeks to strike a balance between the concerns of functional regulation and entity regulation by superimposing an additional layer of regulation that encompasses the entire organization and all of its functions. *Id.* at 115. Alan Greenspan, Remarks at the Conference on Bank Structure and Competition, Letter from John Wheeler, Secretary, SEC, to Lynette Carter, Office of the Comptroller of the Currency, Office of the Comptroller of the Currency, available in 1985 WL 51986 (S.E.C.)(Dec. 20, 1984).

89. The reciprocal functional regulation approach responds to this fundamental similarity by granting banks, securities firms, and insurance companies equal powers to perform the same functions. Fein, *supra* note 77, at 114.

90. *See*, Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services reprinted in 1050 Fed. Banking L. Reports (CCH), at 41.

purposes."[91] In order to break the wall between bank and securities firms, Section 101 of the GLBA repeals Section 20 and Section 32 of the GSA.[92] Therefore, banks are allowed to affiliate with brokers or dealers engaging in underwriting any type of security in any amount. Moreover, banks are permitted to share directors, officers, and employee with entities previously engaged in underwriting securities, such as investment bankers and investment companies.[93]

However, the GLBA did not repeal Section 16 and Section 21 of the GSA. Banks are not allowed to underwrite securities in the capacity of bank.[94] Moreover, relevant provisions in Title II of the GLBA remove a bank from the definition of "broker" and "dealer" in the Securities Exchanges Act of 1934,[95] the Investment Company Act of 1940,[96] and Investment Advisers Act of 1940[97] which previously exclude a bank from the definition of "broker" and "dealer". As a result, retail securities brokerage and underwriting activities by banks will subject to the regulatory provisions of above Acts unless certain bank activities are exempted under the GLBA. In other words, bank securities activities will then subject to SEC's regulation because previous exclusions have been removed from the definition of broker and dealer in the Securities Exchange Act, Investment Company Act and Investment Advisers Act unless certain exceptions of bank activities can be found in the GLBA.

As indicated in the SEC's Release, "[i]n particular, the GLBA eliminated the complete bank exceptions from the definitions of "broker" and "dealer" in the Exchange Act and replaced them with narrower transaction-based bank exceptions,"[98] and "[e]ach of these exceptions permits a bank to act as an agent with respect to specified securities products or in transactions that meet specific statutory conditions."[99] Such arrangement is called "functional regulation" as Title II of the GLBA indicated.[100]

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91. Preamble of GLBA, *supra* note 6.

92. Section 101 provides that Section 20 (12 U.S.C. 377) and Section 32 (12 U.S.C. 78) of the Banking Act of 1933 (commonly referred to as the "Glass-Steagall Act") are repealed. *Id.*

93. *See* Martin E. Lybecker, New Bank Securities Activities, Mutual Fund, and Common Trust Fund Provisions of The Gramm-Leach-Bliley Act, Section of Business Law, American Bar Association, Spring Meeting, Memphis, Tennessee, April 1, 2005, at 1.

94. *Id.*

95. Section 201 (A) and Section 202 (A) of the GLBA, *supra* note 6.

96. Section 215 and Section 216 of the GLBA, *id.*

97. Section 218 and Section 219 of the GLBA, *id.*

98. SEC's Release on Proposed Regulation B, *supra* note 7 (Introduction and Background).

99. *Id.*

100. The Commission testified that complete functional regulation would mean that a bank — just like any other securities business — would have to obtain a broker-dealer license and adhere to consumer protections adopted under the federal securities laws to engage as a broker in securities transactions with investors or shift those activities to a registered broker-dealer that is obligated to provide those protections. Testimony of SEC Chairman Arthur Levitt Before the

Therefore, identifying certain bank exempted activities is helpful to delimit the line between commercial and investment banking. If certain bank activities fall into the exceptions provided by the GLBA, banks should be allowed to engage without triggering any security-related concern. Focusing on the functional regulation of bank collective investment funds, I will address several related bank activities exempted by the GLBA and SEC-proposed Regulation B as follows.

First, a bank shall not be considered to be a broker if it engages in "trust activities" under the conditions described as follows.[101]

(1) The bank should effect transactions in a "trustee" or a "fiduciary"[102] capacity in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards.

(2) The bank is "chiefly compensated" for such transactions, consistent with fiduciary principles and standards, on basis of an administration or annual fee, a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers, or any combination of such fees.

(3) The bank does not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities.

The SEC's Release stated that the congressional purpose of this provision is "to implement the functional regulation of securities activities and to permit banks to continue to conduct limited securities activities while acting as, and being paid as, fiduciaries"[103] and "the statutory conditions that a bank must meet to qualify for this exception are designed to ensure that bank trustees and fiduciaries conducting securities activities outside of the protections of the securities laws are compensated as traditional trustees and fiduciaries."[104]

Second, a bank shall not be considered to be a "dealer" if it engages in certain buying or selling activities. Following investment, trustee, and

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Committee on Commerce Concerning H.R. 10, "The Financial Services Act of 1999" (May 5, 1999).

101. Section 201 (B) (ii) of GLBA, *supra* note 6.

102. The definition of fiduciary capacity tracks the same definition in the Comptroller of the Currency's Regulation 9. With respect to the concept of "fiduciary capacity," the SEC (i) has taken the position that the activities of a transfer agent that resemble those of a broker-dealer are not excepted (other than on behalf of certain stock purchase plans which are the subject of that exception), and (ii) adopted Rule 3b-17(c) and Rule 3b-17 (e) to exempt a bank providing only non-discretionary investment advice on a "continuous and regular" basis. Lybecker, *supra* note 93, at 6 (footnote 8).

103. SEC' proposed Regulation B, *supra* note 7 (Trust and Fiduciary Activities Exception).

104. *Id.*

fiduciary transactions are permissible.[105]

(1) The bank buys or sells securities for investment purposes for the bank.

(2) The bank buys or sells securities for investment purposes for accounts for which the bank acts as a trustee or fiduciary.

Third, Section 221 of the GLBA amends Section 3(c)(3) of the Investment Company Act and provides that a common trust fund is exclude from the definition of investment company if following conditions are met.[106]

(1) Such fund is employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purpose.

(2) Interests in such fund are not advertised, or offered for sale to the general public except in connection with the ordinary advertising of the bank's fiduciary services.

(3) Fees and expenses changed by such fund are not in contravention of fiduciary principles established under applicable Federal or State law.

Therefore, "a bank that effects transactions in securities as agent outside the scope of these exceptions is required to register as a broker in accordance with Section 15(a) of the Exchange Act."[107]

In order to implement the GLBA, the SEC published Regulation B and requested for public comment in June 2004.[108] As a revision of the previous Interim Rule, the proposed Regulation B, as indicated in its title, aims to provide clear exemptions for banks and other financial institutions engaging in securities activities.[109] Among other exemptions, the proposed Regulation B provides two types of exemptions which are relevant to our problem and helpful to define the line between commercial and investment banking, i.e., Trust and Fiduciary Activities Exemption[110] and Special Purpose Exemptions.[111] The bank has to satisfy the required conditions provided by proposed Regulation B in order to be exempted form SEC's supervision.

Under Section 201 (B) (ii) of the GLBA, being "chiefly compensated" for transactions consistent with fiduciary principles is one of the conditions that the bank has to meet to be excluded from considering a broker. Since the concept of "chiefly compensated" is not clear defined, the proposed Regulation B provides specific exemptions from the "chiefly compensated" conditions for banks when effecting

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105. Section 202 (C) (ii) of GLBA, *supra* note 6.
106. Section 221 (c) of GLBA, *id.*
107. SEC proposed Regulation B, *supra* note 7 (Introduction and Background).
108. The history of SEC's rulemaking, see Lybecker, *supra* note 93, at 2.
109. SEC proposed Regulation B, *supra* note 7, 17 C.F.R. § 242.
110. Subpart B of proposed Regulation B, *id.*
111. Subpart G of proposed Regulation B, *id.*

certain transactions such as those for a "living, testamentary, or charitable trust accounts"[112] or that the bank acting "as an indenture trustee in a no-load money market fund".[113] Moreover, it provides exemptions for banks from determining whether they are "chiefly compensated" either on a line of business basis[114] or on an account-by-account basis.[115] As long as either of above exemptions can be satisfied, the bank's security-related transactions can be exempted from registration as a broker under Securities Exchange Act. In addition, one of special purpose exemptions provides the bank exempting from the definition of "broker" for banks effecting transactions in securities in certain employee benefit plans.[116]

To sum up, proposed Regulation B provides rules designed to define and clarify a number of the statutory exceptions from the definition of "broker." In addition, proposed Regulation B would grant new exemptions from the "broker" definition to banks and certain other financial institutions. These proposed exemptions would supplement the statutory exceptions to preserve bank securities activities where consistent with the statutory purpose of investor protection.[117]

IV. CONCLUSION

Financial service integration is an inevitable trend of development worldwide. This article tries to trace the history back to the initial argument between bank and mutual fund industry in the U.S., and clarify the possible legal boundary between commercial and investment banking businesses by focusing on the issue of the legality of bank collective investment funds. The Court's rulings in Camp and Conover provide good illustrations on such issue and we may see the different tests of review, i.e., subtle hazard test and Chevron test, have been adopted in solving the similar problem.

This article found that the Court tended to draw the legal boundary based on the nature of specific bank collective investment funds. There seems to have three rough steps of reasoning to determine the legality of bank collective investment funds. First, the court would survey the characteristics of the bank collective investment fund at issue. Second, the court would examine if such fund constituted the meaning of securities under the GSA so that the sponsoring bank was prohibited from operation. Third, the court looked into the reasonableness of the administrative

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112. SEC proposed Regulation B, 17 C.F.R. § 242.720, *id.*
113. SEC proposed Regulation B, 17 C.F.R. § 242.723, *id.*
114. SEC proposed Regulation B, 17 C.F.R. § 242.721, *id.*
115. SEC proposed Regulation B, 17 C.F.R. § 242.722, *id.*
116. SEC proposed Regulation B, 17 C.F.R. § 242.770, *id.*
117. SEC proposed Regulation B, *id.*

ruling if a clear congressional intent could not be found. In determining the legality of bank collective investment funds, the relevant factors includes the type of capacity the bank acts as a trustee or an agent and the level of risk the fund bears in terms of potential abuses that the GSA purported to avoid.

Functional regulation, a new approach of resolving the bank mutual fund activities, gains the benefit of promoting competitions among various financial service providers. However, it may raise concerns about the potential drawbacks such as duplicate regulation and conflict of interests as well as the impact on imposing additional regulatory burden on banking organizations. Despite such pros and cons, the Congress enacted the GLBA and adopted the functional regulation as a regulatory means to delimit the line between permissible and impermissible bank mutual fund activities partly in responding the trend of financial integration. The SEC released proposed Regulation B to further enforce the GLBA by providing several exemptions for banks from registering as a broker.

After reviewing relevant cases, administrative rulings and new development of functional regulation, this article found that the line remains unclear with respect to the legality of bank collective investment funds. The GLBA and proposed Regulation B provide various clear exemptions for banks from subjecting to the SEC's supervision. However, the relevant exemptions only deal with the trust activities which are traditionally permissible banking businesses. As for the bank collective investment activities, we may still need to look the court's teachings in Camp and Conover in order to delimit the legal boundary.

Despite the significance of legal capacity, we should focus more on the nature of bank collective investment fund as a collective investment vehicle, and see if it is an impermissible banking activity. It is the bank's activities of underwriting and marketing to the public that raises our concern of investor protection. The rationale lies on how the customers perceive the fund sponsored by the bank, and whether the customers may confuse that the fund is insured by the bank to be free from risks. Moreover, the structure of the fund as a separate entity is another important concern that may have impact on the relationship between the bank and its clients. It is the bank not the separate entity that the customers entrust the assets. Therefore, the legal boundary between commercial and investment banking should be drawn from the perspective of investor protection and the nature of trust relationship. A policy tradeoff between disclosure-oriented securities regulation and confidentially-oriented bank regulation should also be considered for further reconciliation.

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