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American Banker's Ass'n v. SEC: SEC Has No Authority to Regulate Banks Dealing with the Purchase and Sale of Securities

by Cynthia A. Houghten

Recently, in *American Banker's Ass'n v. SEC,* 804 F.2d 739 (D.C. Cir. 1986), the United States Court of Appeals for the District of Columbia circuit held that the Securities and Exchange Commission (SEC) has no authority to regulate the transactions that banks make in dealing with the purchase and sale of securities and invalidated a rule issued by the SEC that had attempted to regulate such banks in the same manner as it does securities brokers or dealers. In so holding the court reinforced the clear intent of Congress that the regulation of banks was not among the powers delegated to the SEC in the Securities and Exchange Act of 1934 (1934 Act). 15 U.S.C. § 78a.

In 1985, the SEC adopted Rule 3b-9 following a notice and comment rulemaking procedure. That rule required banks which engaged in the securities brokerage business for profit to register with the SEC as broker-dealers pursuant to the 1934 Act. The American Bankers Association (ABA) filed suit in the United States District Court for the District of Columbia seeking a declaratory judgment that Rule 3b-9 was invalid under the 1934 Act, and an injunction prohibiting the SEC from enforcing the rule against ABA banks. On cross-motions for summary judgment, the court ruled for the SEC and dismissed the case. An appeal to the court of appeals was taken by the ABA.

The controversy in the present case is the result of fifty years of evolving banking and securities regulations. In order to understand the present conflict, a brief history of the earlier legislation concerning the subject is helpful. Section 16 of the Banking Act of 1933, also known as the Glass-Steagall Act, limited securities dealings by banks to purchasing and selling stocks without recourse for existing customers and subjected the purchase of stocks for the bank's own account to certain restrictions mandated by the Comptroller of the Currency. In pertinent part § 16 states:

> The business of dealing in securities and stock by the [national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of customers, and in no case for its own account, and the [national bank] shall not underwrite any issue of securities or stock: *Provided:* That the [national bank] may purchase for its own account investment securities under such limitations and restriction as the Comptroller of the Currency may be regulation prescribe.

12 U.S.C. § 24.

Section 21 of the Glass-Steagall Act established a clear line between investment and commercial banking activities, and prohibited the coexistence of the two in any one organization. That section provides:

> [I]t shall be unlawful . . . for any person, firm, corporation, association, business trust, or similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or though syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided,* that the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 24 of this title. . . .

12 U.S.C. § 378(a)(1).

The Comptroller of the Currency interpreted the Glass-Steagall Act in 1936 as limiting the activities of national banks to brokerage transactions for existing customers of the bank. Banks so dealing were prohibited from retaining any commissions from stock transactions unless the fee did not exceed the cost of the transaction. Therefore, under the Glass-Steagall Act, a bank could engage in the securities business only as "an accommodation agent for the convenience of its existing customers and not for profit." 1 Bulletin of the Comptroller of the Currency paragraph 35 (October 26, 1936).

Since its enactment in 1933, the Comptroller's interpretation of the Glass-Steagall Act has changed several times, each time becoming progressively more liberal. The

first change came in 1957, when an opinion of the Comptroller of the Currency reversed the prohibition against national banks receiving profits from brokerage transactions performed for the convenience of their customers. *See* Digest of Opinions of the Comptroller of the Currency paragraph 220A (August 1957 Edition) (quoted in [1973-1978 Transfer Binder] Fed. Banking L. Rep. (CCH) paragraph 96,272 at 81,357). Nevertheless, a bank's brokerage activities were still limited to an accommodation service for their existing customers whose relationship with the bank existed "independently of the particular securities transaction." *Id.* The next change came in 1974 when the Comptroller allowed banks to "offer and advertise computer-assisted stock purchasing services." *American Banker's Ass'n*, 804 F.2d at 741. This service was still limited to customers with checking accounts at the particular bank. Finally, the interpretation of the Act came full swing when the Comptroller of the Currency permitted national banks to establish subsidiaries to offer retail discount brokerage services, even to non-customers, at branch offices of the banks. *See In re Security Pacific Nat'l Bank* (August 26, 1982) (reprinted in [1982-1983 Transfer Binder] Fed. Banking L. Rep. (CCH) paragraph 99,824 at 86,255). The ruling in *In re Security Pacific Nat'l Bank* was subsequently extended to allow the bank, itself, to offer brokerage services in addition to those of a subsidiary. *See, e.g.*, Comptroller of the Currency Opinion Letter No. 363 (May 23, 1986); *see also* 50 Fed. Reg. 31,605 (August 5, 1985) (withdrawing proposed rule requiring the use of a subsidiary to engage in discount brokerage services). In support, the Federal Reserve Board and the Federal Deposit Insurance Corporation, which have the power to interpret the Glass-Steagall Act, have concurred with this most recent decision of the Comptroller of the Currency.

Prior to the 1980's, the SEC did not attempt to regulate the activities of banks dealing in securities. In recent years, however, numerous banks entered into the discount brokerage service as a result of the changed interpretation of the Glass-Steagall Act. This prompted the SEC to promulgate Rule 3b-9 to subject banks to the same regulations as non-bank brokers. The new rule regulated a bank that either "publicly solicits brokerage business for which it receives transaction-related compensation" or "receives transaction-related compensation for providing brokerage services for trust, managing agency or other accounts to which the bank provides advice." 17 C.F.R. § 240-3b-9(a)(1)-(2) (1986). A "transaction-related compensation" is defined in the rule as the "mean monetary profit to the bank in excess of cost recovery for providing brokerage execution services." 17 C.F.R. § 240-3b-9(d). Thus the rule seeks to regulate all banks which make a profit on securities transactions. The SEC subjected banks dealing in securities to the new rule under the theory that government regulation should be divided among the various agencies "according to the different financial functions performed by the regulated entity, and not according to the species of [the] financial institution." *American Banker's Ass'n*, 804 F.2d at 742.

However, according to the court, the SEC's theory contradicted the express intent of Congress. In order to promulgate the rule, the SEC coined definitions of key terms that conflicted with the definitions for the same words in the 1934 Act. The 1934 Act defines the word "broker" to mean "any person engaging in the business of effecting transactions in securities for the account of others, *but does not include a bank*." 15 U.S.C. § 78c(a)(4). Similarly, the term "dealer" is defined in the Act as "any person engaged in the business of buying or selling securities for his own account . . . *but does not include a bank.*" 15 U.S.C. § 78c(a)(5) (emphasis added). Each definition clearly exempted a bank from the meaning of the words "broker" or "dealer." The definition of a "bank" under the Act was tied to the entities that regulate the banking industry. A bank was "essentially . . . an institution subject to at least one of several existing banking regulators: the federal Comptroller of the Currency (for all nationally chartered banks), the Board of Governors of the Federal Reserve System (for a member bank), or any other state or Federal authority having supervision over banks." 804 F.2d at 744. However, in Rule 3b-9, the SEC reinserts into the definitions of broker and dealer any bank that: "(1) Publicly solicits brokerage business for which it receives transaction-related compensation . . . ;" or "(2) Directly or indirectly receives transaction-related compensation for providing brokerage services for trust, managing agency, or other accounts to which the bank provides advice." 17 C.F.R. § 240-3b-9(a)(1)-(2) 1986). By so doing, the SEC attempted to regulate an area over which it previously had no jurisdiction.

"It was the clear intent of Congress that the regulation of banks was not among the powers delegated to the SEC in the Securities and Exchange Act of 1934."

In striking down the rule, the court relied on and provided a detailed account of the legislative history behind the 1934 Act. The purpose of the 1934 Act was to subject the previously unregulated securities market to government control similar to that already imposed on banks by the Glass-Steagall Act. While Congress created a new agency, the SEC, to supervise investment banking, it clearly excluded banks from further regulation. *See* H. Rep. No 1383, 73rd Cong., 2d Sess. 17. Exclusion of the banks from the SEC's jurisdiction also protected against over-regulation of banks by "two arms of the Government whose purposes and policies might at times conflict." Stock Exchange Practices: Hearings Before the Senate Comm. on Banking and Currency, Part 15, 73rd Cong., 1st Sess. 7222 (1934). In later legislation concerning investment banking, Congress was consistent in its definition of banks according to the agencies which regulated them and excluded commercial banks from regulation by the SEC. *See* Investment Company and Investment Advisers Acts, 54 Stat. 791 (1940).

The SEC argued that Congress exempted banks from regulation in the 1934 Act since Congress believed that the Glass-Steagall Act of 1933 prohibited banks from brokering securities for non-banking customers or for profit. The SEC relied on the testimony before Congress of Mr. Thomas Corcoran, one of the drafters of the Act, and then counsel to the Reconstruction Finance Corporation, to prove that such was Congress' interpretation of the 1934 Act. Corcoran testified that

> under the Glass-Steagall bill a bank can no longer peddle securities at retail. It can do two things: it can buy securities for its own account, for its own investment; and it can act as agent to transmit to a broker an order to purchase or sell securities, given to it by one of the bank's customers.

See Senate Hearings, *supra* at 6470.

Thus, the SEC contended that under the Glass-Steagall Act, banks were either precluded from engaging in specified brokerage activities or that if the Glass-Steagall Act did not so prohibit, that the SEC should be able to regulate the new retail brokerage activities of banks.

The court disagreed with that argument and assumed that the testimony of Corcoran was an incorrect interpretation of the Glass-Steagall Act. Further, the court noted that Congress expressly intended to exempt banks from the regulation by the SEC of broker-dealers since banks were already heavily regulated by other state and federal agencies. Finally, the court refused to believe that in enacting the 1934 Act, Congress had done so based on their misinterpretation of the Glass-Steagall Act, and would not have exempted banks from the SEC's jurisdiction had it known how the Glass-Steagall Act would later be interpreted.

The court lent further weight to the idea that Congress intended to exclude banks from the SEC's regulatory power by pointing out that more recent legislation reaffirmed the separation of regulatory powers over investment and commercial banks. In 1975, while aware of the changed interpretation of the Glass-Steagall Act, which by then had dropped the accommodation concept, Congress declined to redefine the terms broker or dealer to include banks. It did, however, authorize the SEC to conduct a study into the emergence of banks into the retail brokerage industry. Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 111. Further, after the 1957 and 1974 changes in the interpretation of the Glass-Steagall Act, the SEC did not rush in to regulate banks.

The SEC's next argument was based on the Supreme Court's decision in *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1965) (*VALIC*), which upheld the SEC's regulation of a particular type of annuity contract although insurance contracts were clearly excepted from regulation in the Investment Act of 1940. Since a variable rate annuity contract differed from a traditional insurance contract in that annuitants under the former were paid a return based on the insurance company's investment of the premium, it was considered to be an equity share. Further, the laws excepted from SEC regulation a company engaged primarily in the traditional business of insurance. A company selling only the variable rate annuity contract could not meet such a requirement. The SEC argued that a bank selling securities was in essence comparable to the defendant in *VALIC*, and thus could not be defined as merely a bank. Therefore, the SEC should have jurisdiction to regulate an institution that sells securities. However, the court pointed out that banks of the ABA, even if dealing in securities, still qualified as banks as defined in 15 U.S.C. § 78c (a)(6). The court also noted that the ruling in *VALIC* was due to the finding of impercise terms in the applicable statutes. It could not so find in this case where the statutory definitions were clear and unambiguous.

Rather than *VALIC*, the court stated that the instant case was controlled by the decision in *Board of Governors v. Dimension Fin. Corp.*, ____ U.S. ____ (1986), where the Supreme Court struck down the Board of Governors' attempt to regulate as banks certain institutions offering negotiable order of withdraw (NOW) accounts. In so doing, the Court reiterated the fact that only institutions so regulated according to Congress' definition could be considered as banks. Merely offering services which are the functional equivalent of those offered by a regulated bank could not bring such a financial institution under the powers of the bank regulators. While a definition relying on the identity of the regulator rather than, as the SEC contended, the nature of the services offered may be imperfect, the Court noted that only Congress had the power to change the statutory definitions.

The court further rejected the SEC's attempt to show that precatory language in the definitions of the statutes allowed the court to defer to the agencies interpretation of those definitions. The SEC interpreted the phrase "unless the context otherwise requires" as referring to terms not included in the 1934 Act. The court, however, pointed to the legislative history which indicated that the precatory phrase was only intended to apply to any inconsistencies within the 1934 Act itself and did not confer such power on the SEC. Further, the SEC's power under 15 U.S.C. § 78c(b), to define terms of the trade and technical words could not give rise to a definition coined by the SEC that would have given it additional power over an area previously excluded from its jurisdiction.

With the court's ruling in this case, the division in the regulatory responsibility over commercial and investment banking has been clearly delineated. The SEC's attempt at manipulating statutory semantics was summarily rejected. Unless and until Congress changes the definitions of banks, brokers and dealers in the Securities and Exchange Act or until such changes are effectuated, the SEC will not be able to regulate the transactions of banks as brokers or dealers in the securities market.

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