GC-28-86

INFORMATION MEMORANDUM

MAR 2 6 1986

TO: The Commission

FROM: Office of the General Counsel DGael 3/27

RE: Securities Industry Association v. Board of Governors of the Federal Reserve System, No. 80-2730 (D.D.C. Feb. 4, 1986).

PERSONS TO CONTACT:

Elisse B. Walter	272-2476
Alan Rosenblat	272-2428
Marie J. Lilly	272-2425

Introduction

On April 4, 1986, the United States Court of Appeals for the District of Columbia Circuit will hear oral argument on an expedited appeal from a decision rendered on February 4, 1986, by the United States District Court of the District of Columbia. The lower court held that the commercial paper placement activities of Bankers Trust Company violate the Glass-Steagall Act's strictures on the selling, underwriting and distributing of securities. 1/

1/ The case has a long history. Over seven years ago, in January 1979, the SIA and A.G. Becker, Inc., a commercial paper dealer, requested that the Federal Reserve Board prohibit Bankers Trust from selling commercial paper issued by companies not related to the bank, claiming that such sales violated the Glass-Steagall Act. In September, 1980, the Board decided that Bankers Trust's activities were not illegal, because the commercial paper instruments sold by the bank (prime quality third-party commercial paper with a maturity of nine months or less, sold in large denominations to sophisticated customers) were not "notes or other securities" under the Act. The SIA and A.G. Becker then brought suit, and in a decision dated July 28, 1981, the United States District Court for the District of Columbia overturned the Board's decision. A.G. Becker, Inc. v. Board of

(footnote continued)

The decision, if upheld, would significantly restrict banks' abilities to participate in the lucrative commercial paper

---

1/ (footnote continued)

Governors, 519 F. Supp. 602 (D.D.C. 1981). A divided panel of the District of Columbia Circuit reversed, A.G. Becker, Inc. v. Board of Governors, 693 F.2d 136 (D.C. Cir. 1982), but the Supreme Court reversed the court of appeals. Securities Industry Association v. Board of Governors, 104 S. Ct. 2979 (1984). The Supreme Court held that commercial paper falls within the plain language of the Glass-Steagall Act, which applies to "stocks, bonds, debentures, notes, or other securities," and held that the inclusion of commercial paper is fully consistent with the Act's purposes.

The Supreme Court expressed no opinion, however, on whether Bankers Trust's activities also fell within the Act's prohibitions against the "issuing, underwriting, selling, or distributing" of securities. Because the marketing of securities would be prohibited under the Act only if the activities fell within one of these categories, the case was remanded to the district court. The district court, in an order dated October 19, 1984, remanded to the Federal Reserve Board. On June 4, 1985, the Board issued a statement concluding that Bankers Trusts' placement activities, as substantially changed from those that were the subject of the case when it was first brought, do not constitute the "underwriting" or "distributing" of a security and that the bank's activities fall within the Act's description of permissible "selling" activities. On February 4, 1986, the district court overturned the Board's decision in the opinion that is the subject of this Memorandum. Securities Industry Association v. Board of Governors, No. 80-2730 (D.D.C. Feb. 4, 1986).

The Commission filed a brief amicus curiae in the district court, supporting the position of the plaintiffs that the commercial paper at issue was a "security." Prior to briefing in the court of appeals, the Commission received certain assurances from the Board and withdrew from further participation in the case. The Commission staff reviewed and commented on the Board's brief in the Supreme Court, and gave comments to the Board's General Counsel on the draft statement of the Board to the district court on remand.

market 2/ and other private placement activities. 3/ The opinion also contains potentially significant language concerning the federal securities laws and their relationship to the Glass-Steagall Act. Among other things, the opinion states that a "distribution" of securities can occur in the context of a private offering.

Bankers Trust and the Federal Reserve Board have appealed the district court's decision, and, as noted, the court of appeals has agreed to consider the appeal on an expedited basis. 4/

Discussion

In 1978, Bankers Trust Company, a New York-chartered member bank of the Federal Reserve System, began acting as agent for several of its corporate customers in selling their commercial

---

2/ The commercial paper market currently totals about $240 billion a year. Commercial banks handle roughly just 5% of the market, but their participation is rapidly increasing. Bankers Trust, for example, currently serves some 64 issuers of commercial paper, a 50% increase over the last 12 months. See American Banker, "Commercial Paper Ruling May Imperil Other Bank Activities," Feb. 2, 1986 at p.2, col. 1.

3/ Although the bank regulatory agencies have given banks express authority to place securities privately to a small group of sophisticated purchasers, see, e.g., Federal Reserve Board Staff Study, Commercial Bank Private Placement Activities (June 1977), the SIA has stated that it may challenge the authority of banks to engage in private placement activities based on the Bankers Trust decision. See American Banker, "New SIA Target: Bank Private Placements," Feb. 20, 1986 at 1, col. 4.

4/ After Bankers Trust announced that it intended to continue selling commercial paper for its clients while the appeal is pending, the SIA sought and obtained a permanent injunction from the district court on February 18, 1986, barring the bank from its selling activities. The district court stayed the effectiveness of the injunction until March 1, 1986, permitting Banker Trust to seek a prompt appeal without discontinuing its sales of commercial paper. The court of appeals has further stayed the effectiveness of the injunction until April 15, 1986.

paper. Although its activities have varied somewhat over the years, it appears that the bank currently assists issuers in placing their paper with large financial institutions, advises client issuers with respect to the rates and maturities of a proposed issue, solicits potential purchasers and sells the paper to them. The bank at one time lent short-term funds to issuers, but it no longer does so. The bank does not purchase or repurchase the paper, hold it in inventory overnight, take any ownership in the paper or take the paper as collateral for loans. Also, the bank does not enter into any repurchase, endorsement or other guarantee arrangement with purchasers. Slip op. at 5-6.

Section 21 of the Glass-Steagall Act, 12 U.S.C. 378, prohibits any institution engaged in the business of receiving deposits from "engag[ing] in the business of issuing, underwriting, selling or distributing * * * stocks, bonds, debentures, notes or other securities * * *." Section 16 of that Act also restricts bank securities activities but permits certain limited selling transactions by providing that "[t]he business of dealing in securities and stock by [member banks] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account * * *." 12 U.S.C. 24.

In holding that Bankers Trust's activities violate the Glass-Steagall Act, the District Court found that the Bank's activities constitute "selling" within the literal terms of Section 21 of the Act. Also in the court's view, Bankers Trust's activities do not fall within the "narrow authorization" provided by Section 16. Slip op. at 29. In analyzing the scope of Section 16, the court rejected the literal approach to that Section adopted by the Board. 5/ The court stated, "By looking to see

---

5/ The Board had concluded that the bank's activities satisfy each of the criteria set forth in section 16, finding that (1) the bank does not purchase, through loans or otherwise, the commercial paper it places, (2) the bank sells the commercial paper "without recourse," since the bank's only potential liability is under the federal securities laws and this contingent liability does not violate Section 16, and (3) the bank sells "upon the order" of customers since the issuer, not the bank, decides whether to issue the paper and in what amount, since the issuer is a customer of the bank, and since the statute does not require that the customer have a pre-existing relationship with the bank. Slip op. at 11-16.

only whether the bank's sales activities fit within the literal terms of the Act, and ignoring the structure and spirit of the law, the Board has * * * turned the statute on its head." Slip op. at 23.

Relying on the Supreme Court's mode of analysis in ICI v. Camp, 6/ the court instead focused on the legislative history of the Act and an analysis of the "subtle hazards" the Act was designed to prevent. In the court's view, the legislative history indicates that, in adopting Section 16, Congress intended to allow banks to continue only the traditional retail brokerage services they had provided prior to passage of the Act. 7/ The court found that Bankers Trust's commercial paper activities are of a completely different nature, apparently unheard-of in 1933 when the Act was passed, fraught with the very promotional pressures Congress found to be injurious to commercial banking. Slip op. at 23. Moreover, the court stated, Congress drafted the law to eliminate potential conflicts of interest, not just those that were especially likely to occur. Slip op. at 27. 8/

After concluding that Bankers Trust's placement activities constituted the selling of securities in a manner not permitted by Section 16, the court went on to analyze the activities to determine whether the bank was "underwriting" or "distributing" for the purposes of Section 21. The Board had concluded that the bank neither underwrote nor distributed the commercial paper,

---

6/ 401 U.S. 617 (1971).

7/ The Commission has argued that when Congress enacted Section 16, Congress understood that banks' securities-related activities would be limited to performing accommodation services for their customers. See Brief of the SEC at 21-32, American Bankers Association v. SEC, No. 85-6055 (D.C. Cir. filed Oct. 30, 1985).

8/ Among other things, the Board had recognized that a potential conflict exists between the bank's role as lender and promoter, that the bank's reputation could be harmed if the issuer were to default, that the bank might not give disinterested advice to depositors and that companies might issue paper to raise money in order to repay outstanding loans to the bank. In each case, the Board concluded that such dangers were possible but unimportant because they were unlikely.

relying by analogy on the federal securities laws, because, in the Board's view, there is no "underwriting" or "distribution" without a public offering of securities. The court flatly rejected this approach.

As to the underwriting issue, the court observed, "[i]t is true, as the Board claims, that the term 'underwriting' commonly refers to the distribution of securities to the public." Slip op. at 32. Nonetheless, the court found that reliance on the federal securities laws in this regard was inappropriate. It pointed out that the federal securities laws were enacted to prevent fraud and protect the interests of investors, and, accordingly, the public or private nature of an offering is of crucial importance since a private distribution does not implicate provisions designed to protect unsophisticated, nonprofessional, public investors. 9/ By contrast, the court said, the Glass-Steagall Act seeks to eliminate potential conflicts of interest that arise when banks act as promoters of specific securities, and those conflicts arise regardless of whether the offering is public or private. Accordingly, the court held that Bankers Trust's activities, as a form of best-efforts underwriting aimed at large institutional investors, fall within the prohibition against underwriting in Section 21. 10/ Slip op. at 35.

9/ The court also concluded that the term "distribution" in the Securities Act should not be equated with offerings to the public. See infra at pp. 7-8, 11-12.

10/ By deciding that best-efforts underwriting is underwriting for the purposes of the Glass-Steagall Act, the court addressed an issue that was adverted to but was left unresolved by the Supreme Court in Securities Industry Association v. Board of Governors ("Schwab"), 104 S.Ct. 3003, 3010 n.17 (1984). The court's conclusion is consistent with views expressed by the Commission staff in a letter to the Board's General Counsel commenting on a draft of the Board's opinion. In its letter, the staff stated, "[we are] concerned that the [Board's draft opinion] could be read as implying that a 'best efforts distribution' may not constitute underwriting. Although the [opinion] states that the Board expresses no opinion on the question for purposes of the Glass-Steagall Act, the [opinion] concludes that Bankers Trust does not engage in underwriting since it does

(footnote continued)

The court also found that the Board's analysis of the "distribution" question was "equally flawed." Id. The Board had concluded that Bankers Trust does not engage in a public offering of commercial paper in the ordinary sense of the term and that it therefore does not distribute securities for the purposes of the Glass-Steagall Act. But the court again found that the Board had failed to account for important differences between the securities laws and the Glass-Steagall Act. First, the court stated, "the term 'distribution' in the Securities Act does not mean only 'public offerings'; if that were true, then the exemption for non-public offerings would be entirely superfluous, since by definition such offerings would not be 'distributions,' and thus would not be covered by the statute in the first place." 11/

10/ (footnote continued)

not act as a principal and does not purchase or commit its own funds with respect to the commercial paper it places. This is particularly troubling since the [opinion] purports to rely heavily on the federal securities laws for its analysis. Under the federal securities laws, however, it is well-settled that a best efforts distribution is underwriting." See Advice Memorandum from the Office of the General Counsel, GC-91-85 (April 19, 1985).

11/ To support this proposition, the court stated, "The Securities and Exchange Commission ('SEC'), the agency charged with primary responsibility for interpreting and enforcing the securities laws, has rejected the view that no distribution occurs simply because an offering is exempt from the registration under the Securities Act." Slip op. at 36 n.12. The court cited the Commission's release adopting Rule 3b-9, Securities Exchange Act Release No. 22205, 50 Fed. Reg. 28385, 28392 n.58 (July 12, 1985). See discussion infra at p. 11.

The Commission's release, however, asserted merely that a "distribution" can occur in the context of a private offering; it did not, as the court did, assert that if the term "distribution" were limited to public offerings, then the exemption for non-public offerings would be "superfluous." In fact, the court overstated its case. The court failed to note that Section 4(2) of the Securities Act exempts "transactions by an issuer not involving any public offering"

(footnote continued)

Slip op. at 36. Moreover, Congress was well aware of the distinction between public and private offerings in 1933, the court stated, and its failure to draw that distinction in the Glass-Steagall Act indicates that it did not deem the distinction relevant to the Act's purposes. Id.

The court also found that the Board's reliance on the federal securities laws fails for another reason. The Board had acknowledged that Bankers Trust's activities do not meet all the requirements for a private offering exempt from registration under Regulation D, but dismissed that fact as "not germane to the core concerns of the Glass-Steagall Act." 12/ In response the court

---

11/ (footnote continued)

(emphasis added); the section does not use the word "distribution." In the Securities Act, the term "distribution" is used in Section 2(11) in connection with the definition of the term "underwriter." This means that if the term "distribution" were limited to public offerings, a person engaging in a private offering could not be an "underwriter" and could rely on the exemption in Section 4(1) for "transactions by any person other than an issuer, underwriter or dealer," so long as that person was not also an issuer or dealer. But an issuer engaged in a private offering would not fall within the Section 4(1) exemption, and, accordingly, would still have to rely on Section 4(2) to exempt the private placement transactions. Thus, it is not true that the Section 4(2) exemption would be "superfluous" if the term "distribution" were limited to public offerings.

12/ Slip op. at 38, citing Federal Reserve Board, "Statement concerning Applicability of the Glass-Steagall Act to the Commercial Paper Placement Activities of Bankers Trust Company 31 (June 4, 1985). In its letter to the Board's General Counsel commenting on the draft of the Board's opinion, the Commission staff had criticized the proposed dicussion of Regulation D, noting that the draft had failed to focus on a key factor determining the availability of the exemption -- whether there has been a general solicitation. See Advice Memorandum, GC-91-85 (April 19, 1985). Subsequently, the Board added to its opinion a reference to the fact that the bank advertises its services and other facts relevant to Regulation D. The district court specifically noted that the bank's advertising violates Rule 502(c), which prohibits general solicitation, and also noted that the bank places no restrictions on the resale of the paper it sells, in violation of Rule 502(d). Slip op. at 37 n.13.

stated, "this pick-and-choose approach to statutory construction is unsupportable." Slip op. at 38. It said that the Board cannot both rely on the securities laws and reject them as not relevant at the same time. Moreover, the court noted, "[i]t is extremely doubtful" that Congress could have envisioned the Board's appropriation of the SEC's authority to define what constitutes a private placement of securities. Slip op. at 38-39 n.14.

Finally, the court noted that Congress has consistently continued to withhold from the Board the authority to issue regulations concerning securities activities of national banks under the Glass-Steagall Act. Slip op. at 41. Although the Board insisted that it was simply interpreting statutory terms, the court found that the Board's "interpretation" raises a host of difficulties. It pointed out that Congress designed the Act as a series of flat prohibitions; by contrast, the Board's ruling converts these clear statutory commands into "sliding scale prohibitions" necessitating guidelines to demarcate between permissible and impermissible offerings and agency oversight to monitor the sales activities of banks in order to assure adherence to those guidelines. Accordingly, the court held that the Board's ruling must be invalidated.

Analysis

The district court's opinion is important to the Commission in a number of respects. In recent years, the Commission has refrained from expressing any position on the application of the Glass-Steagall Act to particular situations or on the policy issue of whether banks should be permitted to distribute commercial paper. 13/ However, the Commission argued in an earlier phase of the Bankers Trust case that the securities laws should be construed in pari materia and that terms found in both the Glass-Steagall Act and the securities laws should be construed similarly. 14/

13/ See Advice Memorandum, GC-91-85 (April 19, 1985).

14/ See Brief of the SEC, Amicus Curiae, A.G. Becker, Inc. v. Board of Governors, 519 F. Supp. 602 (D.D.C. 1981). In accord with the amicus curiae brief filed by the Commission, the district court held in 1981 that, as in the federal securities laws, commercial paper is a security for the purposes of the Glass-Steagall Act. The court of appeals reversed, and the Supreme Court reversed the court of appeals. See supra note 1.

More recently, we have not pressed an in pari materia theory, in order to maintain flexibility for the Commission in interpreting the securities laws, unencumbered by contrary interpretations by bank regulators. Indeed, shortly after the Board issued its opinion holding that Bankers Trust did not sell, underwrite or distribute commercial paper, the Commission emphasized in its release adopting Rule 3b-9 that the Board's opinion is not relevant to the Rule, which must be interpreted with reference to the federal securities laws. 15/ By refusing

---

15/ Securities Exchange Act Release No. 22209, 50 Fed. Reg. 28385, 28392 n.59 (July 12, 1985). See also Supplemental Memorandum from the Office of the General Counsel, GC-152-85 (June 27, 1985). In adopting Rule 3b-9, the Commission wished to accommodate private placement activities that historically had been held permissible under the Glass-Steagall Act by the bank regulators. See, e.g., Federal Reserve Board Staff Study, Commercial Bank Private Placement Activities (1977). Accordingly, Rule 3b-9 exempts from registration as a broker-dealer any bank that "[e]ffects transactions pursuant to Sections 3(b), 4(2), and 4(6) of the Securities Act of 1933 and the rules and regulations thereunder." See Rule 3b-9(b)(6). However, in the staff's view, Bankers Trust's activities may have gone beyond the scope of private placement activities in the context of the securities laws. In order to avoid giving the impression that the Commission endorsed the Board's Bankers Trust opinion, in the Rule 3b-9 release, the Commission noted crucial differences between the scope of private placement activities under the Glass-Steagall Act and the federal securities laws. Thus, while the Board had ignored certain aspects of Regulation D in concluding that Bankers Trust had engaged in a private placement not constituting underwriting or distributing under the Glass-Steagall Act, the Commission emphasized that an offering must meet all the requirements of Regulation D if a bank does not register as a broker-dealer in reliance on that safe harbor and the Rule 3b-9(b)(6) exemption.

Moreover, the Commission addressed the impression created by the Board's opinion that a "distribution" can occur only in an offering to the public. In the context of Rule 3b-9, the fact that a distribution can occur in a private offering does not affect the operation of the Rule, since a bank will

(footnote continued)

to import the private placement exemptions into the Glass-Steagall Act and by suggesting that the Board improperly "appropriate[d]" the Commission's authority to define what constitutes a private placement, slip op. at 38-39 n.14, the district court confirmed the Commission's efforts to maintain appropriate distinctions between the securities laws and Glass-Steagall.

The district court's opinion also confirms views expressed by the staff and the Commission concerning the scope of the term "distribution" in the federal securities laws. As mentioned above, the court stated that the term "distribution" in the Securities Act does not mean only "public offerings." Slip op. at 36. This view had been expressed by the Commission staff in its letter commenting to the Board on its draft opinion. 16/ Moreover, the Commission stated in its release adopting Rule 3b-9 that "[i]t is the Commission's view * * * that the fact that an offering is exempt from registration pursuant to one of the exemptions [under Sections 3(b), 4(2) and 4(6) of the Securities Act] does not necessarily mean that no 'distribution' has occurred, as that term is used in the definition of 'underwriter' in Section 2(11) of the Securities Act of 1933." 17/

15/ (footnote continued)

be exempt from registration as a broker-dealer if it effects transactions pursuant to a valid private offering, whether or not it engages in a "distribution" or acts as an "underwriter" for the purposes of Securities Act Section 2(11). However, since the existence of a "distribution" in a private offering may be important in other contexts, see infra at pp. 11-12, the Commission emphasized that its interpretation differed from that of the Board's.

16/ See Advice Memorandum, GC-19-85 (April 19, 1985). In its letter, the staff stated, "the [Board's draft opinion] could be read as implying that a Regulation D offering cannot be a distribution for purposes of the definition of an underwriter under Section 2(11) of the Securities Act. The staff believes that the fact that an offering is exempt from Securities Act registration under Regulation D does not necessarily mean that no 'distribution' has occurred, as that term is used in Section 2(11)."

17/ Securities Exchange Act Release No. 22209, 50 Fed. Reg. 28385, 28392 n.59 (July 12, 1985). The district court cited the Commission's release as support in its opinion. Slip op. at 36 n.12. See discussion supra n.11.

Section 2(11) defines the term "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking * * *." Traditionally, the term "underwriting" has been equated with the distribution of securities to the public. 18/

However, as mentioned in this Office's Supplemental Memorandum recommending adoption of the above-cited language in the Commission's Rule 3b-9 release, this Office and the Division of Corporation Finance believe that the terms public offering and distribution should not be considered coterminous, since exempt offerings are now used to sell large amounts of securities to large numbers of investors. Moreover, the Supplemental Memorandum notes, Regulation D is not currently available to persons other than issuers or their agents. Thus, a bank or brokerage firm that acquires securities in a valid Regulation D offering may not, as principal, reoffer the securities to a large number of persons without registration in reliance on Regulation D.

Conclusion

The Commission participated amicus curiae at an early stage in this litigation because of concerns that interpretations of similar terms in the Glass-Steagall Act and the securities laws might have an adverse affect on the Commission's administration of the securities laws. More recently, informal staff efforts and statements in the Commission's release adopting Rule 3b-9 have adequately protected the Commission's interests in this area. Moreover, the District Court opinion makes it clear that its holdings on interpretations of statutory terms are limited to the Glass-Steagall Act. The dicta concerning the meaning of those terms under the securities laws are consistent with Commission and staff positions. We believe that it is not necessary or advisable for the Commission to attempt to participate in the litigation at this time. Depending on how the issues are framed as the case progresses, we may in the future recommend that the Commission consider whether to participate in this matter.

We will continue to monitor the Bankers Trust litigation and keep the Commission informed of new developments.

Attachment: Opinion

18/ See, e.g., H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934); 1 L. Loss, Securities Regulation 551, 654 n.43 (2d ed. 1961); Slip op. at 32.