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CAN 10b-5 FOR THE BANKS? THE EFFECT OF AN ANTIFRAUD RULE ON THE REGULATION OF BANKS*

*MICHAEL P. MALLOY***

In this Article, Professor Malloy explores the effects of the federal securities antifraud rule on the regulation of banks. In particular, he focuses on the changes in regulation of commercial bank trust department activities that followed the revelations in Texas Gulf Sulphur *of alleged tipping between the commercial and trust departments of a major New York bank. He also argues that federal bank regulatory policy has now turned away from disclosure-oriented regulation in favor of capital supervision, and that this may be a mistaken approach to the regulation of banking.*

INTRODUCTION

THE world of banking remains a mysterious realm in which credit is created by the transformation of deposits, many times over, into loans, which themselves are transformed into deposits.[1] Since the beginning of the Republic, this "credit function" has attracted much attention from policymakers, evincing both positive and negative reactions.[2]

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1. For a description of this "credit function," see Michael P. Malloy, The Regulation of Banking 381 (1992); *see also* Frederic S. Mishkin, The Economics of Money, Banking, and Financial Markets 262-70 (2d ed. 1989).

2. This controversy can be seen in its purest form in the Hamilton-Jefferson debate over the proposal to create the First Bank of the United States. Hamilton included the following among the many benefits to be derived from strengthening the banking system by the creation of a central bank:

> The augmentation of the active or productive capital of a country. . . . [W]hen [gold and silver are] deposited in banks, to become the basis of a paper circulation, which takes their character and place, . . . they then acquire life, or, in other words, an active and productive quality. . . . It is a well established fact, that banks in good credit, can circulate a far greater sum than the actual quantum of their capital in gold and silver.

Alexander Hamilton, Treasury Report on a National Bank, Dec. 13, 1790, *reprinted in* 1 American State Papers [Class III] 67-68. Jefferson's reaction to this claimed advantage was dismissive:

> The report . . . states the only *general* convenience [of the creation of a national bank] to be preventing the transportation and re-transportation of money between the States and the treasury, (for I pass over the increase of circulating medium, ascribed to it as a merit, and which, according to my ideas of paper money, is clearly a demerit).

Thomas Jefferson, Opinion, Feb. 15, 1791, *reprinted in* Documentary History of Banking and Currency in the United States 147 (H. E. Kross ed., 1969 ed.) (emphasis in original).

Policymakers have raised many questions concerning the function of banks within the economy, including whether banks can sustain the credit function over time[3] and whether they can maintain public confidence in their safety and soundness.[4] An equally pressing question exists in the intersection between banking regulation and securities regulation: can 10b-5 for the banks?

This question may seem somewhat cryptic. In more straightforward terms, it asks the following: what effect have the antifraud requirements of Rule 10b-5[5] had on the regulation of banks? The answer to this question reveals some interesting features of the peculiar intersection of the federal regimes of banking and securities regulation.

With the first major flowering of the Rule 10b-5 regime in the aftermath of *Securities and Exchange Commission v. Texas Gulf Sulphur Company* ("*TGS*"),[6] bank regulatory policy and practice faced a potential crisis concerning the implications of the generally applicable antifraud rule for the practices of banks. Nevertheless, the antifraud rule was assimilated into the regulations of the federal banking agencies[7] in a

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3. The inability to sustain this function has been the cause of the failure or near-failure of many banks. *See, e.g., Continental Illinois: How Bad Judgments and Big Egos Did It In*, Wall St. J., July 30, 1984, at 1 (significant deposit withdrawal demands and improvident lending creating conditions of collapse).

4. Safety and soundness is a central concept in bank supervision. *See* Michael P. Malloy, *Balancing Public Confidence and Confidentiality: Adjudication Practices and Procedures of the Federal Bank Regulatory Agencies*, 61 Temple L. Rev. 723, 769-74 (1988) (discussing the concept). The safety and soundness concept has also received renewed legislative attention. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 132(a), 105 Stat. 2236, 2267 (codified at 12 U.S.C. § 1831s (Supp. III 1991)) (standards for safety and soundness).

5. 17 C.F.R. § 240.10b-5 (1992). Rule 10b-5 states as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Id.

6. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

7. This Article uses the term "federal banking agencies" generically to refer to the Office of the Comptroller of the Currency ("OCC") (the principal regulator of national banks), the Board of Governors of the Federal Reserve System ("Fed") (the principal federal regulator of state-chartered, Fed-member banks, and of bank holding companies), the Federal Deposit Insurance Corporation ("FDIC") (the principal federal regulator of state-chartered, non-Fed-member, FDIC-insured banks and the administrator of the federal deposit insurance funds), and the Office of Thrift Supervision ("OTS") (the principal federal regulator of savings associations and of savings and loan holding companies). *See* 12 U.S.C. § 1813(q) (Supp. III 1991) (defining the roles of the federal banking agencies). For an extended discussion of the roles and authority of the federal banking agencies, see 1 Michael P. Malloy, The Corporate Law of Banks 21-60 (1988 & Cum. Supp.).

way that may have blunted its significance. In addition, the federal bank regulatory policy decisively turned away from the techniques of securities regulation[8] and toward a regime of capital supervision.[9]

Part I of this Article examines the potential crisis for bank regulatory policy implicit in the Second Circuit's decision in *TGS*, which raised questions concerning the validity of interrelationships between the trust and commercial loan departments of a commercial bank. Part II analyzes federal securities law principles as assimilated into federal bank regulation. Part III reviews the ways capital supervision has emerged as the central focus of federal bank regulatory policy on banks[10] as securities-issuing entities. This Article concludes that the current preoccupation with capital supervision, over the concerns of securities regulation, is misplaced and leaves open the possibility that Rule 10b-5 will continue to be an important consideration for banking enterprises.

I. *TGS* and the Potential Crisis for Bank Regulatory Policy

A. *A Paradigm Shift in Regulatory Treatment of Bank Trust Departments*

The Second Circuit's 1968 *TGS* decision marked an important turning point in the development of the law and lore of Rule 10b-5.[11] Indeed, *TGS* effected so complete a "paradigm shift"[12] in the way we think about

8. Indeed, it may be argued that the federal banking agencies have never, as an institutional matter, been comfortable with securities regulation techniques. *See, e.g.*, Michael P. Malloy, *Public Disclosure as a Tool of Federal Bank Regulation*, 9 Ann. Rev. Banking L. (1990) [hereinafter *Public Disclosure*] (arguing that public disclosure techniques stand in contrast to typical bank regulatory techniques); Michael P. Malloy, *The 12(i)'ed Monster: Administration of the Securities Exchange Act of 1934 by the Federal Bank Regulatory Agencies*, 19 Hofstra L. Rev. 269 (1990) [hereinafter *12(i)'ed Monster*] (criticizing the agencies' administration of federal securities laws).

9. The term "capital supervision" refers to regulatory requirements imposed with the objective of "maintaining capital adequacy of [depository] institutions." Malloy, *supra* note 7, at 409.

10. While the major focus of this Article is on federal regulation of commercial banks, parallels will be cited with respect to the regulation of savings associations—i.e., consumer-oriented depository institutions that share many of the features of banks. For a study on commercial banks and savings associations as types of "depository institutions" subject to similar regulatory regimes, see Malloy, *supra* note 7, at 5-8 (1988 & Cum. Supp.).

11. *See* Donald C. Langevoort, *Rule 10b-5 as an Adaptive Organism*, 62 Fordham L. Rev. S7, S12 (1993) (discussing shift in thinking about 10b-5 marked by the *TGS* decision).

12. The term "paradigm shift" is borrowed from the philosophy of science, as developed in Thomas S. Kuhn, The Structure of Scientific Revolutions (2d ed. 1970), yet Kuhn himself invites the analogy between the experience of scientific research and the development of legal principles. Kuhn writes:

> In a science, . . . a paradigm is rarely an object for replication. Instead, like an accepted judicial decision in the common law, it is an object for further articulation and specification under new or more stringent conditions.

Id. at 23. Paradigms define not only the accepted framework of theory within which the concept of insider trading, that it now appears to have entered that exalted category of "most often cited, least often read" cases. To understand the potential crisis it raised for bank regulatory policy, we need to recreate the impact *TGS* had at the time of its decision.

First, let us recall certain well-received, common law presuppositions. Fraud is reprehensible (and actionable) at traditional common law. In its most general terms, "fraud" means a situation in which a plaintiff has justifiably relied, to his or her detriment, upon a false representation of a material fact made by a defendant who had knowledge of the falsity and intended that the plaintiff rely upon it.[13] In the straightforward world of direct, face-to-face transactions, this rule seems to satisfy intuitively the natural desire to order human interactions in a manner that minimizes conflict. Suppose Ms. D tells Mr. P that a certain scientific process she has perfected will accelerate the aging process of new brandy into a mature and superior brandy. She knows that the process is a clever fake with which she intends to trick Mr. P into parting with a large sum of money. If Mr. P reasonably relies upon Ms. D's representations and parts with the sum,[14] Mr. P will have a viable cause of action against Ms. D for his damage. Alternatively, if instead of selling the process, Ms. D sells to Mr. P stock in the company that owns the process, Mr. P will also have a cause of action in fraud or deceit for his damage.[15]

One challenge to this paradigm arises if we assume that Ms. D has said nothing to Mr. P on the subject, though she knows that the process is fake and that Mr. P thinks otherwise. The common law stumbled over this situation because it did not suit the paradigmatic scenario presupposed by the basic common law rule concerning fraud.[16] Under the so-called majority rule, a nondisclosing defendant possessing material infor-

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science proceeds, but also the instrumental means of achieving experimental results (that is, not only how data is to be interpreted, but also how instruments are to be used). When anomalies are identified, they carry the potential for raising questions about the underlying paradigm itself. This situation may result in a crisis, as described by Kuhn:

> All crises begin with the blurring of a paradigm and the consequent loosening of the rules for normal research.... [A]ll crises close in one of three ways. Sometimes normal science [(i.e., science proceeding under the current paradigm)] ultimately proves able to handle the crisis-provoking problem .... On other occasions the problem resists even apparently radical new approaches.... Or, finally, ... a crisis may end with the emergence of a new candidate for paradigm and with the ensuing battle over its acceptance.

Id. at 84. It is this third case that leads to a paradigm shift. The significance of a paradigm shift lies in the fact that it changes not only a theory but the approach to problems yet to be confronted. "[W]hen paradigms change, there are usually significant shifts in the criteria determining the legitimacy both of problems and of proposed solutions." *Id.* at 109.

13. *See* W. Page Keeton et al., Prosser & Keeton on the Law of Torts 728 (5th ed. 1984).

14. *Cf.* Margery Allingham, *The Widow, in* Mr. Campion and Others 1-24 (1991) (offering a fictional account of such a scheme).

15. *See* Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) (cause of action for fraud under Rule 10b-5 for purchaser of securities).

16. *See* Keeton et al., *supra* note 13, at 737.

mation generally has no affirmative duty of disclosure or fairness to an unsuspecting purchaser or seller.[17] This rule stands in contrast to a decidedly minority rule that imposes a fiduciary duty of disclosure on corporate managers or insiders purchasing shares from a current shareholder of the subject corporation.[18] Splitting the difference between these two rules,[19] and perhaps highlighting the strain on the paradigm caused by intuitively sympathetic cases that do not fit the traditional scenario presupposed by the common law rule, is the so-called special facts doctrine. This doctrine allows recovery to a plaintiff-seller if the information undisclosed by the corporate insider involves "special circumstances or facts . . . mak[ing] it inequitable for the [insider] to withhold information."[20]

In making the transition from traditional common law rules concerning fraud to federal securities law, one must consider how, if at all, the general contours of the former should determine the shape of the latter.[21] "In civil actions instituted on the basis of 10b-5 violations, the keynote of which is fraud, the full panoply of common law fraud elements . . . have crept in and played varying roles of significance."[22] However, the paradigmatic crisis, which was ultimately resolved by *TGS*, involved the specific question of whether "pure" nondisclosure should be actionable in the insider trading context under Rule 10b-5 regardless of whether it is open to question as a matter of common law.

The *TGS* answer that "pure" nondisclosure should be actionable in the insider trading context[23]—raised questions concerning the validity of interrelationships between the trust and commercial loan departments of a bank. *TGS* also challenged certain presuppositions about the way stock trading institutions conducted their operations. In his study of the J. P. Morgan banking enterprise, Ron Chernow described the challenge to these presuppositions in the following terms:

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17. *See, e.g.*, Connolly v. Shannon, 147 A. 234 (N.J. Ch. 1929) (applying traditional rule), *aff'd*, 151 A. 905 (1930). *But cf.* Keeton et al., *supra* note 13, at 738-39 (confidential or fiduciary relationship between buyer and seller results in liability in nondisclosure situation).

18. *See, e.g.*, Taylor v. Wright, 159 P.2d 980 (Cal. Dist. Ct. App. 1945) (imposing liability on fiduciary); Oliver v. Oliver, 45 S.E. 232 (Ga. 1903) (same).

19. One commentator has argued that the "special facts" rule has been generally applied in order to merge the majority rule into the minority rule. *See* 7 Louis Loss & Joel Seligman, Securities Regulation 3474 (3d ed. 1991). *But see* Sherwood E. Sterling, *"Wherefore Art Thou, Fiduciary?": The Securities and Exchange Act of 1934 and the Common Law Fiduciary Duty of the Director*, 35 U. Colo. L. Rev. 410, 422 (1963) (disputing this conclusion).

20. American Trust Co. v. California W. States Life Ins. Co., 98 P.2d 497, 504 (Cal. 1940); *accord* Strong v. Repide, 213 U.S. 419, 433-34 (1909) (holding that duty to disclose may exist in special cases, depending on the facts).

21. For an excellent approach to the problem of transition from a common law regime to a federal regulatory regime, see Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 97 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

22. *Id.*

23. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

> [N]ew fears about insider trading . . . took the banks by surprise. In the twenties, fortunes had been made through whispered tips and sly winks. The public tolerated this because only a tiny percentage of them owned stock. As personal investing grew in the 1950s and early 1960s, the public didn't wish to take part in a rigged game. It took time for the banks to perceive the danger, or at least the new public apprehension. In the 1960s, trust departments weren't yet segregated from other departments. At [Morgan Guaranty Trust Co.], senior bank officers—many of them directors of five or ten companies—sat on the Trust Committee, which also had as members outside directors of the bank . . . . These men were expected to bring their specialized knowledge to bear in picking stocks [for the Trust Department]. At that point, banks didn't worry that they might misuse confidential information from the lending side in making investment decisions [for the Trust Department]; there weren't yet legal barriers, or "Chinese walls," between the commercial and the trust departments.[24]

TGS was not simply an abstract precedent with implications for banks. In fact, it directly enmeshed Morgan Guaranty Trust Company ("Morgan"), one of the major New York banks. The pedigree is as follows. Thomas S. Lamont, a partner at Morgan, was also a director on the board of Texas Gulf Sulphur Company ("TGS"), and had been since 1927.[25] He had regularly recommended the purchase of TGS's stock to Morgan's trust department.[26] In November 1963, TGS discovered an important mineral lode, and from that point until mid-April 1964, it attempted to quiet reports of the discovery.[27] On April 16, 1964, TGS held a board meeting and press conference to announce the discovery, both of which Mr. Lamont attended. The head of Morgan's trust department asked Mr. Lamont to inform him of the results of the proceedings.[28]

What followed resembles a law professor's hypothetical problem. It is well described by Mr. Chernow:

> The [TGS] meeting began at nine sharp, with a full complement of fifteen directors. At about ten o'clock, twenty reporters were herded in for a press conference. . . . The company wanted to keep all reporters in the room until the press conference was over. But once [TGS president] Claude Stephens finished his announcement [of the discovery], [a reporter for Merrill Lynch's monthly magazine] managed to slip out a side door. She got the news on the firm's in-house network at 10:29 A.M. A reporter for a Canadian wire service got out another door. Meanwhile, the other reporters stayed put, forced to watch color slides

24. Ron Chernow, The House of Morgan 562 (1990).
25. *See id.* at 563.
26. *See id.*
27. For a discussion of the factual background of this case, see SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 843-47 (2d Cir. 1968); *see also* Chernow, *supra* note 24, at 563-64 (discussing factual background of *TGS*). For a report of the litigation triggered by the efforts of TGS to quiet reports of the discovery, see Mitchell v. Texas Gulf Sulfur Co., 446 F.2d 90, 93-96 (10th Cir.) *cert. denied*, 404 U.S. 1004 (1971).
28. *See* Chernow, *supra* note 24, at 563.

> of the ore deposit. At the first moment of freedom, they dashed to the telephones to report the sensational news. [It] appeared on the Dow Jones "broad tape" of market news at 10:55 A.M.
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> After the meeting, Lamont mingled with reporters, viewing core samples and color slides . . . . About 10:40 A.M., he phoned [Street Hinton, head of the Morgan trust department,] from the [TGS] offices. "Take a look at the ticker," Lamont said. "There is an interesting announcement coming over about [TGS]." "Is it good?" Hinton asked. "Yes, it's good," Lamont said. . . . In fact, [Hinton] failed to verify that it had appeared. . . . He at once telephoned the trading desk and bought three thousand [TGS] shares for the [Nassau Hospital Association, whose portfolio he ran personally]. Then he advised [Morgan portfolio manager] Peter Vermilye to add the stock to a Morgan Guaranty profit-sharing plan and a mixed fund that invested for two hundred pension plans; Vermilye bought one thousand and six thousand shares respectively. All the while, the story hadn't shown up on the Dow Jones broad tape, even though it had been flashed to 159 Merrill Lynch branches. . . .
>
> Lamont returned to his office . . . and at 12:33 P.M. bought three thousand [TGS] shares for himself and his family. . . . Only twelve days later did Lamont learn of the Trust Department purchases triggered by his call. He hadn't advised Hinton to buy. He later claimed he was discharging a duty and not phoning in a hot tip.[29]

The Securities and Exchange Commission (the "SEC") charged Lamont, along with twelve other TGS insiders and tippees, with insider trading. The District Court for the Southern District of New York dismissed the charges against eleven of the defendants, including Lamont, on the grounds that the material information on which their trading was based was already public at the time of the trades.[30] The SEC appealed, but in April 1967, Lamont died after undergoing heart surgery.[31] The parties to the appeal agreed to a discontinuance of the case against him, but the appeal continued to a conclusion with the Second Circuit's decision.[32]

This resolution was no comfort to the banking world in the wake of the *TGS* crisis. "However misguided in its pursuit of Lamont, the SEC in [*TGS*] drew attention to the growing dangers of financial conglomeration . . . . As both commercial and investment banks developed huge, diversified operations, it would be increasingly difficult for them to segregate diverse and often legally incompatible operations."[33] *TGS* decisively called into question previously accepted practices in which banks implicitly traded on their key role as financial intermediaries, intermingling

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29. *Id.* at 564-65 (footnote omitted).
30. *See* SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966).
31. *See* Chernow, *supra* note 24, at 567.
32. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 842 n.6 (2d Cir. 1968).
33. Chernow, *supra* note 24, at 567.

their commercial lending and advising with the fiduciary activities performed by their trust operations.

In a key strategic move, the Second Circuit blurred completely the fine distinctions of the common law rules concerning fraud.[34] In the court's view, it seemed almost irrelevant where, if at all, a specific duty arose preventing insiders from trading on the basis of nondisclosed, material inside information. The court stated: "Whether predicated on traditional fiduciary concepts or on the 'special facts' doctrine, [Rule 10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[35]

The assertion of this "justifiable expectation" was probably counterfactual,[36] at least until the Second Circuit had introduced it.[37] Nevertheless, the court extended the "equal access" rule beyond statutory insiders (directors, officers, and over-ten-percent shareholders)[38] to include such secondary actors as banks and bankers who are in the confidence of such insiders. The shadow of the *TGS* rule also fell across commercial lending and trust departments of banks:

> [T]he Rule is also applicable to one possessing the information who may not be strictly termed an "insider" . . . . Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[39]

This broadly interpreted rule seemed to extend to virtually anyone in possession of material information that would affect the optimal condition of "equal access." In fact, it took the Supreme Court over a decade to sort out and restrain these implications, and to reestablish firmly the traditional requirement that an insider trading violation could only be triggered by the violation of some sort of duty to the contrary.[40] Nevertheless, according to one writer shortly after the decision was handed down, *TGS* sent "shock waves [that were] . . . felt in bankers' offices from

34. *See TGS*, 401 F.2d at 855.

35. *Id.* at 848 (citations omitted).

36. *But cf.* Symposium, *Insider Trading in Stocks*, 21 Bus. Law. 1009, 1010 (1966) (arguing the opposite).

37. *See* Chernow, *supra* note 24, at 562. *But see In re* Cady, Roberts & Co., 40 S.E.C 907, 912 (1961) (articulating an "equal access" rule with respect to such trading by broker-dealers).

38. *See* 15 U.S.C. § 78p(a) (1988).

39. SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 848 (2d Cir. 1968) (citation omitted).

40. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 231-35 (1980) (requiring specific duty; "mere possession" of inside information affecting equal access rejected as basis for liability); Dirks v. SEC, 463 U.S. 646 (1983) (explaining duty underlying tipper-tippee liability).

coast to coast."[41] Moreover, the dire implications for banks were quite clear even at this early stage: "Short of an absolute reversal by the [United States] Supreme Court, it seems clear that it's a new ball game for those who buy and sell stock on 'inside information[,]' . . . [including] bank officials who, by the nature of their business, are privy to confidential corporate information."[42]

One ominous feature of the insider trading regime that emerged from *TGS* becomes apparent when *TGS* is read in conjunction with the SEC's 1968 settlement of administrative charges against Merrill Lynch for tipping its clients to adverse information about Douglas Aircraft Company;[43] that is, what happens to a tipper who claims to owe a competing fiduciary duty to those for whom it is acting as fiduciary. In terms of *TGS*, the question is whether Morgan had a fiduciary duty to the beneficiaries of the trusts it managed to act on the material information it received from Tommy Lamont. In the face of the contrary duty imposed by Rule 10b-5, this question constitutes a dilemma for bank trust departments[44] that may only be resolved by separating off the decisionmaking of the trust department from other information receptors within the bank.[45] One commentator expressed this dilemma as follows:

> It's one thing to say that the executive cannot trade for his own benefit using material inside information. It's another thing to restrict his actions in buying and selling securities as a fiduciary. The Securities and Exchange Commission has no hesitancy about saying that the rule is the same in both cases.[46]

B. *The Regulatory Response to the Crisis*

The period of the mid-1960s was a time of great change in the regulation of bank securities and securities activities. For example, in 1962, Congress shifted regulatory authority over national bank trust powers from the Federal Reserve Board (which had controlled them since

41. Alvin L. Arnold, *Guidelines for the Banker "Insider" or "Tippee": The Texas Gulf and Merrill Lynch Decisions*, 86 Banking L.J. 319, 319 (1969).

42. *Id.* at 319. The Supreme Court denied certiorari shortly after the Arnold article appeared. *See* Kline v. SEC, 394 U.S. 976 (1969).

43. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 8459, Fed. Sec. L. Rep.(CCH) ¶ 77,629 (Nov. 25, 1968) (accepting offer of settlement in which respondent and its employees consented to findings that they had violated Rule 10b-5 by tipping clients that thereafter sold Douglas stock); *see also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (parallel private cause of action for tipping).

44. *See* Francis J. Bruzda & Richard B. Seidel, *Bank Trust Departments and the 10b-5 Dilemma*, 21 Vill. L. Rev. 367, 368 (1976).

45. *See* Henry Harfield, *Texas Gulf Sulphur and Bank Procedures between the Trust and Commercial Departments*, 86 Banking L.J. 869 (1969). *See generally* Edward S. Herman & Carl F. Safanda, *The Commercial Bank Trust Department and the "Wall"*, 14 B.C. Indus. & Commercial L. Rev. 21 (1972) (discussing use of "walls" between bank commercial and trust departments to cut off informational flows).

46. Arnold, *supra* note 41, at 322-23.

1913[47]) to the Comptroller of the Currency.[48] In April 1963, the Comptroller promulgated regulations.[49]

In August 1964, the Securities Exchange Act of 1934 (the "1934 Act") was amended to extend its applicability, *inter alia*, to publicly traded securities of banks and thrift institutions.[50] However, administration of the 1934 Act in this regard was entrusted to the federal banking agencies, rather than the SEC.[51] In addition, both the Comptroller and the Federal Home Loan Bank Board (and its successor, the Office of Thrift Supervision) have long had regulations governing disclosure in connection with the initial issuance of bank and thrift securities.[52] Thus, the securities activities of banks have been thoroughly circumscribed by a regulatory scheme.

In particular, the Comptroller's rules have sought to insulate bank trust department operations from the problem raised by the SEC actions against TGS and Merrill Lynch. First, a national bank operating a trust department must "designate, employ or retain" counsel readily available "to pass upon fiduciary matters and to advise the bank and its trust department."[53] Thus, it is likely that oversight of a potential 10b-5 dilemma will fall to counsel.

Second, interlocking of bank personnel and facilities between the trust department and other departments is permitted "only to the extent not prohibited by law."[54] The Comptroller offered the following specific guidance with respect to this rule:

> Every national bank exercising fiduciary powers shall adopt written policies and procedures to ensure that the Federal securities laws are complied with in connection with any decision or recommendation to purchase or sell any security. Such policies and procedures, in particular, shall ensure [that] national bank trust departments shall not use material inside information in connection with any decision or recommendation to purchase or sell any security.[55]

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47. *See* Federal Reserve Act, ch. 6, 38 Stat. 261, 262, 265 (1913) (codified at 12 U.S.C. § 248(k) (Supp. III 1991)), *as amended*, Act of Sept. 26, 1918, ch. 177, 40 Stat. 968 (1918); Act of June 26, 1930, ch. 612, 46 Stat. 814 (1930); Act of Aug. 23, 1935, ch. 614, 49 Stat. 722 (1935).

48. *See* Pub. L. No. 87-722, § 1, 76 Stat. 668, 670 (1962) (adding 12 U.S.C. § 92a (1988); repealing § 248(k)), *as amended*, Pub. L. No. 96-221, § 704, 94 Stat. 187 (1980) (adding 12 U.S.C. § 92a(k) (1988)).

49. *See* 12 C.F.R. pt. 9 (1992).

50. *See* Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964) (codified at 15 U.S.C. § 78*l*(g), (i) (1988 & Supp. III 1991)); *infra* notes 67-73 and accompanying text.

51. *See* 15 U.S.C. § 78*l*(i) (Supp. III 1991); *see also* Malloy, *supra* note 7, at 491-93 (discussing applicability of the Act to bank- and thrift-issued securities).

52. *See, e.g.*, 12 C.F.R. pt. 16 (1992) (prescribing securities offering disclosure rules for national banks); 12 C.F.R. § 563g (1992) (prescribing OTS disclosure rules for savings associations). These regulations are equivalent to the requirements of the Securities Act of 1933. *See* 15 U.S.C. §§ 77a-77bb (1988).

53. 12 C.F.R. § 9.7(c) (1992).

54. *Id.* § 9.7(d).

55. *Id.*

This directive has endorsed the use of protective "walls" between the operation of a bank's trust department and other departments.

Third, a bank must keep fiduciary records "separate and distinct" from all other bank records,[56] and it must keep adequate records of all pending litigation involving the exercise of its fiduciary powers.[57] Generally, all of these records must be retained for a period of three years after the termination of a fiduciary account or of litigation relating to the account.[58] These requirements are primarily intended to facilitate both information oversight and inquiry by the Comptroller.[59]

Fourth, a bank's trust department must be audited by a committee of the bank's outside directors at least once each calendar year, or by a system of continuous audit.[60] The auditors must ascertain, among other things, "whether the department has been administered in accordance with law."[61] This requirement places an affirmative burden on a bank's outside directors in that it forces them to play a more active role than is generally required or expected of a general business corporation's outside directors.

Through such regulatory regimes, state and federal banking agencies have sought to minimize the potential crisis raised by *TGS* and its progeny. Yet, a peculiarity exists within the scheme of federal securities regulation that makes it conceptually impossible for banking agencies to contain the problem within their own regulatory purview: section 10(b) of the Securities Exchange Act,[62] and hence Rule 10b-5, are not included in the federal securities regulation power given to federal banking agencies with respect to the institutions that they regulate.[63] Accordingly, direct SEC enforcement of Rule 10b-5 against banks remains a possibility.

II. The Assimilation of Securities Law Principles into Federal Bank Regulation

With respect to the securities of banks and savings associations, the principles of securities regulation embodied in the Securities Exchange Act of 1934 (the "1934 Act"),[64] do not generally exist as a separate regulatory system outside the regime of federal bank regulation. In this Part, we shall examine the extent to which those principles have been assimilated into federal bank regulation.

At one time, the 1934 Act by its own terms had a more limited scope

56. *See id.* § 9.8(a).
57. *See id.* § 9.8(b).
58. *See id.* § 9.8(c).
59. *See id.* § 9.8(a), (c).
60. *See id.* § 9.9. As an alternative to a committee audit, a bank may delegate the audit to "[outside] auditors responsible only to the board of directors." *Id.*
61. *Id.*
62. 15 U.S.C. § 78j(b) (1988).
63. *See infra* notes 77-103 and accompanying text.
64. 15 U.S.C. §§ 78a-78*ll* (Supp. III 1991).

than it does now,[65] with the result that, as a purely practical matter, the Act did not apply to most depository institutions, even those with publicly traded stock. In 1964, following an extensive SEC study of the 1934 Act,[66] Congress amended it,[67] expanding the coverage of the Act so that today it applies generally to publicly traded securities of depository institutions. Hence, as it exists today, section 12 of the 1934 Act requires registration of any security that is either (1) traded on a national securities exchange,[68] or (2) issued by an issuer that falls within the jurisdictional test of the section[69] and that meets certain assets-size and minimum number of shareholder requirements.[70] If registration is required under section 12, then the periodic reporting, proxy, tender offer disclosure, and insider reporting requirements of the Act are imposed with respect to the issuer's registered securities.

With the enactment of the 1964 Amendments, issuers of securities that were not registered with a national securities exchange but that were actively traded "over-the-counter" ("OTC") were brought under the registration and disclosure requirements of the 1934 Act.[71] Thus, a significant number of OTC securities of national and other large, state-chartered banks were subjected to those requirements. However, because there was already pervasive regulation of depository institutions by the federal regulatory agencies, Congress included section 12(i) in the 1964 amendments. This provision delegated certain authority to the federal regulatory agencies, to the exclusion of the SEC, with respect to securities issued by depository institutions.[72]

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65. *See* Malloy, *supra* note 7, at 482-84 (discussing the original scope of the 1934 Act).

66. *See id.* at 484-87 (discussing the SEC Special Study of Securities Markets).

67. *See id.* at 487-91 (discussing the legislative history of the Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964) (codified in scattered sections of 15 U.S.C.)).

68. *See* 15 U.S.C. § 78*l*(a) (1988).

69. *See id.* § 78*l*(g)(1) (1988) (issuer engaged in interstate commerce; business affecting interstate commerce; or, securities traded by use of mails or means or instrumentality of interstate commerce).

70. *See id.* § 78*l*(g)(1)(B) (1988) (total assets in excess of $1 million; 500 or more shareholders of record). By regulation, the assets-size test for banks has been raised to $3 million. *See* 12 C.F.R. § 11.201(b) (1992).

71. *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 565, 566-67 (1964) (adding § 12(g)(1) of the 1934 Act, 15 U.S.C. § 78*l*(g)(1) (1988)). Section 12(g)(1) of the 1934 Act provides in pertinent part as follows:

> Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall . . . register such security.

Id. For the definition of "equity security" under the 1934 Act, see 15 U.S.C. § 78c(a)(11) (1988). Equity securities of which a bank or other depository institution is the issuer are not "exempted securities" for purposes of the 1934 Act, see *id.* § 78c(a)(12) (1988), though they are exempted securities under the 1933 Act. *See id.* § 77c(a)(2),(5) (1988); *see also* Malloy, *supra* note 7, at 390-93 (discussing the exemption of such securities from the registration requirements of the 1933 Act).

72. *See* 15 U.S.C. § 78*l*(i) (Supp. III 1991). 15 U.S.C. § 78*l*(i) reads as follows:

> In respect of any securities issued by banks and savings associations the deposits

Section 12(i) of the 1934 Act[73] delegates to the federal banking agencies authority to administer the requirements of the 1934 Act with respect to bank- and thrift-issued securities. In other words, it delegates the "powers, functions, and duties vested in the [Securities and Exchange] Commission to administer and enforce" the enumerated sections, but not the actual provisions of those sections.[74] The legislative history of the 1964 Amendments suggests that this administrative and enforcement authority is limited to the sections enumerated in 12(i).[75]

Section 10(b), the general antifraud provision of the 1934 Act, is absent from section 12(i)'s list of enumerated sections. Therefore, an im-

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of which are insured in accordance with the Federal Deposit Insurance Act . . ., the powers, functions, and duties vested in the Commission to administer and enforce this section and sections 78m, 78n(a), 78n(c), 78n(d), 78n(f), and 78p of this title [(§§ 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of the 1934 Act)], (1) with respect to national banks and banks operating under the Code of Law for the District of Columbia are vested in the Comptroller of the Currency, (2) with respect to all other member banks of the Federal Reserve System are vested in the Board of Governors of the Federal Reserve System, (3) with respect to all other insured banks are vested in the Federal Deposit Insurance Corporation, and (4) with respect to savings associations the accounts of which are insured by the Federal Deposit Insurance Corporation are vested in the Office of Thrift Supervision. The Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision shall have the power to make such rules and regulations as may be necessary for the execution of the functions vested in them as provided in this subsection. In carrying out their responsibilities under this subsection, the agencies named in the first sentence of this subsection shall issue substantially similar regulations to regulations and rules issued by the Commission under this section and sections 78m, 78n(a), 78n(c), 78n(d), 78n(f), and 78p of this title unless they find that implementation of substantially similar regulations with respect to insured banks and insured institutions are not necessary or appropriate in the public interest or for protection of investors, and publish such findings, and the detailed reasons therefor, in the Federal Register. Such regulations of the above-named agencies, or the reasons for failure to publish such substantially similar regulations to those of the Commission, shall be published in the Federal Register within 120 days of October 28, 1974, and, thereafter, within 60 days of any changes made by the Commission in its relevant regulations and rules.

Id. (citation omitted).

73. *Id.*

74. *Id.*; *see supra* note 73 (for text of § 78*l*(i)).

75. *See generally Investor Protection: Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 88th Cong., 1st & 2d Sess., pt. 1, at 7 (1964) [hereinafter *House Hearings*] (statement of William L. Cary, Chairman, SEC); *id.* at 31 (letter to Rep. Harris from Chairman Cary); *id.* at 72 (statement of Chairman Cary); *id.* at 156 (recommendations of the special study that would be implemented by the bill); *id.* at 161 (statement of the SEC); *id.* at 614 (statement of Hudson B. Lemkau, Vice Chairman, Board of Governors, NASD); *id.* pt. 2, at 1361-67 (memorandum of the SEC); *id.* at 1375-77 (letter from American Bankers Association). Professor Loss takes this same view of the scope of § 12(i): "[T]he enumeration of only a few sections in § 12(i) leaves jurisdiction in the SEC to apply the various investigatory provisions and sanctions as far as any other sections, including the fraud and manipulation provisions, are concerned." Louis Loss, Fundamentals of Securities Regulation 417 (2d ed. 1988) (footnote omitted).

portant question is whether this omission implies that the agencies cannot act against fraud in connection with trading of bank-issued securities. One answer is yes. Because the text of section 12(i) does not itself indicate which "powers, functions, and duties"[76] of the SEC are vested in the federal banking agencies, a literal reading of the section excludes authority for direct enforcement of section 10(b). The legislative history of the 1964 Amendments supports this conclusion.[77]

A contrary answer is that because section 10(b) is one of the powers, functions, and duties available to the SEC when administering and enforcing the enumerated sections of 12(i), it is also available to bank regulatory agencies pursuant to section 12(i). Analysis of this argument begins with the following principle: the "powers, functions and duties" available to the bank regulatory agencies under section 12(i) relate to the sections enumerated in 12(i).[78] These powers include the following: (1)

76. 12 U.S.C. § 78*l*(i) (Supp. III 1991).

77. The debates on the 1964 amendment bill contain explicit references to the delegation to bank regulatory agencies of enforcement authority for certain specifically identified provisions of the 1934 Act. *See, e.g.*, 110 Cong. Rec. 17,916 (1964) (remarks of Rep. Harris, mentioning only §§ 12, 13, 14 and 16 of the Act); *see also id.* at 17, 918-19 (remarks of Rep. Harris); *id.* at 17,925 (remarks of Rep. Keith); *id.* at 18,180-81 (remarks of Rep. Harris). The cosponsors of the Senate version of the bill—the first version to contain the mandatory delegation language of § 12(i)—took the same position. *See, e.g.*, 109 Cong. Rec. 13,725-13,726 (remarks of Sen. Williams) ("The Securities Exchange Act adopted the basic principle of self-regulation to a very large extent . . . . This was evidenced in part by the measure of self-regulation carried on through the stock exchanges."); *see also id.* at 13,728-29 (remarks of Sen. Javits) ("[W]e finally decided that the regulatory agencies will regulate the affairs of the banks."); Loss, *supra* note 76, at 417 ("[O]nly the SEC may discipline registered broker-dealers for violation of *any* provision of the Exchange Act—including even those specified in § 12(i)—in connection with bank securities.").

Assuming this argument is correct, the bank regulatory agencies nevertheless do have authority under the banking laws to take appropriate, indirect enforcement action with respect to violations of § 10(b) of the 1934 Act. This indirect enforcement authority covers violations committed by depository institutions under their respective authority, or by any officer, director or person affiliated therewith. *See, e.g.*, 12 U.S.C. § 1818(b) (Supp. III 1991). Section 1818(b)(1) provides authority for each federal bank regulatory agency to issue a notice of charges (which may lead to issuance of a cease-and-desist order after appropriate notice and hearing) if, for example, in the opinion of the agency, "any insured depository institution, depository institution which has insured deposits, or any institution-affiliated party . . . is violating or has violated, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to violate, a law, rule or regulation." *Id.* Hence, an alleged violation of Rule 10b-5 by a bank or any "institution-affiliated party" (i.e., directors, officers, employees, or certain independent contractors) would appear to be a basis for action under 12 U.S.C. § 1818(b) (Supp. III 1991). It is in this sense that the text speaks of indirect enforcement of § 10(b) of the Act. *Cf.* Comptroller of the Currency, Interpretive Letter No. 458, Sept. 1, 1988, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,682, at 78,071 (Feb. 10, 1989) (purchase of newly issued shares by bank directors, solely to "close out" the newly chartered bank's initial offering, with intended subsequent resale, rendered the offering circular materially false and misleading, in violation of 12 C.F.R. § 16.3(g) (1992) and SEC Rule 10b-5).

78. This was the approach the SEC took in commenting on the draft of § 12(i): "*For the purpose of exercising the functions vested in them by* [§ 12(i)], these designated Federal

the power to promulgate rules and regulations that define technical terms, or to implement and administer the enumerated sections with respect to bank-issued securities;[79] (2) the power to "delist" bank-issued securities that are listed on a national securities exchange;[80] (3) the power to summarily suspend trading in bank-issued securities;[81] (4) the power to issue orders in order to compel compliance with the provisions of sections 12 and 13 of the 1934 Act;[82] (5) the power to investigate, collect evidence, and invoke judicial process in support of an investigation;[83] and (6) the power to initiate civil litigation in order to obtain injunctive relief, or to refer matters to the Justice Department for criminal prosecution.[84]

These powers are obvious components of the administrative authority necessary for any agency to "administer and enforce" the provisions of the 1934 Act. Thus, one must ask whether the rule-making authority contained in section 10(b) of the 1934 Act is also a power necessary to aid in "administering and enforcing" the other provisions of the Act.

It may be argued that Congress intended a general antifraud rulemaking authority to complement the more specific disclosure-oriented provisions of the enumerated sections in 12(i).[85] If this is so, one could argue that this "power" is granted to the bank regulatory agencies under section 12(i), and, thus, not retained by the SEC. Yet, evidence suggests this

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banking agencies would have the authority vested in the Commission under any provision of the Exchange Act." Technical Statement of the Securities and Exchange Commission on H.R. 6789, H.R. 6793, and S. 1642, *House Hearings*, *supra* note 76, at 216 [hereinafter Technical Statement] (emphasis added). The SEC proceeded to relate the various grants of authority contained in the 1934 Act—specifically, the sections enumerated in § 12(i). The SEC did not suggest that power was to be granted to the bank regulatory agencies under the rule-making authority contained in § 10(b).

79. *See* 15 U.S.C. §§ 78c(b), 78w(c) (1988); *see also* Technical Statement, *supra* note 79, at 216 ("For the purpose of exercising the functions vested in them by this section, these designated federal banking agencies would have the authority vested in the Commission under any provision.").

80. *See* 15 U.S.C. § 78*l*(j) (1988). In the SEC's view, the delisting sanction would be available for violations of the sections enumerated in § 12(i). *See* Technical Statement, *supra* note 79, at 216.

81. *See* 15 U.S.C. § 78*l*(k) (Supp. III 1991).

82. *See id.* § 78o(c)(4) (1988).

83. *See id.* § 78u(a)-(c) (1988).

84. *See id.* § 78u(d) (Supp. III 1991); *see also id.* § 78aa (Supp. III 1991) (establishing United States district courts' exclusive jurisdiction over lawsuits brought to enforce any liability or duty created by the chapter); *cf. id.* § 78y (1988 & Supp. III 1991) (judicial review of orders and rules). During congressional consideration of the 1964 amendments, the SEC took the position that such injunctive actions would be available for violations of the sections enumerated in § 12(i) itself, and, thus, not for injunctive actions seeking to enforce § 10(b). *See* Technical Statement, *supra* note 79, at 216.

85. *See, e.g.*, *House Hearings*, *supra* note 76, at 75-76. SEC Chairman Cary testified that the absence of adequate disclosure "deprived investors of important bulwarks against fraud." *Id.* at 75; *see also Hearings on S. 1642 before the Senate Comm. on Banking and Currency*, 88th Cong., 1st Sess. 288 (1963) (same); Statement of the Securities and Exchange Commission, *reprinted in House Hearings*, *supra* note 76, at 165 ("There is no convincing reason why the comprehensive scheme of disclosure that affords effective protection to investors in the exchange markets should not also apply in the over-the-counter market.").

is not so. While the SEC's contemporaneous explanation of the meaning of section 12(i) included an identification of the "powers" referred to above,[86] it made no reference to the antifraud rulemaking authority of section 10(b).[87] The "powers, functions and duties" that vest in the federal banking agencies under section 12(i) were also discussed in an indirect exchange of letters between Comptroller Saxon and the SEC Chairman. Comptroller Saxon, in a letter to the Chairman of the House Banking Committee,[88] took the position that the disclosure requirements imposed by section 12 on national banks should be exercised under the National Bank Act and not the federal securities laws,[89] and raised a series of questions concerning the meaning of section 12.[90] The SEC Chairman sent a reply to the Chairman of the House Subcommittee considering the bill,[91] explaining that "[t]he Senate amendment . . . also clarifies the respective responsibilities of the Commission and the Federal banking agencies by *expressly designating* the banks that are subject to the jurisdiction of each Federal banking agency and the *specific provisions* of the Exchange Act to be administered and enforced by such agencies."[92] Thus, the SEC took the position that the delegation contained in section 12(i) concerned only those enumerated sections.

Considering the above evidence, one might conclude that all powers under the 1934 Act not directly related to those sections enumerated in 12(i) remain with the SEC. In fact, the Comptroller's letter touched upon this implicit conclusion. It specifically asked what powers would be retained by the SEC.[93] The SEC reply provided an overview of the way in which it conceived the division of authority under section 12(i). While it did not explicitly mention section 10(b) authority, it clearly implied that this authority was intended to be retained by the SEC.[94]

86. *See supra* text accompanying notes 80-85.

87. *See* Technical Statement, *supra* note 79, at 216; *see also* S. Rep. No. 379, 88th Cong., 1st Sess. 63-64 (1963) (discussion of § 12(i) powers).

88. Letter to Chairman Harris from Comptroller Saxon, Feb. 19, 1964, *reprinted in House Hearings, supra* note 76, at 1356-57 [hereinafter Comptroller's Letter].

89. As early as 1961, the Comptroller, in relying upon his general regulatory authority, had already promulgated rules imposing extensive disclosure requirements on national banks with respect to their securities. *See generally* SEC, Report of the Special Study of Securities Markets, pt. 3, at 39 (1963), *reprinted in* H.R. Doc. No. 95, 88th Cong., 1st Sess. 39 (1963) [hereinafter Special Study] (discussing regulation).

90. *See id.*

91. *See* Memorandum of the Securities and Exchange Commission with respect to the statement of the Comptroller of the Currency on H.R. 6789 and S. 1642, *reprinted in House Hearings, supra* note 76, at 1361-67 [hereinafter SEC Memorandum].

92. *Id.* (emphasis added).

93. *See* Comptroller's Letter, *supra* note 89, at 1357.

94. *See* SEC Memorandum, *supra* note 92, at 1364. In a memorandum, the SEC stated the following:

> [T]he Commission would have the authority to administer and enforce the provisions of the bill only with respect to banks not subject to the jurisdiction of either the Comptroller of the Currency, the Federal Reserve System or the Federal Deposit Insurance Corporation. . . . It should be noted that [§ 12(i)] would transfer to the designated Fedral [sic] banking agencies the existing power and

This view is also corroborated by the terms of another of the Comptroller's questions. He asked whether the delegation of authority in section 12(i) meant "that the Comptroller will have the powers enumerated in sections 19, 20, 21, 22 and 23 of the 1934 Act."[95] The SEC response confirmed that the powers of sections 19 and 21-23 of the Act, but not section 20, would be available to the designated federal banking agencies,[96] and referred to these provisions as "all the powers of the Commission contained in the Exchange Act that are necessary for the administration and enforcement" of the enumerated sections.[97] Neither party mentioned section 10(b).

Furthermore, SEC testimony indicates that the SEC was already exercising antifraud enforcement authority in situations involving over-the-counter securities, despite the fact that such securities were not otherwise subject to the requirements of the 1934 Act.[98] Therefore, even though, at the time, section 10(b) was one of the few provisions of federal securities law applicable to bank-issued securities traded over the counter, it appears to have been purposefully overlooked in relation to the draft of section 12(i). Section 10(b) remains one of the "other provisions of the Exchange Act in respect of bank securities"[99] that were not vested in the bank regulatory agencies but, rather, were retained by the SEC.

One might argue that by denying bank regulatory agencies authority under section 12(i) to enforce section 10(b) directly, an anomalous result occurs. For example, where an alleged violation of section 10(b) involves

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> authority of the Commission to administer and enforce the provisions of sections 12, 13, 14(a), 14(c), and 16 of the Exchange Act in respect of banks with a security listed for trading on a national securities exchange to the designated Federal banking agencies. *The bill would not, however, affect the Commission's existing powers to enforce other provisions of the Exchange Act in respect of bank securities, whether listed for trading on a national securities exchange or traded in the over-the-counter market.*

Id. (emphasis added).

95. Comptroller's Letter, *supra* note 89, at 1357.

96. *See* SEC Memorandum, *supra* note 92, at 1365. The SEC specifically stated the following:

> [T]he Federal banking agencies . . . would have the power to delist from a national securities exchange under section 19(a)(2), to suspend summarily trading under section 19(a)(4), to investigate, institute suits to enjoin, and forward evidence to the Attorney General for criminal prosecution under section 21, to hold public hearings under section 22 and to make such rules as may be necessary to carry out their functions pursuant to the Exchange Act under section 23. The provisions of section 20, relating to liabilities of controlling persons, also would apply to banks over which the Federal banking agencies would have jurisdiction. However, this section does not confer any powers upon the Commission and, hence, would not confer power upon the Federal banking agencies.

Id.; *cf. supra* notes 80-85 and accompanying text (discussing the powers available to the bank regulatory agencies under § 12(i)).

97. SEC Memorandum, *supra* note 92, at 1365.

98. *See, e.g.*, Statement of the Securities and Exchange Commission, *House Hearings*, *supra* note 76, at 165-66. The SEC testimony did not, however, give any examples of § 10(b) enforcement actions taken against banks.

99. *Id.* at 1364.

a bank officer and other parties outside the bank, the designated bank regulatory authority would have indirect authority[100] to enforce section 10(b) against the bank officer, but not against the outsider. When considering this scenario, it is arguably more reasonable to include section 10(b) authority under section 12(i) implicitly, so that sanctions can be applied consistently in any case involving fraud in connection with the purchase or sale of bank-issued securities.

Yet, the above anomaly is not peculiar to the enforcement policy embodied in section 12(i). Moreover, assuming section 10(b) authority is implied under section 12(i), this does not cure the anomaly. The provisions of 12 U.S.C. § 1818 provide certain enforcement authority to the federal banking agencies with respect to violations of "a law, rule, or regulation" by a bank, or by any officer, director, or other institution-affiliated party.[101] Hence, under 12 U.S.C. § 1818, a federal banking agency has authority over a section 10(b) violation by a bank officer, regardless of whether or not it involves bank-issued securities; however, such authority presumably is limited to violations involving bank-issued securities when pursuant to section 12(i).[102]

With these limitations in mind, one should ask to what degree the principles of securities regulation, as embodied in the 1934 Act, have been assimilated into federal bank regulation? As a general matter, antifraud authority remains within the exclusive purview of the SEC. However, affirmative administration of the 1934 Act with respect to bank- and thrift-issued securities is itself within the exclusive purview of the bank regulatory agencies. Yet, there has been very little, if any, enforcement activity on the part of these agencies with respect to such securities. Moreover, as I have argued elsewhere,[103] there is reason to believe that bank regulatory agencies are institutionally uncomfortable with the disclosure-oriented approach mandated by the federal securities laws. As a result, the agencies have never fully complied with the requirement, under section 12(i), that they update their 1934 Act regulations promptly in response to corresponding amendments in SEC regulations.[104] Instead, the agencies have shifted their attention increasingly over time to a regulatory approach based upon capital supervision of the institutions under their jurisdiction.

100. *Cf. supra* note 78 (discussing indirect authority under § 1818).
101. 12 U.S.C. § 1818(b)(1) (Supp. III 1991).
102. *See* 15 U.S.C. § 78*l*(i) (Supp. III 1991) ("In respect of any securities issued by banks").
103. *See Public Disclosure*, *supra* note 8, at 245.
104. *See 12(i)'ed Monster*, *supra* note 8, at 289-93.

III. Capital Supervision as a Central Focus of Federal Bank Regulatory Policy

A. *Introduction*

Capital supervision has become the central focus of current federal bank regulatory policy with respect to banks as securities-issuing entities. This has occurred primarily because of the convergence of three recent developments: (1) the United States entered into a multilateral arrangement,[105] effective after December 31, 1992, under which it is expected to complete the implementation of a risk-based capital-assets ratio to be used in measuring the adequacy of bank capital; (2) the Department of the Treasury, in a February 1991 study (the Treasury Modernization Study),[106] advanced certain recommendations to strengthen capital supervision of banks;[107] and (3) the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"),[108] which was enacted in December 1991, included provisions for increased capital supervision.[109]

Specifically, the recent Treasury Modernization Study adopted the position that capital is "[t]he single most powerful tool to make banks safer."[110] This is a very traditional view of the role of capital in corporate governance and regulatory oversight of banks. The Treasury explained as follows:

> [Capital] is an "up-front" cushion to absorb losses ahead of the taxpayer, and banks are less likely to take excessive risk when they have substantial amounts of their own money at stake. Yet the [deposit insurance] safety net has permitted banks to have lower capital ratios than other financial companies. The bank regulatory system is not adequately focused on the crucial importance of capital.[111]

There is an inherent analytical confusion contained in this explanation.

105. For a discussion of this arrangement, which was developed under the auspices of the Bank for International Settlements in Basle, Switzerland, see *infra* notes 148-72 and accompanying text; *see also* Michael P. Malloy, *U.S. International Banking and the New Capital Adequacy Requirements: New, Old and Unexpected*, 7 Ann. Rev. Banking L. 75 (1988) (discussing multilateral initiative on capital adequacy).

106. *See* U.S. Department of the Treasury, Modernizing the Financial System: Recommendations for Safer, More Competitive Banks (Feb. 1991), *reprinted in* Fed. Banking L. Rep. (CCH) No. 1376 ¶ 88,367, at 97,335 (Feb. 8, 1991) [hereinafter Treasury Modernization Study].

107. For a discussion of these recommendations, see *infra* notes 173-93 and accompanying text.

108. Pub. L. No. 102-242, §§ 101-502, 105 Stat. 2236 (1991) (codified in scattered sections of 12 U.S.C.).

109. For a discussion of the FDICIA provisions with respect to capital supervision, see *infra* notes 194-210 and accompanying text.

110. Treasury Modernization Study, *supra* note 107, at 97,356.

111. *Id.* For a detailed treatment of capital and capital adequacy, see *id.* Discussion Ch. II (appended to Study; reflecting public comments and comments by agencies participating in the consultation and study).

Deposit insurance, which is provided by the Federal Deposit Insurance Corporation ("FDIC") as an insurer, is a feature of United States banking that is very attractive to bank customers; indeed, it is virtually a necessity for a bank in its marketing of services to

When the Treasury speaks of banks avoiding "excessive risk when they have substantial amounts of their own money at stake,"[112] it is actually speaking of risk-taking from the point of view of the principal investors of banks, not of the banks themselves. The Treasury is assuming that those investors are sufficiently in control of decision-making to influence the degree of risk undertaken. While this may be a safe assumption in the case of a relatively small bank, the situation becomes more complicated when a large, publicly held entity is involved. Furthermore, assuming that this posited role of investors in selecting risks is valid in the context of a general business corporation, it is not necessarily valid in the context of a commercial bank. The funding of a bank's activities comes primarily from its deposits, not from its equity.[113] Yet, functionally, there is only a questionable possibility that depositors will perform the role—usually assigned to equity investors—of selecting risks.[114] Nevertheless, it is in fact the case that capital and capital supervision have long been subject to the attention of the regulators, and this attention has increased over time. Thus, this Article will review the four basic aspects of capital and capital supervision that regulators have focused upon.

1. Capital Formation: Substantive Supervision

Two of the four aspects concern the process of capital formation. The first has to do with substantive supervision of capital formation. For chartering agencies[115] in particular, capital formation by depository institutions[116] is a serious concern subject to prior approval.

In the case of national banks, for example, the National Bank Act

the public at large. For a discussion of deposit insurance, see Malloy, *supra* note 7, at 152-58 (1988 & Cum. Supp.).

112. Treasury Modernization Study, *supra* note 107, at 97,356.

113. *See* Helen A. Garten, *Banking on the Market: Relying On Depositors to Control Bank Risks*, 4 Yale J. on Reg. 129 (1986) (discussing roles of depositors and equity in a commercial bank).

114. The merits and feasibility of relying on depositors to perform such a role—usually characterized as subjecting banks to "market discipline"—was the subject of a series of articles in successive issues of the Yale Journal on Regulation. *See id.* (arguing that market discipline was not feasible in light of probable depositor behavior); Helen A. Garten, *Still Banking on the Market: A Comment on the Failure of Market Discipline*, 5 Yale J. on Reg. 241 (1988) (criticizing market discipline arguments); Helen A. Garten, *Whatever Happened to Market Discipline of Banks?*, 1991 Ann. Surv. Am. L. 749 (reviewing the demise of market discipline arguments); Jonathan R. Macey & Elizabeth H. Garret, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 Yale J. on Reg. 215 (1988) (arguing for increased reliance on market discipline).

115. The Comptroller of the Currency, which is the chartering authority for national banks, is an example of a chartering agency. *See* 12 U.S.C. § 1, 21-27 (1988 & Supp. III 1991). Another chartering agency is the Office of Thrift Supervision (federal chartering authority of savings associations). *See id.* § 1464 (Supp. III 1991). *See generally* Malloy, *supra* note 7, at 100-25 (1988 & Cum. Supp.) (discussion of chartering procedures for national and state banks); *id.* at 159-81 (1988 & Cum. Supp.) (discussion of chartering procedures for federal and state savings associations).

116. On the meaning of the term "depository institution," as used in this context, see *supra* note 10.

("NBA") permits the issuance of common stock[117] and, since 1933, preferred stock,[118] subject to the approval of the Comptroller of the Currency. In the case of an initial offering at the organization stage, the Comptroller may approve or disapprove charter applications in light of, *inter alia*, the particular level of capital to be achieved by the applicant bank in organization.[119] Changes in outstanding equity capital are also subject to prior approval by the Comptroller.[120] The Comptroller will approve changes in capital so long as "the change complies with applicable statutes and regulations and the bank has provided the information requested by the [Office of the Comptroller of the Currency ("OCC")]."[121]

2. Capital Formation: Minimum Capital Requirements

The second aspect concerning the process of capital formation has to do with minimum capital requirements for depository institutions in organization. The imposition of minimum capital requirements addresses fundamental concerns regarding the safety and soundness of *de novo* institutions.[122] Minimum capital requirements are a traditional element of the regulation of depository institutions. Yet, for the most part, these requirements currently have only minimal significance. This is because regulatory emphasis on continuing capital adequacy requirements[123] appears to provide a more effective method of monitoring the safety and soundness of depository institutions.

The NBA provides one example of minimum capital requirements.[124] It calculates minimum capital requirements in relation to the size of the community in which a proposed national bank is to be located.[125] The

117. *See* 12 U.S.C. § 51 (1988).

118. *See id.* § 51a (1988).

119. *See, e.g.*, 12 C.F.R. § 5.20(d)(3)(iii) (1992):

> The Office [of the Comptroller of the Currency ("OCC")] may grant preliminary conditional approval to an application which proposes an unacceptable level of capital, if the application as a whole would warrant approval had capital been proposed at a level acceptable to the [OCC]. However, preliminary approval will be conditioned upon the bank raising the amount of capital required by the [OCC] prior to the commencement of business.

Id. The requirement that approval by the OCC be obtained for capital formation by a *de novo* national bank renders ambiguous the provision included in the OCC's requirements that a bank's offering circular include a boldface disclaimer which states "THE MERITS OF THESE SECURITIES HAVE NOT BEEN PASSED UPON BY THE COMPTROLLER OF THE CURRENCY. . . ." *Id.* § 16.7(c), item 1(d).

120. *See id.* § 5.46(c). Changes in outstanding equity capital involving offers and sales of equity securities also require compliance with the OCC's offering circular requirements. *See id.*; *id.* § 16.1-.8.

121. *Id.* § 5.46(f)(1).

122. On the concept of "safety and soundness" as a bank regulatory concern, see *supra* note 4.

123. *See infra* notes 143-47 and accompanying text.

124. *See* 12 U.S.C. § 51 (1988); 12 C.F.R. § 5.20(c)(3) (1992). For capital requirements of state banks converting to a national charter, see 12 C.F.R. § 5.24 (1992).

125. *See* 12 U.S.C. § 51 (1988). "Capital," as interpreted by the OCC for these pur-

NBA also requires that a national bank have a paid-in-surplus[126] equal to twenty percent of capital before it can commence business.[127] However, the NBA provisions have not been revised since the early 1930s,[128] and are hopelessly out of date. By regulation, the OCC has established higher minimum capital requirements ("in excess of $1,000,000,"[129] net of organizational expenses[130]), but it will permit the initial capital of an applicant bank to be a lesser amount "if the applicant can show that [the] proposed capital is sufficient to support the projected volume and type of business."[131] Thus, the actual amount of initial capital required depends upon the Comptroller's judgment as to projected volume and type of business contemplated for the proposed bank in its operating plan.[132]

The regulations of the Federal Reserve System (the "Fed") concerning eligibility standards include general references to minimum capital requirements.[133] As to the eligibility for federal deposit insurance of state-

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poses, includes "the amount of common stock outstanding and unimpaired plus the amount of perpetual preferred stock outstanding and unimpaired." 12 C.F.R. § 3.100(a) (1992).

126. The Comptroller has interpreted the term "surplus" to include the following:

(1) capital surplus;
(2) undivided profits;
(3) reserves for contingencies and other capital reserves (excluding accrued preferred dividends);
(4) net worth certificates issued pursuant to the Federal Deposit Insurance Act ("FDIA"), 12 U.S.C. § 1823(i);
(5) minority interests in consolidated subsidiaries; and
(6) allowances for possible loan and lease losses;
minus intangible assets.

See 12 C.F.R. § 3.100(c)(1) (1992); *cf. id.* § 3.100(e)(3) (defining intangible assets as purchased assets reported as intangible in accordance with the Call Report). "Surplus" also includes the following:

(7) purchased mortgage servicing rights;
(8) mandatory convertible debt, to the extent of 20% of the sum of capital and surplus items discussed above; and
(9) other mandatory convertible debt, limited life preferred stock and subordinated notes and debentures, subject to the limitations of 12 C.F.R. § 3.100(f)(2).

See id. § 3.100(c)(2)-(4). "Paid-in surplus" may be equated with "capital surplus," which has been defined by the Comptroller, in pertinent part, as "the total of those accounts reflecting: [(1)] [a]mounts paid in in excess of the par or stated value of capital stock; [(2)] [a]mounts contributed to the bank other than for capital stock. . . ." *Id.* § 3.100(e)(2)(i)-(ii). The term "unimpaired surplus fund" is interpreted by the Comptroller as being coterminous with "surplus." *See id.* § 3.100(d).

127. *See* 12 U.S.C. § 51 (1988).

128. *See* Banking Act of 1933, ch. 89, § 17(a), 48 Stat. 162, 185-86 (1933) (amending 12 U.S.C. § 51).

129. 12 C.F.R. § 5.20(d)(3)(iii) (1992).

130. On organizational expenses, see *id.* § 5.20(d)(4)(iii).

131. *Id.* § 5.20(d)(3)(iii).

132. *See id.*

133. *See id.* § 208.2; *see also id.* § 208.5(a)(2) (approval of membership applications; adequacy of capital); *id.* § 208.7(a)(2) (conditions of membership). *See generally* Continental Bank & Trust Co. v. Woodall, 239 F.2d 707 (10th Cir.) (upholding Fed eligibility requirements), *cert. denied*, 353 U.S. 909 (1957).

chartered, non-member banks, the FDIA requires adequacy of capital;[134] the FDIC has taken a position similar to that of the OCC in this regard.[135] Likewise, approval of applications for *de novo* federal mutual and stock savings associations by the OTS are conditioned on capital requirements.[136]

3. Adequate Disclosure

Adequate disclosure to investors of material information concerning the issuer and its securities is a third aspect of capital supervision of banks. In the context of initial offerings of securities, the federal banking agencies have disclosure requirements that are parallel to, but independent of, the rules of the SEC (as promulgated under the Securities Act of 1933).[137] As we have already seen,[138] continuing disclosure requirements for banks with publicly traded securities are derived from the 1934 Act.[139] These requirements are administered and applied by the bank regulators, not by the SEC.[140]

4. Capital Adequacy

Over the past decade or so, increasing attention has been given to the supervision of capital adequacy, or capital maintenance, of depository institutions. To the extent that inadequate capital maintenance constitutes an "unsafe and unsound practice," bank regulators have broad statutory authority to define and remedy such a condition.[141] The use of this authority to address capital adequacy concerns was questioned by the Fifth Circuit in *First National Bank v. Comptroller of the Currency*,[142] but the authority appears to have been confirmed and reinforced by sub-

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134. *See* 12 U.S.C. § 1816 (1988).

135. *See* 12 C.F.R. § 303.7(d)(1)(ii)(B)(1) (1992).

136. *See id.* § 543.2(g)(3)(ii) (federal mutual association; minimum amount of capital to be paid in); *id.* § 552.2-1(b)(3)(ii) (federal stock association; sale of minimum amount of capital stock).

137. *See* Malloy, *supra* note 7, at 411-41 (discussing bank regulatory rules with respect to initial offerings).

138. *See supra* notes 67-73 and accompanying text.

139. *See* 15 U.S.C. §§ 78*l*(a), (b), (g) (1988); Malloy, *supra* note 7, at 498-525 (discussing 1934 Act rules applicable to bank-issued securities).

140. *See* 15 U.S.C. § 78*l*(i) (Supp. III 1991).

141. *See* 12 U.S.C. § 1818(b)(1) (Supp. III 1991); *cf.* Groos Nat'l Bank v. Comptroller of the Currency, 573 F.2d 889, 895 (5th Cir. 1978) (progressive definition of unsafe and unsound practices); First Nat'l Bank v. Dep't of the Treasury, 568 F.2d 610 (8th Cir. 1978) (same). Similar authority has been upheld in the bank holding company context. *See* Board of Governors of the Fed. Reserve Sys. v. First Lincolnwood Corp., 439 U.S. 234 (1978). *But cf.* MCorp Fin., Inc. v. Board of Governors of the Fed. Reserve Sys., 900 F.2d 852 (5th Cir. 1990) (invalidating Fed regulations concerning capital maintenance of bank holding companies in relation to their banking subsidiaries), *rev'd on other grounds*, 112 S. Ct. 459 (1991).

142. 697 F.2d 674 (5th Cir. 1983). An unreported opinion of the Second Circuit upheld the Comptroller's authority to treat capital adequacy problems as unsafe and unsound banking practices. *See* First Nat'l Bank v. United States Dep't of Treasury, 659 F.2d 1059 (2d Cir. 1981). The District Court for the District of Columbia referred to this

sequent congressional action.[143] Pursuant to that authority, the federal banking agencies developed specific capital adequacy requirements, based upon a minimum required ratio of capital-to-assets.[144]

The regulatory maintenance of capital adequacy of depository institutions has become the central theme of capital supervision. The three most recent developments concerning capital supervision[145] all revolve around or presuppose the maintenance of capital adequacy as a primary objective.

B. *The Risk-Based Capital-Assets Ratio*

The basic direction of capital adequacy regulation today was initiated by the Basle Agreement of 1988,[146] which is now in the final stages of implementation.[147] The objective of the Basle Agreement is to "assess[ ]

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opinion in related litigation. *See* First Nat'l Bank v. United States, 530 F. Supp. 162, 165 (D.D.C. 1982).

143. *See* 12 U.S.C. § 3907 (1988). The statute provides in pertinent part as follows:

> (a)(1) Each appropriate Federal banking agency shall cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions . . . .
>
> (2) Each appropriate Federal banking agency shall have the authority to establish such minimum level of capital for a banking institution as the appropriate Federal banking agency, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution.
>
> (b)(1) Failure of a banking institution to maintain capital at or above its minimum level as established pursuant to subsection (a) of this section may be deemed by the appropriate Federal banking agency, in its discretion, to constitute an unsafe and unsound practice within the meaning of [12 U.S.C. § 1818].
>
> (2)(A) In addition to, or in lieu of, any other action authorized by law, including paragraph (1), the appropriate Federal banking agency may issue a directive to a banking institution that fails to maintain captial [sic] at or above its required level as established pursuant to subsection (a) of this section.
>
> (B)(i) Such directive may require the banking institution to submit and adhere to a plan acceptable to the appropriate Federal banking agency describing the means and timing by which the banking institution shall achieve its required capital level.
>
> (ii) Any such directive . . . , including plans submitted pursuant thereto, shall be enforceable under the provisions of [12 U.S.C. § 1818(i)] to the same extent as an effective and outstanding order issued pursuant to section 1818(b) . . . which has become final.

Id.

144. For a discussion of these requirements, see Malloy, *supra* note 7, at 452-66.

145. *See supra* notes 106-10 and accompanying text; *infra* part III.B.

146. Basle Committee on Banking Regulations and Supervisory Practices, Bank for International Settlements, Final Report for International Convergence of Capital Measurement and Capital Standards Dec. 1987, *reprinted in* 1 Fed. Banking L. Rep. (CCH) ¶ 5403 (Nov. 6, 1991) [hereinafter Final Report]. For an excellent discussion of the implications of the capital adequacy initiative, see William A. Lovett, *Moral Hazard, Bank Supervision and Risk-Based Capital Requirements*, 49 Ohio St. L.J. 1365 (1989).

147. *See* Final Report, *supra* note 148, at 3315. For a summary and analysis of the regulatory implementation of the risk-based capital adequacy regime as of December 1992, see Report to Congressional Committees Regarding Differences in Capital and Accounting Standards Among the Federal Banking and Thrift Agencies, 58 Fed. Reg. 3019 (1993); *see also* 57 Fed. Reg. 33,432 (to be codified at 12 C.F.R. pts. 545, 561, 563, 563C,

capital in relation to credit risk (the risk of counterparty failure)."[148] The Agreement acknowledges, however, that "other risks, notably interest rate risk and the investment risk on securities, need to be taken into account by supervisors in assessing overall capital adequacy."[149] New approaches to these elements of risk are currently being explored by the federal banking agencies.[150]

The supervisory framework endorsed by the Basle Agreement consists of a minimum[151] required ratio of certain specified constituents of capital to risk-weighted assets. "Capital" has two constituents: "core capital"[152] and "supplementary capital."[153] Core capital consists of (1) equity capital[154] and (2) disclosed reserves.[155] Supplementary capital consists of (1) hidden reserves;[156] (2) revaluation reserves;[157] (3) general provisions or loan loss reserves;[158] (4) certain hybrid debt capital instru-

567, 571) (OTS regulations; technical and clarifying amendments to risk-based capital requirements); *id.* at 44,078 (to be codified at 12 C.F.R. pt. 3) (OCC regulations; same); *id.* at 46,098 (to be codified at 12 C.F.R. pts. 545, 563, 567, 571) (OTS proposed rule; treatment of troubled, collateral-dependent loans and foreclosed assets).

148. Final Report, *supra* note 148, at 3309.

149. *Id.*

150. *See, e.g.*, 57 Fed. Reg. 35,507 (1992) (OCC, Fed & FDIC proposed rules; incorporating interest-rate risk component into risk-based capital requirements); *id.* at 40,524 (to be codified at 12 C.F.R. § 567) (OTS proposed rule; same); *id.* at 45,757 (OTS proposed rule; incorporating concentration risk and risk of nontraditional activities into risk-based capital requirements).

151. *See* Final Report, *supra* note 148, at 3309 ("It should be stressed that the agreed framework is designed to establish *minimum* levels of capital for internationally active banks. National authorities will be free to adopt arrangements that set higher levels.").

152. *See id.* at 3310. *See generally id.* at 3316 annex 1 (definition of capital).

153. *See id.* at 3310-11. *See generally id.* at 3316 annex 1 (definition of capital).

154. The Final Report defines "equity capital" as "[i]ssued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock (but excluding cumulative preferred stock)." *Id.* at 3310 n.2.

155. Disclosed reserves are from post-tax retained earnings. *See id.* at 3310.

156. Hidden reserves are included only to the extent permitted by local legal and accounting rules. *See id.* Moreover, they are included in supplementary capital only to the extent they "have been passed through the profit and loss account and [have been] accepted by [a] bank's supervisory authorities." *Id.*

157. *See id.* at 3310-11. Revaluation reserves are included only to the extent permitted by local legal and accounting rules. In addition, "latent revaluation" reserves are subject to a substantial discount reflecting, for example, market volatility and any tax effect of realization of the gain. *See id.* at 3311. It has been agreed that a 55% discount on the difference between historical cost book value and current market value is appropriate in this regard. *See id.*

158. Reserves against identified losses or with respect to "known deterioration in the valuation of particular assets" are not included in this category. *See id.* What constitutes a "general" reserve or provision for these purposes is not always easy to determine. In situations where nominally "general" reserves or provisions might include amounts reflecting lower valuations for assets or latent but unidentified losses, the amount qualifying as supplementary capital is phased down by the end of the transition to constitute no more than 1.25% (or up to 2% during exceptional and temporary periods) of supplementary capital. *See id.* at 3311, 3320 annex 4.

ments;[159] and, to a limited extent, (5) subordinated term debt.[160]

The Basle Agreement also mandates certain deductions from capital. Goodwill must be deducted from the figure in order to get core capital.[161] The amount of investments in unconsolidated banking and financial subsidiaries, if any,[162] must be deducted from the total capital base.[163]

In determining the capital-to-assets ratio of a bank, the assets that appear in the denominator of the ratio are risk-weighted.[164] The Basle Agreement establishes a relatively simple methodology for risk-weighting which employs only five risk-weight categories.[165] The result is that different types of assets are grouped under the same risk weight, even though there may be actual differences in the risk involved.[166]

There is a possibility that the assignment of different risk weights to certain types of assets will have the inadvertent effect of influencing banks to rearrange their loan portfolios in order to move out of certain categories of loans and into others.[167] The Basle Agreement's framework does not adequately address these potential problems. However, the framework does recognize the importance of bringing off-balance-sheet risk into the analysis of capital adequacy.[168] All categories of off-balance-sheet risk are brought within the framework by conversion into appropriate credit risk equivalents.[169] The minimum required ratio of capital-to-assets is currently eight percent, of which half must consist of core capital.[170]

C. *The Treasury Modernization Study*

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA")[171] has had both immediate and long-term conse-

159. This category includes mandatory convertible debt instruments (in U.S. practice), perpetual debt instruments (in U.K. practice), long-term preferred shares (in Canadian practice), *titres participatifs* and *titres subordonnés à durée indéterminée* (in French practice), or *Genussscheine* (in German practice). *See id.* at 3311.

160. Subordinated term debt instruments may be included up to an amount equal to 50% of total core capital. *See id.*

161. *See id.*

162. The Final Report generally assumes the normal practice—i.e., that such subsidiaries would be consolidated for the purpose of assessing capital adequacy. *See id.*

163. *See id.* at 3311-12. The Agreement allows for other deductions, subject to the discretion of the individual national supervisory authorities. *See id.* at 3312.

164. *See id.*

165. *See id.* at 3317 annex 2 (risk weights by category of on-balance-sheet asset).

166. For example, all claims on the private sector, regardless of size or creditworthiness of the borrower, and all claims on lesser developed countries denominated in foreign currency are grouped together in one risk-weight category (100% of asset value). *See id.*

167. For example, one might readily move from lending to the private sector (100% risk weight) to debt obligations of the United States government (0% risk weight) or home mortgage lending (50% risk weight). *See id.*

168. *See id.* at 3314 (discussion of off-balance-sheet risk).

169. *See id.* at 3317-19 annex 3.

170. *See id.* This ratio was set at year-end 1992, the end of the framework's transitional period.

171. Pub. L. No. 101-73, 103 Stat. 183 (codified at scattered sections of, *inter alia*, 12

quences for the regulation of depository institutions in the United States. Among the potential long-term effects of the FIRREA are those reflected in the Treasury Modernization Study (the "Study"),[172] which is based upon an eighteen-month interagency consultation and study mandated by the FIRREA.[173]

The Study paints a rather discouraging picture of the United States depository institutions industry; a picture that, when compared with the history of the S&L crisis, prompts a sense of *déjà vu*. Consider, for example, the following observations from the executive summary of the Study, which comment on the need for modernization of the United States financial system:

> [T]he *competitiveness* of the banking industry has been undercut by our failure to adapt our banking laws to the evolution of financial markets, which has brought vigorous new competition to markets traditionally served by banks. . . .
>
> Having lost traditional customers to new competitors, banks have increased their concentration on remaining customer segments. Weaker banks with virtually unlimited access to federally guaranteed funds have chased too few good lending opportunities, which has created problems for healthier banks: underpriced loans, narrowed spreads, eroded underwriting standards, and incentives to reach for riskier loans within the range of traditional bank activities. The result is diminished profitability, which has undercut the safety and soundness of the banking system. . . .
>
> [D]eposit insurance coverage has *expanded* well beyond its original purpose of protecting small unsophisticated depositors. . . . This overextension of deposit insurance has dramatically increased taxpayer exposure.
>
> Overextended deposit insurance has removed *market discipline* that should have constrained the increased riskiness of weak banks. . . . [W]ith expanded federal insurance and no risk of loss, depositors have been more than willing to supply funds to weaker banks engaged in activities that produce inadequate returns and excessive risk. With so little to lose, these weak, undercapitalized banks have had a perverse incentive to take excessive risk—the "moral hazard" problem—exposing the taxpayer to even greater losses.
>
> *[B]ank regulation and supervision* helps provide a substitute for the market discipline removed by deposit insurance. But in the face of the problems discussed above, our fragmented and archaic regulatory system has not been successful in stemming the weakening of the banking

& 15 U.S.C.). On the FIRREA, see generally Daniel B. Gail & Joseph J. Norton, *A Decade's Journey from "Deregulation" to "Supervisory Reregulation": The Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 Bus. Law. 1103 (1990); Daniel B. Gail & Joseph J. Norton, *The Financial Institutions Reform, Recovery, and Enforcement Act of 1989: Dealing with the Regulators*, 107 Banking L.J. 196 (1990); Michael P. Malloy, *Nothing to Fear but FIRREA Itself: Revising and Reshaping the Enforcement Process of Federal Bank Regulation*, 50 Ohio St. L.J. 1117 (1989).

172. *See supra* note 107.

173. FIRREA § 1001 (codified at 12 U.S.C. § 1811 (Supp. III 1991)).

> industry. In recent years, banks have experienced record loan losses and failures that are rapidly depleting the deposit insurance fund. . . .
>
> [T]he *Bank Insurance Fund* . . . is at its lowest level in history as a percentage of insured deposits. It is projected to decline still further over the next two years. Without an infusion of funds, the Federal Deposit Insurance Corporation . . . could face the problems that plagued the Federal Savings and Loan Insurance Corporation—too little cash, too many incentives for forbearance, and possible exposure for the taxpayer.[174]

Against this background, the Study made a number of dramatic recommendations for legislative reform of the financial services system.[175] At its core, the Study recommended that increased supervision be encouraged by improving the techniques and tools of supervision, primarily through an increased focus on capital.[176] In the context of general supervision, the Study also stressed the need for "prompt corrective action,"[177] but this was attuned to the relative capital strength of a subject bank (ranging from "Zone 1" for the most capitalized to "Zone 5" for failing institutions).[178] In addition, the Study stressed the need for annual on-site examination[179] and improved reporting from independent auditors[180] as crucial aids for improved supervision. Yet, it is fair to say that capital supervision was the key theme of the Study.[181]

As has already been mentioned,[182] the Study takes a very traditional

174. Treasury Modernization Study, *supra* note 107, at 97,336-37. Among other things, the Study recommended the recapitalization of the BIF. *See id.* at 97,392-96. A capital infusion was authorized by the FDICIA. *See* FDICIA, § 104 (codified at 12 U.S.C. § 1817(b)(1)(A), (C) (Supp. III 1991)) (assessment rate changes; rules for recapitalizing the BIF); *see also id.* § 105 (codified at 12 U.S.C. § 1824(d) (Supp. III 1991)) (borrowing for BIF from BIF members).

175. For an extended discussion of the recommendations made by the Study, see Michael P. Malloy, The Corporate Law of Banks 49-50, 81-84, 169-70, 284-86, 321-22, 374, 449-50 (Supp. 1992).

176. *See* Treasury Modernization Study, *supra* note 107, at 97,337; *cf. id.* Discussion Ch. IX (appended to Study; discussing risk management techniques and reflecting public comments and comments by agencies participating in the consultation and study); *id.* Discussion Ch. X (appended to Study; discussing the need for prompt corrective action and reflecting public comments and comments by agencies participating in the consultation and study).

177. Treasury Modernization Study, *supra* note 107, at 97,374. FDICIA included prompt corrective action as a major improvement in the regulatory scheme. *See, e.g.*, FDICIA, § 131(a) (codified at 12 U.S.C. § 1831o (Supp. III 1991)) (prompt corrective action required). The agencies have already begun to implement this provision. *See* 57 Fed. Reg. 29,662 (1992) (FDIC proposed rule); *id.* at 29,808 (OCC proposed rule); *id.* at 29,826 (OTS proposed rule); *id.* at 44,866 (OCC, Fed, FDIC & OTS final rules).

178. *See* Treasury Modernization Study, *supra* note 107, at 97,373-76.

179. *See id.* at 97,375. The FDICIA included annual on-site examination as one of its improvements in the regulatory scheme. *See, e.g.*, FDICIA, § 111(a) (codified at 12 U.S.C. § 1820(d) (Supp. III 1991)) (annual on-site examinations required for all depository institutions).

180. *See* Treasury Modernization Study, *supra* note 107, at 97,376-77.

181. In fact, as stated earlier, the Study views capital as the "single most powerful tool" in the supervision of banks. *Id.* at 97,356.

182. *See supra* notes 111-13 and accompanying text.

view of the role of capital in corporate governance and regulation; a view that may be of limited usefulness in achieving the regulatory objectives of safety and soundness in banking. It may be significant, however, that the Study did not recommend that capital standards be raised, but, rather, recommended that "the role of capital . . . be strengthened."[183]

Although it is arguably anomalous to speak of "strengthening" the role of capital without raising capital standards, the Study detailed a series of recommendations that gave substance to this position. First, it recommended that the bank regulatory system give greater emphasis to a bank's relative capital level as an indicator of the degree of supervision that its regulator should exercise.[184] However, the notion of using capital levels in this manner is already a recognized element of bank supervision.[185] Thus, a question exists concerning whether the regulators are effectively utilizing the supervisory techniques already within their authority.

Second, the Study recommended an assessment of deposit insurance premiums on the basis of risk, with risk measured on the basis of a bank's risk-based capital level.[186] The FDICIA has already mandated such a risk-based assessment system.[187]

Third, the Study recommended that "financial services holding companies" with well-capitalized bank subsidiaries be permitted to engage in a range of financial activities through nonbanking affiliates.[188] The Treasury expected that the promise of a broader range of activities would encourage banks to build and maintain capital, and would enhance market prospects for new issues made by previously undercapitalized banks.[189]

Fourth, the Study noted that the current risk-based capital standards did not significantly focus on interest rate risk in evaluating the relative risk of bank assets.[190] It urged the development of methods to monitor interest rate risk and to adjust risk-based capital ratios accordingly, in order to avoid "banks . . . shift[ing] into assets that are more sensitive to interest rate risk."[191]

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183. Treasury Modernization Study, *supra* note 107, at 97,356.

184. *See id.* at 97,360; *see also id.* at 97,373-76 (discussing capital-based supervision as an element of improved supervision).

185. *See, e.g.*, Malloy, *supra* note 7, at 455-57 (discussing Fed regulations; higher degree of oversight for banks with relatively low capital ratios); *id.* at 458 (discussing FDIC regulations; same); *cf. id.* at 453-54 (discussing OCC regulations; higher levels of capital required for higher degree of risk in operation of national bank).

186. *See* Treasury Modernization Study, *supra* note 107, at 97,360.

187. *See* FDICIA, § 302(a) (codified at 12 U.S.C. § 1817(b)(1)-(2) (Supp. III 1991)) (mandating a risk-based assessment system).

188. *See* Treasury Modernization Study, *supra* note 107, at 97,360.

189. *See id.*

190. *See id. But see supra* note 152 and accompanying text (discussing recent efforts to include interest-rate risk).

191. Treasury Modernization Study, *supra* note 107, at 97,360.

D. *FDICIA and Capital Supervision*

In December 1991, President Bush signed the FDICIA into law.[192] It included a series of provisions intended to improve supervision of insured depository institutions, with a significant emphasis on capital supervision as a primary tool.

The FDICIA adopted a general rule requiring annual on-site examinations of all insured depository institutions,[193] effective one year after enactment (December 19, 1991).[194] However, certain specified small institutions—well-capitalized and well-managed institutions with total assets of less than $100 million and no recent change in control—are to be examined every eighteen months.[195]

The FDICIA generally requires "prompt corrective action"[196] by regulators to "resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund."[197] Such action includes the implementation of capital standards.[198] A related FDICIA provision amends the conservatorship and receivership provisions of the FDIA,[199] the National Bank Act,[200] the Bank Conservation Act,[201] the Home Owners' Loan Act,[202] and the Federal Reserve Act[203] to facilitate prompt regulatory action.

The FDICIA focuses upon the safety and soundness of insured depository institutions in several ways. It authorizes federal banking agencies to impose more stringent treatment of capital where an institution is determined to be in an unsafe and unsound condition, or to be engaged in an unsafe and unsound practice.[204] It also requires federal banking agen-

192. Pub. L. No. 102-242, 105 Stat. 2236 (Dec. 19, 1991) (codified at scattered sections of 12 U.S.C.).

193. *See* FDICIA § 111(a) (codified at 12 U.S.C. § 1820(d)(1)-(3) (Supp. III 1991)).

194. *See id.* § 111(b) (codified at 12 U.S.C. § 1820 nt).

195. *See id.* § 111(a) (codified at 12 U.S.C. § 1820(d)(4) (Supp. III 1991)). *But see id.* § 111(c) (codified at 12 U.S.C. 1820 nt) (transition rule).

196. *Id.* § 131 (codified at 12 U.S.C. § 1831o(a)(2) (Supp. III 1991)).

197. *Id.* (codified at 12 U.S.C. § 1831o(a)(1) (Supp. III 1991)); *cf. id.* § 141(a), (e) (codified at 12 U.S.C. § 1823(c)(4)-(11) (Supp. III 1991)) (mandating least-cost resolution of failing institution problems). On principles of early resolution, see *id.* § 143 (codified at 12 U.S.C. § 1820 nts); *see also id.* § 141(b) (codified at 12 U.S.C. § 1821(d)(5)(D) (Supp. III 1991)) (authorizing receiver to disallow secured claims in excess of collateral); *id.* § 142 (codified at 12 U.S.C. §§ 347a, 347b(a)-(b) (Supp. III 1991)) (limiting Federal Reserve discount window advances).

198. *See id.* § 131 (codified at 12 U.S.C. § 1831o(c)-(f), (h)-(i), (k), (n) (Supp. III 1991)). These rules do not apply to depository institutions in conservatorship, or to bridge banks the stock of which is owned only by the FDIC or RTC. *See id.* (codified at 12 U.S.C. § 1831o(j) (Supp. III 1991)). The Act also contains provisions requiring the periodic review and improvement of applicable capital standards. *See id.* § 305 (codified at 12 U.S.C. § 1831o(e)(1)-(2) (Supp. III 1991)).

199. *Id.* § 133(a), (e) (codified at 12 U.S.C. § 1821(c)(5), (9)-(13) (Supp. III 1991)).

200. *Id.* § 133(b) (codified at 12 U.S.C. § 191 (Supp. III 1991)).

201. *Id.* § 133(c) (codified at 12 U.S.C. § 203(a) (Supp. III 1991)).

202. *Id.* § 133(d) (codified at 12 U.S.C. § 1464(d)(2)(A)-(F) (Supp. III 1991)).

203. *Id.* § 133(f) (codified at 12 U.S.C. § 248(p) (Supp. III 1991)).

204. *See id.* § 131(a) (codified at 12 U.S.C. § 1831o(g) (Supp. III 1991)).

cies to create detailed standards for safety and soundness of insured depository institutions and their holding companies[205] in specified areas of concern (such as operational and managerial standards,[206] asset quality, earnings, and stock valuation standards,[207] and compensation standards[208]).

CONCLUSION

In this Article, I have attempted to show how *TGS* and its progeny created the conditions for a crisis in bank regulatory policy. Because of a relative indifference to the interactions between bank trust and commercial departments, banks could have been subjected to a concerted assault on the trading practices of their trust departments with respect to the securities of customers of bank commercial departments. Regulations encouraging or mandating various protective "walls" between such departments blunted this crisis in part.

However, Rule 10b-5 remains a serious consideration for banks and bankers who, by the very nature of their activities, are naturally subjected to many temptations with respect to the illicit use of material inside information in securities trading. While the federal banking agencies have managed to assimilate and control the direct application of securities regulation to banks, it is almost beyond doubt that the SEC retains control of the direct application of Rule 10b-5. Furthermore, the increasing trend of banking enterprises taking a holding company form[209] has increased SEC jurisdiction over the depository institutions industry, since federal banking agency securities jurisdiction does not apply to holding companies.[210]

Yet, certain troubling trends are apparent in the current state of regulation affecting banks and other depository institutions. To the extent that the federal banking agencies retain authority over securities regulation, they have, with striking consistency over the past three decades,

205. *See id.* § 132(a) (codified at 12 U.S.C. § 1831p (Supp. III 1991)).

206. *See id.* (codified at 12 U.S.C. § 1831p(a)(2) (Supp. III 1991)).

207. *See id.* (codified at 12 U.S.C. § 1831p(b) (Supp. III 1991)).

208. *See id.* (codified at 12 U.S.C. § 1831p(c) (Supp. III 1991)).

209. *See generally* Anthony G. Chase, *The Emerging Financial Conglomerate: Liberalization of the Bank Holding Company Act*, 60 Geo. L.J. 1225, 1233-36 (1972) (describing the expansion of one-bank holding companies); Maurice Mann, *The Reality and Promise of Bank Holding Companies*, 90 Banking L.J. 181, 181-82 (1973) (discussing a recent "splurge" in bank holding companies); Benjamin P. Shapiro, *The One-Bank Holding Company Movement: An Overview*, 86 Banking L.J. 291 (1969) (discussing a movement towards one-bank holding companies). Indeed, as of 1990, only approximately 70 national banks that were unaffiliated with a holding company were required to report under the 1934 Act, and only approximately 34 member banks, 240 FDIC-insured nonmember banks, and 318 savings associations were required to report. *See 12(i)'ed Monster*, *supra* note 8, at 288 nn.115-16.

210. *See* 15 U.S.C. § 78*l*(i) (Supp. III 1991) ("In respect of any securities *issued by banks and savings associations*.") (emphasis added).

delayed publication of current securities regulation amendments[211] and appeared relatively indifferent to enforcement of securities laws as applied to depository institutions.[212] This institutional bias raises doubts about the effectiveness and advisability of allowing securities regulation with respect to depository institutions to be coopted by the federal banking agencies.

Furthermore, over the past ten years, we have seen a decisive reorientation of bank regulatory policy in favor of "capital supervision" as a basic approach to the regulation of depository institutions. To the extent that this reorientation turns regulatory policy further away from the techniques of full and fair continuous disclosure, we must ask if this is an appropriate approach to problems that publicly held institutions may face. Here, there are two causes for concern.

First, this reorientation toward capital supervision may reinforce the federal banking agencies' institutional bias against the vigorous use of public disclosure techniques. This possibility itself repudiates the fundamental decision of Congress to subject depository institutions to the regime of federal securities law. Second, it is far from certain that the preoccupation with capital supervision as a central feature of bank regulatory policy is a satisfactory technique on its own terms. Capital supervision, at least as advanced by the Treasury Modernization Study, is premised on a questionable assumption concerning the likely effective role of capital and bank investors in corporate governance.[213] Risk-based capital adequacy standards may provide a useful analytical tool to the supervisor, but they only have an indirect and highly circumspect effect on such problems as safe and sound management of a bank's loan portfolio (its most significant category of assets). In fact, risk-weighting of assets may have the unintended effect of artificially pushing a bank out of, for example, lending to the private commercial sector (risk-weighted at 100% of asset value) and into, for example, home mortgage lending (risk-weighted at 50% of asset value) or public sector lending (risk-weighted variously from 0% to 50% of asset value).[214]

The central concept of banking regulation— the maintenance of safety and soundness of the depository institutions industry—has at its heart, among other things, a concern with the perfidy of human nature. That is, it is concerned with the fact that things often go wrong because people make mistakes, often intentionally or recklessly. A "capital-intensive" approach to supervision and examination assumes that the analytical techniques embodied in the tools of capital supervision can effectively

211. *See, e.g.*, *12(i)'ed Monster*, *supra* note 8, at 306-09 (charting the consistent pattern of delays in promulgating regulations).

212. *See, e.g.*, *Public Disclosure*, *supra* note 8, at 245 & n.90 (citing the "paucity of examples of active enforcement of the securities laws by the bank regulators").

213. *See supra* notes 111-13 and accompanying text.

214. *See* Final Report, *supra* note 148, at 3317 annex 2 (charting various risk weights for different categories of assets).

ensure safety and soundness in that regard. Thus, the labor-intensive approach, which supports direct examination of the asset portfolio and its management, and employs a large, well-trained, experienced, and knowledgeable examination force on site, may well become a thing of the past.

Ironically, Rule 10b-5, which is rooted in the common law tradition of fraud and deceit, is also premised on a concern with the perfidy of human nature.[215] Thus, if the now pervasive policy of capital supervision does not assuage the ills of banking, such labor-intensive devices as Rule 10b-5 may reemerge in yet another paradigm shift in banking's regulatory regime.

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215. One may argue that § 10(b) of the 1934 Act " 'says, "Thou shalt not devise any other cunning devices." ' " Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976) (quoting congressional testimony of Thomas G. Corcoran, spokesman for drafters of § 10(b)).