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ESSAY

LEVELING THE PLAYING FIELD: THE NEED FOR INVESTOR PROTECTION FOR BANK SALES OF LOAN PARTICIPATIONS

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INTRODUCTION

More than sixty years ago, the Glass-Steagall Act erected distinct barriers between banks and the securities business. At the same time, banks were exempted from key provisions of the federal securities laws. Over the last two decades, however, distinctions between

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The key provisions of the Glass-Steagall Act are §§ 16, 20, 21, and 32 of the Banking Act of 1933, codified in 12 U.S.C. §§ 24, 78, 377, and 378 (1988 & Supp. V 1993). Section 16 restricts the power of national banks to underwrite securities and prohibits national banks from purchasing or selling securities except on the order and for the account of customers. Section 20 generally prohibits Federal Reserve System member banks from being affiliated with any firm that is “engaged principally” in underwriting securities. Section 21 prohibits persons and entities that are engaged in underwriting and certain other securities activities from receiving deposits. Section 32 prohibits management interlocks between member banks and entities that are primarily engaged in the securities activities described in § 20.

the banking and securities businesses have blurred. This trend has accelerated in recent times and is likely to continue.

One unfortunate result of this blurring to the potential disadvantage of investors is that similar financial instruments may be offered or sold to a broad investor audience pursuant to dissimilar regulatory schemes with different disclosure requirements. For example, bank-sponsored financial instruments, such as loan participations that function as investments, may be subject to regulation only under the federal banking laws. Consequently, these instruments are subject to laws designed primarily to protect bank depositors and to maintain the safety and soundness of the banking system and thereby avoid the application of the federal securities laws, which were designed to protect investors.

Complicating this problem, sellers often design new financial instruments partially with the objective of avoiding the reach of the federal securities laws. Not surprisingly, when purchasers lose money, litigation often ensues. When faced with interpreting the scope of the definition of "security" under the federal securities laws, courts have not always reached the correct result. This Essay focuses on the development of the law in the Second Circuit regarding sales of participations in debt instruments as exemplified in two recent and important cases, Banco Espanol de Credito v. Security Pacific National Bank and Pollock v. Laidlaw Holdings, Inc. In Banco Espanol, the Second Circuit held that sales of loan participations to institutional purchasers are not the sale of securities. This holding effectively deprives all purchasers of such investment vehicles, even non-bank purchasers, of the protec-

7. 27 F.3d 808 (2d Cir.), cert. denied, 115 S. Ct. 425 (1994).
8. Banco Espanol, 973 F.2d at 56.
tions of the federal securities laws. Although Pollack v. Laidlaw—which held that the securities laws cover sales to individuals of participations in mortgages—narrowsthe applicability of Banco Espanol, serious problems remain.

This Essay argues that purchasers of loan participations that function as investments should be protected by the federal securities laws, whether the purchasers are individuals or corporate entities. The problems created by the Banco Espanol decision are unlikely to be solved either by voluntary reforms in sales practices or by regulatory actions. A legislative solution is probably necessary to ensure that the purchasers of such investment vehicles receive adequate protection.

I. LOAN PARTICIPATIONS: TRADITIONAL AND NEW APPLICATIONS

A loan participation traditionally is an arrangement by which a bank or other financial institution makes a loan to a corporate borrower and then sells all or a portion of the loan to one or more participants. Courts generally have held that traditional loan participations are not securities. The loan participations involved in those cases, however, contained features that justify the courts' decisions. Typically, the participants were in the business of making loans, and the sale or purchase of loan participations was only a part of the business. In addition, the arrangements usually involved only a

12. See, e.g., Marcia Stigum, The Money Market 1086 (3d ed. 1990) (“For years, banks have sold, participated, placed, and syndicated their loans, usually, however, only with other banks.”); Deborah L. Threedy, Loan Participations—Sales Or Loans? Or Is That The Question?, 68 Or. L. Rev. 649, 661-63 (1989) (identifying the reasons for engaging in loan participations, including using the participation as a way to enter a new market using a lead bank to make a loan in a geographically remote location, diversifying risk, and obtaining a higher interest rate than is possible on a direct loan due to usury laws).
handful of participants. As a result, the prospective purchasers could engage in one-to-one negotiations with the lead bank and, if they wished, could perform their own credit analysis of the borrower. Finally, substantial collateral often was present. In these cases, the purchasers had substantial bargaining power and the ability to access information regarding the creditworthiness of the borrower. Thus, it is hard to fault courts for excluding loan participations with these characteristics from the definition of security, as such instruments arguably did not raise serious investor protection concerns.

In the mid-1980s, however, a new market developed for sales of loan participations. High quality borrowers found it cheaper to borrow money through sales to investors of debt instruments, such as commercial paper, rather than through traditional bank loans. In response, money center banks sought to recoup part of this market by moving into investment banking.

13. The most participants in a case holding that participations were not securities was 21. First Citizens, 919 F.2d at 512. See also McVay, 823 F.2d at 1396 (three participants); Union Nat'l Bank, 786 F.2d at 883 (one participant); Gunter, 620 F.2d at 1111 (one participant).

14. See, e.g., American Fletcher, 635 F.2d at 1254 (participant "conducted its own investigations of the project" and "retained the rights of a lender to demand foreclosure, preclude substitution of collateral, and prevent modification of [the loan's terms]"); Manchester Bank v. Connecticut Bank & Trust Co., 497 F. Supp. 1304, 1313 (D.N.H. 1980) (participant "had the opportunity . . . to seek an independent appraisal of the assets which made up the collateral"); Provident Nat'l Bank v. Frankford Trust Co., 468 F. Supp. 448, 455 (E.D. Pa. 1979) (participant "had the right to make inspections and appraisals"); Union Planters Nat'l Bank, 651 F.2d at 1178 (stating that participant bank had access to finance company's records concerning the loan).

15. See, e.g., American Fletcher, 635 F.2d at 1255 (loan was collateralized by the principals of the development of the corporation); Provident Nat'l Bank, 468 F. Supp. at 455 (stating that participant bank had 50% share in collateral); Robbins v. First Am. Bank, 514 F. Supp. 1183, 1188 (N.D. Ill. 1981) (stating that lender was provided with type of collateral indicative of commercial transaction); FBS Fm., Inc. v. Cleve-Trust Realty Investors, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,341, at 93,156 (N.D. Ohio 1977) (finding substantial collateral available to all participating lenders).

16. See, e.g., Dennis Scholl & Ronald L. Weaver, Loan Participations: Are They "Securities"?, 10 Fla. St. U. L. Rev. 215, 231 (1982) (arguing that application of securities law to typical loan participation is unwarranted, because participants have bargaining power and the ability to obtain access to information).

17. See Michael G. Capatides, A Guide to the Capital Markets Activities of Banks and Bank Holding Companies 63 (1993) (noting that since the mid-1980s, the loan sales industry has become a multibillion dollar business that has changed the way commercial banks extend credit to commercial customers); Robert F. Kornegay, Jr., Bank Loans as Securities: A Legal and Financial Economic Analysis of the Treatment of Marketable Bank Assets Under the Securities Acts, 40 UCLA L. Rev. 799, 826 (1993) (stating that market developments in the 1980s "altered banks' motivation to sell loans, the characteristics of the loans being sold, and the makeup of loan purchasers").


19. Id. at 1085.
out of their old make-a-loan-and-hold-it business into a new business, namely, the make-a-loan-and-distribute-it business.”

Perhaps the most important new development in this market was the wider range of purchasers to whom this product was offered and sold. Loan participations were redesigned to take advantage of the fact that money center banks “have a wide range of contacts with investors: through their sales forces, they have for years been selling investors bank products . . ., various exempt securities, and some privately placed securities,” as well as acting offshore as underwriters of “a wide range of securities.” As a result, loan participations are being mass marketed to institutions that are not in the lending business, such as mutual funds and pension funds, as well as to individuals. Because the purchasers are not able to evaluate the creditworthiness of the borrower, these purchasers, in particular, need the protections of the federal securities laws. Yet, as evidenced by the Banco Espanol decision, courts have not fully appreciated these market developments.

A. Loan Notes: The Banco Espanol Decision

Banco Espanol involved the sale of instruments called “loan notes,” which money center banks began selling in the mid-1980s. The loan note program at issue in Banco Espanol was promoted as an alternative to commercial paper. The bank made short-term unsecured loans to corporate borrowers, then sold participations in the loans, usually in minimum denominations of one million dollars. Although the bank remained the nominal payee on the loan, collected on the loan, and distributed the proceeds, the purchasers’ only recourse was against the borrower.

Potential purchasers were solicited, often on a daily basis, and offered a range of investment options with different maturities and interest rates. Entities that had expressed an interest in participating in the program usually signed a Master Participation Agreement prior to their first purchase. The bank only was required to furnish to

20. Id.
21. Id. at 1086.
23. Id.
24. Id.
25. Id. at 60.
participants, upon request, publicly available financial information about the borrower.

The purchasers included foreign and domestic banks, treasury or money management portfolio departments of corporations, pension and retirement funds, insurance companies, mutual funds and savings and loans.\(^{27}\) The purchasers were looking for a short-term vehicle to place excess cash and were driven by the maximum return available from the investments offered.\(^{28}\) The loan note market presented a range of largely fungible investment vehicles, with little opportunity or incentive for an investor to conduct a significant inquiry.\(^{29}\)

After a borrower defaulted on over seventy-five million dollars of loan notes, the plaintiffs in *Banco Espanol* filed suit seeking rescission under Section 12(2) of the Securities Act.\(^{30}\) The plaintiffs claimed that the defendant bank misled them by representing that the borrower was creditworthy when, they assert, the bank knew the borrower was not creditworthy. Although a majority of the purchasers in the loan note program were not banks,\(^{31}\) eight of the eleven plaintiffs in the *Banco Espanol* case were banks.\(^{32}\) This fact made *Banco Espanol* a poor test case, from an investor protection perspective, for deciding whether loan notes are securities.

The district court held that the loan notes were not securities under the four-factor test set forth by the Supreme Court in *Reves v. Ernst & Young*.\(^{33}\) The *Reves* test “begin[s] with a presumption that every note is a security.”\(^{34}\) That presumption is rebuttable if it is shown that a note bears a “strong resemblance” to any instrument on a list of notes that the court previously has deemed not to be securities,\(^{35}\) or if the court determines—looking to the four factors identified in *Reves*—that the note should be on the list.\(^{36}\) The four factors are: (1) an “examin[ation of] the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it;”\(^{37}\) (2) whether the note “is an instrument in which there is ‘common trading for spec-
After considering the four Reves factors, the district court concluded that loan notes are not securities. First, the court reasoned that "the overall motivation of the parties was the promotion of commercial purposes and not investments in a business enterprise." Second, the court explained that the plan of distribution did not involve common trading, but rather was "a limited solicitation to sophisticated financial or commercial institutions and not to the general public." Third, the court noted that the contractual provisions of the Master Participation Agreement put a sophisticated investor on notice that "the instruments are participations in loans and not investments in business enterprises." Fourth, the court reasoned that the banking guidelines, in the form of a circular issued by the Comptroller of the Currency, create a "regulatory scheme" applicable to the seller that makes securities regulation unnecessary.

The plaintiffs appealed the district court decision, and the United States Securities and Exchange Commission ("SEC") filed an amicus brief arguing that the loan notes at issue in Banco Espanol were securities. The SEC acknowledged that courts had excluded traditional loan participations from coverage under the federal securities laws. The SEC argued, however, that loan notes should be covered under the federal securities laws. The SEC explained that "[t]raditional loan participations have generally been taken by banks as an adjunct to direct lending operations." The SEC noted: "[I]n this case, in contrast, [t]he non-financial entities among the purchasers clearly were not acting as commercial lenders, and even the banks that purchased

38. Id. (quoting SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)).
39. Id.
40. Id. at 67.
42. Id.
43. Id.
44. Id. The court also held that loan notes are not investment contracts under the test set forth in SEC v. W. J. Howey Co., 328 U.S. 293 (1946). Banco Espanol, 763 F. Supp. at 44.
45. Brief of the SEC, Amicus Curiae, at 14-43, Banco Espanol de Credito v. Security Pac. Nat'l Bank, 973 F.2d 51 (2d Cir. 1992) (No. 91-7563), cert. denied, 113 S. Ct. 2992 (1993). The SEC argued that loan notes should be evaluated under the Reves test and that because the notes are securities under that test, it is not necessary to reach the question of whether loan notes are "investment contracts." Id. at 17.
46. Id. at 4.
47. Id. at 3
generally did so not through their lending departments but through their investing and trading departments.”

The SEC's brief went on to argue that, contrary to the district court's findings, each of the Reves factors pointed to a finding that loan notes are securities:

The loan notes were purchased by the participants for investment purposes—for the high rate of return they offered compared to other instruments—and not as part of a commercial lending business or to facilitate an independent business relationship with the borrower. They were offered and sold to numerous entities in a market that meets the Reves Court's definition of “common trading for speculation or investment,” since the sales did not involve negotiations in which purchasers had the opportunity individually to verify information concerning the borrower. Purchasers would reasonably expect that these loan notes, which were promoted in language used in securities markets, and as the “equivalent” of commercial paper, were securities. Finally, there is no alternative scheme of regulation, or other factor, that significantly reduces the risk of these loan notes and thus renders the application of the securities laws unnecessary.

A panel of the Second Circuit, however, was not persuaded by the SEC's analysis and held instead that the district court had correctly applied the Reves test.

In a dissenting opinion, then Chief Judge Oakes stated that the court's opinion “makes bad banking law and bad securities law, and stands on its head the law of this circuit and of the Supreme Court in Reves.” He agreed with the SEC's argument that these loan notes were not akin to traditional loan participations and emphasized that loan note purchasers have far less information available to them than do participants in commercial loans. Judge Oakes noted with approval the concurring opinion in Great Western Bank & Trust v. Kotz, which stated that the hallmark of a commercial loan is the ability of lenders “to verify representations and take supervisory and corrective actions.” Here, in contrast, the loan note purchasers had no access to full credit information and no opportunity to perform or to receive a full credit analysis. Judge Oakes concluded, as the SEC had argued, that application of the Reves factors leads to a finding that loan notes are securities.

48. Id.
49. Id. at 4-5.
51. Id. at 56.
52. Id. at 59-60.
53. 532 F.2d 1252 (9th Cir. 1976).
54. Id. at 1261 (Wright, J., concurring).
55. 973 F.2d at 60 (Oakes, C.J., dissenting).
The SEC filed another amicus brief in *Banco Espanol* in support of plaintiff's petition for rehearing. The SEC's brief argued that the court's decision overlooked all of the indicia that these transactions were securities transactions—that they were purchases of instruments marketed as investments, bought by persons acting from an investment motivation and with only the type of publicly available information commonly available to investors, and bought in sales subject to no risk-reducing scheme of regulation. In sweeping these considerations aside, the majority has issued a decision that could call into question the application of the securities laws in a wide range of debt transactions.

Thus, the SEC urged the court to apply the federal securities laws to the loan notes.

The Second Circuit denied the petition, but amended the original decision to narrow its scope in apparent response to the SEC's concerns. The decision, as amended, emphasizes that the court of appeals was only ruling "with respect to the loan participations as marketed in this case" and that "even if an underlying instrument is not a security, the manner in which participations in that instrument are used, pooled, or marketed might establish that such participations are securities." The amended decision also states that the loan notes were not sold to the general public, "thus limiting eligible buyers to those with the capacity to acquire information about the debtor." Despite this narrowing of *Banco Espanol*'s scope, major problems remain for investor protection. The court's apparent premise is that debt instruments sold to institutional purchasers are not securities if the purchasers have the theoretical ability to obtain credit information. The court does not distinguish between banks and other types of institutional purchasers. Whether a mutual fund or local government pension fund purchasing debt instruments for investment is in fact misled or defrauded does not seem to matter to the *Banco Espanol* majority. But this does matter to the SEC, and it should have mattered to the court.

The plaintiffs sought Supreme Court review, and the Court requested that the United States file a brief stating the government's position. Unsurprisingly, the SEC and the federal banking regula-

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57. *Id.* at 7.

58. *Banco Espanol*, 973 F.2d at 56.

59. *Id.* at 55.

tors did not agree as to what position the government should adopt. While the SEC urged that purchasers of loan notes should be protected by the federal securities laws, the federal banking regulators adopted the position that the loan note market “has not to date manifested major problems that suggest a pressing need for further regulatory attention.” The brief ultimately filed by the Solicitor General on behalf of the United States was not joined by the SEC. The Solicitor General’s brief stated that the Banco Espanol decision is open to “serious question.” The brief, however, urged the Supreme Court not to take the case because no circuit conflict existed, and because banking regulators “are considering whether to provide further guidance to the banking industry on loan-participation programs, including guidance on the information that should be made available to purchasers of loan notes and other participations.”

Although the government’s brief did not urge Supreme Court review, it did point out some of the investor protection concerns raised by Banco Espanol. Specifically, the brief noted the changes in the market for sales of loan participations and stated that these developments

61. The federal banking regulators are the Department of the Treasury, including the Office of 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.


64. Id. at 9. The United States argued:

[T]he court erred in the significance it attached to the fact that the notes were sold only to supposedly sophisticated institutions, and not individuals. The court also erred in concluding that the mere existence of banking guidelines for the purchase of loan participations weighs against the conclusion that loan participations are securities.

65. Id. at 16.

66. Id. at 17. To date, the federal banking regulators have not published any such guidelines.

67. See id. The brief noted:

[A]ccording to recent commentary, “the loans sold today are increasingly obligations of noninvestment grade firms without access to the commercial paper market. . . . Consequently, relative to investment-grade participations, less public information is available to investors about the companies whose debt is being marketed.” Those developments have been accompanied by changes in the way loan participations are marketed.

Id. (quoting Kornegay, supra note 17, at 827-28 & n.90).
may also further implicate the concerns of the SEC in ensuring that the protections of the securities laws are afforded to those purchasers of loan notes who do not have adequate access to credit information and who may not participate in the market in the manner of a lender that is in a position to make independent credit determinations.68

The Supreme Court denied certiorari in the *Banco Espanol* case on June 21, 1993.69

B. Pollack v. Laidlaw: *A Partial Retreat From Banco Espanol*

One year later, in *Pollack v. Laidlaw Holdings Inc.*,70 the Second Circuit had another opportunity to decide whether participations in debt instruments are securities, and this time the court reached the correct result.

*Pollack* involved interests in mortgages purportedly secured by commercial real estate.71 The mortgages paid a fixed return and contained maturities ranging from one to three years. The purchasers were two doctors, one of the doctors' sons, the doctors' retirement plans, and a family trust. For purposes of the appeal, the defendants did not dispute that the plaintiffs were "passive, unsophisticated investors."72 The sellers were corporate entities in the securities and investment counselling business.73

The district court held that the instruments were not securities under *Reves*.74 Applying the four *Reves* factors in light of the "framework" provided by *Banco Espanol*, the district court concluded that the instruments strongly resembled notes secured by mortgages on a home, one of the items on the *Reves* list of non-securities.75 In its analysis, the district court recognized that under the second *Reves* factor, the instruments should be viewed as securities because they were sold to members of the general public. The district court held, how-

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68. Id. at 18.
69. 113 S. Ct. 2992 (1993).
70. 27 F.3d 808 (2d Cir. 1994).
72. 27 F.3d at 809.
73. Id.
75. Id. at *4.
ever, that because the other three *Reves* factors pointed to the opposite conclusion, these mortgage interests were not securities.\(^7\)

The plaintiffs appealed the district court decision, and the SEC filed an amicus brief in support of the plaintiffs.\(^7\) The SEC argued that “this case is distinct from *Banco [Espanol]*, that the district court unduly extended *Banco [Espanol]* beyond its holding, and that accepting as true the allegations in the plaintiffs’ complaint, the interests sold in this case are securities under the *Reves* test.”\(^7\)

The Second Circuit agreed with the SEC’s conclusion, and its opinion closely tracks the analysis in the SEC’s brief. The court made clear that *Banco Espanol* does not apply in a case involving sales to the general public. The court stated:

> The marketing scheme in *Banco Espanol* was more analogous to a group of highly sophisticated commercial entities engaging in short-term commercial financing arrangements than to the securities markets. In contrast, the record before us does not suggest that the participations here were restricted to sophisticated investors who had “the capacity to acquire information about the debtor.”\(^7\)

The court’s opinion makes several other important points. First, the fact that an instrument has a fixed return does not mean that purchasers lack an investment motive. The court held that it is “not even a close question” that the plaintiffs had an investment motive, because they

sought to invest funds in secure, conservative instruments. Most of the instruments that such investors would take positions in, such as investment grade commercial bonds, would have a fixed rate of return in the form of interest. Such bonds are nonetheless regulated as securities.\(^8\)

Second, if the purchaser clearly has an investment motive, it does not matter if the seller does not.\(^8\) Finally, the mere existence of another regulatory scheme applicable to the instruments does not mean that the protections of the federal securities laws are unnecessary.\(^8\)

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76. *Id.* at *5-6. The court also held that the mortgage interests were not securities under the *Howey* test. *Id.* at *6.*


78. *Id.* at 2-3 (footnote omitted). The Commission also argued that the court should apply the *Reves* test and need not reach the *Howey* test. *Id.* at 18 n.12.


80. *Id.* at 813. The court also rejected the district court’s reliance on the purported existence of personal guarantees as negating the purchasers’ investment motive. *Id.* 81. *Id.*

81. *Id.* at 815. The court stated that the district court erred in holding that New York state regulation of mortgages provides such an alternative scheme of regulation, because the purchases and sales in this case did not involve “the usual process for extending” a loan under state law. *Id.* The court also stated that the applicability of
Pollack was an important victory for the SEC and, more importantly, for individual investors. The applicability of the definition of security to debt instruments would have been severely and unduly restricted had the decision gone the other way.

Although Pollack purports to distinguish rather than limit Banco Espanol, several of its conclusions in fact narrow the holding of Banco Espanol. Both decisions are based on applications of the four-factor Reves test. Although Reves does not state which factor is the most important, the first factor (motivation of the parties) is crucial. It is highly unlikely that a court would hold that an instrument is a security if neither the purchaser nor the seller has an investment motive. Conversely, a court is not likely to hold that if both do, the instrument is not a security. Difficulties in applying the Reves test have arisen in cases where the parties to a transaction have differing motives, as was arguably the case in Banco Espanol. Pollack is the first appellate decision to resolve this issue. The court's focus on the motive of the purchasers, rather than of the sellers, is critical. Because loan participations are sold by entities in the lending business, the sellers' motivations can almost always be viewed as commercial rather than investment. Unless the purchasers' motives are given priority, participations likely would never be securities under Reves.

Pollack's conclusion that the mere existence of other regulation is not enough to displace the federal securities laws is also important. The Banco Espanol opinion incorrectly pointed to the existence of a banking circular as a factor weighing against the need for securities regulation. But this particular circular only addresses the steps that national banks should follow before they purchase loan participations. It does not directly apply to non-bank purchasers, or even to bank sales of loan participations. Further, the circular is an inadequate substitute for the federal securities laws because by its own terms the circular does not offer substantial protection against investment risk, nor does it provide purchasers with any remedies.

Pollack correctly cautions courts not to invoke lightly the existence of other regulation as an alternative to the federal securities laws under the fourth Reves factor. Although the Reves opinion does not explain the precise scope of factor four, the Court cited and appears

the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21, was not a substitute for the protections provided by the Securities Act and Exchange Act.


86. Id. at 41.

to have drawn the factor from its prior decisions in *Marine Bank v. Weaver*[^88] and *International Brotherhood of Teamsters v. Daniel*.[^89] The certificate of deposit held not to be a security in *Marine Bank* was guaranteed by federal deposit insurance, which the Court emphasized "virtually guaranteed payment in full."[^90] In *Daniel*, the Court stated in dictum, after holding that the securities laws were not applicable, that other federal law had removed the risk of misrepresentation.[^91] These cases indicate that factor four should come into play only where federal law provides comprehensive and strong protections for purchasers such that the investment risk is substantially eliminated.[^92] The existence of a banking circular, as in *Banco Espanol*,[^93] or remedies under state property law, as in *Pollack*, is not enough.[^94]

**C. Current Law: Dangers For Investors**

Although *Pollack* points courts in the right direction, the problems created by *Banco Espanol* remain for purchasers of participations in loans and mortgages. *Banco Espanol* has not been overruled, and it is the only court of appeals decision on loan notes. Therefore, currently the law in the Second Circuit, the most important court of appeals for financial matters, is that loan notes are subject to regulation only under banking law, not the federal securities laws.

Banking law, however, does not provide purchasers with the rights and remedies that would be available under the federal securities laws. For example, purchasers of loan participations would have no private right of action under federal banking law.[^95] In contrast, Section 12(2) of the Securities Act provides a private remedy for false or misleading statements made in the offer or sale of any security.[^96]

[^88]: 455 U.S. 551 (1982).
[^90]: *Marine Bank*, 455 U.S. at 558; see also Olson v. E.F. Hutton & Co., 957 F.2d 622, 628 (8th Cir. 1992) (proclaiming that *Marine Bank* applies only where regulation guarantees a return on the investment).
[^91]: See 439 U.S. at 569. *Daniel* held that a non-contributory, involuntary, defined benefit pension plan is not a security because the plan fails the investment contract test. *Id.* at 558-62. The Court went on to note that the specific issue in *Daniel*—his continuous service requirements for pension benefits—had been dealt with under the Employee Retirement Income Security Act of 1974. *Id.* at 569.
[^92]: See also *Uselton v. Commercial Lovelace Motor Freight*, 940 F.2d 564, 582 (10th Cir.) (the risk-reducing factor must "essentially guarantee the individual's investment"), cert. denied, 112 S. Ct. 589 (1991).
[^93]: See supra notes 83-86 and accompanying text.
[^94]: See supra note 82 and accompanying text.
addition, loan participations would be subject to private fraud actions under Rule 10b-5 of the Exchange Act, unless they qualify for that Act's exclusion of certain types of commercial paper.

But even if courts hold that loan notes are securities, purchasers remain at risk. Under current law, banks that engage directly in securities brokerage activities are generally excluded from sales practice regulation under the federal securities laws. For example, the Exchange Act excludes banks from the definition of "broker" and "dealer." These exemptions for banks were enacted more than half a century ago on the assumption that banks were severely restricted from participating in the securities business. Today, in contrast, investors are increasingly likely to purchase securities directly from a bank. Because the statutory exemptions of sixty years ago remain in place, however, banks can conduct some securities activities beyond the effective reach of the federal securities laws.

The consequence is that many regulatory safeguards designed for the protection of investors do not apply to securities sold by banks. For example, if a bank selling loan notes was not exempt from broker-dealer regulation, the bank's sales personnel would have to pass comprehensive examinations. Specifically, the bank would have an affirmative duty to supervise employees. The bank also would be required to follow rules relating to abusive sales practices, as well as guidelines regarding the content of advertisements. The bank would be subject to periodic examinations by securities regulators, and the bank would have to become a member of the Securities Investor Protection Corporation.

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98. See, e.g., SEC v. American Bd. of Trade, Inc., 751 F.2d 529, 538 (2d Cir. 1984) (stating that short-term paper may still be a security even though there is an exemption for nine-month notes). See generally Randall W. Quinn, After Reves v. Ernst & Young, When Are Certificates of Deposit "Notes" Subject to Rule 10b-5 of the Securities Exchange Act, 46 Bus. Law. 173, 183-87 (1990) (claiming that the Reves dissent was unpersuasive because it ignored the history of the Securities Act in concluding that notes with a maturity of less than nine months are not securities).
100. The bank exclusions are a "historical vestige of a simpler time." Levitt Testimony, Mellon-Dreyfus Merger, supra note 3, at 4.
102. See American Bankers Ass'n v SEC, 804 F.2d 739, 742 n.7 (D.C. Cir. 1986) ("[U]nder current SEC rules, persons associated with broker-dealers must pass SEC examinations before they sell securities... The 1934 Exchange Act itself imposes on broker-dealers an affirmative duty to adequately supervise its employees in order to prevent violations of federal securities laws." (citations omitted)).
103. Id.
104. Id.
These safeguards are necessary to protect purchasers of loan participations that function as investments. Aggressive marketing of loan participations to non-bank purchasers is likely to remain attractive to banks. Because the Second Circuit may adhere to, and other courts may follow, the *Banco Espanol* decision, it is likely that the federal securities laws will not apply to these instruments. Certain purchasers—such as mutual funds and pension funds in which unsophisticated investors have financial stakes—are especially vulnerable, because these entities are not in the commercial lending business and may lack the capability to evaluate the risks inherent in that business. The ultimate victims, when these institutional purchasers suffer losses, often will be the individual investors who had interests in the funds.

II. Possible Solutions

A. Improvements in Sales Practices

A partial solution would be for sellers of loan participations voluntarily to provide more information regarding credit risk to prospective purchasers, or at least to non-bank purchasers. Without this information, purchasers of mass marketed loan participations probably have no realistic opportunity to evaluate the creditworthiness of a borrower. While additional disclosure by sellers may cause participations to be more expensive and less competitive with other types of debt instruments, it would prevent sellers from marketing a product that potentially exposes purchasers to inadequately disclosed risks. Relying on voluntary disclosure by the seller, however, is probably not a realistic solution to protect adequately investors from being misled.

B. Regulation

If sellers do not voluntarily provide adequate information, regulatory action appears to be the next logical step to take to allow purchasers of loan participations to evaluate properly the credit risk. According to *Banco Espanol*, however, the SEC’s hands are tied, because the SEC is confined by jurisdictional limitations if a security is not involved. While the federal banking regulators could act, they have not yet issued any specific guidance on the subject of loan participation sales to supplement the current inadequate pronouncements. Moreover, any action taken by the federal banking regulators is unlikely to eliminate the dangers to investors posed by sales of participations because traditional bank regulation has a differ-

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105. Although the banking regulators have recently issued guidelines and a superseding Interagency Statement designed to supplement their securities regulatory programs, the guidelines and statement “do not compensate for the omission of vital securities law safeguards from federal banking laws and regulations.” See Levitt Testimony, *Securities Regulatory Equality*, supra note 4, at 11; see also supra notes 66, 83-86 and accompanying text.
ent purpose than securities regulation. Bank regulation is intended to regulate the safety and soundness of banks and to protect bank depositors; it is not intended to protect the purchasers of products sold by banks.

C. Legislation

Thus, legislation looms as the only comprehensive solution. One legislative response would be to amend the definition of security to make explicit that the definition encompasses certain types of loan participations. The difficulty, however, in crafting a statutory definition that works well in the fact-specific context of determining when notes are securities should not be underestimated. Even if it were possible to enact a new definition that is neither over- nor under-inclusive, the existence of the bank exemptions from key provisions of the federal securities laws may still leave purchasers of bank-sponsored securities without needed protections.

The best legislative solution would be to amend the definition of security and to impose a scheme of functional regulation, which the SEC has strongly advocated for a number of years. Transactions that in substance are securities activities should be governed by a uniform set of rules, consistently applied by a single expert regulator—the SEC—to all market participants, regardless of whether those participants are banks or securities firms.

For this reason, among others, the SEC historically has urged Congress to enact a functional regulation bill. Among other things, the SEC has supported legislation to

1. repeal the blanket exclusion of banks from the Exchange Act definitions of “broker” and “dealer”;
2. generally require banking organizations to conduct broker-dealer activities in separately incorporated entities, registered with the SEC;

106. See Levitt Testimony, Mellon-Dreyfus Merger, supra note 3, at 3 & n.7 (citing prior SEC testimony).
[B]anks that engage in securities activities have the option of conducting those activities outside the framework of the federal securities laws. As a result, investors who purchase securities directly from unregistered banks receive different standards of protection than those who deal with securities firms. The resulting regulatory structure gives rise to regulatory inefficiency and duplication. . . . In addition, regulatory fragmentation prevents the [SEC] from getting the comprehensive overview of the securities markets it needs to do its job.

Id.

(3) delete the Investment Advisers Act exclusion for banks and bank holding companies that act as investment advisers to registered investment companies; 
(4) address a variety of conflicts of interest that can arise between banks and their affiliated mutual funds; and 
(5) prohibit an investment company from using the name of an affiliated bank.109

In addition, the SEC has supported legislative provisions to repeal the existing exemptions for bank and thrift securities from Securities Act registration (but not the exemptions for bank and thrift deposit instruments) and to consolidate within the SEC jurisdiction over periodic reporting by banks and thrifts through repeal of Section 12(i) of the Exchange Act.110 Enacting such legislation would ensure that the regulatory safeguards designed for the protection of investors would apply to securities sold by banks.

Although hearings have been held on financial modernization in the 104th Congress, it is difficult to predict whether functional regulation will be addressed (or any financial modernization legislation for that matter), much less enacted, in the 104th Congress.111

CONCLUSION

Today's market realities call for an overhaul of the existing regulatory system for securities activities. Bank involvement in the securities markets is here to stay. One example of this involvement is the bank sale, to a broader investor audience, of products that are called loans, but that in economic reality are investment vehicles. Investors may be at risk (as the Banco Espanol decision illustrates) if courts incorrectly interpret the definition of security.

But even if courts recognize that the definition of security must react flexibly to changing market conditions (as the Second Circuit appeared to realize in Pollack), investors may remain at risk. Courts may hold that participations are securities, but the bank exemptions from the regulatory requirements applicable to broker-dealers may mean that investors still are not provided with a single, consistent standard of protection. The unacceptable result is that protections vary depending on whether investors purchase securities (or financial instruments that are remarkably similar to securities) from a bank or from a registered broker-dealer.

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Voluntary reforms in sales practices would represent a substantial improvement, but are not an adequate substitute for the protections provided to investors under the federal securities laws. Coordinating regulatory efforts among the SEC and its counterparts at the federal banking agencies may alleviate some problems, but cooperation among financial regulators can have only modest success under current statutes that impose inconsistent or even conflicting responsibilities. Issuing new federal banking guidelines designed to protect, at a minimum, non-bank purchasers of loan participations also would help. The only comprehensive solution, however, is legislative action that both amends the definition of security to include certain types of loan participations and imposes a scheme of functional regulation as historically supported by the SEC. Unfortunately, it remains to be seen whether such legislation will be enacted in the near future.