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SEPARATION BETWEEN BANKING AND COMMERCE UNDER THE BANK HOLDING COMPANY ACT—A STATUTORY OBJECTIVE UNDER ATTACK

Thomas E. Wilson*

From the inception of this nation's national banking system, our bank regulatory legislation steadfastly has maintained a separation between the business of banking and other forms of commerce.1 Except for a brief period during the first quarter of this century, the activities of banks have been limited to the deposit-taking and lending functions that have long characterized the banking business.2

The statutory walls that Congress erected more than 120 years ago to fence banking away from nonbanking endeavors are today under fundamental attack. Large money center banks have been dismayed by the increasing level of competition from near-bank conglomerates such as Sears, Roebuck & Co. and Prudential-Bache. Likewise, these money center

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2. See, e.g., 12 U.S.C. § 24 (1982). Shortly after the establishment of the national banking system in 1864, first, state banks, and, later, national banks began establishing affiliate relationships with investment banking firms. These relationships occurred in reaction to the competition from trust companies, unregulated entities that managed the assets of large estates and that increasingly undertook bank-like activities. In 1927, the McFadden Act ratified what had been occurring in the marketplace for some time by formally authorizing national banks to engage in investment banking activities. McFadden Act, ch. 191, 44 Stat. 1224 (1927) (codified as amended at 12 U.S.C. §§ 36, 332 (1982)). Aggressive bank speculation in stocks and bonds underwritten by their affiliated investment banking firms was later identified as one of the principal causes of the stock market crash in 1929 and the Great Depression that followed. See generally Perkins, The Divorcement of Commercial and Investment Banking: A History, 88 Banking L.J. 483 (1971). The pervasive scheme of existing federal banking regulation was put into place in direct reaction to the economic and social trauma of the Great Depression. Id.

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banks have been frustrated by their inability to persuade Congress to make significant modifications in federal laws that forbid the intermingling of banking and commerce. As a result, these banks have looked for loopholes in federal statutes that would permit them to undertake previously proscribed activities, such as insurance underwriting and brokerage, real estate investment, and securities underwriting.\(^3\)

In 1983, several large banks proclaimed that they had found a loophole in federal law that would permit them to undertake a potentially broad range of nonbanking activities that were previously thought to be off limits to banking institutions. Those banks relied upon the theory that activities that may not be pursued by bank holding companies either directly or indirectly through their national bank or nonbank subsidiaries may be undertaken through state-bank affiliates so long as state law authorizes the state banks in question to engage in those activities. Additionally, they argued—again, if state law were to permit it—that an out-of-state bank holding company could acquire a state bank with "enriched" nonbanking powers and initiate otherwise prohibited activities on a nationwide scale.

At least three major bank holding companies, Citicorp of New York, BankAmerica Corporation and First Interstate Bancorp of California, attempted to exploit the alleged state-bank affiliate loophole in federal law by seeking Federal Reserve Board authority to acquire banks in South Dakota, banks that the South Dakota legislature recently empowered to engage "directly or through subsidiaries . . . in all facets of the insurance

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3. Bankers are not the only ones who have been poring over federal laws trying to avoid the restrictions against commingling bank and nonbanking activities. Certain insurance companies and securities firms have successfully circumvented some of these restrictions. The principal loophole unearthed by nonbanking interests has come to be called the "nonbank bank" loophole. Under the Bank Holding Company Act of 1956, bank holding companies have limitations placed on the nonbanking activities in which they may engage. A bank holding company is any entity that owns a bank. A bank is defined as any entity that accepts demand deposits and makes commercial loans. 12 U.S.C. § 1841(c) (1982). If a bank stops accepting demand deposits or stops making commercial loans, it stops being a "bank," the ownership of which would bring the entity owning it under the nonbanking limitations of the Bank Holding Company Act. The definition of "bank," therefore, has permitted banks to sell off their commercial loan portfolios and to be acquired by insurance companies and securities firms without rendering the acquiring entities "bank holding companies." As a result of the "nonbank bank" loophole, a number of cross-industry acquisitions have been consummated. In recognition of the reality that the "nonbank bank" loophole could fundamentally undermine the separation of banking from commerce, the Federal Reserve Board recently promulgated regulations which expand the definitions of "deposits" and "commercial loans" in an attempt to expand the universe of entities included within the Bank Holding Company Act's definition of a "bank." In doing so, the Board has attempted to narrow as much as possible the "nonbank bank" loophole. See 49 Fed. Reg. 794-824 (1984).
business."4

On January 5, 1984, the Federal Reserve Board issued a statement announcing that, because of "present law and expressions of [c]ongressional intent," it could not approve the proposed Citicorp, BankAmerica, and First Interstate acquisitions.5 The Board also made it clear that if bank holding companies are to be authorized to undertake insurance activities in South Dakota as a result of South Dakota's new law, Congress and not any given state legislature would need to authorize that action by making the appropriate adjustments in federal law.6 In the face of that judgment, rather than deny their South Dakota bank applications outright, the Board permitted the applicants indefinitely "to suspend the processing of their applications."7

This article summarizes the insurance authority of banks and bank holding companies and evaluates the theory, advanced by the bank holding companies, that bank holding company state-bank affiliates may be used to circumvent nonbanking restrictions imposed by federal banking laws.

I. THE INSURANCE AUTHORITY OF BANKS AND BANK HOLDING COMPANIES

The historical separation between banking and commerce has meant that banks have not been authorized to engage in most insurance activities.8 Before 1916, national banks were not permitted to undertake insur-

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5. FRB Release, Board Statement on Applications to Acquire State-Chartered Banks in South Dakota, Jan. 6, 1984, at 2. The Board's release, which is comprised of only two and one-half pages, fails to include a rationale for its "tentative judgment," beyond the reason that the Board prefers to wait until Congress has acted on the issue.
6. Id.
7. Id.
8. Typically, state banking laws are silent about the insurance authority of state banks. Since banks are corporations with limited and specific powers, any failure to confer specific authority on banks usually has been interpreted to mean that such power is withheld, except where the activity in question is seen as reasonably incidental to a power that is expressly conferred. Many states have determined that the sale (as agent) of credit life and credit disability insurance, special forms of insurance that repay the lender in the event of the death or disability of the borrower, are reasonably incidental to the business of banking and are therefore permissible activities for state banks. Some states have expressly forbidden state banks and even bank holding companies that operate within their borders to engage in all but a very narrow spectrum of insurance activities. See, e.g., MASS. GEN. ANN., ch. 175, § 174E (West Supp. 1983-84); Fla. Stat. § 626.988 (Cum. Supp. 1981). More recently, other states have considered legislation permitting state-chartered banks to engage in a broad range of insurance activities: Delaware, WASH. FIN. REPTS. 507 (March 14, 1983) (Director
ance activities of any kind. In 1916, Congress expressly authorized national banks to offer unlimited lines of insurance as agents, but not as underwriters. This authorization applied only to national banks located in towns having 5,000 or fewer inhabitants.9

The laws that prohibited state and national banks from engaging in most insurance activities only limited what those banks could do directly or through subsidiaries. Those laws did not restrict the activities that could be undertaken by entities that might come to control one or more banks. After the enactment of the Banking Act of 1933 (Glass-Steagall Act),10 the principal federal law that reestablished a rigid separation between banking and commerce in reaction to the economic debacle that began in 1929, banking and nonbanking enterprises remained relatively separate until World War II. After the war, however, commercial and industrial enterprises began with increasing frequency to acquire banks. Fearing that the commingling of banking and commerce under single corporate control would lead to undue concentration of power and would ultimately threaten the safety and soundness of the banking system, regulators and legislators alike began considering legislation that would reinvigorate the long-standing separation between banking and nonbanking activities. This legislation restricted the activities of bank holding companies (corporate entities that own or control banks) and brought those entities under the administrative supervision of federal banking regulators.

After long debate, Congress enacted the Bank Holding Company Act of 1956 (BHC Act).11 The BHC Act severely limited the nonbanking activi-

9. Congress sought to protect the viability of small rural banks, entities that in 1916 were experiencing difficulties in generating sufficient loan revenues to remain in business. See, e.g., Saxon v. Georgia Ass'n of Ind. Ins. Agents, 399 F.2d 1010, 1015-16 (5th Cir. 1968) (quoting 53 Cong. Rec. 11,001 (1916)).


ties of multiple-bank holding companies and brought them under the regulatory control of the Federal Reserve Board. In 1970, the Act's restrictions were expanded to include all bank holding companies.12

The original BHC Act limited the permissible activities of bank holding companies and their subsidiaries to activities of a financial, fiduciary, or insurance nature that are so closely related to the business of banking as to be a proper incident thereto.13 Under that standard, the Federal Reserve Board authorized approximately eighteen bank holding companies, mostly in the Midwest, to undertake property, casualty, and life insurance agency activities. The Board's decisions rested principally on the fact that rural banks in the Midwest had historically possessed insurance agency authority.14 As a result, the Board saw those activities as “closely related” to the business of banking as it had been carried on by the companies in question. By contrast, insurance underwriting was forbidden.15

The BHC Act was amended in 1966 and again in 1970.16 The 1970 amendments, among other things, extended the Federal Reserve Board's jurisdiction from multiple-bank holding companies to include single-bank holding companies as well. Those amendments also altered the test which governed the nonbanking activities that bank holding companies could undertake.17 Specifically, since 1970, bank holding companies have been allowed to engage in banking, managing, or controlling banks. They have also been allowed to engage in those activities that “closely related” to banking, in such a way as to be consistent with the public interest.18

Under the new standard, the Board authorized bank holding companies to undertake a broad range of property, casualty, credit life, and credit disability insurance agency activities. The Board required that such insurance be sold by the bank holding company in a manner bearing a direct

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18. Id.
relationship to extensions of credit or the provision of other financial services (e.g., mortgage servicing activities) by bank or bank-related holding company affiliates. In 1972, the Board also authorized bank holding companies to form subsidiaries to underwrite credit life and credit disability insurance coverages. The underwriting of whole life, and property and casualty insurance were implicitly forbidden.

The Board's interpretation of the insurance authority conferred upon bank holding companies by the 1970 amendments to the BHC Act resulted in more than a decade of litigation. Although the courts trimmed back the property and casualty insurance agency activities that could be undertaken by bank holding companies under the Board's initial rules, opponents of bank holding company insurance authority remained dissatisfied with the breadth of bank holding company insurance authority. They therefore embarked upon a campaign to persuade Congress to amend the BHC Act expressly to prohibit bank holding companies from engaging in most insurance activities. That effort culminated in 1982 with the enactment of the Garn-St Germain Depository Institutions Act of 1982 (Garn-St Germain Act). Section 601 of the Garn-St Germain Act amended section 4(c)(8) of the BHC Act by including in that provision a congressional declaration that most insurance activities are not activities that may lawfully be undertaken by bank holding companies.

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24. Section 4(c)(8) authorized the Federal Reserve Board to permit bank holding companies to engage in those nonbanking activities which it determined to be so "closely related to banking or managing or controlling banks" as to be a proper incident thereto, i.e., in the public interest. Section 601 amended 4(c)(8) expressly to state that acting as "principal [underwriter] agent, or broker in the sale of insurance" is not "closely related" to banking, except in certain situations that are enumerated in subsections (A) through (G) of that provision. See 12 U.S.C. § 1843(4)(c)(8) (1982).
II. REACTION TO SECTION 601 OF THE GARN-ST GERMAIN ACT

Frustrated by Garn-St Germain's imposition of further restrictions on their insurance authority, major banks decided to find a way to get around those restrictions.\(^{25}\) For a full understanding of the issue's development, it is necessary to review the factual background beginning in 1980.

During 1980, Citicorp began looking for ways to escape the adverse financial impact on its credit card operation caused by New York State's usury laws.\(^{26}\) In connection with that effort, Citicorp asked public officials in South Dakota to remove the usury limitations that existed under South Dakota law, and to authorize out-of-state bank holding companies, like Citicorp, to acquire banks in South Dakota for the purpose of conducting credit card operations. In an effort to attract jobs associated with the credit card operations of major banks, South Dakota accommodated Citicorp's wishes. Citicorp then acquired a national bank in Sioux Falls, South Dakota, and moved a major portion of its nationwide credit card operation and more than 1,000 jobs to South Dakota. The South Dakota credit card experience proved to be important in the aftermath of the new insurance restrictions imposed by Garn-St Germain.

III. THE SOUTH DAKOTA INSURANCE LAW

Almost immediately after the enactment of Garn-St Germain, representatives of major bank holding companies again approached South Dakota public officials, this time seeking changes in South Dakota law that would authorize South Dakota banks to undertake unlimited insurance activities.

On March 4, 1983, South Dakota enacted Senate Bill 256. This new law explicitly authorized bank holding companies, whose banking subsidiaries conduct their banking business principally outside of South Dakota, to establish "a single new [South Dakota] bank" or "acquire all or substantially all of the shares of a single existing [South Dakota] bank."\(^{27}\) It also expressly empowered South Dakota banks, "directly or through subsidiaries, to engage in all facets of the insurance business."\(^{28}\)

The principal objective of the new law was to permit major bank holding companies to circumvent the insurance limitations of Garn-St Germain and to bring more new jobs to South Dakota. The preamble to

\(^{25}\) See, e.g., Ringer, First Interstate Plans to Acquire South Dakota Bank, AMERICAN BANKER, Apr. 22, 1983, at 3.
\(^{26}\) N.Y. GEN. OBLIG. LAW § 5-501 (McKinney 1978) (Usury Law).
\(^{27}\) South Dakota S.B. No. 256 § 2 (1983).
\(^{28}\) Id. at § 5.
the bill expressly states that the purpose of the legislation was to create jobs for South Dakotans and to generate tax revenues for the state.29

The bill also limits the banking activities of banks acquired under the Act in order to assure that those banks are “not likely to attract customers from the general public in the state to the substantial detriment of existing banks in the state.”30 Similarly, under the new law, if a bank is acquired in order to conduct insurance activities, “it shall conduct its insurance business . . . in a manner likely not to attract business from the general public to the substantial detriment of insurance companies, insurance brokers or insurance agents to the extent of their business in the state.”31 Finally, the bill’s preamble not only proclaims that its central purpose is to circumvent federal law, but also observes that the bill allows “South Dakota a unique opportunity to secure needed tax revenues and jobs through the utilization of the changes”32 in South Dakota banking law.

At least three major bank holding companies, Citicorp of New York, BankAmerica Corporation, and First Interstate Bancorp of California, applied to the Board for approval to acquire South Dakota banks in order to engage in wide ranging insurance operations.33

Through their applications, these banks raised the fundamental legal question of whether bank holding companies may engage in unrestricted insurance activities through their state-bank affiliates, if they are permitted to do so under state law.

IV. ANALYSIS OF THE BHC ACT

A. The Framework for Construing the BHC Act

It is a fundamental principle of statutory construction that statutes are to

29. See generally id. at § 1. After the bill was enacted the Insurance Commissioner of South Dakota publicly expressed skepticism about the number of jobs the law would generate in South Dakota and was promptly fired by the Governor. See Ringer, New South Dakota Law Claims a Victim, AMERICAN BANKER, May 4, 1983, at 2.
30. South Dakota S.B. No. 256, supra note 27, at § 3.
31. Id. The meaning of this limitation is cast in doubt by a recent opinion of the South Dakota Attorney General. The Attorney General states that the provision merely requires out-of-state bank holding companies that undertake insurance operations through South Dakota banks to restrain themselves from infusing so much capital into the South Dakota insurance operations so as to “transform a competitive marketplace into a monopolistic situation where all or most of the competition has been driven out.” Letter from Mark V. Meierhenry, Attorney General of South Dakota, to Glen F. Rittenbusch, Director of Banking and Finance of South Dakota (Nov. 3, 1983).
32. South Dakota S.B. No. 256, supra note 4, at § 1.
33. See AMERICAN BANKER, supra note 4, at 1.
be construed in ways that effectuate congressional intent. The Supreme Court has stated:

There is, of course, no more persuasive evidence of the purpose of a statute than words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act. Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one ‘plainly at variance with the policy of the legislation as a whole’ this Court has followed that purpose, rather than the literal words.34

In other words,

[while the language of the BHC Act may be the starting point in construing the statute, we may look beyond the plain language, if necessary, to ensure that application of the literal terms does not destroy the practical operation of the statute.35

Consistent with fundamental precepts of statutory construction, the Board has the responsibility of construing the BHC Act through the promulgation of regulations that are calculated to carry out the intended purposes of the BHC Act. In Manhattan General Equipment Co. v. Commissioner, the Supreme Court noted:

The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity.36

35. Wilshire Oil Co. of Tex. v. Board of Gov., 668 F.2d at 735 (emphasis added).
B. The Purpose of the BHC Act

The cornerstone of this nation's bank regulatory legislation has been the separation between the business of banking and other forms of commerce.\textsuperscript{37} Congress' attempt to keep banking separated from commerce has required Congress, on repeated occasions, to adjust the statutory framework to patch loopholes that would have had the effect of permitting the commingling of banking and commerce. Congress' careful and persistent efforts to preserve the formal separation between banking and commerce is compelling evidence that Congress has long perceived that the separation between banking and commerce is a necessary ingredient of a sound banking system.\textsuperscript{38}

As originally enacted, the BHC Act regulated only those bank holding companies owning or controlling more than one bank. Banks and bank holding companies quickly seized upon the "one-bank bank holding company loophole" as a means of evading the nonbanking restrictions of the BHC and Glass-Steagall Acts.\textsuperscript{39}

In 1970, Congress again acted to reinforce its consistent policy of separating banking from other forms of commerce. Through the enactment of the Bank Holding Company Act Amendments of 1970,\textsuperscript{40} Congress made the BHC Act applicable to \textit{all} bank holding companies and established the two-tiered "closely related/public interest" criteria for Board approval of nonbanking activities under section 4(c)(8). Again, it was absolutely clear that the maintenance of the traditional "banking/nonbanking" separation was a paramount consideration in the passage of the legislation.\textsuperscript{41}

The courts have confirmed that, through the enactment of the BHC Act,
Congress sought to insulate banking from nonbanking activities. An exception existed, however, where the nonbanking activities bore a close relationship to banking and could be performed by banks in ways that afforded the public particular benefits. The Board's own regulations acknowledge that a "bank holding company may engage, or retain or acquire an interest in a company that engages, solely in one or more of the activities [enumerated in Regulation. . .]." In the context of its recently proposed repromulgation of Regulation Y, the Board has also declared that:

Section 4 of the BHC Act embodies one of the primary purposes of the BHC Act, the separation of banking and commerce, by limiting the nonbanking activities in which a bank holding company and its subsidiaries may engage and by prohibiting the acquisition of shares in nonbanking entities unless such acquisitions are specifically permitted under one of the exceptions to the section.

In addition, the Board proclaimed that the BHC Act prohibits "a bank holding company and its subsidiaries [from] engaging in any activity other than those of banking or managing or controlling banks or activities otherwise [deemed to be] permissible under the BHC Act, and may not acquire voting securities of a company engaged in impermissible activities."

Section 2(c) of the BHC Act defines the term "subsidiary" to mean "any company" with 25% or more of its shares directly or indirectly owned or controlled by a bank holding company. A "subsidiary" may also mean any company in which a bank holding company controls the election of a majority of directors or otherwise has a controlling influence over the making of policies. The term "company," is broadly defined in section 2(b)
of the BHC Act, as "any corporation, partnership, business trust, association, or similar organization." With respect to its recent repromulgation of a portion of its Regulation Y, the Board defined "company" as including "any bank, corporation, general or limited partnership, association or similar organization . . . ." Elsewhere, the term "subsidiary" has also been defined as including any "bank or company that is controlled by another company or person . . . ."

Congress, the Board, and the courts, therefore, have all declared that the overriding objective of the BHC Act is to prohibit bank holding companies from engaging in nonbanking activities except in those instances where nonbanking activities, in the words of the Board, "are specifically permitted under one of the exemptions to [the BHC Act]."

V. THE LANGUAGE OF THE BHC ACT

A. Section 4(a)(1) of the BHC Act

Section 4(a)(1) of the BHC Act, clearly states that no bank holding company may "acquire direct or indirect ownership or control of any voting shares of any company which is not a bank . . . ." Section 2(b) of the BHC Act, defines "company" to mean "any corporation, partnership, business trust, association, or similar organization . . . ." Any bank holding company proposal to undertake otherwise prohibited insurance activities through one or more subsidiaries of a South Dakota bank necessarily serve Board is the primary supervisory authority over bank holding companies and their nonbanking subsidiaries. Under the Act, the Comptroller of the Currency is the primary supervisory authority over the national and state branch components of national bank holding companies. Both the various state bank regulators and the Federal Deposit Insurance Corporation (FDIC) are the primary supervisory authorities for state banks, including those state banks that are insured through the FDIC. See, e.g., 115 CONG. REC. 32,900 (1969) (remarks of Rep. Stanton); 116 CONG. REC. 32,107 (1970) (remarks of Sen. Packwood). In addition, the BHC Act established limits on the activities of bank holding companies and empowered the Federal Reserve Board to enforce those limits. See, e.g., 12 U.S.C. § 1844(b) (1982) ("The Board is authorized to issue such regulations and orders as may be necessary to enable it to administer and carry out the purposes of [the BHC Act] and prevent evasions thereof."); Board of Gov. v. Investment Co. Inst., 450 U.S. 46, 59-60 n.25 (1981) (Supreme Court approved the "imposition of restrictions on banks [that] prevented bank holding companies . . . from evading the restrictions [of Regulation Y] by allowing subsidiary banks to perform the restricted activities." (emphasis added)).

50. Id. at 819 (emphasis added).
would mean that such holding company would engage in activities prohibited by the BHC Act through acquisition of "indirect ownership or control of . . . voting shares of [insurance] company[s] which [by definition are] not . . . bank[s]." Any such proposal, therefore, would appear to contravene the plain language of section 4(a)(1) of the BHC Act.

B. Section 4(a)(2) of the BHC Act

Section 4(a)(2) of the BHC Act refines section 4(a)(1) by expressly forbidding bank holding companies to

retain direct or indirect ownership or control of any voting shares of any company which is not a bank or bank holding company or engage [by any means] in any activities other than (a) those of banking or managing or controlling banks . . . , and (b) those [activities] permitted under [section 4(c)(8)] subject to all the conditions specified in [that section] . . . .

Section 4(c)(8) of the BHC Act, in turn, excepts from the general prohibition against bank holding company ownership of nonbanking shares, "shares of any company [which, by definition, includes a bank] the activities of which the Board . . . has determined to be closely related to banking or managing or controlling banks as to be a proper incident thereto." Section 4(c)(8) goes on expressly to exclude most insurance activities from any universe of activities that might be found to be "closely related" to

54. It should be noted that, under the Banking Affiliates Act of 1982, Pub. L. No. 97-320, § 410, 80 Stat. 241 (codified at 12 U.S.C.A. § 371(c) (1982)), a majority-owned subsidiary of a bank that itself is a subsidiary of a bank holding company is typically not seen as an "affiliate" of the bank holding company. As a result, it has been argued that subsidiaries of state banks that, in turn, are subsidiaries of holding companies are somehow not reached by the "indirect" language of § 4(a)(1). Nevertheless, the BHC Act and the Banking Affiliates Act are different statutes calculated to achieve wholly different aims and, for that reason, the extrapolation suggested is unjustified. Moreover, engaging in unlimited insurance activities through holding company state banks either directly or through subsidiaries would severely undercut the Banking Affiliates Act, a statute that attempts to mitigate the natural competitive advantage of bank holding companies by requiring their intrasystem loans to be made at arm's length so not to compromise unduly the safety and soundness of the affiliated banks making the loans. If state banks were permitted to engage in insurance operations through state-bank affiliates, those bank affiliates could make favored loans to their own insurance organization, which insurance organizations would technically not be affiliates for purposes of the Bank Affiliates Act.

55. 12 U.S.C. § 1843(a)(2) (1982). It is important to emphasize that the plain language of § 4(a)(2) makes a distinction between banking and nonbanking activities that are "closely related" to banking. As a result, the restrictions embodied in § 4(a)(1) reach insurance activities that are conducted as part of a bank itself (perhaps through a separate "division") just as directly as they reach insurance activities conducted as separate subsidiaries of banking subsidiaries.

banking.  

Proponents of the state-bank loophole theory argued that applications to acquire South Dakota banks (albeit banks through which wide ranging insurance operations would be conducted) are simple bank applications under section 3(a)(3) of the BHC Act. They contended that these applications are not reached by the first operative clause of section 4(a)(2) quoted above. Proponents further argued that the word "indirect" in the first operative clause modifies "ownership or control" found in the same clause and not "engage" found in the second operative clause. Accordingly, they concluded that section 4(a)(2) does not in fact prohibit indirect engagement in activities other than "banking or managing or controlling banks" or activities permissible under the principal nonbanking exception of the Act, section 4(c)(8).

This reading of section 4(a)(2) is unduly narrow. First, if a bank holding company sought to conduct insurance operations through one or more separate subsidiaries of a state-bank affiliate, it is apparent that such a bank holding company would "own or control...voting shares of [an insurance] company which [by definition] is not a bank" in direct violation of section 4(a)(1) of the BHC Act.

Moreover, the contentions that the prohibition against engagement in offending nonbanking activities in the second operative clause of section 4(a)(2) applies only to bank holding companies as discrete corporate entities and to their nonbanking subsidiaries is equally implausible. Both of the operative clauses quoted from section 4(a)(2) modify the term "bank holding company." Furthermore, "bank holding company" can have only one of two possible meanings: a discrete corporate entity or a bank holding company system including all of its bank and nonbank components. If the term were given its first possible meaning, then the prohibition against participation in nonbanking activities in the second quoted clause of section 4(a)(2) would not apply even to the holding company's nonbanking subsidiaries. This reading would produce such a loophole in the BHC Act’s nonbanking prohibitions that the BHC Act thereafter would be rendered essentially meaningless. The only other possible construction of section 4(a)(2) is that the term “bank holding company” means the entire holding company system and that the nonbanking limitations imposed by section 4(a)(2) apply to bank holding companies themselves and to each bank and nonbank element in the holding company system. The second reading, of course, is the only one that produces a result that is consistent

57. Id.
with the congressional intent that banking activities remain separate from nonbanking enterprises.

The most persuasive reading of section 4(a)(2) therefore is this: a bank holding company may not "retain direct or indirect ownership or control of any voting shares of any company which is not a bank or bank holding company. . . ."59 Neither may a bank holding company "engage [by any means] in any activities other than (A) those of banking or of managing or controlling banks . . . and (B) those permitted under [section 4(c)(8)] . . . ."60

Beyond the plain language of section 4(a)(2) itself, such a conclusion is compelled by yet another provision, section 4(c)(12) of the BHC Act.61 Congress added section 4(c)(12) to the BHC Act in 1970 in order to provide the Board with specific guidance in handling divestitures that were necessitated by an extension of the BHC Act's nonbanking prohibitions from just multiple to single bank holding companies as well.62 Section 4(c)(12) states that the section 4's nonbanking prohibitions do not apply to any shares retained or activities conducted by a bank holding company or a subsidiary covered by the BHC Act by virtue of the 1970 amendments, as long as within the time limitations prescribed in section 4(a)(2), the company in question "(i) ceases to be a bank holding company [by selling off its bank], or (ii) ceases to retain direct or indirect ownership or control of those shares and to engage in those activities not authorized under this section . . . ."63 In an effort to clarify its intent in enacting section 4(c)(12), Congress explained:

[T]he divestiture period will effect [sic] two types of companies. The first type will be the company which will divest its bank and [thereby] cease[s] to be a bank holding company. The second type of company is that which will be required to divest a nonbanking subsidiary or cease to engage in a nonbanking activity in order to comply with the grandfather clause, or in order to bring its entire operation under all provisions of the Bank Holding Company Act.64

By its terms, therefore, section 4(c)(12) clearly states that after the time limitations prescribed by section 4(a)(2), no bank holding company may, either directly or through any subsidiary of any type, (i) own the shares of

59. Id.
60. See 48 Fed. Reg. 23,528 (1983); see also supra note 44 and accompanying text.
62. Id. The 1970 amendments included single bank holding companies along with the multiple bank holding companies that were included prior to 1970.
63. Id.
an entity that a bank holding company is prohibited from owning by sections 4(a)(1), 4(a)(2), and 4(c)(8), or (ii) engage by whatever means in any activity that is not authorized under some provision of section 4.

C. Section 4(c)(5) of the BHC Act

The proponents of the state-bank loophole theory relied, in the main, upon section 225.4(e)(2) of the Board's Regulation Y as the principal authority supporting their contention that bank holding companies can use state banks to undertake otherwise prohibited nonbanking activities.65 In pertinent part, section 225.4(e)(2) authorizes bank holding companies, through state-bank subsidiaries, to engage in any activities "in which the parent bank may engage, at locations at which the bank may engage in the activity, and subject to the same limitations as if the bank were engaged in the activity directly."66 Under section 225.4(e)(2), the Board some years ago approved applications by Piedmont Carolina Financial Services, Inc. and American Bancorp, Inc. to retain general insurance agency operations conducted by state banks that later became affiliated with bank holding companies.67

The statutory authority underlying section 225.4(e) is section 4(c)(5) which, despite the nonbanking limitations of the BHC Act, allows a bank holding company to own "any shares which are of the kinds and amounts eligible for investment by national banking associations under the provisions of [12 U.S.C. § 24]."68 Section 24 enumerates those activities that may be undertaken by national banks and thereby limits those activities essentially to accepting deposits, making loans, and investing in a narrow spectrum of government securities.69 As a result, the authority conferred


66. When the Board first promulgated § 225.4(e)(2), it was well aware of the potential distortion it could inflict upon the nonbanking restrictions of the BHC Act. In the release that accompanying the final rule, the Board said that its decision not to apply certain restrictions to the subsidiaries of state-chartered banks "at this time" was made because of the "absence of evidence that acquisitions by holding company banks are resulting in evasions of the purposes of the Act." 36 Fed. Reg. 9292 (1971).


69. Id. at § 24; see 48 Fed. Reg. 23,529 (1983). The only insurance activities that have been determined to be permissible for national banks under § 24 are those activities where the national banks have been acting as agents and, more recently, underwriters in the sale of credit life and credit disability insurance. See Independent Bankers Ass'n v. Heimann, 613
on bank holding companies by section 4(c)(5) appears to be much more limited than section 225.4(e)(2) suggests.\(^7\)

Shortly after the enactment of the BHC Act in 1956, the Board was asked to determine whether shares of a nonbanking company, which were acquired by a banking subsidiary of a holding company, were exempt from the divestment requirements of the BHC Act under section 4(c)(5). The Board responded:

While the exemption specifically refers only to shares held or acquired by the bank holding company, the prohibition of the act against retention of nonbanking interests applies to \textit{indirect} as well as \textit{direct} ownership of shares of a nonbanking company, and, in the absence of a clear mandate to the contrary, any exception to this prohibition should be given equal breadth with the prohibition. Any other interpretation would lead to unwarranted results.\(^7\)

More importantly, the Board went on to state:

Although certain of the other exemptions in Section 4(c) of the act specifically refer to shares held or acquired by banking subsidiaries, an analysis of those exemptions suggests that such specific reference to banking subsidiaries was for the purpose of excluding nonbanking subsidiaries from such exemptions, rather than for the purpose of providing an inclusionary emphasis on banking subsidiaries.\(^7\)

Reflected in the Board's characterization of section 4(c)(5) is its long acceptance of the fact that this section's nonbanking restrictions apply to \textit{all nonbanking activities}—whether those activities are conducted directly by the bank holding company, or through a national-bank, or nonbank subsidiary. The nonbanking restrictions, therefore, are imposed upon \textit{the activities} of all \textit{bank holding companies}, irrespective of any corporate machinations that may occur within a particular bank holding company system.

The Board recently reconfirmed the significance of the nonbanking restrictions of the BHC Act in its proposed repromulgation of Regulation Y.\(^7\) Specifically, the Board explained that the requirement of section

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\(^7\) Federal Reserve Board, \textit{FED. BANKING L. REP. (CCH)} \textsection{99,806} (Dec. 23, 1983).


\(^7\) 12 C.F.R. \textsection{225.101(c)} (1983).

\(^7\) 12 C.F.R. \textsection{225.101(d)} (1983).

4(c)(5), that investments be made "explicitly eligible" by federal statute for investment by national banks, "was adopted by the Board in 1971 to prevent [the section] from being used to circumvent the requirements of Section 4(c)(8)."\textsuperscript{74}

After the enactment of the South Dakota bank insurance legislation, the Board began to give indications that in the current environment, continuation of section 225.4(e)(2) may be ill-advised. In apparent reference to section 225.4(e)(2) and to what is contemplated by proposed section 225.22(d)(2), Board Chairman Paul A. Volcker recently told the Senate Banking Committee:

The Federal Reserve, in administering the Bank Holding Company Act, has for years maintained a policy of permitting state-chartered bank affiliates of bank holding companies to engage in any activity such a bank is permitted to engage in under its State charter. This policy has been premised upon the view that a certain degree of experimentation and difference in approach among the states is a legitimate and desirable aspect of our dual banking system, and that differences in powers allowed by states would be acceptable to the extent they would not dominate established congressional policy. In view of current developments, I believe that policy should be reviewed to consider whether the result is to undercut the federal standards set forth in the Bank Holding Company Act . . . .\textsuperscript{75}

Regardless of the interpretation that the Board may from time to time give to section 225.4(e)(2), it is unlawful for any administrative agency to promulgate a rule or pursue a "policy" that legitimizes activities that are clearly prohibited by a statute that the agency is duty bound to enforce.\textsuperscript{76} It is clear, therefore, that the underlying rationale of section 4(c)(5), which the Board relied upon as a basis for section 225.4(e)(2) and for proposed section 225.22(d)(2), provides no grounds whatsoever for allowing bank holding companies to pursue prohibited activities through their state-bank subsidiaries. This is especially true with respect to insurance because it is the only activity that Congress has expressly prohibited bank holding companies to undertake.\textsuperscript{77} Even assuming that the language of section 225.4(e) was justifiable in 1956, when it was first promulgated as a "policy," under

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\textsuperscript{74} See id.
\textsuperscript{76} See supra note 36 and accompanying text.
\textsuperscript{77} See supra note 23 and accompanying text. See also Saxon v. Georgia Ass'n of Independent Ins. Agents, 399 F.2d 1019 (5th Cir. 1968) (national banks are prohibited under
current circumstances its breadth is not defensible, and thus, it must be construed in a way that conforms with the express language of the enabling provision of the BHC Act, section 4(c)(5).

D. Section 4(c) of the BHC Act

Until last year, section 4(c)(8) permitted bank holding companies to own or acquire "shares of any company the activities of which the Board . . . has determined . . . to be so closely related to banking or managing or controlling banks as to be a proper incident thereto . . . ." On October 15, 1982, Congress augmented the language of section 4(c)(8) through its enactment of section 601 of the Garn-St Germain Act. That provision amended section 4(c)(8) by expressly stating that "for purposes of this subsection it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent, or broker . . . ." By its express terms, section 601 of Garn-St Germain applied the insurance prohibitions to every entity that is a "bank holding company." As in the case of section 4(a)(2), "bank holding company" is susceptible to only two possible meanings—a discrete corporate entity or an entire holding company system. Any suggestions that Congress intended the first possibility would mean that the insurance prohibitions in section 601 would not apply to the nonbanking subsidiaries of holding companies, rendering section 4(a)(2) essentially meaningless. Obviously this was not Congress' intent. The only other alternative, therefore, is to construe "bank holding company" to include bank holding company systems, complete with all of their banking and nonbanking components.

Not only is this construction the only one that makes any sense given the

12 U.S.C. §§ 24 & 92 from undertaking any property and casualty insurance activities other than insurance agency activities in small towns).


79. See supra note 23 and accompanying text.

80. The exemptions to the general prohibition contained in § 601 of Garn-St Germain permit bank holding companies, subject to continued compliance with the "public benefits" test of § 4(c)(8), to offer (i) credit life and credit disability insurance and involuntary unemployment insurance as underwriter or agent; (ii) credit property insurance (within certain limitations); (iii) insurance in towns having 5,000 or fewer inhabitants or where there exist inadequate insurance agency facilities; (iv) any insurance sold prior to May 1, 1982, subject to limited product line and geographical expansion; (v) insurance activities performed by managing general agents (with certain product-line limitations); (vi) any insurance sold by a bank holding company which has total system assets of $50,000,000 or less; and (vii) insurance agency activities undertaken prior to 1971. See 12 U.S.C. § 1843(c)(8) (1982).

81. See supra note 58 and accompanying text.
avowed purposes of the BHC Act, it is also the only one that comports with the legislative history of the Garn St Germain Act.\textsuperscript{82} When the definition of "subsidiary" contained in section 2(d) of the BHC Act is applied, the best construction of the applicability of the insurance proscription contained in section 601 of Garn-St Germain is that the limitations of the insurance prohibition affect every bank holding company and every entity controlled by a bank holding company, whether such entities are banks, nonbanks, national banks or state banks.

It seems obvious that section 225.4(e)(2) of the Board’s Regulation Y, the principal authority relied upon by proponents of the state-bank loophole theory, is fundamentally at odds not only with the plain language of section 601 of the BHC Act but also with Congress’ express intent. As such, section 225.4(e)(2) is in fundamental disharmony with the overall purposes of the BHC Act and with the express language of both section 4(c)(5) and section 4(c)(8). In the context of Garn-St Germain, therefore, section 225.4(e)(2) can have no viability whatsoever.\textsuperscript{83}

E. Section 7 of the BHC Act

Another factor that supports the conclusion that bank holding companies may not be authorized to engage through state-bank affiliates in any activity proscribed for the holding company and its nonbanking subsidiaries is section 7 of the BHC Act. That section provides simply that: “The enactment by the Congress of this [Act] shall not be construed as prevent-


\textsuperscript{83} Following the enactment of § 601 of Garn-St Germain, the Board sent a letter to the various reserve banks making clear that § 601 generally restricted the expansion of the property and casualty insurance activities of bank holding companies. Additionally, the Board’s letter emphasized that the enactment of § 601 “did not relieve bank holding companies of the obligation to file an application to engage in insurance activities and did not relieve the system of the responsibility to make the determinations that: 1) proposed activities are ‘closely related’ to banking, and 2) performance of the proposed activity by an applicant would result in net public benefits.” See Letter dated Feb. 28, 1983, from Federal Reserve Board Division of Banking Supervision and Regulation to all Federal Reserve Banks, 4 FED. BANKING L. REP. (CCH) § 43,082 (1983). It hardly seems likely that the Board issued such instructions while under the supposition that they could legitimately be avoided through any mechanism that might be provided in § 225.4(e)(2) of Regulation Y.
ing any State from exercising such powers and jurisdiction which it now has or may hereinafter have with respect to banks, bank holding companies, and subsidiaries thereof." Moreover, the Supreme Court has explained the meaning of the section as follows:

[Section 7] of the Act does reserve to the States a general power to enact regulations applicable to bank holding companies. This section was intended to preserve existing state regulations of bank holding companies, even if they were more restrictive than federal law. . . . Congress' concern was to define the extent of the federal legislation's pre-emptive effect on state law. In response to criticisms of the provision on the ground that it might be interpreted to expand state authority, one Committee Report stated that it was intended "to preserve to the States those powers which they now have in our dual banking system," yet "to make it clear that a State could not enact legislation inconsistent with the [Act] and therefore nullify its effect." Further reference to the Senate Report upon which the Supreme Court relied makes it absolutely clear that state law cannot be used as a vehicle by which bank holding companies may evade the restrictions of section 4 of the BHC Act:

A great deal of concern has been expressed that section 7 of the bill as reported by the committee granted new authority and powers to States . . . . The language added by the committee . . . provided that States in the exercise of their jurisdiction and powers over banks and bank holding companies could impose 'no less onerous' restrictions than were provided in the bill. The intent of the committee was to make it clear that a State could not enact legislation inconsistent with the bill and therefore nullify its effect. In view of the fact that the meaning of the no less onerous clause has apparently been misconstrued by some persons, the committee agreed to strike the clause and thus return to the language of the comparable section of H.R. 6227. However, your committee reiterates its view that section 7 in no way permits States to exercise such powers and jurisdiction in a manner inconsistent with this proposed legislation.  

86. S. Rep. No. 1095, 84th Cong., 2d Sess., pt. 2, at 5 (1956) (emphasis added). See id., pt. 1 ("[E]ach State may . . . be more severe on banking holding companies" than required by federal law); id. pt. 2; ("[T]here is a reservation of the rights of any State [to regulate] banks, bank holding companies, and the subsidiaries thereof in a manner more restrictive, than the provisions of this bill") (emphasis added).
Therefore, a state may prohibit certain conduct otherwise permitted under the BHC Act. Indeed, the BHC Act may permit state legislatures to authorize nonaffiliated or "free standing" state banks within their borders to engage in activities such as the sale of insurance, subject to any limitations that may be imposed by the Federal Deposit Insurance Act.\(^8\)\(^7\) It may not, however, obviate or render futile the express prohibition against such activities set forth in the BHC Act, or any other federal law.

Thus, even if particular state laws expressly empower state banks to engage in activities prohibited by the BHC Act, a state bank that is a part of a bank holding company system cannot lawfully exercise those powers under the BHC Act. To say otherwise is to argue that Congress intended the BHC Act to be an incipient nullity—a law that establishes boundaries that are subject to the possibility of instantaneous repeal through the actions of one or more states. Congress specifically considered and expressly rejected such a notion.\(^8\)\(^8\) Construing the statute in this manner would turn the carefully constructed pyramid of federal banking regulation that is reflected in the BHC Act and many other statutes on its point, thereby assuring that structure's eventual collapse.

VI. CONCLUSION

A statutory separation between banking and commerce has been maintained in the laws of this nation, almost without interruption, since the advent of the national banking system. On repeated occasions, Congress has acted to reinvigorate that separation through pronouncements that the separation between banking and commerce exists and, in Congress' view, must be maintained as an essential ingredient of a sound banking system. Nevertheless, the major bank holding companies, in their effort to conduct nonbanking activities through their state-bank affiliates, have attempted to circumvent the long-standing separation between banking and commerce.

In response to this attempt, the Federal Reserve Board expressed its "tentative judgment" on January 5, 1984, that it could not lawfully approve major bank holding companies' South Dakota bank applications until "further consideration by Congress." In its announcement, the Federal Reserve Board confirmed that state-bank affiliates of bank holding companies may not be used to perform nonbanking activities that are prohibited under federal banking law. The Board also confirmed that if the federal

\(^8\)\(^7\). See 12 U.S.C. § 1816 (1982) (where one of the factors to be considered in the issuance of deposit insurance is whether the bank's "corporate powers are consistent with the purposes of the [Federal Deposit Insurance Act].")

\(^8\)\(^8\). See supra note 24 and accompanying text.
banking laws are to be amended, such amendments must be accomplished in an integrated and coherent manner by Congress and not in a chaotic and piecemeal fashion by the states. The Board's "tentative" decision, therefore, when viewed in conjunction with its earlier action expanding the definition of the term "bank," is an important administrative step that promotes uniformity in the federal banking laws.